Advanced 529 Planning

529-to-Roth, Dynasty 529, And Other HNW Opportunities

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529 BASICS

- Tax-favored account intended primarily to be used for higher education expenses

- **Two flavors of 529 plans:**
  - College Savings plans
  - Prepaid Tuition plans

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  - College Savings plans
  - Prepaid Tuition plans

Primary focus for today's discussion

529 BASICS

Contributions

- No Federal deduction or other tax benefit
- MAY be eligible for a state tax benefit

State rules vary WIDELY

- Some states don't offer any income tax benefit
- Some offer a tax deduction for contributions up to a specified amount for contributions made to a state-sponsored 529 plan
- Some offer a tax deduction for contributions up to a specified amount for contributions made to any 529 plan
- Some states allow "excess contributions" to be carried forward for a specified number of years
- Some states allow "excess contributions" to be carried forward indefinitely
- Some states offer a deduction for the full amount of all contributions to a state-sponsored 529 plan
- Some states offer a greater potential benefit to married couples filing a joint return than to single filers
- Some states offer the same potential benefit to married couples filing a joint return and to single filers
- Some states limit the maximum tax benefit allowed per beneficiary
- Some states limit the maximum tax benefit allowed per contributor
- Some states only allow 529 plan account owners to receive a tax benefit for contributions made to the account
- Some states only allow any contributor to receive a tax benefit for a contribution made to a 529 plan account, regardless of whether or not they are the owner of the account
- Some states have different rules for taxpayers of different ages
- Some states offer a tax credit for a percentage of contributions, up to a specified amount, for contributions made to a state-sponsored 529 plan
- Some states don't have an income tax

529 BASICS: INCOME TAX TREATMENT

Earnings

- Grow tax deferred at Federal and state level

Distributions (pro-rata)

- Qualified Withdrawals
  - Tax-free at Federal level
  - Typically tax-free at state level
    - Some states, such as Alabama, will include (qualified) distributions from 529 plans of other states in taxpayer's state income
- Non-Qualified Withdrawals
  - Subject to income tax and a 10% penalty at Federal level
  - Subject to income tax, potentially a penalty, and potentially a recapture of previously claimed deductions and/or credits at state level

529 BASICS: INCOME TAX TREATMENT

The 10% penalty for non-qualified distributions is waived if, the beneficiary:

- Dies
- Becomes disabled
- Receives a tax-free scholarship (up to applicable amount)
- Receives veterans' education assistance (up to applicable amount)
- Receives educational assistance through an employer (up to applicable amount)
- Attends a U.S. Military Academy (up to costs of "advanced education")
- There are qualified expenses, but they are used towards an education credit instead of for the 529 plan (up to applicable amount)

529 BASICS: INCOME TAX TREATMENT

Qualified Higher Education Expenses:

- Tuition
- Fees
- Books
- Materials
- Computers, related equipment, software and internet access
- Room and board (enrolled at least ½ time)
- Fees, books, supplies, and equipment for registered apprenticeship programs
- Special needs costs connected to enrollment and/or attendance
- Tuition for K-12 public, private, or religious school
  - Up to $10,000 per year
- Payments of principal or interest of qualified education loans
  - Up to $10,000 per lifetime
  - May also be used for debt of siblings ($10,000 limit applies per person, not per account)

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MOE'S


SQUARE HOUSE

Time for a sidebar

K-12 TUITION & PAYMENT OF QUALIFIED STUDENT DEBT

- These are newer qualified expenses at the Federal level
- Not all states treat these amounts as qualified expenses for state purposes
- Some states treat only K-12 tuition as a qualified expense
  - Indiana, Mississippi
- Some states treat only student loan payments (up to $10,000) as a qualified expense
  - California, Oregon, Nebraska, Illinois
- Some states don't treat either as a qualified expense
  - Montana, Colorado, Minnesota, Michigan, New York

K-12 TUITION & PAYMENT OF QUALIFIED STUDENT DEBT

Question: What happens when an expense is not qualified at the state level?

Answer: It depends…

- The earnings portion of the non-qualified distribution will be subject to state income tax
- In many states, to the extent a tax deduction/credit was received for a contribution, the principal portion of a non-qualified distribution will also be subject to state income tax
- And a few states have an additional wrinkle
  - California has a 2.5% penalty on non-qualified distributions
  - Alabama adds 10% of a non-qualified distribution as income for state income tax purposes

TIMING REQUIREMENTS

- **Federal:** Amount of time money is in the account generally doesn't matter (no Federal tax benefit upon contribution!)
  - Exception for 529-to-Roth Rollovers (covered later)
- **State:** Generally, no requirement to leave money in account for any period of time
  - Exception #1 – Holding period states: Montana (3 years from account opening) and Wisconsin (365 days after a contribution, "FIFO style")
  - Exception #2 – Net contribution states: Michigan and Minnesota

