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Education Planning: 529 Plans

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About your instructor

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Learning Objectives

- State what expenses 529 plan distributions may be used for.
- Recognize ways that remaining funds may be removed from a 529 plan tax-free.
- Identify when a Coverdell ESA might be used instead of a 529 plan.
- Recognize changes to 529 plans due to recent tax legislation.

Education Funding Shortages

- Education funding shortages will occur anytime scholarships, grants, or other financial aid will not cover the costs of the student.
- Student loan interest is only deductible up to $2,500 and phases out very quickly. Alternatives to student loans may be more advantageous.
- 529 plans or Coverdell ESAs are pre-funded, tax-deferred savings vehicles. Both have different rules and different expenses that may be covered.

529 Plans

- **Sec 529(c)(3)(B):** 529 plan distributions are not taxable income as long as the funds are being used to pay for qualified higher education expenses of the **taxpayer, taxpayer's spouse, or the taxpayer's dependents**.

- **Sec 529(c)(7):** Up to **$20,000 per year (2026, up from $10,000)** may be distributed tax-free for a designated beneficiary's K-12 expenses. Under OBBBA, qualified K-12 costs now extend beyond tuition, effective after July 4, 2025.

OBBBA Changes to 529 Plans

- **Expanded K-12 expenses:** qualified K-12 costs now extend beyond tuition, effective for distributions after July 4, 2025.
- **Higher K-12 limit:** the annual K-12 cap doubles from $10,000 to $20,000 per beneficiary, effective January 1, 2026.
- **Postsecondary credentialing:** 529 funds may now cover recognized postsecondary credential programs, effective after July 4, 2025.
- **529-to-ABLE rollover:** made permanent; the prior January 1, 2026 sunset is removed.
- **2026 figures:** inflation adjustments per Rev. Proc. 2025-32 (IR-2025-103, Oct. 9, 2025).

Expanded K-12 Qualified Expenses

- For distributions after July 4, 2025, qualified K-12 expenses under Sec 529 extend beyond tuition to include:
- **Curriculum and instructional materials,** including books and online educational materials.
- **Tutoring** by a provider not related to the student (a licensed, current, or former teacher, or a subject-matter expert).
- **Testing fees** for nationally standardized achievement tests, AP exams, and college admission or entrance exams.
- **Dual enrollment fees** at an institution of higher education, and educational therapies for students with disabilities from a licensed provider.
- **State caution:** many states have not conformed — confirm state treatment before distributing.

K-12 Annual Limit Doubles to $20,000

- **Annual limit:** the cap on tax-free K-12 distributions rises from $10,000 to $20,000 per designated beneficiary.
- **Effective date:** distributions made after December 31, 2025 (2026 and later tax years).
- **Per beneficiary, not per account:** aggregate all 529 accounts for the same beneficiary against the single cap.
- **Planning:** coordinate distributions across family-owned accounts to avoid exceeding the cap.
- **State caution:** some states cap K-12 benefits lower or do not conform; the excess may be taxable at the state level.

Postsecondary Credentialing Expenses

- **New category:** for distributions after July 4, 2025, 529 funds may pay qualified postsecondary credentialing expenses.
- **Eligible programs:** recognized postsecondary credential programs — e.g., WIOA-authorized programs, military credentials, or programs approved or listed by a federal or state government.
- **Covered costs:** tuition, fees, books, supplies, and equipment required for the program, plus testing fees and continuing education needed to obtain or maintain the credential.
- **Planning:** broadens 529 use to trade, licensing, and professional-credential paths (e.g., CDL, cosmetology, CPA and bar exam fees).

What Are Qualified Higher Education Expenses?

Under Sec 529(f)(1):

- Tuition, fees, books, supplies, and equipment
- Expenses incurred for special needs services for a special needs beneficiary.
- Expenses for the purchase of computer or peripheral equipment, computer software, or internet access and related services if it's to be used primarily by the beneficiary during any of the years the beneficiary is enrolled at an eligible educational institution.
- Room and board expenses incurred by an eligible student who is attending an eligible educational institution at least half time.

