

# BACKGROUND

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## Continuing the School Choice March: Policies to Promote Family K–12 Education Investment

*Lindsey M. Burke and Rachel Sheffield*

A part of the Heritage plan



### Abstract

*Coverdell education savings accounts (ESAs), created through the federal tax code, allow families to save money tax-free for K–12 and higher education expenses. Lifting the cap on contributions to Coverdell accounts would provide greater access to school choice options by allowing families to invest more money in their children’s education. Additionally, existing “529” college savings accounts should be expanded to allow families to save for K–12 education expenses. Both reforms would allow parents to use more of their money for a child’s private-school tuition or other education expenses. Since most states offer either tax credits or deductions to encourage saving in a 529 plan, expanding it to make K–12 expenses allowable would effectively create opportunities for millions of American families to open ESAs.*

The momentum for school choice in the United States has never been greater. In 2011, more states passed school choice legislation than in any previous year. Today, 18 states and Washington, D.C., have some form of private-school choice.

Some states provide school choice through scholarships, also known as vouchers, which go directly to students to be used at a private school of the family’s choice. Other states provide tax credits to individuals or corporations that contribute money toward children’s scholarships. Some states provide both types of programs. Education savings accounts (ESAs)—currently available only in Arizona—are a particularly innovative approach to school choice, allowing families of special needs children to use a portion of the dollars that would have been spent on their children in their assigned public schools for a variety of other education options, including private-school tuition, online education, and special-education services.

States and localities have, appropriately, led the way on school choice, since nearly all education funding and constitutional authority for education rests with them. The federal government can also advance school choice by relieving Americans’ tax

### TALKING POINTS

- The federal government can advance school choice by relieving Americans’ tax burden, particularly when saving for education.
- Lifting the cap on Coverdell education savings accounts (ESAs), currently set at \$2,000, would give families greater financial support, and increase school choice options to better direct their children’s K–12 education.
- Federal policymakers should also allow families to contribute money to “529” plans for K–12 educational expenses. Such an expansion would provide new incentives for families to save for education-related expenses while increasing their ability to pay for education options outside the public-school system.
- Expanding 529 college savings accounts to include K–12 education expenses would create opportunities for millions of American families to open ESAs.
- Such an outcome would significantly expand educational choice, consistent with long-term goals for reforming the federal tax code, as described in Heritage’s *Saving the American Dream* plan.

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**The Heritage Foundation**  
214 Massachusetts Avenue, NE  
Washington, DC 20002  
(202) 546-4400 | [heritage.org](http://heritage.org)

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burden, particularly when they save for education.

Today, Coverdell accounts, created through the federal tax code, allow families to save money tax-free for K–12 and higher education expenses.<sup>1</sup> Lifting the cap on contributions to Coverdell accounts would provide greater access to school choice options by allowing families to invest more money in their children’s education. Additionally, existing “529” college savings accounts—named after section 529 of the Internal Revenue Code that established the accounts in 1996 in federal law—should be expanded to allow families to save for K–12 education expenses. Both reforms to the federal tax code would empower families to keep more of their own money to put toward a child’s private-school tuition or other education-related expenses.

Federal policymakers should also promote saving by implementing the policies proposed in The Heritage Foundation’s *Saving the American Dream* plan to “fix the debt, cut spending, and restore prosperity.”<sup>2</sup> *Saving the American Dream* promotes saving by treating savings neutrally, eliminating multiple levels of taxation, and taxing savings only

when spent. Reforming and expanding the Coverdell and 529 savings accounts would be a stepping stone toward how all savings would be treated under *Saving the American Dream*. Under the plan, 529 accounts at the federal level would be superseded by the general savings account proposed in *Saving the American Dream*. Meanwhile, states could still offer their own types of 529 accounts, just as they do today.

Since most states offer either tax credits or deductions to encourage saving in a 529 plan, revising Section 529 of the Internal Revenue Code to make K–12 expenses allowable would effectively create opportunities for millions of American families to open ESAs. Such an outcome would encourage educational choice, consistent with long-term goals for reforming the federal tax code.

