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COLUMBIA THREADNEEDLE INVESTMENTS

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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.

Being able to direct distributions to the beneficiary provides an added opportunity for tax mitigation on non-qualified distributions.

- Suppose the owner of a 529 account wants to use a portion of the funds to pay for a wedding for her daughter, the beneficiary.
- Also suppose that the beneficiary received a scholarship in the amount of $40,000 while attending a qualified higher education institution.

In this case, the account owner can withdraw $40,000 penalty-free due to the receipt of the scholarship. And if the beneficiary is subject to a lower marginal tax rate, the owner can direct the distribution payable to her so that the pro-rata earnings portion is taxable at her lower rate.

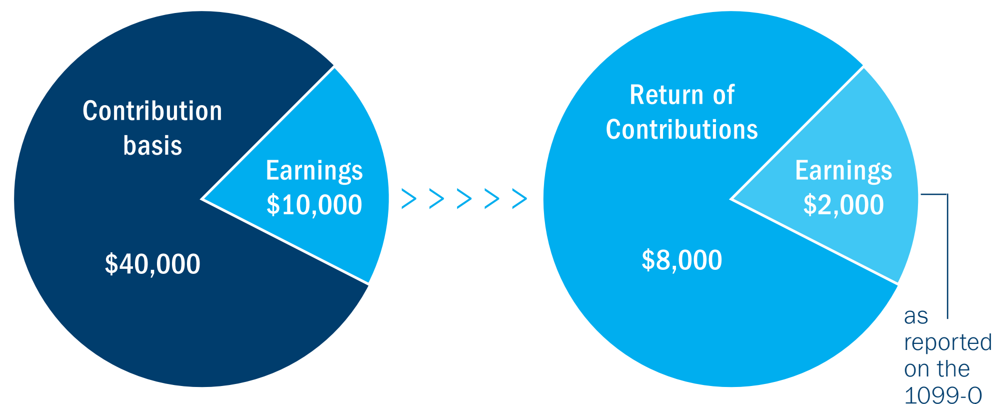
3. The IRS will send a 1099-Q, but that doesn't always mean you owe taxes.

All distributions from a 529 plan, whether qualified or not, result in the generation of a 1099-Q. The 1099-Q is sent to the recipient of the distribution and must be included on the recipient's tax return for the year received. Distributions from 529 plans can be made to:

- Education institution
- Designated beneficiary
- Account owner

For distributions made payable directly to the institution or to the beneficiary, the beneficiary receives the 1099-Q and it is reported under their social security number. Account owners receive the 1099-Q for distributions made payable to themselves.

All 529 plan withdrawals are pro-rata, meaning that the earnings are distributed in proportion to the overall breakdown of contributions and earnings in the account at the time of the distribution. Consider this hypothetical example:



The earnings portion of any distribution is withdrawn tax-free for qualified expenses but is subject to tax at the recipient's ordinary income rate and a potential 10% federal penalty if used for non-qualified expenses. So, it's up to the distribution recipient and their tax professional to determine:

- Is the withdrawal a qualified distribution as defined by section 529 of the IRC?
- If not, is there an applicable penalty waiver?

The earnings portion of any non-qualified distributions is subject to tax at the recipient's ordinary income rate.

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 associated expense was incurred. However, there's no requirement that distributions be taken prior to, or in direct relation to, specific expenses. So account owners can easily reimburse themselves for expenses paid throughout the year with one distribution.

Account owners should be mindful, however, not to withdraw too much money in anticipation of expenses that do not materialize, as these excess withdrawals are not eligible for recontribution to the same beneficiary's 529 plan account within 60 days unless they're refunded directly from the qualified educational institution. It's important for the participant to keep accurate records of expenditures in the event of audit.

If the account owner takes a distribution more than the amount needed to offset qualified expenses, there is a potential work-around to prevent the excess amount being treated as a non-qualified distribution. If the account owner acts within 60 days, the unneeded funds could be recontributed to a different 529 plan for the same beneficiary or another beneficiary who is a family member of the original beneficiary as an indirect rollover — as long as a rollover for the same beneficiary has not occurred within the previous 12 months.

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

With the passage of the Achieving a Better Life Experience (ABLE) Act in 2014 and the birth of 529A accounts, individuals with disabilities can now take advantage of 529 and 529A account saving strategies.

529A accounts, also known as ABLE accounts, can be established for any disabled individual with an age of onset of less than 26 years old. ABLE accounts can be used tax-free to pay for any disability related expenses. However, even though they were added to IRC section 529, ABLE accounts can only be funded up to $15,000 per year in aggregate contributions.

Rollovers are one way to take full advantage of ABLE accounts, despite their lower contribution limit. The IRC allows one tax-free rollover of assets within 60 days from a 529 account to a 529A account for the same beneficiary or a member of the family of the beneficiary per 12-month period.[2] So participants using both accounts together can fund a 529 account — which has much higher contribution and balance limits — and systematically roll $15,000 per year into the ABLE account to be used tax-free for any of these expenses:

- Education
- Transportation
- Assistive technology
- Preventative care
- Legal fees
- Funeral and burial expenses
- Housing
- Employment training and support
- Personal support services
- Financial services
- Oversight and monitoring
- Other expenses approved by the IRS

The 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. Few financial vehicles provide account owners with as much flexibility and control as 529 plans, and fortunately those benefits extend to distributions.

[2] The rollover provision is set to expire on January 1, 2026 unless Congress acts to extend or make the provision permanent.

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Investing involves risk including the risk of loss of principal.

Withdrawal of earnings not used for qualified education expenses will be subject to federal and possibly state and local income tax and may be subject to an additional 10% penalty.

Not FDIC insured • No bank guarantee • May lose value

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