EDUCATION COMMISSION OF THE STATES

POLICY BRIEF

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529 Education Savings Plans: Federal Action and State Policy Trends

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The federal government formally established 529 education savings plans — investment accounts with tax advantages — in 1996 through Section 529 of the Internal Revenue Code.[1] These accounts allow individuals to invest post-federal-tax dollars into managed growth funds that are not subject to additional federal taxes if used for qualified educational expenses.[2] Historically, qualified expenses have included college tuition and fees, room and board, books and supplies, and education technology. Since investments can begin at the time of a beneficiary's birth, 529 plans allow families who invest early the potential for significant tax-free growth of savings.[3]

While federal law authorizes 529 plans, state agencies sponsor and operate accounts. Since the policy governance is split between federal and state governments, these accounts are an example of federalism in action. Forty-nine states and the District of Columbia offer at least one 529 plan. The exception, Wyoming, does not offer its own 529 plan but partners with Colorado to offer plans to its residents. In addition to sponsoring accounts, most states have established further rules and incentives for 529 plans. State policies fall into five categories: tax-free growth, state income tax deductions, matching state funds, account limits and penalties for unqualified expenses.

Forty-nine states and the District of Columbia offer at least one 529 education savings plan.

In 2018, 17 states introduced legislation to change the eligibility of K-12 expenses for 529 plans.

By December 2018, K-12 tuition was considered a 529 plan qualified expense for state income tax purposes in 27 states.

Why Do Federal and State Governments Support 529 Plans?

The federal government invests nearly $2 billion a year to support the tax advantages that come with 529 plans.[4] States that offer incentives for 529 plans also make significant investments. Like any investment, particularly in a time of limited resources, providing incentives for 529 plans requires a diversion of resources from other priorities. What motivates this action?

The investment in 529 plans, at both the state and federal levels, is made to support and encourage college savings. Studies show that even small amounts of college savings can make a significant difference to college-going behavior.[5] Children with savings accounts of $1 to $500 are three times as likely to attend college, and four times as likely to graduate, as those who do not.[6] Some states have established policy to make a small investment — $100 to $200 — to every child born in the state.

Families that save for college are more likely to have children who attend and graduate from college; when more individuals graduate from college, the state and the nation benefit from a more highly educated workforce.[7] This, in turn, can bring in employers seeking high-skilled labor forces, which can fuel the economies of states, regions and the nation as a whole.[8]

TAX-FREE GROWTH

States with an income tax have aligned state policy to federal policy regarding taxes: Post-state-tax dollars grow free of additional state taxes if used for qualified postsecondary educational expenses.

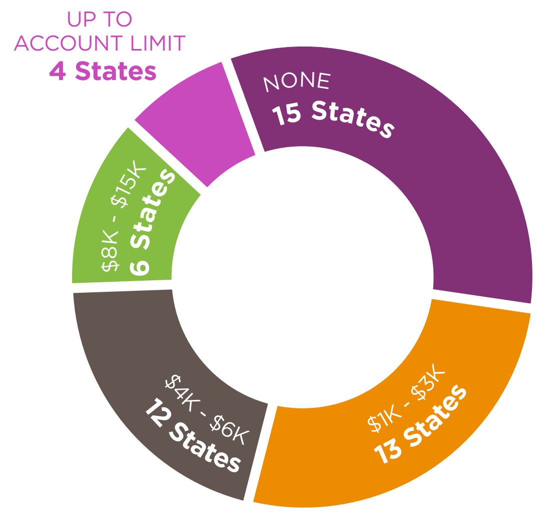
STATE INCOME TAX DEDUCTION

Most states also offer state tax deductions or credits on contributions. In other words, by investing in a 529 plan, account holders can defray a portion of their state taxes. The majority of states offer a limited deduction, between $1,000 and $15,000, of investments annually for a single tax filer. Four states — **Colorado**, **New Mexico**, **South Carolina** and **West Virginia** — offer much greater deductions, up to the account limit, in the state. Nine states have no state income tax, and seven others offer no state tax deduction for 529 plans. Most states require account holders to invest in their home state's plan to qualify for the deduction, but **Arizona**, **Kansas**, **Minnesota**, **Missouri**, **Montana** and **Pennsylvania** offer tax benefits for residents who invest in any state's 529 plan.[9]

MATCHING STATE FUNDS

A minority of states offer a direct or matching contribution of state funds to in-state investors. Three states — **Connecticut**, **Rhode Island** and **West Virginia** — offer a one-time contribution of $100 to every child born in the state; two others — **Maine** and **North Dakota** — offer a $200 matching grant. Six states — **Colorado**, **Kansas**, **Louisiana**, **Maryland**, **North Dakota** and **Tennessee** — offer matching grants between $200 and $500 that are subject to income restrictions for the account holder. Five other states — **Arkansas**, **Michigan**, **Minnesota**, **Missouri** and **West Virginia** — previously offered match programs to residents but have discontinued them within the last decade.

