

COVERDELL EDUCATION SAVINGS ACCOUNTS

Executive Summary.

A *Coverdell Education Savings Account* (ESA) is a trust (or custodial account) created for the exclusive purpose of paying qualified primary, secondary, and higher education expenses of a single designated beneficiary.

Contributions are only permitted until the beneficiary reaches age 18, unless the beneficiary is a special needs beneficiary. Contributions must be made in cash with after tax dollars. Individuals and other entities, such as corporations and tax-exempt organizations, may contribute to the account. The maximum contribution permitted over all ESAs for a given beneficiary is \$2,000 for the year. The maximum contribution permitted, per contributor, for the year is \$2,000. For individual contributors, this limit is subject to phase out when Modified Adjusted Gross Income (MAGI) falls within the following ranges:

Married, Filing Jointly	\$190,000 - \$220,000
All Other Individuals	\$95,000 - \$110,000

Contributions must be made by the due date of the contributor's tax return, not including extensions.

Contributions made on behalf of a given beneficiary are subject to an annual 6% excise tax to the extent they exceed the \$2,000 limit for the year and are not timely corrected. Earnings on excess contributions are subject to an annual 10% excise tax to the extent they are not timely corrected.

Distributions from an ESA are tax-free to beneficiary to the extent they

- do not exceed the qualified education expenses incurred on behalf of the beneficiary for the taxable year,
- are rolled to a qualified ESA (1) within 60 days, and (2) prior to the death of the beneficiary,
- are rolled into a qualified 529 plan account (1) within 60 days, and (2) prior to the death of the beneficiary, or
- are transferred to a spouse or former spouse pursuant to a divorce or separation instrument.

All other distributions are subject to a 10% distribution penalty, unless the distribution is

- a timely distribution of excess contributions and applicable earnings,
- made on account of death,
- made on account of disability, or
- made on account of scholarship received; provided the distribution amount does not exceed the scholarship amount.

The Best Decision Is An Informed Decision.

Educational funding vehicles, such as the ESA, are complex and ever changing. Their evolution has created new education funding opportunities that cut across income tax brackets by providing benefits to taxpayers in the lower, middle and upper tax brackets. As in any other financial decision making process, it is important to start with an understanding of the fundamental mechanics of the education funding vehicle in order to make a strategically sound, tax-smart decision as to its use.

The ESA In General.

The ESA is essentially a savings account set up to pay for the qualified education expenses of a designated beneficiary. Any individual or entity, including corporations and tax-exempt organizations, may establish an ESA for the benefit of a single individual under the age of 18, or a special needs individual of any age. While a minor is not prohibited from establishing an ESA, the ESA contract may be unenforceable under state law.

The ESA may be established with any trustee or custodian approved by the Internal Revenue Service (IRS). Approved trustees and custodians generally consist of banks and other financial institutions. The ESA contract must be written and operated in accordance with applicable federal statutes and administrative requirements.

Contribution Limits.

Contributions to an ESA are subject to two limitations. The first limitation applies to all ESAs established for a given designated beneficiary. The total of all contributions to all ESAs established for a given beneficiary may not exceed \$2,000 for the year. Rollover contributions are not considered for purposes of this limitation.

The second limit applies to the contributors. Each contributor may contribute up to \$2,000 for the year, for each designated beneficiary. For individual contributors, this contribution limit is subject to phase out when MAGI falls within the following ranges:

Married Filing Jointly	\$190,000 - \$220,000
All Other Individuals	\$95,000 - \$110,000

Taxpayers subject to phase out may use the following formula to determine their maximum contribution limit, per beneficiary, for the year:

$$\$2,000 - \left[\$2,000 * \frac{\text{MAGI less } \$95,000 (\$190,000 \text{ if Married, Filing Jointly})}{\$15,000 (\$30,000 \text{ if Married, Filing Jointly})} \right]$$

Note that contributions to an ESA do not reduce the amount an individual may contribute to a traditional or Roth IRA.

Excess Contributions.

The beneficiary is subject to annual excise taxes on excess contributions and any earnings applicable to those excess contributions. Excess contributions are calculated per beneficiary as follows:

$$\begin{array}{rclcl} \text{Excess contributions} & & \text{the total of all contributions} & & \\ \text{carried forward from} & + & \text{made for the year to ESAs} & - & \$2,000 \\ \text{prior years} & & \text{established for a given} & & \\ & & \text{beneficiary} & & \end{array}$$

Excess contributions are subject to a 6% annual excise tax to the extent the excess contribution and any earnings thereon are not timely distributed. Distributions of earnings on excess contributions are subject a 10% annual excise tax to the extent they are not timely distributed.

Distributions are considered timely if made prior to May 30th of the tax year following the tax year during which the contribution was made. The beneficiary must include earnings distributions in ordinary taxable income. Distributions of excess contributions and applicable earnings are not reported on IRS Form 8606.

Alternatively, excess contributions may be left in the account (carried over) and applied as a contribution for a later year. However, the 6% excise tax must be paid for each year that the excess contribution remains in the account and is not applied as a contribution by the end of the tax year.

The beneficiary reports the excess amount and the applicable excise taxes on IRS Form 5329.

Contributions & Control.

Any individual or entity, including corporations and tax-exempt organizations, and the ESA beneficiary may contribute to an ESA. However, contributions are permitted only until the beneficiary reaches age 18, unless the beneficiary is a special needs beneficiary.

Contributions must be made in cash. The contributor may direct the investment of contributions. However, ESA monies may never be invested in life insurance products. The contributor also determines the timing and amount of distributions until the beneficiary reaches the age of 30, or indefinitely for a special needs beneficiary.

