White paper: Taking 529 plan distributions with confidence

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Before an investor starts taking distributions from a 529 plan, it's important to understand the mechanics and potential tax pitfalls. Our five tips can help.

529 plans offer many well-known benefits, including generous contribution limits, tax-deferred growth and tax-free distributions to fund qualified education expenses.

But the mechanics of 529 plan distributions can be confusing for account owners. These five tips may help investors avoid unintended tax consequences, and in some cases, even help account owners and beneficiaries take advantage of little-known tax benefits.

LEARN MORE ABOUT TAKING DISTRIBUTIONS FROM A 529 PLAN

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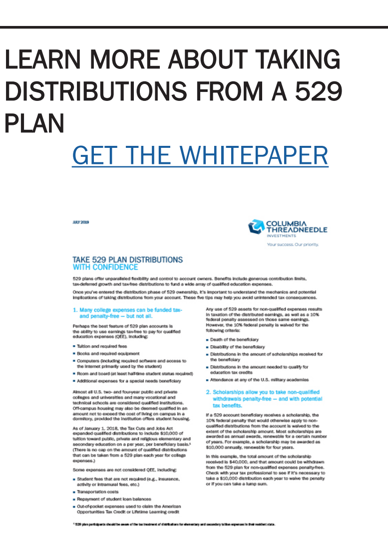

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TAKE 529 PLAN DISTRIBUTIONS WITH CONFIDENCE

529 plans offer unparalleled flexibility and control to account owners. Benefits include generous contribution limits, tax-deferred growth and tax-free distributions to fund a wide array of qualified education expenses.

Once you've entered the distribution phase of 529 ownership, it's important to understand the mechanics and potential implications of taking distributions from your account. These five tips may help you avoid unintended tax consequences.

1. Many college expenses can be funded tax- and penalty-free — but not all.

Perhaps the best feature of 529 plan accounts is the ability to use earnings tax-free to pay for qualified education expenses (QEE), including:

- Tuition and required fees
- Books and required equipment
- Computers (including required software and access to the Internet primarily used by the student)
- Room and board (at least half-time student status required)
- Additional expenses for a special needs beneficiary

Almost all U.S. two- and four-year public and private colleges and universities and many vocational and technical schools are considered qualified institutions. Off-campus housing may also be deemed qualified in an amount not to exceed the cost of living on campus in a dormitory, provided the institution offers student housing.

As of January 1, 2018, the Tax Cuts and Jobs Act expanded qualified distributions to include $10,000 of tuition toward public, private and religious elementary and secondary education on a per year, per beneficiary basis.[1] (There is no cap on the amount of qualified distributions that can be taken from a 529 plan each year for college expenses.)

Some expenses are not considered QEE, including:

- Student fees that are not required (e.g., insurance, activity or intramural fees, etc.)
- Transportation costs
- Repayment of student loan balances
- Out-of-pocket expenses used to claim the American Opportunities Tax Credit or Lifetime Learning credit

Any use of 529 assets for non-qualified expenses results in taxation of the distributed earnings, as well as a 10% federal penalty assessed on those same earnings. However, the 10% federal penalty is waived for the following criteria:

- Death of the beneficiary
- Disability of the beneficiary
- Distributions in the amount of scholarships received for the beneficiary
- Distributions in the amount needed to qualify for education tax credits
- Attendance at any of the U.S. military academies

2. Scholarships allow you to take non-qualified withdrawals penalty-free — and with potential tax benefits.

If a 529 account beneficiary receives a scholarship, the 10% federal penalty that would otherwise apply to non-qualified distributions from the account is waived to the extent of the scholarship amount. Most scholarships are awarded as annual awards, renewable for a certain number of years. For example, a scholarship may be awarded as $10,000 annually, renewable for four years.

In this example, the total amount of the scholarship received is $40,000, and that amount could be withdrawn from the 529 plan for non-qualified expenses penalty-free. Check with your tax professional to see if it's necessary to take a $10,000 distribution each year to waive the penalty or if you can take a lump sum.

[1] 529 plan participants should be aware of the tax treatment of distributions for elementary and secondary tuition expenses in their resident state.

1. Many college expenses can be funded tax- and penalty-free — but not all.

Account owners can use earnings tax-free to pay for qualified education expenses at qualified institutions, including tuition, fees, books, computers and room and board. But using earnings for non-qualified expenses may result in taxation plus a 10% federal penalty. Knowing what isn't considered qualified is critical.

2. Scholarships allow account owners to take non-qualified withdrawals penalty-free.

If an account beneficiary receives a scholarship, the 10% federal penalty that would otherwise apply to non-qualified distributions from the account is waived. And there's also some flexibility around how much can be withdrawn each year.

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3. The IRS will send a 1099-Q, but that doesn't always mean you owe taxes.

All distributions from a 529 plan result in the generation of a 1099-Q, sent to the recipient of the distribution (either the education institution, the designated beneficiary or the account owner). A tax professional can help the recipient determine whether the withdrawal is considered a qualified distribution and what the tax consequences may be.

4. Be careful how much you withdraw in anticipation of future expenses.

Qualified distributions from 529 plans should be taken in the same taxable year the expense was incurred. But distributions don't need to be taken prior to, or in direct relation to, specific expenses. Account owners can easily reimburse themselves for expenses paid throughout the year with one distribution. But they should be mindful not to withdraw too much money in case expenses do not materialize — excess withdrawals usually can't be put back in the same beneficiary's 529 account.

5. 529A accounts offer special opportunities for people with disabilities and their families.

The Achieving a Better Life Experience (ABLE) Act and 529A accounts now allow individuals with disabilities to take advantage of 529 and 529A account saving strategies. ABLE accounts can be used tax-free to pay for any disability-related expenses. And certain investing strategies can help account owners take full advantage of ABLE accounts, beyond the $15,000 annual funding limit.

Bottom line

There's a lot of education on how to fund 529 plan accounts — how much to invest, gifting limits, etc. But knowing how and when to take 529 plan distributions can be just as important to participants. And understanding the mechanics and options can make for an easier experience, with fewer tax consequences.

To find out more, call 800.426.3750
or visit columbiathreadneedle.com

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