Top 10 Tax Facts for 529 College Plans in 2019

(Expanded version)

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IRC Section 529 plans are a valuable way to save funds for a child's college or other education expenses, but the fact remains that many clients don't fully understand the rules that apply to these types of accounts. The issue is compounded by the changes made to the 529 plan rules under Trump's tax reform bill. Here are the top ten things that clients need to know about funding a Section 529 plan in 2019.

1. 2019 Contribution Limits

Contributions to a Section 529 plan are limited by the maximum lifetime limits of a plan and the annual gift tax exclusion amount—meaning that clients can contribute up to $15,000 per year in 2019 without a gift tax liability if no other contribution is made to the beneficiary. 529 plans also offer the chance to bundle contributions – allowing for a $75,000 contribution in one year rather than over a five-year period for gift tax purposes.

2. Taxation Upon Distribution

IRC Section 529 education savings plans are funded with after-tax dollars that are permitted to grow on a tax-free basis (and function much like a Roth IRA), so that distributions from the account are not taxed when received so long as they are used to pay for qualified higher education expenses. Nonqualified distributions—those not used to pay for qualified education expenses—are included in gross income, but only to the extent that the distribution represents earnings on amounts that were contributed. In other words, the after-tax funds that were originally contributed would not be taxed a second time upon distribution.

3. What Exactly Is a "Qualified Education Expense"?

Qualified education expenses include the cost of tuition itself, as well as the cost of fees, books, supplies and equipment that is required for the plan beneficiary's enrollment at an eligible education institution, as well as reasonable costs for room and board (although room and board costs may be subject to specific limits, such as the actual amount charged by the school for student housing). Qualified expenses also include costs related to special needs services incurred in connection with a special needs beneficiary's enrollment or attendance at an educational institution.

4. Using 529 Plans for Elementary and Secondary School Expenses

In addition to the typical use of Section 529 plan funds to finance expenses related to a beneficiary's college education, the 2017 tax reform legislation expanded Section 529 college savings plans to permit the use of up to $10,000 per year for elementary or secondary school expenses. The expansion of Section 529 plans to include elementary and secondary school

expenses means that some clients may wish to open a second Section 529 plan in order to plan for K-12 school expenses.

However, the $10,000 amount applies on a per-student basis (rather than a per-Section 529 account basis), meaning that if the student is beneficiary of several accounts, he or she can only receive a maximum of $10,000 from all accounts (amounts above the $10,000 will be taxable). Clients who wish to take advantage of this new rule must also remember to check the terms of the plan itself—the law only makes it permissible, and some 529 plans may not have changed their rules to permit this use.

5. Homeschooling and 529 Plan Funds

Many clients may have glossed over an article while the 2017 tax reform legislation was being debated, and may now question whether Section 529 plan funds can be used for the expenses relating to homeschooling a child—which is becoming much more popular with each passing year. The answer is "not yet". The provision that would have allowed up to $10,000 in 529 plan funds to be used for homeschooling expenses was taken out of the tax reform bill at the last minute, although the issue has been reintroduced for discussion.

6. Multiple Children and 529 Plans

Clients are permitted to fund multiple Section 529 plans for different children or beneficiaries without incurring gift tax consequences, as long as the annual contribution for any particular beneficiary does not exceed the annual contribution limit ($15,000 in 2019). The client is also permitted to change the original account beneficiary—for example, if one child chooses not to attend college, those funds could be used for another child.

7. How Do Tax Credits Impact Taxation of 529 Plan Distributions?

The student may use Section 529 plan funds and still qualify for education-related credits such as the American Opportunity or Lifetime Learning tax credits, so long as the same amounts are not used to cover the same qualified education expenses. Students are also required to reduce the total amount of their "qualified education expenses" by certain scholarships that they receive.

8. Contribution Deadlines for 529 Plans

The rules governing contribution deadlines vary by state. Some states impose a strict December 31 deadline—meaning that the funds must be received and deposited into the account by December 31, 2019, to qualify as a contribution for the 2019 tax year. In some states, the contribution need only be postmarked by December 31, 2019, to qualify as a 2019 contribution. Other states model their deadline after the IRA contribution rules, and may allow contributions to count for 2019 if they are deposited by the April 15, 2020, tax filing deadline.

9. 529 Plans and ABLE Accounts

The 2017 tax reform legislation also amended the previously existing provisions to allow Section 529 plan funds to be rolled over into an ABLE account for the designated beneficiary or the designated beneficiary's family member. ABLE account rules are similar to those governing 529 plans, but the funds receive tax-preferred treatment upon distribution because they are used for the benefit of a disabled individual.

These rollovers are permitted in an amount up to the annual Section 529 plan contribution limit (rollovers offset any other contributions made to the ABLE account for the year). Amounts rolled over in excess of the limitation are included in the distributee's gross income upon distribution. This new rule is temporary, however, and is currently only effective for rollovers that occur after December 31, 2017, and before January 1, 2026.

10. New Funding Strategies to Consider Post-Reform

For tax years beginning after 2017 and ending before 2026, the 2017 tax reform legislation doubled the value of the child tax credit, increasing its total value from $1,000 to $2,000 per child under age 17 (i.e., a married couple with two children under 17 may receive an extra $2,000 per year, assuming they do not cross the income thresholds). $1,400 of this per-child credit is now refundable, and only this refundable portion will be adjusted annually for inflation going forward. Because a portion of the child tax credit is refundable, the client may receive it even if he or she does not owe any additional taxes to the IRS (meaning that it can be received as a refund).

The child tax credit now begins to phase out only when the client's adjusted gross income (AGI) reaches $400,000 (for joint returns) or $200,000 (for all other filers). This is a substantial increase from the previously applicable income restrictions, and many clients may consider using the extra funds to fund a tax-preferred Section 529 plan.

- ***Check out previous coverage of the post-reform child tax credit in Advisor's Journal.***
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