8. Coverdell Education Savings Account (ESA)

Introduction

If your modified adjusted gross income (MAGI) is less than $110,000 ($220,000 if filing a joint return), you may be able to establish a Coverdell ESA to finance the qualified education expenses of a designated beneficiary. For most taxpayers, MAGI is the adjusted gross income as figured on their federal income tax return.

There is no limit on the number of separate Coverdell ESAs that can be established for a designated beneficiary. However, total contributions for the beneficiary in any year cannot be more than $2,000, no matter how many accounts have been established. See *Contributions*, later.

TIP *This benefit applies not only to higher education expenses, but also to elementary and secondary education expenses.*

What is the tax benefit of the Coverdell ESA. Contributions to a Coverdell ESA are not deductible, but amounts deposited in the account grow tax free until distributed.

If, for a year, distributions from an account are not more than a designated beneficiary's qualified education expenses at an eligible educational institution, the beneficiary will not owe tax on the distributions. See *Tax-Free Distributions,* later.

Table 8-1 summarizes the main features of the Coverdell ESA.

Table 8-1. **Coverdell ESA at a Glance**

Do not rely on this table alone. It provides only general highlights. See the text for definitions of terms in bold type and for more complete explanations.

Question	Answer
What is a **Coverdell ESA**?	A savings account that is set up to pay the **qualified education expenses** of a **designated beneficiary**.
Where can it be established?	It can be opened in the United States at any bank or other IRS-approved entity that offers Coverdell ESAs.
Who can have a Coverdell ESA?	Any beneficiary who is under age 18 or is a special needs beneficiary.
Who can contribute to a Coverdell ESA?	Generally, any individual (including the beneficiary) whose **modified adjusted gross income** for the year is less than $110,000 ($220,000 in the case of a joint return).
Are distributions tax free?	Yes, if the distributions are not more than the beneficiary's **adjusted qualified education expenses** for the year.

What Is a Coverdell ESA

A Coverdell ESA is a trust or custodial account created or organized in the United States only for the purpose of paying the qualified education expenses of the designated beneficiary (defined below) of the account.

When the account is established, the designated beneficiary must be under age 18 or a special needs beneficiary.

To be treated as a Coverdell ESA, the account must be designated as a Coverdell ESA when it is created.

The document creating and governing the account must be in writing and must satisfy the following requirements.

1. The trustee or custodian must be a bank or an entity approved by the IRS.
2. The document must provide that the trustee or custodian can only accept a contribution that meets all of the following conditions.
   a. The contribution is in cash.
   b. The contribution is made before the beneficiary reaches age 18, unless the beneficiary is a special needs beneficiary.
   c. The contribution would not result in total contributions for the year (not including rollover contributions) being more than $2,000.
3. Money in the account cannot be invested in life insurance contracts.
4. Money in the account cannot be combined with other property except in a common trust fund or common investment fund.
5. The balance in the account generally must be distributed within 30 days after the earlier of the following events.
   a. The beneficiary reaches age 30, unless the beneficiary is a special needs beneficiary.
   b. The beneficiary's death.

Qualified Education Expenses

Generally, these are expenses required for the enrollment or attendance of the designated beneficiary at an eligible educational institution. For purposes of Coverdell ESAs, the expenses can be either qualified higher education expenses or qualified elementary and secondary education expenses.

Designated beneficiary. This is the individual named in the document creating the trust or custodial account to receive the benefit of the funds in the account.

Contributions to a qualified tuition program (QTP). A contribution to a QTP is a qualified education expense if the contribution is on behalf of the designated beneficiary of the Coverdell ESA. In the case of a change in beneficiary, this is a qualified expense only if the new beneficiary is a family member of that designated beneficiary. See chapter 9, *Qualified Tuition Plan (QTP)*.

Eligible Educational Institution

For purposes of Coverdell ESAs, an eligible educational institution can be either an eligible postsecondary school or an eligible elementary or secondary school.

Eligible postsecondary school. This is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the U.S. Department of Education. It includes virtually all accredited public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions. The educational institution should be able to tell you if it is an eligible educational institution.

Certain educational institutions located outside the United States also participate in the U.S. Department of Education's Federal Student Aid (FSA) programs.

Eligible elementary or secondary school. This is any public, private, or religious school that provides elementary or secondary education (kindergarten through grade 12), as determined under state law.

Qualified Higher Education Expenses

These are expenses related to enrollment or attendance at an eligible postsecondary school. As shown in the following list, to be qualified, some of the expenses must be required by the school and some must be incurred by students who are enrolled at least half-time.

1. The following expenses must be required for enrollment or attendance of a designated beneficiary at an eligible postsecondary school.
   a. Tuition and fees.
   b. Books, supplies, and equipment.
2. Expenses for special needs services needed by a special needs beneficiary must be incurred in connection with enrollment or attendance at an eligible postsecondary school.
3. Expenses for room and board must be incurred by students who are enrolled at least half-time (defined below).

   The expense for room and board qualifies only to the extent that it is not more than the greater of the following two amounts.
   a. The allowance for room and board, as determined by the school, that was included in the cost of attendance (for federal financial aid purposes) for a particular academic period and living arrangement of the student.
   b. The actual amount charged if the student is residing in housing owned or operated by the school.

