



# Tax-Preferred College Savings Plans: An Introduction to 529 Plans

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## Introduction

In the face of the rising cost of higher education, families may consider a variety of ways to finance their children's college expenses. In order to make higher education more affordable, Congress has enacted legislation that provides favorable tax treatment for college savings. Among the options families may choose to save for college, they may consider using tax-advantaged qualified tuition programs (QTPs), also known as 529 plans. This report provides an overview of the mechanics of 529 plans and examines the specific tax advantages of these plans. For an overview of all tax benefits for higher education, see CRS Report R41967, *Higher Education Tax Benefits: Brief Overview and Budgetary Effects*, by Margot L. Crandall-Hollick.

## Overview of 529 Plans

529 plans, named for the section of the tax code which dictates their tax treatment, are tax-advantaged investment trusts used to pay for higher-education expenses. The specific tax-advantage of a 529 plan is that distributions (i.e., withdrawals) from this savings plan are tax-free if they are used to pay for qualified higher education expenses. If some or all of the distribution is used to pay for nonqualified expenses, then a portion of the distribution is taxable, and may also be subject to a 10% penalty tax.<sup>1</sup> (A description of qualified and nonqualified expenses is provided later in this report.)

Generally, a contributor, often a parent, establishes an account in a 529 plan for a designated beneficiary, often their child.<sup>2</sup> Upon establishment of a 529 account, an account owner, who maintains ownership and control of the account, must also be designated. In many cases the parent who establishes the account for their child also names themselves as the account owner.

According to federal law, payments to 529 accounts must be made in cash using after-tax dollars.<sup>3</sup> Hence, contributions to 529 plans are not tax-deductible to the contributor. The contributor and designated beneficiary cannot direct the investments of the account, and the assets in the account cannot be used as a security for a loan. A contributor can establish multiple accounts in different states for the same beneficiary.<sup>4</sup> Contributors are not limited to how much they can contribute based on their income. Similarly, beneficiaries are not limited to how much they can receive based on their income. However, each 529 plan has established an overall lifetime limit on the amount that can be contributed to an account, with contribution limits ranging from \$250,000 to nearly \$400,000 per beneficiary.<sup>5,6</sup>

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<sup>1</sup> The tax will be paid by either the beneficiary or the owner of the 529 plan account.

<sup>2</sup> The individual who maintains and controls the 529 account may not necessarily be a contributor. For example, a grandparent (contributor) could establish a 529 account for their grandchild (beneficiary), but have the child's parents be the account owners who maintain and control the account.

<sup>3</sup> This can include checks, money orders, and credit card payments. Payments cannot be made in the form of securities.

<sup>4</sup> For example, an account can be established for beneficiary X in state A's 529 plan, and an account can be established for beneficiary X in State B's 529 plan. These two plans for beneficiary X can be established by the same contributor or different contributors.

<sup>5</sup> The Internal Revenue Code (IRC) § 529 (b)(6) does require that 529 plans limit the amount of contributions to an account to an amount "necessary to provide for the qualified higher education expenses of the beneficiary."

## Types of 529 Plans: Prepaid and Savings Plans

There are two types of 529 plans: “prepaid” plans and “savings” plans. A 529 prepaid plan allows a contributor (i.e., a parent, grandparent, or non-relative) to make lump-sum or periodic payments that entitle the beneficiary to a specified number of academic periods, course units, or a percentage of tuition costs at current prices. Essentially, the contributor is paying for and purchasing a given amount of education *today* which will be used by the student in the *future*, providing a hedge against tuition inflation. For example, a contributor could purchase in 2011 two years of community college education in the Nevada Tuition Prepaid Program for a newborn for \$4,170 (extended payment plans are available).<sup>7</sup> Generally, a prepaid plan is used to purchase education at a public in-state institution.<sup>8</sup> Prepaid plans are established and maintained by a state or a state agency or by an educational institution.<sup>9,10</sup> Prepaid plans tend to have certain restrictions in terms of the expenses they cover, residency requirements, and eligible educational institutions. In some states, the value of these plans is backed by the full faith and credit of the state government, implying that the state bears the risk of the account performance, not the account holder.

A 529 savings plan allows contributors to invest in a portfolio of mutual funds or other underlying investments.<sup>11</sup> Contributors can make periodic investments directly in the plan, with the ultimate value of these accounts determined by the performance of the underlying investments. In addition, 529 savings plans can be purchased directly from a plan manager (“direct sold”) or purchased through financial advisers (“broker sold”). Unlike prepaid plans, the amount of education which can ultimately be purchased using a savings plan is not guaranteed. Instead the amount of education that can be purchased depends on both the cost of education and the performance of the underlying assets in the 529 savings plan. In addition, the value of savings plans is not limited to tuition at in-state public institutions. Savings plans are established and maintained by a state or a state agency, but tend to be less risky for the state to administer because their value is typically not guaranteed by the state.<sup>12</sup>

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(...continued)

<sup>6</sup> For more information, see [http://www.savingforcollege.com/compare\\_529\\_plans/index.php?plan\\_question\\_ids%5B%5D=308&mode=Compare&page=compare\\_plan\\_questions&plan\\_type\\_id=](http://www.savingforcollege.com/compare_529_plans/index.php?plan_question_ids%5B%5D=308&mode=Compare&page=compare_plan_questions&plan_type_id=).