529 BASICS: NOT QUALIFIED EXPENSES

- NOT Qualified higher education expenses
  - Travel costs to and from campus
  - Health insurance (even if provided by the school)
  - Extracurricular activities
  - Fraternity/sorority parties

529 BASICS: PARTIES TO THE ACCOUNT

- **Beneficiary:** Individual designated to be the beneficial recipient of amounts paid from the account
  - Must be a U.S. individual
  - No power to compel distributions
  - No power to control investments of the account
- **Owner:** Oversees the account and has maintains all relevant controls over the account
  - Can affect distributions
  - Can make investment decisions
  - Can change the beneficiary
  - Can change the owner

529 BASICS: CONTRIBUTION LIMITS

- No contribution limits!
- "Just" maximum account balances when new contributions are no longer allowed
  - Lowest maximum = Georgia and Mississippi @ $235,000
  - Highest maximum = $569,123
  - Typical maximum ~ $500,000
- Maximums tied to expected cost of a beneficiary's higher education
- Accounts can grow infinitely large via earnings

529 BASICS: GIFT TAX CONSEQUENCES OF CONTRIBUTIONS

- Contributions are considered completed gifts to the beneficiary
- Eligible for the annual gift tax exclusion
- 5-year gift tax averaging ('super-funding')
  - Applies when aggregate contributions exceed annual gift tax exclusion
  - Allows a single contribution to be treated as though it was made over 5 years
    - Taxpayer must elect this treatment
    - Contribution is included ratably in each year
  - All-or-nothing decision
  - Requires the filing of a gift tax return (Form 709) in each of the 5 years
- Gifts in excess of the annual exclusion limit (after application of 5-year gift tax averaging) will 'eat' into the donor's lifetime exclusion amount

529 BASICS: OTHER RULES

- Investment changes may only be made 2x per year at a maximum
  - Automatic changes don't count
    - Age-based shifts in allocation
    - Rebalancing
  - Can generally elect to change allocation of future contributions at any time

- No limit to the number of accounts an individual can have (either as owner or as beneficiary)

- Only 1 beneficiary allowed per account

529 BASICS: OTHER RULES

- Only one change in 529 plan accounts (rollover) per year (365 days)
  - Rollovers to another plan typically result in recapture of previous tax benefits
- No requirement to distribute funds
- Beneficiary may be changed to an eligible family member without any income tax consequences
- Owner may be changed

CHANGING 529 PLAN BENEFICIARIES

- May be changed to eligible family member or trust without resulting in a distribution

- Eligible family members
  - Spouse
  - Child, or the spouse of such child
  - Brother, sister, stepbrother, stepsister, or the spouse of any such person
  - Mother, father, the ancestor of either, or the spouse of any such person
  - Stepfather, stepmother, or the spouse of either such person
  - Nephew, niece, or the spouse of either such person
  - Aunt, uncle, or the spouse of either such person
  - Son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, sister-in-law, or the spouse of any such person
  - First cousin

CHANGING 529 PLAN BENEFICIARIES

- No limit on number of times a beneficiary may be changed

Mechanics:

– Many plans allow changes to a beneficiary to be made online
– Other plans require forms be mailed or faxed in

GIFT TAX CONSEQUENCES OF CHANGING BENEFICIARIES

- Contributions are completed gifts
  - Which means they belong to the beneficiary, right?
- Only the owner has the power to change beneficiaries
- These don't jive!

GIFT TAX CONSEQUENCES OF CHANGING BENEFICIARIES

- No gift tax consequences when changing the beneficiary of the plan to an eligible family member of the same generation
- Changing the beneficiary to a member of the family one generation or more lower than the original beneficiary IS considered a taxable gift

Whose gift is it anyway?

GIFT TAX CONSEQUENCES OF CHANGING BENEFICIARIES

- No definitive answer
- ***Proposed*** Regulations from ***1998(!)*** probably give us the best glimpse into the IRS's thinking…

> *"A transfer which occurs by reason of a change in the designated beneficiary, or a rollover of credits or account balances from the account of one beneficiary to the account of another beneficiary, **will be treated as a taxable gift by the old beneficiary to the new beneficiary if the new beneficiary is assigned to a lower generation than the old beneficiary**, as defined in section 2651, regardless of whether the new beneficiary is a member of the family of the old beneficiary."*
> [Emphasis added]

GST TAX CONSEQUENCES OF CHANGING BENEFICIARIES

- No GST if amounts are transferred to a member of the same family who is one or fewer generations younger than the current beneficiary
- GST tax applicable when amounts are transferred to a member of the same family who is two or more generations younger than the current beneficiary

CHANGING 529 PLAN OWNERS

Remember: 529 plan owners are not the owners of the asset in the traditional sense

- Ownership may generally be changed
  - A small number of states limit changes in ownership to situations where the existing owner becomes incapacitated or dies

