

Maryland Income Tax
ADMINISTRATIVE RELEASE

Administrative Release No. 32

Subject: Maryland College Savings Plans Tax Benefits

I. General

The 1997 Legislative Session created the Prepaid College Trust, which was intended to make access to higher education more affordable. In 1998, the legislature enacted two bills that affected persons who buy prepaid tuition contracts (“accounts”) from the Maryland Prepaid College Trust (“Prepaid College Trust”). Senate Bill 268 (Chapter 572, Acts of 1998) provided for an income tax subtraction modification of up to \$2,500 annually for advance payments for the purchase of a prepaid tuition account. House Bill 257 (Chapter 571, Acts of 1998) provided for an income tax subtraction modification for the amount of the benefit provided to a beneficiary under a prepaid tuition account that is otherwise includable in the beneficiary’s federal adjusted gross income. The bills also provided for an addition modification in the event that a refund is not used for qualified higher education expenses.

In 1999, the legislature enacted Senate Bill 8 (Chapter 7, Acts of 1999), which amended House Bill 268. This Act amended the subtraction modification to allow a subtraction up to \$2,500 of the advance payments made on each prepaid tuition account during the tax year. This Act also provided for a carryforward. To the extent that the payments made on a prepaid tuition account exceed \$2,500 in a taxable year, the excess payments may be taken in subsequent consecutive years until the full amount of the payments have been taken as a subtraction.

In 2000, the legislature enacted House Bill 11 (Chapter 494, Acts of 2000), which amended the Act to rename the “Maryland Higher Education Investment Program” the “Maryland Prepaid College Trust” and to call a “higher education investment contract” a “prepaid tuition contract” and created the Maryland College Investment Plan (“College Investment Plan”).

In 2003, the legislature enacted Senate Bill 499 (Chapter 381, Acts of 2003) and House Bill 30

(Chapter 382, Acts of 2003), which were identical bills. These Acts made several definitional changes to clarify meanings and differentiate between the Prepaid College Trust and the program which administers both the Prepaid College Trust and the College Investment Plan. The changes prescribed by these bills did not affect the eligibility or calculation of the tax benefits provided by the Prepaid College Trust or the College Investment Plan.

In 2008, the legislature enacted House Bill 1534 (Chapter 548, Acts of 2008), which authorized the College Savings Plans of Maryland Board to create the Maryland Broker-Dealer College Investment Plan (“Broker-Dealer Plan”). The Board is currently assessing the requirements of such a plan.

II. Maryland College Savings Plans

A. The Prepaid College Trust. The Prepaid College Trust was created to allow individuals to plan and save for future college expenses by purchasing a specified number of semesters or years of college tuition in a prepaid tuition account. Under the Prepaid College Trust an account holder selects a tuition plan, makes payments to the Prepaid College Trust and receives a future tuition benefit. The Prepaid College Trust is then obligated to pay the purchased tuition and mandatory fees for a named beneficiary (typically a child or grandchild) beginning in a designated future year. Payments received by the Prepaid College Trust are held and invested to be used for future payments of tuition benefits. When the designated year arrives, the beneficiary may use the benefits at any Maryland public college. He or she may also use up to the weighted average tuition and mandatory fees at Maryland public colleges towards tuition and mandatory fees at a private or out-of-state college, or a minimum benefit, whichever is greater. Accounts require either lump-sum payments or installment payments. Prices are based on current tuition and mandatory fees at Maryland public colleges, adjusted for several factors.

B. The College Investment Plan. The College Investment Plan is similar to the Prepaid College Trust in that it is also designed to comply with §529 of the Internal Revenue Code. Funds in a College Investment Plan account can be used towards any accredited public or private college (in state or out-of-state) that is eligible for federal financial aid, as well as for expenses at eligible professional, trade, and business schools. To participate in the College Investment Plan, an individual must open one or more accounts for one or more beneficiaries. The minimum contribution to an account is \$250, but can be waived if automatic monthly contributions of at least \$25 are made from a bank account or payroll deduction. Contributions up to a maximum aggregate account balance of \$320,000 can be made for each beneficiary. Although earnings may cause the balance to exceed this limit, no further contributions will be permitted.