Maximum Annual State Tax Deduction Allowed by Single Filers



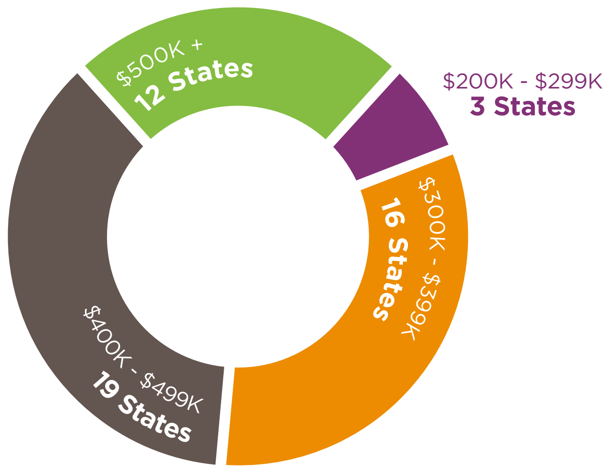
ACCOUNT LIMITS

All states set limits on the total amount of funds allowed in 529 plans for a single beneficiary; the majority have fund limits between $300,000 and $500,000. These limits apply to beneficiaries, not investors; an account holder can own multiple accounts as long as the funds for any single account or beneficiary do not exceed the state limit. Contributions are not limited in time; an investor can contribute the state maximum in a single deposit or over many years.

PENALTIES FOR UNQUALIFIED EXPENSES

When account holders use funds for unqualified expenses, they must pay any deferred federal taxes — as well as an additional 10 percent penalty — to the federal government. All states that have state income tax also require 529 account holders to repay any deferred state taxes on unqualified expenses. A few states set additional penalties: **Montana** and **Oklahoma** charge an additional 5 percent penalty; in **Louisiana**, both earnings enhancements and interest are forfeited.

Maximum Dollar Amount Allowed in 529 Accounts



Profiles of Investors and Non-Investors

The Government Accountability Office analyzed national survey data on the distribution of college savings accounts, including 529 plans, across families in 2010.[10] Among survey respondents:

- Fewer than 3 percent of families had college savings accounts; of families who were expecting or incurring college costs, less than 10 percent had college savings accounts.
- The median annual income for families with college savings accounts was $142,400, while the median for families without such accounts was $45,100.

  > Over 70 percent of families with college savings accounts reported annual household incomes over $100,000; two-thirds of those families reported over $150,000 annually.

  > Over 80 percent of families without college savings accounts reported annual household incomes that are less than $100,000; less than 10 percent reported over $150,000 annually.

- About 91 percent of families with college savings accounts had at least one parent with a college degree, compared with about 44 percent of families without these accounts.

Since the data were collected prior to the expansion of eligible expenses to K-12 through the Tax Cuts and Jobs Act, future studies will be needed to demonstrate the effects of the latest federal legislation — and respondent state legislation — on the characteristics of account holders.

State Response to the Tax Cuts and Jobs Act

In December 2017, Congress passed a comprehensive tax reform bill known as the Tax Cuts and Jobs Act.[11] Part of the legislation modifies section 529 of the federal tax code by extending the definition of qualified expenses. In the new definition, in addition to college expenses, 529 funds can be used without federal tax or penalties for up to $10,000 per year of private K-12 school tuition. Qualified K-12 expenses are limited to tuition and fees; other expenses qualified at the postsecondary level are not allowable at the K-12 level.

