The Guide to Coverdell Education Savings Accounts

Advantages and Disadvantages

What's so great about the Coverdell education savings account?

Back when it was the Education IRA, not too much (despite the lure of tax-free income). In 2002, however, the re-named Coverdell education savings account became a very attractive college savings vehicle for many people, including families that wish to save for elementary and secondary school expenses. In fact, even if you like the 529 plan you may still decide to contribute the first $2,000 of savings for each child into a Coverdell account. There are some items to be aware of, however, such as the following:

There are certain eligibility requirements in the year you wish to contribute to the ESA, which means that not everyone will find them useful. For example, tax law prohibits ESA funding once the beneficiary reaches age 18.

In 2002, the contribution limit was increased from $500 per child to the much more reasonable level of $2,000. However, you need to be careful when accounts are established by different family members for the same child. If total contributions exceed $2,000 in a year, a penalty will be owed. The relatively low contribution limit means that even a small annual maintenance fee charged by the financial institution holding your ESA could significantly affect your overall investment return.
Your contribution goes into an account that will eventually be distributed to your child if not used for college. You cannot simply refund the account back to yourself like you can with most 529 plans. This means you lose some degree of control.

The ESA is on equal footing with the 529 plan when applying for federal financial aid. The account is considered an asset of the account custodian, typically the parent. Withdrawals are not reported as student or parent income as long as it is tax-free for federal income taxes.
Coordinating withdrawals with other tax benefits, especially the Hope or Lifetime Learning credits, can be tricky.

The account must be fully withdrawn by the time the beneficiary reaches age 30, or else it will be subject to tax and penalties.

Unless Congress acts, certain ESA benefits expire after 2010. K -12 expenses will no longer qualify, the annual contribution limit will be reduced to $500, and withdrawals will not be tax-free in any year in which a Hope credit or Lifetime credit or Lifetime Learning credit is claimed for the beneficiary.

So how does it work?

If you know how a Roth IRA works, then you have a pretty good idea of how a Coverdell education savings accounts works. They both allow you to make an annual non-deductible contribution to a specially designated investment trust account. Your account will grow free of federal income taxes, and if all goes well, withdrawals from the account will be completely tax-free as well. You will need to meet certain requirements in the years you wish to make the contributions, and in the years you take withdrawals. (More on these Coverdell education savings account requirements later.) However, a Coverdell education savings account is an investment vehicle targeted to education expenses, not to retirement.

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I'm not sure I understand that part. How can I be sure that I am getting the most tax benefit?

The new tax law says that beginning in 2002 your pool of "qualified expenses" for taking tax-free Coverdell education savings account withdrawals is reduced by the tuition you use to claim the Hope or Lifetime Learning credit. This means that some portion of the Coverdell education savings account withdrawal can become taxable. The good news is that you get to choose the approach that provides you the most benefit. The bad news is that your taxes are complicated by the need to figure out which way is best. Tax-free Coverdell withdrawals can also reduce the amount that you might otherwise be able to claim as an above-the-line deduction under a new provision effective for years 2002 through 2005.

Establishing the Coverdell education savings account and determining contribution amounts

How do I establish a Coverdell education savings account?

The first thing to do is determine if you are eligible to contribute to a Coverdell education savings account. The beneficiary of the account must be under the age of 18 at the time of the contribution. There is no requirement that the beneficiary be your child or have any other particular relationship.

Also, your income must be below a certain level in the year of your contribution. Contributors must have less than $190,000 in modified adjusted gross income ($95,000 for single filers) in order to qualify for a full $2,000 contribution. The $2,000 maximum is gradually phased out if your modified adjusted gross income falls between $190,000 and $220,000 ($95,000 and $110,000 for single filers).

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Starting in 2002, you can begin contributing to both a 529 plan and a Coverdell account for the same beneficiary if you wish. This was not permitted in past years.

The next step is to decide where to establish the Coverdell education savings account. Any bank, mutual fund company, or other financial institution that can serve as custodian of traditional IRAs is capable of serving as custodian of a Coverdell education savings account. Your cash contribution can be invested in any qualifying investments available through the sponsoring institution—stocks, bonds, mutual funds, certificates of deposit, etc (but not life insurance). There is no limit to the number of Coverdell education savings accounts that you can establish for any one child (as long as the total contributions stay within the $2,000 limit), but you will probably find that annual fees and sponsor-imposed minimums make multiple Coverdell education savings accounts impractical in most situations.