Half-time student. A student is enrolled "at least half-time" if he or she is enrolled for at least half the full-time academic work load for the course of study the student is pursuing, as determined under the standards of the school where the student is enrolled.

Qualified Elementary and Secondary Education Expenses

These are expenses related to enrollment or attendance at an eligible elementary or secondary school. As shown in the following list, to be qualified, some of the expenses must be required or provided by the school. There are special rules for computer-related expenses.

1. The following expenses must be incurred by a designated beneficiary in connection with enrollment or attendance at an eligible elementary or secondary school.
   a. Tuition and fees.
   b. Books, supplies, and equipment.
   c. Academic tutoring.
   d. Special needs services for a special needs beneficiary.
2. The following expenses must be required or provided by an eligible elementary or secondary school in connection with attendance or enrollment at the school.
   a. Room and board.
   b. Uniforms.
   c. Transportation.
   d. Supplementary items and services (including extended day programs).
3. The purchase of computer technology, equipment, or Internet access and related services is a qualified elementary and secondary education expense if it is to be used by the beneficiary and the beneficiary's family during any of the years the beneficiary is in elementary or secondary school. (This does not include expenses for computer software designed for sports, games, or hobbies unless the software is predominantly educational in nature.)

Contributions

Any individual (including the designated beneficiary) can contribute to a Coverdell ESA if the individual's MAGI (defined later under *Contribution Limits*) for the year is less than $110,000. For individuals filing joint returns, that amount is $220,000.

Organizations, such as corporations and trusts, can also contribute to Coverdell ESAs. There is no requirement that an organization's income be below a certain level.

Contributions must meet all of the following requirements.

1. They must be in cash.
2. They cannot be made after the beneficiary reaches age 18, unless the beneficiary is a special needs beneficiary, and
3. They must be made by the due date of the contributor's tax return (not including extensions).

Contributions can be made to one or several Coverdell ESAs for the same designated beneficiary provided that the total contributions are not more than the contribution limits (defined later) for a year.

Contributions can be made, without penalty, to both a Coverdell ESA and a QTP in the same year for the same beneficiary.

Table 8-2 summarizes many of the features of contributing to a Coverdell ESA.

When contributions considered made. Contributions made to a Coverdell ESA for the preceding tax year are considered to have been made on the last day of the preceding year. They must be made by the due date (not including extensions) for filing your return for the preceding year.

For example, if you make a contribution to a Coverdell ESA in February 2010, and you designate it as a contribution for 2009, you are considered to have made that contribution on December 31, 2009.

Contribution Limits

There are two yearly limits:

1. One on the total amount that can be contributed for each designated beneficiary in any year, and
2. One on the amount that any individual can contribute for any one designated beneficiary for a year.

Limit for each designated beneficiary. For 2009, the total of all contributions to all Coverdell ESAs set up for the benefit of any one designated beneficiary cannot be more than $2,000. This includes contributions (other than rollovers) to all the beneficiary's Coverdell ESAs from all sources. Rollovers are discussed under *Rollovers and Other Transfers*, later.

Example. When Maria Luna was born in 2008, three separate Coverdell ESAs were set up for her, one by her parents, one by her grandfather, and one by her aunt. In 2009, the total of all contributions to Maria's three Coverdell ESAs cannot be more than $2,000. For example, if her grandfather contributed $2,000 to one of her Coverdell ESAs, no one else could contribute to any of her three accounts. Or, if her parents contributed $1,000 and her aunt $600, her grandfather or someone else could contribute no more than $400. These contributions could be put into any of Maria's Coverdell ESA accounts.

Limit for each contributor. Generally, you can contribute up to $2,000 for each designated beneficiary for 2009. This is the most you can contribute for the benefit of any one beneficiary for the year, regardless of the number of Coverdell ESAs set up for the beneficiary.

Example. The facts are the same as in the previous example except that Maria Luna's older brother, Edgar, also has a Coverdell ESA. If their grandfather contributed $2,000 to Maria's Coverdell ESA in 2009, he could also contribute $2,000 to Edgar's Coverdell ESA.

Reduced limit. Your contribution limit may be reduced. If your MAGI (defined on this page) is between $95,000 and $110,000 (between $190,000 and $220,000 if filing a joint return), the $2,000 limit for each designated beneficiary is gradually reduced (see *Figuring the limit*, later). If your MAGI is $110,000 or more ($220,000 or more if filing a joint return), you cannot contribute to anyone's Coverdell ESA.

Table 8-2. Coverdell ESA Contributions at a Glance

Do not rely on this table alone. It provides only general highlights. See the text for more complete explanations.

Question	Answer
Are contributions deductible?	No.
What is the annual **contribution limit** per designated beneficiary?	$2,000 for each designated beneficiary.
What if more than one Coverdell ESA has been opened for the same designated beneficiary?	The annual contribution limit is $2,000 for each beneficiary, no matter how many Coverdell ESAs are set up for that beneficiary.
What if more than one individual makes contributions for the same designated beneficiary?	The annual contribution limit is $2,000 per beneficiary, no matter how many individuals contribute.
Can contributions other than cash be made to a Coverdell ESA?	No.
When must contributions stop?	No contributions can be made to a beneficiary's Coverdell ESA after he or she reaches age 18, unless the beneficiary is a special needs beneficiary.

Modified adjusted gross income (MAGI). For most taxpayers, MAGI is adjusted gross income (AGI) as figured on their federal income tax return.