From a state perspective, the expanded federal definition raises policy questions about the state tax benefits offered to account holders. States wishing to support the extended federal definition with a tax benefit would need to ensure that state policy also considered K-12 tuition to be a qualified expense. Under the new federal law, states fall into one of four categories:

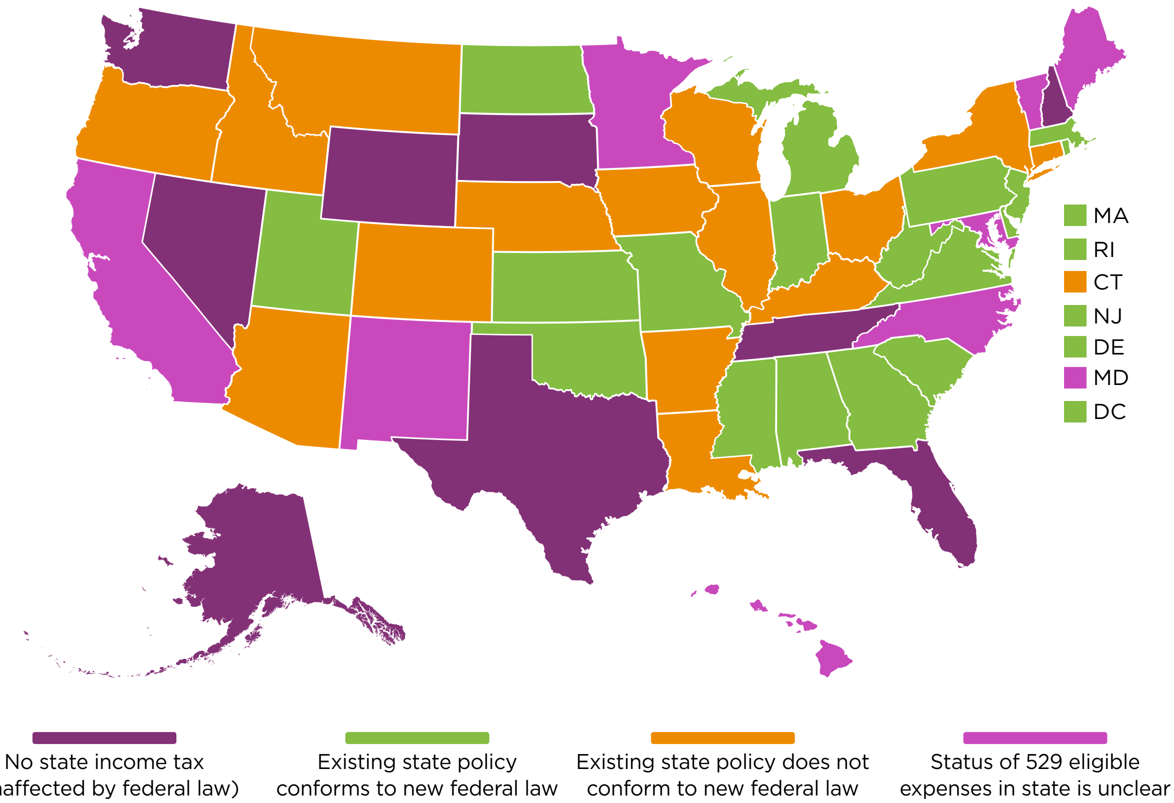
- No state income tax (unaffected by federal law).
- Existing state policy conforms to new federal law.
- Existing state policy does not conform to new federal law.
- Status of 529 eligible expenses in state is unclear.[12]

States with existing policies need to determine whether they wish to extend their 529 tax benefit to K-12 expenses — and, as appropriate, pass legislation to either conform to the federal definition or to limit the existing tax benefit to exclude K-12 expenses. States where the status of 529 eligible expenses is unclear first need to determine whether existing law conforms to the federal definition, then make a further decision about whether to pass legislation on the issue. By examining policy activity in 2018, Education Commission of the States identified 17 states that introduced legislation that, if enacted, would change the eligibility of K-12 expenses for 529 plans.

States That Introduced Status-Changing 529 Legislation in 2018

STATE	2018 Legislation Introduced	Status of Legislation	Status of 529 K-12 Expenses
Arkansas	S.B. 6	Enacted	Allowable
Colorado	H.B. 18-1221	Failed	Excluded
Idaho	H.B. 463	Enacted	Allowable
Indiana	H.B. 1316	Enacted	Allowable
Iowa	S.F. 2417	Enacted	Allowable
Kentucky	H.B. 434	Enacted	Allowable
Louisiana	H.B. 650	Enacted	Allowable
Maine	L.D. 1655	Enacted	Allowable
Missouri	S.B. 882	Enacted	Allowable
Nebraska	N.E. L.B. 804	Failed	Excluded
New Jersey	A. 3773	Pending	Not yet determined
New York	S.B. 7783	Failed	Excluded
North Carolina	H.B. 975	Enacted	Allowable
Ohio	S.B. 22	Enacted	Allowable
Oregon	H.B. 4080	Enacted	Excluded
Vermont	H. 2	Failed	Not yet determined
Wisconsin	AB 259	Enacted	Allowable

States by 529 Eligible-Expenses Status JANUARY 2018



9 states have no income tax. Since these states could not offer income tax benefits for 529 plans, they had no policy on the matter and were unaffected by the federal change. None of these states passed legislation on eligible expenses in 2018.

