FPA FINANCIAL PLANNING PERSPECTIVES

# WHAT TO DO WITH LEFTOVER 529 PLAN FUNDS

It seemed like a good idea at the time. You began stashing away money in a 529 college savings plan for your children's education and have built up a nice little account. But now you learn that your children won't be using some or even any of the funds. What happens to the unused funds?

To answer that question, first understand that money withdrawn from a 529 account is free of tax as long as it is used for qualified college expenses such as tuition, room and board, fees, books, and "required supplies and equipment" such as laptop computers. The rub comes when funds are withdrawn for nonqualified use.

When each nonqualified distribution is made, a formula is used to attribute a portion of the withdrawal to the account owner's original contributions and the remaining portion to earnings. The 529 plan will calculate the amount of each portion for you. The contribution portion is not subject to tax or penalty because contributions are made with after-tax dollars. But the earnings portion of any nonqualified withdrawal is subject to ordinary federal and possibly state income taxes, plus a ten percent federal penalty tax and, in some cases, an additional state penalty or fee.

The income tax is assessed at the tax rate of the person receiving the distribution. Typically, this is typically the account owner, though some state plans allow owners to designate the beneficiary as the recipient, who would likely be in a lower tax bracket (of course, the recipient then gets the money, not the owner).

You may be able to avoid the penalty tax—though not the income taxes on the earnings—depending on the reason you're not using the funds for education expenses and which strategy you subsequently choose. Let's say your child receives a scholarship and you don't need some or any of the funds in the 529 plan. An amount equal to the scholarship awarded can be withdrawn free of the penalty tax. The penalty tax is also waived if the beneficiary becomes disabled or dies.

But what if your child simply decides not to go to college or you accumulate more in the account than what you ultimately spend on education (we should all wish that problem)? You have several choices.

One is to do nothing with the funds, at least for a while, though some plans require the beneficiary to use the funds within a certain time. The funds will continue to grow tax-deferred, and perhaps you can use them down the road for graduate school. Or the beneficiary who chose not to go to college might change his or her mind and decide to enroll.

If you do leave them in the plan, monitor the plan's performance and expenses. You may need to switch plans if performance is poor for too long.

Another strategy is to change beneficiaries. If the beneficiary is a "family member" of the same generation as the previous beneficiary, such as a sibling, cousin or spouse, the transfer of leftover funds is tax free. If the new beneficiary is in a different generation, such as a child of the previous beneficiary, the change may impose a gift tax liability on the *previous beneficiary*. So, you'll definitely want to talk to your financial planner before making a move with potential tax liabilities.

Another option is to simply withdraw the leftover funds and pay the penalty, along with the income taxes. You may choose this because you want to use the funds for retirement, or perhaps you have a financial emergency. One caution here: if the income taxes will be assessed at your tax rate and not the beneficiary's, consider transferring the account to another state's 529 plan that will allow withdrawals to be assessed at the beneficiary's income-tax rate.

If you don't need the funds right away, you might let them continue to grow tax deferred in the account and make the nonqualified withdrawals later. The benefit of delaying taxation may—or may not—eventually outweigh the impact of the penalty tax.

The only risk here is that some state plans allow plan administrators to terminate the account if they feel it's not intended for use for education purposes, and there is some concern at the federal level that people are "abusing" 529 plans for retirement or estate planning purposes, not college.

June 2003— This column is produced by the Financial Planning Association, the membership organization for the financial planning community, and is provided by ZRC Financial Services, a local member in good standing of the FPA.