

**CESAs**

**Coverdell  
Education  
Savings  
Accounts**

**Questions & Answers**

## **What is a Coverdell Education Savings Account?**

A Coverdell Education Savings Account is a type of tax-preferred savings and investment account authorized by Internal Revenue Code Section 530 to encourage taxpayers to save for future education expenses. Coverdell Education Savings Accounts first became available as of January 1, 1998, for the 1998 calendar year, as a result of the Taxpayer Relief Act of 1997. The annual contribution limit for contributions during the period of 1998-2001 was \$500 per designated beneficiary. Since 2002 the contribution limit has been \$2,000 per designated beneficiary.

## **Who generally establishes Coverdell Education Savings Accounts?**

Grandparents and parents generally are the individuals who establish Coverdell Education Savings Accounts. However, there is no legal requirement that a person must be a relative of the person for whom they wish to contribute funds to a Coverdell Education Savings Account.

The new tax law authorizes entities other than individuals to make contributions to a child's Coverdell Education Savings Account. For example, a nonprofit entity such as a church or foundation could make a contribution to a Coverdell Education Savings Account for a child.

## **What is the purpose for Coverdell Education Savings Accounts?**

A Coverdell Education Savings Account exists to allow a person to save money so that it may be used to pay certain education expenses on a tax-preferred basis. The Coverdell Education Savings Account may be used to pay for elementary and secondary education (kindergarten through grade 12) expenses incurred in a public, private or religious schools, as well as for college, technical school, or post-graduate work.

## **What important change has occurred?**

On January 2, 2013, President Obama signed into law the American Taxpayer Relief Act of 2012. It made permanent for 2012 and subsequent years the temporary law changes applying for 2002-2011. These laws are now permanent, subject to being changed by new tax legislation.

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## THE PARTIES

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### Who are the parties involved with a Coverdell Education Savings Account?

There are normally four parties: a financial institution acting as the custodian, a depositor, a responsible individual, and a designated beneficiary.

The custodian is a financial institution which has agreed to serve as the custodian of the Coverdell Education Savings Account. The custodian must be a bank, savings and loan, credit union, or any other party who has IRS approval to serve as the custodian. The custodian will invest the contributions and process distributions.

The designated beneficiary is the individual on whose behalf the Coverdell Education Savings Account is established. Normally the individual will be under the age of 18 or he or she will be an individual with special needs.

The depositor is the individual who establishes the Coverdell Education Savings Account and makes the first contribution and instructs how the first contribution is to be invested. Subsequent contributions may also be made by this individual and other individuals. Generally, the depositor is a parent or a grandparent of the designated beneficiary. The designated beneficiary may also make contributions.

The responsible individual is the person who directs and redirects their custodian with respect to investing the contributions, withdrawing funds, and changing the designated beneficiary. There are also other tasks or duties. The responsible individual is generally to act on behalf of the designated beneficiary and/or other family members

The responsible individual is a parent or guardian of the designated beneficiary unless the plan agreement would provide otherwise. There may only be one responsible individual. Generally, when the designated beneficiary attains the age of majority under state law, he or she also becomes the responsible individual. However, it is possible to set up the Coverdell Education Savings Account or amend it so that the designated beneficiary will not become the responsible individual when he or she attains the age of majority. In many states this is age 18. In addition, it is possible to set up the Coverdell Education Savings account so that a grandparent will be the responsible individual. A special amendment would generally be needed.

The specific Coverdell Education Savings Account must be reviewed to determine the specific rights and duties of the depositor, the responsible individual and the designated beneficiary.

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## THE CONTRIBUTION RULES

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### **Am I eligible to contribute to a Coverdell Education Savings Account?**

You are eligible to contribute to one or more Coverdell Education Savings Accounts as long as your income is within certain limits depending upon your tax-filing status, and the designated beneficiary of each Coverdell Education Savings Account has not attained age 18.

### **Can I make a contribution to a traditional IRA or Roth IRA and a Coverdell Education Savings Account in the same year?**

Yes. There are separate contribution limits for a traditional IRA or Roth IRA and a Coverdell Education Savings Account. These limits are independent of each other.

### **How much can I contribute to a Coverdell Education Savings Account?**

In general, you are allowed to contribute up to \$2,000 per year per beneficiary. This \$2,000 limit is a per-beneficiary limit and not per-contributor. You are eligible to make separate contributions for different beneficiaries. For example, if you have five children, you could fund or contribute \$2,000 to five separate Coverdell Education Savings Accounts, for a total of \$10,000. You are not, however, permitted to contribute \$2,000 if your contribution, when added to contributions which others have made for the same beneficiary, would exceed \$2,000.

The \$2,000 contribution limit is decreased and phased out if your modified adjusted gross income (AGI) exceeds certain limits. For any contributor who is not a married person filing a joint return, the phaseout occurs when your modified AGI is between \$95,000 - \$110,000. For a married person who files a joint return, the phaseout occurs when your modified AGI is between \$190,000 - \$220,000. If your modified AGI exceeds \$110,000 (if no joint return) or \$220,000 (if a joint return), then you are not eligible to make contributions to a Coverdell Education Savings Account on behalf of any beneficiary.