<sup>7</sup> This is often referred to as the contract price. Joseph F. Hurley, *The Best Way to Save for College: A Complete Guide to 529 Plans 2011-2012* (Pittsford, NY: JFH Innovative LLC, 2011), p. 250.

<sup>8</sup> While all 529 distributions can be used to pay for out-of-state colleges, most prepaid plans provide the greatest benefits for in-state colleges. If a student who has a 529-prepaid plan chooses to go to either an in-state private institution or an out-of state public institution, the prepaid benefits will be set at the equivalent level of public in-state tuitions, with many prepaid plans using a weighted-average credit hour value of in-state public institutions. In addition, the value of the prepaid benefits for out-of-state and private institutions is limited to the *lesser* of the value of in-state tuition and fees or the actual tuition. Hence, if the tuition paid at an out-of state institution is less than in-state tuition, the student will *not receive* a refund for the difference.

<sup>9</sup> Currently, there is one prepaid program operated by an educational institution—the Private College 529 Plan. See <https://www.privatecollege529.com/OFI529/>.

<sup>10</sup> States can hire outside vendors like TIAA-CREF, Merrill Lynch, or Fidelity to manage investments and administrative duties.

<sup>11</sup> For example, a portfolio of equities and bonds whose percent composition changes automatically as the beneficiary ages, a portfolio with fixed shares of equities and bonds, or a portfolio with a guaranteed minimum rate of return.

<sup>12</sup> Similar to prepaid plans, states can hire outside vendors to manage investments and handle administrative duties.

While prepaid 529 plans were the first type of 529 plan established, savings plans have grown in popularity and are now the most common type of 529 plan. There are currently 19 prepaid 529 plans offered in contrast to the over 90 savings plans.<sup>13</sup> In addition, according to the most recent data, of the \$164.9 billion worth of assets in 529 plans at the end of 2011, 87.9% (\$144.9 billion) were held in savings plans, while 12.1% (\$20.0 billion) were held in prepaid plans.<sup>14</sup>

There are a variety of differences between savings plans and prepaid plans which may explain the increased popularity of savings plans. States may be more inclined to offer savings plans because they may be less costly or risky for states to run. Many states back prepaid plans with their full faith and credit. In these cases, states must provide a guaranteed benefit to beneficiaries of 529 prepaid plans, even if they do not have sufficient funds in the state's 529 trust to pay for beneficiaries' college expenses. Hence, these plans can be riskier for states to sponsor.<sup>15</sup> In fact, one of the first 529 prepaid plans established, the Michigan Education Trust (MET) had to close to new beneficiaries shortly after starting because "the program administrators had relied on overly optimistic projections of the rate of return on invested funds in relation to the trust's obligation to pay for rising tuition prices. Simply put, the trust was headed toward insolvency."<sup>16</sup>

Savings plans may also be more common because they are more popular with students and their families. Savings plans generally can be used for more types of expenses at a wider variety of institutions than prepaid plans, making them attractive to parents who may not know where their child will ultimately go to college or how much it may cost.<sup>17</sup> In addition, prepaid programs generally require that either the account owner or beneficiary meet state residency requirements, limiting who can ultimately invest in these plans. The majority of savings programs are open to contributors and beneficiaries irrespective of their residency.

Notably, while there are many differences between prepaid and savings plans, the tax treatment of these plans (which will be described later in this report) is identical. Hence, there is not a greater tax benefit associated with one plan rather than another and contributors may compare other features of these plans detailed in **Table 1** when deciding which plan is the most appropriate type for their needs.<sup>18</sup>

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<sup>13</sup> Joseph F. Hurley, *The Best Way to Save for College: A Complete Guide to 529 Plans 2011-2012* (Pittsford, NY: JFH Innovative LLC, 2011).

<sup>14</sup> These data were provided by the College Savings Plan Network and are available upon request.

<sup>15</sup> In spite of the greater popularity of savings plans, prepaid plans tend to be less risk for parents than savings plans. Unlike 529 savings plans, the purchasing power of prepaid plans is guaranteed. In other words, if you purchase one semester of education at today's prices, you will be able to purchase one semester of education when the child attends college.

<sup>16</sup> Joseph F. Hurley, *The Best Way to Save for College: A Complete Guide to 529 Plans 2011-2012* (Pittsford, NY: JFH Innovative LLC, 2011), p. 12. The program later resumed and is again operational after adjusting its pricing.

<sup>17</sup> Andrew P. Roth, "Who Benefits from States' College Savings Plans?" *Chronicle of Higher Education*, January 1, 2001.

<sup>18</sup> Contributors may also look at other attributes of the plans which are specific to each plan, including the fees associated with each plan, when deciding the most appropriate 529 plan.

