529 Education Savings Plan

Federal tax law allows[1] the states to establish tax-advantaged savings programs to pay for a student's qualified educational expenses. In these programs, cash contributions are made to an account established for a named beneficiary. An investment management firm typically manages account funds. The amount ultimately available to pay for the beneficiary's education depends on growth in the account between contribution and withdrawal. Such education savings accounts are not insured and losses are possible.

Under federal tax law, contributions are not tax deductible and any growth in an account is tax-deferred. Distributions used solely to pay for qualified educational expenses are federally tax-exempt. State or local law, however, can vary widely; contributions may or may not be tax deductible, and distributions may or may not be tax exempt.

Key Definitions Under IRC Sec. 529

- **Qualified higher educational expenses:** For post-secondary education, generally, tuition, fees, books, supplies, and equipment required for attendance qualify. Computers, software, peripheral equipment, and internet access also qualify if they are to be used primarily by the beneficiary while the beneficiary is enrolled at an eligible education institution. Reasonable costs of room and board are also included if the student is attending school at least half time. Additionally, qualified expenses include costs incurred to allow a special needs beneficiary to enroll at and attend an eligible institution.

  Beginning in 2018, the Tax Cuts and Jobs Act of 2017 (TCJA) expanded the definition of qualified higher education expenses to include expenses for tuition incurred in connection with the enrollment or attendance of the designated beneficiary at an elementary or secondary, public, private, or religious school.

[1] "529" refers to Section 529 of the Internal Revenue Code, the section of federal law which authorizes these plans. The discussion here concerns federal income tax law. State or local law may differ.

The SECURE Act, effective for distributions after December 31, 2018, further expanded the definition of qualified higher education expenses to include expenses related to participation by a designated beneficiary in an apprenticeship program registered with the Secretary of Labor. This act also provided for distributions for the payment of interest or principal of a qualified education loan for the designated beneficiary or a sibling.

- **Eligible educational institution:** Generally, accredited post high-school institutions offering associates, bachelors, graduate level, or professional degrees qualify as eligible. Certain vocational schools are also included. Elementary or secondary public, private, or religious schools, as well as apprenticeship programs registered with the Secretary of Labor also qualify.

Contributions

Contributions to a savings plan must be in cash and may not exceed the amount necessary to provide the beneficiary's qualified educational expenses. While some donors contribute lump-sum amounts, many 529 savings plan accounts are set up with automatic monthly payments. Other considerations include:

- For federal gift tax purposes, contributions are considered completed gifts of a present interest. Generally, no federal gift tax will be payable if a contribution is limited to the annual gift tax exclusion amount. For 2022, this is $16,000. A married couple can elect to "split" gifts for a total annual contribution of $32,000.
- If a contribution for a single beneficiary in one calendar year exceeds the annual exclusion amount, the donor may elect to treat the contribution as having been made ratably over a five-year period.[1] Thus, for 2022, an individual could contribute up to $80,000 for a single beneficiary in one calendar year. If a married couple elects gift splitting, $160,000 could be contributed.
- Contributions may be made to both a savings plan and a Coverdell Education Savings Account (Coverdell ESA) for the same beneficiary in the same year.

[1] If the donor dies before the end of the five years, a pro-rata portion of the contribution is included in his or her estate. Any amounts in a savings plan when the beneficiary dies will generally be includable in the beneficiary’s estate.

Distributions

For federal income tax purposes, distributions used to pay for post-secondary qualified educational expenses are excluded from gross income if the amount distributed does not exceed the amount of qualified educational expenses. If a distribution is greater than the amount of qualified educational expenses, a portion of the earnings may be subject to federal income tax and a 10% penalty tax may also apply

Tax-free distributions in connection with the enrollment or attendance of a designated beneficiary at an elementary or secondary public, private, or religious school are limited to $10,000 per year. This limitation applies on a per-student basis, not a per-account basis. Any distribution in excess of $10,000 is subject to tax. No more than $10,000 (a lifetime limit) may be distributed for any one individual in payment of principal or interest on a qualified education loan.