- Ownership may generally be transferred to anyone
  - Does not have to be an "eligible family member"

And now, a brief summary of the cumulative IRS guidance on the tax consequences of changing 529 plan owners…

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(LIKELY) TAX CONSEQUENCES OF CHANGING BENEFICIARIES

Income Tax

- Practically, most plans view a(n allowed) change in ownership as a non-reportable event
  - Widely accepted that the IRS will *not* challenge such transactions

Transfer Taxes

- Generally accepted that there are no transfer taxes applicable upon a change of ownership
  - Recall Proposed Regulations view transfer taxes through the lens of the beneficiary

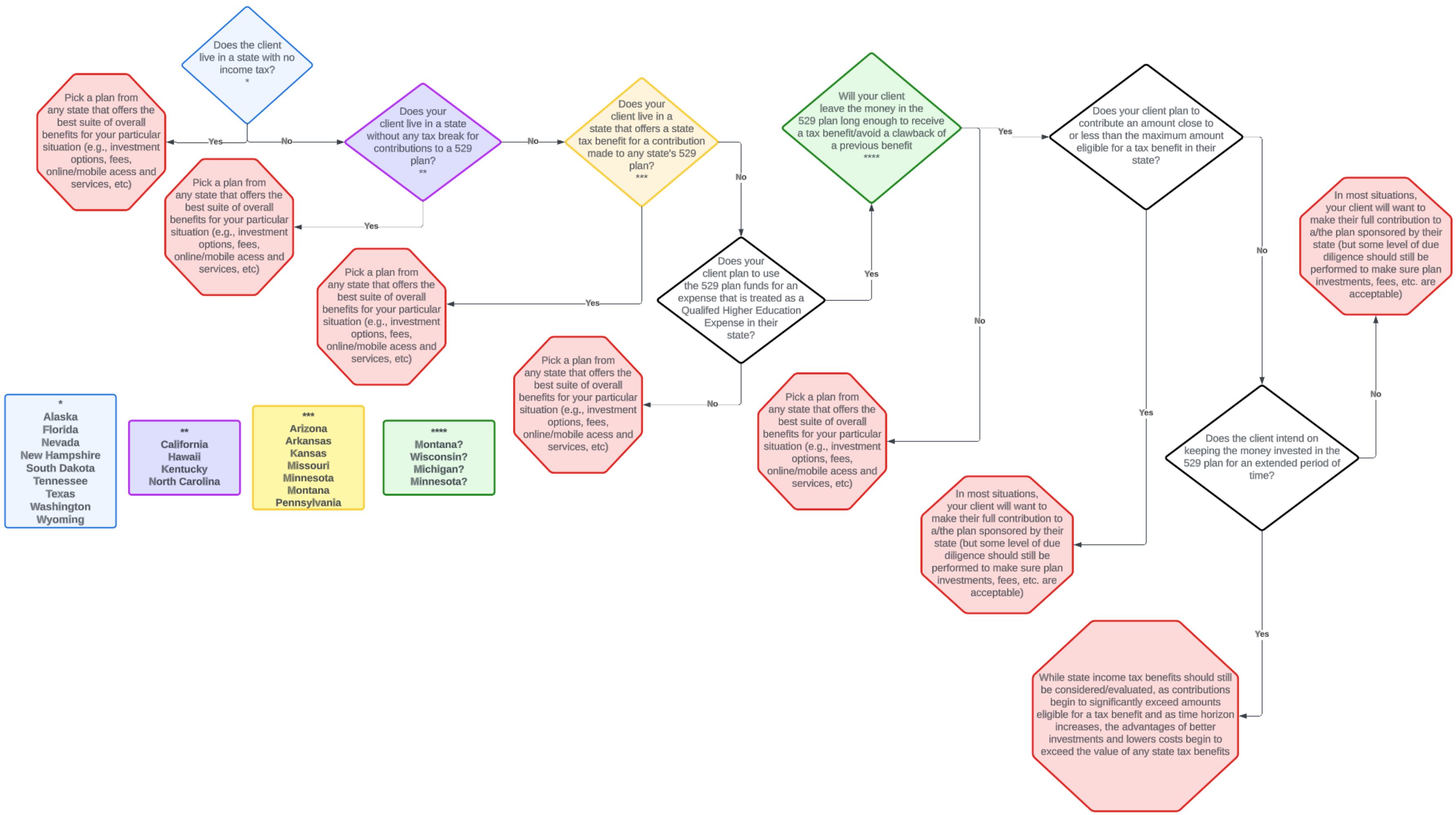
PICKING THE 'BEST' 529 PLAN

- Does the client live in a state with no income tax?
- Does your client live in a state without any tax break for contributions to a 529 plan?
- Does your client live in a state that offers a state tax benefit for a contribution made to any state's 529 plan?
- Does your client plan to use the 529 plan funds for an expense that is treated as a Qualified Higher Education Expense in their state?