**Table I. Comparison of 529 Prepaid and Savings Plans**

	Prepaid	Savings
Number	19	93
Qualified Expenses	Generally they cover tuition and required fees, in most cases at undergraduate institutions.	Qualified distributions can be used for tuition and required fees, room and board (capped), books, supplies, equipment, and additional expenses of special needs beneficiaries.
Residency Requirements	Account owner or beneficiary generally has to meet state residency requirements.	Account owner or beneficiary generally does not have to meet state residency requirements, although more favorable benefits (state tax deductibility, matching) may be provided to in-state residents.
Institutional Limitations	In-state public institution (if used out for out of state school, the amount is generally limited to in-state tuition and fees at public institution).	Varies from plan to plan, but generally available for a wide variety of public and private institutions nationally. (Any eligible educational institution meeting Federal Title IV requirements).
Refund	If not all of the amount is used by the student, contributors can request a refund, although the refund amount is determined by the 529 plan.	An amount not used can be taken out as a nonqualified distribution. The amount withdrawn as a refund is ultimately determined by plan performance.
Distributions Go To	Directly to institution.	Beneficiary or account owner or directly to institution.
Time Limitation	Most prepaid plans can only be used for a limited duration, generally a given number of years from the beneficiary's expected matriculation date.	Generally, there is no program imposed limit on how long the account may remain open (as long as the beneficiary is living).
Enrollment period	Generally yes. Each year, contributors must purchase future college education during a given period. Prices are adjusted annually before each enrollment period.	No
Who Bears Risk?	In some states, the plans are backed by the full faith and credit of the state government, meaning the state bears the risk.	Contributors bear the risk because the performance of the plan is determined by the performance of the underlying assets.

**Source:** Internal Revenue Code (IRC) §529. Internal Revenue Service, *Publication 970: Tax Benefits for Education*, 2011, <http://www.irs.gov/pub/irs-pdf/p970.pdf>. Joseph F. Hurley, *The Best Way to Save for College: A Complete Guide to 529 Plans 2011-2012* (Pittsford, NY: JFH Innovative LLC, 2011).

## Tax Treatment of 529 Plans

As previously mentioned, the specific tax-advantage of a 529 plan is that the withdrawals from these plans are excludable from gross income, and hence not subject to the income tax, if they are used to pay for specific higher education expenses incurred in a given year. These expenses are referred to as adjusted qualified higher education expenses (AQHEE—see shaded text box below). Any amount withdrawn from a 529 account which does not go towards these expenses is subject to income taxation and may be subject to an additional 10% penalty tax.

Logically, a taxpayer who receives a 529 distribution (often the beneficiary or the account owner) would seek to minimize their income tax liability by withdrawing just enough money from their 529 account to cover AQHEE and no more. However, this is not as straightforward as it may seem due to a variety of factors, including the availability of other education tax benefits and student aid.<sup>20</sup> In order to understand the complex decisions taxpayers must consider when determining the amount of money they should withdraw from a 529 plan, this section details the income tax treatment of 529 distributions, including the definition of AQHEE; when 529 distributions may be taxable; and the interaction of 529 distributions with other education tax benefits. (An overview of basic gift tax rules is also included).

### Glossary of Selected Terms<sup>19</sup>

**Account Owner:** The person with ownership and control of the 529 account. This individual is usually a contributor to the account.

**Basis:** The sum of all the cash contributed or paid into the account.

**Designated Beneficiary:** The individual for whom the account is established.

**Distribution:** An amount of cash withdrawn from a 529 account (or in the case of prepaid plans, the value of the education benefits paid by the plan.)

**Earnings:** The total account value minus the basis.

### Adjusted Qualified Higher Education Expenses

Qualified higher education expenses are expenses related to enrollment or attendance at an eligible educational institution and include any of the following (or combination thereof):<sup>21</sup>

- tuition, fees, books, supplies, and equipment *required* for enrollment or attendance of the beneficiary at an eligible educational institution;
- expenses for special needs services incurred in connection with enrollment or attendance of a special-needs beneficiary at an eligible educational institution; and

<sup>19</sup> Adapted from Joseph F. Hurley, *The Best Way to Save for College: A Complete Guide to 529 Plans 2011-2012* (Pittsford, NY: JFH Innovative LLC, 2011), p. 9.

<sup>20</sup> Timing issues may also introduce more complexity. Specifically, education expenses are incurred over an academic year, which does not correspond with a tax year (tax years are generally calendar years).

<sup>21</sup> An eligible education institution for purposes of 529 plans is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the U.S. Department of Education.

- room and board expenses for students enrolled at least half-time<sup>22</sup> at an eligible educational institution.<sup>23</sup>

To determine the amount of *adjusted* qualified higher education expenses, qualified higher education expenses must be reduced by the amount of any tax-free educational assistance. Tax-free educational assistance includes the tax-free portion of scholarships and fellowships, veterans' educational assistance, Pell grants, and employer-provided educational assistance. They also must be reduced by the value of expenses used to claim education tax credits (see "Interaction with Other Education Tax Benefits").

