
Coverdell Education Savings Accounts Opportunities

(Formerly known as Education IRAs)

Questions & Answers

What is the purpose of this brochure?

On July 27, 2001, President Bush signed legislation which changed the name of Education IRAs to be "Coverdell Education Savings Accounts." The reason for the name change was to honor the late Senator Paul Coverdell who had been a very strong proponent for special "Education" accounts. In June of 2001, President Bush signed into law the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). The changes within EGTRRA with respect to Coverdell Education Savings Accounts were very substantial. You will want to understand these changes so you can decide if, how and when you will take advantage of these Coverdell Education Savings Accounts law changes for your children or grandchildren. We are ready to assist you with establishing or expanding your use of Coverdell Education Savings Accounts.

Who generally establishes a Coverdell Education Savings Account?

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 Coverdell Education Savings Account funds.

The new tax law authorizes some 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 can be confusing about Coverdell Education Savings Accounts versus a traditional or Roth IRA?

A Coverdell Education Savings Account is, in most cases, established by a grandparent or parent on behalf of a child. For whatever reason, Congress chose to use the word "designated beneficiary" to describe the child (i.e. the person for whom the contribution is made). In contrast, with respect to a traditional or Roth IRA, the person who establishes and funds the IRA is the individual himself or herself and is called the "account-holder."

What are the purposes of Coverdell Education Savings Accounts?

Prior to EGTRRA, the defined purpose of a Coverdell Education Savings Account was to accumulate funds to be used to pay for college, technical school, or postgraduate work. After EGTRRA, the Coverdell Education Savings Account will be able to 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 postgraduate work.

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 if the designated beneficiary of the Coverdell Education Savings Account has not attained age 18.

Coverdell Education Savings Accounts Contribution Chart

Amount of AGI and Filing Status

All Contributors other than "Married Filing Jointly"

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

*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.

Married Filing Jointly

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.

*Explanation of special formula. Multiply the permissible contribution by the following ratio: amount of adjusted gross income in excess of \$190,000/\$30,000. This will give you a ratio that determines the amount you cannot contribute.

What is the contribution deadline for Coverdell Education Savings Accounts?

It is now April 15 of the following year, without regard to any tax extension.

What is the basic tax benefit realized with a Coverdell Education Savings Account?

The income earned by or within the Coverdell Education Savings Account will not be taxable when distributed if withdrawn to pay qualified education expenses. Under pre-EGTRRA law, the income earned by a Coverdell Education Savings Account was not taxable if it was used to pay qualified higher education expenses. Under EGTRRA, this income is not taxable if it is used to pay qualified education expenses for qualified elementary, secondary, or post-secondary education expenses.

What is the contribution limit?

The contribution limit is \$2,000 per child per year. Prior to EGTRRA, it was \$500 per child per year. Your contribution and the contribution of any other contributor for the same designated beneficiary, when added together, cannot exceed \$2,000.

What impact does this additional annual contribution of \$1,500 have on the amounts which will be accumulated to pay education expenses?

There is a great impact. Two examples illustrate the difference in the accumulated funds.

Example #1. Luke and Mary Adams are blessed with the birth of their son, Phil, on January 3, 2005. Luke establishes a Coverdell Education Savings Account for their son the next day, and annually contributes \$2,000 in January of each year. He makes sure he makes the 19th contribution on January 2, 2023 (i.e. on or before Phil's 18th birthday). The following table illustrates the substantial increase in the amounts accumulated because of the increase in the annual contribution limit to \$2,000 from \$500. For purposes of this table, an earnings rate of 5% is assumed.

Year	\$500 Contribution	\$2,000 Contribution
2005	\$525.00	\$2,100.00
2006	\$1,076.25	\$4,305.00
2007	\$1,655.06	\$6,620.25
2008	\$2,262.81	\$9,051.26
2009	\$2,900.00	\$11,603.82

2010	\$3,571.00	\$14,284.01
2011	\$4,274.55	\$17,098.21
2012	\$5,013.28	\$20,053.12
2013	\$5,788.94	\$23,155.78
2014	\$6,603.39	\$26,413.57
2015	\$7,458.56	\$29,834.25
2016	\$8,356.49	\$33,425.96
2017	\$9,299.31	\$37,197.26
2018	\$10,289.28	\$41,157.12
2019	\$11,328.74	\$45,314.98
2020	\$12,420.18	\$49,680.73
2021	\$13,566.19	\$54,264.77
2022	\$14,769.50	\$59,078.01
2023	\$16,032.98	\$64,131.91

Example #2. Lynn and Jim Bolt are blessed with the birth of triplets (Cheryl, Pam, and Nancy) on January 3, 2005. Jim establishes a Coverdell Education Savings Account for each of them the next day, and annually contributes \$2,000 in January of each year. He makes sure he makes the 19th contribution on January 3, 2023 (i.e. on the triplets' 18th birthday). The following table illustrates the substantial increase in the amounts accumulated because of the increase in the annual contribution limit to \$2,000 from \$500. For purposes of this table, an earnings rate of 5% is assumed.