PICKING THE 'BEST' 529 PLAN

- Will your client leave the money in the 529 plan long enough to receive a tax benefit/avoid a clawback of a previous benefit?
- Does your client plan to contribute an amount close to or less than the maximum amount eligible for a tax benefit in their state?
- Does the client intend on keeping the money invested in the 529 plan for an extended period of time?

PICKING THE 'BEST' 529 PLAN



THE "FAMILY DYNASTY 529 PLAN"

- The intentional 'overfunding' of one or more 529 plan accounts that, between contributions and earnings, can be used to pay for ~~multiple~~ many generations of family members' future education expenses
- Can be created with periodic contributions or a lump sum
- Periodic (partial) transfers made to family members' 529 plan accounts so that tax-free distributions can be made to cover *their* higher education costs

DYNASTY 529 PLAN EXAMPLE: PERIODIC CONTRIBUTIONS

- Greg and Mandy, each 55 years old
- Married and have 2 children
- Financially secure, children's education already 'covered', and value education
- Contributions made for 35 years

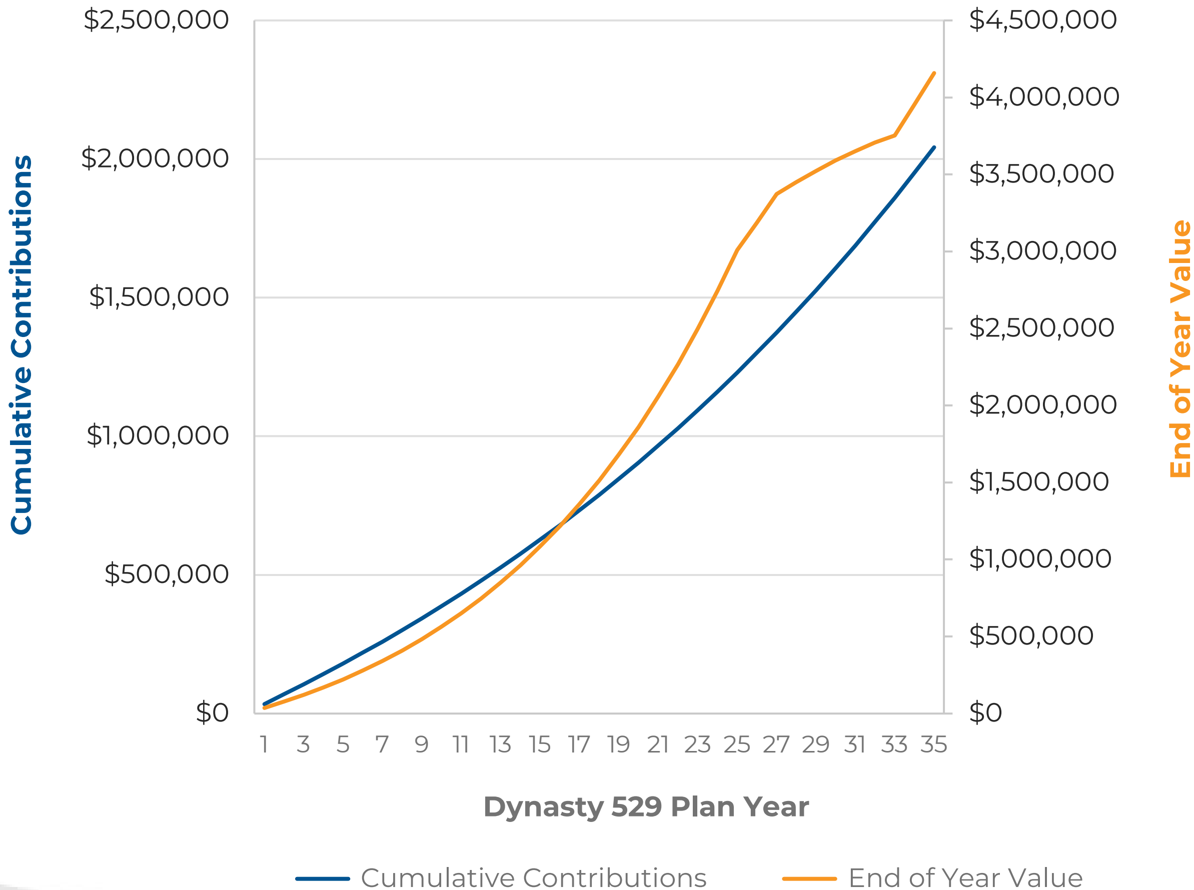
Assumptions

- *Annual exclusion amount inflated at 3% annually*
- *Annual tuition of $30,000 inflated at 5% annually*
- *529 plan net investment returns of 7% annually*

