How to Use a 529 Education Savings Plan to Pay for College Expenses

It's never easy to say goodbye to your kids when it is time for them to enter their college years. Whether you have tears of sadness or joy at the thought of them being on their own, sending them off into the big adult world can be scary for both of you. Financially, you may still have lingering questions. If you have saved through a 529 education savings plan, you can rest in the knowledge that you can now make use of the tax-advantages that it offers.

As the first of many college bills begin to arrive, it is important to understand how to avoid costly mistakes. Here are some common questions parents have when it's time to begin using 529 savings plan assets for college expenses.

Is a 529 savings plan only used for college tuition?

Withdrawals from 529 education savings plans are income tax-free when used for a variety of qualified higher education expenses. Tuition is one type of qualified expense, but it is not the only one. Qualified education expenses also include fees, books, supplies, equipment, and certain expenses required by students with special needs. For students who are enrolled at least half-time, it also includes a limited amount of room and board. Common college expenses that are NOT considered qualified expenses include transportation costs to and from school, club or activity fees charged by the school that are not required for enrollment, and withdrawals used to repay student loans.

Even if the expense is qualified, you need to make sure that you adjust those expenses for scholarships and that you are not also using the same expenses for other purposes, such as the American Opportunity or Lifetime Learning tax credits. Your tax professional can help you determine how the coordination rules apply to your situation.

Do I have to send the payment directly to the college or university?

No, you can generally have the 529 savings plan withdrawals paid to the college or university, to you, or to the student. Before you send it directly to the school, make sure you understand how the financial aid office will apply the payment. Some schools may reduce the amount of financial aid the student receives when receiving a payment from a 529 savings plan. If the check is payable to you or the student, keep in mind that the payee determines who the tax reporting applies to. If the student is the payee, even if you are the 529 savings plan account owner, the withdrawal will be reported to the IRS under student's name and tax-id number on form 1099-Q. If any portion of the withdrawal is non-qualified, the student will be responsible for filing a tax return and paying the tax and penalty, which will generally be at the student's lower income tax rate.

If the bill for spring semester comes in December, can I take a 529 savings plan withdrawal this year or next year to cover it?

Unfortunately, there is no clear answer to this question. Nothing in Section 529 of the Internal Revenue Code specifically requires the matching of withdrawals and expenses within the same year. However, it is a generally accepted tax accounting practice to do so. You could risk taking an unintentional non-qualified withdrawal if your 529 savings plan distribution is not taken in the same tax year as the qualified education expenses were paid or incurred. In many cases, you have the option of paying the spring semester bill in either December or January.

If you wait until January to pay the spring semester bill and take the 529 savings plan withdrawal, you avoid any confusion. By waiting until January you can also avoid problems created from writing a check in December that doesn't clear until January, or those instances where you request the 529 savings plan payment in December but you don't receive the distribution until January. Contact your tax advisor for your specific situation if you have questions.

My child will not be living in on-campus housing. Can I use the 529 savings plan to pay for rent and utilities?

Off-campus housing expenses, like rent or utilities, that are not in excess of the amount the school uses for room and board purposes for federal financial aid would be considered qualified expenses. This amount is commonly known as the room and board "allowance". You will have to request the room and board allowance from the school. Also, keep in mind that the student must be attending at least half-time. Make sure you talk to your tax professional about how best to document those off-campus housing expenses in the event they are ever called into question.

What if I take out too much? Can I put the extra amounts back in the 529 savings plan?

Any amount distributed from a 529 savings plan that is not used for qualified higher education expenses is a non-qualified withdrawal. This can happen if you take out more than your qualified expenses in a year (or if you are using the 529 savings plan for expenses that are not considered qualified). The earnings portion of a non-qualified withdrawal is subject to federal income taxes in addition to a 10% federal tax penalty. There may also be state income taxes and even recapture taxes to consider for state tax deductions you received when making the contributions. The 10% tax penalty will not apply in cases where the student has died, become disabled, or received a scholarship.

If you take out more than your qualified expenses, you cannot redeposit the amount into the same 529 savings plan. However, if you are within 60 days of the withdrawal, you have the option to roll it over to another state's 529 savings plan for the same child − if you have not already done a rollover in the past 12 months − or use it to cover future qualified expenses for an upcoming semester if those expenses are in the same calendar year of the withdrawal.

In the situation where the school has issued a refund to you due to an overpayment, the refunded amount may be recontributed to a 529 savings plan for the same beneficiary as long as the rollover is completed within 60 days. ■