Your *Trust* Matters

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MidWestOne™
TRUST SERVICES

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Income Tax Planning and 529 Plans

Here in Iowa City, the flocks of students returning from their summer slumbers have transformed our serene surroundings into a bustling metropolis. It's a good idea to remind ourselves that despite the lack of parking spaces and the longer wait times at restaurants, the start to college football is only a few weeks away! With the rising cost of tuition and housing, some students may not get an opportunity to fully partake in the college experience. Clients sometimes ask if they are able to help their children and grandchildren pay for these expenses. They are often wondering if there is a tax-efficient way for them to help.

The income tax benefits offered by 529 plans make these plans attractive to parents and grandparents who are saving for college. Qualified withdrawals from a 529 plan are tax free at the federal level, and some states also offer tax breaks to their residents. It's important to evaluate the federal and state tax consequences of plan withdrawals and contributions before you invest in a 529 plan.

Federal income tax treatment of qualified withdrawals. There are two types of 529 plan—savings plans and prepaid tuition plans. The federal income tax treatment of these plans is identical. Your contributions accumulate tax deferred, which means that you don't pay income taxes on the earnings each year. Then, if you withdraw funds to pay the beneficiary's qualified education expenses, the earnings portion of your withdrawal is free from federal income tax. This feature presents a significant opportunity to help you accumulate funds for college.

Qualified education expenses for 529 savings plans include the full cost of tuition, fees, room and board, books, equipment, computers for college and graduate school, and K-12 tuition expenses for enrollment at an elementary or secondary public, private, or religious school up to $10,000 per year. In comparison, qualified education expenses for 529 prepaid tuition plans generally include tuition and fees for college only (not graduate school) at the colleges that participate in the plan.

State income tax treatment of qualified withdrawals. States differ in the 529 plan tax benefits they offer to their residents. For example, some states may offer no tax benefits, while others may exempt earnings on qualified withdrawals from state income tax or offer a deduction for contributions. However, keep in mind that states may limit their tax benefits to individuals who participate in the in-state 529 plan. You should look to your own state's laws to determine the income tax treatment of contributions and withdrawals. In general, you won't be required to pay income taxes to another state simply because you opened a 529 account in that state. But you'll probably be taxed in your state of residency on the earnings distributed by your 529 plan (whatever state sponsored it) if the withdrawal is not used to pay the beneficiary's qualified educations expenses. 529 account owners who are interested in making K-12 contributions or withdrawals should understand their state's rules on how K-12 funds will be treated for tax purposes. States may not follow the federal tax treatment.

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Federal and state income tax treatment of nonqualified withdrawals. If you make a nonqualified withdrawal, the earnings portion of the distribution will usually be taxable on your federal (and probably state) income tax return in the year of the distribution. The earnings are usually taxed at the rate of the person, known as the distributee, who receives the distribution. In most cases, the account owner will be the distributee. Some plans specify who the distributee is, while others may allow you as the account owner to determine the recipient of a nonqualified withdrawal. You'll also pay a federal 10% penalty on the earnings portion of the nonqualified withdrawal. There are a couple of exceptions. The penalty is generally waived if you terminate the 529 account because the beneficiary has died or become disabled, or if you withdraw funds not needed for college because the beneficiary has received a scholarship. A state penalty may also apply.

Deducting your contributions to a 529 plan. Unfortunately, you can't claim a federal income tax deduction for your contributions to a 529 plan. Depending on where you live, you may qualify for a deduction on your state income tax return. A number of states offer a state income tax deduction for contributions to a 529 plan. Again, keep in mind that most states let you claim an income tax deduction on your state tax return only if you contribute to your own state's 529 plan. Many states that offer a deduction for contributions impose a deduction cap, or limitation, on the amount of the deduction. For example, if you contribute $I0,000 to your child’s 529 plan this year, your state might allow you to deduct only $4,000 on your state income tax return. Check the details of your 529 plan and the tax laws of your state to learn whether your state imposes a deduction cap. Also, if you’re planning to claim a state income tax deduction for your contributions, you should learn whether your state applies income recapture rules to 529 plans. Income recapture means that deductions allowed in one year may be required to be reported as taxable income if you make a nonqualified withdrawal from the 529 plan in a later year. Again, check the laws of your state for details.

Please don’t hesitate to contact our experts on the MidWestOne Bank Trust Services team today to set up a 529 Plan today.

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