

# NAIS LEGAL ADVISORY

## New 529 Plan Legislation

Debra P. Wilson, NAIS General Counsel, [wilson@nais.org](mailto:wilson@nais.org)  
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While the wild ride to tax reform at the end of 2017 had many twists and turns, it also contained a potential helping hand. The legislation included a provision that allows families who send their children to tuition-based schools, whether they are independent, religious, or public, to use up to \$10,000 per student from 529 plan funds. This change can provide families with tax benefits that have tended to be just for higher education expenses. This overview provides insight into how these plans will work for independent schools and their families.

### 529 Plans Generally

529 plans are state-based plans primarily designed to allow for the tax-free growth of investment funds that are used for qualified expenses. These expenses have historically only included higher education related costs. The plans invest funds over time, under the name of the “owner” of the account for the benefit of the “beneficiary” named on the account. Any interest or investment income earned on the funds are tax-free, provided they are used for the qualified expenses as designated by the tax code. Each state has at least one plan and the terms of the plans can vary slightly. The definition of qualified expenses was expanded as of January 1, 2018, to also allow those funds to be used for tuition in independent schools. The new language provides that qualified higher education expenses can now include up to \$10,000 per student to be used for independent school tuition. For families with very young children, this benefit is potentially substantial as families can put much of their long-term educational investments in one place to grow tax-free.

The secondary benefit to 529 plans is that most states allow for some form of state income tax deduction when a deposit is made to the 529 account. Depending on the size of the deduction allowed by the state, this can be a substantial amount. For independent schools, this means that a family with two students paying \$25,000 of tuition can deposit \$10,000 in an account for student A and \$10,000 in

an account for student B and use those funds for tuition payment. Depending on the state, the combined \$20,000 may then be taken as a state income tax deduction. This deduction may also [sometimes](#) be taken when grandparents or others contribute to or create a 529 account for a student. States differ on deductions, so it is best to look carefully at [your state's approach](#).

## State Plan Issues

At this point, the federal law is in effect. 529 plan funds can be used by families to pay up to \$10,000 per child. The legislative change should be easy to implement because the language simply adds that the definition of qualified higher education expenses now includes up to \$10,000 of private school tuition. However, the plans themselves are individual plans based in each state and each plan has its own policies and procedures. Some of the plans reference the federal language generally, making this transition simpler and hopefully automatic. Some do not and will require modifications to mirror the federal language. This federal law is very new and it is likely that most 529 plans have not yet assessed how this change will impact their processes. Schools and parents should reach out to the plans within their states to determine how the individual plan will manage the change incorporating elementary and secondary school tuition.

There is also the possibility that some states may not want to allow this change within current plans or may alter state tax law to limit the deduction as this change to tax law can directly affect state coffers. Such changes would likely have to happen at the state legislative level. Schools should watch this particular state legislative area carefully and be aware of any potential changes here.

## Deposit and Withdrawals

A common question is whether funds must be in a 529 plan for a period of time. There is no federal requirement for the funds to stay in a 529 account for any specific window of time, although the separate plans may have different requirements. This means that, if a plan allows for fees to be used for K-12 tuition without a holding window, the funds can be deposited and then used to pay for tuition within a fairly limited period of time (presumably the transfer must fully occur first). Payment is generally then made either directly from the 529 account to the educational institution as directed by the owner, or to the account holder who must then maintain documentation that they used the funds for the appropriate expenses if asked by the IRS. Depositing and then almost immediately withdrawing

the funds obviously does not take advantage of the tax benefit of having investments grow tax-free, but it does potentially allow the account owner to use the state tax deduction. Parents should carefully check the withdrawal rules for the 529 plans they are considering and independent schools should be familiar with the practices of the plans in their state.

Another common question is whether there is a limit on how much can be deposited into a 529 plan account. The only limits are those imposed by the state plans. There is no limit on using the 529 funds for higher education purposes, but the new legislative language requires that no more than \$10,000 be used toward tuition for a single student's independent school tuition in a given year. For example, South Carolina has no limit on the amount of money that may be deposited into a 529 plan. Mr. and Mrs. Jones may deposit \$100,000 into an account for Sally in 2018. South Carolina also allows for an unlimited state tax deduction of that amount. However, Mr. and Mrs. Jones may only use up to \$10,000 a year of that 529 plan fund for Sally's independent school tuition in any single year. The remaining money continues to grow, tax-free, provided it is used for either \$10,000 a year in independent school tuition, or ultimately for Sally's expenses related to higher education.

