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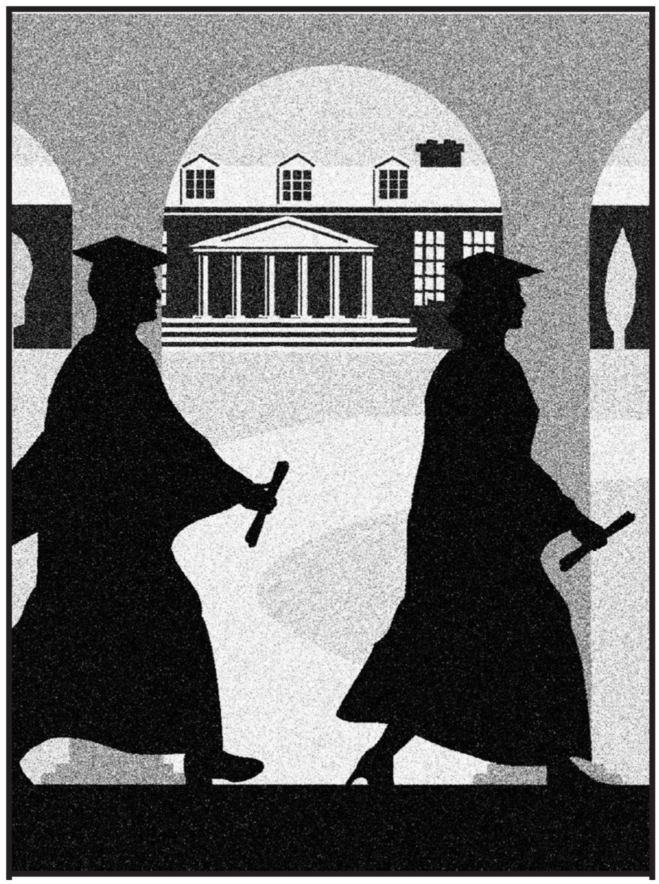
Tax Benefits for Education

For use in preparing **2023** Returns

Volume 3 of 5



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Qualified employer plan. You can't deduct interest on a loan made under a qualified employer plan or under a contract purchased under such a plan.

Qualified Education Expenses

For purposes of the student loan interest deduction, these expenses are the total costs of attending an eligible educational institution. They include amounts paid for the following items.

- Tuition and fees.
- Room and board.
- Books, supplies, and equipment.
- Other necessary expenses (such as transportation).

The cost of room and board qualifies only to the extent it isn't more than:

- The allowance for room and board, as determined by the eligible educational institution, that was included in the cost of attendance (for federal financial aid purposes) for a particular academic period and living arrangement of the student; or

- If greater, the actual amount charged if the student is residing in housing owned or operated by the eligible educational institution.

Eligible educational institution. An eligible educational institution is generally 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. Virtually all accredited public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions meet this definition.

An eligible educational institution also includes certain educational institutions located outside the United States that are eligible to participate in a student aid program administered by the U.S. Department of Education.

For purposes of the student loan interest deduction, an eligible educational institution also includes an institution conducting an internship or residency program leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility that offers postgraduate training.

An educational institution must meet the above criteria only during the academic period(s) for which the student loan was incurred. The deductibility of interest on the loan isn't affected by the institution's subsequent loss of eligibility.

TIP *The educational institution should be able to tell you if it is an eligible educational institution.*

Adjustments to Qualified Education Expenses

You must reduce your qualified education expenses by the total amount paid for them with the following tax-free items.

- Employer-provided educational assistance. See chapter 10.
- Tax-free distribution of earnings from a Coverdell education savings account (ESA). See *Tax-Free Distributions* in chapter 6.
- Tax-free distribution of earnings from a qualified tuition program (QTP). See *Figuring the Taxable Portion of a Distribution* in chapter 7.
- U.S. savings bond interest that you exclude from income because it is used to pay qualified education expenses. See chapter 9.

- The tax-free part of scholarships and fellowship grants. See *Tax-Free Scholarships and Fellowship Grants* in chapter 1.
- Veterans' educational assistance. See *Veterans' Benefits* in chapter 1.
- Any other nontaxable (tax-free) payments (other than gifts or inheritances) received as educational assistance.

Include as Interest

In addition to simple interest on the loan, if all other requirements are met, the items discussed below can be student loan interest.

Loan origination fee. In general, this is a one-time fee charged by the lender when a loan is made. To be deductible as interest, a loan origination fee must be for the use of money rather than for property or services (such as commitment fees or processing costs) provided by the lender. A loan origination fee treated as interest accrues over the life of the loan.

