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Coverdell Education Savings Accounts

Planning Ahead for Your Child's Education

Client Information Series



(c) Expenses for the purchase of any computer technology or equipment or for Internet access and related services if the technology, equipment, or services are to be used by the beneficiary and the beneficiary's family during any of the years that the beneficiary is in school. This will not include expenses for computer software designed for sports, games, or hobbies unless the software is educational in nature.

Distributions Used to Pay Qualified Expenses

Distributions are generally taxed under rules similar to those for annuities. They are made up of principal (under all circumstances excludable from gross income) and earnings (which may or may not be excludable from income).

If the beneficiary uses the entire distributions to pay qualified expenses, the distribution is completely tax-exempt. However, when all or part of the distribution is used for other than qualified expenses, then a portion of the earnings is taxable.

Example: The a Coverdell account for Will Jones contains \$10,508, of which \$7,000 is from contributions to the account and \$3,508 is due to earnings. Will withdraws \$6,000 from the account and uses \$5,000 for qualified educational expenses and \$1,000 for a down payment on a car. Under the annuity rules, 66.62% (\$7,000/\$10,508) of the distribution is treated as principal. This equals \$3,997 (\$6,000 x .6662), which is the amount Will can exclude from his taxable income. The balance, \$2,003, must be allocated to earnings, and it is potentially taxable to Will depending on his use of the funds. In this case, he used 16.67% (\$1,000/\$6,000) of the distribution for unqualified purposes (the car purchase). Therefore, Will must pay tax on 16.67% of the earnings, \$334 (\$2,003 x .1667).

Delayed Distribution

Even though contributions to the account are not permitted past the age of 18, the funds can remain in the account and continue to accrue investment earnings up to the mandatory distribution age (prior to age 30). The longer the income accrues tax-free in the account, the greater the benefit derived by the recipient. To maximize the tax-free income, one would want to delay the distribution as long as possible and still be able to utilize all of the funds to pay qualified education

expenses. Use the table below to predict growth after the education account beneficiary turns 18.

| | | Investment Rate of Return (Annually) | | | | | |
|-----|-----|--------------------------------------|-------|-------|-------|-------|-------|
| YRS | AGE | 2% | 4% | 6% | 8% | 10% | 12% |
| 1 | 19 | 1.020 | 1.040 | 1.060 | 1.080 | 1.100 | 1.120 |
| 2 | 20 | 1.040 | 1.082 | 1.124 | 1.166 | 1.210 | 1.254 |
| 3 | 21 | 1.061 | 1.125 | 1.191 | 1.260 | 1.331 | 1.405 |
| 4 | 22 | 1.082 | 1.170 | 1.262 | 1.360 | 1.464 | 1.574 |
| 5 | 23 | 1.104 | 1.217 | 1.338 | 1.469 | 1.611 | 1.762 |
| 6 | 24 | 1.126 | 1.265 | 1.419 | 1.587 | 1.772 | 1.974 |
| 7 | 25 | 1.149 | 1.316 | 1.504 | 1.714 | 1.949 | 2.211 |
| 8 | 26 | 1.172 | 1.369 | 1.594 | 1.851 | 2.144 | 2.476 |
| 9 | 27 | 1.195 | 1.423 | 1.689 | 1.999 | 2.358 | 2.773 |
| 10 | 28 | 1.219 | 1.480 | 1.791 | 2.159 | 2.594 | 3.106 |
| 11 | 29 | 1.243 | 1.539 | 1.898 | 2.332 | 2.853 | 3.479 |

The table assumes the Coverdell Education Savings Account is not immediately utilized and allowed to continue to accumulate during the period in which no contributions are allowed and up to the age at which mandatory distribution or qualified rollover is required.

Distributions at Death of Beneficiary

If the designated beneficiary of an account dies, the account balance must be distributed within 30 days after the death to his/her estate.

Distribution Requirements When Beneficiary Reaches Age 30

Account funds must be withdrawn or rolled over to another qualified Coverdell account before the beneficiary reaches age 30. Distributions that aren't withdrawn or rolled over are taxable and subject to penalties. Like IRA accounts, the Coverdell Education Savings Accounts can be rolled over once a year, and they can be transferred at will for the benefit of the same beneficiary. The rollover must be within 60 days of the original distribution. The accounts can also be rolled over or transferred to another qualified member of the taxpayer's family who meets the age requirement.

