Tax Reform Expands Section 529 Deductions for Education to Include K-12 Costs

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Background

Along with the District of Columbia, 35 states offer either a full or partial state income tax deduction for contributions to a 529 plan, an investment-type savings plan specifically made for college savings.

See related blog: Kickstart Your College Fund with a 529 Plan

While plans are sponsored by individual states, they are funded through financial institutions designated by each state. Until now, 529 distributions were tax-free only for college expenses. The enactment of the Tax Cuts and Jobs Act in December expands the tax-free withdrawals for K-12 private school and home schooling costs.

Tax Reform Outcome

Until the final outcome of the new tax legislation, educators and students alike were scrambling to keep up with the potential elimination of student loan deductions, the Coverdell Education Savings Account (ESA), the Lifetime Learning Credit, and a new taxation of tuition waiver, which is primarily used by graduate students and employees of higher-education institutions. There was very positive news in the final bill. Not only were all these programs spared, but 529 plans can now be used to fund K-12 education, including those who are home-schooled.

New Provisions

Beginning this year, annual withdrawals of up to $10,000 per student can be taken from a 529 college savings plan account for tuition expenses in connection with enrollment at an elementary or secondary public, private or religious school (excluding home schooling). Such withdrawals are now tax-free at the federal level.

Approximately 20 states and the District of Columbia automatically update their state legislation to align with federal 529 plans. Now, the remaining states will need to take legislative action to include K-12 expenses as a qualified education expense and, if applicable, extend other state benefits to K-12 expenses.

Effect on Coverdell ESAs

The expansion of 529 plans will likely affect Coverdell ESAs, which let families save up to $2,000 per year tax-free for K-12 and college expenses. Prior to tax reform, they were the only vehicle for tax-advantaged K-12 savings. The higher lifetime contribution limits of 529 plans – generally $350,000 and up – compared with the relatively modest annual limit for Coverdell accounts may decrease the popularity of these accounts. However, the Coverdell ESA has one advantage—investment flexibility. With 529 plans, account owners can invest only in the investment portfolios offered by the plan and exchange existing plan investments for new plan investments twice per year. Coverdell owners have more flexibility in the investments they hold in their account, and they can generally changes investments as often as they wish.

What to Do

Owners of 529 accounts interested in making K-12 contributions or withdrawals should understand their state's rules regarding how K-12 funds will be treated for tax purposes. Further, account owners should check with the 529 plan administrator to determine whether a K-12 withdrawal request should be made payable to the account owner, the beneficiary or the K-12 institutions. Expect 529 plans to further refine their rules to accommodate the K-12 expansion and communicate these rules to existing account owners.

A list of 529 plans offered by state, and a comparison tool are available at **collegesavings.org**.