Room & Board Limitation

- **Sec 529(e)(3)(B)(ii):** The amount of Room & Board that may be reimbursed through a 529 plan is limited to the greater of:
    - The allowance for room and board, as determined by the eligible educational institution, that is included in the cost of attendance for federal financial aid purposes for a particular academic period and living arrangement of the student or
    - The actual amount charged if the student is residing in housing owned or operated by the eligible educational institution.

Sec 529(c)(9) – Student Loan Repayments

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"Treatment of qualified education loan repayments

A. In general

Any reference in this subsection to the term "qualified higher education expense" shall include a reference to amounts paid as principal or interest on any qualified education loan (as defined in section 221(d)) of the designated beneficiary or a sibling of the designated beneficiary.

B. Limitation

The amount of distributions treated as a qualified higher education expense under this paragraph with respect to the loans of any individual shall not exceed $10,000 (reduced by the amount of distributions so treated for all prior taxable years).

(NOTE: It is a per borrower limit then – not a per account limit).

Qualified Student Loans

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To be considered a qualified education loan (and thus eligible for the $10,000 reimbursement), the loan must satisfy these requirements:

- The loan must have been borrowed solely to pay for qualified higher education expenses. Mixed-use loans, such as credit cards and home equity loans, do not qualify. Loans that, in combination with financial aid and other student loans, exceed the cost of attendance do not qualify.
- Loans from retirement plans do not qualify, even if they were used to pay for qualified higher education expenses.
- Loans made by someone who is related to the borrower (defined as brothers, sisters, spouses, ancestors and lineal descendants) are not eligible.
- The loan must have been borrowed within 90 days of the date the college costs were paid. Loans for prior year charges do not qualify.

Qualified Student Loans

To be considered a qualified education loan (and thus eligible for the $10,000 reimbursement), the loan must satisfy these requirements:

- The student must have been enrolled on at least a half-time basis during the academic term for which the loan was borrowed. This means that loans made after the student graduates, such as bar study loans and residency & relocation loans, do not qualify.
- The student must have been enrolled in a degree or certificate program. Continuing education loans do not qualify. Loans to pay for dual enrollment programs do not qualify.
- The student must have been enrolled in a college or university that is eligible for Title IV federal student aid.
- Qualified higher education expenses are based on the definition of cost of attendance in the Higher Education Act of 1965 that was in effect on August 4, 1997. Subsequent changes to the definition of cost of attendance, such as the addition of allowances for the purchase of a personal computer and for the cost of obtaining first professional credentials and licensing, do not apply. Any loans that were used to pay for these additional costs are not eligible.

Planning Considerations

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- 529 plans may be used to reimburse room & board. However, scholarships may not be used to reimburse room & board (this creates taxable income). Therefore, if the taxpayer has both, use the 529 plan funds to cover room & board first.

- Only up to ***adjusted*** qualified higher education expenses may be reimbursed through a 529 plan without creating taxable income. In other words, eligible qualified higher education expenses are reduced by the Lifetime Learning Credit, American Opportunity Tax Credit, scholarships, and Coverdell ESA reimbursements.

Example

Caleb is an undergraduate college student. For the 2026 tax year, he has the following expenses:

• Tuition & required fees:	$30,000
• Books:	$6,000
• Room & board:	$9,000
• **Total**	**$45,000**

If he receives a scholarship of $33,000, he can apply this against tuition & fees ($30,000) and books ($3,000). He can then distribute up to $12,000 from a 529 plan (assuming he is a designated beneficiary) to cover room & board ($9,000) and books ($3,000). This will result in no taxable income.

If the scholarship funds were used to cover room & board, this would result in taxable income. Therefore, documentation showing what the scholarship was applied against, as well as the 529 plan distribution, would be imperative.

Distributing Too Much

- If you distribute more than the amount of adjusted qualified higher education expenses, then the excess is taxable – but only to the extent of investment earnings.
- Excess distributions are allocated between earnings and return of principal based on the percentage of earnings in the 529 plan account right before the distribution.
- In addition to being taxable income, investment earnings are also subject to a 10% penalty.

