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Abstract: If money is held too long in a Section 529 college savings plan, there could be tax consequences. This article describes alternatives for savers who have overfunded their accounts.

Oops, you overfunded your 529 plan

Some might consider it a good problem to have: saving *too much* money for college. But if the money is held in a Section 529 college savings plan, there could be tax consequences to overfunding the account.

The tax man giveth

529 plans are tax-advantaged accounts designed to help families save money for college education expenses. Savings grow on a tax-deferred basis, and withdrawals are made tax-free if the money is used to pay for qualified education expenses such as college tuition, fees, books, and, generally, room and board. Further, some states offer tax incentives for contributions to 529s.

The tax consequences come into play if 529 funds are used for anything other than qualified education expenses. Specifically, earnings on investments held in the account will be taxable and a 10% penalty will be assessed if the money is used for noneducation-related expenses.

Note that only the earnings portion of the account will be subject to taxes and penalties. Funds you've contributed to the account (or principal) won't be taxed upon withdrawal regardless of what they're used for, because contributions were made with after-tax dollars.

Your alternatives

So what should you do if your child graduates from college and there are funds left in your 529 account? Here are a few options to consider:

Change the beneficiary. The flexibility that characterizes 529 plans includes the ability to name someone else as the account's beneficiary. So if you have other children in college now or who're planning to attend college, you can simply make them the beneficiaries of the account.

You can even change the beneficiary to yourself. This would allow you to use the funds for qualified expenses for your own education.

Use the funds to pay for private school education. The Tax Cuts and Jobs Act changed the 529 plan rules so that up to $10,000 of funds per year can now be used for private K-12 tuition. Therefore, if you have younger children, you can potentially make beneficiary changes so you can use the 529 plan funds to send them to a private school. But beware that, depending on the state, there could be state tax consequences.

Investigate nonqualified 529 plan withdrawal options. The law specifies certain situations where nonqualified withdrawals can be made from 529 plans penalty-free. These include a child's death or disability and a graduate's attendance at a U.S. military academy.

Also, if your child is awarded an academic or athletic scholarship, you can use withdrawals up to the scholarship amount for expenses that aren't education-related and avoid the 10% penalty on earnings. But you'll still have to pay income tax on the earnings when you file your federal tax return.

There's also a new provision that allows — subject to restrictions, of course — 529 plans to be used to repay student loans.

Leave the money alone. There's no deadline for 529 account withdrawals, so you can leave funds in the account to pay for future education expenses. The money will continue to grow tax-deferred as long as it stays in the account.

So if your child decides later to attend graduate school, funds can be used to help cover these expenses. You can even keep funds in the account for the long term to help pay education expenses for your future grandchildren. This will give your children a good head start on college saving for their kids.

If all else fails

If none of these strategies are ideal for your situation, you may just have to withdraw excess 529 funds and pay the taxes and penalties due. Since they apply only to the earnings portion of the account, the tax hit may not be too severe.