Penalties For Distributions When Not Used For Education

A 10% withdrawal penalty applies to the taxable portion of all distributions unless they are:

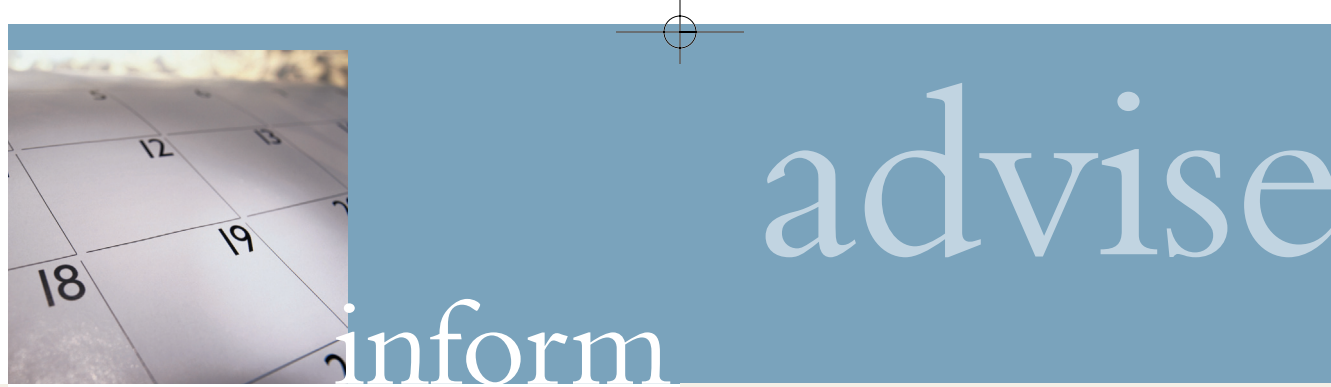
- Made after the death of the designated beneficiary;
- Due to the beneficiary's disability;
- Made on account of a tax-free scholarship or other payment to the extent the amount of the distribution isn't more than the amount of the tax-free payment; or
- Excess contributions (over the annual maximum) and the excess is returned, along with income attributable to it, by the due date of the contributor's income tax return. The net income is included in the distributee's income in the year of the contribution.

Other Requirements

- Can't invest in life insurance contracts.
- The Coverdell account assets can't be commingled except in common trust or investment funds.
- The trustee must be a bank or another person who will administer the trust as required (to the IRS' satisfaction).

The advice included in this brochure is not intended or written by this practitioner to be used, and it cannot be used by a practitioner or taxpayer, for the purpose of avoiding penalties that may be imposed on the practitioner or taxpayer.

Coverdell Education Savings Accounts



Overview of Coverdell Education Savings Accounts

These accounts, originally referred to as Education IRAs, have been available for over 15 years. These accounts are nondeductible education savings accounts. The investment earnings from a Coverdell account accrue and are withdrawn tax-free, provided the proceeds are used to pay qualified education expenses of the account beneficiary.

Annual Contributions

The allowable nondeductible contribution is \$2,000 per year per beneficiary. Contributions are only allowed for designated beneficiaries under the age of 18.

Contributions

Contributions that CANNOT be made:

- Those that aren't made in cash;
- Those that are made after the account holder reaches age 18 (special needs students discussed later), or
- Those that exceed the annual contribution limit (except for rollovers)

Timing of the Contributions

Contributions to these accounts must be made by April 15 of the subsequent tax year. If April 15 falls on a Saturday, Sunday or legal holiday, the due date is delayed until the next business day.

