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529 Distribution Planning

There are many things to consider before taking a withdrawal from your 529 College Savings Plan. 529 distribution planning can be particularly tricky and you don't want to make the mistake of paying unnecessary taxes or penalties on your withdrawals.

Education Planning

Jeannette Haen
VP, Education Planning Consultant

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IT'S IMPORTANT TO BE AWARE OF:

- What you can use your 529 funds for tax and penalty free
- The timing of your 529 withdrawals - especially around year-end before it's too late
- Who is responsible for keeping track of withdrawals and expenses
- What taxes and penalties you owe if you take a non-qualified withdrawal

What is considered a qualified higher education expense and what is not?
Account owners may assume they can use their 529 funds tax and penalty free to pay for any expense on a college bill. However, the IRS may disagree with you. Below are some expenses that typically show up on a college bill. You can review which expenses on this bill would be considered qualified or non-qualified, per section 529 of the IRC.

Sample Bill

Tuition	**$9,450**	(Qualified)
Meal Plan	**$2,100**	(Qualified)
General Dormitories (Housing)	**$2,000**	(Qualified if considered at least a ½ time student)
Parking Permit	**$60**	(Non-qualified. Any transportation or parking is non-qualified)
Health Insurance	**$100**	(Non-qualified)
Lab Fees	**$65**	(Qualified if required for a class, enrollment or attendance)

Let us review further. Per section 529 of the IRC, a qualified education expense at an eligible institution includes:

- Tuition & Mandatory fees
- Room and board. Limited to the amount determined by the institution included in their cost of attendance for room and board. (Dorms or off campus living, including living at home if attending school at least ½ time.)
- Meal plans
- Books, supplies and equipment required for enrollment
- As of 1/1/15, the PATH Act made computers, computer equipment, internet services and software required for enrollment a qualified education expense
- As of 1/1/18, the Tax Cuts and Jobs Act made distributions up to $10,000 annually per beneficiary used to cover tuition for K-12 at public, private or religious school come out federally tax-free*
- As of 1/1/19, the SECURE Act made distributions for fees, books, supplies and equipment required for the participation of a designated beneficiary in an apprenticeship program registered and certified with the Secretary of Labor under section 1 of the National Apprenticeship Act come out federally tax-free*
- As of 1/1/19, the SECURE Act made distributions used to repay principal and/or interest on qualified education loans excluded from federal income tax. Qualified distributions are limited to $10,000 over a lifetime for a 529 plan beneficiary and $10,000 for each of the beneficiary's siblings*

**529 plan distributions used to pay for K-12 tuition, apprenticeship programs and/or student loan debt may be treated as non-qualified at the state tax level if your state has not conformed to the new federal tax codes. Please check your state rules or consult with a tax advisor before taking a distribution for these expenses.*

We received a $1,000 refund from the college due to my son dropping a course. The reimbursement was deposited into my son's school account. The funds were originally withdrawn from his 529 account earlier this year to cover tuition costs. My son is still attending college. What are my options to avoid taxes and penalties on the withdrawal?

The 529 account owner has two options in this scenario:

1. The account owner can "apply" the $1,000 towards other qualified higher education expenses (QHEEs) the student may incur the remaining of the calendar year. As long as your total 529 withdrawal at the end of the calendar year does not exceed the total amount of QHEEs, you can claim there is no tax reporting.
2. The account owner can recontribute the refunded amount from the college back into their 529 plan within 60 days of receiving the refund to avoid taxes and penalties. Check with the specific 529 plan for more details.

We paid my daughter's Freshman college tuition from our own savings last Fall. This Fall my daughter is starting her Sophomore year. Can we now reimburse ourselves for tuition paid last year from our 529 without paying any taxes or penalties?
No. Your 529 distributions must match up with your qualifying education expenses paid within the same calendar year; otherwise, your withdrawal may be deemed as non-qualified and subject to taxes and penalties on the earnings portion.

> **Don't withdraw too late or too early!** Reimbursing yourself can get a little tricky especially at year-end when spring tuition is due and knowing the school year doesn't go by calendar year. Students sometimes have the option to pay early in December. Be cautious. To make things simple and to avoid a conflict with the IRS, always remember to reimburse yourself within the same calendar year as when you pay the education expense. If the school allows you to pay early in December, make sure to withdraw from your 529 before December 31st. If you plan on paying the tuition bill in January, hold off from withdrawing from your 529 until after the 1st of the New Year.

Can I use my 529 funds to pay for housing and food while staying off-campus?
Maybe. As with everything else, there are restrictions. If all the items listed below are met, you can withdraw from your 529 to pay for rent or food living on **or** off-campus tax and penalty free.

1. Room and board is defined as rent and food whether staying on campus in the dorms and using a meal plan, or staying off campus renting an apartment and paying for groceries
2. Per the IRS 529 tax code, you should only make a withdrawal for the expenses paid while the student is enrolled and attending an eligible institution during the academic year to avoid taxes and penalties
3. The IRS sets a limit as to how much you can withdraw for room and board, and that is dependent upon what the school sets as the cost of attendance for room and board for on or off-campus living for that academic year. Each school will publish their estimated cost of attendance including room and board for the academic year on their website.
4. Students must be considered at least a half-time student to pay for room and board
5. Keep in mind that it is recommended that your expenses and withdrawals from your 529 should be completed within the same calendar year, not school year.