Example – Excess Distributions

Brooke has $24,000 of tuition expenses for the 2026 tax year. She receives scholarships of $6,000 and a 529 plan distribution of $20,000. Her Form 1099-Q indicates that $4,000 of the $20,000 529 plan distribution consists of investment earnings.

Brooke's adjusted qualified higher education expenses is $18,000 ($24,000 - $6,000 = $18,000). There is an excess distribution of $2,000.

Because the distribution from the 529 plan was higher than this amount, the investment earnings portion will be included in gross income.

($16,000 ÷ $20,000) × $2,000 = $1,600 tax-free return of principal

($4,000 ÷ $20,000) × $2,000 = $400 taxable investment earnings

The $400 would be included in gross income and be subject to a 10% penalty.

Remaining 529 Plan Funds

- **If there are funds left in a 529 plan and the qualified beneficiary is done with college, there are several options to avoid a taxable distribution:**
    - Rollover the funds to another 529 plan
    - Change the designated beneficiary
    - Rollover the funds to an ABLE account
    - Rollover the funds to a Roth IRA
- There are several considerations to think through with each of these options though…

Sec 529(c)(3)(C)(i) - Rollover to Another 529 Plan

- In order to be considered a rollover, the funds need to be distributed and then transferred within 60 days to either:

    I. Another 529 plan for the same beneficiary or

    II. The 529 plan of a different beneficiary who is a member of the family of the designated beneficiary with respect to which the distribution was made

- Only one rollover may be made every 12 months for clause I above (not for clause II).

Sec 529(e)(2) - Member of the Family

The term “member of the family” means, with respect to any designated beneficiary—

A. the spouse of such beneficiary;

B. an individual who bears a relationship to such beneficiary which is described in subparagraphs (A) through (G) of section 152(d)(2);

C. the spouse of any individual described in subparagraph (B); and

D. any first cousin of such beneficiary.

Changing Beneficiaries

- **Sec 529(c)(3)(C)(ii)** – *"Any change in the designated beneficiary of an interest in a qualified tuition program shall not be treated as a distribution for purposes of subparagraph (A) if the new beneficiary is a member of the family of the old beneficiary."*

- In other words, a change in designated beneficiaries is not a distribution, as long as the change is to a family member.

- This is different from a rollover, because there is no transfer of funds to a new account. There is also no 60-day rule to deal with and no one every 12-month rule either.

Sec 529(c)(3)(C)(i)(III) - Rollover to an ABLE Account

- The 60-day rule applies to rollovers to an ABLE account, but not the 12-month rule.
- The rollover must be *"to an ABLE account (as defined in section 529A(e)(6)) of the designated beneficiary or a member of the family of the designated beneficiary."*
- Under OBBBA (P.L. 119-21), the 529-to-ABLE rollover is now permanent — the prior January 1, 2026 sunset has been removed.

Sec 529A - ABLE accounts

- An ABLE account is a tax-advantaged savings vehicle. Contributions are allowed to grow tax-free.
- Distributions are generally tax-free to the extent they are used for expenses of a disabled individual.
- For 2026, the base contribution limit is $19,000 (equal to the annual gift tax exclusion).
- Rollovers from 529 plans count toward the ABLE contribution limit; under OBBBA, the 529-to-ABLE rollover is now permanent.

Rollover to a Roth IRA Qualifications (effective 2024)

- Rollover must be a trustee-to-trustee transfer
- 529 plan must have been maintained for 15-year period ending on date of transfer.
- Amount of transfer to Roth IRA may not exceed aggregate contributions and earnings before 5-year period ending on the date of transfer.
- Transfers for any one taxable year cannot exceed the IRA contribution limitation for the year reduced by the amount of all contributions made to all IRAs maintained for the beneficiary's benefit during the year.
- Maximum $35,000 aggregate limitation on qualified transfers for current and all prior years.

