

Guidance on Recontributions, Rollovers and Qualified Higher Education Expenses under Section 529

Notice 2018-58

I. PURPOSE AND OVERVIEW

This notice announces that the Department of the Treasury (the Treasury Department) and the Internal Revenue Service (the IRS) intend to issue regulations providing clarification regarding (1) the special rules for contributions of refunded qualified higher education expenses to a qualified tuition program under § 529(c)(3)(D) of the Internal Revenue Code (Code); (2) the new rules under § 529(c)(3)(C)(i)(III) permitting a rollover from a qualified tuition program to an ABLÉ account under § 529A; and (3) the new rules under § 529(c)(7) treating certain elementary or secondary school expenses as qualified higher education expenses.

II. BACKGROUND

Under § 529, a State or its agency or instrumentality may establish or maintain a program that permits a person to prepay or contribute to an account for a designated beneficiary's qualified higher education expenses (QHEEs). In addition, an eligible educational institution may establish or maintain a program that permits a person to prepay a designated beneficiary's QHEEs. These programs are collectively referred to as section 529 qualified tuition programs (QTPs). Section 529(c)(3) provides that distributions (including any attributable earnings) from a QTP are not included in gross income if such distributions do not exceed the designated beneficiary's QHEEs. To the extent distributions exceed the designated beneficiary's QHEEs, a portion of the distribution is included in gross income.

Prior to its amendment by “An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018”, Pub.L. 115-97 (the “2017 Act”), signed into law on December 22, 2017, § 529(e)(3)(A) defined QHEEs to include tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution,¹ including certain computer equipment and software used primarily by the beneficiary during any years the beneficiary is enrolled at an eligible educational institution. In the case of a special needs beneficiary, QHEEs include expenses for special needs services that are incurred in connection with such enrollment or attendance. QHEEs also include reasonable costs for room and board for eligible students as defined in § 25A(b)(3) (generally, those who are enrolled at least half-time).

Sections 529(c)(3)(C)(i)(I) and (II) permit a tax-free rollover of a distribution from a QTP, made within 60 days of the distribution, to another QTP for the benefit of either the same designated beneficiary or another designated beneficiary who is a member of the family of the original designated beneficiary. However, Notice 2001-81, 2001-52 I.R.B. 617, provides that the distributing QTP must provide a breakdown of the earnings portion of the rollover amount to the recipient QTP and, until the recipient QTP receives appropriate documentation showing the earnings portion, the entire rollover amount is treated as earnings. Notice 2001-81 applies the same rule to a direct transfer (i.e., a trustee-to-trustee transfer) from a QTP to another QTP.

Section 529(c)(3)(D), added to the Code by the Protecting Americans from Tax Hikes Act of 2015 (PATH Act), part of the Consolidated Appropriations Act, 2016 (Pub. L. 114-113), addresses situations in which QTP funds are distributed for a beneficiary’s QHEEs, but some

¹ Section 529(e)(5) defines an “eligible educational institution” as an institution (A) which is described in § 481 of the Higher Education Act of 1965 (20 U.S.C. 1088), as in effect on the date of the enactment of this paragraph, and (B) which is eligible to participate in a program under title IV of such Act.

portion of those expenses is refunded to the beneficiary by the eligible educational institution. This could occur, for example, if the beneficiary were to drop a class mid-semester. Section 529(c)(3)(D) provides that the portion of such a distribution refunded to an individual who is the beneficiary of a QTP by an eligible educational institution is not subject to income tax to the extent that the refund is recontributed to a QTP of which that individual is the beneficiary not later than 60 days after the date of such refund and does not exceed the refunded amount. Section 529(c)(3)(D) applies to refunds received after December 31, 2014. The PATH Act also included a transition rule with regard to the deadline for recontributing a refund received after 2014 but before the date of enactment (December 18, 2015). Specifically, those refunded distributions are exempt from income tax if they were recontributed to the beneficiary's QTP not later than February 16, 2016 (60 days after the date of enactment of the PATH Act).

