

# Mistakes Families Make with 529 Plans

*5 common errors to avoid + 2 big factors to consider.*

**Provided by Brad Connors, Certified Wealth Strategist®**

Most families that start 529 college savings plans have done their “homework” about these programs. Missteps are made, though, often with the distribution of 529 plan assets. Here are some of the major gaffes, and the major factors anyone should think about before enrolling.

**Assuming a university will withdraw 529 plan assets for you.** When the time comes, you have to tell the 529 plan that you need the money and specify the payee. Typically, a 529 program offers you either a check written out to you, to your student, or a payment made directly from the 529 plan to the university. There are two big reasons why a check made payable to the student may be the best option.

\*A 529 plan distribution triggers a Form 1099-Q. You most likely want your student’s name and Social Security number on that form, not yours. If your student’s name is on the 1099-Q and your student has qualifying higher education expenses (QHEE) equaling or exceeding the gross distribution figure for that tax year listed on the form, that whole 529 plan withdrawal becomes tax-free and the distribution from the 529 doesn’t show up on the student's Form 1040. If your name is on the 1099-Q, the distribution doesn’t show up on *your* 1040. Even if your student’s QHEE equals or exceeds the magic number on the 1099-Q for the tax year, an omission may trigger an IRS notice to you, and you will have to defend the exclusion.<sup>1</sup>

\*Let’s say you accidentally overestimate your student’s qualified education expenses, or maybe parents and grandparents make withdrawals without each other’s knowledge. In this event, the earnings portion of the distribution is partly or fully taxable. If the distribution is paid out to you, then the earnings are taxed at your federal tax rate. If it is made payable to your student, then the earnings are taxed at his or her federal tax rate, which barring the “kiddie tax” is presumably just 10-15%.<sup>1</sup>

Having a payment made directly the school can lead to a second common mistake.

**Inadvertently reducing a student’s financial aid potential.** When a university takes a direct payment from a 529 plan, its financial aid office may make a dollar-for-dollar adjustment to the need-based aid a student receives. Often, it is viewed the same as scholarship money.<sup>1</sup>

Since the IRS bars you from using multiple education tax benefits to pay for the same education expenses, using tax-deferred 529 plan earnings to pay for the first semester of college may disqualify your student for an American Opportunity Credit. You should read up on the IRS income restrictions on education credits or consult a tax professional. Paying the first few thousand dollars in freshman year expenses with funds outside the plan may allow your student to retain eligibility.<sup>2</sup>

**Mistiming the distributions.** It can take up to two weeks to arrange and carry out a 529 plan distribution; telling a financial aid office that you are using 529 funds to pay tuition just a few days before a tuition deadline is cutting it close.<sup>3</sup>

Some families withdraw 529 monies during freshman year, which can conflict with federal tax returns. If a tuition payment is due in January, withdrawing it in December will create an incongruity between total withdrawals and expenses. The same will apply if a withdrawal is made in January, but tuition was due in December.<sup>3</sup>

**Botching the tax break offered to you on the distribution.** To get a tax-free qualified withdrawal from a 529 plan, the withdrawn funds have to be used for qualified, college-related expenses. If the distribution isn't qualified, it will be considered fully taxable, and you may be hit with a 10% federal penalty plus state and local income taxes. If you withdraw more plan assets than necessary, any excess distribution is also nonqualified. Calculating and withdrawing the "net" qualifying expenses of your student's college education could help you avoid this last problem, or alternately, you could report the excess 529 funds on the student's 1040.<sup>3,4,5</sup>

**Ceasing 529 contributions once a student enters college.** You can keep putting money into a 529 plan throughout your student's college years, with the opportunity for additional tax-deferred growth of those savings.<sup>2</sup>

**Finally, two other factors are worth noting.** These would be a 529 plan's expenses and deductions.

Tax deductions represent a key reason why families choose in-state 529 plans. Most states that levy income tax offer 529 programs with deductions or credits for taxpayers. It varies per state. For example, in Michigan, a married couple can deduct the first \$10,000 of 529 contributions annually, which leads to a state tax savings of up to \$425. Some other states offer no deductions.<sup>6</sup>

Make no mistake, 529 plans offer great potential advantages for households striving to meet future college costs. Just remember to read the fine print, especially as your student's freshman year draws closer.

Investors should consider carefully the investment objectives, risks, charges and expenses of the municipal fund before investing. This, as well as other important information, is contained in the official statement. Please read it carefully before investing or sending money.

An investor's home state may offer favorable tax treatment only for investing in a plan offered by such state. Withdrawals for non-qualified expenses may be subject to additional penalties and taxes. Consult your tax advisor regarding state and federal tax consequences of the investment.

Participation in a 529 Plan does not guarantee that the contributions and investment return will be sufficient to cover future higher education expenses. Investments involve risk and you may incur a profit or a loss.

Brad Connors is a Representative with Investment Centers of America, Inc. and may be reached at [www.iWealth4me.com](http://www.iWealth4me.com), 507-835-9111 or [info@iWealth4me.com](mailto:info@iWealth4me.com).

Securities, advisory services, and insurance products are offered through Investment Centers of America, Inc. (ICA), member FINRA, SIPC, a Registered Investment Advisor, and affiliated insurance agencies. ICA and iWealth are separate companies.

This material was prepared by MarketingLibrary.Net Inc., and does not necessarily represent the views of the presenting party, nor their affiliates. All information is believed to be from reliable sources; however we make no representation as to its completeness or accuracy. Please note - investing involves risk, and past performance is no guarantee of future results. The publisher is not engaged in rendering legal, accounting or other professional services. If assistance is needed, the reader is advised to engage the services of a competent professional. This information should not be construed as investment, tax or legal advice and may not be relied on for the purpose of avoiding any Federal tax penalty. This is neither a solicitation nor recommendation to purchase or sell any investment or insurance product or service, and should not be relied upon as such. All indices are unmanaged and are not illustrative of any particular investment.

#### **Citations.**

- 1 - [www.bankrate.com/finance/college-finance/3-ways-to-take-a-529-plan-distribution.aspx](http://www.bankrate.com/finance/college-finance/3-ways-to-take-a-529-plan-distribution.aspx) [10/5/09]
- 2 - [www.usnews.com/education/best-colleges/paying-for-college/articles/2012/08/01/4-costly-mistakes-parents-make-when-saving-for-college](http://www.usnews.com/education/best-colleges/paying-for-college/articles/2012/08/01/4-costly-mistakes-parents-make-when-saving-for-college) [8/1/12]
- 3 - [www.savingforcollege.com/articles/20101001-5-blunders-by-first-time-529-plan-spenders](http://www.savingforcollege.com/articles/20101001-5-blunders-by-first-time-529-plan-spenders) [10/01/10]
- 4 - [www.foxbusiness.com/personal-finance/2011/11/14/dont-make-your-52-plan-distribution-taxing/](http://www.foxbusiness.com/personal-finance/2011/11/14/dont-make-your-52-plan-distribution-taxing/) [11/14/11]
- 5 - [www.529.com/content/benefits.html](http://www.529.com/content/benefits.html) [3/28/13]
- 6 - [www.forbes.com/sites/baldwin/2013/03/27/the-two-step-guide-to-529s/](http://www.forbes.com/sites/baldwin/2013/03/27/the-two-step-guide-to-529s/) [3/27/13]