Besselman & Associates
Patricia Ann Besselman
CFP®
James M. Besselman, CLU,
ChFC
111 Veterans Blvd. Ste. 360
Metairie, LA 70005
504-831-3506
pbesselman@besselmanandassoc.com

529 Plans vs. Coverdell Education Savings Accounts

529 Plans vs. Coverdell Education Savings Accounts

Section 529 plans and Coverdell education savings accounts are two of the most popular ways to save for college. But which savings option is right for you?

Definitions

A Coverdell ESA is a tax-advantaged savings vehicle that lets you save money for the qualified education expenses of a named beneficiary, such as a child or grandchild. Qualified education expenses include college expenses and certain elementary and secondary school expenses.

529 plans are tax-advantaged savings vehicles that let you save money for the college expenses of a named beneficiary, such as a child or grandchild. There are two types of 529 plans--college savings plans and prepaid tuition plans. A college savings plan lets you save money in an individual investment account. A prepaid tuition plan pools your contributions with those of other investors and allows you to prepay the cost of college at today's prices for use in the future.

Contribution limits and restrictions

The annual contribution limit for Coverdell ESAs is $2,000 per beneficiary. That's considerably less than you can contribute to most 529 plans (most plans have lifetime contribution limits of at least $300,000 total). So the more money you have to invest, the more attractive a 529 plan becomes. Just make sure you're familiar with all the contribution rules before you invest in a 529 plan. In addition to the lifetime contribution limit, some plans impose annual maximums and/or minimums.

Another potential drawback of the Coverdell ESA is that you may not be able to contribute if you earn over a certain amount for the year. The allowable contribution is gradually phased out based on your modified adjusted gross income (MAGI) for the year. For single tax filers, your annual MAGI must be less than $95,000 for you to make a full contribution (a partial contribution is allowed if your income is $95,000 to $110,000). For joint filers (if you're married, you must file a joint return to be eligible to contribute to a Coverdell ESA), your annual MAGI must be less than $190,000 to make a full contribution ($190,000 to $220,000 to make a partial contribution). But you don't have to worry about any of this with a 529 plan, because no income limits apply.

The age of the beneficiary also limits the use of a Coverdell ESA. You can't start a Coverdell ESA for any beneficiary who's age 18 or older, because you can't make any contributions to a Coverdell ESA after the beneficiary reaches age 18. The exception is if the beneficiary is a child who has special needs. This typically means that you can't keep adding to the kitty once your child's in college, since most children are at least 18 when they start college. And a Coverdell ESA that you have properly established cannot continue after the beneficiary reaches age 30 (unless the beneficiary has special needs). By contrast, the federal government imposes no age restrictions on 529 plans. However, a minority of states impose such restrictions of their own (usually only on 529 prepaid tuition plans), so make sure to check with your plan administrator.

Income tax treatment

The tax treatment of Coverdell ESAs and 529 plans is generally similar. At the federal level, there is no deduction for contributions made to a Coverdell ESA or a 529 plan (though states may offer one). And withdrawals from both a Coverdell ESA and a 529 plan that are used to pay the beneficiary's qualified education expenses (called qualified withdrawals) are free from income tax at the federal level. At the state level, whether the withdrawal is income tax free or deductible from income depends on the state you live in. And keep in mind that states may limit their tax benefits to individuals who participate in the in-state 529 plan.

Withdrawals from a 529 plan or a Coverdell ESA that are used for purposes other than the beneficiary's qualified education expenses (called nonqualified withdrawals) aren't treated as favorably. First, you'll pay income tax on the earnings portion of the withdrawal. For 529 plans, the person who receives the distribution (typically the account owner) pays the tax, while for Coverdell ESAs, the beneficiary generally pays the tax. Second, you'll pay a 10 percent federal penalty on the earnings portion. Plus, depending on the state you live in, you may also owe an additional state penalty on the earnings portion.

Control of the account

As the account owner of a 529 account, you decide when withdrawals will be made and for what purpose. You're also free to change the designated beneficiary, and as long as the new beneficiary fits the definition of a qualified family member of the previous beneficiary, you won't be penalized for making the change. As a parent or guardian, you generally have these same rights with a Coverdell ESA, but the exact degree of control may depend on the trustee's policies. For example, control will sometimes pass to the beneficiary once he or she is no longer a minor. And when the beneficiary (who is not a beneficiary who has special needs) turns age 30, the funds in a Coverdell ESA must be distributed within 30 days. The earnings may be subject to tax and penalty, and the beneficiary will have control of the funds. By contrast, the money in a 529 account can generally stay there as long as you like (though prepaid tuition plans may have restrictions on how long an account can remain open).