The 2017 Act added § 529(c)(3)(C)(i)(III) which provides that a distribution from a QTP made after December 22, 2017, and before January 1, 2026, is not subject to income tax if, within 60 days of the distribution, it is transferred to an ABLÉ account (as defined in § 529A(e)(6))² of the designated beneficiary or a member of the family of the designated beneficiary. Under § 529(c)(3)(C)(i), the amount of any rollover to an ABLÉ account is limited to the amount that, when added to all other contributions made to the ABLÉ account for the taxable year, does not exceed the contribution limit for the ABLÉ account under § 529A(b)(2)(B)(i), i.e., the annual gift tax exclusion amount under § 2503(b).

In addition, the 2017 Act expanded the definition of QHEEs to include tuition in connection with the designated beneficiary's enrollment or attendance at an elementary or secondary public, private, or religious school. See § 529(c)(7). The 2017 Act also amended

² Generally, an ABLÉ account is established under a § 529A qualified ABLÉ program to pay the qualified disability expenses of an eligible individual who is blind or has a disability.

§ 529(e)(3)(A) to limit the total amount of these tuition distributions for each designated beneficiary to \$10,000 per year from all QTPs of the designated beneficiary. Both amendments apply to distributions made after December 31, 2017.

III. RECONTRIBUTION OF REFUNDED QHEEs

The Treasury Department and the IRS are aware of concerns expressed by QTP administrators regarding the administrative burdens that would arise if a recontribution of a refunded QHEE is treated in the same manner as a rollover under Notice 2001-81 requiring a breakdown of the earnings portion of the recontribution. Because the amount is refunded by the eligible educational institution, which will have no information regarding the income portion of each tuition payment (whether made from a single or multiple QTPs), QTP administrators generally would be unable to determine the earnings portion of the recontribution. Accordingly, the Treasury Department and the IRS intend to issue regulations providing that the entire recontributed amount will be treated as principal. This rule of administrative convenience will eliminate the burdens associated with determining the earnings portion. Furthermore, because the recontributed amount previously was taken into account in applying the overall contribution limit under § 529(b)(6), the Treasury Department and the IRS anticipate that the regulations will provide that the recontributed amount does not count against the limit on contributions on behalf of the designated beneficiary under § 529(b)(6). In addition, consistent with § 529(c)(3)(D), the Treasury Department and the IRS anticipate that the regulations will confirm that the recontribution must be to a QTP for the benefit of the designated beneficiary who received the refund of QHEEs, although the recontribution need not be to the QTP from which the distributions for the QHEEs were made.

IV. ROLLOVER FROM A QTP TO AN ABLE ACCOUNT

In accordance with new § 529(c)(3)(C)(i)(III), the Treasury Department and the IRS intend to issue regulations providing that a distribution from a QTP made after December 22, 2017, and before January 1, 2026, to the ABLE account of the designated beneficiary of that QTP, or of a member of the family of that designated beneficiary, is not subject to income tax if two requirements are satisfied. First, the distributed funds must be contributed to the ABLE account within 60 days after their withdrawal from the QTP. Second, the distribution, when added to all other contributions made to the ABLE account for the taxable year that are subject to the limitation under § 529A(b)(2)(B)(i) (the annual gift tax exclusion under § 2503(b)), must not exceed that limitation. Specifically, the regulations are expected to provide that the sum of the distribution and all other contributions to the ABLE account for the taxable year, other than contributions of the designated beneficiary's compensation as described in § 529A(b)(2)(B)(ii), must not exceed the annual gift tax exclusion for that taxable year. Consistent with the longstanding approach of treating direct transfers similarly to rollovers in Notice 2001-81, the Treasury Department and the IRS also anticipate that the regulations will provide that the same rules will apply regardless of whether such a QTP distribution is rolled over to an ABLE account or instead is transferred by a direct transfer from a QTP to an ABLE account.