18 states had policy at the start of 2018 that already conformed to the federal definition. These states did not need to pass legislation to allow the extension of eligible expenses to K-12; however, four of these states saw activity:

- **Indiana** passed H.B. 1316 and **Missouri** passed S.B. 882, confirming the extension of eligibility of tax advantages to K-12 expenses.
- **New Jersey** introduced legislation, A 3773, that would exclude K-12 expenses from eligibility for tax advantages; the bill is still pending.
- **Michigan**'s governor has indicated that, upon review of state policy, he is now unsure whether the state conforms to the federal definition.

8 states were unclear at the start of 2018 whether existing policy conformed to the new federal definition. By the end of 2018:

- The **District of Columbia** and **Maryland** determined that their policies already conformed.

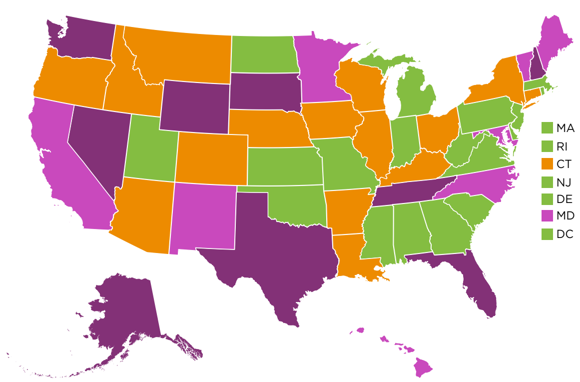
- **California** and **New Mexico** determined the opposite, that their policies did not conform; however, no legislation was introduced.
- **Maryland** passed L.D. 1655 and **North Carolina** passed H.B. 975 to extend eligibility to K-12 expenses, conforming policy to the federal definition.
- **Hawaii**, **Minnesota** and **Vermont** remain inconclusive about their status. However, **Vermont** introduced H.B. 2 in special session to exclude K-12 expenses from tax advantages; that legislation failed.

15 states did not conform with the expanded federal definition of eligible expenses at the start of 2018. By the end of 2018:

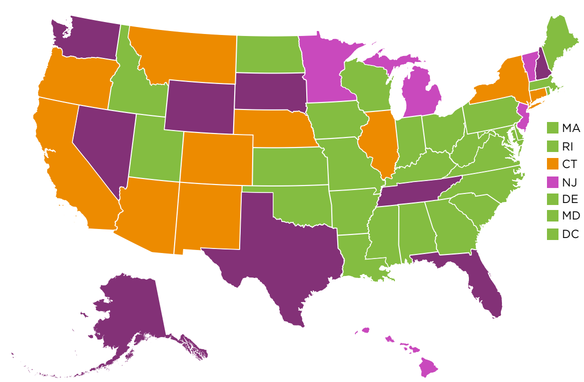
- Seven states — **Arkansas, Idaho, Iowa, Kentucky, Louisiana, Ohio** and **Wisconsin** — passed legislation to extend eligibility to K-12 expenses, conforming policy to the federal definition.
- **Oregon** enacted H.B. 4080, making it the only state that passed legislation to exclude K-12 expenses from tax advantages.
- **Colorado** introduced H.B. 1221, **New York** introduced S.B. 7783 and **Nebraska** introduced L.B. 804 to extend eligibility to K-12 expenses; all three failed.
- **Arizona**, **Connecticut**, **Illinois** and **Montana** did not introduce legislation in 2018.

Changes in 529 Status by State in 2018

JANUARY 2018



DECEMBER 2018



NUMBER OF STATES BY STATUS	January 2018	December 2018	Net Change
No State Income Tax	9	9	0
State Policy Conforms to Federal Law	18	27	+9
State Policy Does Not Conform to Federal Law	15	10	-5
Status Unclear	9	5	-4

State Policy Considerations

When 529 plans were first established, federal and state governments chose to forgo collecting certain taxes in order to give families a financial boost while saving for college. This created a pool of tax funds for postsecondary institutions by removing those funds from other federal and state priorities. Over time, investments in 529 plans have grown, increasing the associated costs in terms of dedicated tax funds.[13] The annual federal cost grew to $2 billion by 2017, or about 6 percent of total federal spending on college aid.[14] The Tax Cuts and Jobs Act now extends a portion of those tax advantages to families saving for K-12 expenses — thereby creating a pool of tax funds for private elementary and secondary schools.

