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White House Proposals on 529 College Plans Would Reduce Benefits

By TARA SIEGEL BERNARD
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Under new proposals, withdrawals from 529 plans would no longer be tax-free, while an education tax credit would be expanded. President Obama is proposing a radical change to the 529 college savings plans held by millions of families, which would require those who use them to rethink their approach to college savings.

As part of his plan to simplify the tax code and help the middle class, one of the 529 plan's most attractive benefits would be eliminated: Money could no longer be withdrawn tax-free. (The new rules would apply only to new contributions.)

The accounts, many of which are run by the states, allow people to make contributions that grow tax-free. The money can be withdrawn without the paying of capital gains taxes as long as the proceeds are used for education expenses. Many states provide state income tax deductions for contributions as well.

"I was very surprised by the Obama 529 proposal because in many ways it is anti-middle class for families trying to afford college," said Joe Hurley, founder of the SavingforCollege.com website. "And so much of the emphasis in the Obama administration has been pro-middle class."

But some experts said 529 plans, which are used by seven million families and hold $217 billion, disproportionately benefit the most affluent families, which can afford to save. More than 12 million accounts are in circulation, according to Strategic Insight, an investment consultant that tracks the industry. If more affluent families can afford to start saving early and often, the compounding over time enables them to avoid paying more taxes, especially those in higher tax brackets.

“They primarily provide a subsidy to people who would save in other forms anyway,” said Sandy Baum, a senior fellow at the Urban Institute.

The proposed changes — which many experts say would be difficult to pass in a Republican-controlled Congress — would discourage savers from using the accounts because the withdrawals would be taxed as ordinary income. Because that income will be recognized on families’ tax returns, it is also likely to reduce how much they may receive in federal financial aid, said Mark Kantrowitz, publisher of Edvisors.com, since they will be expected to contribute more.

Mr. Hurley of SavingforCollege.com said he would expect 529 contributions to dry up immediately, which would hurt the plans’ financial positions. “States that are not able to retain sufficient assets in their 529 plans will have a difficult time keeping their plans open,” he added.

Even if many middle-income families save in 529 plans, an administration official, referring to the Federal Reserve’s Survey of Consumer Finances, said that more than 70 percent of the account balances for 529 plans and another option known as Coverdell Education Savings Accounts are held by families with incomes over $200,000. (Those figures also include health savings accounts, but still provide a reasonable best estimate, the administration said.) A report from the Government Accountability Office found that a small percentage of families use 529 plans and Coverdell accounts. And those that do use them have a median income that is three times the median income of families without the accounts.

Still, Mary Morris, chairwoman of the College Savings Foundation, a nonprofit that supports the programs, said middle-class families still reaped great benefits from 529s. She said she would expect average account balances and monthly contributions to be far higher if only the most affluent families were benefiting. The average value of a 529 account is $19,774, according to Strategic Insight, while it estimates the average contribution to accounts that receive regular electronic contributions is about $175 a month.

A White House official said the overall goal was to simplify and consolidate many of the existing education-related tax breaks and redirect more money to middle-class families.

As part of that effort, it would also expand and make permanent theAmerican Opportunity Tax Credit, a credit for qualified education expenses for the first four years of higher education. The maximum credit is $2,500, and phases out for married people filing joint returns who earn $160,000 to $180,000 and for single people earning $80,000 to $90,000. Forty percent of the credit is refundable, with a maximum of $1,000, which means that those who have no federal tax liability will still receive money back.

The Obama plan would increase the refundable portion to a flat $1,500 and make it available for up to five years, as well as extend part of the break to part-time students.

The Obama administration's proposal would also eliminate the student loaninterest deduction on new loans, in part because the overall benefit is typically small, or about $100, and not widely claimed; repeal tax incentives on new contributions to Coverdell accounts; and eliminate the Lifetime Learning Credit and the tuition and fees tax deduction. But it would also wipe away the often surprising tax bill owed when a student's loan debt is forgiven under "pay as you earn" and other income-based repayment plans.

If the proposed changes to 529 plans somehow did pass, the plans would still have some benefits: Earnings would grow tax-deferred, and 35 states offer either tax deductions or credits for money placed into the accounts. But even with those perks, the plans are not likely to be as enticing given the restrictions on how the money can be invested and used.

"Taxpayers would be better off investing in mutual funds that operate in a tax-efficient manner or with a buy-and-hold strategy for individual stocks than in a 529 plan, since long-term capital gains tax rates are likely to be lower, yielding less of a tax bite if you invest in taxable accounts," Mr. Kantrowitz of Edvisors.com said.

"Not only would they have a greater net return on investment, but they'd have the flexibility to use the money for any purpose, not just their children's college education," he added. "The financial aid impact would be similar, assuming that the taxable accounts are in the parent's name."

He went as far as saying that the proposal could be characterized as a broken promise. "People saved money in 529 plans because of the expectation that the favorable tax treatment would continue," he said. "Imagine the uproar if the federal government were to begin taxing Roth I.R.A.s."