## Receiving Funds

Beyond the parents, independent schools are wondering what sort of impact using 529 plan funds may have on the school itself. The effect of the 529 plan funds is mostly a tax one for the plan owner and beneficiary, not the recipient of the funds. The owner of the plan never relinquishes control over the funds and the funds are not considered "federal funds" or "federal financial assistance." That being said, individuals need to be able to show they used the funds for qualified expenses, namely tuition, to retain the federal tax-free investment growth benefit. School tuition statements or receipts should be sufficient for this purpose, but schools should be ready with additional documentation if requested and may want to consider building in such documentation or receipts for individuals as part of their regular accounting process. This is particularly the case if payments are received directly from 529 plans. Such documentation both notifies the individual that payment has been received and provides them with documentation should they need it.

## Tax Forms for Schools

The IRS has not yet issued guidance related to tax forms that may need to be filed by independent schools receiving payment from 529 accounts. The tax form 1098-T currently must be provided by “[eligible institutions](#)” of higher education to parents or students that have paid qualified educational expenses in higher education during the year. These expenses can include those related to eligible expenses under 529 plans, but they are mostly used by individuals who are using the information to file for [tuition deductions or tax credits](#) under different sections of the tax code that do not apply to independent schools. The “eligible institutions” are those within higher education that can participate in federal student aid programs. Again, these are not independent schools. That being said, the IRS could either create a new form or tweak this form to require such reporting by independent schools. Some form of reporting requirement is likely as unlike expenses related to college costs, these expenses do have the \$10,000 limit per child, per year.

## Grandparents and Other Family Members

Grandparents and other family members or friends can also use 529 plans to fund a child’s education while retaining control over the account. Funding a 529 plan does fall within the gift tax exclusion; an individual can make a gift to an individual of up to \$14,000 or a married couple filing jointly can make a gift of up to \$28,000, but unlike with other tools or approaches, the grandparents retain control over the 529 account as the owners. Gifts can also be made in a lump sum gift of \$70,000 (individually) or \$140,000 (if married filing jointly) and the gift can be treated as though it is spread out over five years. Greater gifts can also be made as part of the [lifetime exclusion](#) if the giver would like to use that approach. In some states, the state tax laws allow these nonparent owners to take [a state income tax deduction](#) for their contributions even though the beneficiary is *not* their dependent. To learn more about the gift tax, try [this resource](#).

Schools and parents should note, however, that the new language only allows for \$10,000 from 529 plans to be used per student, per year. This means that parents can make a 529 account payment of \$5,000 from a plan they own, and an uncle and aunt can make a 529 account payment of \$5,000 from an account they own, but the aggregate cannot be more than \$10,000. At this point, it does not appear that there is any obligation on behalf of the receiving independent school to track these payments as the tax benefit is with the individuals and it is their obligation to comply with the law but, as previously stated, that could change.

## What Should Schools Do Next?

Schools must be very careful not to engage in tax advice to parents, grandparents, and others. Schools should familiarize themselves with the 529 plans within their state and understand the deductibility for 529 plan contributions. They should research the 529 plan websites and see if there are any updates related to the use of 529 accounts to pay for independent school tuition and reach out to the 529 plan directly if no such information is available. This may spur the plan into creating processes independent school families can use to access this new benefit and provide the school with “official” documentation from the plan to give to families and others interested in this exciting new benefit. Schools should also revisit their documentation of payments for tuition and make sure that they are regular and clear so that those paying for tuition have clear documentation if they need it.

Schools should also watch for several developments: 1) any additional documentation or steps that the IRS may initiate around this legislation, including new forms; 2) any action that might be needed to encourage the state 529 plan to embrace the federal language; and 3) any legislative action on the state level seeking to limit the state tax deductibility of this recent change. NAIS will keep tracking the federal issues surrounding this important new benefit for independent school families and watch for any state trends that may appear.