

Coverdell education savings accounts

One way to save for a child's (or grandchild's) education—through a Coverdell education savings accounts, also known as a Coverdell ESA or CESA (and formerly known as an “education IRA”). Although for federal tax purposes there is no upfront deduction for contributions made to a Coverdell ESA, the earnings on the contributions build tax-free. Moreover, there is no tax when the funds in the account are distributed, to the extent the amounts distributed don't exceed the child's qualified education expenses such as tuition, fees, books and room. A Coverdell ESA can be used to pay elementary and secondary, as well as higher education expenses.

The aggregate contributions that can be made to any one child's Coverdell ESA is limited to \$2,000 per year—from all contributors for all Coverdell ESAs for the same child. The maximum dollar amount that any individual can contribute is phased out (reduced) if the contributor's adjusted gross income (with certain modifications) exceeds \$95,000 (exceeds \$190,000 in the case of joint return filers). However, this phase out is easily avoided. A child can contribute to his or her own Coverdell ESA, so a parent or other person whose contribution may be limited by the phase out rule can give the money to a Coverdell ESA as custodian for the child. Under those circumstances, the child is considered to be the contributor and if the child's adjusted gross income is below \$95,000, the phase out won't apply. (Corporations and other entities can also make contributions to Coverdell ESAs, regardless of the corporation's or entity's income.)

Contributions that exceed \$2,000 in total for any child for a year are subject to a 6% penalty tax until the excess (plus earnings on it) are withdrawn.

Contributions to a child's Coverdell ESA can be made until the child reaches age 18 (but this age limitation doesn't apply to a beneficiary with special needs, defined as an individual who because of a physical, mental or emotional condition—including learning disability—requires additional time to complete his or her education). The beneficiary needn't be your own child.

Distributions or withdrawals from a Coverdell ESA during a year that exceed the child's qualified education expenses for that year are includible in the child's income (to the extent of the earnings portion of the distribution) and are also subject to an additional 10% tax.

A Coverdell ESA must be a trust or custodial account, designated as a Coverdell ESA and set up for the purpose of paying qualified education expenses. The Coverdell ESA trustee or custodian generally must be a bank. A Coverdell ESA trust can be set up so that the grantor, or a parent or guardian of the designated beneficiary, has the power to direct the investment of amounts in the Coverdell ESA.

Please note that a taxpayer will be allowed to claim a Hope or a Lifetime Learning credit for a tax year and exclude from gross income amounts distributed (both the principal and the earnings portions) from a Coverdell ESA for the same student, as long as the distribution isn't used for the same educational expenses for which a credit was claimed.

Please note also that a taxpayer may not claim the deduction for higher education expenses allowed through 2007 for amounts taken into account in determining the amount excludable from gross income due to a distribution from a Coverdell ESA.

Tax-free transfers or rollovers of account balances from one Coverdell ESA benefiting one beneficiary to another account benefiting another beneficiary (as well as re-designations of the named beneficiary) are allowed, if the new beneficiary hasn't reached 30, and is a member of the family of the old beneficiary (age limit doesn't apply to a beneficiary with special needs).