Sec 529(c)(3)(E) – Rollover to Roth IRA

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Special Rollover to Roth IRAs From Long-Term Qualified Tuition Programs

i. In General *— In the case of a distribution from a qualified tuition program of a designated beneficiary which has been maintained for the 15-year period ending on the date of such distribution, subparagraph (A) shall not apply to so much the portion of such distribution which—*

I. — does not exceed the aggregate amount contributed to the program (and earnings attributable thereto) before the 5-year period ending on the date of the distribution, and

II. — is paid in a direct trustee-to-trustee transfer to a Roth IRA maintained for the benefit of such designated beneficiary.

529 Plan Funding

- In general, there are no federal limits to how much can be contributed to a 529 fund (some states have limits), but amounts over the annual gift tax exclusion are generally taxable gifts. The annual gift tax exclusion for 2026 is $19,000 per donor per donee (Rev. Proc. 2025-32).

- Sec 529(c)(2)(B): *"If the aggregate amount of contributions described in subparagraph (A) during the calendar year by a donor exceeds the limitation for such year under section 2503(b), such aggregate amount shall, at the election of the donor, be taken into account for purposes of such section ratably over the 5-year period beginning with such calendar year."*

OBBBA: Permanent Estate & Gift Exemption

- **Permanent $15M exemption:** OBBBA sets a permanent basic exclusion amount of $15,000,000 per individual for estate, gift, and GST tax, effective in 2026.
- **Up from 2025:** increased from $13,990,000, and the scheduled post-2025 sunset to roughly half that amount is repealed.
- **Inflation indexing:** the $15,000,000 amount is indexed for inflation beginning in 2027.
- **Married couples:** up to $30,000,000 combined, with portability of a deceased spouse's unused exclusion.
- **529 planning tie-in:** the annual gift tax exclusion is $19,000 (2026), and the 5-year election allows front-loading up to $95,000 per beneficiary to remove assets from the taxable estate.
- **Source:** IR-2025-103; Rev. Proc. 2025-32 (Oct. 9, 2025).

529 Contributions – State Level

- There is no federal deduction for 529 plan contributions. There is only tax-free growth within the account.
- Some states offer contribution deductions on the state return. These can vary significantly – for example, Virginia offers an up to $4,000 contribution deduction, whereas North Carolina offers no deduction.
- To get the deduction, a taxpayer would generally need to file a return in that state (and possibly also contribute to the 529 plan for that state).
- Investment options can vary significantly from one state to another.

Discussion

Would it ever be advisable to open a 529 plan outside of a client's state of residence? What would be the considerations before doing this?

529 Plans vs Coverdell ESAs

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- Coverdell ESAs have a $2,000 per year limit. 529 plans do not have a federal limit, but states may impose a limit (including a lifetime contribution limit).

- Coverdell ESAs have income restrictions (MAGI must be less than $110K or $220K if filing jointly for 2026 – phaseouts begin at $95K and $190K respectively). 529s do not have any federal income restrictions.

- Contributions to a Coverdell ESA may only be made until the beneficiary is age 18. Funds need to be withdrawn by the time the beneficiary reaches age 30. No equivalent rules for 529 plans.

529 Plans vs Coverdell ESAs

- More flexibility may be offered in Coverdell ESAs in terms of what you can invest in, since most investments are self-directed. 529 plans may offer a limited selection (this depends on the state).

- For elementary and secondary education, only tuition is a covered reimbursement for 529 plans. Coverdell ESAs cover tuition and fees.

- Coverdell ESAs may not be used to repay student loans. 529 plans can be used for this purpose (given the limits discussed earlier).

Can I Contribute to a 529 & ESA?

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- In general, yes. There are no federal tax issues with doing this. However, the gift tax annual exclusion may become an issue.
- Practically speaking, this may not make sense. If a 529 plan does not have a contribution limit, why contribute to an ESA as well? This creates an additional account to track for the client too.
- Utilizing an UGMA or UTMA in conjunction with a 529 plan could also be an option.