Can I use my 529 funds to pay for housing and food over summer and winter break?
Depends. Unless the student is enrolled during the summer months it may be in your best interest to not use your 529 money to pay for rent and food over the summer. As for winter break, there isn't language or IRS clarification on this. Dependent upon the college, winter break could be 2 weeks up to 6 weeks long. The account owner could prorate rent and food for the month or just decide to not use their 529 funds during this time.

What is an eligible institution? An eligible institution includes most 4-year and 2-year public, private, vocational and trade schools around the U.S., and some foreign institutions that offer federal financial aid and programs to their students. These schools are identified by having a federal school code. You can check for the school's federal code on this website: https://www.savingforcollege.com/eligible-institutions

Does the 529 plan keep track of my qualified and non-qualified expenses for me?
No. The responsibility is on the account owner. The 529 plan provides a 1099Q each year a withdrawal is made which provides the total amount withdrawn. If the total amount of qualified expenses paid you can claim is less than the total amount of withdrawals made from your 529 in a given calendar year, the recipient of the withdrawal money will have to pay taxes and penalties on the earnings portion that is considered non-qualified.

Remember to account for any tax benefits for education already claimed, such as the American Opportunity Tax Credit. There is no double dipping allowed. See IRS Publication 970 for more details. Account owners do not have to report any qualified withdrawals from their 529 to the IRS at tax time but they must report all non-qualified withdrawals.

Are there exceptions to the 10% tax penalty?
Yes, in some cases. In the event the beneficiary becomes disabled, dies, or attends a U.S. Military School you can make a withdrawal and avoid the 10% penalty, but the earnings portion of the withdrawal is treated as ordinary income and taxable to the recipient.

Scholarship Exception
If the child receives a scholarship or grant you can withdraw up to the amount of the scholarship penalty free, but the earnings portion of the withdrawal is treated as ordinary income and taxable to the recipient. You must take the distribution in the same calendar year you receive the scholarship.

Consider not withdrawing the funds but rather spending down the assets on other QHEEs that the scholarship may not cover such as computer technology. You could also consider holding onto the funds to use at a later time in the event the beneficiary continues their education or change the beneficiary to a family member.

If I do not end up using my 529 fund towards a qualified education expense what are my options?

1. Change the beneficiary to a family member such as a sibling, as defined in IRS Publication 970. This can be done tax and penalty free.
2. Hold on to the 529 account and use the funds down the road in the event the student decides to go to grad school or for a future grandchild. There are no time constraints or age restrictions in 529 college savings plans.
3. Take a full or partial non-qualified withdrawal. You can make a withdrawal from your 529 at any time for any reason, but you must report any non-qualified withdrawals *(withdrawals not used towards a qualified education expense)* at tax time. The withdrawal comes out pro-rata. This means that the earnings portion will be treated as ordinary income and taxable to the recipient and the earnings portion is assessed a 10% penalty.
4. As part of the Secure 2.0 Act beginning in 2024 account owners are able to roll 529 funds into a Roth IRA. If you meet the following requirements, consider rolling the 529 funds into a Roth IRA.
    - Amounts held in a 529 can only be rolled to a Roth IRA in the name of the same beneficiary as the 529 plan. If an individual is considered the owner of a 529 held for the benefit of a child, the Roth IRA must also be for that child.
    - The maximum rollover amount in any year is limited to the IRA contribution limit for that year ($7,000 for 2024) reduced by any actual Traditional or Roth IRA contributions made that year. Also, there is a lifetime maximum rollover of $35,000.
    - The 529 plan must have been opened for at least 15 years as of the date of the rollover. Also, the rollover amount is limited to any contributions made to the plan (and attributed earnings) prior to 5 years before the rollover occurs. For example, a rollover done July 1, 2024 must come from a 529 plan opened prior to July 1, 2009 and can only be made from the balance in the account prior to July 1, 2019.

What if my child becomes disabled?

In the event the beneficiary becomes disabled you can make a withdrawal and avoid the 10% penalty, but the earnings portion of the withdrawal is treated as ordinary income and taxable to the recipient.

Another option to consider is rolling the funds into an **ABLE Account**. Per the IRS a 529 owner can roll funds from their 529 to an ABLE account if the beneficiary is disabled and when the following items are met.

1. The distributed funds must be contributed into an ABLE account within 60 days.
2. When added to all other contributions made to the ABLE account you must not exceed the annual gift tax exclusion which is $17,000 in 2023.

Word of Advice:

We recommend our clients keep tuition bills, transactional history, receipts, and documents in the event of an IRS audit as the responsibility of keeping track of qualified expenses is on the account owner. An Excel Workbook is a good way to track expenses. Please contact your Baird Financial Advisor if you have further questions. Clients may also consult a tax advisor.