Taxation of 529 College Savings Account Withdrawals

The big advantage of 529 plans is that qualified withdrawals are always federal-income-tax-free—and usually state-income-tax-free too.

What you may not know is that not all 529 withdrawals are tax-free qualified withdrawals, even in years when you have heavy college costs.

Here are six important points to know about 529 withdrawals.

Point No. 1: You Usually Have Several Payment Options

Say you are the 529 *account owner* or *plan participant*. Plans commonly use both terms to describe the person who established and controls the account. This letter will use *account owner*.

As the account owner, you can generally have a withdrawal check cut in your own name or have an electronic deposit made into your own account.

Alternatively, you can have a withdrawal issued in the name of the *account beneficiary* (the college student for whom you set up the 529 account, usually a child or grandchild) or issued directly to the educational institution for the benefit of the account beneficiary.

You choose your payment option by submitting a withdrawal request to the 529 plan.

Point No. 2: Watch Out for Withdrawals from 529 Accounts Funded with Custodial Account Money

Say you funded the 529 account with money that came from a *custodial account* that was set up for the account beneficiary—your child or grandchild—under your state's Uniform Gift to Minors Act (UGMA) or Uniform Transfer to Minors Act (UTMA).

In this situation, you must use any money taken from the custodial account for the benefit of the child or grandchild.

You can't take a 529 account withdrawal for yourself if the 529 account was funded with money from a child's or grandchild's custodial account. Because the money in the 529 account came from the custodial account, the 529 account money legally belongs to your child or grandchild, not you.

On the other hand, if you funded the 529 account with your own money, the money in the account is fair game. You can take withdrawals and do whatever you want with them—subject to the potential federal income tax implications explained later.

Point No. 3: The IRS Knows about Withdrawals

For any year that a 529 withdrawal is taken, the plan must issue a Form 1099-Q, Payments From Qualified Education Programs (Under Sections 529 and 530), by February 1 of the following year.

If the withdrawal goes to the 529 account beneficiary (your child or grandchild), the 1099-Q goes to him or her. If the withdrawal goes to you as the account owner, the 1099-Q goes to you.

Either way, the IRS gets a copy, so the IRS knows what happened.

Point No. 4: Withdrawals May Be Taxable Even in Years When Substantial College Costs Are Incurred

When the Form 1099-Q shows withdrawn earnings, the IRS becomes interested in the 1099-Q recipient's Form 1040 because some or all of the earnings might be taxable. Here's the deal on that.

Withdrawn earnings are always federal-income-tax-free and penalty-free when total withdrawals for the year do not exceed what the IRS calls the account beneficiary's *adjusted qualified education expenses*, or AQEE, for the year.

AQEE equals the sum of the 529 account beneficiary's

- college tuition and related fees;
- room and board (but only if the beneficiary carries at least half of a full-time course load);
- required books, supplies, and equipment;
- computer hardware and peripherals, software, and internet access costs; and
- expenses for special needs services.

Next, you must subtract any federal-income-tax-free educational assistance to calculate the account beneficiary's AQEE.

According to the IRS, tax-free educational assistance includes costs covered by

- tax-free Pell grants;
- tax-free scholarships, fellowships, and tuition discounts;
- tax-free veterans' educational assistance;
- an employer's tax-free educational assistance program under Internal Revenue Code Section 127; and
- any other tax-free educational assistance (other than assistance received in the form of a gift or an inheritance).

In addition, tax-free educational assistance includes any costs used to claim the American Opportunity tax credit or the Lifetime Learning tax credit.

Key point. You can also include in AQEE

- up to $10,000 annually for the account beneficiary's K-12 tuition costs;
- the account beneficiary's fees, books, supplies, and equipment required to participate in a registered apprenticeship program; and

- interest and principal payments on qualified student loan debt owed by the account beneficiary or a sibling of the account beneficiary—subject to a $10,000 lifetime limit.

Bottom line. When withdrawals during the year *exceed* AQEE for the year, all or part of the withdrawn earnings will be taxable. When withdrawals *don't* exceed AQEE, all the withdrawn earnings are federal-income-tax-free.

Point No. 5: When You Keep a Withdrawal, There Are Tax Consequences

Assuming the 529 account was funded with your own money (as opposed to money from a custodial account), you are free to change the 529 account beneficiary to yourself and then take federal-income-tax-free withdrawals to cover your own AQEE if you decide to go back to school.

But if you take a withdrawal that you use for purposes other than education, report the taxable portion of any related account earnings as miscellaneous income on your Form 1040. Taxable amounts may also get hit with a 10 percent penalty tax to boot (see below).

Finally, if you liquidate a loser 529 account (worth less than the total amount of contributions), there are no federal income tax consequences. (The government stopped participating in your losses for tax years 2018-2025.)

Point No. 6: Withdrawals Not Used for Education Can Also Be Hit with a 10 Percent Penalty Tax

As explained earlier, some or all of the earnings included in a 529 withdrawal taken during the year must be included in gross income when the withdrawn earnings exceed the account beneficiary's AQEE for the year. But there's more.

According to the general rule, the taxable amount of earnings is also hit with a 10 percent penalty tax.

But the 10 percent penalty tax doesn't apply to earnings that are taxable only because the account beneficiary's AQEE was reduced by

- tax-free Pell grants;
- tax-free scholarships, fellowships, and tuition discounts;
- tax-free veterans' educational assistance;
- tax-free employer-provided educational assistance;
- any other tax-free educational assistance; or
- costs used to claim the American Opportunity or Lifetime Learning tax credit.

In addition, the 10 percent penalty tax doesn't apply to earnings withdrawn when the account beneficiary attends one of the U.S. military academies (such as West Point, Annapolis, or the Air Force Academy).

Finally, the 10 percent penalty tax doesn't apply to earnings withdrawn after the account beneficiary dies or becomes disabled.