Education Savings Accounts (ESAs)

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Table of Contents

Introduction

Many people start a college savings fund for their newborn children. However, you may also decide you want to send your son or daughter to private school at some point during his or her elementary or high school years. Luckily there is a tax-advantaged fund that covers both, the Coverdell Education Savings Account (ESA).

The Coverdell Education Savings Account allows individuals to deposit up to $2,000 per year in an educational savings account for an eligible beneficiary (child) without being taxed on earnings from interest, dividends, appreciation, etc. – as long as the child uses the funds before the age of 30 for qualified educational expenses. The account must be started and all contributions made before the child is 18.

***Note**: The age 18 and age 30 limitations are waived if the beneficiary has special needs. This waiver allows the ESA to be funded after age 18 and allows the assets to remain in the account after age 30.*

For example, suppose you deposit $2,000 at the beginning of the year into an ESA. Your account earns 4%, or $80. You paid taxes on the $2,000 via your paycheck. The child will not have to pay taxes on the $80 earned, unlike a regular savings or investment account.

In this tutorial, you'll learn how to open and contribute to an ESA and how to avoid tax penalties.

Qualifying To Contribute

Before you decide to open an ESA, you should figure out if you qualify to contribute based on your modified adjusted gross income (MAGI).

Why is it "qualify to contribute" rather than "qualify to open" an account? ESAs can be a community fund for a child's education. Aunts, uncles, parents, grandparents or friends of the family may all decide to contribute to little Billy's education at some point. Each person doesn't need to open a separate account, but each one does need to be within qualifying income limits.

As of tax year 2010, contributors must have a MAGI of under $110,000 for a single person or $220,000 for a married couple. However, toward the upper limit for single and married filers, the maximum allowable contribution amounts are reduced. The MAGI range subject to partial contributions is $95,000 to $110,000 for single individuals and $190,000 to $220,000 for married couples.

Example - Income and ESA Contributions

Johnny wants to help his brother Dave save for his daughter Jodi's future education. Being that Jodi's only three, Johnny has no idea whether Jodi will go to a private elementary or high school at some point, which can be as expensive as college. So Johnny decides he'd like to contribute to an ESA for Jodi. The problem is Johnny makes $100,000 per year.

Johnny can calculate the amount he can contribute with the following equation:

Maximum MAGI ($110,000) - Johnny's MAGI ($100,000) = $10,000

$10,000/ ($110,000-maximum MAGI to qualify for full contribution ($95,000))= 2/3 or .67

2/3 x $2,000 = $1,333

Next year, Johnny marries Cindy who has a $100,000 MAGI. They have a baby later in the year. The power couple's total income is $210,000. Now they want to contribute to Jodi and baby Tommy's education.

Johnny and Cindy calculate their allowed contributions with married MAGI limits:

Maximum MAGI ($220,000) – Johnny and Cindy's MAGI ($210,000) = $10,000

$10,000/ (Maximum MAGI for a married couple ($220,000 - $190,000) = 1/3 or 0.33

1/3 x $2,000 = $667 per child. Johnny can contribute $667 and Cindy can put the first $667 in their son's account.

Check out the table below for more details for more contributions based on MAGI.

Contributions Allowed per Child (beneficiary)			
Single		Married	
MAGI	Contribution Allowed	MAGI	Contribution Allowed (per spouse)
$95,000	$2,000	$190,000	$2,000
$100,000	$1,333	$200,000	$1,333
$105,000	$667	$210,000	$667
$110,000	$0	$220,000	$0

Summing Up Qualifications
Contributing to a Coverdell Savings Account isn't just for the parents of the child. Anyone can contribute, as long they meet income limits. You can contribute $2,000 per child if your modified adjusted gross income (MAGI) is below $95,000 as a single person or $190,000 as a married couple. Individuals with MAGIs

above $95,000 and below $110,000 can contribute a portion of $2,000, as well as married couples making above $190,000 and below $220,000.

Opening an ESA

Once you know you can contribute to an account, you can open an ESA at pretty much any bank, credit union, mutual fund company, or brokerage firm. The question is when a whole community of people can contribute to an account, who should open it and where?

Choosing Where to Open an ESA

Like any other investment opportunity, you will want to think about fees, average returns and minimum deposits. A good way to start is by talking with people and places you trust.

- **Ask family members and friends who have ESA accounts where they have theirs.** Then call the financial institution for details.
- **Talk to your bank and financial advisors.** You can take it a step further and find out if mutual funds you currently own have ESA options, too.
- **Research online.** If you don't know anyone with an ESA, turn to the opinions of others. Search for professional ratings and personal opinions online. Call financial institutions that are highly recommended to ask for details such as minimum opening deposit, fees involved, procedures for making deposits and average returns.
- **Use all three above and then compare on paper.** Take out a sheet of paper or open a computer file. Write down important information about the top three ESAs recommended. Compare benefits of each before choosing an ESA. Since the child could have this investment account for up to 30 years, you want to be as careful about choosing an ESA as you would a mortgage. Of course, if you are not happy with your original choice you can always transfer the ESA to another financial institution.

Organizing Accounts Among Relatives and Friends

A time-cherished gift from grandparent to grandchild is a savings bond. An ESA contribution is a continuation of this tradition.

Each contributor can open his or her own account, but the parents of the child will then need to keep track of the money in all accounts. Otherwise, they won't be able to calculate what additional funds they need to pay for their child's education. If possible, it's better for parents to open the ESA and for contributors to deposit the money into the ESA opened by the parent.

What Investments Are in an ESA?

ESAs can be comprised of any combination of investments: mutual funds, stocks, bonds, money market funds etc. The investments not allowed in an ESA include collectibles, with the exception of U.S. Treasury coins. Equally as important as the investment is making sure cash is being deposited into the ESA.

