

You Don't Need To Know What a Coverdell Is



[Update: The Fiscal Cliff Bill of 2013 has made this post somewhat obsolete. ESA contributions have been increased back to \$2000 per year and you can still use them for primary and secondary education. At this time (Jan 2013) Vanguard won't let you open a new one.]

Most of you are aware of what a 529 plan is. They are state-specific plans where you contribute after-tax money that grows tax-free, and if spent on education, is never taxed again. Before 529s were instituted, there was a similar type of account called an Education IRA or a Coverdell Education Savings Account (ESA for short.) [Paul Coverdell](#) was a Georgia Republican Senator (just like Senator Roth).

Like A Roth IRA

It's just like a 529 except it's run by a brokerage or mutual fund company instead of your state. Think of a Roth IRA for education. You don't get a state tax deduction for contributing to it, but there are plenty of low-cost investing options if you opened it someplace like Vanguard or Fidelity,

or use an account at TD Ameritrade or Schwab to buy low-cost ETFs. In fact, your investing expenses are often lower with an ESA than with a 529. I used them for a couple of years when I was an Alaska resident since there was no state tax deduction for using their 529.

Ridiculously Low Contribution Limits

So why don't you ever hear about these accounts? The main reason is because the contribution limit is so low- only \$2K a year (and it becomes \$500 starting next year). Even if you start at age 0, contribute the max every year and earn 5% real on your money, that's only \$15K by the time junior hits 18. Compared to a 529 where you can contribute \$13K a year, that's a pretty important difference. When you combine it with no state tax deduction and the many cheap 529 plans out there (with their own advertising budgets), it's no surprise that no one knows about these things.

Income Restriction

Many doctors technically can't even use these things if they wanted to, since there is an income restriction. If you make more than \$190-210K (\$95-110K single), you can't contribute. Of course, you can give the money to your kid who can make the contribution in his own name.

Congress Hates ESAs

Starting next year, you can't use ESA money to pay pre-college education expenses anymore (think private high school), and its use isn't deductible if you get a hope credit or lifetime learning credit. Combining that with the new \$500 contribution limit, it seems to me that Congress just wants you to use a 529 instead. In fact, [Vanguard](#) won't even open any new ones (although you can maintain and contribute to an existing one.) Don't bother fighting them on this and just go with the 529. Even if you're looking for another tax-

protected (and lawsuit-protected) account, at \$500 a year, this is ridiculous. See, I told you that you didn't need to know what a Coverdell is.