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Major Features of 529 Plans and Coverdells

There are two types of tax-advantaged education savings accounts. The first are qualified tuition programs (QTPs), commonly called 529 plans (referring to the section of the tax code that dictates their tax treatment). The second are Coverdell education savings accounts (ESAs), often referred to simply as Coverdells. This In Focus compares the major features of these two types of accounts.

529 Plans

With 529 plans, distributions (i.e., withdrawals) are tax-free (including any investment earnings) if they are used to pay for qualified higher education expenses. In addition, up to $10,000 may be withdrawn tax-free per beneficiary per year and used for qualifying elementary and secondary school tuition expenses. If some or all of the distribution is used to pay for nonqualified expenses, then the earnings portion of the distribution is taxable, and may be subject to a 10% tax penalty.

Most 529 plans are 529 savings plans, in which a contributor invests in a portfolio of mutual funds or other underlying investments. The savings and accumulated investment earnings can be used to pay for qualified education expenses at a later point in time.

Another less common type of 529 plan is a prepaid tuition plan. In a prepaid plan, a contributor makes payments at current prices that entitle the beneficiary to future academic periods, course units, or a percentage of tuition costs.

Coverdells

A Coverdell is a tax-advantaged investment account that can be used to pay for both higher-education expenses and elementary and secondary school expenses (elementary and secondary school expenses are not limited to tuition expenses). The tax advantages of Coverdells are very similar to those of 529 plans. Unlike 529 plans, annual contributions are limited to $2,000 per beneficiary across all Coverdell ESAs, and the ability to make contributions is phased out for higher-income taxpayers. In contrast, 529 plans are typically capped only by significantly higher lifetime contribution limits.

There are also benefits to 529 plans and Coverdells outside of the tax code. These plans are treated more favorably than other types of college savings or investments when determining a student's eligibility for federal need-based student aid.

More information can be found in CRS Report R42807, *Tax-Preferred College Savings Plans: An Introduction to 529 Plans*, by Margot L. Crandall-Hollick, and CRS Report R42809, *Tax-Preferred College Savings Plans: An Introduction to Coverdells*, by Margot L. Crandall-Hollick.

Table 1. Major Features of 529 Plans and Coverdells

	529 Plans	Coverdells
Federal Income Tax Treatment		
Contributions	Not deductible from federal income tax.	Not deductible from federal income tax.
Withdrawals	Excluded from gross income (exempt from income tax) if distributed for qualified expenses; subject to income tax and possibly a 10% penalty if not used for qualified expenses.	Excluded from gross income (exempt from income tax) if distributed for qualified expenses; subject to income tax and possibly a 10% penalty if not used for qualified expenses.
Contribution Limit		
	No fixed contribution limit. Lifetime account balance limit set by state; ranged from $235,000 to $529,000 in 2018.	Annual limit of $2,000 per beneficiary, subject to phase-out if contributor's income is between $95,000 and $110,000 (between $190,000 and $220,000 for joint filers). Contributions in excess of $2,000 are subject to a 6% excise tax.

	529 Plans	Coverdells
Federal Gift and Estate Tax Treatment of Contributions		
Gift	Contributions are treated as completed gifts; for 2018 and 2019, contributions of $15,000 or less are excluded from the gift tax. This amount is adjusted for inflation. A contributor may be able to make a contribution above the $15,000 gift tax exclusion by treating the contribution as if it were spread over five years.	Contributions are treated as completed gifts; for 2018 and 2019, contributions of $15,000 or less are excluded from the gift tax. This amount is adjusted for inflation.
Estate	Value of plan not included in contributor's gross estate, except if the contributor has taken the five-year election, in which case the portion of contributions allocable to periods after the death of the donor is included in the gross estate.	Value of plan not included in contributor's gross estate.
Qualifying Expenses		
Elementary and Secondary	Up to $10,000 per beneficiary in annual expenses for tuition only.	Tuition, fees, books, supplies, equipment, academic tutoring, and special-needs services. Room and board, uniforms, and transportation if required for attendance. Computer and peripheral equipment, software, and Internet access if used by beneficiary and/or the beneficiary's family while the beneficiary is in elementary or secondary school.
Higher Education	Tuition, fees, books, supplies, and equipment required for enrollment; expenses for special-needs services; room and board expenses for students enrolled at least half-time.	Tuition, fees, books, supplies, and equipment required for enrollment; expenses for special needs services; room and board expenses for students enrolled at least half-time.
Time Limitation		
	Time limitation is determined by plan type and the state in which it was opened. In prepaid tuition plans, contributors generally purchase future education during a given period. Plans can be used only in the predetermined period. In savings plans, there is typically no program-imposed limit on how long the account may remain open (as long as the beneficiary is living).	Contributions must be made before beneficiary turns 18; balance of account must be liquidated before beneficiary turns 30, except for special-needs beneficiaries.
Who Manages Investments?		
	In prepaid tuition plans, the state plan administrator or college/university administrator fully manages investments. In savings plans, the state plan administrator or a private contractor develops a menu of investment strategies, similar to many employer-sponsored retirement plans.	Plan contributor, beneficiary's legal guardian, or other "responsible person" fully manages investments, similar to an individual retirement account (IRA).
Plan Ownership		
	In most plans, the contributor retains ownership of the account.	Beneficiary becomes owner of plan at age of majority (18 or 21 in most states).
Who Bears Risk?		
	In prepaid tuition plans, plans are backed by the full faith and credit of the state government, and therefore the state bears the risk. In savings plans, contributors bear the risk. Performance is determined by the performance of the underlying assets and the price of education.	Contributors bear the risk. Performance is determined by the performance of the underlying assets and the price of education.

Source: Internal Revenue Code (IRC) Sections 529-530; Internal Revenue Service, *Publication 970: Tax Benefits for Education, 2018*, https://www.irs.gov/pub/irs-pdf/p970.pdf.

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