Cross-Border Implications of Holding a **529 Plan**

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CROSS-BORDER WEALTH MANAGEMENT

Thousands of Canadians relocate to the U.S. for career opportunities each year. They often envision staying a couple years to garner valuable experience before returning home. However, what was originally meant to be a short sojourn can quickly become a decade or more. Their life may change significantly during that time, perhaps due to a marriage or the birth of children. This article focuses on 529 plans for children and the tax implications of this educational investment vehicle in a move back to Canada.

529 Basics

As its name suggests, this plan is derived from Section 529 of the Internal Revenue Code. It states that a qualified tuition plan shall be exempt from taxation. There are two types of 529 plans: prepaid tuition plans and educational savings plans. For more information on the nature of these categories see Cardinal Point's blog titled: Canada & U.S. Education Savings Options.

529 plans are sponsored by individual states, and it is not uncommon for a resident of one state to utilize another state's 529 plan. Why? Because not all states allow for an income tax deduction or credit on the 529 contributions (34 states do). As such, the resident of that state may look for a 529 plan in a state where there are better investment options, lower fees, lower minimum contribution amounts, or higher total lifetime account balance thresholds.

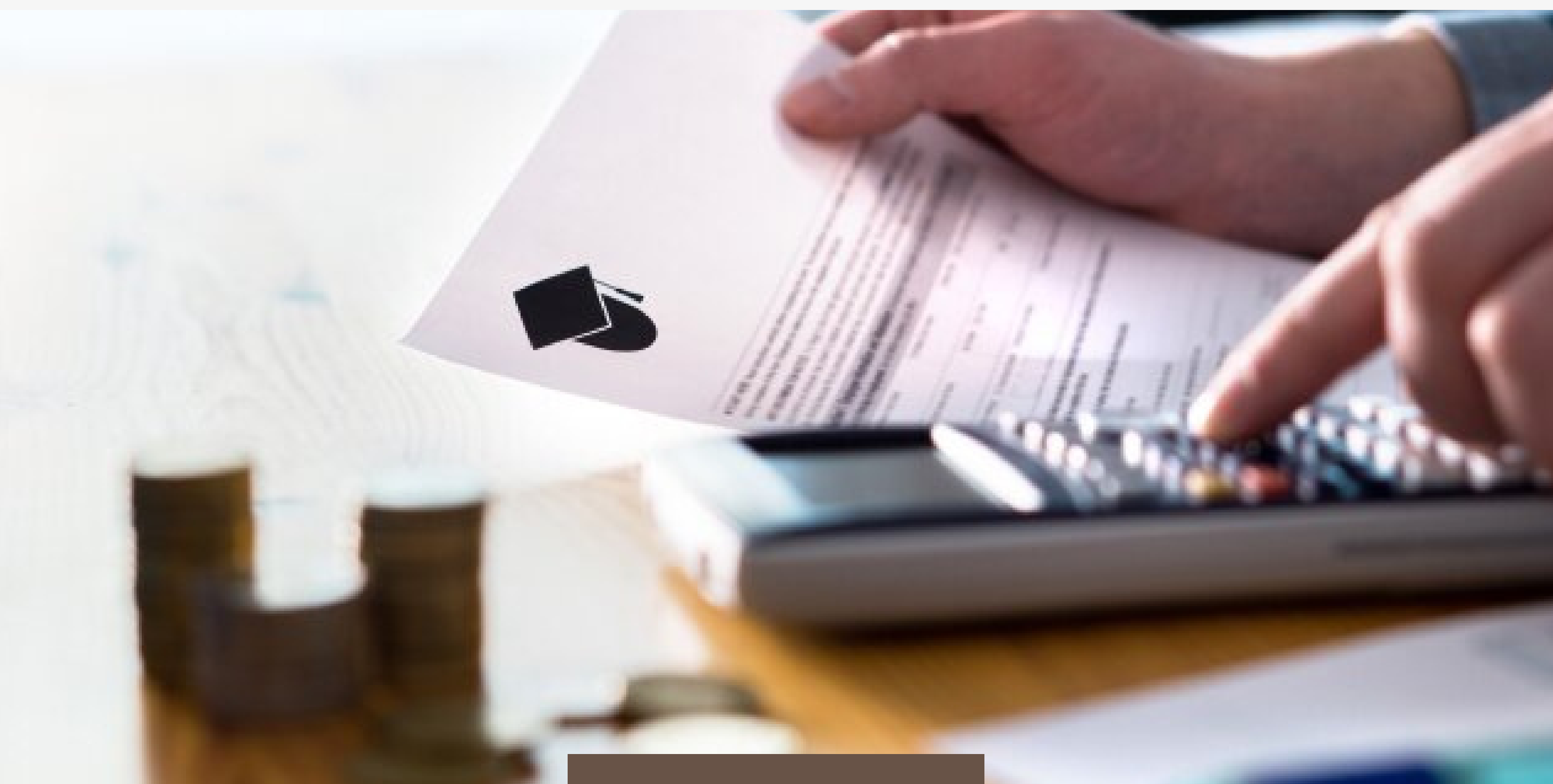
529 Mechanics

Contributions made to a 529 plan are limited to an annual $16,000 per beneficiary. This amount doubles to $32,000 if the donors are married filing jointly. There is also an option that exists to “front load” the 529 with up to five years’ worth of contributions ($160,000) if married filing jointly. As long as no additional contributions to that beneficiary are made within that five-year window, no gift tax filing obligations are required.

