529 plans aren’t just for college anymore

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Section 529 College Savings Plans — commonly referred to as simply “529 plans” — were introduced in their current form in 2001. Traditionally these plans have been used by families to save and invest for their children’s and grandchildren’s college educations. However, legislative reform over the last decade has impacted how 529 plans can be used as an educational funding vehicle.

529 plan basics

529 plans are investment accounts administered by a mutual fund provider, insurance company or bank. Each plan is sponsored by a state, and some states sponsor more than one plan. Families can select a 529 plan from any state regardless of their residence or the location of the school their student attends.

The primary advantage of a 529 plan is their significant tax benefits:

- **Tax reduction —** In some cases, a single contribution to a 529 plan can reduce a family’s state income taxes, federal income taxes and federal estate taxes!
- **Tax-free withdrawals —** 529 plans provide for tax-free withdrawals of principal and earnings when they are used for “qualified” education expenses, such as college tuition, room and board, computers, fees, or for “qualified” tuition for kindergarten through 12th grade. (Taxes and tax penalties may apply to non-qualified withdrawals.)
- **Assets not included in the owner’s estate—** While these accounts are typically owned by a parent or grandparent (owners retain control of investment decisions and have the sole ability to make withdrawals), assets are removed from the account owner’s estate when calculating federal estate taxes.
- **Flexibility to exceed annual gift exclusion —** Parents and grandparents are also able to exceed the annual gift tax exclusion amount (currently $18,000) by “super funding” up to five years of contributions in a single year.
- **State tax benefits —** Many states (including Illinois) provide state tax benefits for contributions to 529 plans. For example, Illinois provides a state tax deduction for contributions to an Illinois-sponsored 529 plan (up to $10,000 for single taxpayers and $20,000 for those married filing joint returns).

Using a 529 plan for K-12 tuition

There are notable differences in what is included as a “qualified” expense for primary and secondary school costs versus college costs. Qualified K-12 withdrawals can only be used for school tuition (not books, computers or other fees). Withdrawals for educational camps or other enrichment programs are not qualified and may also be subject to taxes and tax penalties.

Caution! Many states have not updated their tax codes

While withdrawals for K-12 tuition may be exempt from federal taxation, many states have not updated their tax codes to provide for the same tax treatment. Additionally, states may not have updated the guidelines for their own state-sponsored 529 Plans.

For example, as of this writing, Illinois’s tax code has not been modified to treat K-12 withdrawals as a “qualified” expense. A withdrawal from Illinois-sponsored *Bright Start* and *Bright Directions* 529 plans for K-12 tuition expenses is not a qualified expense for Illinois tax purposes, and may be subject to income taxes, recapture of tax deductions, and tax penalties.

In contrast, many states have adopted the language used by the TCJA, and will treat withdrawals for primary and secondary school tuition as “qualified” for their states’ 529 plans and income tax reporting.

Caution! Don’t overlook the power of tax-deferred growth

One of the most powerful benefits of 529 plans is their ability to defer taxation on investment growth over longer-term timeframes. In most cases, this tax deferral will provide the greatest benefit when used for college costs. For families who have yet to accumulate sufficient assets for their college goals, it may be most efficient to use their 529 plans to target college costs, and to use other resources for their shorter-term primary and secondary school needs.

Once enough assets have been accumulated in a 529 plan for college expenses, various strategies can be used to maximize state and federal tax benefits. These strategies include “super funding” accounts for children and grandchildren, and/or by taking advantage of tax-free rollovers of transfers from one family member to another.

529 ABLE accounts

TCJA changed the way that families can contribute to a 529 ABLE account. As of January 1, 2018, 529 plan assets can be rolled over into a 529 ABLE account on a tax-free basis. Like 529 College Savings Plans, 529 ABLE accounts provide for tax-free withdrawals of principal and earnings when used for qualified expenses. These accounts are available for disabled individuals, and qualified expenses include housing, transportation and medical expenses.

Rollovers to 529 ABLE accounts are included in the annual contribution limit ($18,000 for 2024). It is also important to note that there are important limitations that apply; for example, there are strict rules about who qualifies as an account beneficiary, the maximum balance allowed in the account, and the distribution of remaining funds upon the beneficiary's death.

Next steps

We understand that many of our clients' investment objectives include providing for their children's educations and being certain that disabled family members have access to appropriate financial resources. As we monitor the evolution of the 529 College Savings Plan and the 529 ABLE programs, we will respond to the changing regulatory landscape to assure our solutions are relevant to each household's individual goals.

In partnership with your tax professional, we look forward to discussing how these tax changes may impact your education planning strategy going forward.

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