HOW AN ESA CAN HELP WITH BACK-TO-SCHOOL EXPENSES

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August is winding down and September is just around the corner. That means that it is back to school time! Education can be expensive. This year, with inflation raging, that seems even more true than ever. If you have children looking to further their education, you will need to explore every possible option out there that can help you save. One savings tool that many parents overlook is the Coverdell Education Savings Account (ESA).

Getting Started with an ESA

How can you start an ESA? There is a lot of flexibility here. Unlike other types of tax advantaged savings plans, there is no need for any involvement from an employer. You may establish an ESA with the custodian of your choice. The paperwork you complete is very similar to the paperwork necessary to establish an IRA. When you establish the ESA, you will need to name a responsible individual. The responsible individual controls the ESA, including investment choices and when distributions are taken. Many custodians will allow you, as the contributor, to name yourself as the responsible individual.

Contributions are made to the account to help save for education expenses of a designated beneficiary. The designated beneficiary is a child under the age of 18. Contributions may be made for designated beneficiaries older than 18 if they have special needs. The maximum contribution amount is $2,000 per year for each designated beneficiary, but you may contribute that amount to ESAs for multiple beneficiaries. For example, if you have five grandchildren, you could contribute $2,000 each year to each of their ESAs.

There is no earned income or taxable compensation requirement to contribute to an ESA. There are no age limits either. There are income limits. If your income is above them, you might consider giving the funds to the child or another person with income under the limits and having them make the contribution to avoid those limits. If you are already funding a qualified tuition plan or 529 plan, you can fund an ESA as well. ESA funds are even eligible to be rolled over to qualified tuition plans.

The contribution deadline is generally the tax-filing deadline, April 15. Your ESA contribution is not deductible, but the earnings will be tax-free if the funds are used to pay for qualified education expenses.

Taking ESA Distributions

Qualified distributions from an ESA are tax-free. The definition of qualified education expenses is very broad for ESA purposes. Qualified education expenses include college tuition, room and board as well as required books and supplies. The student can be a full time or part time student. Vocational school or community college expenses are included as well. A student's computer and internet expenses are also qualified education expenses.

An important benefit of an ESA is that qualified tax-free distributions may be taken for primary and secondary school expenses. You are not limited to expenses after high school graduation. Eligible expenses include tuition, fees, tutoring and special needs services and expenses incurred in connection with enrollment of the designated beneficiary at a public or private school.

If an ESA distribution is not used for education expenses, the earnings portion will be taxable to the designated beneficiary and may be subject to a 10% penalty unless an exception applies. Funds may be rolled over from an ESA to an ESA for a member of the designated beneficiary's family who is under age 30.