

Costly frills: Extending 529 deduction to K-12 education

A largely insignificant benefit to Iowans who already can afford private school

By Peter Fisher, Iowa Policy Project

The Governor's Tax Plan (HSB 671) and the Senate-passed plan (SF2383) both would expand the current deduction for contributions to a college savings account — a 529 plan — by allowing the funds in those accounts to be used for private K-12 school tuition. It does this by conforming to the new federal definition of allowable withdrawals.

Conformity to the IRC here is something of a misnomer. A taxpayer who makes a contribution to a 529 plan receives a federal benefit: The interest or other earnings on the contribution are not taxed when the money is withdrawn to pay college education expenses. The tax advantage exists only to the extent that there is genuine savings involved over a period of time, with interest earnings or capital appreciation that would otherwise be taxed.

Iowa law currently goes beyond the federal law by allowing the taxpayer to deduct the contribution to the plan, up to a dollar limit of \$3,239 per child per contributor, for the year when the contribution is made.¹ It thus provides an immediate tax benefit, which can be taken whether or not the funds are left in the account to earn interest. By conforming to the federal definition of what is an allowable use of 529 plans, Iowa would be extending this state deduction benefit to parents of children in private K-12 schools.

If the goal is to increase access to private schools, extending the 529 plan tax benefits is a very weak tool for several reasons:

- Many low-income families will receive no benefit because even without the 529 deduction they have little or no taxable income. This will be even more common if a tax bill is passed that raises the Iowa standard deduction, because that would put many more families, primarily those with lower than average income, in the zero taxable income category where a further deduction is of no value.
- Even for low-income families with taxable income the deduction will be worth very little and will not make private school tuition appreciably more affordable. Consider a family with \$40,000 total income, taxable income of \$30,000. The additional deduction for private school tuition would reduce their state income tax by just \$210. Even a family with \$80,000 total income and \$60,000 in taxable income would save just \$257 by taking the maximum deduction for one child of \$3,239.
- Fiscal impact estimates by the Iowa Department of Revenue indicate that 71 percent of the benefit of the 529 plan extension would go to the 20 percent of taxpayers with incomes above \$100,000 per year — those who can afford private school tuition already.

Extending the 529 savings plan to cover K-12 private school tuition, in other words, is little more than a tax subsidy to parents already sending their children to private school, most of them with incomes well above the average.

The current 529 plan for *college* tuition does operate as a savings incentive for some. But there is no requirement that a family actually put money aside for future college expenses. A family with a college tuition bill due Sept. 4 can put \$3,239 in a 529 plan on Sept. 3, and take it all out again the next day to pay tuition. When they go to pay taxes the following April, they will be able to deduct that \$3,239 from their income just as if they had put it in a savings account years ago. Still, it is likely that most families use the 529 Plan today to save for higher education, particularly as those costs can be \$10,000 a year for a state university and more for a private college.

The extension of the 529 tax benefit to K-12 tuition largely applies to people who already are enrolling their children in private school. Currently, there are about 32,600 K-12 students enrolled in private schools² with parents of most of them paying tuition and also paying state income taxes. The extension of the 529 plan offers, in essence, a backdoor way for Iowa to subsidize this nonpublic education. There is little time to actually save for a child's K-12 education, making it likely that this extension of tax benefits will simply be used to get an immediate taxpayer-financed subsidy to cover tuition bills of these 32,600 students.

Iowa already provides some support for nonpublic education through the Tuition and Textbook Credit (TTC), and the proposed bill does not appear to prevent double dipping. For example, a couple paying \$6,000 in private-school tuition for their 10-year-old could each put \$3,000 in a 529 plan, then take it out a few days later to pay the tuition bill. Come tax time, they could deduct the \$6,000 on line 24 of the Iowa 1040, reducing taxable income by \$6,000. Then on line 44 they could take the maximum Tuition and Textbook Credit (TTC) of \$1,000, for the same tuition payment.

The Iowa Department of Revenue estimated that extending the 529 plan to K-12 education would cost the state \$5.2 million in tax year 2019,³ while the State Treasurer's Office put the estimate at \$7.5 million.⁴ It would add to existing uses of the public's tax subsidies for private education: the tuition and textbook credit, and the \$12 million tax credit for contributions to private school tuition organizations. There are longstanding issues and concerns regarding the extent to which Iowa should provide any assistance to students enrolled in nonpublic education. This approach, however, adds administrative complexity and cost to the 529 program, reduces state revenue available for other needs, and adds to the subsidies of nonpublic education in a way that also disproportionately benefits high-income families. In terms of tax principles of fairness, simplicity, revenue adequacy, and public purpose, this extension of the 529 program fails on all counts.

¹ A married couple with two children, for example, could contribute \$12,956 per year (two contributors, times two children). In addition, grandparents or others could each contribute \$3,239 per child, and would get the same Iowa tax benefit.

² State Treasurer's Office: "Expanding 529 State Tax Treatment to K-12." January 19, 2018

³ Letter from the Iowa Department of Revenue, Research and Analysis Division, to the Legislative Services Agency, January 17, 2018.

⁴ State Treasurer's Office: "Expanding 529 State Tax Treatment to K-12." January 19, 2018

Iowa Fiscal Partnership

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