Topic
Qualified Tuition (529) Plans

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A qualified tuition program (QTP or 529 plan) is a tax-favored program that allows individuals to prepay or contribute to an account for the qualified education expenses of a designated beneficiary. Contributions to a 529 account on behalf of any designated beneficiary cannot exceed the necessary amount of qualified education expenses of the beneficiary at an eligible educational institution. There are no adjusted gross income (AGI) limits on contributions.

Distributions from a 529 account may be excluded from the designated beneficiary's gross income to the extent used to pay for qualified education expenses. This includes qualified higher education expenses, as well as:

- up to $10,000 per year for elementary and secondary expenses after 2017;
- up to $10,000 for student loans of the designated beneficiary or sibling after 2018; and
- certain expenses associated with registered apprenticeship programs after 2018.

Distributions generally may be rolled over from one 529 account to another 529 account for the benefit of the same designated beneficiary or a member of the same family. The designated beneficiary can also be changed to a new beneficiary who is a member of the same family.

QTP Requirements

A QTP program must be established and maintained[1] by a state, state agency or instrumentality, or an eligible educational institution. The program must satisfy the following requirements:

- no contribution may be accepted unless it is in cash[2];
- a separate accounting[3] must be made for each designated beneficiary;
- the program may permit contributors or designated beneficiaries to direct, directly or indirectly, the investment of contributions[4] and earnings up to two times during the calendar year;
- no portion of any interest in the program may be used as a security for a loan[5]; and
- adequate safeguards to prevent contributions in excess[6] of those necessary for the qualified educational expenses of the designated beneficiary.

In the case of a state program, the state, agency, or instrumentality must be actively involved[7] on an ongoing basis in the administration of the program.

Comment

The same federal tax rules govern all state plans, but each state's plan may have unique features. For example, in certain states individuals are not penalized when it comes to eligibility for state financial aid, although in many states they are. Also, the investment features of each plan are different and should be thoroughly investigated to see if they satisfy the clients' investment risk levels and the beneficiaries financial needs.

Amounts contributed to a program of an eligible educational institution must be held in a qualified trust[8] created or organized in the United States for the exclusive benefit of the designated beneficiary (i.e., similar to IRA requirements). The school must have also received a ruling or determination that its QTP meets all applicable requirements.

An eligible educational institution[9] for this purpose is any accredited college, university, vocational school, or other post-secondary educational institution that is eligible to participate in the student aid programs administered by the Department of Education (i.e., virtually all accredited public, nonprofit, and proprietary post-secondary institutions).

Designated Beneficiary. A designated beneficiary[10] of a QTP is:

- the student or future student designated at the commencement of participation in the QTP as the beneficiary for whom the program is intended to provide benefits;
- in the case of a change in beneficiaries (discussed below), the individual who is the new beneficiary; or
- if an interest in a QTP is purchased by a state or local government (including any agency or instrumentality), or a tax-exempt organization as part of a scholarship program operated by the government or organization, the individual receiving the interest as a scholarship.

Contributions

Contributions[11] to a QTP on behalf of a designated beneficiary are limited to the amount necessary to provide for the qualified education expenses. Amounts rolled over from a QTP to another QTP for the same designated beneficiary or a member of the beneficiary's family, or if the QTP account is transferred to a member of the beneficiary's family, do not count as contributions.

While contributions to a QTP are not deductible by the donor, there are no adjusted gross income (AGI) phaseout limits. Also, an individual can contribute to both a QTP and a Coverdell education savings account (ESA) in the same year for the same designated beneficiary (see Coverdell Education Savings Accounts).

Planning Note

Although contributions to 529 accounts are not deductible, a taxpayer can effectively make them with tax-free funds from the redemption of U.S. savings bonds. Redemption proceeds used to make the contributions can be excluded from income as used to pay qualified education expenses. The amount excludable from income is not included as a contribution for purposes of determining the taxable portion of a distribution

Comment

Contributions to a 529 plan are includible in the bankruptcy estate of a debtor if made within one year of filing the bankruptcy petition. Contributions made between 365 and 720 days of filing the bankruptcy petition may be excluded from the bankruptcy estate to the extent they are less than $6,825 for petition files on or after April 1, 2019 ($6,425 for petitions filed on or after April 1, 2016). Any contributions made more than 720 days from filing the bankruptcy petition maybe fully excludable from the bankruptcy estate. See 11 U.S.C. Section 541(b)(6).