### **Lifting the Cap on Coverdell Accounts**

Coverdell accounts allow parents to save up to \$2,000 per year for a child’s educational expenses.<sup>3</sup> While contributions to Coverdell accounts are made with after-tax dollars, interest earned on contributions accrues free from federal income taxes. Coverdell accounts are

unique in that they allow funding to cover K–12 education expenses as well as college expenses. Savings can be used for private-school tuition, as well as for tutoring, special-education services, or other associated education costs (school uniforms, transportation, books and supplies, etc.).<sup>4</sup> By allowing families to save for education needs, Coverdell accounts increase educational options for elementary and secondary students.

Titled after the late Senator Paul Coverdell (R-GA), Coverdell accounts were signed into law in 2001 as part of President George W. Bush’s Economic Growth and Tax Relief Reconciliation Act.<sup>5</sup>

Parents may contribute to Coverdell accounts beginning with the birth of their children, and accounts require that all contributions be made before a child is 18 years of age.<sup>6</sup> Savings must be used by the time a child is 30 years old—or be distributed to another family member younger than age 30—to avoid penalty.<sup>7</sup> (In the case of special-needs students, these age limits do not apply.) Savings used for purposes other than education are taxable and receive a 10 percent penalty.<sup>8</sup> There is an income phase-out range of \$220,000 for a married couple

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1. Coverdell accounts—sometimes referred to as “education savings accounts”—are distinct from the newer state education savings accounts (ESAs). Coverdell accounts allow parents and other individuals to contribute their own after-tax dollars to a tax-free account from which withdrawals may be made for a child’s K-12 or college education-related expenses. State ESAs, by contrast, give families access to state per-pupil education expenditures that would have been spent on their child in public school, allowing them to use those funds in alternate educational venues.

2. Stuart M. Butler, Alison Acosta Fraser, and William W. Beach, *Saving the American Dream: The Heritage Plan to Fix the Debt, Cut Spending, and Restore Prosperity*, The Heritage Foundation, 2011, at [http://thf\\_media.s3.amazonaws.com/2011/pdf/sr0091.pdf](http://thf_media.s3.amazonaws.com/2011/pdf/sr0091.pdf).

3. Internal Revenue Service, “Coverdell Education Savings Accounts,” at <http://www.irs.gov/newsroom/article/0,,id=107636,00.html> (accessed April 13, 2012).

4. Matthew Ladner and Nick Dranias, “Education Savings Accounts: Giving Parents Control of their Children’s Education,” Goldwater Institute *Policy Brief* No. 11-01, January 28, 2011, at <http://www.goldwaterinstitute.org/sites/default/files/Policy%20Brief%2011-01%20Education%20Savings%20Accounts%20B.pdf> (accessed April 13, 2012).

5. *Ibid.*

6. Any individual can contribute money into a Coverdell account for a child. Contributions are not limited to parents.

7. Bob Lyke and James B. Stedman, “Education Savings Accounts for Elementary and Secondary Education,” Congressional Research Service, *Report for Congress*, RS20289, August 23, 2001, [http://digital.library.unt.edu/ark:/67531/metacrs1820/m1/1/high\\_res\\_d/RS20289\\_2001Aug23.pdf](http://digital.library.unt.edu/ark:/67531/metacrs1820/m1/1/high_res_d/RS20289_2001Aug23.pdf) (accessed April 13, 2012).

8. *Ibid.*

(\$110,000 for a single filer), meaning that the allowable annual contribution is reduced if income exceeds that amount. Corporations and non-profit organizations can make contributions regardless of total income.<sup>9</sup>

While Coverdell accounts increase a family's options for a child's K-12 education, they are currently limited by a maximum annual contribution of \$2,000. Lifting the cap on Coverdell accounts would give families greater financial support and increase school choice options to better direct their children's education.

In addition to lifting the cap on Coverdell contributions, policymakers should ensure that measures are in place concerning potential tax penalties if money earned in a Coverdell account is not used for education-related expenses. If a child does not attend a private school, or for whatever reason cannot use the money accrued in the account, contributors should be allowed to either hand that money down to the next generation without a tax penalty, or to roll it into their gross income without an additional tax penalty.

### Expanding 529 Accounts to Include K-12 Expenses

States and school districts across the country have appropriately led the way in expanding school choice options for families. In addition to

lifting the cap on Coverdell accounts, federal policymakers have the opportunity to advance school choice by making K-12 education costs an allowable expense under 529 college savings plans.