## **Income Tax Treatment**

Contributors to 529 plans receive no federal income tax benefit from funding a 529 plan. Instead the main beneficiaries (in terms of reduced income taxes) of 529 plans are the recipients of 529 distributions, who may be able to exclude the entire 529 withdrawal from income taxation. In most cases, the recipient of the 529 distribution (and hence the person who may be liable to pay tax on the distribution) is either the designated beneficiary or the account owner.<sup>24</sup>

## **Contributions**

Contributions made to 529 plans are not deductible from income, meaning that contributions to these plans are made using after-tax dollars. Additionally this implies that contributors to 529 plans receive no federal tax benefit from contributing to a 529 plan. In contrast, many states allow residents to deduct part or all of their 529 contributions from their *state* income taxes if they contribute to an in-state plan. All 529 plan contributions are allowed to grow tax-free in the 529 account. Hence, unlike the typical bank savings account, where interest income is annually subject to income taxes, the increase in asset values in a 529 plan account is not subject to current income taxes, while the funds are in the account.

## **Distributions**

Distributions from 529 plans are not subject to federal income taxes if, for a given year, the withdrawal entirely covers adjusted qualified higher education expenses (AQHEE). In other words, if the amount of the distribution is *less than or equal to* the adjusted qualified higher education expenses (AQHEE), the entire distribution is tax free.

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<sup>22</sup> A student is considered "enrolled half-time" if he or she is enrolled for at least half the full-time workload for his or her course of study, as determined by the educational institution's standards.

<sup>23</sup> Room and board expenses cannot be more than the greater of (1) the allowance of room and board that was included in the cost of attendance for federal financial aid purposes for a particular academic period and living arrangement of the student or (2) the actual amount of room and board charged if the student resided in housing owned or operated by the eligible educational institution.

<sup>24</sup> In the case of a prepaid 529 plan, the payment goes directly to the institution, instead of the beneficiary or the account owner.



If a distribution is used to pay for nonqualified expenses, a portion of the withdrawal, specifically the *earnings portion* of the distribution, is subject to the income tax and may be subject to a 10% penalty tax. In other words, if the amount of a 529 withdrawal is *greater than* the beneficiary's AQHEE, the earnings portion of the distribution is taxable. The earnings portion of a distribution reflects the growth of the value of the 529 plan and not amounts originally contributed (which are sometimes referred to as basis). The percentage of the earnings portion subject to taxation is equal to the ratio of the difference of the total distribution amount and AQHEE to the total distribution amount (see shaded text box above). To ultimately calculate the amount of tax the taxpayer will owe, the taxpayer's marginal tax rate must be applied to this taxable income. In addition, in many cases, a 10% penalty tax will also be applied to this taxable income.<sup>25</sup>

**The Taxable Portion of a 529 Distribution**

$$\text{Earnings Portion of Distribution} \times \frac{(\text{Distribution} - \text{AQHEE}^1)}{\text{Distribution}}$$

<sup>1</sup> AQHEE (adjusted qualified higher education expenses) are qualified higher education expenses (QHEE) reduced by any tax free educational assistance and by the portion of the expenses used to claim higher education tax credits.

### Calculating the Taxable Portion of a 529 Distribution: A Stylized Example

Mr. Smith establishes an account in a 529 plan for his daughter Sara in 2007. He is the account owner and his daughter is the designated beneficiary. He makes a one-time contribution (i.e., basis) of \$10,000. Five years later the account balance is \$15,000 (i.e., it has increased in value by \$5,000) and Mr. Smith takes a \$9,000 distribution in 2012 for his daughter's \$9,000 fall 2012 tuition payment. But Sara also receives a \$4,000 tax-free scholarship. Hence, Sara has \$5,000 in AQHEE in 2012 (\$9,000 of tuition minus \$4,000 in tax-free aid). Notably, Mr. Smith pays Sara's tuition costs and also designates himself as the recipient of the 529 distribution, implying he (and not his daughter) will be liable to pay any taxes on the 529 distribution.<sup>26</sup>

The steps to calculate the taxable portion of the distribution—and it is taxable because adjusted qualified education expenses (\$5,000) are less than the 529 distribution (\$9,000)—are outlined in **Figure 1**.

