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Your guide to 529 college savings plan withdrawals

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Each fall, many of our clients' children and grandchildren begin their college experience. As we guide these families from the accumulation phase through the use of their college savings, we've found that it has been helpful to review the features of 529 College Savings Plans and offer reminders on how to take advantage of these benefits. Of course, each family's circumstances are unique and we welcome the opportunity to discuss your specific situation.

529 College Savings Plans ("529 plans")

529 plans are state-sponsored investment accounts that offer tax advantages to parents and grandparents saving for college. Each account has an "owner" (typically the parent or grandparent) and a "beneficiary" (the student). Investments within a 529 plan grow tax-free and withdrawals for qualified college costs can be withdrawn free of federal income tax.

Additionally, many states offer state tax benefits for contributions (Illinois provides a state tax deduction[1] for investments made to an Illinois-sponsored plan) and most states exempt qualified withdrawals from state taxation (Illinois exempts qualified withdrawals from any state's sponsored plan)[2].

Common questions as students prepare for the fall semester

What expenses are considered "qualified" for the purposes of tax-free 529 withdrawals?

Qualified expenses include:

- Tuition and fees paid directly to the school
- Books, supplies and required equipment. Textbooks must be on the required reading list.
- Computers and peripheral equipment, software and internet access, as long as they're used primarily by the student. Computer software must be educational in nature.
- Room and board, as long as the student is enrolled half time or greater. 100% of on-campus housing expenses are considered qualified, while students living in off-campus housing are limited to the amounts published by the school's "Cost of Attendance" figures. This information is generally available via the school's website.
- Up to $10,000 per year for tuition at K-12 private schools. Check with your accountant first though! Some states, including Illinois, have not yet amended their state tax code to allow for this type of withdrawal.

These withdrawals are considered qualified if they are used for certain expenses incurred by attending a school that meets the required higher education or post-secondary training criteria. Eligible schools include those with a "Federal School Code" for the purposes of federal student aid.

Expenses that are not considered qualified include:

- Travel and transportation costs
- Insurance
- Sports expenses or health club dues
- Equipment used for amusement and/or entertainment

When must funds be withdrawn to be considered "qualified"?

To qualify for tax benefits, 529 withdrawals must be made in the same calendar year (not academic year) as the year the payment was received for the education expense. It is important to consider the time frame necessary for processing, as a withdrawal made during the year must be used for an expense paid prior to year-end. For example, a withdrawal processed in December for an expense paid in January of the following year would not be considered qualified for tax purposes.

What is the impact of a non-qualified withdrawal?

Withdrawals that are not used for qualified expenses may be subject to federal and state income taxes. In most cases, the "earnings" portion of the withdrawal will be taxable as ordinary income and subject to a 10% federal income tax penalty. Additionally, non-qualified withdrawals may be subject to state taxes and the recovery of a state tax deduction filed for in previous years (for Illinois taxpayers, the earnings portion of a non-qualified withdrawal is subject to state income taxes and the recovery of past deductions taken for contributions to an Illinois-sponsored plan).

The 10% federal income tax penalty does not apply to withdrawals due to death or disability of the beneficiary, or for the portion of the distribution equal to or less than any scholarships received.

Non-qualified withdrawals paid to the account owner are subject to the owner's marginal income tax rate, while distributions paid to the beneficiary are subject to the beneficiary's marginal rate. Keep in mind that any non-qualified withdrawals will be considered for the calculation of any "kiddie tax" due on unearned income.

How can I keep good records?

While the 529 account provider will provide an annual statement detailing the allocation between the account's "basis" (contributions) and "earnings," it's the responsibility of the account owner to maintain records documenting the student's expenses and withdrawals.

Account owners should keep all receipts for educational expenses and segregate the qualified expenses from non-qualified costs. Additionally, many 529 accounts allow for payments to be made directly to the school. This may simplify the documentation and recordkeeping.

What if anything is left over?

In the event that a 529 account has a balance at the conclusion of the student's college term, an account owner has a number of options:

- The account can remain invested for the student's graduate school or other post-secondary

education.
- The account owner can change the account beneficiary to another family member at any time. This change can be used to transfer the account balance for a sibling's or cousin's use.
- The account owner can also transfer the ownership of the 529 to another family member (including the previous account beneficiary). This will allow the new account owner to name another family member as a beneficiary – in some cases, the account can be maintained for the original beneficiary's children's educations!
- Withdrawals can be paid to the account owner or beneficiary, though distributions that are not used for qualified expenses will be subject to income taxes and penalties.

Something to note – starting in 2024, a 529 plan beneficiary will have the ability to transfer 529 plan funds into their own Roth IRA. This will come at no penalty nor create additional tax implications, and can be done once the beneficiary is no longer withdrawing money for qualified higher education expenses.3

As parents and grandparents ourselves, it's often bittersweet to see our clients' children go off to college. But it is satisfying to know that all our planning for this event is now coming to fruition. Please don't hesitate to reach out to your wealth advisor with any additional questions or concerns you may have about college funding as you begin this exciting next step in your child's or grandchild's life.

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1 Illinois limits the annual state tax deduction to $10,000 for single taxpayers and $20,000 for married taxpayers filing joint returns.

2 https://www.savingforcollege.com/compare_529_plans/?plan_question_ids%5B%5D=437&page=compare_plan_questions

3. https://stwserve.com/secure-act-2-0-allows-for-rollover-of-unused-529-plan-funds-to-a-roth-ira/

Before investing in an "out-of-state" 529 college savings plan review the potential other benefits that may be provided by investing in a 529 college savings plan offered by the home state of the investor or of the designated beneficiary. Those benefits may include financial aid, scholarship funds, and protection from creditors.