DYNASTY 529 PLAN EXAMPLE: PERIODIC CONTRIBUTIONS

Annual Funding Cumulative Contributions & End-of-Year Values

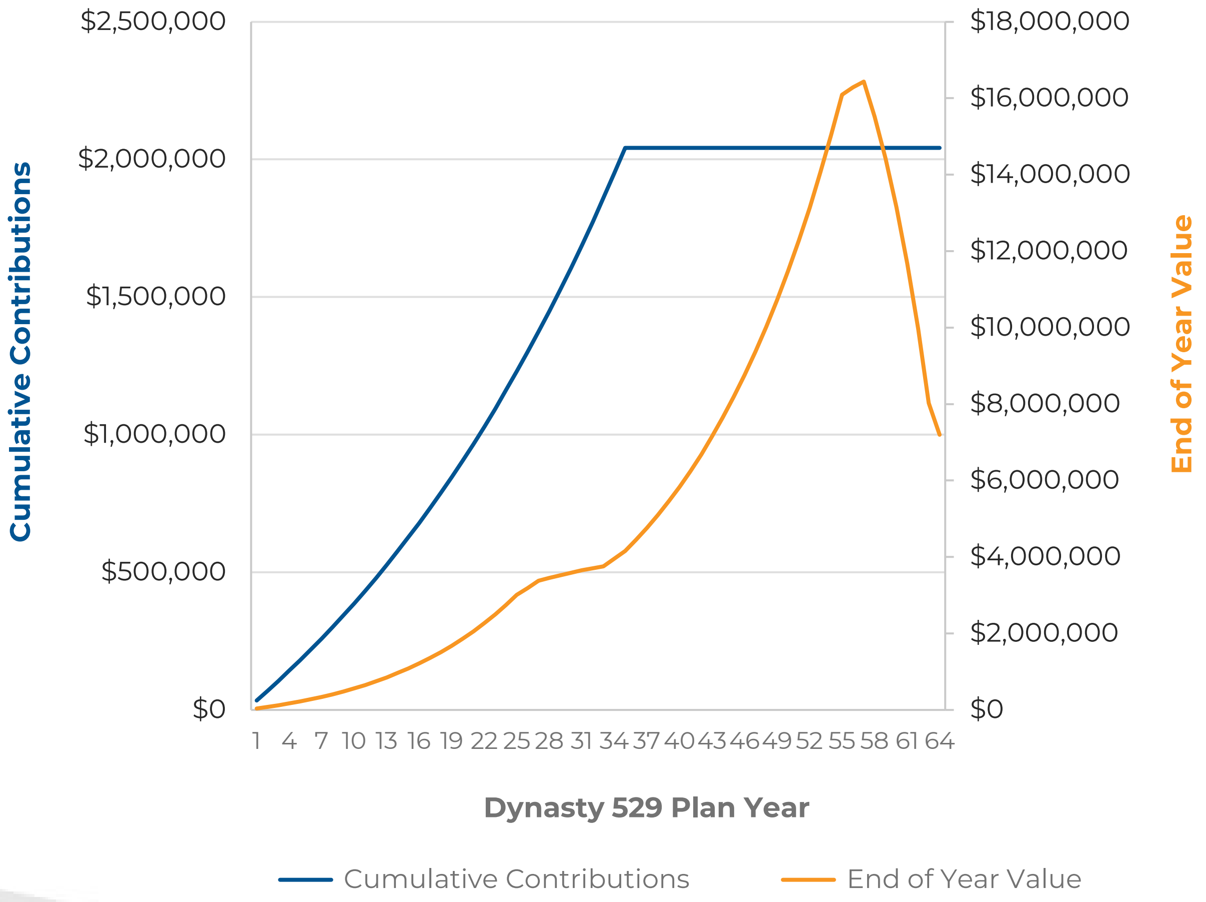
Years 1-35



DYNASTY 529 PLAN EXAMPLE: PERIODIC CONTRIBUTIONS

Annual Funding Cumulative Contributions & End-of-Year Values

Years 1-65



DYNASTY 529 PLAN EXAMPLE: LUMP-SUM

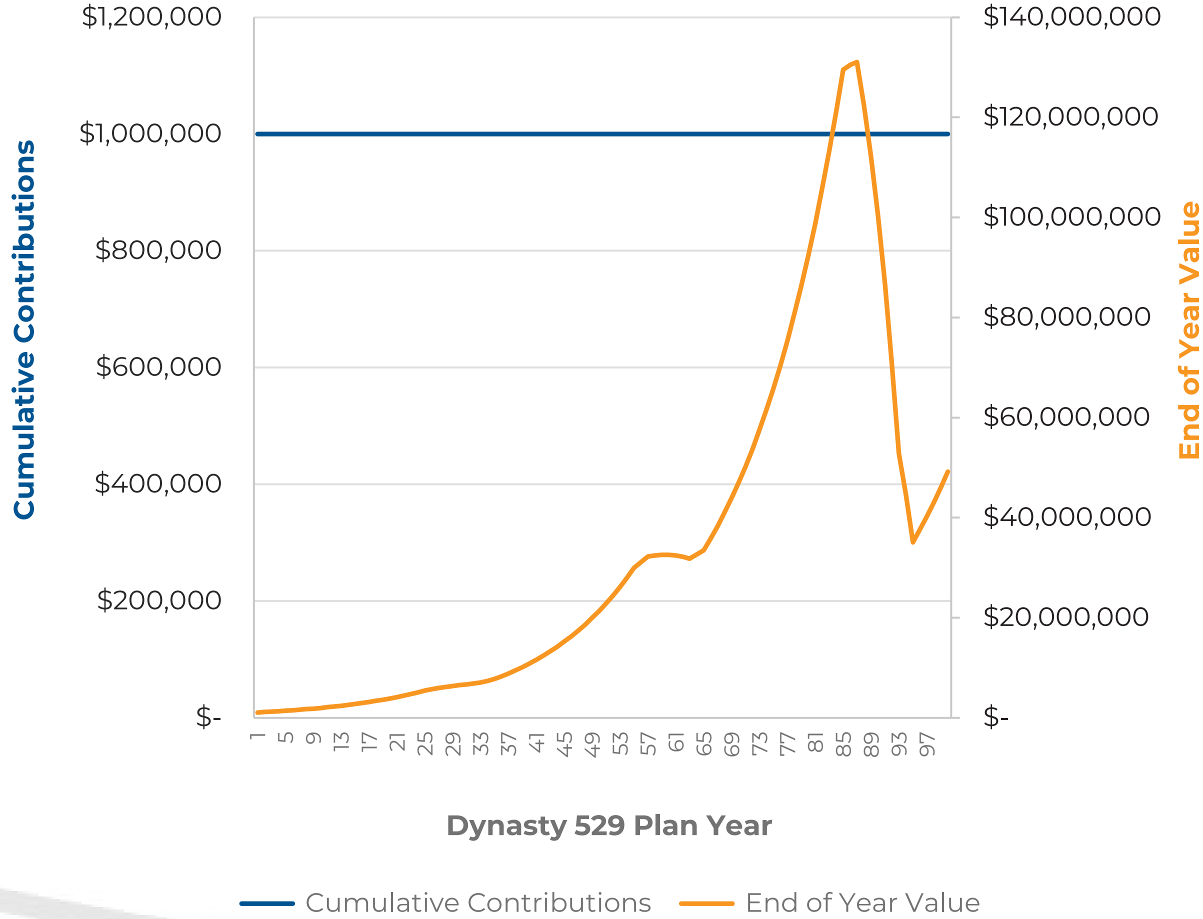
- John and Babs, each 55 years old
- Married and have two children
- Financially secure, children's education already "covered", and value education
- Single cumulative contribution to 529 plans of $1MM

Assumptions

- *Annual tuition of $30,000 inflated at 5% annually*
- *529 plan net investment returns of 7% annually*

DYNASTY 529 PLAN EXAMPLE: LUMP-SUM

Lump-Sum Funding Cumulative Contributions & End-of-Year Values



DYNASTY 529 PLAN: KEY CONSIDERATIONS

- Generally makes sense to make the contributions to the youngest generation
- Consider contributing to multiple eligible family members and later combining accounts to minimize taxable gifts
  - Be mindful of step transactions
- Plans with higher maximum limits are preferable
- Plans with longer maximum account "lifespans" are preferable
- Place more weight on the investment options and fees than any state tax benefits
- Consider the plans rules and policies regarding a change in owner

DYNASTY 529 PLAN: WHAT COULD GO WRONG?

- The rules could change
  - Though, if anything, Congress has trended towards making 529 plans *more* flexible
