529 Plans Expanded

Tax-free college savings plans and prepaid tuition programs can be used to buy computer equipment and services for an eligible student during 2009 and 2010. These 529 plans — qualified tuition programs authorized under section 529 of the Internal Revenue Code — have, in recent years, become a popular way for parents and other family members to save for a child's college education. Though contributions to 529 plans are not deductible, there is also no income limit for contributors.

529 plan distributions are tax-free as long as they are used to pay qualified higher education expenses for a designated beneficiary. Qualified expenses include tuition, required fees, books, supplies, equipment and special needs services. For someone who is at least a half-time student, room and board also qualifies.

For 2009 and 2010, the ARRA change adds to this list expenses for computer technology and equipment or Internet access and related services to be used by the student while enrolled at an eligible educational institution. Software designed for sports, games or hobbies does not qualify, unless it is predominantly educational in nature. In general, expenses for computer technology are not qualified expenses for the American opportunity credit, Hope credit, lifetime learning credit or tuition and fees deduction.

States sponsor 529 plans that allow taxpayers to either prepay or contribute to an account for paying a student's qualified higher education expenses. Similarly, colleges and groups of colleges sponsor 529 plans that allow them to prepay a student's qualified education expenses.

Coverdell Education Savings Account

This account was created as an incentive to help parents and students save for education expenses. Unlike a 529 plan, a Coverdell ESA can be used to pay a student's eligible k-12 expenses, as well as post-secondary expenses. On the other hand, income limits apply to contributors, and the total contributions for the beneficiary of this account cannot be more than $2,000 in any year, no matter how many accounts have been established. A beneficiary is someone who is under age 18 or is a special needs beneficiary.

Contributions to a Coverdell ESA are not deductible, but amounts deposited in the account grow tax free until distributed. The beneficiary will not owe tax on the distributions if they are less than a beneficiary's qualified education expenses at an eligible institution. This benefit applies to qualified higher education expenses as well as to qualified elementary and secondary education expenses.

Here are some things to remember about distributions from Coverdell accounts:

- Distributions are tax-free as long as they are used for qualified education expenses, such as tuition and fees, required books, supplies and equipment and qualified expenses for room and board.

- There is no tax on distributions if they are for enrollment or attendance at an eligible educational institution. This includes any public, private or religious school that provides elementary or secondary education as determined under state law. Virtually all accredited public, nonprofit and proprietary (privately owned profit-making) post-secondary institutions are eligible.

- Education tax credits can be claimed in the same year the beneficiary takes a tax-free distribution from a Coverdell ESA, as long as the same expenses are not used for both benefits.

- If the distribution exceeds qualified education expenses, a portion will be taxable to the beneficiary and will usually be subject to an additional 10% tax. Exceptions to the additional 10% tax include the death or disability of the beneficiary or if the beneficiary receives a qualified scholarship.

For more information, see Tax Tip 2008-59, Coverdell Education Savings Accounts.