529 Plans: More than Education Savings for Wealthy Families

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You may have noticed Congress passed a new bill dubbed "SECURE Act 2.0", and, over the last month, many outlets have begun unpacking the legislation, doling out articles covering the many facets of the new retirement plan rules. One provision that has garnered a lot of attention is the new option to rollover unused 529 funds to a Roth IRA for the benefit of the 529 plan beneficiary. While this provision is helpful for some families who wish to kick-start their child's retirement savings, it does come with a list of prerequisites that must be met. Since 529 plans are having their spotlight moment right now, I want to shed more light on just how robust these vehicles can be for wealthy families.

First, let's recap what a 529 plan is. Simply put, a 529 plan is an educational savings vehicle set up for a beneficiary by the account owner. Anyone can contribute to the 529 plan, and for any one person the maximum contribution in a single year is the annual gift tax exclusion ($17,000 for 2023). However, someone can pre-fund a 529 plan with five years' worth of gifts ($85,000 for 2023), but they may not contribute again until after the five years have passed. If a husband and wife want to split gift to a child's or grandchild's 529, they can give up to $34,000 in one year, or $170,000 if they utilize the maximum pre-funding option. The money in the account grows tax-free and is also tax-free when distributed if it is used for a qualified educational expense. Educational expense is a broad category, but up to $10,000 per year can be used for preparatory school (K-12th), and most college expenses will qualify, including room/board, food card stipends, books, computers, and, of course, tuition.

Now, on the Roth IRA rollover. This may make sense in certain circumstances, but you should know the following: the rollover must be to an IRA for the benefit of the 529 beneficiary; the 529 must have been open for at least 15 years; the rollover amount cannot include 529 contributions made in the last 5 years; rollovers are subject to the Roth contribution limits (currently $6,500 for a person under the age of 50); the lifetime maximum amount of 529-to-Roth rollovers is $35,000; the income limitations on Roth IRA contributions do not apply to 529 rollovers, so this method of contributing can take place even if the beneficiary has income over $153,000 for 2023. If you successfully meet all of those requirements, then this strategy is available to you; however, there are other options for unused 529 funds that may make more sense.

For wealthy families, a 529 plan can be an impactful tool for gifting and estate planning. Using the money for education is an obvious option for the account, but another option is using it as a gifting mechanism to move a portion of assets out of their estate, thereby avoiding potentially confiscatory estate and inheritance taxes.

Take the aforementioned split-gifting scenario. A husband and wife who are grandparents can split-gift $170,000 to a 529 account in one year. The money is then outside of their estate and free of gift taxes as well. If they had seven grandchildren, they could remove $1.19 million out of their estate in one year, free of gift and estate tax. Need to remove more? They could also pay tuition directly to the school for the child's benefit to fully maximize the gifting opportunity. Every five years thereafter, the couple could do another maximum split-gift of $170,000 to each 529 plan until the total value of each account reaches $550,000, which is the maximum ceiling where contributions may be added into the account. There is no cap on earnings potential. Now, you have a multi-generational vehicle compounding for decades. In the example, the $1.19 million compounded over 27 years assuming an 8% average rate of return (rule of 72) could turn into over $9.5 million across the seven accounts.

Multi-generational? Yes, indeed. The techniques that make this possible are the ability to change beneficiaries and successor owners. Changing beneficiaries is simple and is similar to "transferring" funds from one account to another, or from one (grand)child to another. When the elder exits college or graduate school and there is still leftover money, that amount may be moved over to the account for the benefit of another (grand)child. Don't have a younger child to move the money to? That's fine! You can change the beneficiary of the account to yourself! Why? Not to use it for educational purposes (unless you want to finally learn French before that trip to Paris), but to hold it and let it compound so that one day when grandchildren enter the picture, you can name them as the beneficiary. One account can split into as many different accounts as you have future grandchildren.

Naming a successor owner of the account in the event you pass away is an important part of the strategy. Most clients would name their spouse. If you are the surviving spouse and need to name a successor owner, you can name your child as successor owner of their child's 529 plan. This can continue down the bloodline indefinitely, as long as the beneficiary on the account is changed at least once every 30 years and is a family member to the previous beneficiary. Using these techniques, you can set up a 529 plan (or several) that can be in place for generations until someone, someday, actually uses the money for education expenses.

There are many intricacies in working with 529 plans and as you can see, things can get complicated. At Truxton Trust, our Wealth Management Services group is here to help clients make these types of decisions and many others, to ensure the proper execution of such plans with high regard for estate and gift tax considerations every step of the way. If you would like to discuss your situation or have questions, please reach out to your Wealth Advisor, or give us a call. We are happy and eager to help! ▪