### **Must the designated beneficiary be under age 18 when the contribution is made?**

Yes, unless the designated beneficiary is a special needs individual.

**The following chart and example illustrates the contribution rules:**

| Contribution Chart For<br>Coverdell Education Savings Accounts  |  |
|---|--|
| Amount of AGI and Filing Status   |  |
| <u>All Contributors other than "Married Filing Jointly"</u>   |  |
| Below \$95,000  | Entitled to full contribution amount of \$2,000*                 |
| \$95,000-\$109,999  | Entitled to prorated contribution amount – use special formula** |
| \$110,000 or over   | No contribution permissible                                      |
| *Your contribution and the contribution of any other contributor for the same beneficiary, when added together, cannot exceed \$2,000   |  |
| **Explanation of special formula. Multiply the permissible contribution by the following ratio: amount of adjusted gross income in excess of \$95,000/\$15,000. This will give you a ratio that determines the amount you cannot contribute.  |  |
| <u>Married Filing Jointly</u>   |  |
| Below \$190,000   | Entitled to full contribution amount of \$2,000*                 |
| \$190,000-219,999   | Entitled to prorated contribution amount – use special formula** |
| \$220,000 or over   | No contribution permissible.                                     |
| *Your contribution and the contribution of any other contributor for the same beneficiary, when added together, cannot exceed \$2,000.  |  |
| **Explanation of special formula. Multiply the permissible contribution by the following ratio: amount of adjusted gross income in excess of \$190,000/\$10,000. This will give you a ratio that determines the amount you cannot contribute. |  |

**When do I have to establish and fund the Coverdell Education Savings Account?**

You have until the due date (without extensions) for filing your federal income tax return, normally April 15, to establish and fund the Coverdell Education Savings Account for the previous tax year.

**Must I make a contribution to a designated beneficiary's Coverdell Education Savings Accounts each year?**

No. You may vary your contributions as you wish.

**What special rules will apply to a designated beneficiary who is a special needs individual?**

First, contributions are permissible even though this individual has attained age 18. For example, a contribution may still be made at age 38 for a special needs individual.

Second, a distribution to the individual is not mandatory at age 30 for an individual with special needs.

### **What if I or someone else makes an impermissible contribution to the Coverdell Education Savings Account?**

It will be an excess contribution. The designated beneficiary must pay a 6% excise tax each year on excess contributions that are in the Coverdell Education Savings Account at the end of the year.

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## **THE TAX BENEFIT**

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The income earned by or within Coverdell Education Savings Accounts will not be taxable when distributed if withdrawn to pay qualified education expenses for qualified elementary, secondary, or post-secondary education expenses.

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## **THE DISTRIBUTION RULES**

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### **When may the responsible individual start to withdraw money or assets from the Coverdell Education Savings Account?**

The responsible individual may begin withdrawals at any time. However, he or she will want to understand the income tax consequences of taking distributions at certain times.

### **What distributions from a Coverdell Education Savings Account will not be taxed at all?**

If money is withdrawn from the Coverdell Education Savings Accounts and used to pay qualifying education expenses, the designated beneficiary will not be required to pay income tax on the amount withdrawn. Another way to make this statement is: distributions from a Coverdell Education Savings Account will be excluded from income tax (i.e. not subject to tax) to the extent that the distributions do not exceed the qualified education expenses incurred by the beneficiary of the account in the year of the distribution.

The amount of educational expenses for which a distribution from a Coverdell Education Savings Account can be used and not be subject to the tax must be reduced by the amount of any qualified scholarship, educational assistance allowance, or payment that is excludable from the beneficiary's gross income.

## **What distributions from a Coverdell Education Savings Account will be partially taxable?**

A distribution is composed of both contributions and earnings. A portion of the earnings will be taxable if either the distribution is not used for qualifying educational purposes, or if such amount is more than the total amount of incurred higher education expenses. The law mandates the use of a pro rata allocation formula.

A distribution of earnings which either exceeds the amount of qualified education expenses or which is not used for qualified education expenses will be taxable.

## **Why will distributions from a Coverdell Education Savings Account only be partially taxable?**

You did not receive any tax deduction with respect to your contribution to your Coverdell Education Savings Accounts, so it would not be fair to tax this amount. The amount of the contributions as reduced by any previous withdrawal of contributions, if any, is called the "basis," and the designated beneficiary will not owe tax on the basis when it is returned.

## **Is there an additional tax of 10% for distributions not used for education expenses?**

Yes. If a distribution is not used for education expenses (and none of the exceptions apply at the time funds are withdrawn from the account, i.e. death, disability, receipt of scholarship, or removal of an excess contribution) then the designated beneficiary will be liable to pay the 10% excise tax on that portion of the distribution that is taxable. The 10% excise tax will not be owed on the portion of the distribution that consists of the basis or contributions to the account.