The federal government currently provides tax advantages for families saving for college tuition and other higher education expenses. This incentive, known as a 529 college savings account, allows money to grow tax-free, without incurring federal tax penalties; 529 college savings plans are municipal securities regulated by states, with contributions largely managed by private investment firms. In addition to interest accruing free from federal tax penalties, many states also allow college savings to accrue in 529 accounts without requiring investors to pay state taxes on interest earned in order to encourage saving. In these states, families can withdraw money tax-free to pay for tuition, books, and other education-related expenses at any college, graduate, or trade school.

While 529 plans are codified in federal law, states "retain discretion over designing plan features, such as investment options, fee structures, and distribution methods, as well as the state income tax treatment of contributions and distributions."<sup>10</sup> Most 529 plans put contributors' money into various investments, including stocks and bonds, with

money typically shifting to less risky investments as a child nears college age. Not only are parents not penalized on the interest earned on money that accrues in a 529, they can then withdraw that money tax-free, as long as it is being used to pay for higher education-related expenses.<sup>11</sup> The ability to withdraw money tax-free from a 529 savings account provides a significant advantage over traditional savings accounts, as interest earned in a traditional savings account is subject to income tax.<sup>12</sup>

There are two types of 529 plans: 529 college savings accounts, and 529 prepaid tuition plans.

**State 529 Plans.** State 529 plans include both prepaid tuition and college savings plans. All 50 states and Washington, D.C., now offer either the prepaid or college savings state 529 plan, with 17 states offering both.<sup>13</sup> Washington State offers the prepaid tuition option but not the college savings plan, while 32 states and Washington, D.C., offer the college savings option but not the prepaid tuition account.<sup>14</sup> Several states' prepaid tuition plans are currently closed to new investors.

Families in Kentucky, for example, have access to the state's 529 college savings plan. Through the Kentucky Educational Savings Plan Trust (KESPT), parents can save money for their child's future college expenses

9. Ibid.

10. Raquel Meyer Alexander and LeAnn Luna, "States Battle to Win 529 Plan Investors: Differences Lead to Complexity and Confusion," University of Kansas, August 8, 2005, at [http://people.ku.edu/~raquela/\\_pdf/State%20Tax%20Notes%20Aug%202005%20States%20battle%20to%20win%20529%20plan%20investors.pdf](http://people.ku.edu/~raquela/_pdf/State%20Tax%20Notes%20Aug%202005%20States%20battle%20to%20win%20529%20plan%20investors.pdf) (accessed April 13, 2012).

11. Matt Krantz, "Are 529 College Savings Plans Too Risky to Invest In?" *USA Today*, January 11, 2012, at <http://www.usatoday.com/money/perfi/columnist/krantz/story/2012-01-11/529-college-savings-plans/52500512/1> (accessed April 23, 2012).

12. Ibid.

13. Alabama, Colorado, Florida, Illinois, Kentucky, Maryland, Massachusetts, Michigan, Mississippi, Nevada, New Mexico, South Carolina, Tennessee, Texas, Virginia, West Virginia, and Wisconsin offer both prepaid tuition 529 plans and college savings 529 plans. See FinAid, "State Section 529 Plans," at <http://www.finaid.org/savings/state529plans.phtml> (accessed April 13, 2012).

14. FinAid, "State Section 529 Plans."

without having to pay state taxes on contributions to the account or federal or state taxes on any earnings that accrue from the investments. In order to remain free from federal or state tax liability, earnings accrued through the 529 college savings plan must be used for higher-education expenses.

Anyone can open a 529 account on behalf of a beneficiary, and plans are managed through the TIAA-CREF financial services company.<sup>15</sup> Kentucky's 529 college savings plan is overseen by the Kentucky Higher Education Assistance Authority.

Massachusetts families have access to the U. Plan Prepaid Tuition Program. The Massachusetts Educational Financing Authority manages the state's 529 prepaid college tuition plan, which allows parents to prepay up to 100 percent of their child's future college costs at current rates. Parents can prepay tuition at current rates even though their child might not attend college for many more years.<sup>16</sup>

The Small Business Job Protection Act of 1996 codified 529 college savings plans and prepaid tuition accounts through section 529 of the Internal Revenue Code. Before providing the federal tax incentive, just a handful of states—Florida and Michigan being the first in 1980—had implemented 529 college savings accounts or prepaid tuition plans.<sup>17</sup> A subsequent change to federal law through the Economic Growth and

Tax Relief Reconciliation Act of 2001 amended Internal Revenue Code section 529 to allow distributions, that is, qualified higher-education expenses, to also be withdrawn tax-free. The change, which now meant that withdrawals from 529 plans would be exempt from federal income tax, led to an explosion in interest in state 529 plans.<sup>18</sup>

In fact, 529 accounts have become so popular among families that investments have increased significantly in recent years. In 2000, there were \$2.6 billion in total investments in 529 plans; by 2006, that figure had increased to \$92 billion,<sup>19</sup> and by 2011 had reached \$135 billion—a 47 percent increase.