The investment can be used for tuition, mandatory fees, room and board, books, course-specific fees or certain expenses for “special needs” students. The College Investment Plan does not have any state residency requirements and offers Maryland State and federal tax benefits similar to the Prepaid College Trust. Both residents and nonresidents with Maryland source income are entitled to a subtraction modification of up to \$2,500 per year per designated beneficiary.¹

¹ When the College Investment Plan was launched in December 2001, an account holder was able to invest in more than one investment portfolio for a single beneficiary. As the College Investment Plan was administered, a separate “account” had to be established for each portfolio. Because the law limits the subtraction modification available to an “investment account,” the question was raised as to the extent of the subtraction available. Clarifying legislation was passed by the General Assembly in 2002, but was vetoed by the Governor because of language extending the tax benefit to other states’ 529 plans. In his veto letter, the Governor wrote that permitting the subtraction modification for contributions by one account holder to more than one investment portfolio for a single beneficiary was not the intent of the original legislation.

The Comptroller of Maryland requested an opinion of the Maryland Attorney General as to the proper interpretation of the State income tax deduction for contributions to the College Investment Plan. On September 9, 2002 the Attorney General issued his

Contributions made in excess of \$2,500 in a single year to the same account may be carried forward to consecutive subsequent years until fully claimed as a subtraction or the 11th taxable year, whichever occurs first. The bill also provides for an addition modification in the event that a distribution from an account is not used for qualified higher education expenses. The College Investment Plan may be used in conjunction with or independent of the Prepaid College Trust. The College Investment Plan began accepting contributions in December, 2001. Both the College Investment Plan and the Prepaid College Trust are offered under the combined program name, the College Savings Plans of Maryland. For more information on these plans, call toll-free at 1-888-4MD-GRAD (1-888-463-4723) or access through the Internet at <http://www.collegesavingsmd.org>.

III. Qualified State Tuition Programs Under Federal Law

Under Internal Revenue Code §529, a qualified state tuition program is generally exempt from federal income taxation. The Prepaid College Trust and the College Investment Plan are qualified state tuition programs under §529.

A. Federal Income Tax Treatment of Account Holders and Beneficiaries

The general rule for §529 programs is that neither the account holder (typically the parent or grandparent) nor the beneficiary (the future student) will include in federal taxable income the

opinion (87 *Opinions of the Attorney General* ____ (2002) [Opinion No. 02-013 (September 9, 2002)]). In his opinion, he wrote that “in our opinion, a Maryland taxpayer may take a subtraction modification of up to \$2,500 each year for contributions to the Investment Plan on behalf of a particular beneficiary, regardless of whether those contributions are spread among one or more of the portfolios that are part of the Investment Plan. The taxpayer may take a similar deduction for each beneficiary for whom the taxpayer makes contributions.”

In response to the Opinion of the Attorney General, the Comptroller promulgated Regulation .15 under COMAR 03.04.02 that provides that the subtraction modification is limited to \$2,500 per year per qualified designated beneficiary regardless of the number of investment options included in an investment account.

increase in value of the account over time. For tax years beginning before January 1, 2002, the beneficiary included this increase in his or her federal taxable income, and owed tax thereon, when the funds were actually used towards qualified higher education expenses. Beginning January 1, 2002,² the beneficiary is no longer required to include the increase in his or her federal taxable income. If the account is refunded or distributed to the account holder and not used for qualified higher education expenses, the account holder will be required to include any earnings realized in his or her federal taxable income. Generally, any earnings on amounts not used for qualified higher education expenses will also be subject to a 10% federal surtax.

B. Example of Federal Taxation

Holly pays \$9,000 in 2008 to the Prepaid College Trust for the purchase of a single year of future tuition for her son, Michael, in the year 2015. When the benefit is used in 2015 a year of tuition and mandatory fees at Towson University, where Michael is enrolled, costs \$13,000. Michael will not include the \$4,000 increase in his federal taxable income that year. If Holly requests a reduced refund in 2012, and receives \$10,000, Holly will include \$1,000 in her federal taxable income that year. The \$1,000 may also be subject to a 10% federal surtax.