Loan origination fees weren't required to be reported on Form 1098E, Student Loan Interest Statement, for loans made before September 1, 2004. If loan origination fees aren't included in the amount reported on your Form 1098E, you can use any reasonable method to allocate the loan origination fees over the term of the loan.

Capitalized interest. This is unpaid interest on a student loan that is added by the lender to the outstanding principal balance of the loan. Capitalized interest is treated as interest for tax purposes and is deductible as payments of principal are made on the loan. No deduction for capitalized interest is allowed in a year in which no loan payments were made.

Interest on revolving lines of credit. This interest, which includes interest on credit card debt, is student loan interest if the borrower uses the line of credit (credit card) only to pay qualified education expenses. See *Qualified Education Expenses*, earlier.

Interest on refinanced and consolidated student loans. This includes interest on a loan used solely to refinance a qualified student loan of the same borrower. It also includes a single consolidation loan used solely to refinance two or more qualified student loans of the same borrower.

CAUTION *If you refinance a qualified student loan for more than your original loan and you use the additional amount for any purpose other than qualified education expenses, you can't deduct any interest paid on the refinanced loan.*

Allocating Payments Between Interest and Principal

The allocation of payments between interest and principal for tax purposes might not be the same as the allocation shown on the Form

1098E or other statement you receive from the lender or loan servicer. To make the allocation for tax purposes, a payment generally applies first to stated interest that remains unpaid as of the date the payment is due, second to any loan origination fees allocable to the payment, third to any capitalized interest that remains unpaid as of the date the payment is due, and fourth to the outstanding principal.

Example. In August 2022, you took out a $10,000 student loan to pay the tuition for your senior year of college. The lender charged a 3% loan origination fee ($300) that was withheld from the funds you received. The interest (5% simple) on this loan accrued while you completed your senior year and for 6 months after graduating. At the end of that period, the lender determined the amount to be repaid by capitalizing all accrued but unpaid interest ($625 interest accrued from August 2022 through October 2023) and adding it to the outstanding principal balance of the loan. The loan is payable over 60 months, with a payment of $200.51 due on the first of each month, beginning November 2023.

You didn't receive a Form 1098E for 2023 from the lender because the amount of interest you paid didn't require the lender to issue an information return. However, you did receive an account statement from the lender that showed the following 2023 payments on your outstanding loan of $10,625 ($10,000 principal + $625 accrued but unpaid interest).

Payment Date	Payment	Stated Interest	Principal
November 2023	$200.51	$44.27	$156.24
December 2023	$200.51	$43.62	$156.89
Totals	$401.02	$87.89	$313.13

To determine the amount of interest that could be deducted on the loan for 2023, you start with the total amount of stated interest you paid, $87.89. Next, allocate the loan origination fee over the term of the loan ($300 ÷ 60 months = $5 per month). A total of $10 ($5 of each of the two principal payments) should be treated as interest for tax purposes. You then apply the unpaid capitalized interest ($625) to the two principal payments in the order in which they were made, and determine that the remaining amount of principal of both payments is treated as interest for tax purposes. Assuming that you qualify to claim the student loan interest deduction, you can deduct $401.02 ($87.89 + $10 + $303.13).

For 2024, you will continue to allocate $5 of the loan origination fee to the principal portion of each monthly payment you make and treat that amount as interest for tax purposes. You will also apply the remaining amount of capitalized interest ($625 − $303.13 = $321.87) to the principal payments in the order in which they are made until the balance is zero, and treat those amounts as interest for tax purposes.

Don't Include as Interest

You can't claim a student loan interest deduction for any of the following items.

- Interest you paid on a loan if, under the terms of the loan, you aren't legally obligated to make interest payments.
- Loan origination fees that are payments for property or services provided by the lender, such as commitment fees or processing costs.
- Interest you paid on a loan to the extent payments were made through your participation in the National Health Service Corps Loan Repayment Program (the NHSC Loan Repayment Program) or certain other loan repayment assistance programs. For more information, see *Student Loan Repayment Assistance* in chapter 5.

When Must Interest Be Paid?

You can deduct all interest you paid during the year on your student loan, including voluntary payments, until the loan is paid off.

Can You Claim the Deduction?

Generally, you can claim the deduction if all of the following requirements are met.

- Your filing status is any filing status except married filing separately.
- No one else is claiming you as a dependent on their tax return.
- You are legally obligated to pay interest on a qualified student loan.
- You paid interest on a qualified student loan.

Claiming you as a dependent. Another taxpayer is claiming you as a dependent if they list your name and other required information on page 1 of their Form 1040, 1040-SR, or 1040-NR.