#### **Revising 529 College ESAs to Include K–12 Education Expenses.**

Families might question why the federal government tax-advantages one form of education savings (higher education) over another (K–12). The popularity of 529 college savings accounts indicates that families would likely take advantage of the option if it were made available for K–12 education expenses.

The biggest advantage to investing in a 529 plan is that withdrawals from the accounts are free from any federal income tax. Funds spent from 529s are tax-free, as long as disbursements are used to cover qualified educational expenses. But there is another significant advantage to 529 plans: In order to encourage saving for college, 35 states currently

provide tax credits or deductions for contributions to 529s (although contributions cannot be deducted from federal income tax liability). Of the 44 states that levy an income tax on earnings, 35 offer credits or deductions for contributions to 529 plans (80 percent).

Expanding section 529 of the Internal Revenue Code to allow families to contribute money to 529 plans for K–12 educational expenses would provide new incentives for families to save for K–12 education-related expenses while increasing their ability to pay for education options outside the public-school system.

This relatively small change to federal tax law could have major implications for school choice. Since most states have either tax credits or deductions to encourage saving in a 529 college plan, revising section 529 to include K–12 expenses would likely encourage states to allow parents to deduct their contributions to 529 plans from their state income tax obligations, in order to encourage saving for K–12 education costs.

A change in the federal tax code to expand 529 college savings accounts to include K–12 education expenses could effectively provide access to education savings accounts for millions of American families. Such an outcome would significantly expand educational choice, consistent with long-term goals for reforming the federal tax code.<sup>20</sup>

15. Kentucky Education Savings Plan Trust, "Benefits and Tax Advantages," at <http://www.kentuckytrust.org/benefits/index.shtml> (accessed April 13, 2012).

16. Massachusetts Educational Financing Authority, "U. Plan Prepaid Tuition Program," at <http://www.mefa.org/saveforcollege/saveforcollege.aspx?id=1302> (accessed April 13, 2012).

17. Alexander and Luna, "States Battle to Win 529 Plan Investors: Differences Lead to Complexity and Confusion."

18. *Ibid.*

19. FinAid, "State Section 529 Plans."

20. Another argument for extending 529 plans to include K-12 education expenses is the looming higher education "bubble." If college becomes significantly less expensive as a result of shifts toward online learning and other innovations, the hundreds of billions of dollars currently trapped in 529 accounts should be available for K-12 education expenses.

## Recommendations for Federal Policymakers

- **Lift the Cap on Coverdell Accounts.** Congress can reform the existing Coverdell program to empower families with increased access to school choice. The existing \$2,000 annual cap on Coverdell contributions prevents the accounts from being as beneficial as they could be to help families afford a variety of education options outside the traditional public-school realm. Lifting the cap on Coverdell contributions would provide greater support for school choice.
- **Expand 529 Accounts to Include K-12 Education Expenses.** Section 529 of the

Internal Revenue Code should be expanded to allow families to contribute money to 529 plans for K-12 educational expenses. Contributors should be allowed to invest in 529 plans, with disbursements for education expenses remaining exempt from federal income tax requirements. Revising Section 529 to make K-12 expenses allowable would significantly increase the school choice landscape by creating opportunities for millions of American families to open ESAs.

### Conclusion

The momentum for school choice has never been stronger. There is growing consensus that a child's educational destiny should not be bound to his or her parents' zip

code, and that the best way to free children to pursue a bright future is through educational choice. Existing provisions in federal tax law could be strengthened and expanded to ensure that parents have the greatest opportunity to direct their own money to provide a quality education for their children. Lifting the cap on Coverdell accounts and expanding 529 plans to allow K-12 expenditures would go a long way toward achieving that goal.

—*Lindsey M. Burke is the Will Skillman Fellow in Education, and Rachel Sheffield is a research associate in Domestic Policy Studies, at The Heritage Foundation.*