Year	3 contributions of \$500	3 contributions of \$2,000
2005	\$1,575.00	\$6,300.00
2006	\$3,228.75	\$12,915.00
2007	\$4,965.19	\$19,860.75
2008	\$6,788.45	\$27,153.79
2009	\$8,702.87	\$34,811.48
2010	\$10,713.01	\$42,852.05
2011	\$12,823.66	\$51,294.65
2012	\$15,039.84	\$60,159.38
2013	\$17,366.83	\$69,467.35
2014	\$19,810.17	\$79,240.72
2015	\$22,375.68	\$89,502.76
2016	\$25,069.46	\$100,277.90
2017	\$27,897.93	\$111,591.80
2018	\$30,867.83	\$123,471.39
2019	\$33,986.22	\$135,944.96
2020	\$37,260.53	\$149,042.21
2021	\$40,698.56	\$162,794.32
2022	\$44,308.49	\$177,234.04
2023	\$48,098.91	\$192,395.74

Is it permissible to contribute to a Coverdell ESA and a qualified state tuition program?

Yes. However, a person will not be able to receive a double tax benefit.

How will Coverdell Education Savings Accounts be coordinated with the Hope Credit, the Lifetime Learning Credit, and a qualified state tuition program?

Under the rules in effect for 1998-2001, if there was a distribution from a Coverdell Education Savings Account of which the income was not to be taxed (i.e. it was to be excluded), then neither the HOPE credit nor the Lifetime Learning credit could be claimed for the same tax year unless there would have been an express waiver of the exclusion rule. After 2001, this will no longer be the rule as long as the distribution from the Coverdell Education Savings Account (contribution and earnings portions) is not used for the same educational expenses for which a credit is claimed.

Under the rules in effect for 1998-2001, a six-percent (6%) excise tax was imposed if a contribution was made to a state qualified education program on behalf of a child and there also was a contribution to a Coverdell Education Savings Account for this child. The imposition of the 6% excise tax has been repealed. In order to prevent a double tax benefit, 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.

After EGTRRA, will funds in existing Coverdell Education Savings Accounts be able to be used to pay for elementary and secondary school expenses?

Yes. Even though the funds were originally intended to be used to pay for a child's college costs, these funds may now be used to pay for elementary and secondary school expenses. For example, in 1998, Char originally established a Coverdell Education Savings Account for her son, Fred, age 5, with the intent to pay for some of his college expenses. In 2005, Fred will benefit by receiving some special tutoring. Funds withdrawn from the Coverdell Education Savings Account for this purpose will be a qualified education expense and will not be taxed.

What is the new definition of qualified education expenses?

It is the original definition of qualified higher education expenses, with the addition of the new qualified elementary and secondary education expenses which are defined as follows:

- (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.

Has there been a change in what room and board expenses will qualify as a qualified higher education expense?

Yes. Prior to EGTRRA, the room and board expenses were subject to the following amount:

- (1) \$1,500 per academic year for a student living at home;
- (2) the college's normal room and board charge for a student living in housing owned and/or operated by the school; and
- (3) \$2,500 per academic year for all other students.

The maximum room and board allowance is now the greater of:

- (1) the actual amount charged the student by the school for room and board, or
- (2) the amount applicable to the student in calculating costs of attendance for Federal financial aid purposes as determined by the school.

Have the rules allowing a child's Coverdell Education Savings Account to be rolled over tax free to a Coverdell Education Savings Account established for a family member been expanded?

Yes. If funds have been accumulated in a Coverdell Education Savings Account for one child, but then are

not used for such child, the funds may be rolled over to the Coverdell Education Savings Account of another family member of the original designated 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, step-sister, 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. For 2002 and subsequent years, family members also include any first cousin of such beneficiary.

Will Coverdell Education Savings Accounts have a different deadline for correcting excess contributions than a traditional IRA or a Roth IRA?

Yes. The deadline used to be April 15, (including any extensions). Under EGTRRA, an excess contribution must be corrected before the first day of the sixth month of the taxable year following the applicable tax year. Normally, the deadline will be May 31 of the following year. The related income must also be returned. This income is taxable for the tax year in which the excess contribution was made.

Are there new special rules for individuals with special needs?

Yes. There are two special rules. A special needs individual is a person who needs additional time to complete his or her education on account of a physical, mental, or emotional condition, including a learning disability.

The first rule is that a contribution may not be made once an individual is older than age 18. After EGTRRA, contributions may continue to be made past the age of 18 for an individual who has special needs. The second rule is that it is mandatory that the account's funds be distributed to the beneficiary when the beneficiary reaches the age of 30. Such a distribution will no longer be required if the individual has special needs.