Example 1. During 2023, you paid $600 interest on your qualified student loan. Only you are legally obligated to make the payments. No one claimed you as a dependent for 2023. Assuming all other requirements are met, you can deduct the $600 of interest you paid on your 2023 Form 1040 or 1040-SR.

Example 2. During 2023, you paid $1,100 interest on your qualified student loan. Only you are legally obligated to make the payments. Your parents claimed you as a dependent on their 2023 tax return. In this case, neither you nor your parents may deduct the student loan interest you paid in 2023.

Interest paid by others. If you are the person legally obligated to make interest payments and someone else makes a payment of interest on your behalf, you are treated as receiving the payments from the other person and, in turn, paying the interest.

Example 1. You obtained a qualified student loan to attend college. After graduating from college, you worked as an intern for a nonprofit organization. As part of the internship program, the nonprofit organization made an interest payment on your behalf. This payment was treated as additional compensation and reported in box 1 of your Form W-2. Assuming all other qualifications are met, you can deduct this payment of interest on your tax return.

Example 2. You obtained a qualified student loan to attend college. After graduating from college, the first monthly payment on the loan was due in December. As a gift, your mother made this payment. No one is claiming you as a dependent on their tax return. Assuming all other qualifications are met, you can deduct this payment of interest on your tax return.

No Double Benefit Allowed

You can't deduct as interest on a student loan any amount that is an allowable deduction under any other provision of the tax law (for example, home mortgage interest).

You also can't deduct as interest on a student loan any amount paid from a distribution of earnings made from a QTP after 2018 to the extent the earnings are treated as tax free because they were used to pay student loan interest. For more information, see chapter 7.

For payments made after March 27, 2020, and before January 1, 2026, do not deduct as interest on a student loan any interest paid by your employer under an educational assistance program. See chapter 10.

Figuring the Deduction

Your student loan interest deduction is generally the smaller of:

- $2,500, or

- The interest you paid during the tax year.

However, the amount determined above may be phased out (gradually reduced) or eliminated based on your filing status and MAGI as explained below. You can use Worksheet 4-1 (at the end of this chapter) to figure both your MAGI and your deduction.

Form 1098-E. To help you figure your student loan interest deduction, you should receive Form 1098-E. Generally, an institution (such as a bank or governmental agency) that received interest payments of $600 or more during 2023 on one or more qualified student loans must send Form 1098-E (or an acceptable substitute) to each borrower by January 31, 2024.

For qualified student loans taken out before September 1, 2004, the institution is required to include on Form 1098-E only payments of stated interest. Other interest payments, such as certain loan origination fees and capitalized interest, may not appear on the form you receive. However, if you pay qualifying interest that isn't included on Form 1098-E, you can also deduct those amounts. See *Allocating Payments Between Interest and Principal*, earlier.

The lender may ask for a completed Form W-9S or similar statement to obtain the borrower's name, address, and taxpayer identification number. The form may also be used by the borrower to certify that the student loan was incurred solely to pay for qualified education expenses.

Effect of the Amount of Your Income on the Amount of Your Deduction

The amount of your student loan interest deduction is phased out (gradually reduced) if your MAGI is between $75,000 and $90,000 ($155,000 and $185,000 if you file a joint return). You can't claim a student loan interest deduction if your MAGI is $90,000 or more ($185,000 or more if you file a joint return).

Modified adjusted gross income (MAGI). For most taxpayers, MAGI is AGI as figured on their federal income tax return before subtracting any deduction for student loan interest. However, as discussed below, there may be other modifications.

Table 4-2 shows how the amount of your MAGI can affect your student loan interest deduction.

Table 4-2. **Effect of MAGI on Student Loan Interest Deduction**

IF your filing status is...	**AND your MAGI is...**	**THEN your student loan interest deduction is...**
single, head of household, or qualifying surviving spouse	not more than $75,000	not affected by the phaseout.
	more than $75,000 but less than$90,000	reduced because of the phaseout.

	$90,000 or more	eliminated by the phaseout.
married filing joint return	not more than $155,000	not affected by the phaseout.
	more than $155,000but less than $185,000	reduced because of the phaseout.
	$185,000 or more	eliminated by the phaseout.

MAGI when using Form 1040 or 1040-SR. If you file Form 1040 or 1040-SR, your MAGI is the AGI on line 11 of that form figured without taking into account any amount on Schedule 1 (Form 1040), line 21 (student loan interest deduction), and 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 1040-NR. If you file Form 1040-NR, your MAGI is the AGI on line 11 of that form figured without taking into account any amount on Schedule 1 (Form 1040), line 21 (student loan interest deduction).