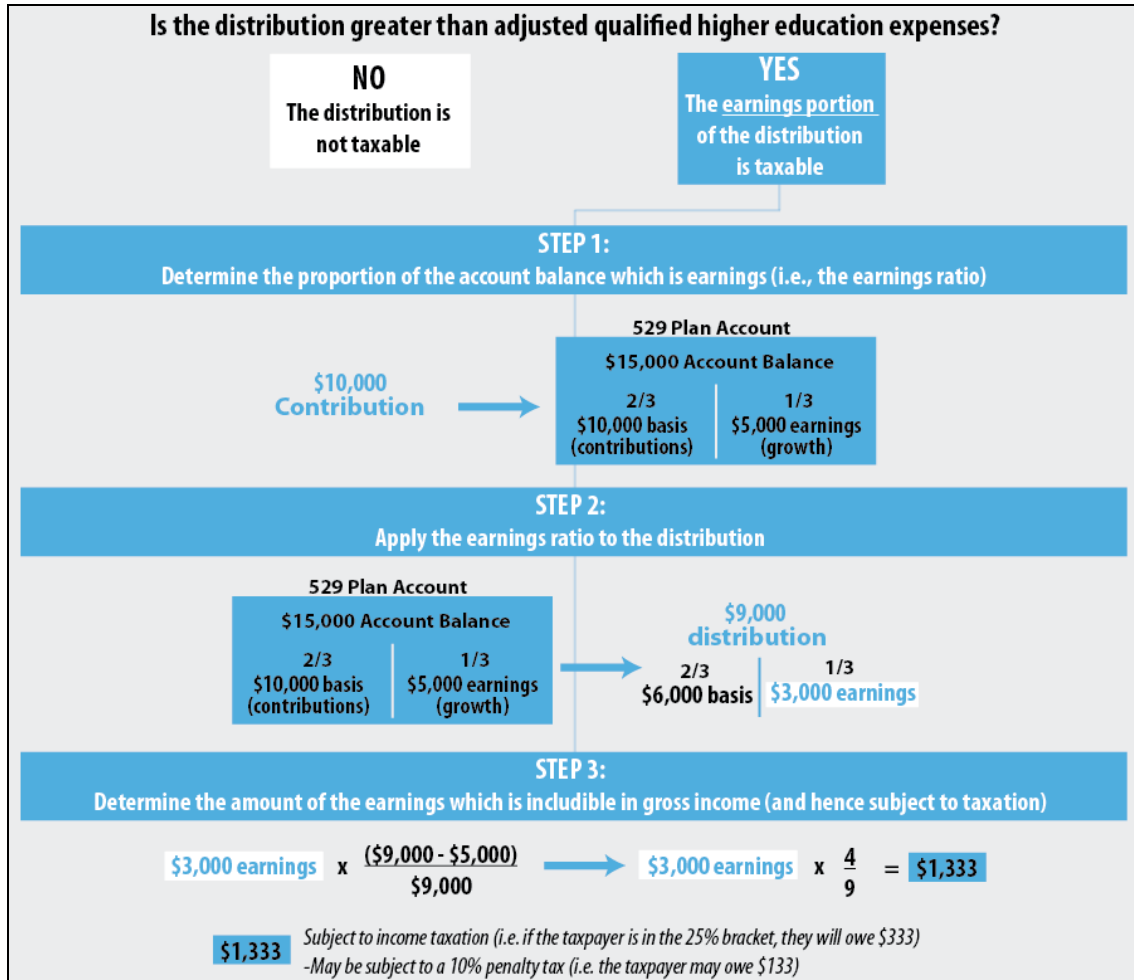
First, Mr. Smith must calculate the proportion of the distribution which is earnings. Since one-third of the account balance (\$5,000) reflects earnings (two-thirds of the account balance reflects \$10,000 of contributions), *one-third* of the distribution is attributable to earnings. Second, Mr. Smith applies the earnings ratio (in this case, one-third) to the distribution. Hence, of the \$9,000 distribution, one-third or \$3,000 reflects earnings. Finally, Mr. Smith calculates the proportion of the \$3,000 earnings portion which is subject to taxation. The percentage of the earnings portion which is subject to taxation is equal to the ratio of the difference of the total distribution amount

<sup>25</sup> The 10% penalty tax is waived in the following cases: (1) the distribution is paid to the beneficiary after their death; (2) the distribution is made because the beneficiary is disabled (the beneficiary is considered disabled if he shows proof that he cannot do any substantial gainful activity because of a disability. A physician must determine that the disability is either life threatening or will have an indefinite duration); (3) the distribution is greater than qualified education expenses (and hence the earnings portion is taxable) because the beneficiary received tax-free educational assistance as long as distribution is not more than the tax-free assistance; (4) the distribution was made as a result of the beneficiary's attendance at a U.S. military academy to the extent that the distribution is not greater than the cost of attendance at such an academy; (5) the distribution was taxable as a result of reducing qualified expenses in order to claim higher education tax credits.

<sup>26</sup> The account owner of a 529 account selects the recipient of the distribution when filing out the program's withdrawal request form.

(\$9,000) and AQHEE (\$5,000) to the total distribution amount (\$9,000). Ultimately, as **Figure 1** illustrates, of the \$9,000 distribution, \$1,333 of it is includible in Mr. Smith’s income and thus subject to taxation on his 2012 income tax return.

**Figure 1. Calculating the Taxable Portion of a 529 Distribution: A Stylized Example**



**Source:** Congressional Research Service using information obtained from the Internal Revenue Service, Publication 970: Tax Benefits for Education, <http://www.irs.gov/pub/irs-pdf/p970.pdf> and Joseph F. Hurley, *The Best Way to Save for College: A Complete Guide to 529 plans 2011-2012* (Pittsford, NY: JFH Innovative LLC, 2011).

