

## COVERDELL EDUCATION SAVINGS ACCOUNTS

One way to save for a child's education is through a Coverdell education savings account, also known as a Coverdell ESA (and formerly known as an "education IRA").

- # 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 the grantor, or a parent or guardian of the designated beneficiary, has the power to direct the investment of amounts in the Coverdell ESA.
- # Although there is no up-front deduction for contributions made to a Coverdell ESA, the earnings on contributions build up tax-free. Further, the earnings portion of distributions from a Coverdell ESA is not subject to federal income tax to the extent that the amounts distributed are used to pay for the child's qualified higher education expenses such as tuition, fees, books and room and board-if the year's education expenses at least equal the total amount of the distribution. If not, a 10% penalty is imposed on any taxable portion of the distribution. Beginning in 2002, the rules governing Coverdell ESAs are liberalized to provide a greater incentive for families and other persons to save for educational purposes at all levels of education, not just college. Under the new rules, expenses that can be paid from these accounts are expanded to include elementary (including kindergarten) and secondary school tuition and expenses, including books, supplies, tutoring, computer equipment, software and services, room and board, uniforms and extended-day program costs.
- # The total amount of contributions that can be made to any one child's Coverdell ESA is \$2,000 per year-from all contributors. Also, the maximum amount that each individual may contribute for any one child can be as high as \$2,000 per year-depending on the contributor's adjusted gross income. Corporations and other entities will be able to make contributions to Coverdell ESAs, regardless of the corporation's or entity's income. Contributions to a beneficiary's Coverdell ESA can be made until the beneficiary reaches age 18. This limitation does not 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 need not be your own child.
- # Beginning in 2002, the limitation on concurrent use of the Coverdell ESA exclusion and the HOPE/Lifetime Learning credits is repealed. Thus, starting in 2002, a taxpayer will be allowed to claim a HOPE or a Lifetime Learning credit for a tax year and to 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 is not used for the same educational expenses for which a credit was claimed. Also, the 10% penalty won't apply where a distribution from a Coverdell ESA is used to pay qualified education expenses, but the taxpayer elects to claim a HOPE or Lifetime Learning credit in lieu of the Coverdell ESA exclusion.
- # Note also, a taxpayer may not claim the deduction for higher education expenses allowed from 2002 through 2005 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 benefitting one beneficiary to another account benefitting another beneficiary (as well as redesignations of the named beneficiary) are allowed, provided that the new beneficiary hasn't reached 30, and is a member of the family of the old beneficiary. The requirement that the beneficiary not have reached 30 will not apply to a beneficiary with special needs.

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