MAGI when using Form 1040A. If you file Form 1040A, your MAGI is the AGI on line 22 of that form.

MAGI when using Form 1040. If you file Form 1040, your MAGI is the AGI on line 38 of that form, modified by adding back any:

1. Foreign earned income exclusion,
2. Foreign housing exclusion,
3. Foreign housing deduction,
4. Exclusion of income by bona fide residents of American Samoa, and
5. Exclusion of income by bona fide residents of Puerto Rico.

MAGI when using Form 1040NR. If you file Form 1040NR, your MAGI is the AGI on line 36 of that form.

MAGI when using Form 1040NR-EZ. If you file Form 1040NR-EZ, your MAGI is the AGI on line 10 of that form.

You can use Worksheet 8-1 on the next page to figure your MAGI.

Worksheet 8-1. **MAGI for a Coverdell ESA**

1. Enter your adjusted gross income (Form 1040, line 38)		**1.** ______
2. Enter your foreign earned income exclusion and/or housing exclusion (Form 2555, line 45, or Form 2555-EZ, line 18)	**2.** ______	
3. Enter your foreign housing deduction (Form 2555, line 50)	**3.** ______	
4. Enter the amount of income from Puerto Rico you are excluding	**4.** ______	
5. Enter the amount of income from American Samoa you are excluding (Form 4563, line 15)	**5.** ______	
6. Add lines 2, 3, 4, and 5		**6.** ______
7. Add lines 1 and 6. This is your **modified adjusted gross income**		**7.** ______

Figuring the limit. To figure the limit on the amount you can contribute for each designated beneficiary, multiply $2,000 by a fraction. The numerator (top number) is your MAGI minus $95,000 ($190,000 if filing a joint return). The denominator (bottom number) is $15,000 ($30,000 if filing a joint return). Subtract the result from $2,000. This is the amount you can contribute for each beneficiary. You can use Worksheet 8-2 to figure the limit on your contributions.

Worksheet 8-2. **Coverdell ESA Contribution Limit**

1. Maximum contribution	**1.** $ 2,000
2. Enter your modified adjusted gross income (MAGI) for purposes of figuring the contribution limit to a Coverdell ESA (see definition or Worksheet 8-1 earlier)	**2.** ______
3. Enter $190,000 if married filing jointly; $95,000 for all other filers	**3.** ______
4. Subtract line 3 from line 2. If zero or less, enter -0- on line 4, skip lines 5 through 7, and enter $2,000 on line 8	**4.** ______
5. Enter $30,000 if married filing jointly; $15,000 for all other filers **Note.** *If the amount on line 4 is greater than or equal to the amount on line 5, **stop here**. You are not allowed to contribute to a Coverdell ESA for 2009.*	**5.** ______
6. Divide line 4 by line 5 and enter the result as a decimal (rounded to at least 3 places)	**6.** .
7. Multiply line 1 by line 6	**7.** ______
8. Subtract line 7 from line 1	**8.** ______

Note: *The total Coverdell ESA contributions from all sources for the designated beneficiary during the tax year may not exceed $2,000.*

Example. Paul, who is single, had a MAGI of $96,500 for 2009. Paul can contribute up to $1,800 in 2009 for each beneficiary, as shown in the illustrated Worksheet 8-2.

Worksheet 8-2. **Coverdell ESA Contribution Limit—Illustrated**

1. Maximum contribution	**1.** $ 2,000
2. Enter your modified adjusted gross income (MAGI) for purposes of figuring the contribution limit to a Coverdell ESA (see definition or Worksheet 8-1 earlier)	**2.** 96,500
3. Enter $190,000 if married filing jointly; $95,000 for all other filers	**3.** 95,000
4. Subtract line 3 from line 2. If zero or less, enter -0- on line 4, skip lines 5 through 7, and enter $2,000 on line 8	**4.** 1,500
5. Enter $30,000 if married filing jointly; $15,000 for all other filers **Note.** *If the amount on line 4 is greater than or equal to the amount on line 5, **stop here**. You are not allowed to contribute to a Coverdell ESA for 2009.*	**5.** 15,000
6. Divide line 4 by line 5 and enter the result as a decimal (rounded to at least 3 places)	**6.** .100
7. Multiply line 1 by line 6	**7.** 200
8. Subtract line 7 from line 1	**8.** 1,800

Note: *The total Coverdell ESA contributions from all sources for the designated beneficiary during the tax year may not exceed $2,000.*

Additional Tax on Excess Contributions

The beneficiary must pay a 6% excise tax each year on excess contributions that are in a Coverdell ESA at the end of the year. Excess contributions are the total of the following two amounts.

1. Contributions to any designated beneficiary's Coverdell ESA for the year that are more than $2,000 (or, if less, the total of each contributor's limit for the year, as discussed earlier).
2. Excess contributions for the preceding year, reduced by the total of the following two amounts:
   a. Distributions (other than those rolled over as discussed later) during the year, and
   b. The contribution limit for the current year minus the amount contributed for the current year.

Exceptions. The excise tax does not apply if excess contributions made during 2009 (and any earnings on them) are distributed before the first day of the sixth month of the following tax year (June 1, 2010, for a calendar year taxpayer).

