Wander CPA
Tax-Saving Tips

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Taxation of 529 College Savings Account Withdrawals

The big advantage of 529 plans is that qualified withdrawals are always federal-income-tax-free—and usually state-income-tax-free too.

What you may not know is that not all 529 withdrawals are tax-free qualified withdrawals, even in years when you have heavy college costs.

Here are six important points to know about 529 withdrawals.

Point No. 1: You Usually Have Several Payment Options

Say you are the 529 *account owner* or *plan participant*. Plans commonly use both terms to describe the person who established and controls the account. This letter will use *account owner.*

As the account owner, you can generally have a withdrawal check cut in your own name or have an electronic deposit made into your own account. Alternatively, you can have a withdrawal issued in the name of the *account beneficiary* (the college student for whom you set up the 529 account, usually a child or grandchild) or issued directly to the educational institution for the benefit of the account beneficiary.

You choose your payment option by submitting a withdrawal request to the 529 plan.

Point No. 2: Watch Out for Withdrawals from 529 Accounts Funded with Custodial Account Money

Say you funded the 529 account with money that came from a *custodial account* that was set up for the account beneficiary—your child or grandchild—under your state's Uniform Gift to Minors Act (UGMA) or Uniform Transfer to Minors Act (UTMA).

In this situation, you must use any money taken from the custodial account for the benefit of the child or grandchild.

You can't take a 529 account withdrawal for yourself if the 529 account was funded with money from a child's or grandchild's custodial account. Because the money in the 529 account came from the custodial account, the 529 account money legally belongs to your child or grandchild, not you.

On the other hand, if you funded the 529 account with your own money, the money in the account is fair game. You can take withdrawals and do whatever you want with them—subject to the potential federal income tax implications explained later.

Point No. 3: The IRS Knows about Withdrawals

For any year that a 529 withdrawal is taken, the plan must issue a Form 1099-Q, Payments From Qualified Education Programs (Under Sections 529 and 530), by February 1 of the following year.

If the withdrawal goes to the 529 account beneficiary (your child or grandchild), the 1099-Q goes to him or her. If the withdrawal goes to you as the account owner, the 1099-Q goes to you.

Either way, the IRS gets a copy, so the IRS knows what happened.

Point No. 4: Withdrawals May Be Taxable Even in Years When Substantial College Costs Are Incurred

When the Form 1099-Q shows withdrawn earnings, the IRS becomes interested in the 1099-Q recipient's Form 1040 because some or all of the earnings might be taxable. Here's the deal on that.

Withdrawn earnings are always federal-income-tax-free and penalty-free when total withdrawals for the year do not exceed what the IRS calls the account beneficiary's *adjusted qualified education expenses,* or AQEE, for the year.

AQEE equals the sum of the 529 account beneficiary's

- college tuition and related fees;
- room and board (but only if the beneficiary carries at least half of a full-time course load);
- required books, supplies, and equipment;
- computer hardware and peripherals, software, and internet access costs; and
- expenses for special needs services.

Next, you must subtract any federal-income-tax-free educational assistance to calculate the account beneficiary's AQEE.

According to the IRS, tax-free educational assistance includes costs covered by

- tax-free Pell grants;
- tax-free scholarships, fellowships, and tuition discounts;
- tax-free veterans' educational assistance;
- an employer's tax-free educational assistance program under Internal Revenue Code Section 127; and
- any other tax-free educational assistance (other than assistance received in the form of a gift or an inheritance).

In addition, tax-free educational assistance includes any costs used to claim the American Opportunity tax credit or the Lifetime Learning tax credit.
Key point. You can also include in AQEE

- up to $10,000 annually for the account beneficiary’s K-12 tuition costs;

- the account beneficiary’s fees, books, supplies, and equipment required to participate in a registered apprenticeship program; and

- interest and principal payments on qualified student loan debt owed by the account beneficiary or a sibling of the account beneficiary—subject to a $10,000 lifetime limit.

Bottom line. When withdrawals during the year *exceed* AQEE for the year, all or part of the withdrawn earnings will be taxable. When withdrawals *don’t* exceed AQEE, all the withdrawn earnings are federal-income-tax-free.

Point No. 5: When You Keep a Withdrawal, There Are Tax Consequences

Assuming the 529 account was funded with your own money (as opposed to money from a custodial account), you are free to change the 529 account beneficiary to yourself and then take federal-income-tax-free withdrawals to cover your own AQEE if you decide to go back to school.

But if you take a withdrawal that you use for purposes other than education, report the taxable portion of any related account earnings as miscellaneous income on your Form 1040. Taxable amounts may also get hit with a 10 percent penalty tax to boot (see below).

Finally, if you liquidate a loser 529 account (worth less than the total amount of contributions), there are no federal income tax consequences. (The government stopped participating in your losses for tax years 2018-2025.)

