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A beginner’s guide to 529 plans

529 plans have emerged as a powerful tool for families planning future education expenses. These specialized savings accounts were introduced by Congress in 2001 and offer a unique combination of tax advantages, investment growth, and flexibility, making them an ideal choice for families and individuals looking to invest in the future of education.

Investments in a 529 plan grow tax-free, meaning that any investment income or capital gains will not be taxed as long as withdrawals are used for qualified education expenses. While there isn't a federal tax deduction for contributions, many states offer tax deductions or credits on state income tax for contributions to their state's 529 plan. It's important to understand the specifics of funding, paying, the timing and handling of distributions, and managing leftover funds in these accounts to maximize the tax advantages offered by 529s.

Ways to fund 529 plans

Funding a 529 plan can start with as little as a few dollars and grow substantially over time, thanks to the power of compounding interest and strategic contributions.

- **Consistent contributions:** Like any long-term investment, 529 plans thrive on consistency. Regular, scheduled contributions can turn modest sums into significant savings, thanks to the compound interest effect. Setting up automatic transfers from a checking or savings account ensures you stay on track without thinking about it each month.
- **Gift contributions:** Transform birthdays, holidays, and graduations into opportunities for educational investment. 529 plans often allow for gift contributions, which means relatives and friends can contribute directly to your or your child's future education.
- **Lump-sum contributions:** Windfalls, tax refunds, or bonuses present a golden opportunity to boost your 529 plan balance. In 2025, you can gift up to $19,000 per recipient without those contributions counting toward your lifetime gift tax exemption. So, if you have three kids and three 529 plans and are a single parent, you can contribute $19,000 each, or $57,000 total, in a year without having to report those contributions to the IRS. You can also frontload up to five years' worth of contributions. By doing so, you can only contribute for the following four years if the annual exclusion increases, permitting a slight increase to the gift over the subsequent four years.

What can 529 plans be used for?

The timing of distributions from a 529 plan is crucial to ensure they align with the payment of qualified education expenses. To avoid penalties and taxes, 529 distributions must be used for qualified expenses in the same tax year the expenses are incurred. Qualified Expenses include:

- Tuition and fees for the total amount of college or vocational school tuition. Some states also allow K-12 tuition for public, private, or religious schools up to $10,000 per year.
- Books, supplies, computers, software, internet access and equipment required for enrollment or

attendance at an eligible educational institution.
- Room and board if the student is enrolled at least half-time.
- Student loans, with a lifetime limit of $10,000.

How can you make withdrawals?

When it's time to pay for education expenses, you have two primary options for making payments from your 529 plan:

- Direct payment: Many 529 plans allow direct payment to the educational institution. Direct payments simplify the process and ensure the funds are used for qualified expenses.
- Reimbursement: If you've already paid out-of-pocket for qualified expenses, you can reimburse yourself from the 529 plan. Keep meticulous records of expenses and withdrawals for tax purposes.

Managing leftover funds

There are several strategies for managing leftover funds in a 529 plan, each with its implications:

- **Change the beneficiary:** The flexibility of 529 plans allows for the beneficiary to be changed to another family member, such as a sibling, cousin, or even the account holder themselves, for further education pursuits.
- **Transfer to a Roth IRA:** Effective January 1, 2024, 529 account funds may be transferred to a Roth IRA if the account has been maintained for at least 15 years and the amount being transferred was contributed at least 5 years prior. The Roth IRA also must be that of the 529 account's designated beneficiary since 529 plans are considered part of the beneficiary's estate. While the aggregate transfer amount is capped at $35,000, the Roth IRA annual limit ($7,000 in 2025 for those under 50) will still apply.
- **Non-qualified withdrawals:** You can make non-qualified withdrawals, but these will be subject to income tax and a 10% penalty on the earnings portion of the withdrawal. This option should be the last resort.

A 529 plan is a versatile and beneficial tool for financing education, but maximizing its benefits requires understanding and strategic planning. By carefully managing contributions, timing distributions correctly, and wisely handling any leftover funds, families can make the most out of their 529 plans. Whether you're planning for your child's future education or managing current educational expenses, a well-considered approach to your 529 plan can provide significant financial advantages and peace of mind. Please consult your Mesirow Wealth Advisor to see if a 529 plan suits your situation.

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Sources:

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