- Higher education could be made available at no cost
  - Though it's hard to imagine a scenario where private and or graduate school would be made available at no cost
- It can be tough to enforce
  - But there is a potential solution!

TRUST-OWNED 529 PLANS

- **Potential benefits include:**
  - Ensure that funds in the 529 are actually used for education
    - Trustee is a fiduciary bound to act by terms of the trust
  - Allowing grantors to maximize annual exclusion gifts without the need to provide Crummey powers
  - Pass unused funds to other beneficiaries without transfer tax implications

- For trust-owned 529 plans, the trustee is the account owner

- **Trust-owned plan may receive contributions from the:**
  - Trust creator
  - The trust, itself
  - Any other individual

TRUST-OWNED 529 PLANS

- When picking the 'best' 529 plan, the trustee should consider what is best for the trust beneficiaries, and not the person(s) making 529 plan contributions

- Specific authorization of 529 plan-related duties for the trustee is preferable, such as the authorization to:
  - Choose the 529 plan they deem is most appropriate
  - Establish and invest in a 529 plan
  - Change or modify a 529 plan's investment selection
  - Receive a plan as a successor owner
  - Designate beneficiaries (typically limited to current beneficiaries)
  - Make distributions to beneficiaries
  - Rollover funds to a new 529 plan, or to a Roth IRA owned by the 529 plan beneficiary

