Avoiding the Unintended Tax Consequences of the 529 Plan Refund

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One of the many consequences of the COVID-19 pandemic has been the closure of colleges and universities across the country. If you or your student has been affected by this unforeseen disruption, you may receive a refund of payments originally made for "qualified" educational expenses from your 529 educational savings plan.

Some common qualified educational expenses covered by 529 plans include, but are not limited to, tuition, books, supplies, and on- or off-campus room and board. If used for these expenses, 529 plans can offer unique tax advantages. But unless planned accordingly, your 529 account refund could have some unintended tax consequences.

Please note: Although the discussion here specifically pertains to 529 plans, many of the same concepts and rules apply to other tax-advantaged college savings tools (e.g., prepaid college tuition plans and Coverdell Educational Savings Accounts).

Recontribute Your Refund to a 529 Plan

The receipt of refunded amounts that were originally in a 529 account is generally considered a nonqualified withdrawal subject to a tax on the account earnings plus a 10 percent penalty. But under the Protecting Americans from Tax Hikes Act of 2015, individuals can avoid these tax implications by returning the refunded amount to a 529 account within 60 days of the refund.

IRS guidance. In light of the COVID-19 pandemic, the IRS has issued guidance indicating that if the 60-day deadline falls between April 1, 2020, and July 15, 2020, then the recontribution may be made at any time before the later of July 15, 2020, or 60 days after the refund date.

Here, it is not essential that the funds be returned to the same 529 plan, provided that the funds are deposited into another plan with the *same beneficiary*. Failure to recontribute the funds to a 529 plan for the same beneficiary would likely result in the IRS recharacterizing the distribution as a taxable event. In addition, many states have provisions specifying that a state income tax deduction related to the contribution of funds to a 529 plan may be recaptured if a nonqualified withdrawal occurs.

Required paperwork. Many 529 plans have specific paperwork you need to use to recontribute funds. It is important to verify your plan's requirements *before* recontributing the funds. Failure to keep a detailed paper trail of the process will likely result in problems when trying to substantiate the deposit as a recontribution and in avoiding the recharacterization of the refund as a nonqualified withdrawal.

Consider Your Other Refund Options

Rather than depositing the funds back into a 529 plan, as an account owner, you can use the funds on alternative qualified expenses for the 529 beneficiary (e.g., computer equipment, which could be especially pertinent given the transition of many schools to online classes during the pandemic). In addition, you could keep the funds on hand, so you can later use the refunded amount on future tuition or room and board anticipated to be due later in the tax year. Keep in mind that this strategy is particularly risky given the uncertainty of when campuses will reopen, and such expenses would likely be outside the acceptable recontribution window.

Some schools may offer an alternative option of having the refund amount credited toward future school expenses. Although there does not appear to be clear IRS guidance on how this option would be handled from a tax perspective, it is unlikely that a refund that is not physically returned to the student or parent in cash would result in a recharacterization of the withdrawal as taxable. On the other hand, these amounts held on credit by the university are often readily accessible by a student in the form of a refund request to the university. Therefore, you should work with a tax professional to determine the potential tax treatment of a student's credit amount held at any particular educational institution.

Understanding the Consequences

The COVID-19 pandemic has caused unprecedented implications to daily life that have the potential to result in unintended economic consequences if certain rules are not taken into account. Be sure to consult with your tax professional to gain a better understanding of how to avoid the adverse tax implications of a nonqualified withdrawal from a 529 account.

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