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A Little-Known Tax Break for Bruised 529s

Families saving for education may be eligible to recoup some of the money lost in the market this year.

By BRETT ARENDS

It's hard enough saving to send children to college, especially when the market collapses as it has this year.

But millions of Americans saving for education may be missing out on a big tax break that could save them thousands of dollars this year. The break is so obscure that several accountants I spoke to hadn't even heard of it.

But it could benefit people saving for their children's or grandchildren's college costs through a qualified tuition plan such as a 529 plan.

529 plans are tax shelters that allow you to invest tax-free for college expenses. In a curious twist, if you have lost money in one of these accounts, you may still be able to deduct those losses from your adjusted gross income.

In the current market, anything that lets you deduct losses is especially good news. And for middle-class Americans, struggling to save up enough to put children through college, this could be a lucky break.

"We can't solve the problem that this has been a painful year for families and college savers," says Larry Glazer, managing partner at Mayflower Advisers in Boston. "But at least this is a silver lining that can help people as they try to position themselves for the recovery."

The tax break in question would show up as an miscellaneous itemized deduction on your income tax return. You can only deduct those to the extent they exceed 2% of your adjusted gross income.

Here's how it works:

Imagine a couple that put \$120,000 into a 529 tax shelter for a grandchild a year ago. If the market had continued to boom, that money would have grown tax-free. As long as it was eventually spent on qualified tuition expenses, no tax would have been paid on withdrawals. These 529 plans are terrific tax shelters for middle-class couples with children or grandchildren.

Obviously, though, investing has been a hazardous occupation of late. Imagine that same couple now looks at the 529 and realizes those investments have plunged to just \$70,000 in value.

Yikes. That's a \$50,000 loss.

The couple can close the account and withdraw the money. At that point, they may be able to deduct nearly all of that loss from their taxable income. That wouldn't restore all the money lost, but could at least soften the blow.

Many Americans may be missing out on this deduction. Most 529 plans are sold through financial advisors, but comparatively few know about this rule. (For those seeking more details, they can be found in IRS Publication 970, Tax Benefits for Education, page 51, and in the Federal Register, Vol. 73, No. 13, page 3445.)

There are lots of caveats. This is one of those things you don't want to try on your own with consulting your tax accountant.

Joseph Hurley, 529 expert and founder of SavingforCollege.com, notes that you won't be able to deduct the losses from alternative minimum tax, the stealth bomber hitting middle-class families. If you deduct your 529 plan contributions from your state income tax, you may face recapture of some of those deductions. If you want to reinvest the money in another 529 after taking the loss, you should wait 61 days: Otherwise the IRS may deem you're a non-taxable rollover and you will lose the deduction. That new investment, incidentally, may count as a new, taxable gift to the beneficiary.

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