Money contributed does not receive a tax deduction at the federal level. However, if the contributor resides in one of the 34 states that allows for a state income tax deduction or credit, then there is a tax benefit that can potentially be utilized. The earnings on the associated investments within the plan grow tax free as long as future withdrawals are utilized for qualified higher education expenditures.

Expenses that do not qualify for tax-free withdrawal include room and board, transportation, and medical expenses to name a few. If the withdrawal is deemed unqualified, then the earnings on the distribution are subject to income tax and an additional 10% penalty per the “Kiddie Tax” rules (see below).

The Tax Cuts & Jobs Act (TCJA) of 2017 added a feature to qualified 529 withdrawals that allowed $10,000 of annual distributions to be used for K-12 school tuition. The Secure Act of 2020 preserved this condition in the legislation. In addition, the Secure Act revitalized the old “Kiddie Tax” regime.



Kiddie Tax Basics

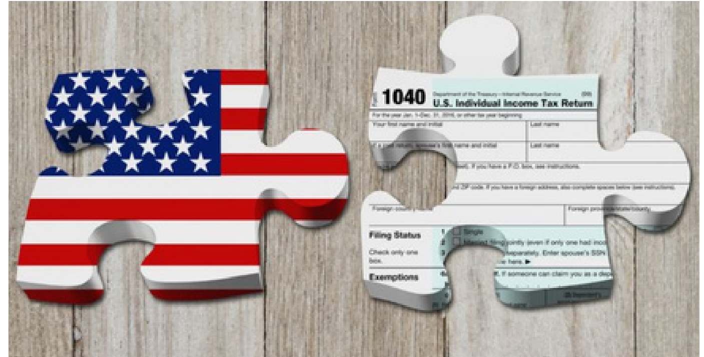
The tax applies to children under the age of 19 unless they are full-time students. In the latter scenario, these tax rules apply until the young adult turns 24. Under these rules, a portion of a child's unearned income could be taxed at the parent's marginal income tax rate. This would include any unqualified distributions from a 529 plan.

When analyzing the federal income tax bill of the child subject to the "Kiddie Tax," the standard deduction rules apply. For 2022, the child's standard deduction is the greater of: $1,100 or earned income plus $350, not to exceed $12,950. Any annual unearned income between the standard deduction and $2,200 is taxed at the child's tax rate. Once the annual $2,200 threshold is exceeded, the remaining unearned income is taxed at the parent's marginal tax rate, which could be as high as 37%.

Cross-Border Implications of 529 Plans

Let's assume a Canadian family living in Texas had two children during their U.S. tenure. These children are dual citizens of Canada and the U.S., are currently in high school, and plan to go to a Canadian university for higher education. Now that the entire family has made the decision to return to Canada, how should they deal with the 529 plans they've accumulated and what are the tax considerations?

U.S. Taxation



If the Canadian college or university is eligible for Section 529, any qualified distributions are tax free for U.S. tax purposes. Many, but not all, Canadian institutions are eligible, and the list evolves over time. The Federal School Code Lookup Tool gives you an easy way to determine whether your chosen Canadian college or university is eligible for Section 529. The custodian of the 529 reports the distribution on a Form 1099-Q and, assuming the funds were paid to the 529 beneficiary, college/university, or student loan provider, the distribution would be reported on the child's tax return.

Canadian Taxation

Although 529 plans provide income tax savings for U.S. residents, they are effectively taxable brokerage accounts for Canadian income tax purposes. As such, any investment income earned in the account would be taxable on an annual basis. Upon re-establishing Canadian tax residency, there is a step up in the cost basis (converted into CAD) that is applicable to certain assets inclusive of 529 accounts. This is called the "deemed acquisition date" and resets the book value for Canadian tax purposes to the fair market value on the date Canadian residency is established.

There is also an argument that the 529 plan would be a deemed resident trust that would require Canadian trust filings. In order to avoid Canadian taxation of these accounts in some form or another, you may want to consider transferring ownership of the account to a trusted family member or other individual who resides in the U.S. prior to your move to Canada. That transfer should not trigger any tax. After transfer of ownership, you could continue to contribute to the fund through gifts, and the account would avoid taxation in Canada. However, some do not feel comfortable transferring ownership of their 529 accounts.

In Conclusion

The future changes constantly, and it's difficult to know with certainty where you'll choose to reside or where your child will decide to pursue his or her higher education. If you are confident your child will choose to go to school in the U.S. or enroll in an international institution that is 529 eligible, then a 529 plan is worth exploring. For a more detailed analysis of the options available to meet this goal, it is prudent to have a conversation with a cross border expert.

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