## Interaction with Other Education Tax Benefits

In addition to 529 plans, there are a variety of other tax benefits taxpayers (either the beneficiary or the account owner) may use to lower their income tax bill based on education expenses.<sup>27</sup>

<sup>27</sup> As a result of a temporary provision, from 2002 through 2012, taxpayers can make contributions to both a 529 and Coverdell for the same beneficiary in the same year. However, beginning in 2013, this temporary provision is scheduled to expire. Hence, if a taxpayer makes a contribution to both a 529 and Coverdell for the same beneficiary in the same year, the contribution to the Coverdell will be considered an excess payment and be subject to income taxation and a penalty tax.

Notably, taxpayers may be eligible to claim either the American Opportunity tax credit (AOTC),<sup>28</sup> the Lifetime Learning credit, or the tuition and fees deduction.<sup>29</sup> A taxpayer cannot claim more than one of these tax benefits for the same student in a given year.

To determine if any of their 529 distribution is taxable, a taxpayer must reduce their 529 qualified higher education expenses by any amounts used to claim either the AOTC or the Lifetime Learning credit. The qualified higher education expenses as defined for 529 plans are not identical to the qualified higher education expenses of education tax credits. The qualified higher education expenses common to both 529 plans and education tax credits are tuition and fees, and hence these are the expenses which taxpayers may (mistakenly) try to use to claim both an education tax credit and a tax-free 529 distribution. (Other expenses, like room and board which are a qualified expense for 529 plans, are not a qualified expense for education tax credits and hence would not be used to claim an education tax credit.) For example, if an eligible taxpayer has \$10,000 of tuition payments of which they used \$4,000 to qualify for an American Opportunity tax credit, the amount of qualified higher education expenses used to determine if their 529 distribution is tax free is \$6,000. Thus, if a 529 distribution is *less than or equal to* \$6,000, none of the distribution is subject to taxation because the distribution covered all of their AQHEE.

Instead of an education tax credit, a taxpayer may choose to take both a 529 distribution and claim the tuition and fees deduction for the same student in the same year. Taxpayers who take a 529 distribution and also choose to claim the tuition and fees deduction must reduce the amount of expenses used for the tuition and fees deduction by the *earnings* portion of the 529 distribution (not the entire amount of the distribution).<sup>30</sup>

## **Rollovers and Transfers**

Any distribution from a 529 plan for a given beneficiary which is rolled over into a different 529 plan for either the same beneficiary<sup>31</sup> or a member of the beneficiary's family<sup>32</sup> is not taxable. A distribution is considered "rolled over" if it is paid to another 529 plan within 60 days of the distribution. Importantly, a rollover between 529 plans for the *same beneficiary* is limited to once

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<sup>28</sup> For more information on the AOTC, see CRS Report R42561, *The American Opportunity Tax Credit: Overview, Analysis, and Policy Options*, by Margot L. Crandall-Hollick.

<sup>29</sup> Under current law, the tuition and fees deduction expired at the end of 2011. Hence, barring any legislative changes, taxpayers will be ineligible from claiming this above-the-line deduction on their 2012 tax returns.

<sup>30</sup> The Internal Revenue Code (IRC) and IRS Publication 970 provide different explanations on how to coordinate 529 distributions and the tuition and fees deduction for a given student. Since IRS Publication 970 does not have the force of law, the literal interpretation of the IRC is described in this report. According to IRC § 222(c)(2)(B), the total amount of qualified tuition and related expenses used to claim the tuition and fees deduction must be reduced by the earnings portion of a 529 distribution used for the same expenses. In contrast, according to Publication 970, a taxpayer reduces the amount of AQHEE used to calculate the taxable portion of a 529 distribution by the amount of tuition and fees used to claim the tuition and fees deduction. In some cases, the tax savings of these two different approaches may differ.

<sup>31</sup> Only one rollover from one 529 plan to a different 529 plan for the same beneficiary is allowed in a 12-month period.

<sup>32</sup> For the purposes of a 529 plan, the beneficiary's family includes the following: the beneficiary's son, daughter, stepchild, foster child, adopted child (or decedent of any of these children); brother, sister, stepbrother, stepsister; father, mother, or their ancestors; son or daughter of a brother or sister; brother or sister of father or mother; son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law; the spouse of any of the individuals previously listed (including the beneficiary's spouse); and first cousin.

every 12 months. In addition, if the designated beneficiary of an account is changed to a member of the beneficiary's family, the transfer of funds is not taxable.