Contribution & Distribution Coordination With Education Credits & 529s.

Contributions to an ESA do not reduce the amount an individual may contribute to a traditional or Roth IRA.

Contributions may be made to an ESA and a 529 Qualified Tuition Program in the same year for the same beneficiary. Additionally, contributions to a 529 are qualified education expenses and can be made tax-free from an ESA.

Hope or lifetime learning credits can be claimed in the same year you take a tax-free distribution from a Coverdell ESA, provided that the distribution from the ESA is not used for the same expenses for which the credit is claimed.

Distributions.

Distributions may be made at any time. Distributions are tax free to the beneficiary to the extent they

- do not exceed the qualified education expenses incurred on behalf of the beneficiary during the tax year of distribution, or
- are rolled to an ESA or 529 account for the benefit of
 1. the same beneficiary (if under the age of 30),
 2. a family member under the age of 30, or
 3. a family member who is a special needs beneficiary,within 60 days, and prior to the date of death of the original designated beneficiary, or
- are transferred, pursuant to a divorce or separation instrument, to an ESA for the benefit of a spouse or former spouse, who treats the ESA as their own.

All other distributions are subject to a 10% excise tax, unless the distribution is

- a timely distribution of excess contributions plus applicable earnings, as described in the section titled “Excess contributions,”
- a distribution paid to a beneficiary after the death of the designated beneficiary,
- made on account of the qualifying disability of the designated beneficiary. A beneficiary is considered disabled when they can show proof that they are no longer able to do any substantial gainful activity because of a physical or mental condition. A physician must determine that the beneficiary’s condition can be expected to result in death or be of long-continuing and indefinite duration, or
- made on account of scholarship, educational assistance allowance, or other educational assistance payment, which may be excluded for ordinary taxable income, received, provided the distribution amount does not exceed the amount of the scholarship, allowance, or payment received.

IRS Publication 970 provides the following calculation to determine the taxable portion of the distribution.

1. Multiply the amount withdrawn by a fraction. The numerator is the total contributions in the account. The denominator is the total balance in the account before the distribution.
2. Subtract the amount figured in (1) from the total amount distributed during the year. This is the amount of earnings included in the distribution.
3. Multiply the amount of earnings figured in (2) by a fraction. The numerator is the total qualified education expenses paid during the year. The denominator is the total amount distributed during the year.
4. Subtract the amount figured in (3) from the amount figured in (2). This is the amount of the beneficiary must include in income.

The beneficiary reports distributions on IRS Form 8606. The beneficiary reports the taxable amount of a distribution on IRS Form 1040 or 1040A.

Distributions of, and tax reporting relating to, excess contributions and associated earnings are discussed in the section titled “Excess Contributions.”

Rollovers.

The rollover of an ESA is a non-taxable event to the extent that the funds

- are rolled to an ESA or 529 account for the benefit of
 1. the same beneficiary (if under the age of 30),
 2. a family member under the age of 30, or
 3. a family member who is a special needs beneficiary,and prior to the date of death of the original designated beneficiary, or
- are rolled, pursuant to a divorce or separation instrument, to an ESA for the benefit of a spouse or former spouse, who treats the ESA as their own.

All rollover must take place within 60 days of the receipt of the initial distribution. Additionally, only one rollover transaction is permitted during any 12-month period with respect to the same beneficiary.

Eligible Educational Institution.

IRS Publication 970, “Tax Benefits for Higher Education,” defines an eligible educational institution includes any elementary, secondary, college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the Department of Education. It includes virtually all accredited, public, private, religious, nonprofit, and proprietary (publicly owned profit-making) educational institutions. Any educational institution will know if it is eligible. Additionally, the Department of Education publishes a list of eligible educational institutions on the Internet.

Qualified Education Expense.

Qualified education expenses include qualified expenses incurred while the beneficiary is in attendance or enrolled at an eligible educational institution. A complete list of these expenses can be found at Internal Revenue Code (IRC) Section 529(e)(3) and includes: tuition, fees, books, supplies, equipment, special needs services, contributions to a 529 plan, and room and board. Per IRS Publication 553, qualified education expenses for primary and secondary education also includes tutoring, uniforms, transportation, extended day programs, computer hardware, certain computer software and possibly Internet access.

Room and board expenses are only available if the beneficiary is at least a half-time student. The expense is limited

- for students living at home with parents, to an amount determined by the educational institution,

- for student residing in housing owned or operated by the school, to a standard allowance based on the amount most of the school's residents are normally charged for room and board, and
- for all other students, to the amount of expenses reasonably incurred by the student.

IRC Section 530(b) limits expenses for the purchase of any computer technology or equipment or Internet access and related services, if such technology, equipment, or services are to be used by the beneficiary and the beneficiary's family during any of the year the beneficiary is in school. This does not include expenses for computer software designed for sports, games, or hobbies unless it is predominately educational in nature.

Family Members.

The definition of family members includes a son, daughter, descendant of either a son or daughter, sister, brother, step-sister, step-brother, father, mother, ancestor of either a father or mother, nephew, niece, aunt, uncle, son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, sister-in-law, or the spouse of any of the foregoing.

Special Needs Beneficiary.

A special needs beneficiary is generally defined as an individual who due to a physical, mental, or emotional condition (including a learning disability) requires additional time to complete their education. An ESA may be established for a special needs beneficiary of any age. Contributions may be made to the ESA after the special needs beneficiary has reached their 18th birthday. Qualified educational expenses include expenses for special needs services that are incurred in connection with enrollment or attendance.