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Tax Cuts and Jobs Act: 529 Plans Expanded

Which states offer a 529 plan state tax benefit?

A total of 35 states and the District of Columbia offer a full or partial state income tax deduction for contributions to a 529 plan (however, most restrict the deduction to contributions made to the in-state plan only). California, Delaware, Hawaii, Kentucky, New Jersey, and North Carolina do not offer a state income tax deduction; and Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming do not have a state income tax.

Source: The Smart Student Guide to Financial Aid, www.finaid.org, January 14, 2018

In December 2017, the Tax Cuts and Jobs Act, a sweeping $1.5 trillion tax-cut package, became law. College students and their parents dodged a major bullet with the legislation, as initial drafts of the bill included the elimination of Coverdell Education Savings Accounts, the Lifetime Learning Credit, and the student loan interest deduction. Also on the table in early drafts of the bill was the taxation of tuition waivers, which are used primarily by graduate students and employees of higher-education institutions. In the end, none of these provisions made it into the final legislation. What did make the final cut was the expanded use of 529 plans.

Expansion of 529 plans to allow K-12 expenses

Under the new law, the definition of a 529 plan "qualified education expense" has been expanded to include K-12 expenses. Starting in 2018, annual withdrawals of up to $10,000 per student can be made 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.

At the state level, roughly 20 states and the District of Columbia automatically update their state legislation to align with federal 529 legislation, but 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 tax benefits to K-12 expenses; for example a deduction for K-12 contributions.

529 account owners who are 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. In addition, 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 institution. It's likely that 529 plans will further refine their rules to accommodate the K-12 expansion and communicate these rules to existing account owners.

The expansion of 529 plans to allow K-12 expenses will likely impact Coverdell Education Savings Accounts (ESAs). Coverdell ESAs let families save up to $2,000 per year tax-free for K-12 and college expenses. Up until now, they were the only game in town for tax-advantaged K-12 savings. Now the use of Coverdell ESAs may decline as parents are likely to prefer the much higher lifetime contribution limits of 529 plans — generally $350,000 and up — compared to the relatively paltry $2,000 annual contribution limit for Coverdell accounts.

Coverdell ESAs do have one important advantage over 529 plans, though — investment flexibility. Coverdell owners have a lot of flexibility in terms of what investments they hold in their account, and they may generally change investments as often as they wish. By contrast, 529 account owners can invest only in the investment portfolios offered by the plan, and they can exchange their existing plan investments for new plan investments only twice per year.

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

Expansion of 529 plans to allow transfers to ABLE accounts

The new tax legislation also allows 529 account owners to roll over (transfer) funds from a 529 plan to an ABLE plan without federal tax consequences. This ability to transfer funds will expire at the end of 2025 unless a future Congress acts to extend the law.

An ABLE plan is a tax-advantaged account that can be used to save for disability-related expenses for individuals who become blind or disabled before age 26. Like 529 plans, ABLE plans allow funds to accumulate tax deferred, and withdrawals are tax-free when used to pay the beneficiary's qualified disability expenses, which may include (but are not limited to) housing, transportation, health care and related services, personal assistance, and employment training and support.

ABLE accounts have annual and lifetime contribution limits. Contributions from all donors combined during the year cannot exceed the annual gift tax exclusion ($15,000 in 2018). As for lifetime limits, each state sets its own limit, which is also the state's maximum for its 529 college savings plan contributions. In most states, this limit is at least $350,000.

A list of ABLE plans offered, by state, and a comparison tool are available at ablenrc.org.

Note: *Investors should carefully consider the investment objectives, risks, charges, and expenses associated with 529 plans and ABLE plans before investing. Specific information is available in each plan's official statement. Participating in a 529 plan or ABLE plan may involve investment risk, including the possible loss of principal, and there is no guarantee that any investment strategy will be successful. Before investing, consider whether your state offers residents favorable state tax benefits for 529 plan or ABLE plan participation, and whether those benefits are contingent on joining the in-state plan. Other state benefits for 529 plans may include financial aid, scholarship funds, and protection from creditors.*