Point No. 6: Withdrawals Not Used for Education Can Also Be Hit with a 10 Percent Penalty Tax

As explained earlier, some or all of the earnings included in a 529 withdrawal taken during the year must be included in gross income when the withdrawn earnings exceed the account beneficiary’s AQEE for the year. But there’s more.

According to the general rule, the taxable amount of earnings is also hit with a 10 percent penalty tax.

But the 10 percent penalty tax doesn’t apply to earnings that are taxable only because the account beneficiary’s AQEE was reduced by

- tax-free Pell grants;

- tax-free scholarships, fellowships, and tuition discounts;

- tax-free veterans’ educational assistance;

- tax-free employer-provided educational assistance;

- any other tax-free educational assistance; or

- costs used to claim the American Opportunity or Lifetime Learning tax credit.

In addition, the 10 percent penalty tax doesn’t apply to earnings withdrawn when the account beneficiary attends one of the U.S. military academies (such as West Point, Annapolis, or the Air Force Academy).

Finally, the 10 percent penalty tax doesn't apply to earnings withdrawn after the account beneficiary dies or becomes disabled.

Tax-Home Rules You Should Know

When you travel out of town overnight, you need to know the tax-home rule. The IRS defines your tax home, and it's not necessarily in the same town where you have your personal residence.

If you have more than one business location, one of the locations will be your tax home. It's generally your main place of business.

In determining your main place of business, the IRS takes into account three factors:

1. the length of time you spend at each location for business purposes;
2. the degree of business activity in each area; and
3. the relative financial return from each area.

Here's a recent court case that illustrates this rule.

Akeem Soboyede, an immigration attorney, was licensed to practice law in both Minnesota and Washington, D.C., and he maintained solo law practices in both Minneapolis and Washington, D.C.

Although Mr. Soboyede's primary personal residence was in Minneapolis, he divided his time between his office in Minneapolis and his office in Washington, D.C.

Get ready for a chuckle: in court, Mr. Soboyede admitted in his testimony that he did not keep the necessary documentation because he "did not know . . . [he] was going to get audited."

Due to the lack of records, the IRS disallowed most of the deductions. The remaining issue for the court was the travel expenses for lodging, for which Mr. Soboyede had the records.

The court noted that Mr. Soboyede's lodging expenses were only deductible if he was "away from home" as required by Section 162(a)(2).

In deciding whether Mr. Soboyede's tax home was in Minneapolis or Washington, D.C., the court used the following two factors:

- Where did he spend more of his time?
- Where did he derive a greater proportion of his income?

Answer: Washington, D.C. Think about this: He had his home in Minneapolis, but the court ruled that his "tax home" was in Washington, D.C. As a result, he lost his travel deductions.

Principal Residence Gain Exclusion Break

Here's a look at how to apply the $250,000 ($500,000, if married) principal residence tax break when getting married or divorced, or when converting another property into your home.

In both marriage and divorce situations, a home sale often occurs. Of course, the principal residence gain exclusion break can come in very handy when an appreciated home is put on the block.

Sale during Marriage

Say a couple gets married. They each own separate residences from their single days. After the marriage, the pair files jointly. In this scenario, it is possible for each spouse to individually pass the ownership and use tests for their respective residences. Each spouse can then take advantage of a separate $250,000 exclusion.

Sale before Divorce

Say a soon-to-be-divorced couple sells their principal residence. Assume they still are legally married as of the end of the year of sale because their divorce is not yet final. In this scenario, the divorcing couple can shelter up to $500,000 of home sale profit in two different ways:

1. **Joint return.** The couple could file a joint Form 1040 for the year of sale. Assuming they meet the timing requirements, they can claim the $500,000 joint-filer exclusion.
2. **Separate returns.** Alternatively, the couple could file separate returns for the year of sale, using married-filing-separately status. Assuming the home is owned jointly or as community property, each spouse can then exclude up to $250,000 of his or her share of the gain.

To qualify for two separate $250,000 exclusions, each spouse must have

- owned his or her part of the property for at least two years during the five-year period ending on the sale date, and
- used the home as his or her principal residence for at least two years during that five-year period.

Sale in Year of Divorce or Later

When a couple is divorced as of the end of the year in which their principal residence is sold, they are considered divorced for that entire year. Therefore, they will be unable to file jointly for the year of sale. The same is true, of course, when the sale occurs after the year of divorce.

Key point. Under the preceding rules, both ex-spouses will typically qualify for separate $250,000 gain exclusions when the home is sold soon after the divorce. But when the property remains unsold for some time, the ex-spouse who no longer resides there will eventually fail the two-out-of-five-years use test and become ineligible for the gain exclusion privilege.

