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Understanding 529 Plans vs. Coverdell Education Savings Accounts





529 Plans vs. Coverdell Education Savings Accounts



How do 529 plans and Coverdell education savings accounts compare when saving for education costs?

Definitions

A 529 plan is a tax-advantaged savings vehicle that let you save money for the education expenses of a named beneficiary, such as a child or grandchild. There are two types of 529 plans: savings plans and prepaid tuition plans. A savings plan lets you save money for college or K-12 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 tuition at today's prices for use in the future.

For 529 savings plans, qualified education expenses include the full cost of tuition, fees, room and board, books, equipment, and computers for college and graduate school, plus K-12 tuition expenses for enrollment at an elementary or secondary public, private, or religious school up to \$10,000 per year.

For 529 prepaid tuition plans, qualified education expenses generally include tuition and fees only at the colleges that participate in the plan.

A Coverdell education savings account (ESA) is a tax-advantaged savings vehicle that lets you save money for college and K-12 for a named beneficiary, such as a child or grandchild. Qualified education expenses cover tuition, fees, room and board, books, equipment, computers, tutoring, uniforms, and transportation.

Contribution limits and restrictions

Coverdell ESAs have an annual contribution limit of \$2,000. That's considerably less than you can contribute to 529 plans. Most 529 plans have lifetime contribution limits of \$350,000 and up (limits vary by state).

Coverdell ESAs also have income restrictions on who can open an account. To make the full \$2,000 annual contribution in 2025, single filers must have a MAGI less than \$95,000 (a partial contribution is allowed with a MAGI between \$95,000 to \$110,000) and joint filers must have a MAGI less than \$190,000 (a partial contribution is allowed with a MAGI between \$190,000 to \$220,000). With a 529 plan, anyone can open an account; no income limits apply.

Coverdell ESAs also restrict the age of the beneficiary. You can't open a Coverdell account for any beneficiary who is age 18 or older because you Coverdell accounts do not allow any contributions after the beneficiary reaches age 18. (An exception exists if the beneficiary has special needs.) This typically means that you can't keep contributing to the account once your child starts college. In addition, a Coverdell ESA can't 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, some states may impose such restrictions of their own (usually only 529 prepaid tuition plans), so make sure to check with your plan administrator.

Income tax treatment



The tax treatment of 529 plans and Coverdell ESAs is generally similar. At the federal level, there is no deduction for contributions made to either a 529 plan or a Coverdell ESA (though states may offer one). Withdrawals from either 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 Coverdell ESA that are not used for the beneficiary's qualified education expenses (called nonqualified withdrawals) are also treated similarly. First, you'll owe income tax on the earnings portion of the withdrawal (you may also owe state income tax). 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 owe a 10% federal penalty on the earnings portion of the withdrawal (you may also owe a state penalty).

Control of the account

As the owner of a 529 account, you decide when withdrawals will be made and for what purpose. You're also free to change the 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).

Investment options and flexibility

In terms of investment control, 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 529 savings plan. When you open a 529 saving plan account, 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. In any 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.

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. Generally, you can change the investment options on your existing contributions twice per calendar year, or whenever you 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 (savings plan or prepaid tuition plan) without changing the beneficiary. However, you're limited to one such rollover once per calendar year. If you want to do more than one rollover in a calendar year, 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. In 2025, you can gift up to \$19,000 a year (\$38,000 for joint gifts) 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 education savings vehicle. Specifically, you can make a lump-sum contribution to a 529 plan of up to five times the annual gift tax exclusion — \$95,000 for individual gifts and \$190,000 for joint gifts in 2025 — and avoid gift tax by making a special election on your tax return to spread the gift evenly over five years, provided no other gifts are made to the same beneficiary during the five-year period. And the fact that you're making a completed gift generally means that those funds are removed from your taxable estate.



Financial aid treatment

The federal financial aid treatment of 529 plans and Coverdell ESAs 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 529 plan that are used to pay the beneficiary's qualified education expenses aren't classified as either parent or student income, which means that the money is not counted again when it's withdrawn.

Grandparent-owned 529 plans or Coverdell ESAs aren't counted as parent assets, and starting with the 2024–2025 FAFSA (Free Application for Federal Student Aid) distributions (withdrawals) from either account are not counted as student income. Students won't be required to report any type of cash support.

Can you have both?

Yes. You can open both a 529 account and a Coverdell ESA for the same beneficiary. And you can contribute to both types of plans in the same year for the same beneficiary. In fact, due to the low annual contribution limit of Coverdell ESAs, it's hard to imagine saving enough money for college by using only this type of account.

If withdrawals are made from a 529 account and a Coverdell ESA 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.

Note: Before investing in a 529 plan, please consider the investment objectives, risks, charges, and expenses carefully. The official disclosure statements and applicable prospectuses, which contain this and other information about the investment options, underlying investments, and investment company, can be obtained by contacting your financial professional. You should read these materials carefully before investing. As with other investments, there are generally fees and expenses associated with participation in a 529 plan. There is also the risk that the investments may lose money or not perform well enough to cover college costs as anticipated. Investment earnings accumulate on a tax-deferred basis, and withdrawals are tax-free as long as they are used for qualified education expenses. For withdrawals not used for qualified education expenses, earnings may be subject to taxation as ordinary income and possibly a 10% federal income tax penalty. The tax implications of a 529 plan should be discussed with your legal and/or tax professionals because they can vary significantly from state to state. Also be aware that most states offer their own 529 plans, which may provide advantages and benefits exclusively for their residents and taxpayers. These other state benefits may include financial aid, scholarship funds, and protection from creditors.

To schedule an appointment with Faye Sykes, click [here](#) .

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