

Coverdell ESAs Explained: Everything You Need to Know

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Introduction to the Coverdell ESA

A Coverdell ESA is a tax-advantaged savings plan designed to reduce the financial burden of education expenses. While there are many potential uses for the funds held within a plan, the most common use is for higher education expenses. The account type, formerly called an “Education IRA”, was established as part of the Taxpayer Relief Act of 1997 and has helped millions of people pay for education expenses since.

Why Should I Invest in a Coverdell ESA?

If managed properly, a Coverdell ESA could help you attain your education planning goals. Coverdell ESAs offer tax advantages over a standard brokerage account, specifically as it relates to the deferral of capital gains (i.e., tax-deferred growth) and tax-free withdrawals for qualifying education expenses.

Investments made within a Coverdell ESA are protected from capital gains tax while those funds remain in the account. If an investment within the account generates a realized gain, taxes are not immediately due on the gain but are instead **deferred**. The impact of the **tax-deferred** nature of this account is significant in the long-run.

What’s more, is that distributions from a Coverdell ESA have the ability to be completely **tax-free** if used for qualifying education expenses. There are many types of qualifying expenses, which we will touch on later.

When compared to a standard brokerage account or regular savings account, a Coverdell ESA offers planners the chance to earn a relatively high rate of return while minimizing tax burden.

Who Can I Name as the Beneficiary of a Coverdell ESA?

When establishing a Coverdell ESA account, the designated beneficiary must be under age 18 or a special needs beneficiary. You can list anyone who meets this eligibility, including children, grandchildren, or other relatives, as the beneficiary of an ESA.

You can change the beneficiary of a Coverdell ESA at any time. For example, if you had been saving in an ESA for a child that chooses to enter the workforce immediately after high school rather than attending college, you can modify the beneficiary of that ESA to be another one of your children or a grandchild. If you want to change the beneficiary, you can do so without penalty, as long as the new beneficiary is a qualifying family member of the original beneficiary.

Qualifying family members include siblings, parents, children, nieces, nephews, first cousins, and others related by blood or marriage.

How Much Can I Contribute to a Coverdell ESA?

In 2024, the maximum contribution to a Coverdell ESA is \$2,000 per beneficiary. The contribution limit applies to both (a) the total amount that any one individual can contribute for a specific beneficiary in a year, as well as (b) the total amount that can be contributed on behalf of a beneficiary by all contributors in a given year. The latter can be difficult to track when multiple ESAs are active for a single beneficiary.

Additionally, there are income limitations for those who would like to contribute to a Coverdell ESA. For those with higher levels of income (calculated using Modified Adjusted Gross Income “MAGI”), contribution limits phase out until being completely eliminated. For single tax filers, the phase-out begins at \$95,000 and concludes at \$110,000 (at which point Coverdell ESA contributions are not allowed). For married filing jointly filers, the phase-out begins at \$190,000 and concludes at \$220,000.

Organizations, such as corporations and trusts, can also contribute to Coverdell ESAs with no income limitations.

Can I Deduct My Contribution to a Coverdell ESA?

No. Coverdell ESA contributions are not tax-deductible at either the federal or state level.

What are the Withdrawal Rules of a Coverdell ESA?

Coverdell ESAs are subject to specific withdrawal rules that, when not followed, could result in substantial penalties and additional taxes. Withdrawals can be made at any time and for any reason, but must be for qualified education expenses in an appropriate amount for that calendar year in order to maintain preferential treatment.

The balance in the account must be distributed, or rolled over to a new beneficiary, within 30 days after the beneficiary reaches age 30. The 30-day requirement also applies to an untimely death of the beneficiary.

Qualified expenses—those that are eligible for **tax-free withdrawals** from a Coverdell ESA—include:

- **Tuition, fees, books, supplies, and equipment** required to enroll or attend an eligible educational institution (K-12 or postsecondary) or apprenticeship program
- **Academic tutoring** in connection with enrollment or attendance at an eligible elementary or secondary school
- For a student carrying at least one-half the normal full-time workload for the course of study being pursued at a postsecondary institution, **room and board** expenses, not to exceed the greater of (a) the allowance in the cost of attendance or (b) the actual amount charged to the student to reside in housing owned or operated by the eligible educational institution

- **Room and board, uniforms, transportation,** and other supplementary items and services required or provided by an eligible elementary or secondary school
- **Special needs services** for a special needs beneficiary, incurred to permit that individual's enrollment or attendance
- The purchase of **computer or peripheral equipment, computer software, or internet access** related to educational purposes

Non-qualified withdrawals are subject to income tax and a penalty in the amount of 10% on the earnings portion. The penalty can be avoided through one of a small handful of exceptions, such as the beneficiary of the plan: dying or becoming disabled, receiving a tax-free scholarship, receiving educational assistance through a qualifying employer program, or attending a US military academy. Though the penalty may be avoided in this case, taxes are still owed on the earnings portion of non-qualified withdrawals.

Withdrawals from a Coverdell ESA must be made in the same calendar year in which the qualifying expense was paid. It is important to keep a good record of expenses and payments in case an audit is done.

Can I Roll Over Funds from a Coverdell ESA into a Roth IRA?

No. Unlike 529 Plans, Coverdell ESAs are not included in the provision of the SECURE 2.0 Act that permits rollovers into Roth IRAs.

Do Coverdell ESAs Impact College Financial Aid?

Yes. Funds held in a Coverdell ESA are considered assets for FAFSA (federal aid) and are expected to be used to help pay for college. This is unlike other investment accounts, such as retirement accounts and HSAs, which are not considered assets for FAFSA.

Parent assets, including a Coverdell ESA held in the name of a child, are subject to an annual expected financial contribution rate of 5.64%. This means that every \$1,000 in a Coverdell ESA reduces financial aid eligibility by approximately \$56.40. Student assets, on the other hand, are subject to an annual expected financial contribution rate of 20%.

While it is advantageous to have Coverdell ESA funds owned by a parent rather than a student, another idea entails a third-party, such as a grandparent or close friend, owning the ESA on behalf of the student. Funds held in these Coverdell ESAs are not counted as assets of either the parent or child, and therefore are not factored into the expected financial contribution calculation.

What Types of Assets Can I Invest in with a Coverdell ESA?

A Coverdell ESA allows its account owner to invest in a fairly broad spectrum of assets. Stocks, exchange-traded funds (ETFs), mutual funds, bonds, money market funds, and certificates of deposit (CDs) are all permitted assets in a Coverdell account. Examples of investments that are prohibited include life insurance, artwork and collectibles, S corporation stock, and real estate for personal use, among others.

It is important to establish an allocation of assets in your Coverdell ESA that best matches your financial objectives and risk tolerance. A dynamic portfolio that evolves over time can help you meet your financial needs, wants, and wishes for this account type.

How Do Coverdell ESAs Differ from 529 Plans?

Coverdell ESAs are similar to 529 Plans in that both are educational savings vehicles. In general, 529 Plans have fewer restrictions on contributions to the account, while Coverdell ESAs provide more flexibility in investment options.

For those looking for a more active approach to investing education funds, a Coverdell ESA is superior. For those who are higher-income earners or would like to contribute a significant amount to an education account, a 529 Plan is the way to go.

How Can I Start Investing in a Coverdell ESA?

If you think a Coverdell ESA is right for you, reach out to us at **FreeMind Financial Advisory** and we would be happy to provide a **free strategy session** personalized for you. We can help determine if a Coverdell ESA is the best investment account for you, and if it is, we can assist in setting up your account, choosing an initial investment allocation, and actively monitoring your account.

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