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Prop. Treas. Reg. Section 1.529-3(c)(1)

Income tax treatment of distributees

(a)Taxation of distributions.

(1)In general. Any distribution, other than a rollover distribution, from a QSTP account must be included in the gross income of the distributee to the extent of the earnings portion of the distribution and to the extent not excluded from gross income under any other provision of chapter 1 of the Internal Revenue Code. If any amount of a distribution is forfeited under a QSTP as required by §1.529-2(e), this amount is neither included in the gross income of the distributee nor deductible by the distributee.

(2)Rollover distributions. No part of a rollover distribution is included in the income of the distributee. Following the rollover distribution, that portion of the rollover amount that constituted investment in the account, defined in §1.529-1(c), of the account from which the distribution was made is added to the investment in the account of the account that received the distribution. That portion of the rollover amount that constituted earnings of the account that made the distribution is added to the earnings of the account that received the distribution.

(b)Computing taxable earnings.

(1)Amount of taxable earnings in a distribution.

(i) Educational savings account. In the case of an educational savings account, the earnings portion of a distribution is equal to the product of the amount of the distribution and the earnings ratio, defined in §1.529-1(c). The return of investment portion of the distribution is equal to the amount of the distribution minus the earnings portion of the distribution.

(ii) Prepaid educational services account. In the case of a prepaid educational services account, the earnings portion of a distribution is equal to the value of the credits, hours, or other units of education distributed at the time of distribution minus the return of investment portion of the distribution. The value of the credits, hours, or other units of education may be based on the tuition waived or the cash distributed. The return of investment portion of the distribution is determined by dividing the investment in the account at the end of the year in which the distribution is made by the number of credits, hours, or other units of education in the account at the end of the calendar year (including all credits, hours, or other units of education distributed during the calendar year), and multiplying that amount by the number of credits, hours, or other units of education distributed during the current calendar year.

(2)Adjustment for programs that treated distributions and earnings in a different manner for years beginning before January 1, 1999. For calendar years beginning after December

31, 1998, a QSTP must treat taxpayers as recovering investment in the account and earnings ratably with each distribution. Prior to January 1, 1999, a program may have treated distributions in a different manner and reported them to taxpayers accordingly. In order to adjust to the method described in this section, if distributions were treated as coming first from the investment in the account, the QSTP must adjust the investment in the account by subtracting the amount of the investment in the account previously treated as distributed. If distributions were treated as coming first from earnings, the QSTP must adjust the earnings portion of the account by subtracting the amount of earnings previously treated as distributed. After the adjustment is made, the investment in the account is recovered ratably in accordance with this section. If no previous distribution was made but earnings were treated as taxable to the taxpayer in the year they were allocated to the account, the earnings treated as already taxable are treated as additional contributions and added to the investment in the account.

(3)Examples. The application of this paragraph (b) is illustrated by the following examples. The rounding convention used (rounding to three decimal places) in these examples is for purposes of illustration only. A QSTP may use another rounding convention as long as it consistently applies the convention. The examples are as follows:
Example (1).
(i) In 1998, an individual, A, opens a prepaid educational services account with a QSTP on behalf of a designated beneficiary. Through the account A purchases units of education equivalent to eight semesters of tuition for full-time attendance at a public four-year university covered by the QSTP. A contributes $16,000 that includes payment of processing fees to the QSTP. In 2011 the designated beneficiary enrolls at a public four-year university. The QSTP makes distributions on behalf of the designated beneficiary to the university in August for the fall semester and in December for the spring semester. Tuition for full-time attendance at the university is $7,500 per academic year in 2011 and 2012, $7,875 for the academic year in 2013, and $8,200 for the academic year in 2014. The only expense covered by the QSTP distribution is tuition for four academic years. The calculations are as follows:

2011

Investment in the account as of 12/31/2011 = $16,000
Units in account = 8
Per unit investment = $ 2,000
Units distributed in 2011 = 2
Investment portion of distribution in 2011 ($2,000 per unit × 2 units) = $ 4,000
Current value of two units distributed in 2011 = $ 7,500
Earnings portion of distribution in 2011 ($7,500 − $4,000) = $ 3,500

2012

Investment in the account as of 12/31/2012 ($16,000-$4,000) = $12,000
Units in account = 6
Per unit investment = $ 2,000
Units distributed in 2012 = 2
Investment portion of distribution in 2012 ($2,000 per unit × 2 units) = $ 4,000
Current value of two units distributed in 2012 = $ 7,500
Earnings portion of distribution in 2012 ($7,500 − $4,000) = $ 3,500

2013

Investment in the account as of 12/31/2013 ($12,000-$4000) = $ 8,000
Units in account = 4

Per unit investment = $ 2,000
Units distributed in 2013 = 2
Investment portion of distribution in 2013 ($2,000 per unit × 2 units) = $ 4,000
Current value of two units distributed in 2013 = $ 7,875
Earnings portion of distribution in 2013 ($7,875 − $4,000) = $ 3,875
2014
Investment in the account as of 12/31/2014 ($8,000-$4000) = $ 4,000
Units in account = 2
Per unit investment = $ 2,000
Units distributed in 2014 = 2
Investment portion of distribution in 2014 ($4,000 per unit × 2 units) = $ 4,000
Current value of two units distributed in 2014 = $ 8,200
Earnings portion of distribution in 2014 ($8,200 − $4,000) = $ 4,200
12/31/2014 (after distributions)
Investment in the account as of 12/31/2014 ($4,000-$4000) = 0

(ii) In each year the designated beneficiary includes in his or her gross income the earnings portion of the distribution for tuition.

