Expanded Planning Opportunities with 529 Plans and Roth IRAs

With the passing of the SECURE 2.0 Act, a new opportunity now exists with 529 savings plans and Roth IRAs. While historically these were two distinctly different types of accounts with different purposes, the gap has closed between the two. The following is a high-level overview of 529 savings plans, Roth IRAs, and the new rules surrounding them.

529 Basics

A 529 plan, often referred to as a qualified tuition program, is a tax-favored education savings plan. There are two versions of 529 plans: a prepaid tuition plan and a savings plan. A prepaid tuition plan allows an individual to prepay for college credits at today's rates, hedging against tuition increases in the future. A 529 savings plan allows for ongoing contributions and the funds in the account to be invested. It grows tax-deferred, and distributions, including gains, are free of federal tax if they are used to pay for qualified education expenses.

Qualified Higher Education Expenses include:

- Tuition and fees
- Books and materials
- Room and board if the student is enrolled at least half-time (usually at least 6 credits)
  - For on-campus, limited to the actual cost of room and board
  - For off-campus, limited to the "cost of attendance" figure that is published by most colleges
- Computers
- Internet access
- Student debt ($10,000 lifetime limit)

Historically, 529 plans were only intended for higher education; however, the rules have changed recently to add some flexibility. For K-12, the cost of school tuition is now also considered a qualified expense (up to $10,000 per year). While these withdrawals may be free of federal income tax, states vary on how K-12 withdrawals are handled for state income tax.

Withdrawals that are not considered qualified education expenses are considered nonqualified withdrawals wherein any gain is included in income and subject to a 10% additional tax, although some exceptions apply:

- The student receives a tax-free scholarship
- The student attends a U.S. military academy
- The student dies or becomes disabled

Contributions to 529 plans cannot be more than the amount necessary to provide for the qualified education expenses of the beneficiary. You can contribute without counting toward your lifetime gift tax exemption, up to the annual gift limit, currently $18,000 for 2024; however, 529 plans have a special rule that allows up to five years' worth of gifts to be made in a single year, but treated as though they were made over five years (the current year, and the next four). This is often referred to as "super-funding." A significant benefit of 529s over other savings vehicles, such as Coverdell Savings Accounts, is the fact there are no income limitation phase outs.

The owner of a 529 savings plan is typically not the child. The plan is typically owned by someone else, ex. parent, grandparent, aunt, uncle, etc. Any 529 savings plan owned by the child would have to be disclosed on the FAFSA and count against them for determining any financial aid assistance.

One of the main reasons why 529 savings plans have not been more widely used, is the penalty for nonqualified distributions. If there are left over funds due to the child going to a less expensive school, a trade school, or not attending college at all, funds not used for education are subject to the 10% additional tax unless the beneficiary can be changed to a family member and used for their education.

Roth IRA Basics

Contributions in Roth IRAs grow tax-deferred and distributions, including gain, are free from tax if they are deemed a qualified distribution. For a distribution of gain from a Roth IRA to be deemed qualified, it must meet the following test:

The owner of the Roth made their first contribution at least five years ago, and:

- *Attains age 59 ½*
- *Dies*
- *Becomes disabled, or*
- *Uses it for a first-time home purchase (up to $10,000)*

Unlike contributions to a traditional IRA, contributions to a Roth IRA are not tax deductible. The value of the Roth is tax-free growth and tax-free withdrawals in retirement a time when managing taxable income can be an important part of a retirement income plan. Roth IRAs can also provide a tax-free death benefit to heirs.

New Rules Mean New Opportunities

One of the provisions contained in the SECURE 2.0 Act allows a new type of transfer relating to 529 accounts and Roth IRAs. Starting in 2024, individuals are now allowed to transfer funds directly from a 529 savings plan to a Roth IRA. While it is potentially a good option for leftover education funds, it comes with several limitations:

- The 529 savings account must be open for at least 15 years.
- Any contributions made in the last five years, and earning associated with those contributions, are not eligible for transfer.
- The funds must be transferred to a Roth IRA in the beneficiary's name, not the owner's (529 accounts are typically owned by someone else, not the child).

- The amount that can be transferred every year is the beneficiary's Roth IRA contribution limit, meaning the child must have earned income. You need earned income to make an IRA contribution.
- The annual amount is reduced by any regular Roth IRA contributions made for the year.
- The maximum allowed per beneficiary is $35,000 (not currently indexed for inflation).

The idea behind this is pretty straightforward, if a beneficiary has left over funds in a 529 account that were not used for education, they can be transferred to a Roth IRA additional tax free to be used for retirement instead. It encourages savings in 529 accounts with at least some level of protection against having to pay additional tax if the funds are not used for education, which is often a concern for parents.

Conclusion

One of the biggest limitations of this new rule is the 15-year wait. For many individuals, this may not be an opportunity today, but certainly could be in the future. The question often comes up from parents, "Can I put money in Roth IRAs for my children?" Unfortunately, the answer is often "no." You must have earned income in order to make a Roth IRA contribution, so if the child does not have earned income, no Roth contribution can be made for them. There is no earned income requirement for 529 contributions though, meaning, as soon as a child has a Social Security number, an account can be established, and contributions can be made. A 529 savings plan can grow tax deferred until college. Any withdrawals used to pay for qualified education expenses are tax free. If there are left-over funds, they can be transferred (up to the limit) to a Roth IRA to be used for retirement instead. That strategy has the potential of 60+ years of deferred growth, and 60+ years of gains never subject to tax, if the funds are either used for education or transferred to a Roth IRA to be used for retirement.

Prudential is Here to Support You

Anyone looking to jump-start savings for their children or grandchildren should talk to a financial professional about how this new strategy could help them achieve their goals.
Prudential's Advanced Planning Team is available to support you as you address the spectrum of client needs. For further discussion of 529 plans, Roth IRAs, or any advanced strategy, contact the team at 888-425-1022.

This Advanced Planning Insights and Ideas bulletin was published in June 2024.