In terms of investment control, though, Coverdell ESAs have the edge. You can set up a Coverdell ESA with any number of banks, mutual fund companies, and other institutions. And you can customize your portfolio, choosing investments on your own. You're also typically free to move money among a company's investments or to transfer your Coverdell ESA from one trustee to another as often as you like. Finally, you can take a withdrawal from your Coverdell ESA and roll it over to a Coverdell ESA with a different trustee. The new account can be for the same beneficiary or for a new one within the same family. You can only do one rollover per year, though, and you must complete the rollover within 60 days to avoid tax and penalty.

By contrast, you lack such investment freedom with a college savings plan, though the trend is for college savings plans to offer more investment choices and flexibility. If you're lucky, at the time you join a college savings plan you'll get to choose one or more investment portfolios offered by the plan, which typically consist of mutual funds tailored to different investment styles. Otherwise, your contributions will automatically go into a single investment portfolio based solely on your child's age. In either case, though, you don't get to choose the underlying mutual funds held in an investment portfolio--the plan's professional money managers make those decisions. And you can't move money from fund to fund within the portfolio that you have.

Once you've invested money in a portfolio, you have limited opportunities to change investment options if you're unhappy with the portfolio's investment performance. Depending on a plan's individual rules, some plans may let you direct future contributions to a different portfolio. As for your existing contributions, some plans may let you change the investment option once each calendar year without changing the beneficiary, or they may let you change the investment option anytime you do change the beneficiary.

But there's one option that's mandated by federal law and not subject to a plan's discretion. You can change the investment option on your existing contributions without penalty by doing a rollover to another 529 plan (college savings plan or prepaid tuition plan) without changing the beneficiary. However, you're limited to one such rollover every 12 months. If you want to do more than one rollover in a 12-month period, you'll need to change the beneficiary to avoid a penalty and taxes.

Note: With a prepaid tuition plan, your money is generally invested in a trust fund that's managed by professional money managers. You don't get to choose a portfolio, and you have virtually no say in how your money is invested. But you are typically guaranteed a minimum rate of return.

Gift tax

You may be concerned about the gift tax consequences of contributing to a 529 plan or a Coverdell ESA. The treatment will be similar in both cases--your contribution is considered a completed gift to the account beneficiary, and so it qualifies for the annual federal gift tax exclusion. This means that you can gift up to $13,000 a year, per person, to an unlimited number of people without triggering federal gift tax.

However, because the annual maximum contribution allowed to a Coverdell ESA is $2,000, you won't trigger the gift tax rules if this is your only gift to the beneficiary for the year. As for 529 plans, they offer a special gifting feature that's not available with any other college savings vehicle. Specifically, you can make a lump-sum contribution to a 529 plan of up to $65,000 in 2010, elect to spread the gift evenly over five years, and completely avoid federal gift tax, provided no other gifts are made to the same beneficiary during the five-year period. A married couple can gift up to $130,000. And the fact that you're making a completed gift generally means that those funds are removed from your taxable estate. Keep in mind, though, that because the annual maximum contribution allowed to a Coverdell ESA is $2,000, you won't trigger the gift tax rules if this is your only gift to the beneficiary for the year.

Federal financial aid

The federal financial aid treatment of Coverdell ESAs and 529 college savings plans is identical. Each is considered an asset of the parent if the parent is the account owner (which is a more favorable result than if the account were classified as a student asset). Also, distributions (withdrawals) from either a Coverdell ESA or a college savings plan that are used to pay the beneficiary's qualified education expenses aren't classified as either parent or student income, which means that some or all of the money is not counted again when it's withdrawn.

Note: The financial aid treatment of 529 plans and Coverdell ESAs is complex and subject to change. You should consult a financial planner experienced in financial aid issues for more information.

Can you have both?

Yes. You can open both a Coverdell ESA and a 529 account for the same beneficiary. And you can contribute to both types of plans in the same year for the same beneficiary. However, if withdrawals are made from a Coverdell ESA and a 529 account in the same year for the same beneficiary, you'll need to allocate the qualified education expenses you're covering between the two accounts. For more information, consult an experienced tax professional.

Legislative impact

A provision of the Economic Growth and Tax Relief Reconciliation Act of 2001 that raised the annual contribution limit for Coverdell ESAs to $2,000 is scheduled to expire on December 31, 2010. Unless Congress acts, after this date, the annual contribution limit for Coverdell ESAs will revert to $500, which is the limit that was in effect prior to January 1, 2002.

Note:*Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing. More information about specific 529 plans is available in the issuer's official statement, which should be read carefully before investing. Also, before investing, consider whether your state offers a 529 plan that provides residents with favorable state tax benefits.*

Forefield Inc. does not provide legal, tax, or investment advice. All content provided by Forefield is protected by copyright. Forefield is not responsible for any modifications made to its materials, or for the accuracy of information provided by other sources.

Besselman & Associates
Patricia Ann Besselman
CFP®
James M. Besselman, CLU,
ChFC
111 Veterans Blvd. Ste. 360
Metairie, LA 70005
504-831-3506
pbesselman@besselmanandassoc.com

Prepared by Forefield Inc. Copyright 2010