529 Plans: Save for College *and* K-12 Schooling

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AMONG THE WAYS TO SAVE for a college or graduate school education, 529 plans get top ratings. While the contributions to the plans are not tax-deductible for federal income tax purposes — many states offer some level of income tax deductibility — 529 plan funds grow tax-deferred, and distributions used to pay for higher education are tax-free. For non-qualified withdrawals — that is, withdrawals that don't meet 529 distribution rules — contribution amounts withdrawn are not taxed, but tax-deferred earnings and growth are taxed as ordinary income as well as being subject to a 10 percent penalty.

The 2017 Tax Cuts and Jobs Act created another reason to invest in 529 plans. You can now use the plans to pay up to $10,000 per student per year for private, public, or religious K-12 schooling. But if you're a parent or grandparent who has been contributing to a 529 plan, should you use the funds to pay for K-12 schooling? My answer is "yes," but in a specific way.

Before 529 plans could be used for K-12 schooling, the parent or grandparent would request a distribution from the plan custodian who would write the check to the school. I now recommend that tuition check — up to the $10,000 limit — first "flows through" an already established 529 plan. The tuition check is used to purchase a money market fund, and the money market fund is sold to pay for the schooling. Two things happen with this transaction:

1) You receive a state income tax deduction for the contribution. For example, Pennsylvania, where state income tax deductions are rare, allows for 529 plan deductions. At a tax rate of 3.07 percent, you have, in essence, earned an instant, risk-free 3.07 percent on the withdrawn amount.

2) When the tax-free distribution is made, earnings and contributions are distributed pro-rata from the account. The tax savings can be substantial when a 529 account has accumulated substantial deferred-tax earnings. And if a non-qualified distribution

from that same 529 account is made at a later date, those earnings that are subject to tax and the 10 percent penalty are reduced, providing for additional savings.

There are many different 529 plans to choose from. Your HBKS® advisor can help you find the 529 plan that best suits your needs.

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Matthew Costigan is a principal and senior financial advisor in the HBKS® Pittsburgh office. His clients benefit from his extensive knowledge and practical experience with tax laws and best practices as they affect individuals, including planning for the tax impact of qualified and non-qualified investments.