Estate and Gift Tax Treatment of Contributions. Contributions to a QTP are treated as a completed gift[12] of a present interest from the donor to the beneficiary. Thus, they are not includible in gross income of the designated beneficiary. Even though they are treated as completed gifts, contributions to a QTP do not qualified for the unlimited gift tax exclusion for money used to pay educational expenses (see Gift Tax Exclusions and Deductions).

Contributions to a QTP also do qualify for the annual gift tax exclusion. If a donor's contribution exceeds the annual gift-tax exclusion amount ($15,000 for 2019[13] and 2020[14]), he or she may elect to take the excess into account ratably over five years beginning with the calendar year of the contributions.

Compliance Note

The election to take excess contributions ratably over five years is made on Form 709 for the year of the contribution. In the case of joint gifts by spouses, the gift-splitting rules apply before applying the QTP rules. Each spouse would then elect whether to make the QTP election.

No portion of a contribution is generally includible in the estate of a donor[15], unless the donor dies during the five-year period in which excess contributions to a QTP are being ratably taken into account.

Distributions

Distributions from a QTP are excludable from gross income[16] to the extent they do not exceed the adjusted qualified education expenses (AQEE) incurred by the designated beneficiary during the year. Distributions for this purpose include any cash or in-kind disbursement that provides benefits to the beneficiary such as tuition credits or waivers. Excess distributions are includible in gross income and subject to a 10-percent addition to tax or penalty.

Taxable Portion of Distributions. Distributions from a QTP that exceed the beneficiary's AQEE generally are includible in gross income[17] under the IRC §72[18] annuity rules. The portion of a distribution that represents contributions to the QTP is excludible from gross income as it represents a return of the investment in the plan.

Compliance Note

A designated beneficiary who receives a distribution from a QTP should receive a Form 1099-Q from the trustee of the account reporting gross distribution, earnings, and basis. The QTP must provide a copy of the form to the designated beneficiary and the IRS. Form 1099-Q should be provided to the designated beneficiary by January 31 of the following calendar year. A penalty may apply if the trustee fails to provide the payee statement or file the form with the IRS (see Information Returns).

The portion of distribution that represents earnings (box 2 of Form 1099-Q) is includible in gross income to the extent it exceeds AQEE, but reduced by the ratio of the AQEE over the total distributions for the year (box 1 on Form 1099-Q). A beneficiary's AQEE for this purpose is the amount of his or her qualified education expenses for the tax year reduced by:

- any other tax-free educational assistance received by the beneficiary, including scholarships and fellowships, veterans educational assistance, Pell grants, employer-provided educational assistance, and any other nontaxable payments (other than gifts or inheritances) received as educational assistance;
- any qualified education expenses taken into account in calculating the American opportunity or lifetime learning credits[19].

Compliance Note

If a taxpayer receives distributions from a 529 plan and a Coverdell ESA in the same year, and the total is more than the beneficiary's AQEE for the year, then the expenses must be allocated[20] between the distributions using any reasonable method. For tax years beginning before 2021, the tuition and fees deduction can be claimed in the same year the beneficiary takes a tax-free distribution from a QTP, as long as the same expenses are not used for both benefits. See Tuition and Fees Deduction.

Example

Sara is the beneficiary of a QTP that has a total account balance of $27,000, which represents $18,000 in contributions and $9,000 in investment earnings. She has $8,300 in qualified education expenses during the tax year, which she pays with a $3,100 tax-free scholarship, $1,600 gift from her parents, and a $5,300 distribution from the QTP.

Before Sara can determine the taxable part of her distribution, she must reduce her total qualified education expenses by any tax-free educational assistance ($8,300 - $3,100 scholarship = $5,200 AQEE). Because this amount is less than her distribution from the QTP, a portion of the earnings in the distribution is taxable. Sara's Form 1099-Q shows that $950 of the QTP distribution is earnings. The taxable portion of the distributed earnings not used for AQEE is $19 calculated as follows:

- $950 earnings x ($5,200 AQEE / $5,300 distribution) = $932 tax-free earnings
- $950 earnings - $932 tax-free earnings = $18 taxable earnings.

If a beneficiary receives a refund of any qualified education expenses[21] from an eligible educational institution, the beneficiary is not required to include in gross income the portion of the distribution that the beneficiary recontributes to the QTP. The amount must be recontributed no later than 60 days after the date of the refund and the recontributed amount cannot exceed the refunded amount. Any recontributed amount is not treated as a rollover and therefore is considered principal[22].