Let’s see how we can avoid that unpleasant outcome.

When the Non-Resident Ex Continues to Own the Home for Years after Divorce

Sometimes ex-spouses will continue to co-own the former marital abode for a lengthy period after the divorce. Of course, only one ex-spouse will continue to live in the home. After three years of being out of the house, the non-resident ex will fail the two-out-of-five-years use test. That means when the home is finally sold, the non-resident ex’s share of the gain will be fully taxable.

But with some advance planning, you can prevent this undesirable outcome.

If you will be the non-resident ex, your divorce papers should stipulate that as a condition of the divorce agreement,

- your ex-spouse is allowed to continue to occupy the home for as long as he or she wants, or
- until the kids reach a certain age, or
- for a specified number of years, or
- for whatever time period you and your soon-to-be ex can agree on.

At that point, either the home can be put up for sale, with the proceeds split per the divorce agreement, or one ex can buy out the other's share for current fair market value.

This arrangement allows you, as the non-resident ex, to receive "credit" for your ex's continued use of the property as a principal residence. So, when the home is finally sold, you should pass the two-out-of-five-years use test and thereby qualify for the $250,000 gain exclusion privilege.

The same strategy works when you wind up with complete ownership of the home after the divorce, but your ex continues to live there. Stipulating as a condition of the divorce that your ex is allowed to continue to live in the home ensures that you, as the non-resident ex, will qualify for the $250,000 gain exclusion when the home is eventually sold.

Little-Known Non-Excludable Gain Rule Can Mean Unexpectedly Higher Taxes on a Property Converted into Your Principal Residence

Once upon a time, you could convert a rental property or vacation home into your principal residence, occupy it for at least two years, sell it, and take full advantage of the home sale gain exclusion privilege of $250,000 for unmarried individuals or $500,000 for married, joint-filing couples. Those were the good old days!

Unfortunately, legislation enacted back in 2008 included an unfavorable provision for personal residence sales that occur after that year. The provision can make a portion of your gain from selling an affected residence ineligible for the gain exclusion privilege.

Let's call the amount of gain that is made ineligible the *non-excludable gain*. The non-excludable gain amount is calculated as follows.

Step 1. Take the total gain, and subtract any gain from depreciation deductions claimed against the property for periods after May 6, 1997. Include the gain from depreciation (so-called unrecaptured Section 1250 gain) in your taxable income. Carry the remaining gain to Step 3.

Step 2. Calculate the non-excludable gain fraction.

The *numerator* of the fraction is the amount of time *after 2008* during which the property is *not* used as your principal residence. These times are called *periods of non-qualified use*.

But periods of non-qualified use don't include temporary absences that aggregate two years or less due to changes of employment, health conditions, or other circumstances specified in IRS guidance.

Periods of non-qualified use also don't include times when the property is not used as your principal residence, if those times are

- after the last day of use as your principal residence, and

- within the five-year period ending on the sale date.

The *denominator* of the fraction is your total ownership period for the property.

Step 3. Calculate the non-excludable gain by multiplying the gain from Step 1 by the non-excludable gain fraction from Step 2.

Step 4. Report on Schedule D of Form 1040 the non-excludable gain calculated in Step 3. Also report any Step 1 unrecaptured Section 1250 gain from depreciation for periods after May 6, 1997. The remaining gain is eligible for the gain exclusion privilege, assuming you meet the timing requirements.

The Basics of Depreciation

Are you thinking about buying personal property (such as a car, a computer, or other equipment) or real property (such as a building)?If you use the property for personal purposes, it's not deductible.

But if you use it in a business, you can deduct the full cost using regular depreciation, bonus depreciation, or IRC Section 179 expensing.

Regular depreciation takes three to 39 years depending on the property involved, while bonus depreciation allows you to deduct 100 percent of the cost of personal property in one year through 2022. Up to $1,050,000 of personal property may also be deducted in one year under IRC Section 179.

But depreciation won't begin if you purchase property with the intent of beginning a new business. You must actually be in business to claim depreciation. This doesn't require that you make sales or earn profits—only that your business is a going concern.

Also, depreciation doesn't begin the moment you purchase property for your business. It begins only when you place property in service in your business. You don't have to use the property to place it in service, but the property must be available for use in your active business. This could occur after you purchase the property.

Finally, if you use regular depreciation, you must apply rules called *conventions* to determine the month in which your depreciation deduction begins. The earlier in the year, the larger your deduction for the first year.

The default rule is that regular depreciation for personal property begins July 1 the first year (mid-year convention). But if you purchase 40 percent or more of your total personal property for the year during the fourth quarter, your depreciation begins at the midpoint of the quarter in which it is placed in service (mid-quarter convention).

First-year depreciation for real property begins at the middle of the month during which the property is placed in service (mid-month convention).