However, you must include the distributed earnings in gross income for the year in which the excess contribution was made. You should receive Form 1099-Q, Payments From Qualified Education Programs (Under Sections 529 and 530), from each institution from which excess contributions were distributed. Box 2 of that form will show the amount of earnings on your excess contributions. Code "2" or "3" entered in the blank box below boxes 5 and 6 indicate the year in which the earnings are taxable. See

Instructions for Recipient on the back of copy B of your Form 1099-Q. Enter the amount of earnings on line 21 of Form 1040 (or Form 1040NR) for the applicable tax year. For more information, see *Taxable Distributions*, later.

The excise tax does not apply to any rollover contribution.

Note. Contributions made in one year for the preceding tax year are considered to have been made on the last day of the preceding year.

Example. In 2008, Greta's parents and grandparents contributed a total of $2,300 to Greta's Coverdell ESA—an excess contribution of $300. Because Greta did not withdraw the excess before June 1, 2009, she had to pay an additional tax of $18 (6% × $300) when she filed her 2008 tax return.

In 2009, excess contributions of $500 were made to Greta's account, however, she withdrew $250 from that account to use for qualified education expenses. Using the steps shown on the previous page under *Additional Tax on Excess Contributions*, Greta figures the excess contribution in her account at the end of 2009 as follows.

(1)	$500 excess contributions made in 2009	
+ (2)	$300 excess contributions in ESA at end of 2008	
− (2a)	$250 distribution during 2009	
	$550 excess at end of 2009	× 6% = $33

If Greta limits 2010 contributions to $1,450 ($2,000 maximum allowed − $550 excess contributions from 2009), she will not owe any additional tax in 2010 for excess contributions.

Figuring and reporting the additional tax. You figure this excise tax in Part V of Form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts. Report the additional tax on Form 1040, line 58 (or Form 1040NR, line 54).

Rollovers and Other Transfers

Assets can be rolled over from one Coverdell ESA to another or the designated beneficiary can be changed. The beneficiary's interest can be transferred to a spouse or former spouse because of divorce.

Rollovers

Any amount distributed from a Coverdell ESA is not taxable if it is rolled over to another Coverdell ESA for the benefit of the same beneficiary or a member of the beneficiary's family (including the beneficiary's spouse) who is under age 30. This age limitation does not apply if the new beneficiary is a special needs beneficiary.

An amount is rolled over if it is paid to another Coverdell ESA within 60 days after the date of the distribution.

Do not report qualifying rollovers (those that meet the above criteria) anywhere on Form 1040 or 1040NR. These are not taxable distributions.

Members of the beneficiary's family. For these purposes, the beneficiary's family includes the beneficiary's spouse and the following other relatives of the beneficiary.

1. Son, daughter, stepchild, foster child, adopted child, or a descendant of any of them.
2. Brother, sister, stepbrother, or stepsister.
3. Father or mother or ancestor of either.
4. Stepfather or stepmother.
5. Son or daughter of a brother or sister.
6. Brother or sister of father or mother.
7. Son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law.
8. The spouse of any individual listed above.
9. First cousin.

Example. When Aaron graduated from college last year he had $5,000 left in his Coverdell ESA. He wanted to give this money to his younger sister, who was still in high school. In order to avoid paying tax on the distribution of the amount remaining in his account, Aaron contributed the same amount to his sister's Coverdell ESA within 60 days of the distribution.

CAUTION *Only one rollover per Coverdell ESA is allowed during the 12-month period ending on the date of the payment or distribution.*

Military death gratuity. If you received a military death gratuity or a payment from Servicemember's Group Life Insurance (SGLI) after October 6, 2001, you may roll over all or part of the amount received to one or more Coverdell ESAs for the benefit of members of the beneficiary's family (see *Rollovers,* earlier). Such payments are made to an eligible survivor upon the death of a member of the armed forces.

This rollover contribution is subject to the contribution limits discussed earlier under *Contribution Limits*. The amount you roll over cannot exceed the total survivor benefits you received, reduced by contributions from these benefits to a Roth IRA or other Coverdell ESAs.

The contribution to a Coverdell ESA from survivor benefits received after June 16, 2008, cannot be made later than 1 year after the date on which you receive the gratuity or SGLI payment. If you received survivor benefits before June 17, 2008, with respect to a death from injury occurring after October 6, 2001, you could have contributed to a Coverdell ESA no later than June 17, 2009.

The amount contributed from the survivor benefits is treated as part of your basis (cost) in the Coverdell ESA, and will not be taxed when distributed. See *Distributions* on this page.

CAUTION *The limit of one rollover per Coverdell ESA during a 12-month period does not apply to a military death gratuity or SGLI payment.*

Changing the Designated Beneficiary

The designated beneficiary can be changed to a member of the beneficiary's family (defined earlier). There are no tax consequences if, at the time of the change, the new beneficiary is under age 30 or a special needs beneficiary.

Example. Assume the same situation as in the last example. Instead of closing his Coverdell ESA and paying the distribution into his sister's Coverdell ESA, Aaron could have instructed the trustee of his account to simply change the name of the beneficiary on his account to that of his sister.

Transfer Because of Divorce

If a spouse or former spouse receives a Coverdell ESA under a divorce or separation instrument, it is not a taxable transfer. After the transfer, the spouse or former spouse treats the Coverdell ESA as his or her own.

