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Tips on Spending the Money in College Savings Accounts

Funds in 529 plans grow tax free and can be withdrawn tax free if they're spent on eligible education expenses. But there is some fine print.

By Ann Carrns

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You've put aside money for college in a 529 account for years. Now it's time to start withdrawing funds to pay the higher-education bills. What's the best way to do that?

First, a little background. A 529 account — named for a section of the federal tax code — lets people save and invest for college while avoiding taxes. Money is contributed after it's taxed and grows tax free, and the funds withdrawn are not subject to federal taxes when spent on eligible education expenses. At the end of June, there were nearly 14.6 million accounts holding more than $373 billion. And while there's no federal tax deduction for contributions to a 529, some states offer tax breaks.

To protect the tax advantages and use the money wisely, it makes sense to plan for how and when to spend 529 funds. "You want to be intentional in how you pay for things," said Mark S. Kelly, a financial planner in Raleigh, N.C.

Be aware, advisers say, of what expenses are eligible for payment from a 529 plan. You can withdraw money from a 529 for any reason, but if the expenses you're paying aren't "qualified," you'll pay federal income taxes and a 10 percent penalty on the portion of the withdrawal that comes from investment earnings. (If you are awarded a scholarship, you can take a "nonqualified" withdrawal from a 529 up to the amount of the scholarship. You'll owe taxes on the investment earnings, but you won't have to pay the 10 percent penalty.)

Tuition, required fees, on-campus housing and meal plans all qualify, as do required books, supplies, school-related special services and computers.

If your student lives off campus, you can use 529 funds to cover the cost of rent and utilities — up to the college's housing allowance, said Lee C. McGowan, a financial adviser in Concord, Mass. (To find that amount, check your college's "cost of attendance" website or call the financial aid office.)

Once you add up all the eligible costs, deduct any scholarships, grants and other financial aid to get the amount you'll need from your 529.

If your income makes you eligible for education tax credits, such as the American Opportunity Tax Credit, it's particularly important to plan ahead for spending from a 529. The credit is worth up to $2,500 a year per student, in each of the first four years of college. (Its calculation is a bit complicated: It's based on 100 percent of the first $2,000 in tuition, books and supplies, plus 25 percent of the next $2,000.)

You can't "double dip" tax breaks, however. So if you claim the credit, you should set aside funds from outside your 529 to pay for $4,000 of eligible expenses. Then use 529 funds to pay remaining costs.

"If you're eligible for the tax credit, you have to pay eligible expenses with something other than 529 money," said Ann Garcia, a financial adviser in Portland, Ore.

Financial advisers differ on whether families should withdraw funds themselves and then pay the college, or have the 529 plan pay the college directly.

Melissa Sotudeh, a financial planner near Washington, D.C., said having the college paid directly from the 529 made it clear that the funds were used for educational expenses.

"You want to make sure your paper trail is as clean as possible," she said. "Paying the school directly is just super clean."

Others, however, suggest that families or students should receive the funds first and then pay the school themselves to avoid any potential confusion about how the funds are classified. Mark Kantrowitz, publisher of Savingforcollege.com, said in an email that it was possible that some colleges might misinterpret direct payments from a 529 account as "cash support," which could reduce a student's financial aid eligibility.

Whichever option you choose, keep good records in case you are ever audited by the Internal Revenue Service and have to document that the funds were used for eligible expenses. Ms. Sotudeh said she printed out the bill from her child's school and highlighted the costs paid from the 529.

What if you withdraw more money than you need from your 529 plan and you want to put it back? Generally, you'll avoid paying taxes and penalties if you recontribute the money within 60 days. Many families faced this situation this year when some colleges issued refunds for housing and other costs after the coronavirus closed campuses. The I.R.S. granted extra time to reinvest the money, via a temporary extension allowed by the federal pandemic relief program. (Students returning to college this fall mostly didn't need to worry, though, since they could apply the funds to this semester's expenses.)

Here are some questions and answers about paying for college with a 529 account:

My daughter may have to borrow for college. Should she spend all of her 529 money before taking out student loans?

Families often spend down 529 funds first so they can wait as long as possible to take on debt. But it may be better to borrow as you go rather than waiting until the 529 is drained, advisers say.

"I suggest spreading it out over four years," Mr. Kelly said, referring to the 529 balance.

That's because there are limits on the amount of low-interest federal student loans that can be borrowed each year (and in total). Once you have missed the borrowing deadline for a given year, you can't tap those loans retroactively. If it turns out that the remaining amount available to borrow is insufficient, you may need federal Plus loans, which carry a higher interest rate, or private student loans, which lack important borrower protections.

Under a law passed last year, up to $10,000 from a 529 account can be used to repay the beneficiary's student loans. So if you end up with leftover money in a 529, you can use the money toward the student loan balance.

Do I have to spend the money I withdraw from the 529 right away?

Generally, withdrawals from a 529 must be made during the same calendar year that the expenses are paid. Families should be particularly careful about spring tuition bills, advisers say, because academic years span two calendar years. The spring term often begins in January, but colleges may send out the bill in December. If you withdraw the money in

December, make sure to pay the bill before Jan. 1. Similarly, if you wait to pay the bill in January, you should also withdraw the money after Jan. 1.

“If the timing is off, you risk owing tax because it’s considered a nonqualified withdrawal,” according to Fidelity.

Do 529 plans have withdrawal deadlines?

No. You can keep funds in a 529 plan indefinitely. If the account’s beneficiary doesn’t need all of the money for college — perhaps because of scholarships — the money can be used to pay for graduate school. Or the beneficiary can be changed to a sibling or another family member so the funds can be used to cover their college costs.