(a) 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 an education IRA's trust as an elementary or secondary school student at a public, private, or religious school.

(b) 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.

(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 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). Will can exclude this 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

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.

update

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 meet the age requirements.

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 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).

Coverdell Education Savings Accounts

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Overview of Coverdell Education Savings Accounts

These accounts, originally referred to as Education IRAs, became available in 1998 and subsequent 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

When these accounts first became available, the non-deductible contributions were limited to $500 per year for the benefit of the designated beneficiary. Beginning in the year 2002, the allowable nondeductible contribution has been increased to $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 accountholder reaches age 18 (special needs students discussed later), or
- Those that exceed the annual contribution limit (except for rollovers)

Timing of the Contributions

Under the original rules, the contributions to these accounts must have been made before the end of the tax year. This presented problems for taxpayers with modified AGIs close to the phase-out limitation. Recognizing the problems created by the requirement to make the contribution prior to the close of the tax year, Congress changed that requirement as part of the 2001 act. Thus, for tax years after 2001, contributions to a Coverdell account for a tax year can be made by April 15 of the following tax year.

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 8%. From the table, the growth factor for 14 years at 8% is 24.215. 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 $36,322.50.

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. For tax years after 2001, corporations and other entities (including tax-exempt organizations) will be 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

Phase-Out Range	2001	2002 & After
Married Taxpayers Filing Jointly	$150,000 – $160,000	$160,000 – $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 in 2002 or later years 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:

(continued on the next page)