Example. In their divorce settlement, Peg received her ex-husband's Coverdell ESA. In this process, the account was transferred into her name. Peg now treats the funds in this Coverdell ESA as if she were the original owner.

Distributions

The designated beneficiary of a Coverdell ESA can take a distribution at any time. Whether the distributions are tax free depends, in part, on whether the distributions are equal to or less than the amount of adjusted qualified education expenses (defined later on this page) that the beneficiary has in the same tax year.

See Table 8-3 for highlights.

Table 8-3. **Coverdell ESA Distributions at a Glance**

Do not rely on this table alone. It provides only general highlights. See the text for definitions of terms in bold type and for more complete explanations.

Question	**Answer**
Is a distribution from a Coverdell ESA to pay for a designated beneficiary's qualified education expenses tax free?	Generally, yes, to the extent the amount of the distribution is not more than the designated beneficiary's adjusted qualified education expenses.
After the designated beneficiary completes his or her education at an **eligible educational institution**, can amounts remaining in the Coverdell ESA be distributed?	Yes. Amounts ***must*** be distributed when the designated beneficiary reaches age 30, unless he or she is a special needs beneficiary. Also, certain transfers to **members of the beneficiary's family** are permitted.
Does the designated beneficiary need to be enrolled for a minimum number of courses to take a tax-free distribution?	No.

Adjusted qualified education expenses. To determine if total distributions for the year are more than the amount of qualified education expenses, reduce total qualified education expenses by any tax-free educational assistance. Tax-free educational assistance includes:

- The tax-free part of scholarships and fellowships (see chapter 1),
- Veterans' educational assistance (see chapter 1),
- Pell grants (see chapter 1),
- Employer-provided educational assistance (see chapter 12), and
- Any other nontaxable (tax-free) payments (other than gifts or inheritances) received as educational assistance.

The amount you get by subtracting tax-free educational assistance from your total qualified education expenses is your adjusted qualified education expenses.

Tax-Free Distributions

Generally, distributions are tax free if they are not more than the beneficiary's adjusted qualified education expenses for the year. Do not report tax-free distributions (including qualifying rollovers) on your tax return.

Taxable Distributions

A portion of the distributions is generally taxable to the beneficiary if the distributions are more than the beneficiary's adjusted qualified education expenses for the year.

Excess distribution. This is the part of the total distribution that is more than the beneficiary's adjusted qualified education expenses for the year.

Earnings and basis. You will receive a Form 1099-Q for each of the Coverdell ESAs from which money was distributed in 2009. The amount of your gross distribution will be shown in box 1. For 2009, instead of dividing the gross distribution between your earnings (box 2) and your basis (already-taxed amount) (box 3), the payer or trustee may report the fair market value (account balance) of the Coverdell ESA as of December 31, 2009. This will be shown in the blank box below boxes 5 and 6.

Figuring the Taxable Portion of a Distribution

The taxable portion is the amount of the excess distribution that represents earnings that have accumulated tax free in the account. Figure the taxable portion for 2009 as shown in the following steps.

1. Multiply the total amount distributed by a fraction. The numerator is the basis (contributions not previously distributed) at the end of 2008 plus total contributions for 2009 and the denominator is the value (balance) of the account at the end of 2009 plus the amount distributed during 2009.
2. Subtract the amount figured in (1) from the total amount distributed during 2009. The result is the amount of earnings included in the distribution(s).
3. Multiply the amount of earnings figured in (2) by a fraction. The numerator is the adjusted qualified education expenses paid during 2009 and the denominator is the total amount distributed during 2009.
4. Subtract the amount figured in (3) from the amount figured in (2). The result is the amount the beneficiary must include in income.

The taxable amount must be reported on Form 1040 or Form 1040NR, line 21.

Example. You received an $850 distribution from your Coverdell ESA, to which $1,500 had been contributed before 2009. There were no contributions in 2009. This is your first distribution from the account, so your basis in the account on December 31, 2008, was $1,500. The value (balance) of your account on December 31, 2009, was $950. You had $700 of adjusted qualified education expenses (AQEE) for the year. Using the steps above, figure the taxable portion of your distribution as follows.

1. $\$850 \text{ (distribution)} \times \dfrac{\$1{,}500 \text{ basis} + \$0 \text{ contributions}}{\$950 \text{ value} + \$850 \text{ distribution}}$

   = $708 (basis portion of distribution)

2. $850 (distribution) − $708 (basis portion of distribution)

   = $142 (earnings included in distribution)

3. $\$142 \text{ (earnings)} \times \dfrac{\$700 \text{ AQEE}}{\$850 \text{ distribution}}$

   = $117 (tax-free earnings)

4. $142 (earnings) − $117 (tax-free earnings) = $25 (taxable earnings)

You must include $25 in income as distributed earnings not used for qualified education expenses. Report this amount on Form 1040, line 21, listing the type and amount of income on the dotted line.

Worksheet 8-3, at the end of this chapter, can help you figure your adjusted qualified education expenses, how much of your distribution must be included in income, and the remaining basis in your Coverdell ESA(s).

Coordination With American Opportunity, Hope, and Lifetime Learning Credits

The American opportunity, Hope, or lifetime learning credit can be claimed in the same year the beneficiary takes a tax-free distribution from a Coverdell ESA, as long as the same expenses are not used for both benefits. This means the beneficiary must reduce qualified higher education expenses by tax-free educational assistance, and then further reduce them by any expenses taken into account in determining an American opportunity, Hope, or lifetime learning credit.

