Tax Cuts and Jobs Act Has Changed 529s

The Tax Cuts and Jobs Act, characterized as the first major reform of the Internal Revenue Code in 31 years, brings a lot of changes to individuals and businesses alike.

The legislation slashes the top corporate tax rate to 21 percent, lowers the top marginal rate for individual taxpayers to 37 percent, eliminates or scales back several popular deductions, reduces taxes on business income earned by pass-through businesses, doubles the estate tax exemption, and substantially enhances immediate expensing of capital investments.

It also impacts how families save for college—especially with respect to 529 plans. But there are some details still being worked out. Let's explore.

529 Plans

Designed to promote saving for future college costs, a 529 plan is a tax-advantaged savings plan authorized by Section 529 of the Internal Revenue Code. Sponsored by every state and the District of Columbia, there are two types of 529 plans: Prepaid Tuition Plans and College Savings Plans.

In simple terms, a Prepaid Tuition Plan allows you to effectively lock-in tuition costs to avoid tuition inflation; whereas, a College Savings Plan is a tax-advantaged investment account.

With a 529 savings accounts, you can set aside after-tax contributions that grow tax free—the proceeds can be used for qualified educational expenses, such as tuition, room and board, and books. Many states offer tax breaks and credits to residents, so it's worth examining the 529 plan offered in your state. But it's important to know that many states no longer offer a Prepaid Tuition Plan, so talk to a financial advisor well-versed in your state's offerings.

Consider 529s as Education Accounts

The Tax Cuts and Jobs Act changed the 529 plan in a few ways. Parents might want to consider 529s as education savings accounts rather than simply college savings accounts. Under the new rules, money from a 529 can be used tax-free on qualifying expenses for K-12 private and religious schools.

What Are Qualified Expenses?

Before the Tax Cuts and Jobs Act, qualified expenses were those incurred at post-secondary school and included tuition, fees, books, supplies, and equipment. While these qualified expenses still exist, the list of qualified expenses was increased to include expenses from K-12 as well as religious schools. But there is a catch to the new K-12 rules: those expenses can cover no more than $10,000 during a tax year beginning after 2017.

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The State Tax Deduction Challenge

Right now, earnings on qualified withdrawals for K-12 expenses are tax-free at the federal level for everyone. However, the withdrawals may or may not be state tax-free, and any tax benefits taken on deposits may be subject to recapture. The challenge is that every state has its own unique tax laws on 529 plans and not every state has amended their laws to mirror the federal law when it comes to K-12 expenses.

So, parents need to exercise caution if they are considering withdrawing money to pay for tuition at a K-12 school because they may incur state tax penalties. Right now, according to the College Savings Foundation, approximately 20 states treat K-12 expenses the same as federal law, as their legislation mirrors federal definitions. But it's important that parents review their chosen program to determine whether or not there may be state tax penalties.

For example, the Alabama plan warns parents that "the Alabama statute establishing the Plan does not permit such distributions and will need to be modified to permit such distributions."

It's unclear of course how the remaining states will proceed, because this is likely to become a political football. The key is to understand how your state treats 529 withdrawals to pay for tuition at a K-12 school.

The 529 ABLE Account

529 ABLE is an acronym for "Achieve a Better Life Experience." These accounts were established in 2014 to allow families with disabled children to save in a tax-deferred account. One of the benefits of these accounts is that, as long as the account does not exceed $100,000, they do not count as assets when determining state and federal aid eligibility.

The new Tax Cuts and Jobs Act allows parents to roll over annual gift limit amount (up to $15,000 for 2018) from an existing 529 account into a 529 ABLE account for the same beneficiary. This is great news for families because regular 529 plans typically count against state and federal benefits.

Revisit Your Education Savings Strategies

The rising costs of education and the potential burden of student loans have made saving for education more important than ever. And while the laws are constantly changing, remember this:

It's never too early to begin your child's education funding plan.

However, as with other types of financial planning, bear in mind that your child's education funding plan requires a disciplined approach that emphasizes consistency with your overall goals and objectives.

Planning is Key

Here is where planning comes in: a financial advisor can help you establish a goal and determine how much you need to (and can) save for your child's education. More than simple saving, this means creating a plan and choosing the right investment vehicles so that you can increase growth potential and steadily accumulate more for education.

Your biggest advantage for saving for education is time. The sooner you start saving, the more time you have to grow your education fund through long-term compounding. Even the smallest contributions make a difference over many years.

Let me know when I can help you build a customized education savings plan for you and your children.