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BACKGROUNDER

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Improved and Expanded 529 Savings Plans Create More Opportunities for Families

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Abstract

The Tax Cuts and Jobs Act gives families more opportunities to save and pay for education options. The law expands the uses of 529 college savings accounts to include K–12 private school tuition, giving families more freedom with their own savings, while not having to pay federal taxes on the growth of such savings. 529 plans can now be used in addition to the private school choice laws available in some states to create an educational experience that meets a child's needs. Families can save their own money in a 529 plan and, if they live in a state with an education savings account, K–12 private school voucher, or tax credit scholarship law, also participate in those opportunities. Although additional allowable uses should be incorporated in the future, such as the option of using a 529 to pay for K–12 tutoring or homeschooling, the new law gives American families more education options with their own savings, putting the attainment of the American Dream within closer reach for families and students across the country.

The Tax Cuts and Jobs Act provides families with more opportunities to save and pay for education options that are the right fit for their children. The law expands the uses of "529 college savings accounts" (named after Section 529 of the U.S. Code) to include K–12 private school tuition.

529 plans are tax-neutral investment accounts that remove the second layer of tax on savings and investment for families who save for higher education and now K–12 private school tuition expenses. Withdrawals from 529 accounts used to pay for eligible expenses are not subject to federal income tax. The Tax Cuts and Jobs Act,

Key Points

- 529 plans are tax-neutral investment accounts that remove the second layer of tax on savings and investment for families who save for higher education and now K–12 private school tuition expenses.
- Withdrawals from 529 accounts used to pay for eligible expenses are not subject to federal income tax.
- The popularity of 529 savings plans has risen over the past decade, with investments in the accounts growing from $2.4 billion in total investments in 1996—the year the accounts were codified in federal law—to more than $133 billion in 2009. Since then, 529 holdings have doubled to $275 billion.
- Under the new law, families can contribute to 529 plans, benefit from interest accruing in the accounts free from federal tax penalties (and in some cases state tax penalties), use those funds for K–12 private school tuition, and postsecondary expenses.
- Families can spend up to $10,000 annually on tuition expenses at an elementary or secondary public or private school.

This paper, in its entirety, can be found at **http://report.heritage.org/bg3274**

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signed into law December 21, 2017, simplifies the process of saving for a child's K–12 and postsecondary education needs and gives families more freedom with their own savings.

Advancing Education Choice Through Tax Reform

The Trump Administration's support for K–12 private school choice is welcome, but federal officials should acknowledge the appropriate constraints on Washington's ability to advance education choice. Federal efforts should be limited to areas within Washington's jurisdiction over non- or inter-state populations, including Native American children attending Bureau of Indian Education schools, children of members of the armed services, and District of Columbia students.

State policymakers are rightfully expanding students' learning opportunities around the U.S. The steadily growing enrollment of students in public and private education choice options—three million public charter school students and nearly a half million K–12 private school students using a scholarship or education savings account, and counting—are the result of state lawmakers and coalitions.

However, Washington oversees the federal tax code, and the recent Tax Cuts and Jobs Act reformed the tax benefits of 529 savings accounts to treat savings for K–12 education and higher education in a similar manner. The popularity of 529 savings plans has risen over the past decade, with investments in the accounts growing from $2.4 billion in total investments in 1996—the year the accounts were codified in federal law—to more than $133 billion in 2009.[1] Since then, 529 holdings have doubled to $275 billion.[2] By contrast, Coverdell savings accounts, which are limited to contributions of just $2,000 annually for K–12 and college expenses, had aggregate deposits of just $718 million in 2009, a fraction of the $133 billion invested in 529 accounts that same year.[3]

The new tax law gives families a simple way to prepare for their student's K–12 and potential college career. Furthermore, in states where lawmakers have enacted private school choice opportunities such as K–12 education savings accounts and private school scholarships, parents will have another way to use personal funds to pay for additional learning opportunities.

To understand the implications of the new tax law, lawmakers, taxpayers, and families should recognize the distinctions between state private school choice laws and federal K–12 and college savings plans.

530 College Savings Plans (Coverdell Savings Accounts). Federal lawmakers established Coverdell education savings accounts in 2001. President George W. Bush signed the accounts into law as part of the Economic Growth and Tax Reconciliation Act. The accounts, named after the late Senator Paul Coverdell (R–GA), allow individuals, families, and organizations to invest after-tax dollars into a designated beneficiary's account. Interest that accrues in the accounts grows tax-free (free of federal tax), as long as funds are used to pay for qualified higher education and K–12 education expenses.