What If You Have More Than One Child?
Just like Johnny and Cindy could contribute to an account for their niece and their own child, you can contribute up to $2,000 for each of your children. If you can't afford to contribute $2,000 per child, divide what you can afford among all your children. You can do this equally or use a strategy of putting more in your eldest child's account, since he or she will need the money first. Once the eldest goes to college, you can start contributing more for your younger children.

However, pay attention to your yearly contributions if others are contributing. If total contributions from all involved exceed $2,000, there could be tax penalties that your child would have to pay. We'll look at these in the next section.

Don't let the fear of taxes make you refuse money; just ask for excess contributions to go to another account, such as a 529 plan.

Takeaways for Opening a Coverdell Education Savings Account
Choose an ESA carefully. Your children may hold this investment account for up to 30 years, so you want to choose a financial institution that comes highly recommended. If you have a community contributing to your child's education, keep track of all contributions. The preferred method is by asking contributors to deposit into an account you open on your child's behalf.

Avoiding Taxes on Distributions

ESAs are technically considered tax-advantaged accounts. If your child pays any tax on earnings or contributions, it's because you've disobeyed the ESA rules.

We'll look at the actions that trigger tax penalties and how you can avoid breaking the rules.

Non-Education Withdrawals
If the beneficiary withdraws money for non-education expenses, there is a hefty penalty for withdrawal. The penalty tax is 10% of the taxable amount, and your child will have to pay income tax on the earnings. To ensure your child won't be taxed, follow these steps.

1. Pick a school that qualifies.

- School eligibility for post-secondary training programs, including college, is any school that's eligible for federal financial aid.
- School eligibility for elementary and high school students is any institution that meets state requirements.

2. Use the money in your account only for these expenses based on information from IRS Publication 970

Qualifying Education Expenses	
Elementary or High School Education	**College or other Postsecondary Programs**
Tuition and fees	Tuition and fees
Books, supplies or equipment	Books, supplies or equipment
Special needs services	Special needs services (only if required to complete course of study)
Room and board if required or offered by school	Room and board to the extent that: a) The total amount is less than the estimated housing cost according to financial aid. b) The total amount is less than the price of school owned or operated housing *Coverdell Education Savings Account Funds can only be used for room and board if the beneficiary is at least a half-time student.
Academic tutoring	
If required or offered by the school: transportation, uniforms and services offered to supplement schooling with the exception of extended day programs.	
Computers and internet usage is allowed, too, if used solely for educational purposes.	

ESA Tax Rules

There are two situations that will result in getting taxed on the money earned and also on deposited funds:

1. Waiting Too Long
The beneficiary needs to withdraw his or her money on time. According to the IRS, if there is a balance in the ESA when the beneficiary reaches age 30, it must be distributed within 30 days. A portion representing earnings on the account will be taxable and subject to the additional 10% tax. The beneficiary may avoid these taxes by rolling over the full balance to another Coverdell ESA for another family member.

How high could a penalty climb? Let's say Julie accumulated $2,000 in deposits per year until her 18th birthday. She has $36,000 of pre-profit or interest earnings. She earned $18,000 from this investment. She started off her 18th year with $52,000 in the bank. This is partially due to the fact that her parents and grandparents put the money into the account for her college education. She never went to private school in her pre-college years.

Julie won a full-ride scholarship and didn't need much monetary help to attend college. She only spent money from her ESA for textbooks. She used a total of $2,000 of her contributions. Her investment earned another $30,000 by the time she turned 30. With $48,000 in earnings and $34,000 in contributions, she would be taxed on the earnings and 10% early distribution penalty as well which would amount to $4,800. While this seems like a lot of money, she still has $77,200, less any income tax owed on the earnings. She could transfer her ESA to a beneficiary, a younger sibling or spouse, to avoid taxes. However, she would no longer have the money.

Putting In Too Much
There are also problems if the child's combined contributions go over $2,000 in a given year. All contributions combining for the benefit of a particular child over $2,000 for a taxable year will be treated as excess contributions. There will be a 6% excise tax if the excess contributions and earnings on them are not withdrawn from the child's account(s) before June 1 of the following tax year. The tax will be levied for each year the excess amount remains in the account.

For example, Toby was lucky enough to receive $4,600 in contributions in his ESA from various relatives this past year. If he doesn't withdraw the extra $2,600 out of his account for educational expenses by June 1 of the next tax year, he will owe 6% of $2,600 plus 6% of any interest or profits derived from the $2,600 invested. On the excess contributions alone, that's $156. If Toby keeps the $2,600 in his account for future years, he will owe another $156 per year until the excess contributions are withdrawn.

Parting Tax Tips
Your child can avoid most tax penalties by using the ESA for qualified education

expenses. However, there may be circumstances like a full-ride scholarship that can't and shouldn't be avoided. In this case, taxes will be charged, but this still leaves a hefty payout for your child when he or she turns 30.

Conclusion

Recap:

- Anyone can contribute to an ESA on behalf of a child.
- ESAs must be started and funded before age 18, but after a child is born.
- Co-ordinate with other contributors as much as possible so you don't accidentally cause your son or daughter to pay taxes.
- The maximum contribution is calculated two ways: maximum contribution per individual and maximum per child.
- You can't contribute to an ESA if your modified adjusted gross income is above $110,000 as a single person or $220,000 as a married couple. Contributions are calculated on a sliding scale for individuals with MAGIs above $95,000 and below $110,000. Married couples contribute on a sliding scale if their combined MAGI is above $190,000 and below $220,000.
- Contributing to an ESA isn't the only way to save for your child's education. Also consider 529 plans. Contributions aren't based on income and can be larger amounts.