10% Additional Tax. If any portion of a distribution from a QTP is includible in designated beneficiary's gross income, a 10-percent addition to tax[23] (penalty) also applies to that portion of the distribution. The additional 10-percent tax or penalty does not apply to distributions:

- paid to a beneficiary or the estate of a designated beneficiary after the beneficiary's death;
- attributable to the designated beneficiary being disabled, as defined under IRC §72(m)(7)[24];
- included in gross income because the designated beneficiary received tax-free educational assistance, including any tax-free scholarships and fellowships, Veteran's educational assistance, Pell grants, employer-provided educational assistance, and any other nontaxable payment received as educational assistance (other than gifts or inheritance);
- included in gross income only because the designated beneficiary's qualified education expenses were taken into account for purposes of the American opportunity or the lifetime learning credit; or
- made on account of the attendance of the designated beneficiary at a U.S. military academy to the extent the distribution does not exceed the costs of attendance attributable that academy.

Compliance Note

Form 5329 is used to report the 10 percent additional tax.

Losses on QTP Investments. For tax years beginning in 2018 through 2025, a designated beneficiary may not deduct a loss on investments in a QTP. A loss for this purpose only occurs if the total amount in the account is distributed and the total distributions are less than any unrecovered basis.

Compliance Note

For tax years beginning before 2018 and after 2025, a loss in a 529 plan may be claimed as a miscellaneous itemized deduction on Schedule A (Form 1040) subject to the two-percent of AGI limit. No miscellaneous itemized deduction subject to the two-percent-of-AGI limit may be claimed in tax years 2018 through 2025.

Qualified Expenses

Distributions from a 529 account are excludable from gross income to the extent that they are used to pay qualified education expenses. This includes qualified higher education expenses, up to $10,000 of qualified elementary or secondary education expenses after 2017, up to $10,000 of principal or interest for student loan payments after 2018, and expenses associated with registered apprenticeship programs after 2018.

Higher Education Expenses. Qualified expenses of a QTP generally include qualified higher education expenses (QHEEs)[25] required for enrollment or attendance of the designated beneficiary at an eligible educational institution. QHEEs consist of:

- tuition, fees, books, supplies, and equipment;
- expenses incurred for special needs services for a special needs beneficiary;

- room and board expenses incurred by an eligible student who is attending an eligible educational institution at least half time; and
- expenses for the purchase of computer or peripheral equipment, computer software, or Internet access and related services if it's to be used primarily by the beneficiary during any of the years the beneficiary is enrolled at an eligible educational institution.

Caution

Computer software primarily involving sports, games, or hobbies is not considered a qualified education expense unless the software is predominantly educational in nature.

Room and board costs[26] are qualified education expenses only if they are incurred while the designated beneficiary is an eligible student with respect to any academic period and carries at least one-half the normal full-time work load. To be an eligible student, the individual must be enrolled or accepted for enrollment in a degree, certificate, or other program leading to a recognized educational credential at an eligible educational institution of higher learning. The maximum amount of room and board expenses that are qualified education expenses is limited to the greater of:

- the allowance for room and board, as determined by the eligible educational institution, that is included in the cost of attendance for federal financial aid purposes for a particular academic period and living arrangement of the student; or
- the actual amount charged if the student is residing in housing owned or operated by the eligible educational institution.

Planning Note

Room and board costs are defined for purposes of federal financial aid as follows:

- for students living at home with parents, an amount determined by the institution;
- for students residing in housing owned or operated by the school, a standard allowance based on the amount most of the school's residents are normally charged for room and board; and
- for all other students, the amount of expenses reasonably incurred by the student for room and board.

Room and board expenses for purposes of distributions from QTPs for students in school-owned or school-operated housing, however, are defined as the amount actually charged the student, rather than a standard allowance.

An eligible educational institution[27] is a postsecondary school that is an accredited college, university, or vocation school that is eligible to participate in the U.S. Department of Education student aid program. This may include certain educational institutions located outside the United States.

Elementary and Secondary School Expenses. For any distribution made after 2017, qualified education expenses include up to $10,000 of expenses for tuition in connection with the designated beneficiary's enrollment or attendance at an elementary or secondary school[28] during the tax year, whether public, private, or religious school. An elementary or secondary school for this purpose means kindergarten through grade 12[29] as determined under State law.

Student Loan Repayments. For any distribution made after 2018, qualified education expenses of a QTP includes up to $10,000 of principal or interest on any qualified student loan[30] of the designated beneficiary or a sibling. A sibling includes the designated beneficiary's brother, sister, stepbrother, or stepsister.