Projecting the Account Growth

The table below allows you to predict the growth of an account over various periods and at selected investment rates.

| ACCOUNT GROWTH FACTORS BASED ON THE SAME CONTRIBUTION EVERY YEAR AT VARIOUS INTEREST RATES | | | | |
|---|--------|--------|--------|--------|
| YEAR | 4% | 6% | 8% | 10% |
| 1 | 1.000 | 1.000 | 1.000 | 1.000 |
| 2 | 2.040 | 2.060 | 2.080 | 2.100 |
| 3 | 3.122 | 3.184 | 3.246 | 3.310 |
| 4 | 4.246 | 4.375 | 4.506 | 4.641 |
| 5 | 5.416 | 5.637 | 5.867 | 6.105 |
| 6 | 6.633 | 6.975 | 7.336 | 7.716 |
| 7 | 7.898 | 8.394 | 8.923 | 9.487 |
| 8 | 9.214 | 9.897 | 10.637 | 11.436 |
| 9 | 10.583 | 11.491 | 12.488 | 13.579 |
| 10 | 12.006 | 13.181 | 14.487 | 15.937 |
| 11 | 13.486 | 14.972 | 16.645 | 18.531 |
| 12 | 15.026 | 16.870 | 18.977 | 21.384 |
| 13 | 16.627 | 18.882 | 21.495 | 24.523 |
| 14 | 18.292 | 21.015 | 24.215 | 27.975 |
| 15 | 20.024 | 23.276 | 27.152 | 31.772 |
| 16 | 21.825 | 25.673 | 30.324 | 35.950 |
| 17 | 23.698 | 28.213 | 33.750 | 40.545 |
| 18 | 25.645 | 30.906 | 37.450 | 45.599 |

Example of how to use the table:

Assume contributions of \$1,500 are made each year for 14 years to the account and the account is earning 4%. From the table, the growth factor for 14 years at 4% is 18.292. To determine the value of the account at the end of the 14-year period, multiply the factor times the annual contribution of \$1,500. In this example, the account value would be \$27,438.

Who Can Make Contributions?

Contributions to Coverdell Education Savings Accounts can be made by any individual, including the beneficiary, if the "modified adjusted gross income (AGI)" of the contributor is less than the statutory phase out limit. The annual contribution per beneficiary is available in full only to an individual contributor with a modified AGI below a certain phase out limit. Corporations and other entities (including tax-exempt organizations) are permitted to make contributions to these accounts, regardless of the amount of the income of the corporation or entity during the year of the contribution.

Phase-Out Limits

The annual contribution per beneficiary is available in full only to an individual contributor with a modified AGI below the phase-out limits.

| PHASE-OUT LIMITS – MODIFIED AGI | |
|----------------------------------|-----------------------|
| Filing Status | Modified AGI |
| Married Taxpayers Filing Jointly | \$190,000 – \$220,000 |
| All Others | \$95,000 – \$110,000 |

"Modified AGI" is figured by adding back to regular AGI any income the contributor excluded under the foreign provisions (e.g., foreign earned income or income from U.S. possessions). The contribution limit is phased out ratably for contributors with modified AGIs between the lower and top modified AGI levels. No contributions are allowed once the Coverdell account beneficiary reaches age 18.

If you think you will be limited in making contributions because of your AGI level, one option might be gifting the funds for the contribution to either the beneficiary or someone else whose modified AGI is low enough to allow the contribution on behalf of the beneficiary.

A 6% excise tax applies to excess contributions - i.e., any contribution over the annual limit. Contributions may be made to both a Coverdell Savings Account and a Qualified Tuition Plan for the same beneficiary without penalty. The excise tax also isn't charged if:

- The contribution is withdrawn before the due date (including extensions) of the contributor's income tax return; or
- The contribution is a rollover.

Qualified Education Expenses

If a beneficiary's "qualified education expenses" in a year equal or exceed total Coverdell account distributions for the year, the distributions are 100% excluded from the beneficiary's gross income. "Qualified education expenses" are limited to expenses for school or higher education and generally include tuition, fees, books, supplies, equipment and certain room and board expenses. The term "school" for this definition includes any school that provides elementary or secondary education (kindergarten through 12th grade, as determined under state law).

"Qualified elementary and secondary education expenses" are defined as follows:

- Expenses for tuition, fees, academic tutoring, special needs services in the case of a "special needs beneficiary," books, supplies, and other equipment, which are incurred in connection with the enrollment or attendance of the designated beneficiary of a Coverdell account as an elementary or secondary school student at a public, private, or religious school.
- Expenses for room and board, uniforms, transportation, and supplementary items and services (including extended day programs), which are required or provided by a public, private, or religious school in connection with the enrollment or attendance of the designated beneficiary at the school.