529 PLAN TO ROTH TRANSFERS

- NEW via SECURE Act 2.0
- Effective 2024
- Allows 529 plan funds to be moved *directly* to a Roth IRA
- The ***beneficiary of the 529*** plan and the ***owner of the Roth IRA*** must be the ***same person***

529 PLAN TO ROTH TRANSFERS

- Roth IRA income limitation do ***not*** apply
- Contributions ***do*** require ‘compensation’
  - Earned income (most common)
  - Taxable alimony
  - Non-taxable combat pay

- ‘Marination’ periods
  - Account level: 15 years
  - Contributions (and earnings thereupon): 5 years

529 PLAN TO ROTH TRANSFERS

Maximum annual transfer: 'Regular' IRA contribution limit for the year

- 'Coordinated' with 'regular' Traditional IRA/Roth IRA contribution limit
  - 'Regular' contributions will reduce available 'space' for 529-to-Roth transfers

Maximum lifetime limit: $35,000

- Limit applies per beneficiary
- NOT indexed for inflation

- But there could be some challenges at the state level
  - Will it be a Qualified Distribution for state income tax purposes?
  - Could it result in the recapture of a previously allowed tax benefit?

529 PLAN TO ROTH TRANSFERS: OPEN QUESTIONS

- What happens when you change the beneficiary of a 529 plan account?
- What happens if you transfer a portion of a 529 plan to a new beneficiary?
- What happens if you roll over the account to another 529 plan for the same beneficiary?

THE 'SWEET 16 ROTH' PLAN

- Most newborns do not have 'compensation', so they cannot make IRA/Roth IRA contributions

- There is no compensation requirement to contribute to a 529 plan

- Contribute to the 529 plan at birth and by the time the child is 16, the 15-year Rule will have been met
  - Provided that they have compensation (e.g., summer job, work in the family business), 529 plan money can begin to be 'leaked' over to the Roth IRA

THE 'SWEET 16 ROTH' PLAN EXAMPLE

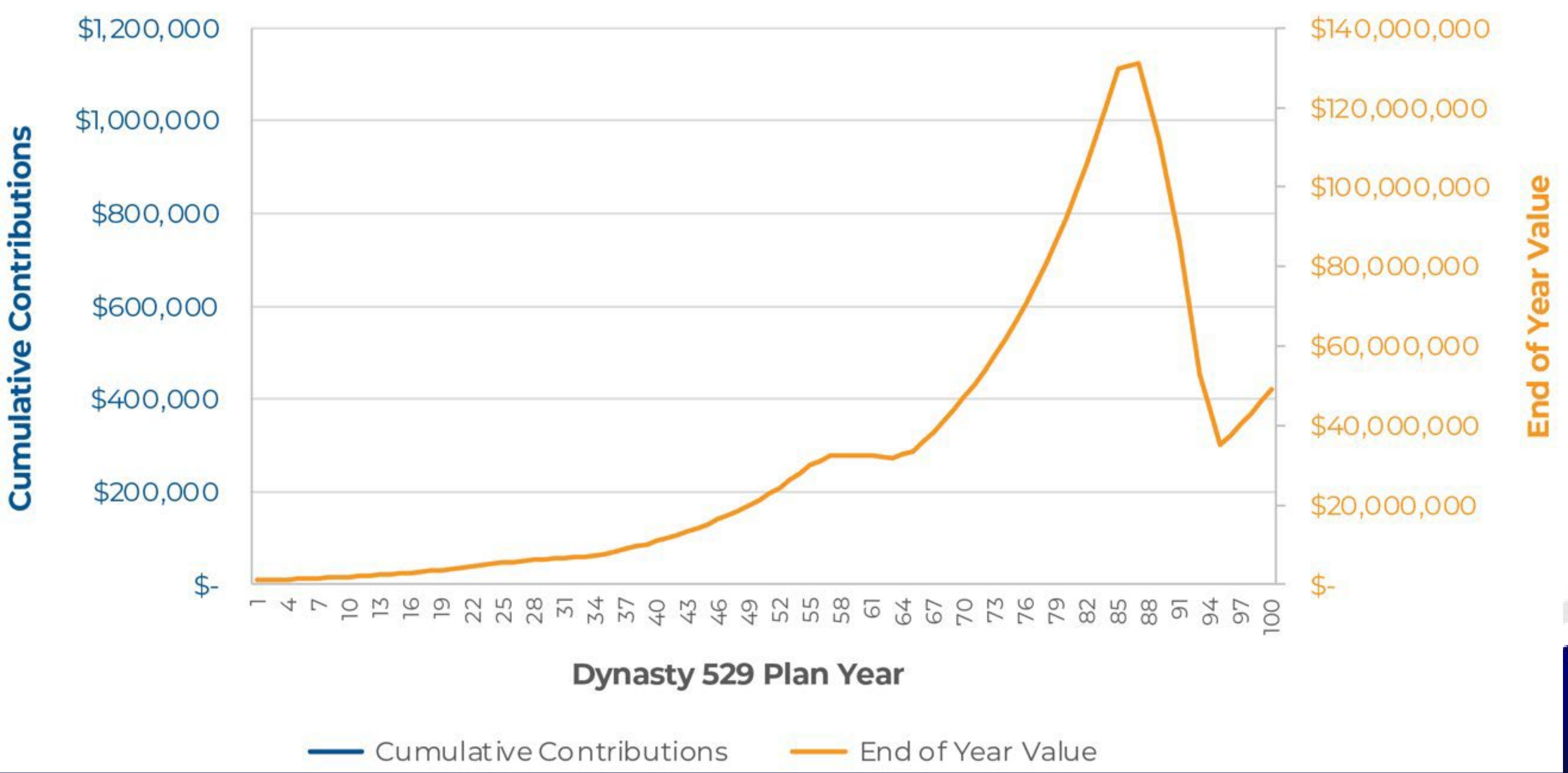
- Initial 529 plan contribution at birth of $11,000
- Annual transfers from the 529 plan to a Roth IRA beginning at age 16
  - Maximum estimated IRA contribution limit at time

