



## WEALTH PLANNING BASICS

### Income Tax Planning and 529 Plans

The income tax benefits offered by 529 plans make these plans attractive to parents and others who are saving for college or K-12 tuition. Qualified withdrawals from a 529 plan are tax-free at the federal level, and many states also offer tax breaks to their residents. It's important to evaluate the federal and state tax consequences of plan withdrawals and contributions before you invest in a 529 plan.

#### **Federal Income Tax Treatment of Qualified Withdrawals**

There are two types of 529 plans: savings plans and prepaid tuition plans. The federal income tax treatment of these plans is identical. Your contributions accumulate *tax-deferred*, meaning you don't pay income taxes on the earnings each year. Then, if you withdraw funds to pay the beneficiary's qualified education expenses, the earnings portion of your withdrawal is free from federal income tax. This feature presents a significant opportunity to help you accumulate funds for education.

Qualified education expenses for 529 savings plans include the following:

- tuition,
- fees,
- room and board,
- books,
- equipment, and
- computers for college and graduate school.

Additionally, up to a certain amount per year can be used for K-12 tuition expenses for enrollment at an elementary or secondary public, private, or religious school. Furthermore, under the SECURE Act of 2019, a portion of funds from a 529 plan can be used toward student loan expenses.

Qualified education expenses for 529 prepaid tuition plans generally include tuition and fees for college only (not graduate school) at the colleges that participate in the plan.

### **State Income Tax Treatment of Qualified Withdrawals**

States differ in the 529 plan tax benefits they offer to their residents. Some states offer no tax benefits, while others may exempt earnings on qualified withdrawals from state income tax or offer a deduction for contributions. Keep in mind that states may limit their tax benefits to individuals who participate in its in-state 529 plan. For example, some states allow residents to deduct a portion of their 529 plan contributions on their state income tax returns, while others do not offer any deduction or credit. It is important to check with your state's tax authority or plan administrator for details on available benefits.

You should also consult your state's laws to determine the income tax treatment of contributions and withdrawals. In general, you won't be required to pay income taxes to another state simply because you opened a 529 account in that state. However, you'll probably be taxed in your state of residency on the earnings distributed by your 529 plan if the withdrawal is not used to pay the beneficiary's qualified education expenses.

529 account owners interested in making K-12 contributions or withdrawals should understand their state's rules regarding how K-12 funds will be treated for tax purposes, as states may not follow the federal tax treatment.

### **Income Tax Treatment of Nonqualified Withdrawals (Federal and State)**

If you make a nonqualified withdrawal (i.e., one not used for qualified education expenses), the earnings portion of the distribution will generally be taxable on your federal (and probably state) income tax return in the year of the distribution. The earnings are usually taxed at the rate of the person who receives the distribution (known as the distributee). In most cases, the account owner will be the distributee. Some plans specify who the distributee is, while others may allow you (as the account owner) to determine the recipient of a nonqualified withdrawal.

You'll also pay a federal 10 percent penalty on the earnings portion of the nonqualified withdrawal. There are exceptions, though. The penalty is generally waived if you terminate the 529 account because the beneficiary has died or become disabled, or if you withdraw funds not needed for college because the beneficiary has received a scholarship. A state penalty may also apply.

### **Deducting Your Contributions to a 529 Plan**

Contributions to a 529 plan are not deductible on your federal income tax return. However, depending on where you live, you may qualify for a deduction or credit on your state income tax return. Many states offer a state income tax deduction or credit for contributions to a 529 plan. Keep in mind that



most states let you claim an income tax deduction or credit on your state tax return only if you contribute to your own state's 529 plan.

Many states that offer a deduction for contributions impose a deduction cap or limitation on the amount of the deduction. For example, if you contribute a certain amount to your child's 529 plan this year, your state might allow you to deduct only a portion of that amount on your state income tax return. Check the details of your 529 plan and the tax laws of your state to learn whether your state imposes a deduction cap. Your financial advisor can help you understand 529 plan rules in your state.

If you're planning to claim a state income tax deduction for your contributions, you should learn whether your state applies income recapture rules to 529 plans. Income recapture means that deductions allowed in one year may be required to be reported as taxable income if you make a nonqualified withdrawal from the 529 plan in a later year. Again, check the laws of your state for details, or talk to your financial advisor.

## **Coordination with Coverdell Accounts and Education Tax Credits**

You can fund a Coverdell education savings account and a 529 account in the same year for the same beneficiary without triggering a penalty.

You can also claim an education tax credit (American Opportunity credit or Lifetime Learning credit) in the same year you withdraw funds from a 529 plan to pay for qualified education expenses. However, your 529 plan withdrawal will not be completely tax-free on your federal income tax return if it's used to cover the same education expenses that you are using to qualify for an education credit. When calculating the amount of your qualified education expenses for purposes of your 529 withdrawal, you'll have to reduce your qualified expenses figure by any expenses used to compute the education tax credit.



Note: Before investing in a 529 plan, consider the investment objectives, risks, charges, and expenses carefully. The official disclosure statements and applicable prospectuses, which contain this and other information about the investment options, underlying investments, and investment company, can be obtained by contacting your financial professional. You should read these materials carefully before investing. As with other investments, there are generally fees and expenses associated with participation in a 529 plan. There is also the risk that the investments may lose money or not perform well enough to cover college costs as anticipated. Investment earnings accumulate on a tax-deferred basis, and withdrawals are tax-free as long as they are used for qualified education expenses. For withdrawals not used for qualified education expenses, earnings may be subject to taxation as ordinary income and possibly a 10% federal income tax penalty. The tax implications of a 529 plan should be discussed with your legal and/or tax professionals because they can vary significantly from state to state. Also be aware that most states offer their own 529 plans, which may provide advantages and benefits exclusively for their residents and taxpayers. These other state benefits may include financial aid, scholarship funds, and protection from creditors.

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