

Wealth  
Planning  
Made  
Easy

**Wealth Planning Made Easy**

Chad Danowsky

800-815-3130

[ask@wealthplanningmadeeasy.com](mailto:ask@wealthplanningmadeeasy.com)

[www.wealthplanningmadeeasy.com](http://www.wealthplanningmadeeasy.com)

Wealth  
Planning  
Made  
Easy

# Coverdell Education Savings Accounts



May 05, 2022

Page 1 of 7, see disclaimer on final page



# Coverdell Education Savings Accounts

## What is it?

A Coverdell education savings account is a tax-advantaged educational savings account that you can establish for a child under the age of 18 (this limit does not apply to beneficiaries with special needs). The child does not need to be your dependent. Contributions to a Coverdell ESA can total up to \$2,000 each year. While contributions are made with after-tax dollars, distributions used to pay qualifying education expenses are not included in income.

### *The basics*

- If you meet specified income limits, you can contribute up to \$2,000 per child per year to a Coverdell ESA
- Contributions must be in cash
- Contributions can be made by April 15 of the year following the tax year for which the contribution is being made
- The beneficiary must be under age 18 at the time you open the Coverdell ESA, unless the beneficiary is an individual with special needs
- You don't get a deduction for contributions that you make to a Coverdell ESA; the dollars that you contribute are after-tax dollars
- Earnings in the Coverdell ESA grow tax deferred, and the earnings portion of any distributions are income tax free as long as they are used to pay qualifying education expenses (the contribution portion is also tax free because they are made with after-tax dollars)

### *Qualifying education expenses*

For purposes of a Coverdell ESA, qualifying education expenses include tuition, fees, books, supplies, and equipment required for enrollment or attendance at an accredited post-secondary school (college) that is eligible to participate in the federal student aid program. For students enrolled at least half time, qualifying education expenses also include room and board.

Qualifying education expenses also include elementary and secondary education expenses. In addition to tuition, fees, books, supplies, equipment, and room and board, qualifying elementary and secondary education expenses may include tutoring, computer equipment, Internet access, and software that is primarily educational in nature.

**Tip:** For purposes of taking distributions from a Coverdell ESA, qualified education expenses must be reduced by any scholarships or other financial aid received.

## Requirements

### *You must meet income limits*

If your modified adjusted gross income (MAGI) is less than \$95,000 for single filers or less than \$190,000 for joint filers, you can make a full \$2,000 contribution to a Coverdell ESA. A partial contribution is allowed for single filers with a MAGI between \$95,000 and \$110,000 and joint filers with a MAGI between \$190,000 and \$220,000.

### *Contributions in the maximum amount have not already been made this year to a Coverdell ESA with the same beneficiary*

You can establish and contribute to more than one Coverdell ESA (assuming you meet the income limits), but no more than \$2,000 can be contributed in any calendar year on behalf of any one beneficiary.

**Example:** You set up a Coverdell ESA for your five-year-old son. You also set up a Coverdell ESA for your three-year-old daughter. You can contribute the maximum amount to your daughter's Coverdell ESA each year and the same amount to your son's Coverdell ESA each year.

**Example:** You establish a Coverdell ESA for your nephew Joe. Joe's father also establishes a Coverdell ESA for Joe. Joe's father



contributes \$1,900 to the Coverdell ESA that he established. You can contribute only \$100 for that year to the Coverdell ESA that you established.

### ***Beneficiary of Coverdell ESA has not yet reached age 18***

When the beneficiary of a Coverdell ESA reaches age 18, no further contributions can be made. The exception is if the beneficiary is an individual with special needs, in which case there is no age limit.

## **Strengths**

### ***Distributions used for the beneficiary's qualified education expenses are income tax free***

For distributions (withdrawals) used to pay qualified education expenses, the earnings portion of the distribution is tax exempt (contributions are also tax exempt because they're made with after-tax dollars).

### ***Funds can be rolled over to another Coverdell ESA for a family member of the current beneficiary***

A Coverdell ESA can be rolled over without tax or penalty consequences to another Coverdell ESA established for the same beneficiary, or for a family member of the original beneficiary.

### ***Contributions are discretionary***

You do not have to make a contribution to a Coverdell ESA in any given year or years. Except for limits on the maximum amount that you can contribute in a year, you can exercise complete discretion in determining how much and when to contribute.

### ***You have control over investments***

With a Coverdell ESA, you can control the underlying investments. This is usually not the case with a 529 college savings plan or prepaid tuition plan.

### ***Distributions from a Coverdell ESA can be tax exempt in same year an education tax credit is taken***

A beneficiary can take a tax-free distribution from a Coverdell ESA in the same year that he or she takes the American Opportunity credit or Lifetime Learning credit. (The result is the same if the beneficiary's parent takes the credit.) However, the catch is that the same qualified education expenses can't be used to qualify for the tax-free distribution and the credit.