## **Gift Tax**

A contribution to a 529 plan is generally not subject to the gift tax if the amount contributed is less than the annual gift tax exclusion.<sup>33</sup> For 2012, the annual gift tax exclusion is \$13,000.<sup>34</sup> For example, a grandparent could contribute \$13,000 to each of their seven children's 529 accounts without being subject to the gift tax.<sup>35</sup> In addition, a contributor may be able to deposit more than the annual exclusion amount into a 529 plan without being subject to the gift tax.<sup>36</sup> The Internal Revenue Code (IRC) allows a donor to make a contribution larger than the annual gift tax exclusion by treating the contribution as if it were made ratably over five years. In other words, a contributor could open a 529 savings plan for a beneficiary in 2012 and contribute up to \$65,000 (five times \$13,000) without being subject to the gift tax. The contributor could not make another excludable gift to that beneficiary's 529 plan until 2017. In addition to these gift tax rules, for the purposes of the estate tax, a donor can exclude the value of the 529 plan from their gross estate, even though they maintain control of the account.

## **Interaction of Assets and Distributions from 529 Plans with Federal Student Aid<sup>37</sup>**

In addition to the tax advantages of 529 plans, these plans are also treated more favorably than other types of college savings or investments when determining a student's eligibility for federal need-based student aid. For instance, 529 plans generally have a minimal impact on a student's federal expected family contribution (EFC). The EFC is the amount that, according to the federal need analysis methodology, can be contributed by a student and the student's family toward the student's cost of education. All else being equal, the higher a student's EFC, the lower the amount of federal student need-based aid he or she will receive. A variety of financial resources are reported by students and their families on the Free Application for Federal Student Aid (FAFSA). These resources are assessed at differing rates under the federal need analysis methodology<sup>38</sup>

Distributions<sup>39</sup> from 529 plans are generally not considered income in the federal need analysis calculation and are therefore not reported on the FAFSA, although the value<sup>40</sup> of the 529 plan is

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<sup>33</sup> Contributions to 529 plans treated as a completed gift which implies the transfer of ownership from the contributor to the beneficiary, even though contributors to Section 529 plans maintain control of the accounts.

<sup>34</sup> \$26,000 for a married couple using gift-splitting.

<sup>35</sup> Each grandparent could contribute \$13,000 each, meaning they could deposit \$26,000 per grandchild as a couple without being subject to the gift tax.

<sup>36</sup> For an overview of the current law of the gift tax, see CRS Report 95-416, *The Federal Estate, Gift, and Generation-Skipping Transfer Taxes*, by Emily M. Lanza.

<sup>37</sup> For further description of federal need analysis, see CRS Report R42446, *Federal Pell Grant Program of the Higher Education Act: How the Program Works and Recent Legislative Changes*, by Cassandra Dortch.

<sup>38</sup> The details of the federal need analysis methodology are beyond the scope of this report.

<sup>39</sup> Additionally, distributions from 529 plans are not considered a resource when calculating other estimated financial assistance (EFA) during the federal aid packaging process. For more information on EFA and the packaging of aid, see the *AY2012-13 Federal Student Aid Handbook, Volume 3*, at <http://ifap.ed.gov/fsahandbook/1213FSAHbVol3.html>.

considered an asset in the federal need analysis methodology and should be reported on the FAFSA.<sup>41</sup>

When calculating a student's EFC, the federal need analysis methodology considers a percentage of the student's assets and a percentage of the parents' assets reported on the FAFSA. A student's assets are assessed at a flat rate of 20%, while parents' assets are assessed on a sliding scale, resulting in a maximum effective rate of up to 5.64%.<sup>42</sup> Therefore, the ownership of the asset is important when determining how it will affect a student's EFC. For students who are classified as dependent students for FAFSA purposes (which differs from the classification of dependent for tax purposes),<sup>43</sup> the 529 plans are considered an asset of the parent, as long as the custodial ownership of the plan belongs either to the parent or student. Therefore, dependent students benefit from a lower assessment rate on 529 plans, which, all else being equal, results in a lower EFC and the potential for more federal need-based student aid. For students who are classified as independent students for FAFSA purposes, 529 plans are treated as an asset of the student, as long as the custodial ownership of the plan belongs either to the student or student's spouse (if applicable). 529 plans that are owned by someone other than the student, parent, or spouse are not reported as an asset on the FAFSA, but distributions from these 529 plans are reported as untaxed income for the beneficiary on the FAFSA.<sup>44</sup> In general, income is assessed at a higher rate compared to assets in the federal need analysis methodology.

## Legislation in the 114<sup>th</sup> Congress

As of the date of this report, there have been a variety of bills introduced that would modify 529 plans. One bill, H.R. 529, was reported favorably with amendment by the House Committee on Ways and Means on February 20, 2015. As reported, H.R. 529 would make three changes to 529 plans. First, it would expand the definition of qualified higher education expenses to include computers and other peripheral equipment, as well as expenses for Internet access and related services used primarily by the beneficiary. Second, the bill would repeal current aggregation rules that require 529 plan administrators to aggregate 529 accounts for a designated beneficiary for purposes of calculating the taxable portion of a distribution.<sup>45</sup> For example, if a designated beneficiary received multiple distributions from different 529 plans in a given year, the plan administrators would aggregate these accounts, effectively considering them as one account, as well as aggregating distributions, and treating them as one distribution from the aggregate 529

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(...continued)

<sup>40</sup> For 529 plans that are considered pre-paid tuition plans, the asset value is equal to the refund value.