IV. Maryland Income Tax Treatment of Account Holders and Beneficiaries

A. Current Law - Account Holders and Beneficiaries

Maryland taxation generally follows the federal definitions of income. However, Maryland law changes this rule and provides additional Maryland tax benefits for account holders and beneficiaries of the accounts in the College Savings Plans of Maryland.

Tax-General §10-208(n) provides a subtraction modification of up to \$2,500 annually for amounts paid for the purchase of each prepaid account. Tax-General §10-208(o) provides a subtraction

modification of up to \$2,500 annually for amounts contributed to each College Investment Plan account. If an individual makes payments in excess of \$2,500 in a taxable year, the amount of the subtraction modification is limited to \$2,500 for each account in the Prepaid College Trust and \$2,500 for each beneficiary in the College Investment Plan. Any excess amount may be carried over to subsequent consecutive taxable years until the full amount of the payment or contribution has been allowed as a subtraction for a Prepaid College Trust account or the 11th year if a College Investment Plan account. If a joint return is filed and each spouse has established an account in the College Savings Plans of Maryland and has contributed at least \$2,500 to their respective account, the married couple could subtract \$5,000 on their Maryland return. If each spouse files a married filing separate return, then the spouse that owns and makes payments or contributions to that account may take up to \$2,500 of the amount paid or contributed to that account as a subtraction modification. The other spouse (the spouse that does not own the account) will not qualify for the subtraction modification.

In the example above, Holly has made a payment of \$9,000 to purchase a single year of future tuition in a Prepaid College Trust account. If Holly files either as single, head of household, or married filing separate, she may subtract \$2,500 from her Maryland taxable income for the year in which she makes her payment of \$9,000 and subtract \$2,500, \$2,500 and \$1,500 in the following three years, respectively. If Holly were to make her payments over time, (making payments of \$2,000 a year, for example) Holly would subtract \$2,000 in each year that she made payments – but never more than \$2,500 a year.

In the College Investment Plan, if an account holder invests \$27,500 in Year 1, the account holder may subtract \$2,500 in each of Years 1 through 11. If the account holder invests \$10,000 in Year 1 to a College Investment Plan account and invests \$10,000 in Year 2 to the same account, the account holder may subtract \$2,500 in each of Years 1 through 8.

² The Pension Protection Act of 2006 eliminated the 2010 sunset provision for the federal tax exempt status of Section 529 plans.

B. Prior Law –Beneficiaries

As noted above, prior to January 1, 2002, the beneficiary included the increase in value of the account in federal taxable income even when the funds were used towards qualified higher education expenses. Beginning January 1, 2002, the beneficiary is no longer required to include the increase in federal taxable income. For qualified expenditures incurred prior to January 1, 2002, Maryland law provides a tax exemption on the earnings at the State level for beneficiaries in the College Savings Plans of Maryland when distributions are made for qualified higher education expenses. This is accomplished by providing a subtraction modification on the Maryland return for the earnings that must be claimed on the federal return. For example, Adam is a beneficiary in a College Savings Plans of Maryland account and he enters Towson University in the fall of 2001. If funds used from the account include \$2,000 in earnings, then Adam will be required to include \$2,000 in his federal adjusted gross income for the year in which he used his benefit (2001). For Maryland income tax purposes, Adam may subtract \$2,000 from his Maryland taxable income. This subtraction modification for a beneficiary may only be used for amounts includable in federal adjusted gross income that are used by the beneficiary for tuition or other qualified college expenses. If Adam enrolls in Towson University in 2003, then he will not be required to include the increase in his federal adjusted gross income and, therefore, he will not be entitled to claim the Maryland subtraction on this increase.

V. Refunds and Distributions From The College Savings Plans of Maryland To The Account Holder

Tax-General §10-205(h) provides for an addition modification for any refunds or distributions from the Prepaid College Trust or the College Investment Plan that are not used for qualified higher education expenses. In the above example, if Adam did not attend college after reaching 18 years of age and his father Henry asked for and received all or a portion of the amount paid as a

refund or distribution, then Henry would have to include the amount received in his Maryland taxable income. The income (or earnings) portion of the refund or distribution will be included in federal adjusted gross income and no further Maryland adjustment will be necessary. An addition modification will be required for all amounts previously taken as a subtraction modification on his Maryland return. The addition modification however, may not exceed the cumulative amount of the subtraction modification taken under the bills. The addition modification would be made on the return in the year in which the refund or distribution amounts were received. The addition modification works the same for distributions from the College Investment Plan.