Tax-advantaged 529 plans represent a federal and state investment in education. To make the most of that investment, states will need to ensure it aligns with their specific goals for college access and school choice. State policymakers need state-specific information to help them make sound policy decisions, yet little is known at the state level about the annual costs of 529 plans — much less who invests, how much and to what effect. The following questions may help state policymakers identify the types of data they wish to collect on their existing 529 plans:

- **Cost data.** What is the annual cost of the state's 529 plan incentives in terms of forgone revenue? What percentage of the state's budget does this figure represent? How does it compare with other existing state investments in college access, such as scholarship programs or free college initiatives? How does it compare with other existing state investments in school choice, such as vouchers, scholarship tax credits or education savings accounts?
- **Use data.** What are the demographic characteristics of the state's 529 plan investors? How does this compare with the demographics of the state as a whole? What is the average investment amount? How does this compare to the average cost of four years of tuition, fees, and room and board at a state postsecondary institution? What is the average length of investment? What proportion of funds are used for postsecondary versus K-12 expenses?
- **Outcomes data.** What are the demographic characteristics of the state's 529 plan beneficiaries? How does this compare with the demographics of the college-going population of the state? Are individuals who use 529 plan funds for K-12 education more likely to attend college than those who do not? Are individuals who use 529 plan funds for postsecondary education more likely to persist and/or graduate than those who do not? What is the average postsecondary debt burden of 529 plan beneficiaries? How does this compare to individuals without 529 plan funds?

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ENDNOTES

1. *Tax Benefits for Education: For use in preparing 2018 returns, Publication 970, Cat. No. 25221V* (Washington, DC: Department of the Treasury, Internal Revenue Service, 2018), https://www.irs.gov/pub/irs-pdf/p970.pdf.

2. Any member of an individual's extended family, including themselves, who is a U.S. citizen is eligible to open an account on the individual's behalf. Account owners can purchase plans in any state, though some states limit certain benefits to in-state plan holders. Plans are held to the rules and regulations of the originating state, but funds may be used for educational expenses in any state.

3. Nat Malkus, Richard V. Reeves, and Nathan Joo, "The costs, opportunities, and limitations of the expansion of 529 education savings accounts" *Evidence Speaks Reports 2, no. 47* (April 12, 2018): https://www.brookings.edu/wp-content/uploads/2018/04/529-reports_njproofed.pdf.

4. *How Governments Support Higher Education Through The Tax Code* (Philadelphia: The Pew Charitable Trusts, February 2017), https://www.pewtrusts.org/-/media/assets/2017/02/how-governments-support-higher-education-through tax-code.pdf?la=en&hash=398471DB3F79FE9A86B3B48457781A884C5D55D4.

5. *Building Expectations, Delivering Results: Asset-Based Financial Aid and the Future of Higher Education* (Lawrence, KS: Assets and Education Initiative, 2013), https://www.citigroup.com/citi/foundation/pdf/news130716.pdf.

6. Allison Beer, Julie Ajinkya, and Carl Rist, *Better Together: Policies that Link Children's Savings Accounts with Access Initiatives to Pave the Way to College* (Washington, DC: Institute for Higher Education Policy, May 2017), http://www.ihep.org/sites/default/files/uploads/docs/pubs/ihep_cfed_better_together_report.pdf.

7. William Elliott III, *Creating a Financial Stake in College, Report III: We save, we go to college* (Washington, DC: New America Foundation and Center for Social Development at Washington University, 2012), https://files.eric.ed.gov/fulltext/ED540298.pdf.

8. Enrico Moretti, *The New Geography of Jobs* (New York: *Houghton Mifflin Harcourt*, 2013).

9. Matthew Toner, "How much is your state's 529 plan tax deduction really worth?" *Savingforcollege.com*, September 27, 2018, https://www.savingforcollege.com/article/how-much-is-your-state-s-529-plan-tax-deduction-really-worth.

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11. *Tax Reform Basics for Individuals and Families, Publication 5307, Cat. No. 71626U* (Washington, DC: Department of the Treasury, Internal Revenue Service, 2018), https://www.irs.gov/pub/irs-pdf/p5307.pdf.

12. At the start of 2018, state policy leaders in these states were unclear about the intent of existing state law.

13. "529 Plan Data: June 2018," Investment Company Institute, published November 7, 2018, https://www.ici.org/research/stats/529s/529s_18_q2.

14. *How Governments Support Higher Education*.