The Short Answer

Avoid This 529 Misstep to Help Maximize Savings

Taking too large a distribution from a college savings plan can have costly tax consequences.

By Karen Wallace | 08-15-17 | 05:00 AM | Email Article

Taking money out of your 529 plan seems like it should be the easy part, but if you don't carefully right-size your 529 plan distributions, you may find that you owe both a penalty and extra taxes.

The key is that is that in any tax year (not academic year), you want to ensure that the amount you withdraw from the 529 college savings plan doesn't exceed your qualified education expenses. You'll need to figure in tax-free educational assistance such as scholarships and grants and also factor in the impact of credits, such as the American Opportunity Tax Credit or the Lifetime Learning Credit.

Any amount you withdraw in excess of qualified expenses will be subject to taxes on the earnings portion of the withdrawal, and could incur a 10% penalty. If you figure the amount correctly,

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though, no tax or penalty will be due.

Know What's Covered

You'll need to calculate your qualified education expenses. We'll refer to that as QEE. But before you do that, you need to know what is and isn't covered.

- Tuition and fees. (You probably figured that was covered.)
- Books, supplies, and equipment. This includes the cost of any computer technology, related equipment, and/or related services such as Internet access. The technology, equipment, or services qualify if they are used primarily by the beneficiary of the plan during the years the beneficiary is enrolled at the college or university.
- Room and board. This has a few important caveats. The student must be enrolled at least half time in the institution, and the room and board expenses can't exceed the greater of these two amounts:

  1. The allowance for room and board that was included in the cost of attendance determined by the college or university.
  2. The actual amount charged if the student is residing in housing owned or operated by the eligible educational institution.

That means off-campus housing is considered a 529-eligible expense, but only to the extent that it doesn't exceed the greater of the two aforementioned amounts. If your student is planning to live off campus, it's a good idea to call the campus housing department and confirm the qualified housing costs amount when you're calculating your QEE.

Calculate Your QEE

Per the IRS, taxes do not have to be paid on the contributed amount (as 529s are funded with aftertax dollars) and generally aren't owed on any earnings distributed from a 529 if the total distribution is less than or equal to adjusted qualified education expenses. It's important to figure this number accurately, lest you will owe taxes--and possibly a 10% penalty--on the overdistribution, or the portion of the distribution in excess of QEE. If your child receives a scholarship, the 10% penalty on a nonqualified withdrawal is waived up to the amount of the scholarship. However, you will still owe taxes on the earnings portion of the overdistribution.

Add qualified expenses: tuition and fees, books and supplies, and housing. Be sure to subtract the amount of any tax-free educational assistance. This includes tax-free scholarships and fellowship grants, veteran's assistance, the tax-free portion of the Pell Grant, employer-provided educational assistance, and any other tax-free assistance. This doesn't include gifts or inheritances.

The resulting figure is your adjusted qualified educational expense.

Here's an example: Let's say you opened a 529 college savings account in 2007 for your daughter. For simplicity's sake, let's say you funded the account with $10,000 and didn't make any further contributions. The account returned 7% per year. After 10 years of compounding, the account now has about $20,000 and half of it is principal and the other half is earnings. Your daughter will be starting college in the fall, and she has $9,000 of qualified education expenses for 2017 (match up the *calendar* year, not the academic year). You took a $9,000 529 distribution. Here's a closer look at how your daughter actually paid for her college expenses:

Gift from grandparents: $1,000
Partial tuition scholarship (tax-free): $1,000
529 distribution: $9,000

But you also have to reduce your daughter's total qualified education expenses by the amount of the partial tuition scholarship, because it is tax-free. Here are the adjusted qualified education expenses.

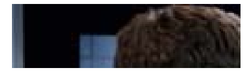
Total qualified education expenses: $9,000
Tax-free scholarship: −$1,000
Adjusted qualified education expenses (AQEE): $8,000

In this case, the $9,000 529 withdrawal exceeds the amount of adjusted qualified educational expenses. So come tax time, you will owe taxes on part of the earnings portion of this overdistribution.

How to Calculate Taxes Owed on Distributions

Here's how to figure what you're on the hook for if your distribution exceeded your QEE. You will receive a Form 1099-Q from any 529 from which you received a distribution in 2017. The amount of your gross distribution (box 1) shown on each form will be divided between your earnings (box 2) and your basis, or contribution amount (box 3). Let's say that the number in box 2, our earnings, was $4,410.

Multiply the total distributed earnings shown on Form 1099-Q, box 2, by a fraction



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that represents the percentage of how much of your 529 distribution went to QEE. The fraction's numerator is the adjusted qualified education expenses paid during the year and the denominator is the total amount distributed during the year.

In our example: $4,410 * ($8,000/$9,000) = $3,920 tax-free earnings.

$4,410 - $3,920 = $490. You must report $490 on your 2017 taxes (filed in 2018) as the amount of distributed 529 earnings that were not used for adjusted qualified education expenses.

Figure in the American Opportunity Tax Credit and Lifetime Learning Credit
The American Opportunity Tax Credit and the Lifetime Learning Credit are two common educational tax credits. (Remember, a credit directly reduces your tax liability, while a deduction reduces your taxable income.)

The American Opportunity Tax Credit allows families of undergraduates to deduct the first $2,000 spent on qualified education expenses and 25% of the next $2,000 (up to a maximum of $2,500). The Lifetime Learning Credit provides up to a $2,000 tax credit on the first $10,000 of college expenses. This credit is available for an unlimited number of tax years, but it cannot be filed in the same year that the American Opportunity Tax Credit is filed. (Both credits have modified adjusted gross income thresholds.) Click here to read more.

If you plan to claim the Lifetime Learning Credit and the American Opportunity Tax Credit when you file your taxes, make sure you anticipate the impact it will have on your adjusted qualified education expenses when you figure your 529 withdrawal amount. You'll need to deduct the costs used to calculate the credit from your QEE.

Let's add the Lifetime Learning Credit into our example. We'll leave our 529 withdrawal amount the same, at $9,000, but we'll further reduce the adjusted QEE by subtracting the expenses used to figure the credit.

Total qualified education expenses: $9,000
Tax-free scholarship: −$1,000
Expenses taken into account in figuring LLC: −$4,000
Adjusted qualified education expenses: $4,000

Figure the taxable portion of the 529 withdrawal as follows: $4,410 * ($4,000/$9,000) = $1,960

$4,410 - $1,960 = $2,450. This is the amount of distributed 529 earnings not used for adjusted qualified education expenses, and therefore subject to taxes and possibly a 10% penalty.

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