

Federal Changes to 529 Plans

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Issue

Explain the new federal tax law's changes to 529 plans and how the changes affect the (1) Connecticut Higher Education Trust (CHET) program and (2) state budget. Also, identify what the state can do to mitigate the fiscal impact.

The Office of Legislative Research is not authorized to provide legal opinions and this report should not be considered one.

Summary

The Tax Cuts and Jobs Act of 2017 (P.L. 115-97) expands the allowable use of 529 plans to include public, private, and religious K-12 tuition costs (up to \$10,000 per child each year). Federal law previously allowed the plans to be used only for higher education expenses (e.g., tuition, room and board, fees, and books). The new law also allows tax-free rollovers of amounts in 529 plans to certain qualified Achieving a Better Life (ABLE) accounts (i.e., tax-advantaged accounts to help eligible individuals and families to save for qualifying disability-related expenses).

This federal expansion of 529 plans affects the CHET program (Connecticut's state-sponsored 529 plan) because it operates pursuant to federal law. However, the CHET statutes specify that the program is used only to "promote and enhance the affordability and accessibility of higher education for

What are 529 Plans?

529 plans are tax-advantaged investment plans sponsored by states that are designed to encourage saving for a child's future education expenses. These plans are known as "529 plans" after the federal tax code provision that exempts their investment earnings from federal income tax as long as the withdrawals are used for qualified expenses. If the withdrawals are not used for qualified expenses, the earnings are subject to federal (and state) income taxes and an additional 10% federal tax penalty

residents of the state” ([CGS § 3-22g](#)). According to Christine Shaw, chief compliance officer and assistance treasurer for policy at the Office of the State Treasurer (OTT), the OTT is working on proposed legislation to conform the statutes to the federal changes.

The federal expansion could also impact the state’s budget. Under state law, taxpayers can subtract the amount they contributed to CHET accounts during the tax year from their Connecticut adjusted gross income (up to \$5,000 for single filers and \$10,000 for joint filers). If the federal tax changes result in an increase in the number of, and contributions to, CHET accounts, and thus increase the utilization of the CHET tax deduction, they could result in a state revenue loss.

The legislature could potentially mitigate this revenue loss by either (1) reducing the value of the CHET deduction or (2) making the deduction subject to recapture (i.e., repayment) if the CHET withdrawals are used for purposes other than paying higher education expenses. However, a recapture requirement may be difficult for the Department of Revenue Services (DRS) to enforce.

Changes to 529 Plans

The Tax Cuts and Jobs Act of 2017 modifies 529 plans by authorizing withdrawals for elementary and secondary (K-12) school tuition of up to \$10,000 per child per year. Under prior law, withdrawals had to be used for qualified higher education expenses (e.g., tuition, mandatory fees, and room and board) in order for the earnings on the invested funds to be exempt from federal income tax. As under existing law, any withdrawals not used for qualified expenses are subject to federal and state income tax and an additional 10% federal tax penalty (PL 115-97, § 11032).

The new law also authorizes, before January 1, 2026, tax-free rollovers from a 529 plan to an ABLE account if the ABLE account is owned by the same designated beneficiary of the 529 plan or a member of his or her family (PL 115-97, § 11025). Any amounts rolled over count towards the annual ABLE account contribution limits (currently \$15,000 per tax year). Under prior law, a rollover from a 529 account to an ABLE account was subject to income taxes (and in some cases a 10% penalty) on the earnings in the account.

Implications for Connecticut

Connecticut, like many other states, offers state tax benefits for its 529 plan, known as the CHET program. Contributions to CHET accounts are deductible for state income tax purposes, meaning that taxpayers can subtract the amount they contributed to CHET accounts during the tax year from

their Connecticut adjusted gross income. The law limits annual deductions to \$5,000 for single filers and \$10,000 for joint filers. Taxpayers can carry forward any unused deductions for up to five years, as long as each deduction does not exceed the annual maximum ([CGS 12-701\(a\)\(20\)\(B\)\(xii\) & 12-701a](#)).

To the extent the federal expansion of 529 plans results in greater utilization of the CHET deduction, it could result in a state revenue loss. According to the Office of Fiscal Analysis, the CHET deduction cost the state approximately \$11 million in foregone revenue in the 2016 tax year. If the federal tax changes result in an increase in the number of, and contributions to, CHET accounts (either for purposes of paying K-12 tuition or rolling over the funds to a qualified ABLE account), the \$11 million revenue loss would increase. The magnitude of the additional revenue loss depends on the increase in the CHET program's utilization. For example, a 100% increase in utilization at current average contribution levels would result in an additional \$11 million revenue loss per year.

To mitigate this revenue loss, the legislature could amend the state income tax statutes to (1) reduce the value of the CHET deduction or (2) require taxpayers to repay the deduction if the CHET withdrawals are used for purposes other than paying higher education expenses. The latter approach could be patterned after [New York](#), which imposes a tax recapture requirement on its deduction for contributions to the New York 529 college savings program in certain circumstances, such as rollovers to another state's 529 plan or nonqualified withdrawals. However, a recapture requirement could be difficult for DRS to enforce, according to Susan Sherman, DRS's legislative program manager. DRS would have to use its audit process to verify whether CHET distributions are subject to recapture.

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