You will then need to complete the Coverdell education savings account enrollment forms from the sponsor, including the designation of a beneficiary and a "responsible individual", and make the contribution.

Our income is above the allowable limit. Can our child make the contribution?

Yes, there is no problem with having your child, who has income below the allowable limit, make the Coverdell education savings account contribution. You would simply gift the money to the child first. There is no requirement that the contributor have earned income as there is for traditional and Roth IRAs.

Do we have until April 15 of the next year to make the $2,000 contribution, like we do with our traditional IRA?

Starting with the contribution year 2002 the law allows you to make your contribution after the end of the year and apply it to the prior year limit as long as it is made before the April 15 tax filing deadline. This rule did not apply for 2001 when the contribution limit was $500.

The $2,000 annual contribution limit doesn't seem high enough. Can we have different family members each set up an account and contribute $2,000?

The answer, unfortunately, is no. Besides the $2,000 annual limit on how much you can contribute for a particular child, there is also an overall $2,000 annual limit on contributions to Coverdell education savings account for the benefit of that particular child. If multiple accounts are established, and more than $2,000 is contributed in total, the excess is subject to a 6% excise tax penalty. You can eliminate the penalty by withdrawing the excess contributions (and earnings on the excess, taxable to the beneficiary in the year the contribution was made) before the due date of the beneficiary's tax return for that year. If you do not do this, the excess contribution will be subject to penalties in subsequent years unless withdrawn or "absorbed" by unused annual contribution allowances.

Can a corporation, partnership or other non-living entity make the contribution to a Coverdell education savings account?

The tax law does not restrict the ability to make contributions to living individuals. The new tax law makes it clear that corporations and other entities may make contributions without regard for the usual donor income limit.

If anyone can establish a Coverdell education savings account for my child, how will we know if more than the $2,000 limit has been contributed?
You will most likely be able to find this out after the end of the year when the institutions sponsoring the Coverdell education savings accounts mail out Contribution Information on Form 5498 to your child at the end of the year. If you see that more than $2,000 has been contributed for your child, you know you have a problem.

If my child's grandparent contributes $2,000 to my child's Coverdell education savings account but should not have contributed anything because the grandparent's income was too high, who pays the excise tax?

Since the Form 5329 is filed with your child's tax return, it looks like your child is ultimately responsible for the penalty. How would you or your child know whether the grandparent is eligible to contribute $2,000? That is a mystery to us, too.

Control of the account

I know that with a 529 plan I keep complete control of the account as the account owner and I can even ask that the account value be refunded to me. Does it work the same way with a Coverdell education savings account?

No, with a Coverdell education savings account the trustee or custodian must administer the account for the benefit of the child. Any withdrawals from the Coverdell education savings account are paid to the beneficiary, and are not refunded to the parent or other person who establishes the account. Because the beneficiary of the Coverdell education savings account is a minor at the time contributions are made, an adult is named as the "responsible individual" when the Coverdell education savings account is first established. The responsible individual is generally the parent or guardian of the beneficiary. The institution where you establish the Coverdell education savings account will have policies determining the decision-making authority for the account. As the responsible individual, you may be able to retain that authority for as long as the account is open (it must be distributed within 30 days after the beneficiary reaches age 30). Or you may be allowed to transfer that authority to the child once he or she reaches the age of majority.

Let's say I wish to establish a Coverdell education savings account for my grandchild. Does all this mean that I am not able to change the beneficiary or ask for a refund of the account in the future?

That is correct. You can name either the parent or guardian of your grandchild as responsible individual, but you are probably not going to be able to name yourself. If you prefer that the parent/guardian not have the ability to change beneficiaries after you establish the account (you want the account to remain with your named beneficiary no matter what happens in the future) you should look to restrict the responsible individual's powers on the account agreement.
In any event, you as grandparent (or uncle, aunt, neighbor, etc.) do not have the same ability to retain control that a 529 plan generally affords. This may play a part in your decision as to which vehicle to use.

Income tax rules

Are my contributions to a Coverdell education savings account made with pre-tax or after-tax dollars?

