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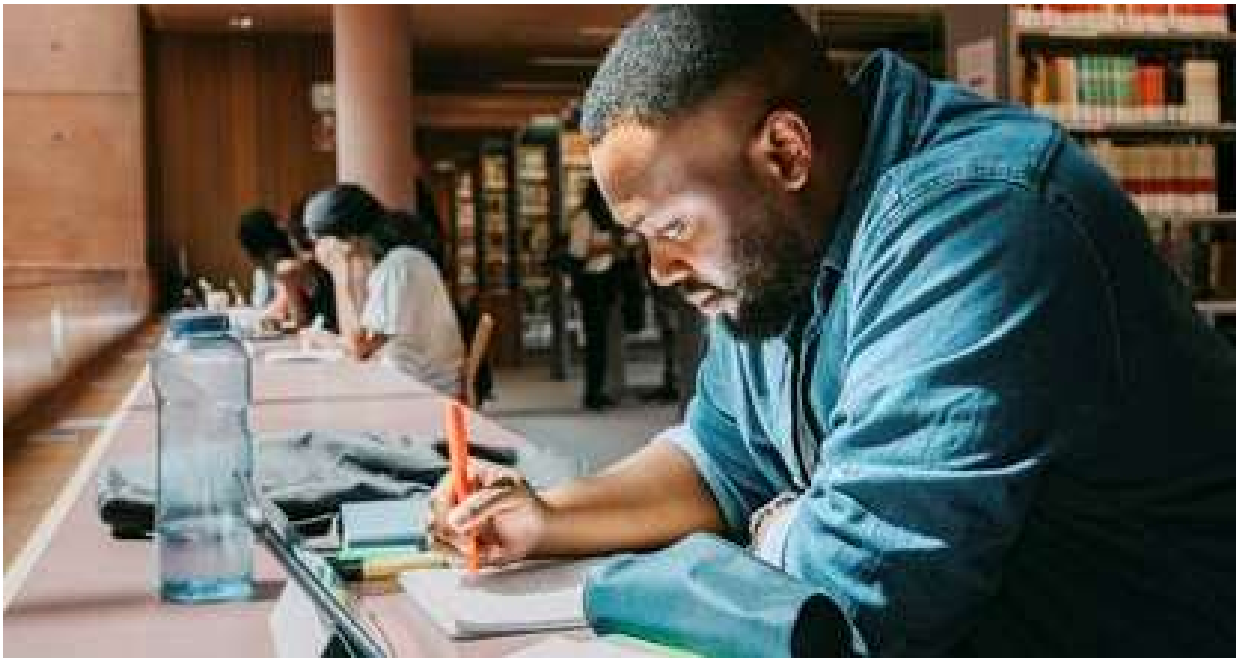
Using a 529 Plan? Here's What to Keep in Mind

As the school year progresses, ensure you're using the money for qualified expenses and keeping track of documentation. Taxes and options for unused funds are also considerations.



(Image credit: Getty Images)

If you have a 529 plan — a tax-exempt education savings account — you may already be tapping it this school year or considering tapping it soon. In the process, you'll want to examine your long-term education goals, understand what constitutes as a qualified expense and have a tax-minded strategy for withdrawal. Here are a few considerations to keep top of mind while using your 529.

Remember your goals

Just like education, 529 plans offer many paths to success. In addition to covering tuition and fees for traditional college and K-12, a 529 can also cover trade and grad school, apprenticeships, study abroad programs — minus traveling costs — and other items like books, supplies, internet access and even student loan repayments.

When making withdrawals, think about your long-term education goals. Ask yourself if you plan to attend graduate school, go to vocational school or even study abroad. Taking a collective tally and potential timeline of expenses will help you understand when and how to make strategic withdrawals.

With that understanding, consider if using the money in the account makes sense now, or if you'd be better served saving it for anticipated future education expenses. If a client is early in an education journey and can comfortably pay for expenses out of pocket, I'll often encourage them to consider allowing the 529 funds to continue to grow, reaping the benefits of compounding returns.

Understand the logistics

Once you do start making withdrawals, take stock of the limits of how much you can take at a given time. For instance, K-12 tuition expenses have a limit of $10,000 per year, while student loan repayments have a lifetime limit of up to $10,000.

Another part of this planning is understanding tax deductions, penalties and responsibilities. There's a contribution portion and an earnings portion in all 529 plans. The earnings portion of the plan is not subject to federal income tax and usually not subject to state income tax if used on a qualified expense.

But you'll face income tax and a 10% withdrawal penalty on the earnings portion if you use a 529 on a non-qualified expense. Non-qualified expenses include college application and testing fees, health insurance, extracurricular activities and transportation costs. The contribution portion is never taxed or penalized, as it's made with after-tax dollars.

Tax reporting is the responsibility of the 529 account owner, and the IRS requires proof that withdrawals were indeed made for qualified expenses only. Keep track of all payment documentation accumulated throughout the year. This includes receipts of both processed and canceled payments, as well as ongoing billing statements. If the 529 is being used by your child — to pay for college textbooks, for example — be sure to have a discussion around saving documentation.

Keep in mind that withdrawals must be made during the same tax year as the incurred, qualified expense. While this is not an official rule, it's implied by published IRS guidance. So, pay attention to semester tuition bills and try to align withdrawals as necessary.

In any instance, I recommend you consult with a tax and or legal professional to ensure you're meeting all requirements and to avoid costly mistakes, as qualified expenses, taxes and penalties can vary by state.

Recognize your options

If education is no longer a goal for the intended recipient, don't fret. Procedures vary by plan, but 529s offer the flexibility to freely move money from one beneficiary's account to another. The account owner can also change the beneficiary to another eligible family member without facing penalties or taxes.

Starting in 2024, 529 plans will also offer the option to roll up to $35,000 into a Roth IRA. However, there are some conditions that apply. The account must have been in existence for at least 15 years, and only funds that have been in the account for at least five years (as well as the earnings on those contributions) may be moved. The conversion limit must also be equal to the annual Roth IRA limit (i.e., $6,500 in 2023), and the Roth IRA must also be in the same name as the 529 beneficiary.

Additionally, state rules and considerations apply. If your account qualifies, rolling the funds over can give you — or a loved one — a head start on achieving long-term financial success. This option is considered one of the most compelling features of 529s, according to a recent Vanguard survey.

Balancing education goals — especially for more than one child, or concurrent with retirement and big purchase goals — can be daunting. As a financial adviser, part of my job is to help highlight the big picture and keep you on track financially to achieve all your goals. With this lens, figuring out your finances can go from an arduous task to a celebration of your bright future.

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Julie Virta, CFP®, CFA, CTFA is a senior financial adviser with Vanguard Personal Advisor Services. She specializes in creating customized investment and financial planning solutions for her clients and is particularly well-versed on comprehensive wealth management and legacy planning for multi-generational families. A Boston College graduate, Virta has over 25 years of industry experience and is a member of the CFA Society of Philadelphia and Boston College Alumni Association.

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