WEALTH MANAGEMENT

529 College Savings Plans Are Even More Advantageous Now

By Sandi Weaver, CPA, CFP, CFA

Many of us have clients who contribute to their children's and grandchildren's 529 college savings accounts. For Missouri or Kansas residents, the client gets a state tax deduction regardless of which state's 529 plan they're using. (Those are two of seven states with this benefit.) To reference a table explaining each state's benefits, read "How Does Your State's 529 Plan Income Tax Benefit Work?" at *savingforcollege.com*. Missouri offers a state tax deduction of $16,000 per taxpayer (MFJ), no carryforward; at the top 5.4 percent marginal rate that's worth $864. Kansas allows a state tax deduction of $6,000 per beneficiary, no carryforward; it's worth about the same per dollar contributed.

The Secure Act 2.0 of 2022 added a new benefit starting in 2024 that allows tax- and penalty-free rollovers from 529 plans into a Roth IRA. The 529 plan must have been open for at least 15 years. Clients could be advised to open an account and contribute $1 to get that clock started. (It is not known yet if that clock restarts if the beneficiary has been changed, but pros assume it will not.)

The beneficiary on the 529 account must be the owner on the Roth IRA account. When rolling money from the 529 to the Roth, it needs to be "old money." The child cannot roll over contributions (and related earnings) made in the last five years.

In a given year, the child can roll over an amount equal to the annual contribution limit to a Roth IRA as long as they have sufficient earned income. That's a maximum of $6,500 for 2023 (or their earnings if less); this limit is indexed for inflation.

If they also contribute directly to their Roth IRA, the 529 transfer plus the direct contribution cannot exceed the maximum either.

The child can roll a maximum of $35,000 in their lifetime. If the parent is fairly certain early that college funding costs are covered, they might start rollovers at the child's age 16 when there's earned income because only a small amount can be transferred annually.

There are no income limits on these rollover contributions; it's similar to a backdoor Roth in that sense. If the child earns over $228,000 on a joint return early in their career, they cannot contribute directly to a Roth IRA.

The Roth IRA's tax advantages are better than the 529's; once the client gets money inside a Roth IRA, it grows without being taxed again if withdrawn after 59½ or permanently disabled. This account too has a year-year clock for withdrawals; same strategy may apply—get $1 in there. Clients can also take withdrawals before 59½. But there's a 10 percent penalty unless it's for higher education, $10,000 penalty for a first home, as well as penalties for some medical expenses, for equal periodic payments, and more. Income tax is due if earnings (versus only past contributions) are used. So the Roth IRA can serve as an emergency fund in many cases.

To affect a rollover they'll need to ask the 529 plan custodian what's required for the transfer. If the same custodian holds the 529 and the Roth IRA, the process will be easier. Rollover distributions can be moved in-kind so liquidating to cash may not be required unless the custodian dictates that. If different institutions hold the two accounts, more will be required. Be careful about moving the 529 account to the custodian of the Roth; do not restart that 15-year clock. The beneficiary may need to take a 529 plan withdrawal and then make a contribution to their Roth IRA.

How can your clients use this? Over-funding isn't such a problem anymore. If extended family is contributing to the 529 also, excess funds can be rolled to a Roth now. In the past, excess 529 funds which were not used for education were taxed when withdrawn; a 10 percent penalty plus income tax was levied on the earnings portion. The other option was to change the 529 beneficiary to another family member.

How can the child use this? Young people starting out have many demands on their funds. Rolling over an excess balance in their 529 plan lets them start the savings habit early while preserving the paycheck for immediate needs. The Roth can be an emergency fund. If the child has quickly entered a lucrative career with high income, they avoid the Roth income limits.

Clients can coordinate an extended family approach for holiday and birthday gifts to 529s. Planning for and funneling excess funds into the child's Roth account, in light of the Secure Act 2.0 of 2022, just made the 529 even better.

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