Example. Derek Green had $5,800 of qualified higher education expenses for 2009, his first year in college. He paid his college expenses from the following sources.

Partial tuition scholarship (tax free)	$1,500
Coverdell ESA distribution	1,000
Gift from parents	2,100
Earnings from part-time job	1,200

Of his $5,800 of qualified higher education expenses, $4,000 was tuition and related expenses that also qualified for an American opportunity credit. Derek's parents claimed a $2,500 American opportunity credit (based on $4,000 expenses) on their tax return.

Before Derek can determine the taxable portion of his Coverdell ESA distribution, he must reduce his total qualified higher education expenses.

Total qualified higher education expenses	$5,800
Minus: Tax-free educational assistance	−1,500
Minus: Expenses taken into account in figuring American opportunity credit	−4,000
Equals: Adjusted qualified higher education expenses (AQHEE)	$ 300

Since the adjusted qualified higher education expenses ($300) are less than the Coverdell ESA distribution ($1,000), part of the distribution will be taxable. The balance in Derek's account was $1,800 on December 31, 2009. Prior to 2009, $2,100 had been contributed to this account. Contributions for 2009 totaled $400. Using the four steps outlined earlier, Derek figures the taxable portion of his distribution as shown below.

1. $\$1{,}000 \text{ (distribution)} \times \dfrac{\$2{,}100 \text{ basis} + \$400 \text{ contributions}}{\$1{,}800 \text{ value} + \$1{,}000 \text{ distribution}}$

   = $893 (basis portion of distribution)

2. $1,000 (distribution) − $893 (basis portion of distribution)

   = $107 (earnings included in distribution)

3. $\$107 \text{ (earnings)} \times \dfrac{\$300 \text{ AQHEE}}{\$1{,}000 \text{ distribution}}$

   = $32 (tax-free earnings)

4. $107 (earnings) − $32 (tax-free earnings) = $75 (taxable earnings)

Derek must include $75 in income (Form 1040, line 21). This is the amount of distributed earnings not used for adjusted qualified higher education expenses.

Coordination With Qualified Tuition Program (QTP) Distributions

If a designated beneficiary receives distributions from both a Coverdell ESA and a QTP in the same year, and the total distribution is more than the beneficiary's adjusted qualified higher education expenses, those expenses must be allocated between the distribution from the Coverdell ESA and the distribution from the QTP before figuring how much of each distribution is taxable. The following two examples illustrate possible allocations.

Example 1. In 2009, Beatrice graduated from high school and began her first semester of college. That year, she had $1,000 of qualified elementary and secondary education expenses (QESEE) for high school and $3,000 of qualified higher education expenses (QHEE) for college. To pay these expenses, Beatrice withdrew $800 from her Coverdell ESA and $4,200 from her QTP. No one claimed Beatrice as a dependent, nor was she eligible for an education credit. She did not receive any tax-free educational assistance in 2009. Beatrice must allocate her total qualified education expenses between the two distributions.

1. Beatrice knows that tax-free treatment will be available if she applies her $800 Coverdell ESA distribution toward her $1,000 of qualified education expenses for high school. The qualified expenses are greater than the distribution, making the $800 Coverdell ESA distribution tax free.
2. Next, Beatrice matches her $4,200 QTP distribution to her $3,000 of QHEE, and finds she has an excess QTP distribution of $1,200 ($4,200 QTP − $3,000 QHEE). She cannot use the extra $200 of high school expenses (from (1) above) against the QTP distribution because those expenses do not qualify a QTP for tax-free treatment.
3. Finally, Beatrice figures the taxable and tax-free portions of her QTP distribution based on her $3,000 of QHEE. (See *Figuring the Taxable Portion of a Distribution* in chapter 9 for more information.)

Example 2. Assume the same facts as in *Example 1*, except that Beatrice withdrew $1,800 from her Coverdell ESA and $3,200 from her QTP. In this case, she allocates her qualified education expenses as follows.

1. Using the same reasoning as in *Example 1*, Beatrice matches $1,000 of her Coverdell ESA distribution to her $1,000 of QESEE—she has $800 of her distribution remaining.
2. Because higher education expenses can also qualify a Coverdell ESA distribution for tax-free treatment, Beatrice allocates her $3,000 of QHEE between the remaining $800 Coverdell ESA and the $3,200 QTP distributions ($4,000 total).

$$\begin{matrix}\$3{,}000 \\ \text{QHEE}\end{matrix} \times \frac{\$800 \text{ ESA distribution}}{\$4{,}000 \text{ total distribution}} = \begin{matrix}\$600 \\ \text{QHEE (ESA)}\end{matrix}$$

$$\begin{matrix}\$3{,}000 \\ \text{QHEE}\end{matrix} \times \frac{\$3{,}200 \text{ QTP distribution}}{\$4{,}000 \text{ total distribution}} = \begin{matrix}\$2{,}400 \\ \text{QHEE (QTP)}\end{matrix}$$

3. Beatrice then figures the taxable part of her:
   a. Coverdell ESA distribution based on qualified education expenses of $1,600 ($1,000 QESEE + $600 QHEE). See *Figuring the Taxable Portion of a Distribution*, earlier in this chapter.
   b. QTP distribution based on her $2,400 of QHEE (see *Figuring the Taxable Portion of a Distribution* in chapter 9).

