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How does a 529 plan compare with a Coverdell education savings account?

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Answer:

Several key restrictions apply to Coverdell education savings accounts that don't apply to 529 plans. First, the annual contribution limit for Coverdell ESAs is $2,000, much less than you can contribute to most 529 plans (most plans have lifetime contribution limits of at least $300,000 per beneficiary). Second, depending on your income, you may not be able to contribute to a Coverdell ESA. To contribute anything, single filers must have a modified adjusted gross income (MAGI) under $110,000, and married filers must have a MAGI under $220,000. Another drawback is that you can't contribute to a Coverdell ESA for a beneficiary who is 18 or older, unless the beneficiary is a child who has special needs. By contrast, 529 plans don't restrict your ability to contribute based on your income, and most plans let you contribute after the beneficiary reaches age 18.

The tax treatment of Coverdell ESAs and 529 plans is generally similar. At the federal level, withdrawals from both a Coverdell ESA and a 529 plan that are used to pay the beneficiary's qualified education expenses (qualified withdrawals) are free from income tax. Such withdrawals may also be exempt from state income tax, depending on the state you live in. Keep in mind, though, that there is no federal deduction for contributions made to a Coverdell ESA or a 529 plan, but states may offer their residents a deduction for contributions made to that state's 529 plan.

Not surprisingly, withdrawals from a Coverdell ESA and a 529 plan that aren't used to pay the beneficiary's qualified education expenses (nonqualified withdrawals) aren't treated as favorably. Specifically, the earnings portion of such withdrawals is subject to a 10 percent federal penalty (a state penalty may also apply to 529 plan nonqualified withdrawals) and federal income tax. For 529 plans, the person who receives the distribution pays the tax--usually the account owner--while the beneficiary of a Coverdell ESA generally pays the tax. And depending on the state you live in, state income taxes may also apply.

Yet Coverdell ESAs do have a couple of advantages over 529 plans in funding your child's education. First, you can use Coverdell ESA funds for elementary, secondary, and higher education expenses (529 plan funds can be used only for higher education expenses). Second, you have full control over your underlying investments with a Coverdell ESA.

By contrast, 529 plans give you only limited control over your investments. Specifically, with a prepaid tuition plan, you have no say in how your money is invested (though you are generally guaranteed a certain rate of return or that a certain amount of future tuition costs will be paid). With a college savings plan, you can generally select an investment portfolio at the time you join the plan (though never the portfolio's underlying investments). However, college savings plans differ with regard to the investment flexibility they give you. If you want to change your investment option due to poor performance, the IRS has given states the discretion to let you change your investment option once per calendar year, or anytime you change the beneficiary. Plans may also let you direct future contributions to a different investment option. But it's up to the individual plans whether to offer such flexibility, so check with your specific plan.

If your college savings plan doesn't offer this investment flexibility, you have another option guaranteed by federal law--a rollover. You can roll over your existing 529 account (college savings plan or prepaid tuition plan) to a different 529 plan once every 12 months without penalty (and without having to change the beneficiary).

Note: Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing. More information about 529 plans is available in each 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.

Janney Montgomery Scott LLC Financial Advisors are available to discuss the suitability and risks involved with various products and strategies presented. We will be happy to provide a prospectus, when available, and other information upon request. Please note that the information provided includes reference to concepts that have legal, accounting and tax implications. It is not to be construed as legal, accounting or tax advice, and is provided as general information to you to assist in understanding the issues discussed. Neither Janney Montgomery Scott LLC nor its Financial Advisors (in their capacity as Financial Advisors) give tax, legal, or accounting advice. We would urge you to consult with your own attorney and/or accountant regarding the application of the information contained in this letter to the facts and circumstances of your particular situation.

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