Any individual or organization can contribute to a Coverdell account on behalf of a designated beneficiary; there is no limit to the number of accounts that can be established for a designated beneficiary. However, contributions to all accounts for a beneficiary cannot exceed $2,000 annually. Once funds are deposited into a Coverdell account, the beneficiary can make distributions free of federal taxation in order to pay for qualified K–12 and higher education expenses.[4] All funds must be expended by the time a beneficiary reaches the age of 30 (excepting students with special needs).[5] Families can use their Coverdell accounts for:

- K–12 expenses such as private school tuition, as well as tutoring, books, transportation, and computer technology, and

1 Lindsey Burke and Rachel Sheffield, "Continuing the School Choice March: Policies to Promote Family K–12 Education Investment," Heritage Foundation *Backgrounder* No. 2683, April 25, 2012, http://thf_media.s3.amazonaws.com/2012/pdf/bg2683.pdf.

2 The College Savings Plans Network, "529 Report: An Exclusive Year-End Review of 529 Plan Activity," March 2017, http://www.collegesavings.org/wp-content/uploads/2015/09/FINAL-CSPN-Report-3.20.pdf (accessed December 21, 2017).

3 Lou Carlozo, "Tax-free Coverdell Savings Accounts Saved by Congress," Reuters, February 13, 2013, https://www.reuters.com/article/us-college-savings-coverdells/tax-free-coverdell-savings-accounts-saved-by-congress-idUSBRE91C13420130213 (accessed December 21, 2017).

4 Internal Revenue Service, "Tax Topics: Topic Number: 310—Coverdell Education Savings Accounts," https://www.irs.gov/taxtopics/tc310 (accessed December 21, 2017).

5 26 U.S. Code § 530.

- Higher education expenses, such as tuition, textbooks, and room and board.

529 Prepaid Tuition Plans. With 529 college prepaid tuition plans, parents and families can buy units of college tuition at today's prices.[6] States manage the investments. For example, in Georgia, the state treasurer allows families to prepay tuition at state colleges and universities at today's rates.[7] Approximately half of U.S. states offer such prepayment accounts, although some are closed to new investors.[8] The Tax Cuts and Jobs Act did not revise laws pertaining to prepaid tuition plans.

529 Savings Plans. Federal lawmakers created 529 savings plans through the Small Business Job Protection Act of 1996. 529 college savings accounts are tax-neutral savings plans that help families save for their child's K–12 and postsecondary expenses. These accounts, like their Coverdell counterparts, allow individuals to open up an investment account and contribute after-tax dollars, with any interest that accrues growing tax-free as long as funds are used for qualified education expenses. 529 accounts are municipal securities regulated by states and (generally) managed by private investment firms. As with Coverdell, 529 accounts are codified in federal law, but states manage the investments and have discretion over plan features and tax rules.[9] In addition to interest growing free of federal tax in a 529 plan, most states also allow interest to accrue without a state tax penalty, as long as funds are put toward eligible higher education expenses. Moreover, of the 44 states that levy an income tax on earnings, 34 states and Washington, DC, allow families to receive tax credits or deductions for investments in their state's 529 plan, with five of those states (Arizona, Kansas, Missouri, Montana, and Pennsylvania) providing a state income tax deduction for investment in a 529 plan managed by any other state.[10]

The average 529 investor has more than $32,600 saved in her child's 529 plan by the time that child reaches the age of 17.[11] In addition to the benefit of 34 states and Washington, DC, providing state tax deductions for contributions into 529s, along with the federal tax benefits, 529 accounts also have a much higher cap than Coverdell accounts on annual deposits. Parents and families can contribute up to $14,000 per year without incurring tax penalties, along with lump sum contributions of $70,000 for individual benefactors and $140,000 for joint contributions.[12] In most states, total contributions to 529 accounts are capped at $300,000 per beneficiary.[13] No income restrictions exist on either the contributor to a 529 plan or the beneficiary of a 529 plan.[14]

Under the new law, families can contribute to 529 plans, benefit from interest accruing in the accounts free from federal tax penalties (and in some case state tax penalties), and use those funds for K–12 private school tuition and postsecondary expenses. Families can spend up to $10,000 annually on tuition expenses at an elementary or secondary public or private school.