## **How is the term "qualified education expenses" defined?**

Qualified education expenses include tuition, fees, books, supplies, and equipment required for enrollment or attendance at an eligible educational institution. Distributions used for these expenses will be excluded from income tax, regardless of whether or not the beneficiary is a full-time, half-time, or less than half-time student. Distributions will also be excludable for students who are carrying at least one-half of the normal full-time course load, when used for

the reasonable expense amounts incurred for room and board. Reasonable expense amounts for room and board are determined by the institution in calculating costs of attendance for federal financial aid programs. Qualified education expenses also include any purchase of tuition credits or any amount contributed to a state tuition program for the beneficiary.

In addition, the term “qualified education expenses” includes the following:

1. expenses for tuition, fees, academic tutoring, books, supplies and other equipment incurred on account of enrollment at or attendance in an elementary or secondary school;
2. expenses for special needs services in the case of a special needs person;
3. expenses for room and board, uniforms, transportation and supplementary items (including extended day programs) which are provided or required by the school;
4. expenses for the purchase of any computer equipment or technology, including internet access and services as long as used during any of the years the beneficiary is in school. However, any software must be predominantly educational in nature.

### **How is a Coverdell Education Savings Account coordinated with the Hope Credit, the Lifetime Learning Credit, and a qualified state tuition program?**

If funds are withdrawn from a Coverdell Education Savings Account and a state qualified tuition program, and such amounts EXCEED the beneficiary's qualified higher education expenses for the year (after reduction for any claimed HOPE or lifetime learning credits), then the beneficiary is required to allocate the expenses between the two types to determine the amount includible in income.

### **Can a distribution from a Coverdell Education Savings Account be rolled over to another Coverdell Education Savings Account?**

Yes. A distribution from a Coverdell Education Savings Account will not be taxable if it is paid to “another” Coverdell Education Savings Account either for the same beneficiary or a member of his or her family. If rolled over to a family member, that person must be under 30 years of age. The recontribution must occur within 60 days after the

day it is received. A distribution from a Coverdell Education Savings Account is eligible to be rolled over only if no prior distribution had been rolled over within the preceding twelve months as calculated from the date of this distribution.

### **Who is considered “family” of the beneficiary?**

Family members of the designated beneficiary include the spouse of the designated beneficiary. Family members also include a child, grandchild, stepchild, brother, sister, half brother, half sister, stepbrother, stepsister, father, mother, stepfather, stepmother, grandfather, grandmother, niece or nephew, son-in-law, daughter-in-law, uncle or aunt, father-in-law, mother-in-law, brother-in-law, or sister-in-law of the designated beneficiary, and the spouse of any such individual. In addition, a first cousin of the designated beneficiary is also a family member.

### **What are the requirements and the tax consequences when the beneficiary dies?**

A beneficiary can be designated to receive the Coverdell Education Savings Account upon the death of the designated beneficiary. If the inheriting beneficiary is the spouse or a family member of the designated beneficiary, upon the death of designated beneficiary, the Coverdell Education Savings Account automatically becomes the Coverdell Education Savings Account of that inheriting beneficiary. This transfer will not be subject to income tax. If, however, this inheriting beneficiary is over age 30 at the time of death, the funds will then have to be distributed to them within 30 days, and the earnings portion will be taxable income in the year received. If the inheriting beneficiary is not a family member of the designated beneficiary, the funds must be distributed to that person within 30 days of the date of death, and the earnings portion will be included in the income of the inheriting beneficiary in the year received. If there is no beneficiary named, the rule is that the balance in the Coverdell Education Savings Account must be distributed to the estate of the designated beneficiary within 30 days of the date of the designated beneficiary's death. The earnings portion of the distributed amount will be included in the income of the deceased beneficiary on his or her final income tax return, and is includible in the estate of the designated beneficiary for estate tax purposes.

## **Do the special taxes for prohibited transactions, unrelated business income, and excess contributions apply to a Coverdell Education Savings Account?**

Yes. These special tax rules do apply to Coverdell Education Savings Accounts.

## **Must a Coverdell Education Savings Account be terminated when the beneficiary attains age 30?**

Yes. The earnings portion of such account will need to be included in income, and the 10% additional tax will apply because the distribution was not used for qualifying education expenses. Such taxation may be avoided if a qualifying rollover to a family member takes place prior to age 30. This requirement does not apply to a designated beneficiary with special needs.

## **What are the tax consequences if the beneficiary is involved in a divorce?**

If a court orders that the beneficiary of a Coverdell Education Savings Account transfer this account partially or totally to the other spouse, then it becomes the Coverdell Education Savings Account of that spouse. This transfer is not taxable.

## **Can there be a change in the beneficiary of a Coverdell Education Savings Account?**

Yes. The statute provides that any change in the beneficiary of a Coverdell Education Savings Account shall not be considered a taxable distribution as long as the new beneficiary is a member of the previous beneficiary's family and is under 30 years of age. The Coverdell Education Savings Account plan agreement controls who has the right to make any such change.

## **How do I establish a Coverdell Education Savings Account?**

Just come in and talk with us or give us a call.