

Coverdell Education Savings Accounts

A Coverdell Education Savings Account (CESA) is a trust or custodial account set up to pay the college expenses of a designated beneficiary without ever incurring a tax liability on the earnings in the account. CESA's involve two parties: a custodian, who manages the account, and a beneficiary, who receives the distributions. The parties are usually a parent and their child, although a grandparent, another person, or an organization may set up a CESA.

The custodian establishes and controls the assets in the CESA for the beneficiary, who must be under the age of 18. All assets in a CESA must be distributed to the beneficiary before he or she is 30 years old. However, the custodian may name a new beneficiary for the CESA if he or she wishes to preserve the account for another child.

CESA's may be self-directed investment accounts. They may hold cash and CD's as well as securities such as stocks, bonds, and mutual funds. The value of the assets will rise and fall with the respective values of the securities in it. They are normally set up so that the custodian can select from a wide range of investment options.

Contributions

Contributions to a CESA are made in cash and are not tax deductible. An individual whose modified adjusted gross income is under the income limit set for a given tax year can make a contribution of up to \$2,000. The income limit for 2023 is \$220,000 for a married couple and \$110,000 for single filers.

Contributors must act by the due date for their Federal tax returns, not including extensions, which is April 15th for the prior calendar year. There's no limit to the number of CESA's that can be established for a single beneficiary. However, the total contributions to all CESA's on behalf of a single beneficiary cannot exceed \$2,000 in one year.

Distributions and Tax-Advantages

Although CESA contributions are not tax deductible, amounts deposited in them grow tax-free. The beneficiary receives tax-free distributions if they are used to pay qualified educational expenses, which include tuition, fees, books, supplies, room and board, and special needs services and equipment if required by the student. Qualifying educational institutions include colleges, universities, and other educational entities such as postsecondary vocational schools as long as they are eligible to receive Federal student aid.

There are no restrictions on the amount of qualified funds that may be distributed from a CESA in a given year. If a beneficiary uses all of the money withdrawn from a CESA to pay for qualified educational expenses, the distributions remain untaxable and don't need to be reported to the IRS. Beneficiaries should complete an *IRS Form 1099-Q: Payments From Qualified Education Programs* but keep it with their own tax records.

Distributions are only tax-free to the extent that the amount of distributions does not exceed the beneficiary's qualified educational expenses. If distributions exceed expenses,

the excess portion is taxable to the beneficiary. In such cases, they need to file an *IRS Form 1099-Q: Payments From Qualified Education Programs* and submit it to the IRS.

If the Beneficiary Does Not Attend College

If a beneficiary receives a distribution and pays tuition or other college expenses with it, they owe no income tax. If the beneficiary spends the money on anything else, they must pay income tax on the CESA's earnings plus a 10% penalty.

Disadvantages of CESA's

Despite their tax benefits, CESA's have drawbacks, as noted below.

1. **Limit on Contributions:** The maximum contribution of \$2,000 per year, even when accumulated with earnings, is small in the context of today's college costs.
2. **Deductibility:** Contributions toward a CESA are not tax deductible.
3. **Contributors:** Some families cannot set up a CESA due to the income limitation.
4. **Age Limits:** CESA's place age limits on beneficiaries. Custodians can contribute only until the beneficiary reaches age 18.

Mistakes to Avoid

For families who want to start saving for college, a CESA is among the tax-advantaged options. Before opening a CESA, families should consider these factors:

1. **Value** – Annual contributions to CESA cannot exceed \$2,000 per student per calendar year. With the high costs of college, a CESA at maturity will probably cover only a small part of college expenses even after 18 years of contributions and earnings accumulation.
2. **Beneficiary's Age** – CESA's are intended for children who are 18 years old or younger. If a custodian makes contributions after the child turns 18, the funds are subject to a 6% excise tax. Any assets remaining in the account when the beneficiary turns 30 must be distributed within 30 days. If not, the earnings portion of the distribution is subject to income tax plus a 10% penalty. However, a recent rule change allows a CESA balance at age 30 to be rolled into a 529 Plan.
3. **Effect on Financial Aid** – A CESA can have a negative effect on Federal financial aid eligibility, but the effect is minimal compared to other types of educational accounts. Up to 5.64% of the value of a CESA owned by a parent will be included in the child's FAFSA Student Aid Index (SAI). If a grandparent owns the CESA, nothing will be added to the SAI. Distributions from parent-owned CESA's are excluded from the parent's Federal income tax returns, but if a grandparent or someone else owns the

CESA, the amount of the distribution is “added back” and must be counted as student income on the following year’s FAFSA. Student income is assessed at 50% for FAFSA purposes. This means that if a grandparent distributes \$10,000 from a CESA to pay educational expenses for their grandchild, that grandchild’s SAI will be increased by \$5,000. The higher the SAI — the less eligibility a student has for Federal financial aid.

How to Set Up a CESA

CESA’s are available at banks, credit unions, savings banks, and other types of financial services firms. Parents are advised to compare options to determine the ones with the best performing investment options and the lowest fees.