The $10,000 limit applies in the aggregate, over the course of the individual's lifetime. Any QTP distribution for student loan repayments made during the year is reduced by the amount of such distributions for all prior tax years. Separate accounting is made for student loan distributions made for the designated beneficiary and a sibling. Thus, a student loan distribution from a 529 account of the designated beneficiary to a sibling is applied towards the sibling's $10,000 lifetime limit, and not the designated beneficiary's $10,000 lifetime limit.

Comment

According to the House Committee Report H.R. Rep No. 116-65, the $10,000 limit applies to distributions from all QTP accounts. Thus, an individual may not avoid the limit by receiving separate $10,000 distributions from multiple accounts. To the extent that an individual receives student loan payment distributions in excess of $10,000, they are subject to the usual tax treatment of 529 distributions (i.e., the earnings are included in income and subject to a 10-percent penalty).

A qualified student loan for purposes of QTP distributions is the same as for claiming the student loan interest deduction. However, no double benefit[31] is allowed. The deduction is reduced by the amount of any student loan interest distributed from a 529 account that is excluded from gross income (see Student Loan Interest Deduction).

Registered Apprenticeship Programs. For any distribution made after 2018, qualified education expenses of a QTP include certain expenses associated with registered apprenticeship programs[32]. This includes expenses for fees, books, supplies, and equipment required for the participation of the designated beneficiary in an apprenticeship program registered and certified with the Department of Labor under section 1 of the National Apprenticeship Act (29 U.S.C. 50).

Rollovers & Transfers

A distribution from a QTP may be excluded from gross income if rolled over[33] to:

- another QTP for the benefit of the same designated beneficiary;
- to the QTP for the benefit of a member of the designated beneficiary's family; or
- after 2017 before January 1, 2026, to an ABLE account for the benefit of the same designated beneficiary or another beneficiary who is a member of the same family (as long as the total contributed to the ABLE account, including the amount rolled over, does not exceed to contribution limit).

A distribution from the first QTP must be paid into the second QTP or ABLE account no later than the 60th day after the payment or distribution is made to qualify to rollover treatment. If the rollover is made to another QTP of the same designated beneficiary, then only one such transfer is permitted within 12 months[34] of the previous transfer to any QTP for that designated beneficiary.

Compliance Note

Rollover distributions are reported on Form 1099-Q, but a separate form is used to report any trustee-to-trustee transfers. Qualifying rollovers are not reported on the designated beneficiary's return.

Changing the Designated Beneficiary. A change in designated beneficiary[35] in a QTP has no tax consequences if the transfer is within the same or higher generation of the same family. For example, a change in a designated beneficiary from the QTP of an older child to a younger child. Transfers to a new beneficiary in a lower generation than the old beneficiary are treated as taxable gifts[36] by the old beneficiary to the new beneficiary, regardless of family relationships. They are also subject to the generation-skipping transfer (GST) tax if the new beneficiary is assigned to a generation that is two or more levels lower than the generation assignment of the old beneficiary.

Members of Family. A member of the beneficiary's family[37] for a rollover distribution or change in beneficiary of a QTP includes the designated beneficiary's spouse and the following relatives of the beneficiary:

- son, daughter, stepchild, foster child, adopted child, or a descendant of any of them;
- brother, sister, stepbrother, or stepsister;

- father, mother, or ancestor of either, as well as stepfather or stepmother;
- niece, nephew, aunt, or uncle;
- son-in-law, daughter-in law, father-in-law, mother-in-law, brother-in-law or sister-in-law;
- the spouse of any individual listed above; and
- first cousin.

Citations

1. §529(b)
2. §1.529-2(d)
3. §1.529-2(f)
4. §1.529-2(g)
5. §1.529-2(h)
6. §1.529-2(i)
7. §1.529-2(b)
8. §529(b)
9. §529(e)(5)
10. §529(e)(1)
11. §529(b)(6)
12. §529(c)(2)
13. REVPROC2018-57
14. REVPROC2019-44
15. §529(c)(4)
16. §529(c)(3)
17. §529(c)(3)(A)
18. §72(e)(9)
19. §529(c)(3)(B)(v)
20. §529(c)(3)(B)(vi)
21. §529(c)(3)(D)
22. NOTICE2018-58
23. §529(c)(6)
24. §72(m)(7)
25. §529(e)(3)(A)
26. §529(e)(3)(B)
27. §529(e)(5)
28. §529(c)(7)
29. NOTICE2018-58
30. §529(c)(9)
31. §221(e)
32. §529(c)(8)
33. §529(c)(3)(C)(i)

34. §529(c)(3)(C)(iii)
35. §529(c)(3)(C)(ii)
36. §529(c)(5)(B)
37. §529(e)(2)