How the New Tax Law Affects 529 Plans

For many years, 529 college savings plans have offered a tax-favored way to save for higher education. These plans, officially qualified tuition programs, are named for the IRC section that provides their advantages.

In brief, 529 plans are funded with after-tax dollars. In college savings plans, account owners choose from a menu of investments, and any earnings are untaxed. Distributions are also tax-free if they do not exceed the qualifying educational expenses of the account beneficiary: payments of tuition, fees, supplies, and certain housing expenses for the account beneficiary's study at an eligible educational institution. Before 2018, eligible educational institutions included only post-secondary institutions.

Youth Movement

Under the new tax law, the benefits mentioned previously (tax-free investment earnings, potentially tax-free distributions) remain as they were. The difference is that for tax years beginning after December 31, 2017, 529 plans are no longer limited to higher education at a post-secondary institution. Now they can be used for elementary and secondary education, as well. That includes learning in public, private, and religious schools.

There is one key caveat: Tax-free distributions for elementary and secondary education are capped at $10,000 per student per year. As before, there is no annual limit on qualified distributions from 529 plans for higher education.

Example 1: Bill and Claire Dawson open a 529 account for their newborn son Noah. Over the years, they invest thousands of dollars there. When Noah is age 10, in the fifth grade, he goes to a private school where the tuition is $15,000. The Dawsons take $10,000 from Noah's 529 account to pay part of his tuition with a tax-free distribution. A larger distribution could lead to an income tax obligation and possibly an additional 10% tax on the amount of the taxable distribution.

Sooner than Later

For families like the Dawsons, using 529 money for pre-college costs might not be an ideal strategy. The earlier money is withdrawn, the less time there will be for compounding earnings. Extending untaxed investment buildup, which eventually may come out as a tax-free distribution, is a prime benefit of 529 plans.

Even so, the new law can prove beneficial in some situations. When cash is short and private school costs are high, a $10,000 tax-free distribution from a 529 plan may be welcome. If students are now attending an expensive high school but are expected to attend an inexpensive college, it may make sense to use the $10,000 529 distribution each year.

Moreover, even though the new 529 provision applies to federal tax, substantial benefits might come from state taxes. Nearly every state offers a 529 plan, and most of them provide state income tax credits or state tax deductions to residents who invest in the home state's plan. (Some states have tax benefits for investing in any 529 plan.)

So far, states have differed on how they'll treat 529 plan distributions for K-12 distributions. Assuming your state goes along with the new federal law, using $10,000 a year for pre-college costs may become especially attractive.

Example 2: Suppose Ted and Sarah Raymond live in a state that offers a 10% tax credit for 529 contributions. They invest $10,000 in their state's plan this year, getting a $1,000 credit against state tax. Then, they use that $10,000 to pay part of their daughter Gina's private high school tuition. With the $1,000 state tax saving, the Raymonds effectively reduce Gina's school cost by $1,000 by streaming their cash through their state's 529 plan.

Our office can inform you of your state's tax treatment of 529 contributions and how the state is dealing with the new rules on 529 distributions.

Trusted Advice

Eligible Schools

- For qualified tuition program tax benefits, an eligible educational institution now can be either an elementary, a secondary, or a post-secondary school.
- Among post-secondary schools, eligible schools are generally any accredited public, nonprofit, or privately owned profit-making college, university, vocational school, or other post-secondary educational institution.
- A post-secondary school also must be eligible to participate in a student aid program administered by the U.S. Department of Education.
- Eligible elementary and secondary schools include any public, private, or religious school that provides elementary or secondary education (Kindergarten through grade 12 classes).