K–12 Education Savings Accounts, Private School Vouchers, and Tax-Credit Scholarships. K–12 education savings accounts, vouchers, and tax-credit scholarships are state laws. With education savings accounts, as enacted in Arizona, Florida, Mississippi, Nevada, North Carolina, and Tennessee,

6 U.S. Securities and Exchange Commission, "An Introduction to 529 Plans," https://www.sec.gov/reportspubs/investor-publications/investorpubsintro529htm.html (accessed December 21, 2017).

7 See Path2College, "529 Plan," https://www.path2college529.com/plan/save.shtml (accessed December 21, 2017).

8 For more information, see Edvisors, "Prepaid Tuition Plans—Listed by State," https://www.edvisors.com/plan-for-college/saving-for-college/prepaid-tuition-plans/state-list/ (accessed December 21, 2017).

9 Raquel Meyer Alexander and LeAnn Luna, "States Battle to Win 529 Plan Investors: Differences Lead to Complexity and Confusion," University of Kansas, August 8, 2005, http://taxprof.typepad.com/taxprof_blog/files/alexander_luna.pdf (accessed December 21, 2017).

10 Tom Anderson, "It's 529 Day, and 68 Percent of People Don't Know What a College Savings Plan Is," CNBC, May 29, 2017, https://www.cnbc.com/2017/05/26/its-529-day-and-68-percent-of-people-dont-know-what-a-529-plan-is.html (accessed December 21, 2017).

11 Ibid.

12 Ibid.

13 AXA Group, "529 Plans: The Ins and Outs of Contributions and Withdrawals," https://us.axa.com/goals/saving-for-college/articles/529-plans-contributions-withdrawls.html (accessed December 21, 2017).

14 Internal Revenue Service, "529 Plans: Questions and Answers," https://www.irs.gov/newsroom/529-plans-questions-and-answers (accessed December 21, 2017).

parents access a portion of a K–12 student's funds from the state funding formula—no federal taxpayer funds are involved—to buy educational products and services.[15] Parents and students can hire personal tutors, pay private school tuition, save for college in some states, and pay for online classes, among other allowable uses. Parents can choose multiple products and services simultaneously and save unused funds in the accounts from year to year.

K–12 private school vouchers, which generally use taxpayer money from state general funds, and state tax-credit scholarships are also available in more than half of U.S. states. Tax-credit scholarships allow students to attend private school using charitable contributions to nonprofit scholarship organizations that award scholarships to eligible students. Donors receive a tax credit on their state taxes for their contribution.

Such laws are often enacted with the specific purpose of helping students from low-income families. Wisconsin lawmakers operate the nation's oldest K–12 private school voucher law in Milwaukee, which is available to low-income students living in the city.[16] Florida lawmakers and scholarship organizations operate the nation's largest private school scholarship program, and some 100,000 low-income students use these scholarships to attend private schools.[17]

The important distinction between 529 plans and education savings accounts, vouchers, and other private school scholarship laws is that with 529 plans individuals and families are using their own savings. Education savings accounts and other state K–12 scholarship laws allow students to use state taxpayer resources or charitable contributions to scholarship organizations to attend private school or buy educational products and services.[18]

The significant policy change is that now, along with these state-level K–12 public and private school choice options, families can use 529 plans to find quality private education opportunities for their children.

For example, a family living in Georgia could invest their savings in a 529 investment plan that South Carolina's treasurer maintains, although the child could choose to attend college in Tennessee. Under the new tax law, this family could save money in 529 plans and make tax-free withdrawals for in-state K–12 private school tuition.[19]

Other families may have a quality K–12 traditional school option and choose to save money in a 529 plan exclusively for postsecondary expenses. Either way—whether a family chooses to spend some of their child's savings for K–12 uses or all for college—parents can make the choice that is in the best interest of their child. Parents have more flexibility with their own savings for their child's educational benefit.

States, Private School Choice, and 529 Plans

529 plans can now be used in addition to the private school choice laws available in some states to create an educational experience that meets a child's needs. If they choose, families can save their own money in a 529 plan and, if they live in a state with an education savings account, K–12 private school voucher, or tax-credit scholarship law, also participate in those opportunities.

