PENNSYLVANIA DEPARTMENT OF REVENUE

PERSONAL INCOME TAX BULLETIN 2006–04
QUALIFIED TUITION PROGRAMS
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Qualified Tuition Programs

§ 1. Statutory deduction for contributions.

In computing taxable income for taxable years beginning on or after January 1, 2006, a donor may deduct amounts paid as a contribution into a qualified tuition program ("QTP") described in IRC § 529.

§ 2. Limitation on deduction.

(a) The amount paid as a contribution to a QTP that is allowable as a deduction cannot exceed the "annual exclusion" from Federal gift tax under IRC § 2503(b) for each designated beneficiary, and, for all designated beneficiaries, cannot exceed the donor's taxable personal income for the taxable year of the contribution(s). For 2006, under IRC § 2503(b), the first $12,000 in gifts ($24,000 with gift-splitting) made in 2006 to each donee to whom the donor makes taxable gifts during the year may be excluded from Federal gift tax. This annual deduction is not otherwise limited as to the number of donees or QTPs with respect to whom it may be taken.

(b) For purposes of computing the deduction from personal income for contributions to a QTP, each person who makes a contribution to a QTP shall be regarded as a donor, and each designated beneficiary of a QTP that receives a contribution shall be regarded as the donee of the contribution.

(c) No deduction is permitted for any amount rolled over from, or derived through, another QTP or for the interest portion of redemption proceeds from qualified U.S. savings bonds that are contributed to a QTP. However, redemption proceeds from Coverdell educational savings plans that are contributed to a QTP are deductible on the same basis as other contributions.

§ 3. Statutory exclusions.

In computing taxable income for taxable years beginning on or after January 1, 2006, the following are not subject to personal income tax—

- Any benefit furnished under, or amount distributed from, a qualified tuition program that is excludable from Federal income tax under IRC § 529(c)(3)(B),

. Any rollover that is excludable from Federal income tax under IRC § 529(c)(3)(C),

. Undistributed earnings on contributions to a qualified tuition program, or

. Exempt distributions described in Section 5.

However, any benefit furnished under, or amount distributed from, a qualified tuition program other than the foregoing is taxable.

§ 4. Who is the taxpayer?

(a) In general.

Any taxable benefit furnished under, or amount distributed from, a qualified tuition program is taxed to the account owner.

(b) Exception.

If the account owner designates the designated beneficiary or another person to receive a distribution from the account, the distribution is taxed to the distributee.

§ 5. Exempt Distributions by qualified tuition programs.

(a) A distribution or withdrawal shall constitute an exempt distribution to the extent it consists of contributions made by the taxpayer before January 1, 2006, and excess contributions made by the taxpayer to the program account after December 31, 2005.

(b) The cost-recovery method shall be used to determine the amount of a distribution or withdrawal that shall be recognized as an exempt distribution. Under the cost-recovery rule, no income is recognized with respect to distributions and withdrawals until the distributee has enjoyed a full recovery of accumulated contributions made before January 1, 2006, and excess contributions credited to the program account after December 31, 2005. Only distributions in excess of such unrecovered contributions are taxable.

(c) The portion of a distribution or withdrawal that is an exempt distribution shall be determined in accordance with the following:

(1) Every distribution or withdrawal made after August 20, 1996, shall be deemed to be made first out of accumulated, unrecovered contributions made by the taxpayer before January 1, 2006, and accumulated, unrecovered excess contributions made by the

taxpayer to the program account after December 31, 2005 to the extent thereof;

(2) The remaining portion, if any, thereof shall not be exempt.

(3) Contributions by a husband or wife shall be treated as made one-half by each spouse.

(d) For purposes of this section, "excess contribution" means a contribution to a QTP in excess of the limitations set forth in section 2.

(e) Examples.

EXAMPLE 1. As of January 1, 2006, X's qualified tuition program has a balance of $1,205, including unrecovered contributions of $1,200 made by X. No contributions were made to the QTP after December 31, 2005. A distribution of $1,000 is made to X on January 1, 2006. The distribution is excludable from Federal income tax under IRC § 529(c)(3)(B). A distribution of $205 is made to X on January 2, 2006 that is not excludable from Federal income tax.

