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Strategies for Using a 529 Plan to Repay Student Loans

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The SECURE Act, which became law on December 20, 2019 as part of an annual appropriations bill, allows families to take a qualified distribution from their 529 college savings plans to repay up to $10,000 in student loans owed by each of the beneficiary and the beneficiary's siblings. But, why would anyone want to use a 529 plan to repay student loans?

After all, the best use of 529 plan money is to spend it up front, to avoid the need to borrow student loans at all.

But, despite all of the planning, sometimes families have leftover 529 plan funds as well as student loans, and want to use the leftover money to repay the student loan debt. The SECURE Act provides families with greater flexibility in spending 529 plan money.

New Use for Leftover 529 Plan Money

There are several situations in which a family might have both student loans and leftover 529 plan money.

- **Sibling's 529 plan.** If a younger child doesn't go to college, enrolls at a less-expensive college, such as a community college or in-state public 4-year college, or enrolls at a U.S. military academy, the leftover 529 plan funds can be used to repay the student loans of an older sibling who has already graduated.

- **American Opportunity Tax Credit (AOTC).** The AOTC is worth more, per dollar of qualified expenses, than a tax-free distribution from a 529 plan. So, families should carve out up to $4,000 in qualified expenses to be paid with cash or student loans instead of a 529 plan distribution to qualify for the maximum AOTC. Although one can avoid the 10% tax penalty on a non-qualified distribution, up to the amount used to claim the AOTC, one must still pay income tax on the earnings portion of the distribution. Using the 529 plan to repay student loans avoids both the tax penalty and the income tax on the distribution.

- **Lifetime Learning Tax Credit (LLTC).** A similar situation applies to the LLTC, but involves up to $10,000 in qualified expenses.

- **Scholarships.** If the student wins a qualified scholarship, the 10% tax penalty is waived on a non-qualified distribution up to the amount of the scholarship. Likewise, veterans' educational assistance or employer-paid educational assistance can qualify for a tax penalty waiver.

- **Timing the stock market.** Sometimes the stock market does not cooperate with the timing of college bills. After a correction or bull market, the best strategy might be to borrow to pay the bursar's bill so you can leave the 529 plan funds invested. Then, after the economic recovery, one can use the 529 plan money to repay the student loans.

- **Miscommunications between parents and grandparents.** Sometimes the account owner of a 529 plan does not tell the student's parents how much money is in the 529 plan, leading to a suboptimal spending strategy. This can lead to there being leftover money in the 529 plan.

- **Student graduates in three years instead of four.** If the student graduates in three years instead of four (or four years instead of five), there might be leftover money in the student's 529 plan.

Using Loans to Avoid Affecting Financial Aid

Sometimes it is advantageous to borrow instead of taking a 529 plan distribution, since taking a 529 plan distribution can affect the student's eligibility for need-based financial aid.

- **Impact of grandparent-owned 529 plan on student aid.** Grandparents may have opened 529 plans for their grandchildren with themselves as the account owner, without understanding that this could have a big impact on their grandchildren's eligibility for need-based financial aid. Distributions from a grandparent-owned 529 plan can reduce aid eligibility by as much as half the distribution amount. Ten states – Iowa, Massachusetts, Missouri, Montana, Nebraska, New York, Rhode Island, Utah, Virginia and Washington DC – require the taxpayer to be the account owner to claim the state income tax deduction or tax credit on contributions to the state's 529 plan. Fixing this by changing the account owner to the parent or rolling over the money to a parent-owned 529 plan might not be an option. If so, the grandparent could wait until January 1 of the sophomore year in college to take a distribution, when no subsequent year's FAFSA will be affected if the student graduates in four years. But, then the stude and parents may have had to borrow during the freshman year and the fall term of the sophomore year.

- **Minimizing impact on financial aid.** When someone other than the student's parents (custodial parent if the parents are divorced) helps pay for college, it can hurt eligibility for need-based financial aid. Some colleges treat such gifts as cash support (reduces aid by half of the amount of the gift) or as a resource (reduces aid dollar for dollar). Waiting until the student graduates to pay down student loans avoids the risk of a reduction in the student's aid eligibility.

- **Subsidized loans.** Borrowers of subsidized loans do not pay interest during the in-school and grace periods. Waiting until after the student graduates to pay off these loans yields more time for the earnings in the 529 plan to compound.

- **Student loan repayment as a graduation present.** Giving a student a graduation present of paying down their student loans can provide an incentive for on-time graduation and for getting good grades. The student's parents or grandparents might give this gift through a 529 plan in order to claim the state income tax deduction or tax credit on contributions to the state's 529 plan.

- **Change in plans.** Sometimes grandparents want to give their grandchild money after graduation to give them a head start on a down payment on a house, to start a business or for other purposes. But, if plans change, the grandchild might be left with student loans. The grandparent might contribute the money to a 529 plan to take advantage of the estate planning advantages.

Opens Up New Strategies

There are also several new ways to use 529 plans with student loans, given the tax-free status of a qualified distribution to repay student loans.

- **Repay parent loans.** Although the SECURE Act limited qualified distributions from 529 plans to repay qualified education loans of the beneficiary and their siblings, the account owner can change the beneficiary of a 529 plan to the beneficiary's parent, so that the parent can take a $10,000 distribution to repay federal and private parent loans.

- **Get a discount on student loan repayment.** If a borrower lives in one of the states that offers a state income tax break on contributions to the state's 529 plan, the borrower can get a discount on their student loans by contributing money to the state's 529 plan and then taking a qualified distribution to repay their student loans. Keep in mind your state might not conform to the new federal law. In some states the distribution to pay student loans may be considered a non- qualified expense. The 529 plan account owner should check their state's rules.

- **Use student loans to pay for non-qualified 529 plan expenses.** Some college costs, such as health care and transportation costs, can not be paid for with 529 plan savings. However, a 529 plan beneficiary can take out student loans to cover these costs, and then take a 529 plan distribution to repay the student loans later. If the student loans are subsidized, the loan balance can be paid off before interest begins to accrue.

- **Create new student loan forgiveness programs.** Philanthropists and foundations can now use 529 plans to create tax-free student loan forgiveness programs, up to $10,000 per borrower. Instead of paying off the borrower's student loans directly, the loan forgiveness program would contribute the funds to a 529 plan in the borrower's name.

The $10,000 lifetime limit on loan repayment prevents abuse of qualified distributions to repay student loans, but also constrains legitimate uses of distributions to repay student loans.

The coordination restrictions with the student loan interest deduction also helps avoid abuse. The earnings portion of distributions to repay the taxpayer's student loans will reduce the $2,500 annual limit on the student loan interest deduction. Of course, if the earnings portion of the distribution exceeds the $2,500 limit, the excess will not reduce the student loan interest deduction below zero.

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