Tax-advantaged college-savings plans known as 529 plans have gotten very popular since their introduction in 1996. But while their tax benefits are attractive, a question has hung over them: What happens to the funds that aren't spent?

There's now a new answer to that question, and in my view it makes 529 plans a lot more attractive. Under the SECURE 2.0 Act of 2022, as much as $35,000 can be rolled from a 529 into a beneficiary's Roth IRA account. It's true that college costs continue to rise far faster than the general rate of inflation. But even so, it's not uncommon for beneficiaries to use only part of their 529 funds for college, graduate school or trade school.

They may get scholarships, may end up going to a less-expensive school than they'd planned, or might skip college altogether. However they wind up with leftover 529 funds, these beneficiaries can now use that money to jumpstart their retirement savings in a Roth IRA. By starting young, they can use the power of compounding over several decades to build a big chunk of what they'll need to retire.

Before the SECURE 2.0 Act, leftover 529 funds could be saved in case the beneficiary wound up with more education expenses, or could be transferred to a family member's 529 plan. Any other withdrawals of the money resulted in an income tax and a 10% federal tax on earnings. Now, 529-account owners or beneficiaries can roll $35,000 into a Roth IRA with the same beneficiary over their lifetime. The catch is that it has to be done in increments; the annual rollover limit is the same as the yearly IRA contribution limit. For 2024 it's $7,000. Starting at age 59 ½, principal and earnings in the Roth can be withdrawn tax-free.

Here's an example of how 529-plan money can be turned into retirement nest-egg money. Say a 529-plan beneficiary has $35,000 left if the account after completing their education. They start rolling $7,000 a year into a Roth. Assuming they earn 8% a year in the IRA, They'll have a total of $51,778.76 after five years in that account. Now let's say they're age 29 when that process ends, and that they intend to retire at age 65. That's 36 years of compounding, after which, at an 8% return, they've have $922,114.21 of tax-free retirement funds. The power of compounding over time would ensure the beneficiary winds up with nearly $1 million toward retirement.

As always, there are caveats. One big one is that the 529 account being rolled into a Roth IRA has to have been open for at least 15 years. Contributions made less than five years ago aren't eligible, and neither are their earnings. And remember that $7,000 is the total IRA contribution limit for this year, including whatever amount you move from a 529 to a Roth. So if you've contributed $2,000 to a Roth since the start of the year, your 529 rollover total for the year can only be $5,000.

The new rollover rules, and the age-old power of compounding make contributing to 529 plans a lot more attractive than they used to be. Please reach out to us if you'd like to learn more.