TIP *The above examples show two types of allocation between distributions from a Coverdell ESA and a QTP. However, you do not have to allocate your expenses in the same way. You can use any reasonable method.*

Losses on Coverdell ESA Investments

If you have a loss on your investment in a Coverdell ESA, you may be able to deduct the loss on your income tax return. You can deduct the loss only when all amounts from that account have been distributed and the total distributions are less than your unrecovered basis. Your basis is the total amount of contributions to that Coverdell ESA. You claim the loss as a miscellaneous itemized deduction on Schedule A (Form 1040), line 23 (Schedule A (Form 1040NR), line 11), subject to the 2%-of-adjusted-gross-income limit.

If you have distributions from more than one Coverdell ESA account during a year, you must combine the information (amount of distribution, basis, etc.) from all such accounts in order to determine your taxable earnings for the year. By doing this, the loss from one ESA account reduces the distributed earnings (if any) from any other ESA account. For examples of the calculation, see *Losses on QTP Investments* in chapter 9 under *Figuring the Taxable Portion of a Distribution*.

Additional Tax on Taxable Distributions

Generally, if you receive a taxable distribution, you also must pay a 10% additional tax on the amount included in income.

Exceptions. The 10% additional tax does not apply to distributions:

1. Paid to a beneficiary (or to the estate of the designated beneficiary) on or after the death of the designated beneficiary.
2. Made because the designated beneficiary is disabled. A person is considered to be disabled if he or she shows proof that he or she cannot do any substantial gainful activity because of his or her physical or mental condition. A physician must determine that his or her condition can be expected to result in death or to be of long-continued and indefinite duration.
3. Included in income because the designated beneficiary received:
   a. A tax-free scholarship or fellowship (see chapter 1),
   b. Veterans' educational assistance (see chapter 1),
   c. Employer-provided educational assistance (see chapter 12), or

   d. Any other nontaxable (tax-free) payments (other than gifts or inheritances) received as educational assistance.

4. Made on account of the attendance of the designated beneficiary at a U.S. military academy (such as the USMA at West Point). This exception applies only to the extent that the amount of the distribution does not exceed the costs of advanced education (as defined in section 2005(d)(3) of title 10 of the U.S. Code) attributable to such attendance.
5. Included in income only because the qualified education expenses were taken into account in determining the American opportunity, Hope, or lifetime learning credit (see *Coordination With American Opportunity, Hope, and Lifetime Learning Credits*, earlier).
6. Made before June 1, 2010, of an excess 2009 contribution (and any earnings on it). The distributed earnings must be included in gross income for the year in which the excess contribution was made.

Exception (3) applies only to the extent the distribution is not more than the scholarship, allowance, or payment.

Figuring the additional tax. Use Part II of Form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts, to figure any additional tax. Report the amount on Form 1040, line 58, or Form 1040NR, line 54.

When Assets Must Be Distributed

Any assets remaining in a Coverdell ESA must be distributed when either one of the following two events occurs.

1. The designated beneficiary reaches age 30. In this case, the remaining assets must be distributed within 30 days after the beneficiary reaches age 30. However, this rule does not apply if the beneficiary is a special needs beneficiary.
2. The designated beneficiary dies before reaching age 30. In this case, the remaining assets must generally be distributed within 30 days after the date of death.

Exception for Transfer to Surviving Spouse or Family Member

If a Coverdell ESA is transferred to a surviving spouse or other family member as the result of the death of the designated beneficiary, the Coverdell ESA retains its status. ("Family member" was defined earlier under *Rollovers*.) This means the spouse or other family member can treat the Coverdell ESA as his or her own and does not need to withdraw the assets until he or she reaches age 30. This age limitation does not apply if the new beneficiary is a special needs beneficiary. There are no tax consequences as a result of the transfer.

How To Figure the Taxable Earnings

When a total distribution is made because the designated beneficiary either reached age 30 or died, the earnings that accumulated tax free in the account must be included in taxable income. You determine these earnings as shown in the following two steps.

1. Multiply the amount distributed by a fraction. The numerator is the basis (contributions not previously distributed) at the end of 2008 plus total contributions for 2009 and the denominator is the balance in the account at the end of 2009 plus the amount distributed during 2009.
2. Subtract the amount figured in (1) from the total amount distributed during 2009. The result is the amount of earnings included in the distribution.

For an example, see steps (1) and (2) of the *Example* under *Figuring the Taxable Portion of a Distribution*, earlier.

The beneficiary or other person receiving the distribution must report this amount on Form 1040, line 21, or Form 1040NR, line 21, listing the type and amount of income on the dotted line.

Worksheet 8-3. **Coverdell ESA—Taxable Distributions and Basis** *Keep for Your Records*

How to complete this worksheet.
- Complete Part I, lines A through H, on only one worksheet.
- Complete a separate Part II, lines 1 through 15, for each of your Coverdell ESAs.
- Complete Part III, the Summary (line 16), on only one worksheet.

