Avoid these 529 withdrawal traps

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Your son or daughter has finally graduated from high school and soon will be heading off to college. Before he or she even meets their professors, you will have received the first of many tuition bills from the college bursar's office. It's a good thing you've been saving for college with a 529 plan. You've got money set aside for just this very occasion. But once you've entered the "529 withdrawal phase", be sure you make the right decisions when tapping your 529 account. Here are six mistakes you'll want to avoid:

1. Taking too much money.

529 withdrawals are tax-free to the extent your child (or other account beneficiary) incurs qualified education expenses (QHEE) during the year. If you withdraw more than the QHEE, the excess is a non-qualified distribution. You or your beneficiary — you get to choose who receives the money — will have to report taxable income and pay a 10% federal penalty tax on the earnings portion of the non-qualified distribution. The principal portion of your 529 withdrawal is not subject to tax or penalty.

QHEE includes tuition, fees, books, supplies, computers and related equipment, and the additional expenses of a "special needs" beneficiary. You can also use money from a 529 account to pay student loans. For students who are pursuing a degree on at least a half-time basis, QHEE also includes a limited amount of room and board. Since January 1, 2018, qualified expenses also include up to $10,000 in tuition expenses at private, public or religious elementary, middle and high schools (per year, per beneficiary). You CANNOT include the following college expenses:

- Insurance, sports or club activity fees, and many other types of fees that may be charged to your students but are not required as a condition of enrollment
- Transportation costs
- Room and board costs in excess of the amount the college includes in its "cost of attendance" figures for federal financial aid purposes. If your student is living off campus, ask the financial aid department for the room and board allowance for students living at home with parents, or living elsewhere off campus, as the case may be. If the student is living in campus-owned dormitories, the amount you can include in QHEE is the amount the college charges for its room and board.

Even if you've properly accounted for all qualifying expenses, and withdraw from your 529 account only enough to pay for those expenses, you may end up with a non-qualified distribution. This happens because of the coordination rules (aka anti-double-dipping rules) surrounding the various education tax incentives. You must remove from your total QHEE any of the tuition expense that is used to generate an American Opportunity tax credit or a Lifetime Learning credit. For example, if you claim a $2,500 American Opportunity credit on a federal tax return you must remove from QHEE the $4,000 in tuition and related expenses that was used to support the credit.

What can you do if you receive a distribution check from your 529 plan only to discover after speaking with your accountant that you've taken too much? If you are still within the 60-day rollover window, you can take the excess and roll it into a different 529 plan so that amount is no longer treated as a distribution, provided you have not rolled over that child's 529 account within the prior 12 months. If you are outside the 60-day window, but within the same calendar year, you can look to prepay next year's expenses to increase this year's QHEE. If you discover the excess 529 withdrawal after year-end, there's not much you can do about it. The good news is that if the non-qualified distribution is caused by the tax-credit adjustment described above, the 10% penalty is waived.

2. Taking too little money.

Generally speaking, you don't want to have money left over in your 529 account once your child graduates from college. Unless your student is planning postgraduate education, or you have another potential beneficiary in the family to whom you can change the beneficiary designation, you'll be left with a 529 account that used for any other purpose will incur tax and 10% penalty. If you have a substantial balance in your 529 account, consider tapping the account at the earliest tax-free opportunity. You may also want to take 529 withdrawals even when you know that they will result in non-qualified distributions, provided they do not incur the 10% penalty. The penalty is waived on "scholarship withdrawals" and, as described above, when the distribution is non-qualified because of the tax-credit coordination rule. By having the money distributed to the student, the reportable 529 earnings will go on his or her tax return. Not only might your student be in a low tax bracket, but he or she may also be able to wipe out any resulting tax with American Opportunity credit or Lifetime Learning credit. (Because of income limitations, you may not be eligible to claim the credit on your own return.)

3. Taking the money in the wrong year.

Although you will not find this rule explicitly stated anywhere in the IRS' publications or tax forms, the withdrawals you take from your 529 account must match up with the payment of qualifying expenses in the same tax year. If you withdraw the 529 money in December for a tuition bill that isn't paid until January, you risk not having enough QHEE during the year of 529 withdrawal. Likewise, if you take a distribution in January to pay for expenses from the previous December, that distribution will be a non-qualified distribution.

You can ensure proper matching by requesting that the distribution from the 529 plan be sent directly to the college's bursar.

4. Requesting payment be made directly to the college.

Didn't we just suggest that you request your 529 distribution be made directly to the college to ensure proper matching? Then why would we now say this is a mistake?

Requesting the payment directly to the college could be a mistake if you are not sure how the college treats the 529 money in its financial-aid process. The correct process is for the college to treat the 529 plan money as a payment of the college's bill. But, colleges often receive checks for outside scholarships won by their students, and they will typically reduce the student's federal, state and institutional need-based grants by an equivalent amount. This is called *scholarship displacement*.

You would not want the college to view the 529 money the same way it views a scholarship and reduce your child's financial-aid package. Check with the college first and confirm its policy with respect to funds received directly from a 529 plan. You always have the option to request the distribution be made payable to you or your student. It then becomes your responsibility to pay the college.

5. Taking the money from the wrong 529 account.

Some parents have more than one 529 account. Most often this happens when a parent prefers an out-of-state 529 plan over the in-state 529 plan, but does not want to forsake the state tax deduction in those states offering that particular benefit. Contributions are first made to the in-state 529 plan to take maximum advantage of the state tax benefit, and any remaining money is contributed to the out-of-state 529 plan.

Multiple accounts may also be used when investors wish to diversify or when they see a particularly attractive aggressive option in one 529 plan and an attractive conservative option in another.

Different accounts are going to experience different growth rates. By first tapping the account with the higher earnings ratio once your child gets to college, you are locking in maximum tax savings. If your child graduates when you still have money in 529 plans, the tax cost associated with non-qualified distributions is minimized because the lowest-growth account is left for last.

In a similar way, you may also be locking in a state tax deduction in those states that require a "recapture" of your deduction with non-qualified 529 withdrawal.

Of course, you will also be concerned about future growth of your 529 money and want to make sure you are not liquidating the account that would be performing best going forward and remain stuck with a low-performing account. Remember, you can adjust your investments through the annual investment change opportunity or through a qualifying rollover.

6. Failing to coordinate the 529 withdrawal with other family members.

Sometimes a child will be the beneficiary of multiple 529 accounts that have different account owners—not just parents, but grandparents and other relatives and friends as well. When it comes time to pay for Junior's college expenses, whose account is used first?

If at all possible, do not leave this question to the last minute. Family members should be speaking to the parents and discussing how best to use their 529 accounts to help pay for Junior's college expenses. In some situations, the best solution is for the family members to request that ownership of their 529 accounts be transferred to the parents so that withdrawals can be easily controlled and coordinated. Not all 529 plans accept requests to change ownership so first check with your plan.