DISCUSSION. Every distribution or withdrawal made after August 20, 1996, shall be deemed to be made first out of accumulated, unrecovered contributions made by the distributee or withdrawee before January 1, 2006. The remaining portion, if any, thereof shall not be exempt.

As of January 1, 2006, the unrecovered contributions that were made by X before January 1, 2006, amount to $1,200. Thus, $1,000 of the nontaxable $1,000 distribution made to X on January 1 constitutes an exempt distribution described in this section.

However, the unrecovered contributions made by X before January 1, 2006, as of January 2, 2006, are ($1,200 - $1,000 =) $200. Therefore, since the $205 distribution exceeds X's unrecovered contributions by $5, $5 of the $205 distribution made to X is *not* an exempt distribution.

EXAMPLE 2. As of January 1, 2006, Y's qualified tuition program has a balance of $1,205, including unrecovered contributions of $1,200 made by Y. No contributions were made to the QTP after December 31, 2005. A distribution of $1,000 is made to Z on January 1, 2006. The distribution is excludable from Federal income tax under IRC § 529(c)(3)(B). A distribution of $205 is made to Y on January 2, 2006 that is not excludable from Federal income tax.

DISCUSSION. Every distribution or withdrawal made after August 20, 1996, shall be deemed to be made first out of accumulated, unrecovered contributions made by the distributee

or withdrawee before January 1, 2006. The remaining portion, if any, thereof shall not be exempt.

As of January 1, 2006, the unrecovered contributions that were made by Z before January 1, 2006, amounted to zero. Thus, none of the nontaxable $1,000 distribution made to Z on January 1 constitutes an exempt distribution described in this section.

However, as all of the contributions that were made before January 1, 2006 were made by Y, Y has unrecovered contributions totalling $1,200, as of January 2, 2006. As the $205 distribution to Y does not exceed Y's unrecovered contributions, the $205 distribution made to Y is an exempt distribution.

EXAMPLE 3. Assume the same facts as in Example 1, except that X was married at the times the contributions were made.

DISCUSSION. As of January 1, 2006, the unrecovered contributions that were made before January 1, 2006, amount to $1,200. However, each contribution made by a husband or wife is treated as made one-half by each spouse. Thus, only $500 of the nontaxable $1,000 distribution made to X on January 1 constitutes an exempt distribution described in this section.

The unrecovered contributions made by X before January 1, 2006, as of January 2, 2006, are ($1,200 ÷ 2 - $1,000 ÷ 2 =) $100. Therefore, only $100 of the $205 balance may be counted as X's unrecovered contributions.

Thus, since the $205 distribution exceeds X's unrecovered contributions by $105, $105 of the $205 distribution made to X is *not* an exempt distribution.

§ 6. Operating rules.

(a) Separate accounting for each designated beneficiary shall be employed.

(b) For personal income tax purposes, all QTPs of which an individual is a designated beneficiary shall be treated as one program and all distributions therefrom during a taxable year shall be treated as one distribution.

(c) Any change in the designated beneficiary of an interest in a qualified tuition program shall be treated as a distribution to the new beneficiary unless the new beneficiary is a member of the family of the old beneficiary.

(d) Qualified educational expenses shall first be reduced for excludible scholarships or

fellowship grants. Where a beneficiary receives distributions from both a Coverdell Education Savings Account and a QTP that together exceed remaining qualified education expenses, the expenses must be allocated pro rata between the distributions.

(e) Excess contributions for a taxable year may not be taken into account for purposes of section 1 over any other period.

§ 7. Questions and answers

Q-1. What are the limits on the deduction if the tax return is "Single" or "Married, filing separately?"

