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529 Plans: Advanced Questions

During the presidential primary campaigns, the cost of higher education and the burden of education loans upon recent graduates was been a recurring theme. Families with higher incomes have addressed these costs by contributing to tax-preferred savings vehicles, such as the 529 plan (named for a section of the tax code).

In his 2015 State of the Union address, President Obama called for an end to the tax freedom for distributions from 529 plans for college expenses. The justification for the change was that the tax benefits of 529 plans have been flowing disproportionately to higher-income taxpayers, given that they have the highest marginal tax rates and do the most saving. Reducing that benefit for them would allow for expansion of the tax credits that have greater value to lower-income families. But after a bipartisan outcry, the President backed off the proposal, his spokesman saying that it had become a "distraction."

We can be confident that 529 plans are here to stay. Here are some unusual questions that we've heard recently.

Because I am employed by a private university, my child will be attending my school tuition free. However, the value of the tuition shows up on my W-2 as additional compensation. Can I tap the 529 plan I set up for my child to cover the tax payments?

No, you can't do that. Taxes are not among the qualified education expenses permitted for 529 plans, even if the taxes arise in connection with education. If your child won't be living at home with you, the costs of room and board may be qualified expenses that the 529 plan can cover.

I know that direct payment of college tuition is not a taxable gift. How about if I put $50,000 into a 529 plan for my grandchild this year?

Contributions to 529 plans are potentially taxable gifts. They are shielded by the $14,000 annual gift tax exclusion, so up to that amount no gift tax return is required. You are permitted to bunch up to five future annual exclusion gifts together, so that a contribution of up to $70,000 in one year ($140,000 for married couples) may be contributed in a single year. However, you can't make any other gifts to the individual during the five-year period, and there will be some paperwork to do every year.

If you wanted to contribute $100,000 to a 529 plan, there would be a taxable gift. However, unless you've already made more than $5.45 million in taxable gifts, a gift tax won't be payable. Instead, the gift will reduce the amount of your federal estate tax exclusion at your death. See your tax advisors to learn more.

It appears that I put too much money in a 529 plan for my child, who just graduated. What happens to the excess?

There are only three choices for unused 529 plan accumulations. First, you may roll the funds into another 529 plan for a member of the beneficiary's family—a brother or sister, for example. Second, wait a couple years to see if the child decides to go to graduate school, and use the money for those expenses. Or third, withdraw the money and pay income taxes and the 10% penalty on the earnings portion of the withdrawal.

Because distributions are split pro rata between earnings and principal, these taxes may not be as serous as you might think. Assume that a $100,000 529 plan consists of 2/3 contributions and 1/3 earnings. Next assume that $82,000 was consumed for college expenses,