RAYMOND JAMES

Withdrawing From Your 529 Plans

It won't be long before colleges start sending out bills for next semester's college expenses. This is a good time to consider strategies for withdrawing funds from a 529 plan.

Just like with any investment, withdrawing from your 529 college savings plan should be done carefully and deliberately. To receive the full benefit of your 529 plan, withdrawals should be for qualified education expenses only. Withdrawals for non-qualified expenses can result in penalties and tax liabilities. Your financial advisor and tax advisor can help ensure you get the most out of your 529 plan and its tax benefits.

TAX REPORTING

The broker-dealer or program manager administering your 529 account is responsible for keeping records of the amounts contributed to the account and the earnings accumulated, as well as reporting that information to the Internal Revenue Service. As a tax-deferred account, no reporting is done until an investment in the plan is liquidated. After the end of the year in which liquidations and withdrawals are made, a Form 1099-Q will be sent to both the IRS and to the person who received the distribution – for tax reporting purposes, distributions sent directly to the school are considered to be made to the beneficiary. Withdrawals come out of the account on a pro rata basis, meaning the withdrawal consists of two parts – return of principal and earnings. Unlike other tax-deferred accounts, 529 accounts treat all withdrawals as pro-rata. The principal portion of the withdrawal is federal tax-free, while the earnings portion may be taxable if not used for a qualified expense. The Form 1099-Q will show how much of the withdrawal consists of return of principal and how much consists of earnings.

State tax treatment varies. Some states, for example, tax withdrawals for qualified expenses if made from an "out-of-state" plan while other states tax withdrawals when used to pay for K-12 tuition, student loans or apprenticeship programs. States may also recapture previously claimed state tax deductions when making a non-qualified withdrawal. Talk to your tax advisor about your state's tax treatment of 529 withdrawals.

KEY TAKEAWAY

A 529 plan is a tax-advantaged savings plan designed to encourage saving for future college expenses. It is usually operated by a state but can be used to meet the costs of colleges nationwide. The 529 plan can be an effective way to pay for your child's, grandchild's or any other person's education costs, but as with most savings vehicles, there are ways to better take advantage of the 529's tax advantages.

TIP

In most cases, it may be best to request withdrawals in the beneficiary's name or to the school as any refunds that may become taxable will be at the student's income tax rate.

QUALIFIED EDUCATION EXPENSES

To maximize the impact of your 529 savings, withdrawals should be made for qualified education expenses for a student enrolling in and attending an eligible educational institution.

These include:

- Tuition and fees
- Books, supplies, computers and peripheral equipment
- Room and board (if attending school more than half-time)
  - If a student is residing off campus and enrolled in school more than half-time, room and board will be considered a qualified expense only if the total cost of off campus room and board does not surpass what the school determines to be the estimated housing cost for the year. This amount can be found on the school's "Cost of Attendance" webpage.
- Expenses for special needs services incurred in connection with enrollment or attendance by a special needs beneficiary
- A maximum of $10,000 may be used for tuition at an eligible primary or secondary school
- Distributions made after 2018 may be used for:
  - Books, fees, supplies, equipment associated with participation in a registered and certified apprenticeship program
  - No more than $10,000 paid as principal or interest on qualified student loans of the designated beneficiary or their sibling
- It is important to note not all states allow qualified 529 plan withdrawals for K-12 education, student loans, or apprenticeship programs, therefore, you may be subject to varying tax consequences depending on which state the client who purchased the 529 plan resides. Check with a tax professional for considerations specific to your state.

WITHDRAWAL FOR QUALIFIED EXPENSES

Withdrawals made for qualified education expenses for the school year are federal tax-free. We suggest you keep receipts and records to substantiate your qualified expenses in case of an audit by the IRS. When making a withdrawal from your 529 plan, consider the following:

- The withdrawal can be made before you pay for the qualified expenses. In all likelihood, you will know what the expenses will be at the beginning of the semester, although some of those costs won't be due until later. You can request a withdrawal large enough to cover expenses as they are due for the next several months. Just remember to make the withdrawal in the same year as the expense is paid. Only withdraw for expenses you are certain to incur, as the earnings portion of an excess withdrawal will be taxable.
- A withdrawal can be made to cover expenses already paid as long as the withdrawal occurs in the same year as the payment. For example, if you have already paid for tuition, fees and other qualified expenses from your checking account, you can request a withdrawal to reimburse yourself.

WITHDRAWALS FOR NON-QUALIFIED EXPENSES

The earnings portion of a withdrawal for non-qualified expenses is taxed as ordinary income and assessed an additional 10% penalty tax. So, should you find it necessary to take a withdrawal for non-qualified expenses, ask that it go directly to the beneficiary, assuming the student is in a lower tax bracket than the owner or participant. That way the beneficiary can report the withdrawal as income on his or her year-end tax return and potentially pay less tax on it.

Plan as you might, sometimes your withdrawals will end up going to unintended non-qualified expenses. For example, your bright student beneficiary may be awarded a scholarship that covers a portion of his tuition and room and board after you requested and received a withdrawal from your 529 plan. Or, perhaps the student withdraws from a class or leaves school and is given a refund by the institution.

On December 18, 2015, the PATH Act was signed into law, which allows a refund by an eligible institution to be re-contributed to a 529 plan for which the student is the beneficiary. A re-contribution must be made no more than 60 days after the date of the refund, and the re-contributed amount cannot exceed the amount of the refund.

Requesting payments to the right person and timing distributions to coincide with events that avoid the penalty tax can help you maximize your 529 plan withdrawals.

CONCLUSION

A 529 plan is a great way to save money for a child's or grandchild's education, and a wonderful, generous gift that can give your loved ones a great head start in their adult lives by limiting their student loan debt. Making the right kinds of withdrawals can help you and your beneficiaries enjoy the tax benefits 529s offer and help ensure your gift goes on for as long as possible.

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