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COVERDELLS VS. 529 PLANS

There is more than one way to save for college.

Presented by Gary Mastrodonato, CEA

Today, some parents are wondering if they should convert Coverdell Education Savings Accounts to 529 college savings plans. With that mind, here is a brief look at how both of these accounts work.

Why were Coverdell ESAs so popular in the past decade? Imagine a Roth IRA used only for college savings. That's basically the concept behind a Coverdell. In fact, the Coverdell ESA (created in 2002) evolved from the Education IRA (created in 1998).

Contributions to a Coverdell ESA aren't deductible, but you get tax-deferred growth. Contributions must be made in cash. Withdrawals from Coverdells are (currently) tax-free if used for qualified educational expenses such as tuition, fees and books. The funds can also pay for certain K-12 education costs.^{1,2}

You can allocate Coverdell account assets among many different kinds of investment vehicles, and many banks, credit unions and mutual fund providers offer these accounts. However, Coverdells have some drawbacks. The annual contribution limit to a Coverdell is \$2,000, and phase-outs kick in at \$95,000 for single filers and \$190,000 for married filers. An individual taxpayer with modified adjusted gross income above \$110,000 cannot contribute to a Coverdell (the MAGI limit is \$220,000 for joint filers).^{2,3}

Aside from a limit on annual contributions, there are also some age requirements. The Coverdell ESA beneficiary must be younger than 18 when the account is set up, and the money in the account must be spent or transferred before the beneficiary turns 30. At that point, the funds will have to be withdrawn and taxes and a 10% penalty may be assessed on the withdrawal. (If a beneficiary has special needs, contributions after age 18 and retention of the account assets after age 30 may be allowed - see IRS Publication 970 for details.)^{1,2}

Big changes are coming for Coverdells in 2012. Unless Congress intervenes, these accounts will be a lot less attractive next year. Beginning in 2012:

- The annual contribution limit drops from \$2,000 to \$500.
- Distributions will be tax-free only if you don't claim a Hope or Lifetime Learning Credit in the same tax year.
- No withdrawals may be used to pay for K-12 education expenses.⁴

All this has many parents thinking about shifting their Coverdell funds to a 529 plan.

Thinking of moving Coverdell assets into a 529? You can do a rollover from a Coverdell ESA to a 529 plan without incurring any tax penalties as long as the 529 plan will have the same beneficiary as the present Coverdell account.⁵

When it comes to your federal tax picture, the IRS is pretty kind to 529 plans. The earnings from a 529 plan can be withdrawn tax-free (assuming they are used for qualified education expenses). Contributions are taxed. (Some states do give you a break and let you deduct part of your 529 contribution from state tax returns.)⁶

You can go one of two ways with a 529:

- You can prepay tuition at today's rates (at a qualifying college or university) through a *529 prepaid tuition program*.
- You can save to pay tomorrow's college tuition through a *529 savings plan* which gives you tax-deferred growth. Most people prefer this option for its flexibility and asset accumulation potential.⁷

You can put much more money into a 529 annually. You can put up to \$13,000 in a 529 plan this year without having to file a gift tax report. Your spouse can, too. So can your relatives. So can anyone: any individual taxpayer can contribute up to \$13,000 to a 529 plan in 2011. In fact, a taxpayer can pour in up to five years worth of contributions in one year (\$65,000) without incurring gift taxes or eating into the unified credit, as long as that taxpayer refrains from making further contributions for the next five years. (For married couples filing jointly, this limit is $\$65,000 \times 2 = \$130,000$.) Such contributions would only be included in the donor's taxable estate if the donor died within the five-year period that the \$65,000 represents.⁸

Most 529 plans allow annual contributions of more than \$200,000. Some have "lifetime" limits on the total contribution. All 529 contributions must be in cash.^{8,9}

A 529 plan has no phase-outs. You are never too rich to contribute to a 529 plan. 529s do not have any form of income restrictions.⁷

Other nice features. The owner of a 529 plan retains control of the assets and has the power to change the beneficiary. You can even start multiple 529 plans in different states.¹⁰

In many respects, 529 plans have left Coverdell ESAs in the dust.

You may wish to move assets from a Coverdell ESA to a 529 plan. You certainly will want to keep up with developments affecting these accounts and other education savings options. Your financial consultant can help you stay informed.



Gary C. Mastrodonato, CEA
The Masters, LLC

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Gary C. Mastrodonato is a Representative with Capital Investment Companies and may be reached at:
807 Broad Street Suite C PO Box 306, Oriental, North Carolina 28571
Phone: (252)249-0100 Fax: (252)249-0105

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Citations.

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