The best way to withdraw 529 funds

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If your clients' children are heading to college soon, it's time to start considering 529 withdrawal strategies. Here are three important issues you'll want to cover:

1. How much to withdraw

I generally recommend that 529 account owners lock in their tax benefit by taking the maximum amount from their accounts that will qualify for tax-free treatment. If the account owner tells me they would prefer to withdraw less than the maximum amount this year so they can spread the money over the college years, I will suggest they still withdraw the maximum, and follow it up by making new contributions into the 529. This way they end up with a higher tax basis in the account, and perhaps additional state tax deductions.

How much is the maximum tax-free withdrawal? For most parents, it will be 100% of the beneficiary's qualified higher education expenses paid this year—tuition, fees, books, supplies, equipment, and room and board—less $4,000. The $4,000 is redirected to the American Opportunity Tax Credit (AOTC), which based on a formula is worth up to $2,500 in federal tax savings.

If the account owner neglects to make the $4,000 adjustment and withdraws 529 money equivalent to 100% of eligible expenses, the likely result is a $4,000 non-qualified distribution from the 529 plan. The earnings portion of the non-qualified distribution will be reportable as ordinary income, but the 10 percent penalty on earnings is waived.

Of course, if income phase-outs prevent the taxpayer from claiming the AOTC, the $4,000 adjustment need not be made. Another reason for NOT making the $4,000 adjustment is where doing so will lead to a leftover balance in the 529 plan once college is completed. Better to pay the tax now with no penalty, than to pay it in the future plus a 10 percent penalty.

2. When to withdraw it

Take withdrawals in the same calendar year that the **qualified expenses** were paid. It doesn't matter if funds are withdrawn in January for expenses that are not paid until August. Or if the withdrawal occurs in December for expenses previously paid during that year. Just make sure they match up within the same calendar year.

The IRS is considering new rules that would offer a little additional flexibility across the calendar year divide, but thus far has not finalized those proposals.

Towards year-end, 529 account owners should sit down and figure out exactly how much was spent on qualified expenses during the year and make the appropriate "catch-up" distribution from the 529 plan. As part of this process, determine if the AOTC is maximized by paying second semester college bills in December versus January.

Just don't wait until the last day of the year to go through this exercise. The 529 plan administrator must be given sufficient lead time to process the distribution request in the current calendar year.

3. Designating the distributee

Most 529 plans let the account owners decide how they want their withdrawals to be paid out. They typically have three options: (1) a check made out to the account owner, (2) a check made out to the account beneficiary, or (3) a check made out to the educational institution (or jointly to the institution and the beneficiary).

Since it is usually best that the Form 1099-Q be issued to the beneficiary, and show the beneficiary's social security number, I prefer to use either option (2) or (3).

If the check goes to the account owner, the Form 1099-Q goes out under the account owner's social security number. In theory, this should not matter. As long as the beneficiary incurs sufficient qualified higher education expenses, the distribution remains tax-free to the account owner.

However, in practice, the IRS has a nasty habit of sending out notices assessing additional taxes, interest, and penalties whenever the Form 1099-Q is sent to the account owner, as opposed to the beneficiary. The unnerved account owner must respond by submitting substantiation of the beneficiary's college expenses to the IRS. Why go through this process if you can avoid it by ensuring the Form 1099-Q goes to the beneficiary?

Another reason for wanting to have the Form 1099-Q go to the beneficiary is because a portion of the distribution may end up being non-qualified, and therefore reportable. (See the discussion above concerning the expense adjustment for the AOTC.) If that happens, it is generally best to have the income reported on the student's tax return, not the parents'. Most students are in the lowest tax brackets.

As between options (2) and (3), my preference is option (2): Make the distribution payable to the beneficiary, not to the educational institution. I see the advantage here as being better control over the flow of funds. (I assume that the parent can wrestle the money back from the student if so desired.) By keeping the 529 withdrawal away from the college, the parent and student avoid any complications with the bursar's office. They also avoid the risk that the school's financial aid office will view the payment as some sort of scholarship, and reduce the student's financial aid package accordingly.

4. What about scholarships?

Many students receive scholarships, occasionally resulting in 529 balances that are not needed to pay for college. The 10 percent penalty on a non-qualified distribution from a 529 plan is waived when the excess distribution can be attributed to **tax-free scholarships**. While there is no direct guidance from the IRS, many tax experts believe the distribution and the scholarship do not have to match up in the same calendar year when applying the penalty waiver. Simply keep track of scholarships received over the course of the beneficiary's college career and use the total amount to justify the penalty waiver if excess (i.e. non-qualified) 529 money is later withdrawn.

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