Example (2).
(i) In 1998, an individual, B, opens a college savings account with a QSTP on behalf of a designated beneficiary. B contributes $18,000 to the account that includes payment of processing fees to the QSTP. On December 31, 2011, the total balance in the account for the benefit of the designated beneficiary is $30,000 (including distributions made during the year 2011). In 2011 the designated beneficiary enrolls at a four-year university. The QSTP makes distributions on behalf of the designated beneficiary to the university in August for the fall semester and in December for the spring semester. Tuition for full-time attendance at the university is $7,500 per academic year in 2011 and 2012, $7,875 for the academic year in 2013, and $8,200 for the academic year in 2014. The only expense covered by the QSTP distributions is tuition for four academic years. On the last day of the calendar year the account is allocated earnings of 5% on the total account balance on that day. Under the terms of the QSTP, a penalty of 15% is applied to the earnings not used to pay tuition. The calculations are as follows:
2011
Investment in the account = $ 18,000
Total account balance as of 12/31/2011 = $ 30,000
Earnings as of 12/31/2011 = $ 12,000
Distributions in 2011 = $ 7,500
Earnings ratio for 2011 ($12,000 / $30,000) = 40%
Earnings portion of distributions in 2011 ($7,500 × .4) = $ 3,000
Return of investment portion of distributions in 2011 ($7,500 − $3,000) = $ 4,500
2012
Investment in the account as of 12/31/2012 ($18,000 − $4,500) = $ 13,500
Total account balance as of 12/31/12 [($30,000-$7,500) × 105] = $ 23,625
Earnings as of 12/31/2012 = $ 10,125
Distributions in 2012 = $ 7,500
Earnings ratio for 2012 ($10,125 / $23,625) = 42.9%
Earnings portion of distributions in 2012 ($7,500 × .429) = $ 3,217.50

Return of investment portion of distributions in 2012 ($7,500 − $3,217.50) = $ 4,282.50

2013

Investment in the account as of 12/31/2013 ($13,500 − $4,282.50) = $ 9,217.50

Total account balance as of 12/31/13 [($23,625-$7,500) × 105%] = $ 16,931.25

Earnings as of 12/31/2013 = $ 7,713.75

Distributions in 2013 = $ 7,875

Earnings ratio for 2013 ($7,713.75 / $16,931.25) = 45.6%

Earnings portion of distributions in 2013 ($7,875 × .456) = $ 3,591

Return of investment portion of distributions in 2013 ($7,875 − $3,591) = $ 4,284

2014

Investment in the account as of 12/31/2014 ($9,217.50 − $4,284) = $ 4,933.50

Total account balance as of 12/31/14 [($16,931.25 − $7,875) × 105%] = $ 9,509.06

Earnings as of 12/31/2014 = $ 4,575.56

Distributions in 2014 for qualified higher education expenses (QHEE) = $ 8,200

Distributions in 2014 not for qualified higher education expenses (Non-QHEE) = $ 1,309.06

Total distributions = $ 9,509.06

Earnings portion of QHEE distribution in 2014 [($8,200 / $9,509.06) × $4,575.56] = $ 3,945.68

Return of investment portion of QHEE distribution in 2014 = $ 4,254.32

Earnings portion of Non-QHEE distribution subject to penalty [($1,309.06 / $9,509.06) × $4,575.56)] = $ 629.89

Return of investment portion of non-QHEE distribution in 2014 = $ 679.17

(ii) In years 2011 through 2013 the designated beneficiary includes in gross income the earnings portion of the distributions for tuition. In year 2014 the designated beneficiary includes in gross income the earnings portion of the distribution for tuition, $3,945.68, plus the earnings portion of the distribution that was not used for tuition after reduction for the penalty, i.e. $535.41 ($629.89 minus a 15% penalty of $94.48).

(c) Change in designated beneficiaries.

(1) General rule. A change in the designated beneficiary of a QSTP account is not treated as a distribution if the new designated beneficiary is a member of the family of the transferor designated beneficiary. However, any change of designated beneficiary not described in the preceding sentence is treated as a distribution to the account owner, provided the account owner has the authority to change the designated beneficiary. For rules related to a change in the designated beneficiary pursuant to a rollover distribution see §§1.529-1(c) and 1.529-3(a)(2).

(2) Scholarship program. Notwithstanding paragraph (c)(1) of this section, the requirement that the new beneficiary be a member of the family of the transferor beneficiary shall not apply to a change in designated beneficiary of an interest in a QSTP account purchased by a State or local government or an organization described in section 501(c)(3) as part of a scholarship program.

(d)Aggregation of accounts. If an individual is a designated beneficiary of more than one account under a QSTP, the QSTP shall treat all contributions and earnings as allocable to a single account for purposes of calculating the earnings portion of any distribution from that QSTP. For purposes of determining the effect of the distribution on each account, the earnings portion and return of investment in the account portion of the distribution shall be allocated pro rata among the accounts based on total account value as of the close of the current calendar year.