VI. Frequently Asked Questions

A. If parents file married filing separate returns, will there be a limit of \$1,250.00 per return?

Parents may not split the contributions to a College Savings Plans of Maryland account. Only one account holder is permitted for each account. If the father opens an account for a child and the mother opens another account for the same child, the father will get a subtraction modification for \$2,500 for his account, and the mother will get a subtraction modification for \$2,500 for her account. The same principles apply when each parent opens two separate accounts for two different children.

B. Does the beneficiary have to be the taxpayer's dependent?

The beneficiary does not have to be the taxpayer's dependent. Anyone may contribute to an account, but only the account holder is entitled to take a subtraction for the amounts the account holder contributes.

C. If the grandparents (not claiming the dependent) make the payment, would they get a \$2,500 deduction?

Regardless of the relationship to the beneficiary, only the account holder is entitled to take the subtraction modification. For example, if a grandmother established one account for a child and the father owned another account for the same child, each would be entitled to a maximum \$2,500 subtraction modification on their respective returns for the contributions to the account that each

made. This would also be true if the grandmother owned an account for one child and the father owned an account for a different child.

D. What if a parent holds an account for a child, but the grandparents make the payments?

Only the account holder may take the subtraction modification for the amounts the account holder contributes. The grandparents may not take the subtraction because they are not the account holder. The parent also cannot take the subtraction because the parent did not make the payment. The account holder is the person that controls the account and has the right to direct distribution payments or change the person who receives the benefits. The account holder also has the right (subject to some restrictions) to receive a refund or distribution from an account.

E. Will there be a required attachment to the individual's tax return to get the deduction?

This is a subtraction modification and not a deduction. There will be no requirement to attach records or documentation to the individual's tax return to qualify for the subtraction modification. It should be kept in mind that the Revenue Administration Division will be able to match the records of the College Savings Plans of Maryland to verify the amounts subtracted.

F. Will the subtraction modifications reduce both state and local income tax?

Yes, the subtraction modifications operate to reduce both state and local income tax.

G. If the funds are not used for eligible higher education expenses when the funds are returned to the account holder, is the account holder taxed on both the interest earned and any modifications taken on his or her returns in prior years?

An addition modification is required for the account holder for any refund or distribution where the contributions were previously subtracted from income. The addition modification must be made in the taxable year in which the account holder receives the refund or distribution. With regard to the return of interest, the effect is generally the same: the recipient of the refund or distribution (the account holder) will report the income element

on his or her return as part of federal adjusted gross income.

H. When does my payment or contribution have to be made to be eligible for the subtraction modification in a particular tax year?

Your payment or contribution must be completed online or postmarked no later than December 31 of that year.

VII. Effective Date

The effective date of Senate Bill 268 and House Bill 255 is July 1, 1998 and is applicable to all taxable years beginning after December 31, 1997.

Senate Bill 8 is an emergency measure and became effective on the date of enactment. This bill is also retroactive and is applicable to all taxable years beginning after December 31, 1997.

House Bill 11 is effective July 1, 2000 and, for income tax purposes, is applicable to taxable years beginning after December 31, 2000.

Senate Bill 499 and House Bill 30 are both effective July 1, 2003 and apply to all prepaid contracts purchased and investment accounts opened before the effective date of these Acts.

House Bill 1534 is effective October 1, 2008 and is applicable to all taxable years beginning after December 31, 2007.

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Revenue Administration Division
Revenue Administration Center
Annapolis, Maryland 21411-0001

Telephone: **410-260-7980**
or **1-800-MD TAXES**

taxhelp@comp.state.md.us

www.marylandtaxes.com

For the deaf or hard of hearing:
call via Maryland Relay at 711 in Maryland
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