Season 1 – Episode 16 - Unlocking the Power of Educational Savings Accounts: A Deep Dive into 529s, Coverdells, Roths, and More

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Welcome to Tax Blueprints, a Rohr CPAs podcast. I'm Daniel Rohr, the managing shareholder of Rohr and Associates, a premier CPA firm based in California. I'm a CPA, Personal Financial Specialist and Enrolled Agent. I have extensive experience advising individuals and business owners with tax minimization and personal financial planning strategies. On each episode of Tax Blueprints, I delve into the intricacies of tax laws, explain the subtleties of business tax planning, and guide individuals towards a path of financial stability. Whether you're a business owner navigating the murky waters of taxation or an individual planning for a worry-free retirement, Tax Blueprints will provide you with the tools and knowledge you need. I hope you enjoy this episode.

Today we'll unpack the intricacies of various educational savings accounts, including 529 accounts Coverdell ESAs, Roth IRAs, savings bonds, and custodial accounts like UGMA and UTMA accounts. The recent changes to 529 accounts under the Secure Act 20 only make this discussion more timely and critical. A 529 account or a qualified tuition plan is not just your typical savings account. It's an investment vehicle designed with educational expenses in mind. Administered by state agencies or educational institutions, these accounts permit individuals, be it parents, grandparents or even friends, to make contributions for a beneficiary's education expenses. One of the most appealing features of a 529 plan is its significant tax advantages. When you invest in a 529 account, your contributions grow tax free as long as they remain in the account. Even better, withdrawals are also tax free if used for qualified educational expenses, which can range from tuition and room and board to textbooks and certain supplies.

This double tax advantage, tax free growth, and tax-free withdrawals for educational purposes makes an unparalleled tool for educational financial planning. But what if plans change? What if your child, the initial beneficiary, decides not to go to college or receives a full scholarship? The 529 is designed with such contingencies in mind, you can easily change the beneficiary to another family member without incurring any tax penalties or liabilities. This flexibility can extend to siblings, parents, cousins or even yourself. Should you decide to further your own education, it ensures that the money you've diligently saved will go toward education just as intended, without financial loss. Now, with all that said, the Secure Act 20, enacted at the tail end of 2022, brings transformative changes to 529 accounts, broadening their utility and flexibility. Beneficiaries can now roll over up to $35,000 over their lifetime into a Roth IRA.

Conditions include that the account be open for a minimum of 15 years. The 529 beneficiary must be the Roth IRA owner, and the contributions made to the 529 plan in the last five years, including the earnings on those contributions, are ineligible for tax free transfers. Transfers from the 529 to a Roth IRA also count against yearly Roth IRA contribution caps, which are currently at $6,500. And you cannot contribute more than that annual cap to the 35,000 total. So if it's $6,500 a year. You only can do that for a number of years to get to $35,000. The possibility of rolling over 529 funds to a Roth IRA addresses the previous overfunding risks that were of concern for many families. And a way to utilize this provision is to roll the $35,000 to a Roth IRA for the beneficiary of the 529, and whatever's left over can be transferred to another family member or yourself, as previously mentioned, to be used for educational purposes only.

To be clear, though, you can't roll amounts transferred to a new beneficiary into another Roth IRA for that new beneficiary. You can only do that for the initial beneficiary of the 529 account. Another educational savings account to consider is the Coverdell. Education savings account ESA. The annual contribution limit, however, is relatively low at $2,000, and income limitations apply. The advantage of a Coverdell ESA is its flexibility investment options and the absence of tax upon qualified withdrawals. Now, while Roth IRAs are generally considered retirement accounts, they offer a level of flexibility that makes them viable for educational savings as well. You can make tax free withdrawals for qualified education expenses. If the funds are not used for education, they can be repurposed for retirement without any penalties, making Roth IRAs a dual-purpose financial tool. Series EE and Series I Savings Bonds offer additional education savings vehicles with a more traditional approach.

Their interest rates generally trail those of other investment options, but the interest is tax free if used for qualified education expenses. Plus, there are no income limitations like there is for the Coverdell. Lastly, custodial accounts like UGMA or UTMA accounts provide a wide range of uses for the funds from education to any other activities that benefit the child. These accounts come with a catch the child gains full control upon reaching the age of majority. While all the savings options we've discussed offer substantial benefits for securing child's educational future, their tax implications can vary quite extensively. A nuanced understanding of these aspects can help you optimize your financial planning. So, as discussed, 529 accounts offer tax free growth and withdrawals for qualified educational expenses. But what's often not mentioned is that if you withdraw the money for non-educational purposes, you will owe income tax and a 10% penalty on the earnings portion of the non-qualified withdrawals.

It's important to note, though, for planning purposes, the tax and penalty is applied to the beneficiary's tax rate. The beneficiary's rate plus the 10% penalty may still be less than the tax rate of the parents, which means that the parents would be no worse off had they been saving funds into a taxable account and with tax deferred earnings. In this scenario, contributing to the 529 would still be advisable. Regarding the Coverdell, earnings in a Coverdell ESA grow tax free and are exempt from federal tax upon withdrawal for qualified educational expenses. Note, however, that contribution limits and income limitations can curtail your ability to make the most of this account from a tax perspective. And regarding the Roth though traditionally a retirement savings account, a Roth IRA provides the advantage of tax-free growth and withdrawals for qualified educational expenses. However, withdrawing earnings before age 59 and a half for any purpose other than qualified educational expenses can trigger a 10% penalty.

In addition to regular income tax. There are a couple of other exceptions in there as well, but for this purpose, we'll focus on the educational side and be mindful that this can dilute the account's tax advantages. When used for non-educational needs, it's best just to use it for educational purposes or other qualifying expenses, and if not needed for those, wait until retirement to take the money out of the rod so you get the tax-free benefit. Series EE and Series I bonds offer tax free interest if used for qualified educational expenses, which is a benefit worth considering. The downside is that if you cash them out for non-educational expenses, the interest earned becomes taxable at your regular income tax rate. For custodial, UGMA or upma accounts, these can be a double-edged sword when it comes to taxes. On the one hand, the first one, $250 in earnings, is tax free, and the next, 1250 is taxed at the child's tax rate, typically much lower than the adults.

However, investment income beyond this threshold may trigger the kitty tax, which could potentially be taxed at the parent's higher rate, reducing the account's tax efficiency. In conclusion, the landscape of educational savings is ever changing, especially with the transformative amendments introduced by the Secure Act 20 for 529 accounts with various vehicles available from 529s and Coverdell ESAs to Roth IRAs saving bonds and custodial accounts. Understanding each option's nuances is vital for making informed decisions.

That's all for this episode of Tax Blueprints of Rohr CPAs podcast. You can find us online at Rohrcpas.com/podcast and don't forget to subscribe on Apple podcasts or Spotify. If you enjoy the show, please consider rating or reviewing us wherever you listen. I'm your host, Daniel Rohr. Thanks for listening.

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