Part I. Qualified Education Expenses (Complete for total expenses)

A.	Enter your total qualified education expenses for 2009		**A.** ______
B.	Enter those qualified education expenses paid for with tax-free educational assistance (for example, tax-free scholarships, veterans' educational benefits, Pell grants, employer-provided educational assistance)	**B.** ______	
C.	Enter those qualified **higher** education expenses deducted on Schedule C or C-EZ (Form 1040), Schedule F (Form 1040), or as a miscellaneous itemized deduction on Schedule A (Form 1040 or 1040NR)	**C.** ______	
D.	Enter those qualified **higher** education expenses on which an American opportunity, Hope, or lifetime learning credit was based	**D.** ______	
E.	Add lines B, C, and D		**E.** ______
F.	Subtract line E from line A. This is your adjusted qualified education expense for 2009		**F.** ______
G.	Enter your total distributions from **all** Coverdell ESAs during 2009. Do not include rollovers or the return of excess contributions (see instructions)		**G.** ______
H.	Divide line F by line G. Enter the result as a decimal (rounded to at least 3 places). If the result is 1.000 or more, enter 1.000		**H.** ___ . ___

Part II. Taxable Distributions and Basis (Complete separately for each account)

1.	Enter the amount contributed to **this** Coverdell ESA for 2009, including contributions made for 2009 from January 1, 2010, through April 15, 2010. Do **not** include rollovers or the return of excess contributions		**1.** ______
2.	Enter your basis in **this** Coverdell ESA as of December 31, 2008 (see instructions)		**2.** ______
3.	Add lines 1 and 2		**3.** ______
4.	Enter the total distributions from **this** Coverdell ESA during 2009. Do **not** include rollovers or the return of excess contributions (see instructions)		**4.** ______
5.	Multiply line 4 by line H. This is the amount of adjusted qualified education expense attributable to this Coverdell ESA	**5.** ______	
6.	Subtract line 5 from line 4	**6.** ______	
7.	Enter the total value of **this** Coverdell ESA as of December 31, 2009, plus any outstanding rollovers (see instructions)	**7.** ______	
8.	Add lines 4 and 7	**8.** ______	
9.	Divide line 3 by line 8. Enter the result as a decimal (rounded to at least 3 places). If the result is 1.000 or more, enter 1.000	**9.** ___ . ___	
10.	Multiply line 4 by line 9. This is the amount of basis allocated to your distributions, and is tax free		**10.** ______
	Note. *If line 6 is zero, skip lines 11 through 13, enter -0- on line 14, and go to line 15.*		
11.	Subtract line 10 from line 4		**11.** ______
12.	Divide line 5 by line 4. Enter the result as a decimal (rounded to at least 3 places). If the result is 1.000 or more, enter 1.000	**12.** ___ . ___	
13.	Multiply line 11 by line 12. This is the amount of qualified education expenses allocated to your distributions, and is tax free		**13.** ______
14.	Subtract line 13 from line 11. This is the **portion of the distributions from this Coverdell ESA in 2009 that you must include in income**		**14.** ______
15.	Subtract line 10 from line 3. This is your **basis in this Coverdell ESA as of December 31, 2009**		**15.** ______

Part III. Summary (Complete only once)

16.	**Taxable amount.** Add together all amounts on line 14 for all your Coverdell ESAs. **Enter here and include on Form 1040, line 21**, or **Form 1040NR, line 21**, listing the type and amount of income on the dotted line		**16.** ______

Worksheet 8-3 Instructions. **Coverdell ESA—Taxable Distributions and Basis**

Line G. Enter the total distributions received from **all** Coverdell ESAs during 2009. Do not include amounts rolled over to another ESA within 60 days (only one rollover is allowed during any 12-month period). Also, do not include excess contributions that were distributed with the related earnings (or less any loss) before the first day of the sixth month of the tax year following the year for which the contributions were made.

Line 2. Your basis (amount already taxed) in **this** Coverdell ESA as of December 31, 2008, is the total of:

- All contributions to this Coverdell ESA before 2009
- Minus the tax-free portion of any distributions from this Coverdell ESA before 2009.

If your last distribution from this Coverdell ESA was before 2009, you must start with the basis in your account as of the end of the last year in which you took a distribution. For years before 2002, you can find that amount on the last line of the worksheet in the Instructions for Form 8606, Nondeductible IRAs, that you completed for that year. For years after 2001, you can find that amount by using the ending basis from the worksheet in Publication 970 for that year. You can determine your basis in this Coverdell ESA as of December 31, 2008, by adding to the basis as of the end of that year any contributions made to that account after the year of the distribution and before 2009.

Line 4. Enter the total distributions received from **this** Coverdell ESA in 2009. Do not include amounts rolled over to another Coverdell ESA within 60 days (only one rollover is allowed during any 12-month period).

Also, do not include excess contributions that were distributed with the related earnings (or less any loss) before the first day of the sixth month of the tax year following the year of the contributions.

Line 7. Enter the total value of **this** Coverdell ESA as of December 31, 2009, plus any outstanding rollovers contributed to the account after 2008, but before the end of the 60-day rollover period. A statement should be sent to you by February 1, 2010, for this Coverdell ESA showing the value on December 31, 2009.

A **rollover** is a tax-free withdrawal from one Coverdell ESA that is contributed to another Coverdell ESA. An **outstanding rollover** is any amount withdrawn within 60 days before the end of 2009 (November 2 through December 31) that was rolled over after December 31, 2009, but within the 60-day rollover period.