- **Distributions due to the death or disability of the beneficiary, or the receipt of certain scholarships:** The earnings portion of the distribution is taxable as ordinary income to the recipient of the payment.

- **Rollover distributions:** Federal law allows one tax-free transfer every twelve months, from one savings plan to another, for the same beneficiary. Funds may be rolled from a 529 education savings plan to a 529 prepaid tuition plan and vice versa. If there is a change of beneficiary within the same family, the rollover must be completed within 60 days or the earnings portion will be subject to tax. If a new beneficiary is not part of the same family as the original beneficiary, the earnings portion of the transfer is subject to current income tax.

- **ABLE account rollovers:** TCJA, for 2018 – 2025, allows amounts from 529 plans to be rolled over to an ABLE account, provided that the ABLE account is owned by the beneficiary of the 529 account or a member of the beneficiary's family. Such rolled-over amounts count toward the annual limitation ($16,000 in 2022) that can be contributed to an ABLE account. Any amount rolled over in excess of this limit will be included in the beneficiary's gross income.

- **Other distributions:** If a distribution is made from a savings plan for any other reason, the earnings portion of the distribution is included in the taxable income of the recipient. A 10% penalty tax is also applied against the distributed earnings.

- **State and local law:** State and local law can vary widely from federal law with regard to the income tax treatment of both contributions and withdrawals.
- **Coordination with other programs:** A beneficiary may generally also claim either the American Opportunity Tax Credit or Lifetime Learning Credit (not both in the same tax year) or, receive a distribution from a Coverdell ESA, as long as the qualifying educational expenses are not the same.

Education Savings Account Characteristics

There are a number of account characteristics that a donor should clearly understand:

- The beneficiary must be identified at the time an account is created.[1] The account owner is usually the primary contributor. However others, such as grandparents, may also contribute.
- The account owner may change the beneficiary. If the new beneficiary is a member of the same family,[2] there is generally no current federal income tax liability.
- Amounts accumulated in a savings plan operated by one state generally may be used at educational institutions in a different state.
- An education savings plan involves investment risk, including the potential to lose money. Contributing to an education savings plan does not ensure that your education funding goals will be met. Further, there is no guarantee that a beneficiary will be admitted to a particular school or college.
- Under federal law, neither the beneficiary nor the account owner is permitted to direct the investments in the account. Account owners may, however, choose among broad investment strategies established by the program sponsor. A change in investment strategy is generally permitted twice each calendar year, or when a new beneficiary is named.
- Most 529 savings plans require that funds contributed for a beneficiary from a custodial account become the property of the beneficiary when the beneficiary

[1] An exception exists for organizations accumulating funds for future scholarships.

[2] Generally, siblings, children, grandchildren, parents, grandparents, nieces or nephews, uncles or aunts, their spouses, and first cousins are considered members of the same family.

reaches his or her majority. A custodial account is one set up under the Uniform Gifts to Minors Act (UGMA), the Uniform Transfers to Minors Act (UTMA), or the local state version.

Other Issues to Consider

- **Home State Plans:** The fees, expenses, and features of education savings plans vary widely from state to state; some states have more than one plan. Consider whether the plan in your (or the beneficiary's) home state offers any tax or other benefits that are only available to participants in that particular state's plan.
- **Effect on financial aid:** Assets in a 529 savings plan are considered in the "Expected Family contribution" calculations. Tax-free distributions from a 529 savings account (those used to pay for qualified educational expenses) are not counted as income to either the parent or student in the financial aid determination process.[1]

Internet Resources

- **The College Board:** https://www.collegeboard.org
- **Finaid:** https://www.finaid.org
- **College Savings Plan Network:** links to state-run web pages on prepaid tuition or college savings plans, at: https://www.collegesavings.org
- **U.S. Department of Education – student aid website:** https://studentaid.gov

Seek Professional Guidance

Individuals considering an education savings plan are faced with a number of income, gift, estate tax, and investment questions. The guidance of appropriate tax, legal, need-based student aid, and financial professionals is highly recommended.

[1] See the U.S. Department of Education "Dear Colleague" letter of January 22, 2004, GEN-04-02.