### ***Coverdell ESA considered parental asset for federal financial aid purposes***

The federal financial aid formula counts a Coverdell ESA as a parent's asset. This means that 5.6 percent of the funds must be applied to college costs each year before a student is eligible for federal financial aid. Also, distributions that are used to pay qualified education expenses aren't counted as either parent or student income for federal financial aid purposes.

## **Tradeoffs**

### ***After-tax dollars are contributed***

You receive no deduction for amounts contributed to a Coverdell ESA. Your contribution comes from after-tax dollars.

### ***Ability to contribute depends on income***

If your MAGI is \$110,000 or more for single filers or \$220,000 or more for joint filers, you can't contribute to a Coverdell ESA. A partial contribution is allowed for single filers with a MAGI between \$95,000 and \$110,000 and joint filers with a MAGI between \$190,000 and \$220,000. If your MAGI is less than \$95,000 for single filers or less than \$190,000 for joint filers, you can make a full \$2,000 contribution to a Coverdell ESA.



## ***Distributions not used to pay qualified education expenses partly subject to tax and penalty***

Distributions that are not used to pay qualifying education expenses are included in the beneficiary's income to the degree that the distribution consists of earnings. All distributions are considered made partly from contributions and partly from earnings. Also, any portion of a distribution that is included in a beneficiary's income is subject to an additional 10 percent penalty tax.

## ***Any remaining funds in a Coverdell ESA must be distributed when the beneficiary reaches age 30***

Any funds remaining in a Coverdell ESA when the beneficiary reaches age 30 must be distributed (except for beneficiaries with special needs). Funds distributed from a Coverdell ESA at such time are considered taxable income to the beneficiary to the extent of earnings.

## ***Fees and expenses***

There are commission costs and other fees generally associated with opening a Coverdell ESA account.

## **How to do it**

### ***Establish Coverdell ESA at a bank or other financial institution***

Coverdell ESAs can be established at a bank or other financial institution approved by the IRS.

### ***Make contributions***

Contributions to a Coverdell ESA must be made by April 15 of the year following the year for which the contribution is made.

## **Tax considerations**

### **Contributions to a Coverdell ESA are made with after-tax dollars**

You receive no deduction for amounts contributed to a Coverdell ESA. Your contribution comes from after-tax dollars.

### **Qualifying distributions are tax free**

If distributions are used to pay qualifying education expenses, the earnings portion of the distribution is tax exempt (the contribution portion is also tax free because they are made with after-tax dollars).

### **Portion of nonqualifying distribution is included in income and subject to 10 percent penalty tax**

When a beneficiary takes a distribution from a Coverdell ESA but does not have qualifying education expenses in that tax year, the portion of the distribution that represents earnings is included in the beneficiary's income. This portion of the distribution is generally also subject to an additional 10 percent penalty tax. However, this 10 percent penalty tax will not apply if the distribution is:

- Made after the death of the beneficiary to his or her beneficiary or estate
- Attributable to the beneficiary's disability, or
- Made on account of a scholarship, an educational assistance allowance, or a payment of the designated beneficiary's educational expenses that is excludable from gross income

### **Coverdell ESA may result in taxable income upon death of beneficiary**

If a Coverdell ESA is transferred upon the death of the beneficiary to anyone other than a surviving spouse or family member, the Coverdell ESA ceases to be a Coverdell ESA, and whatever portion of the account represents earnings is income to the recipient.

### **A contribution to a Coverdell ESA is considered a completed gift**



Contributions that you make to a Coverdell ESA are considered completed gifts. However, unless your Coverdell ESA contribution and other gifts you make to the same beneficiary (in the same year) total more than the annual gift tax exclusion, there is no federal gift and estate tax liability. And, gift tax due on gifts in excess of the annual gift tax exclusion may be offset by your applicable exclusion amount.

**Caution:** *There may be state gift tax consequences as well.*

## Coverdell ESA is not included in calculating estate tax

Because money contributed to a Coverdell ESA is considered a completed gift to the beneficiary at the time of the contribution, such money is no longer part of the contributor's assets once it has been contributed to the Coverdell ESA. Therefore, the money contributed would not be included in the contributor's estate upon his or her death. However, if the beneficiary dies before using up all of his or her Coverdell ESA money, the remaining balance in the Coverdell ESA may be included in the beneficiary's estate for estate tax purposes, depending on the value of the estate at the time of death and the year in which he or she dies.

## Rollovers

A Coverdell ESA can be rolled over without tax or penalty consequences to another Coverdell ESA established for the same beneficiary, or for a family member of the original beneficiary. This can be done once every 12 months. Like IRAs, there is a 60-day window in which funds may be rolled over.

## Transfers

If the beneficiary dies while there is money in a Coverdell ESA, and the Coverdell ESA is transferred to a surviving spouse or other family member, there is no taxable transaction. Similarly, if a Coverdell ESA is transferred to a spouse or former spouse as the result of a divorce decree, there is no tax consequence. However, if upon the beneficiary's death, the Coverdell ESA is transferred to anyone other than a surviving spouse or other family member, the Coverdell ESA stops being a Coverdell ESA, and the portion of the account that represents earnings is considered income to the person who receives the funds.