While money from a 529 cannot be deposited in a state education savings account or added to a private school scholarship, families can save with a 529 and use their funds to help pay K–12 private school tuition over and above what an account or private school voucher may cover.

15 For more on these accounts, see Jonathan Butcher, "A Primer on Education Savings Accounts: Giving Every Child the Chance to Succeed," Heritage Foundation *Backgrounder* No. 3245, September 15, 2017, http://www.heritage.org/sites/default/files/2017-09/BG3245.pdf.

16 See Wisconsin Department of Public Instruction, "Private School Choice Programs," https://dpi.wi.gov/sms/choice-programs (accessed December 21, 2017).

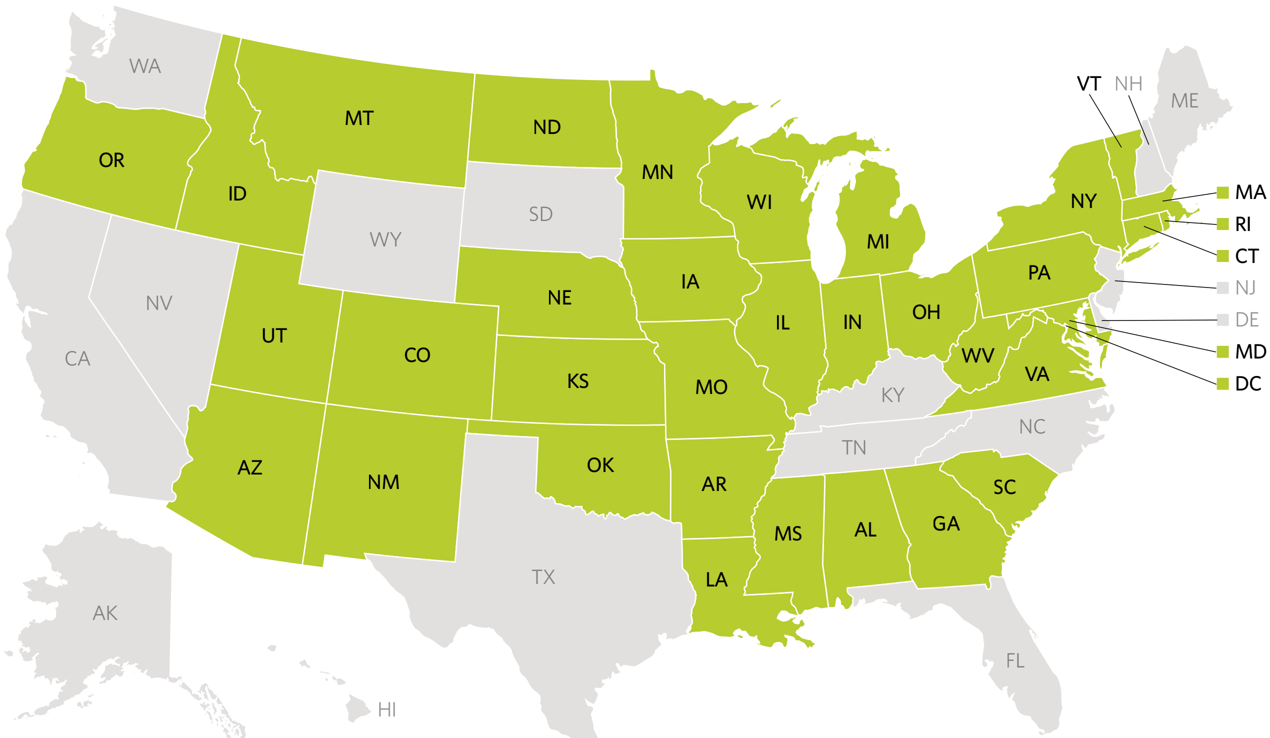
17 See Florida Department of Education, "Florida Tax Credit Scholarships," http://www.fldoe.org/schools/school-choice/K-12-scholarship-programs/ftc/ (accessed December 21, 2017), and Travis Pillow, "Nation's Largest Private School Choice Program Tops 100,00 Students," redefinED, August 8, 2017, https://www.redefinedonline.org/2017/08/nations-largest-private-school-choice-program-tops-100000-students/ (accessed December 21, 2017).

