The ABCs of 529 Plans

> *A 529 plan is a tax-advantaged savings program designed to help families prepare for future education expenses. Named after Section 529 of the Internal Revenue Code, these plans have transformed the way families save and pay for college. In addition to tax benefits, 529 plans offer diverse investment options, allow funds to be used for a wide range of expenses—including college costs, trade schools, and K-12 tuition—and can reduce the impact of personal savings on financial aid eligibility.*

History of 529 Plans

In the late 1980s, Michigan, Florida, Ohio, and Wyoming introduced prepaid tuition programs to help families manage rising college costs. In 1994, a federal court ruled that Michigan's plan was tax-exempt. Following this decision, the IRS announced it would review the tax status of each plan individually, prompting states to intensify their lobbying efforts in Congress for federal tax benefits and to encourage college savings.

In 1996, Senators Bob Graham of Florida and Mitch McConnell of Kentucky—both representing states with prepaid savings programs—led a bipartisan effort to secure federal tax relief for all college savings programs. This effort resulted in the creation of Section 529 of the Internal Revenue Code.

Today, 49 states and the District of Columbia offer 529 plans, helping dramatically increase savings to meet the rising costs of education. While 529 plans evolved from prepaid savings programs, they are not the same. Many states offer one or both options.

Getting Started with Plan Selection

Step One: Determine Which 529 Plan to Use

While most states offer their own 529 plans, you can invest in any state's plan. If your home state provides a tax deduction or credit, it often makes sense to use that plan. Some states also allow state income tax-free withdrawals for qualified expenses, and more than 30 states offer some form of tax benefit.

If your state does not provide a tax advantage, consider comparing plans based on:

- features,
- costs, and
- investment options.

Step Two: Determine the Owner of the Account

Parents or guardians are typically the best choice as account owners because they maintain control over the account and can help ensure funds are used as intended. Grandparents and other relatives can open their own 529 accounts or contribute to an existing one. The *beneficiary* is the student who will use the funds.

Financial Aid Considerations

Funds in a 529 plan count toward the student aid index (SAI), which measures a family's ability to pay for college and affects need-based aid eligibility. Parent-owned accounts are assessed more favorably on the Free Application for Federal Student Aid (FAFSA) than student-owned accounts.

Beginning with the 2024-25 academic year, grandparent- or other relative-owned accounts do not affect FAFSA eligibility, although they may impact the College Scholarship Service (CSS) profile used by some private colleges.

Unlike a custodial account, the owner maintains oversight of investments and can change the beneficiary for any reason.

Contributions

Each state sets a lifetime contribution limit for its 529 plan, typically between $235,000 to $550,000 per beneficiary. Unlike individual retirement accounts (IRAs) or 401(k)s, there is no annual federal contribution limit for 529 plans. Yet, gift tax rules still apply. An individual can contribute any amount up to the annual gift exclusion amount per beneficiary each year without triggering gift tax consequences. In addition, 529 plans allow a special five-year election that lets clients front-load up to 5 years' worth of annual gifts for each beneficiary.

Although anyone—parents, grandparents, relatives, and friends—can contribute to a 529 plan, the account owner retains control over the funds. Contributions must be made in U.S. dollars, and non-cash assets such as stocks or property cannot be held within a 529 plan.

Investments Within a 529 Account

Each investment provider will offer different options, but most plans include target-date funds, objective-based portfolios, and individual mutual funds. Target-date funds are designed around the year that the beneficiary is expected to begin withdrawals. They simplify asset allocation by automatically rebalancing to become more conservative as the withdrawal date approaches.

Objective-based portfolios focus on specific investment goals rather than risk level or asset class. For example, a growth portfolio may seek long-term capital appreciation by investing in companies with strong growth potential. This approach can be suitable for investors who typically buy individual stocks but want greater diversification to meet long-term goals.

Some plans also allow you to build a custom portfolio using a mix of mutual funds, giving account owners flexibility to tailor investments to their preferences.

Withdrawals from a 529 Account

One of the most appealing features of 529 savings plans is that withdrawals used for qualified education expenses—including the earnings within the plan—are exempt from federal income tax. Qualified expenses include tuition, fees, books, room and board, and computers for higher education and post-secondary programs. Additional qualified expenses include up to $10,000 per year per beneficiary for K-12 tuition and a lifetime limit of $10,000 per person toward student loan payments. To receive tax-free treatment, withdrawals must occur in the same calendar year that the expenses were paid.

Nonqualified expenses include transportation, sports, entertainment, and student phone bills. The earnings portion of withdrawals for nonqualified expenses is subject to federal and state income tax and a 10 percent federal penalty.

It is important to note that not all states conform to federal tax rules for 529 plans. For example, some states impose income tax on earnings used for K-12 tuition, while others apply their own rules and penalties on non-qualified distributions. Clients should be sure to review their state's specific rules before making withdrawals.

Additional Options for unspent 529 Funds

If the original beneficiary does not use all the funds in a 529 plan, there are several ways to reallocate the money.

- **Change the beneficiary.** You can transfer the account to another eligible family member, which includes blood relatives and relatives by marriage and adoption. Transfers are generally tax-free, involve a simple beneficiary change, and can be done as often as needed.

- **Roll over to another 529 plan.** A rollover can only occur once in a 12-month period. Common reasons for rollovers include moving to a state that offers tax benefits, consolidating multiple accounts for the same beneficiary, or switching to a plan with lower fees.
- **Convert to a Roth IRA.** Under certain conditions, up to $35,000 of unused funds can be rolled into a Roth IRA. The 529 account must have been open for at least 15 years and maintained for the same beneficiary. Rollovers are subject to annual Roth contribution limits.
- **Transfer to an ABLE account.** 529 funds can also be rolled over to an Achieving a Better Life Experience (ABLE) account. Both accounts must share the same beneficiary, or the new beneficiary must be an ABLE-eligible member within the family. Transfers are limited to the annual ABLE contribution limit. This option allows families to use funds for qualified disability expenses without affecting eligibility for most public disability benefits.

Sources:

Internal Revenue Service. n.d. “Internal Revenue Service | an Official Website of the United States Government.” Irs.gov. https://www.irs.gov/

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