

Education Savings Accounts—529s and Coverdells



With college costs on the rise, financing a child's higher education can be a challenge. There are two types of education savings accounts that are specifically designed to help parents, grandparents and others save for a child's educational expenses on a tax-advantaged basis.

Both 529 plans and Coverdell Education Savings Accounts (CESAs) permit after-tax contributions that grow tax-free until distributed. With both, distributions used towards the qualified education expenses of the beneficiary at an eligible educational institution are free from federal and in most cases, state income taxes. Unlike other vehicles used for education savings such as UGMA/UTMA accounts, with both 529s and CESAs, you control the account including who is beneficiary and changing the beneficiary, how much to contribute, and when and how much to distribute. You can also choose to make contributions to both a 529 and a CESA on behalf of the same beneficiary during the same tax year.

An important factor to understand about 529 plans is that they are sponsored by individual states. The states determine the maximum contributions, eligible investments and state tax advantages for their programs. Therefore, state plans vary greatly in their tax benefits, investment options, costs and features. By contrast, CESAs work more like IRAs in that you can choose any investment options available through the financial institution you choose to serve as your CESA custodian or trustee. Residents are not required to invest in their own state's 529 plan, and distributions do not need to be used to pay for schools only within the contributor's

or beneficiary's state of residence. In addition, individuals may contribute to more than one state's 529 plan. The chart below compares the important features of these two types of education savings accounts:

	529	CESA
Who may establish	Anyone	Individuals below certain AGI limits as follows: Single filers: \$110,000 Joint filers: \$220,000
Maximum contribution	No annual maximum, but annual contributions over \$13,000 may be subject to gift tax. (see details below) State determines maximum lifetime limit	\$2,000 per beneficiary (under age 18 or a special needs beneficiary) for single filers with AGI under \$95,000 and joint filers under \$190,000. Phased out contribution between \$95,000 – \$110,000 (single filers) and \$190,000 – \$220,000 (joint filers)
Tax deduction on contributions	State tax deduction may be available depending on state plan	None
Eligible investments	Mutual funds available through state sponsored plan	Generally the same as IRAs (e.g. stocks, bonds, mutual funds, etc.)
Eligible educational expenses	Only higher education (e.g. college)	Both higher education and primary/secondary education
Contribution due date	Generally either year-end or contributor's tax return due date, depending on state rules	Due date of contributor's tax return (generally April 15)
Non-qualified distributions	Earnings taxed as ordinary income and may be subject to a 10% penalty if not rolled to a new beneficiary*	Earnings taxed as ordinary income and may be subject to a 10% penalty if not distributed by age 30 or rolled to a new beneficiary*
Transfer/rollover ability	Both transfers and rollovers limited to one per beneficiary per 12 months	Unlimited transfers; rollovers limited to one per beneficiary per 12 months.

Making significant gifts to a 529

529s have a special feature known as accelerated gifting. Instead of just gifting \$13,000 per beneficiary per year using the annual exclusion, you may contribute five years of gifts in the first year for a total of \$65,000 per individual (or \$130,000 for married couples filing jointly) without paying gift tax. This also removes this money from your estate. Taking advantage of this option allows you to make significant contributions early and benefit from the tax-deferred growth within the 529 account. **

Your Financial Advisor Can Help

The best way to prepare for education expenses is to become familiar with your savings options and determine how each can address your specific needs. Call your Financial Advisor today to discuss 529s, CESAs and other education savings alternatives in light of your current goals, objectives and financial situation.

*The 10% penalty does not apply on account of death, disability or scholarship. The new beneficiary must be a family member of the current beneficiary.

**The accelerated gifting election is made on IRS Form 709 and filed with your federal tax return in the first year the accelerated gift is given. You cannot use the annual exclusion for gifts to this individual before the end of five calendar years but subsequent rounds (i.e. every five years) of accelerated gifting is permitted.

529 plans are sold with program descriptions that contain details of the risks, fees and charges associated with the particular investment which you should read carefully before investing.

Even though individuals are not required to invest in their in-state plan, some states do provide tax or other advantages exclusively to residents who invest in their own state's plan. For example, many states offer a state income tax deduction for contributions and/or state income tax exemption for qualified withdrawals. States may impose state tax liability on withdrawals and/or earnings from out-of-state 529 plans. In addition, some states offer prepaid tuition plans. You should carefully review this with your tax advisor before deciding on a 529 plan.

Many features of the CESA are set to expire at the end of 2012 if Congress does not enact legislation to extend them.

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