18 For more on the differences between state school choice laws, see Jonathan Butcher, "West Virginia and Education Savings Accounts," Cardinal Institute, September 19, 2016, pp. 4–8, http://www.cardinalinstitute.com/publication/west-virginia-and-education-savings-accounts/ (accessed December 21, 2017).

19 U.S. House of Representatives, Conference Report on H.R. 1, 115th Cong., 1st Sess., http://docs.house.gov/billsthisweek/20171218/CRPT-115HRPT-466.pdf (accessed December 21, 2017).

MAP 1

States that Allow State Tax Deductions or Credits for Contributions to 529 College Savings Plans



SOURCE: Vanguard, "529 State Tax Deduction Calculator," https://vanguard.wealthmsi.com/stdc.php (accessed December 18, 2017).

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For example, the new federal law allows families in Pennsylvania, where students have had access to private school scholarships since 2001, to use savings in a 529 plan to help cover private school tuition.[20] Families in Mississippi, where children with special needs can use education savings accounts, can use 529 savings to help pay private school tuition.[21]

In states where lawmakers have not enacted such laws, families that want to send their child to a private school have more of an incentive now to begin saving for a child's K–12 and postsecondary expenses as early as possible. For students that decide to enroll in college, the new tax law gives families a new way to pay for a private K–12 experience to help prepare them for life after graduation.

Meanwhile, state lawmakers should recognize the extra efforts families make to provide a quality education for their child and consider enacting education savings account and private school scholarship laws. State lawmakers can also help families as they save for a child's education by providing state tax deductions for deposits in 529 savings plans.

The federal move to expand the allowable uses of 529 savings plans will allow parents to help pay for private school tuition with a family's own savings—

20 Pennsylvania Department of Education, "Opportunity Scholarship Tax Credit Program," http://www.education.pa.gov/K-12/opportunity%20scholarship%20tax%20credit%20program/pages/default.aspx#tab-1 (accessed December 21, 2017).

21 For more on Mississippi's education savings accounts, see Mississippi Department of Education, "Education Scholarship Account Overview," http://www.mde.k12.ms.us/ose/esa (accessed December 21, 2017).

and not have to pay federal taxes on the growth of such savings. In addition to the federal tax benefits of 529 plans, 34 states offer parallel tax deductions for contributions to the accounts.

Policy Recommendations

Expanding the uses of 529 savings plans to include K–12 private school tuition can help more families find quality education options for their child. However, prior versions of the Tax Cuts and Jobs Act demonstrate how federal lawmakers can improve K–12 and college savings plans in the future.

- **Combine Coverdell Savings Accounts and 529 Plans.** As Heritage has suggested in the past—and as was included in the U.S. House of Representatives' version of the tax proposal—lawmakers should streamline the federal tax code by eliminating Coverdell Savings Accounts. Now that 529 plans can be used for K–12 expenses, taxpayers could benefit from a simpler tax code with one federal savings tool that includes elementary, secondary, and postsecondary options.

- **Allow Families to Save for Learning Options in Addition to K–12 Private School Tuition and College Expenses.** Federal lawmakers should expand the uses of 529 savings plans to include personal tutors, education therapy, online classes, textbooks and curriculum, apprenticeship programs, and job-training expenses. Some of these expenses were considered in prior versions of the Tax Cuts and Jobs Act and should be revisited in the future. This change would allow students from more walks of life to save for personal improvement in education. Homeschool students, for example, would benefit from being able to use all or a portion of their 529 account for K–12 expenses. Moreover, individuals who choose not to attend college could save in a 529 plan for K–12 uses and then use some of their savings for job-training and apprenticeship opportunities.

Giving Families and Students More Options with Their Own Savings

At present, all fifty states offer either 529 college savings accounts or prepaid tuition plans (49 out of 50 offer college savings plans, 13 offer prepaid tuition plans, and 17 offer both).[22] The Tax Cuts and Jobs Act provides families with an additional savings vehicle through which they can choose private education options that are a good fit for their child.

While the Tax Cuts and Jobs Act is a good start in expanding K–12 and postsecondary options, prior versions of the law demonstrate how federal lawmakers can improve the law in the future. Still, the new law gives American families more education options with their own savings, putting the attainment of the American Dream within closer reach for families and students across the country.

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22 College Savings Plans Network, "What is a 529 Plan?" http://www.collegesavings.org/what-is-529/ (accessed December 21, 2017).