

AskPB: 529s Transcript

Patti Brennan: Hi, everybody. Welcome to "The Patti Brennan Show." Whether you have \$20 or \$20 million, this show is for those of you who want to protect, grow, and use your assets to live your very best lives.

Today's podcast is part of the series called "Ask Patti Brennan." We have a lot of people who ask us questions about 529 plans. What I'd like to focus on are the mistakes people make with 529 plans, expensive mistakes.

It is simple, but it is not easy. What you don't know can definitely hurt you. First and foremost, 529 plans are state sponsored. Depending on where you live, you can set up a 529 plan.

Some states give you a tax deduction for your contributions, but many states have limits. Pennsylvania, for example, has a limit that is based on the annual gift tax exclusion. So, if a husband and wife want to contribute \$17,000 per person, they get a nice tax deduction on their Pennsylvania income tax return. That is wonderful.

I wouldn't let the tax tail wag the dog, except that a 529 plan grows completely tax-free if it's used for qualified education expenses. Those expenses are up to \$10,000 for high school or undergrad, and then it can be used for tuition, room and board for college expenses.

Let's go through an example of a family that has three kids. A lot of times, young families are really motivated. They plow a ton of money into a 529 for the first child with the knowledge and understanding that they can allocate some of that money in the first plan for the other two kids.

Yes, you can allocate that money for the other two; however, it's not one big pot. Let's say that you've got \$100,000 in the oldest 529 plan, \$10,000 in the second, \$5,000 in the third.

You can earmark that money, but it must be transferred to the second beneficiary's account. You can't just take it out of the first account and send it. Let's say this is John, Sandy, and Samantha. Let's say that John didn't use all of his money. Mom and dad, hear this loud and clear. You cannot have John's money used for Sandy's education.

You must transfer the money and any excess into Sandy's 529 account first. Then you can send it or use it for Sandy's education. Same thing with Samantha's account. That is important because a lot of people are motivated to pay for education and sometimes there's money that's left over. Before I go into that, you can reimburse yourselves.

Let's say that things are running late, you forgot to call wherever you're housing your 529 plan to send it to the institution and tuition is due. You can pay it yourself and reimburse yourself, but it must be to the penny.

Be very careful because I know I have four kids and they were in the dorms for the first year or two before moving into apartments. The amount of the 529 plan that

can be used to pay for that rent is limited to the amount that the university charges for the dorm. So, there are no luxury apartments for those kids! You can't take that money out of the 529; however, it can be used for computers, books, things of that nature.

Again, you've got the three kids and John did well. He may have gotten a scholarship, he's graduating, and he's got money left over in his 529 plan. To add to this, we have this new law. Money left over in a 529 plan can be rolled into a Roth account for that child.

First and foremost, John's 529 can only go into a Roth account for John as the owner. It can't go into Sandy's. That's important. Just think of that as segregated money for that child.

There are certain rules you've got to keep in mind when it comes to these Roth rollovers, which are a home run for these kids. What a great way to start life with a funded Roth IRA that's going to grow tax-free for their lives.

They can use it as a first-time homebuyer for a downpayment on their house. There are a lot of cool things that can be done. I just want to go through the rules and here is rule number one. For that 529 plan to be eligible for the Roth rollover, it had to be in place for 15 years. So, mom and dad had to be planners, set up the account, fund it with \$1,000 and start the clock.

Secondly, the money that you want to have transferred into the Roth IRA had to have been in there for a period of five years. Just remember, 15 on the account and 5 for the money. The most you can roll over into a Roth IRA for that child is \$35,000.

Let's say that John graduated from college, really motivated, took finance courses in college, and he understands the value of contributing to a Roth IRA. Here's the deal.

If he wants to do that Roth IRA, the amount that you can put in and roll over from the 529 is reduced by the contribution amount that John's going to make into his own Roth IRA. You don't have to do it all at once.

Let's say that there's money left over. He wants to do a Roth IRA contribution. You want to encourage that kind of savings and the behavior that is being instilled into him at a young age. It's awesome! That's honestly more important than anything for him to develop that habit. You reduce the amount that goes into the rollover.

Understanding that the limit is \$35,000, you can do it over two years instead of one. You'll still get the \$35,000 into the Roth. Just be aware there are limits. You might say, Patty, how in the world is the IRS ever going to know?

They do. I'm here to tell you what the rules are. The IRS is getting really smart. There's a 1099-Q that is issued for anybody that has a 529 plan. If you take money out of it, a 1099-Q is coming out to you. Under these rules, the IRS requires the universities to send out a Form 1098-T, that reflects tuition payment. In the example above, let's say Mom pulled out \$90,000 from John's 529 plan and used it for Sandy. Then the 1098-Q comes out and it says John's tuition was \$30,000.

The IRS is going to say, wait a minute, there's a disconnect here. It lacks congruence and doesn't match. It might be a red flag causing an audit. You're going to have to prove that the money was taken out of John's 529 plan and that it was really for John. If you can't prove that, what happens? You owe taxes on the amount that wasn't used for John, and there's a 10 percent excise penalty.

This is important. You don't want to pay taxes. You took the time to save the money in the first place. It's a pain in the neck and I get it. It's a paperwork thing to take the money out of John's account, put it into Sandy's account and Samantha's account.

It's an administrative burden that is imposed on us by the IRS. It is what it is. Do it anyway so that you get this wonderful benefit that the 529 plan provides.

I am Patti Brennan. That's just a little bit about 529 plans. We can go into the different states, the advantages, and pros and cons of different states because there is a very big difference between the states.

We won't get into those weeds today. I just wanted to hit the highlights. Thank you so much for joining me today. I hope you have a fantastic day. We are Key Financial, Wealth Management with Wisdom and Care. Take care now.