Assumptions

- *IRA contribution limit inflated at 3% annually*
- *529 plan and Roth investments grow at 7% annually*

THE 'SWEET 16 ROTH' PLAN EXAMPLE

- 529 plan is roughly depleted by child's 20th birthday
- Roth IRA is worth roughly $1MM at child's age 65
- More than $2.5MM at child's age 80



A 'BETTER BACK-DOOR ROTH'?

- Same general principle as the Sweet 16, but for a high-income individual's own retirement
- **Primary benefit:** 'Regular' Back-Door Roth IRAs are funded entirely with after-tax money
  - Better Back-Door Roth would be funded with after-tax contributions and <u>*pre-tax*</u> earnings
- **Potential challenge:** Compensation will be needed in the year the transfers are made

529 TO 529A (ABLE ACCOUNT) ROLLOVER

- Limited to annual ABLE contribution limit
- Currently set to expire at the end of 2025 (when TCJA changes expire)
- ABLE accounts have much more flexible qualifying expenses

HOW TO (LEGALLY) CIRCUMVENT CERTAIN LIMITATIONS

- **Problem:** I "want" to superfund a 529 plan in excess of the 5-year gift tax-averaging maximum, but I don't want to use any of my lifetime exclusion
- **Solution:** Superfund multiple 529 plan accounts for different beneficiaries who are related (are an eligible family member) of the actual intended recipient
  - Later, transfer the funds to the intended recipient

HOW TO (LEGALLY) CIRCUMVENT CERTAIN LIMITATIONS

- **Problem:** I "need" to make an investment change, but this would be my third within a 1-year window
- **Solution:** Change the beneficiary of the account to another eligible family member and submit a new investment allocation for that account
  - Can always transfer back to the original beneficiary at a later date

HOW TO (LEGALLY) CIRCUMVENT CERTAIN LIMITATIONS

- **Problem:** I “need” to change my 529 plan account again, but this would be my second change within a 1-year window
- **Solution:** Change the beneficiary of the account at the same time you change plans
  - Can always transfer back to the original beneficiary at a later date

CHANGES TO FAFSA REDUCE 529 PLAN OWNERSHIP ISSUES FOR GRANDPARENTS

- Grandparent-owned 529s have historically had a significantly negative impact on financial aid compared to parent-owned plans
  - Parent-owned = Reduce aid by up to 5.64% of account value
  - Grandparent=owned = Distributions reported as untaxed income and reduce aid by up to 50% (of distribution amount)

- Changes to FAFSA via CAA are set to take effect on October 1, 2023 (for 2023-2024 school year)
  - Reduction in questions by roughly 2/3ds
  - Question regarding cash gifts from grandparents appears to be on the chopping block

- Appears grandparents (and anyone who is not part of the custodial household) will be able to help pay for college without impacting FAFSA-informed financial aid

- Still pending formal DOE guidance, so stay tuned!

- **Important note:** Changes do not impact CSS Profile
  - Still used by more than 200 schools
  - See https://profile.collegeboard.org/profile/ppi/participatingInstitutions.aspx

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CHECK STABLE FUNDS YIELD

- Re-evaluate stable funds (if being used)
- If rates are comparably low, consider:
  - Taking distributions early in the year, for upcoming tuition bills and investing in higher-interest-rate ‘safe’ investments
    - Make sure higher rate will be more after-tax considerations
  - Rolling the 529 plan over to a plan with better stable account options
    - Watch out for state recapture

THAT'S IT!
WE'RE DONE!

Questions?