<sup>41</sup> For prepaid 529 plans, the asset value is the refund value of the plan.

<sup>42</sup> Parental assets are also protected by an asset protection allowance, which means that a certain amount of assets are not considered in evaluating the effective family contribution (EFC).

<sup>43</sup> For the purposes of taxes, IRC §152 defines dependents which includes (but is not limited to) a requirement that the dependent has the same principal residence as the taxpayer for more than half the year, and that the dependent has not provided over one-half of their support. In contrast, student under 24 are generally considered a dependent for financial aid purposes. If certain criteria are met, the student is considered an independent student for financial aid purposes. A student can determine their dependency status for financial aid at <http://www.finaid.org/calculators/dependency.phtml>.

<sup>44</sup> For more information, see <http://www.finaid.org/savings/loophole.phtml>.

<sup>45</sup> According to guidance from the Treasury, "it is expected that the final regulations [of 529 plans] will provide that only accounts maintained by a § 529 program and having the same account owner and the same designated beneficiary must be aggregated for purposes of computing the earnings portion of any distribution." For more information, see <http://www.irs.gov/pub/irs-drop/n-01-81.pdf>.

account. Under H.R. 529, plan administrators would no longer be required to aggregate 529 plans and provide aggregate 529 distribution information. Hence, in our previous example, a taxpayer would receive information for *each withdrawal* (including the earnings portion of each withdrawal) from each plan.<sup>46</sup> Finally, the bill would create a new rule regarding the tax treatment of re-contributions to 529 plans of any refunded higher education expenses. Under this rule, if a 529 distribution is used to pay an expense which is later refunded, the portion of the distribution ultimately refunded will not be taxable if it is re-contributed to the 529 account within 60 days of the refund. The Joint Committee on Taxation (JCT) estimates that H.R. 529 would reduce revenues by \$51 million between 2015 and 2025.<sup>47</sup>

In addition to H.R. 529 (and its Senate companion, S. 335), H.R. 554 and S. 306 would both expand the definition of qualified expenses to include pre-kindergarten and elementary and secondary education expenses. In mid-January 2015, President Obama proposed changing the tax treatment of 529 plans as part of a fact sheet released in advance of the Administration's FY2016 budget.<sup>48</sup> Specifically, the President proposed taxing the earnings portion of 529 distributions (which would apply to new contributions), regardless of whether they were used for higher education expenses or not. However, the Administration later dropped this proposal.<sup>49</sup>

## Concluding Remarks

Students and their families may have a variety of resources to choose from when they finance higher education expenses, including 529 plans. While these plans may encourage some families to save for and fund their child's future education expenses, they may also introduce additional complexity in financial planning. For example, parents may start contributing to a 529 plan when their child is very young, based on their predictions of future college costs that they may not ultimately pay because their child receives a scholarship, or another education tax benefit or

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<sup>46</sup> The Committee Report to accompany H.R. 529 included an example to illustrate the impact of repealing the aggregation rule.

The following example illustrates the operation of this provision: Assume that two designated savings accounts have been established by the same account owner within the same qualified tuition program for the same designated beneficiary. Account A contains \$20,000, all of which consists of contributed amounts (i.e., it has no earnings). Account B contains \$30,000, \$20,000 of which constitutes an investment in the account, and \$10,000 attributable to earnings on that investment. Assume a taxpayer were to receive a \$10,000 distribution from Account A, with none of the proceeds being spent on qualified higher education expenses. Under present law, both of the designated beneficiary's accounts would be aggregated for purposes of computing earnings. Thus, \$2,000 of the \$10,000 distribution from Account A ( $\$10,000 * \$10,000 / \$50,000$ ) would be included in the designated beneficiary's income. Under the provision, the accounts would not be aggregated for purposes of determining earnings on the account. Thus, because Account A has no earnings, no amount of the distribution would be included in the designated beneficiary's income for the taxable year.

See H.Rept. 114-25 at <http://www.lis.gov/cgi-lis/cpquery/R?cp114:FLD010:@1%28hr025%29>.

<sup>47</sup> Congressional Budget Office, *Cost Estimate of H.R. 529, A bill to amend the Internal Revenue Code of 1986 to improve 529 plans*, February 19, 2015, <http://www.cbo.gov/sites/default/files/cbofiles/attachments/hr529.pdf>.

<sup>48</sup> For more information, see The White House, "Fact Sheet: A Simpler, Fairer Tax Code that Responsibly Invests in Middle Class Families," press release, January 17, 2015, <http://www.whitehouse.gov/the-press-office/2015/01/17/fact-sheet-simpler-fairer-tax-code-responsibly-invests-middle-class-fami>.

<sup>49</sup> For more information, see Jonathan Weisman, "Obama Relents on Proposal to End '529' College Savings Plans," *New York Times*, January 27, 2015, Politics.

federal financial aid. This would result in the parent over-contributing to a 529 plan, when those contributions could have been used for other purposes, like their retirement accounts. Hence, while these plans may be beneficial to students, benefits should also be weighed against potential drawbacks.

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