Why Choose an ESA?

- The main reason could be the flexibility of self-directed investments. Also, there are less limits on reimbursing for elementary and secondary school costs.
- This could be a good option, if family income is limited – and they are not planning to give more than $2,000 annually anyway.
- If you are in a state that does not offer a 529 plan contribution deduction, then this may not make a difference either.

Rollover of an ESA to a 529 Plan

- Distributions used to fund a 529 plan are considered a qualified expense as long as both accounts have the same beneficiary.
- A Coverdell ESA to 529 plan rollover may be done as a trustee-to-trustee transfer. If done this way, there is no limit to the number of Coverdell ESA transfers that may be made for a designated beneficiary.
- A 529 plan may generally not be rolled into an ESA.

Trump Accounts (Sec 530A): The Basics

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- New under OBBBA (§70204; IRC Sec 530A) – a non-Roth IRA for a child under 18 with a valid SSN. Applies to tax years beginning after Dec. 31, 2025; funding opens July 4, 2026.
- **$1,000 federal seed:** one-time pilot contribution (Sec 6434) for U.S.-citizen children born Jan. 1, 2025–Dec. 31, 2028; no income limits.
- **Annual cap:** up to $5,000 per child in after-tax (nondeductible) contributions, indexed after 2027; none in or after the year the child turns 18.
- **Employer contributions:** up to $2,500 per year under Sec 128, excluded from the employee's income and counted within the $5,000 cap.
- **Investments:** limited to low-cost funds or ETFs tracking a qualified U.S. equity index (e.g., S&P 500), fees ≤ 0.1%; earnings grow tax-deferred.
- **Distributions:** generally none before age 18; the account then follows traditional IRA rules – ordinary-income tax on withdrawals and a 10% penalty before 59½ (education and first-home exceptions).

Trump Accounts vs. 529 Plans

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Feature	Trump Account (Sec 530A)	529 Plan (Sec 529)
Tax treatment	Tax-deferred growth; withdrawals taxed as ordinary income (traditional-IRA rules)	Tax-free growth; qualified education withdrawals are tax-free
Contributions	After-tax, nondeductible	After-tax; no federal deduction (many states offer one)
Annual limit	\$5,000/child (indexed after 2027), incl. up to \$2,500 employer (Sec 128)	No annual cap; gift-tax exclusion \$19,000, or \$95,000 5-year front-load
Federal seed	\$1,000 pilot for U.S.-citizen children born 2025–2028	None
Qualified uses	No use restriction, but no education tax break; IRA rules after 18	College, K-12 (≤\$20k/yr), apprenticeships, credentials, \$10k loans
Non-qualified withdrawals	Ordinary-income tax + 10% penalty before 59½ (exceptions)	Tax on earnings + 10% penalty
Access & control	Locked until 18; then the child's own IRA	Owner-controlled; beneficiary changes allowed

Summing It Up

- 529 plan distributions may only be used to cover certain types of education costs.
- If an ineligible cost is reimbursed (or an amount above the adjusted higher qualified education costs), the amount is taxable to the extent of earnings. It is also subject to a 10% penalty.
- 529s are usually preferred over Coverdell ESAs. However, you may receive more investment flexibility with a Coverdell ESA. Also, some expenses may be covered with a Coverdell ESA that are not reimbursable under a 529 plan.

Thank you!

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Sources

- **IR-2025-103 (Oct. 9, 2025) and Rev. Proc. 2025-32** — 2026 inflation adjustments, including amendments from the One, Big, Beautiful Bill Act.
- **IRC Section 529, as amended by P.L. 119-21** (OBBBA, July 4, 2025) — expanded K-12 expenses, the $20,000 K-12 limit, postsecondary credentialing, and permanent 529-to-ABLE rollover.
- **IRS, Education Credits — AOTC and LLC;** IRS Publication 970, Tax Benefits for Education.
- **IRS Tax Tip 2026-21 (Mar. 12, 2026)** — education credits and the student loan interest deduction.