## Questions& Answers

### *How much can you contribute if your income falls in the phaseout range?*

The most you can ever contribute to a Coverdell ESA for a single beneficiary in a year is \$2,000. If your MAGI is between \$95,000 and \$110,000 for single filers or \$190,000 and \$220,000 for joint filers, your ability to contribute to a Coverdell ESA is limited. This limitation is calculated as follows:

#### **MAGI between \$95,000 and \$110,000:**

1. Subtract \$95,000 from your MAGI (if your MAGI is less than \$95,000, you can contribute the maximum). If the result is \$15,000 or more, stop--you cannot contribute to a Coverdell ESA.
2. Divide the result from line 1 by \$15,000.
3. Multiply the result from line 2 by \$2,000.
4. Subtract the result from \$2,000.

This is the maximum amount you can contribute to a Coverdell ESA.

#### **MAGI between \$190,000 and \$220,000:**

1. Subtract \$190,000 from your MAGI (if your MAGI is less than \$190,000, you can contribute up to \$2,000). If the result is \$30,000 or more, stop--you cannot contribute to a Coverdell ESA.
2. Divide the result from line 1 by \$30,000.
3. Multiply the result from line 2 by \$2,000.
4. Subtract the result from \$2,000.

This is the maximum amount you can contribute to a Coverdell ESA.

### *Are there restrictions on taking distributions from a Coverdell ESA?*



Yes and no. Generally, contributions that you make to a Coverdell ESA are considered gifts. Once you contribute to a Coverdell ESA, distributions from the Coverdell ESA can only be made to the beneficiary (except for withdrawals of excess contributions). Distributions can be made from Coverdell ESAs at any time, but only qualifying distributions qualify for tax-free status.

Qualifying distributions are tax exempt if they are used for qualifying education expenses and if they do not exceed the expenses incurred by the beneficiary during the year.

Nonqualifying distributions are distributions made for noneducation expenses, and they are partially included in the beneficiary's income and may be subject to a 10 percent penalty. Distributions are considered to consist partly of original contributions and partly of earnings. Only the portion of a distribution that represents earnings is included in the income of the beneficiary.

The part of the distribution that represents contributions (and is therefore not included in income) is calculated by multiplying the amount of the distribution by the ratio of contributions in the Coverdell ESA (prior to the distribution) to the total balance in the Coverdell ESA prior to the distribution. The remainder of the distribution represents earnings.

**Example:** A Coverdell ESA has a total balance of \$5,000. The \$5,000 consists of \$4,000 in contributions and \$1,000 in earnings. A \$1,000 distribution is made to the Coverdell ESA beneficiary, but none of the \$1,000 is used for qualified education expenses. Because 80 percent of the entire value of the account at the time of the distribution consists of contributions, 80 percent of the distribution (\$800) is considered to represent original contributions, and only 20 percent (\$200) is considered to be earnings includable in income.

A special calculation is required when you have qualifying education expenses but the distribution exceeds these expenses.

What happens when a beneficiary has \$5,000 in qualifying education expenses but receives \$6,000 as a Coverdell ESA distribution?

Any time that a distribution from a Coverdell ESA totals more than the qualifying education expenses, a beneficiary must make a special calculation to determine how much of the distribution must be included in income:

1. Enter total qualifying higher education expenses.	
2. Enter total amount of distribution.	
3. Enter portion of distribution that represents earnings.	
4. Divide line 1 by line 2.	
5. Multiply line 4 by line 3. This amount must be excluded from income.	

## ***What happens if you contribute too much money to a Coverdell ESA in a given year?***

If you contribute more to a Coverdell ESA than you are allowed in one year, you have until May 31 of the following tax year to withdraw the funds, along with any earnings attributable to the funds. Any over contributions remaining after this date are subject to a 6 percent excise tax.

**Caution:** The 6 percent excise tax is also assessed if total contributions to all Coverdell ESAs for any one beneficiary exceed the maximum \$2,000 amount.

**IMPORTANT DISCLOSURES** Broadridge Investor Communication Solutions, Inc. does not provide investment, tax, legal, or retirement advice or recommendations. The information presented here is not specific to any individual's personal circumstances. To the extent that this material concerns tax matters, it is not intended or written to be used, and cannot be used, by a taxpayer for the purpose of avoiding penalties that may be imposed by law. Each taxpayer should seek independent advice from a tax professional based on his or her individual circumstances. These materials are provided for general information and educational purposes based upon publicly available information from sources believed to be reliable — we cannot assure the accuracy or completeness of these materials. The information in these materials may change at any time and without notice.

Wealth  
Planning  
Made  
Easy

Wealth Planning Made Easy

Chad Danowsky

800-815-3130

[ask@wealthplanningmadeeasy.com](mailto:ask@wealthplanningmadeeasy.com)

[www.wealthplanningmadeeasy.com](http://www.wealthplanningmadeeasy.com)