To the extent that a direct transfer (or, in the case of a rollover, a contribution of the distributed amount) would cause the contribution limit under § 529A(b)(2)(B)(i) to be exceeded, it would be subject to income tax and a 10% additional tax under § 529(c)(6), if applicable.³ Therefore, the Treasury Department and the IRS anticipate that the regulations will require a QTP to prohibit the direct transfer of any amount that would cause the limit under

³ Section 529(c)(6) provides that the additional 10% tax imposed by § 530(d)(4) applies to any payment or distribution from a QTP in the same manner as it applies to a payment or distribution from a Coverdell education savings account.

§ 529A(b)(2)(B)(i) to be exceeded. Furthermore, a qualified ABLE program is prohibited from accepting certain contributions in excess of the limitations applicable to ABLE accounts, and any violation of those rules could cause the designated beneficiary to incur tax, and could impact adversely the ABLE beneficiary's eligibility for certain public benefits.⁴

The Treasury Department and the IRS encourage the QTP designated beneficiary, in the case of a rollover, or the QTP, in the case of a direct transfer, to contact the qualified ABLE program before contributing any funds to the ABLE account to ensure that the § 529A(b)(2)(B)(i) limit will not be exceeded. However, the Treasury Department and the IRS anticipate that the regulations will provide that, in the case of a direct transfer, any excess contribution that is rejected by the qualified ABLE program and returned to the QTP will not be deemed to be a new contribution to the QTP for purposes of the § 529(b)(6) contribution limit.

Further, the Treasury Department and the IRS anticipate that the regulations will specify that, for purposes of identifying the ABLE accounts permitted to receive such a rollover from a designated beneficiary's QTP, a member of the family of the designated beneficiary means a member of the family as defined in § 529(e)(2), rather than the more limited definition in § 529A(e)(4) that applies for purposes of qualified ABLE programs.

V. SECTION 529 EXPANSION OF QHEES TO INCLUDE ELEMENTARY AND SECONDARY EDUCATION TUITION EXPENSES

Consistent with new § 529(c)(7) and (e)(3)(A), respectively, the Treasury Department and the IRS anticipate that the regulations will provide that QHEEs include tuition in connection with the designated beneficiary's enrollment or attendance at an elementary or secondary public,

⁴ For more information on the effect of ABLE accounts on the beneficiary's eligibility for public benefits, see the preamble of the Notice of Proposed Rulemaking (80 FR 35602) published in the Federal Register on 6/22/2015.

private, or religious school, but that such QHEEs are limited to a total of \$10,000 per year per designated beneficiary, regardless of the number of QTPs making such distributions for that same designated beneficiary. The Treasury Department and IRS intend to issue regulations defining the term “elementary or secondary” to mean kindergarten through grade 12 as determined under State law, consistent with the definition applicable for Coverdell education savings accounts in § 530(b)(3)(B). Coverdell education savings accounts are another type of tax-favored savings account governed under § 530 and also may be established to pay for tuition and other expenses in connection with enrollment or attendance at an elementary or secondary public, private, or religious school. Applying the same definition to both a QTP and a Coverdell education savings account will facilitate the allocation of expenses between those two accounts as is required by § 530(d)(2)(C)(ii) if a designated beneficiary receives distributions from both a QTP and a Coverdell education savings account and those total distributions exceed the designated beneficiary’s qualified expenses.

VI. RELIANCE

Before the issuance of the proposed regulations described in this notice, taxpayers, beneficiaries, and administrators of 529 and ABLE programs may rely on the rules described in sections III, IV, and V of this notice.

VII. DRAFTING INFORMATION

The principal author of this notice is Peter A. Holiat of the Office of the Associate Chief Counsel (TEGE). For further information regarding this notice contact Mr. Holiat at 202-317-4541 (not a toll-free number).