Your contributions are made with after-tax dollars, as you are not able to take an income tax deduction for your contributions. This means that any portion of future withdrawals that represent your contributions will come out tax-free even if the earnings portion is taxable.

How are withdrawals taxed?

Your child can receive tax-free withdrawals in any year to the extent that he or she incurs qualified higher education expenses (QHEE). If your child withdraws more than the amount of QHEE, then the earnings portion of that excess is subject to income tax and an additional 10% penalty tax. If you also take withdrawals from a 529 plan in the same year for the same student, you will need to allocate the available QHEE between the accounts.

Beginning in 2002, you will also be permitted to take tax-free withdrawals from a Coverdell account to pay for certain elementary and secondary school expenses. This includes tuition, fees, tutoring, books, supplies, and equipment incurred in connection with school (grades K through 12). It also includes any room and board, uniforms, transportation, and supplementary items which are required or provided by the school. Finally, it includes expenses for the purchase of computer technology or equipment, or Internet access, used by the beneficiary and family during the years the beneficiary is in school.

What are qualified higher education expenses?

These are certain expenses required for your child's enrollment or attendance at an eligible educational institution: tuition, fees, books, supplies and equipment. It also includes a limited amount of room and board if your child is at least a half-time student.
Qualified higher education expenses must be reduced by any other tax-free benefits received, such as scholarships and benefits under a qualifying employer-provided educational assistance program.

What is an eligible educational institution?

This is any college, university, vocational school, or other postsecondary educational institution eligible to participate in student aid programs administered by the Department of Education. For a list of institutions that have a federal school code, and thus qualify under this definition, go to http://www.ed.gov/offices/OSFAP/Students/apply/search.html.

How do we report the withdrawals from the Coverdell education savings account for tax purposes?

In any year in which a withdrawal is taken from the Coverdell education savings account (assuming it is not the correction of an excess contribution), your child will need to file Form 8606 with his or her federal tax return. You use this form (along with a worksheet in the instructions) to compute your taxable amount, in the event your child did not incur a sufficient amount of qualified education expenses.

If income is reportable because insufficient qualified education expenses were incurred, then your child is probably also subject to the additional 10% penalty tax. Form 5329 must be filed to compute this tax.

How long does the beneficiary have to use the account?

The Coverdell education savings account must be fully withdrawn by the time the beneficiary reaches age 30. If it is not, the remaining amount will be paid out within 30 days subject to tax on the earnings and the additional 10% penalty tax.

What are the exceptions to the additional 10% penalty tax?

The additional 10% tax will not apply to withdrawals made due to the beneficiary's death or disability, or to the extent that the beneficiary receives a tax-free scholarship. Also, it will not apply if the withdrawal is taxable only because the beneficiary elects to waive the exclusion (2001 and prior), nor will it apply to a withdrawal that is a return of an excess contribution.

This all sounds like a lot of work and extra complication on our tax returns. How bad is it?

The IRS reports that the average amount of time relating to Form 8606, including recordkeeping, learning about the law or the form, preparing the form, and copying, assembling, and sending it to the IRS, is approximately six and one-half hours. Form 5329 (if needed) is an extra five hours.

Estate and gift tax rules

How is my contribution to a Coverdell education savings account treated for gift tax purposes?

Your contribution is treated as a gift from you to the beneficiary. It qualifies for the annual $11,000 (in 2002) gift tax exclusion. Be sure to keep this in mind in 2002 if you also contribute to a 529 plan for the same child. You will need to add these contributions together in determining your gift tax filings.

What happens if the beneficiary dies?

Usually the account value will be paid to the beneficiary's estate and income tax will be paid on the earnings portion of the distribution. As an alternative, the account beneficiary can be changed to a surviving spouse or other eligible family member without triggering income tax. The value of the account will presumably still be in the estate of the deceased beneficiary, although it may not be "stepped-up" in basis for income tax purposes.

Is there a gift tax consequence if I change the beneficiary on an existing Coverdell education savings account?

There could be. Although the IRS has not yet issued any regulations, the tax law says that the gift rules should be similar to those for 529 plans. This means that a deemed gift will occur from the old beneficiary to the new beneficiary, but only if the new beneficiary is at least one generation below the old beneficiary.

NOTE: This summary of information was taken from www.SavingForCollege.com. Please consult the website for more specific information.