A-1. The deduction for each designated beneficiary cannot exceed the annual exclusion from Federal gift tax under IRC § 2503(b), and, for all designated beneficiaries, the deduction cannot exceed the donor's taxable personal income for the taxable year of the contribution. For example, for 2006, if there is only one donor and beneficiary, the deduction cannot exceed the least of—

- The total of the amounts contributed to the QTP by the donor,
- $12,000, or
- The donor's taxable personal income for the taxable year of the contribution(s).

Contributions in excess of deduction limitations constitute "excess contributions."

Q-2. What are the limits on the deduction if the tax return is "married, filing jointly?"

A-2. Each spouse can claim up to the $12,000 deduction as long as each separately has that amount of taxable income. For example, if there is only one spouse with taxable income, only $12,000 per beneficiary may be deducted. However, if one spouse has $50,000 in taxable income but the other has $6,000, the couple may jointly deduct $18,000.

Q-3. What happens if gifts are made out of a joint account?

A-3. Contributions by a husband or wife out of a jointly held account may be treated as made by either spouse. Accordingly, if a husband or wife make a $24,000 gift out of a joint account, each spouse may take a $12,000 deduction, provided that each has personal income of at least $12,000.

Q-4. A married couple filing a joint Pennsylvania Income Tax Return could conceivably deposit $24,000 ($12,000 x 2) for their child in 2006, reduce their taxable income by $24,000, and save nearly $740 in tax. Under these circumstances, is it necessary that two separate accounts be established with the 529 Plan for that child: one account for $12,000 whose owner is the husband and a second account for $12,000 whose owner is the wife, the child being the beneficiary of both accounts? Or, on the other hand, could all $24,000 be deposited in one 529 Plan account in the ownership of just one spouse with the beneficiary being the child?

A-4. There is no need to establish separate accounts for each contributor. All accounts having the same designated beneficiary are treated as one program.

Q-5. What is the level of documentation that must be maintained to demonstrate that the deposit into the 529 Plan was made from each spouse?

A-5. Each spouse has to be able to prove how much he or she contributed in order to prove his or her allowable deduction. However, account distributees also will need to know how much each spouse contributed in order to compute how much of the distributions they receive is taxable. Cancelled checks or receipts and account statements should be kept for at least three years after all of the accounts for a designated beneficiary are closed.

Q-6. Is there any time limit that the funds deposited into a 529 Plan account must remain in that account prior to withdrawal to qualify for the Pennsylvania State Income Tax deduction?

A-6. There is no time limit that the funds deposited into a 529 Plan account must remain in that account prior to withdrawal to qualify for the deduction. However, donors should verify whether the program restricts early withdrawals.

Q-7. Can funds contributed to a 529 Plan account be used to reimburse college expenses for tuition and books that were incurred in 2006 but prior to the opening of the 529 Plan account?

A-7. If, for each designated beneficiary, total distributions for a taxable year do not exceed the qualified higher education expenses for that taxable year, no amount of distributions is includible in gross income. It does not matter whether an expense is incurred before or after the opening of an account.

Q-8. What happens if a taxpayer could have claimed a deduction but failed to do so?

A-8. The taxpayer should file a corrective amended return. A deductible contribution is not considered an excess contribution.

Q-9. Are transfers from Coverdell education savings accounts deductible?

A-9. Yes. However, the redemption proceeds are taxable on the same basis as an early distribution from an IRA.

Q-10. IRC § 529 states that a program shall be treated as a § 529 program unless it provides that any contributor to, or designated beneficiary under, such program may not directly or indirectly direct the investment of any contributions to the program or the earnings thereon. Is this requirement violated if the program permits a person who establishes a § 529 account to select among different investment strategies designed exclusively by the program?

A-10. The requirement is not violated if the person may select among the strategies *only*—

- At the time when the initial contribution is made establishing the account,
- Once per calendar year, or
- Upon a change in the designated beneficiary of the account.

If these requirements are met, an investment direction is not a distribution for purposes of the Pennsylvania Personal Income Tax.

Q-11. Are transfers of credits between different section 529 plans (or investment strategies) within a section 529 program deductible?

A-11. No.

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