Phaseout. If your MAGI is within the range of incomes where the credit must be reduced, you must figure your reduced deduction. To figure the phaseout, multiply your interest deduction (before the phaseout, but not more than $2,500) by a fraction. The numerator (top part) is your MAGI minus $75,000 ($155,000 in the case of a joint return). The denominator (bottom part) is $15,000 ($30,000 in the case of a joint return). Subtract the result from your deduction (before the phaseout) to give you the amount you can deduct.

Example 1. During 2023, you paid $800 interest on a qualified student loan. Your 2023 MAGI is $170,000 and you are filing a joint return. You must reduce your deduction by $400, figured as follows.

$$\$800 \quad \times \quad \frac{\$170{,}000 - \$155{,}000}{\$30{,}000} \quad = \quad \$400$$

Your reduced student loan interest deduction is $400 ($800 − $400).

Example 2. The facts are the same as in *Example 1*, except that you paid $2,750 interest. Your maximum deduction for 2023 is

$2,500. You must reduce your maximum deduction by $1,250, figured as follows.

$$\$2{,}500 \quad \times \quad \frac{\$170{,}000 - \$155{,}000}{\$30{,}000} \quad = \quad \$1{,}250$$

In this example, your reduced student loan interest deduction is $1,250 ($2,500 − $1,250).

Which Worksheet To Use

Generally, you figure the deduction using the Student Loan Interest Deduction Worksheet in the Schedule 1 (Form 1040) instructions included in the Instructions for Form 1040. However, if you are filing Form 2555, Foreign Earned Income; Form 4563, Exclusion of Income for Bona Fide Residents of American Samoa; or you are excluding income from sources within Puerto Rico, you must complete Worksheet 4-1.

Claiming the Deduction

The student loan interest deduction is an adjustment to income. To claim the deduction, enter the allowable amount on Schedule 1 (Form 1040), line 21.

Worksheet 4-1. **Student Loan Interest Deduction Worksheet**

Keep for Your Records

*Use this worksheet instead of the worksheet in the Schedule 1 (Form 1040) instructions if you are filing **Form 2555** or **4563**, or you are excluding income from sources within Puerto Rico. Before using this worksheet, you must complete **Form 1040** or **1040-SR**, line 9, and **Schedule 1 (Form 1040)**, lines 11 through 20, and 23 and 25.*

1.	Enter the total interest you paid in 2023 on qualified student loans. **Don't** enter more than $2,500		**1.**______
2.	Enter the amount from Form 1040 or 1040-SR, line 9	**2.**______	
3.	Enter the total of the amounts from Schedule 1 (Form 1040), lines 11 through 20, and 23 and 25	**3.**______	
4.	Subtract line 3 from line 2	**4.**______	
5.	Enter any foreign earned income exclusion and/or housing exclusion (Schedule 1 (Form 1040), line 8d)	**5.**______	
6.	Enter any foreign housing deduction (Schedule 1 (Form 1040), line 24j)	**6.**______	
7.	Enter the amount of income from Puerto Rico you are excluding	**7.**______	
8.	Enter the amount of income from American Samoa you are excluding (Form 4563, line 15)	**8.**______	
9.	Add lines 4 through 8. This is your **modified adjusted gross income**		**9.**______
10.	Enter the amount shown below for your filing status . . . . • Single, head of household, or qualifying surviving spouse—$75,000 • Married filing jointly—$155,000		**10.**______
11.	Is the amount on line 9 more than the amount on line 10? ☐ **No.** Skip lines 11 and 12, enter -0- on line 13, and go to line 14. ☐ **Yes.** Subtract line 10 from line 9		**11.**______
12.	Divide line 11 by $15,000 ($30,000 if married filing jointly). Enter the result as a decimal (rounded to at least three places). If the result is 1.000 or more, enter 1.000		**12.**___ . ___
13.	Multiply line 1 by line 12		**13.**______
14.	**Student loan interest deduction.** Subtract line 13 from line 1. Enter the result here and on Schedule 1 (Form 1040), line 21. **Don't** include this amount in figuring any other deduction on your return (such as on Schedule A, C, E, etc.)		**14.**______

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5.

Student Loan Cancellations and Repayment Assistance

Reminder

Student loan forgiveness. The American Rescue Plan Act of 2021 modified the treatment of student loan forgiveness for discharges in 2021 through 2025.

Introduction

Generally, if you are responsible for making loan payments, and the loan is canceled or repaid by someone else, you must include the amount that was canceled or paid on your behalf in your gross income for tax purposes. However, in certain circumstances, you may be able to exclude this amount from gross income if the loan was one of the following.

- A loan for postsecondary educational expenses.

- A private education loan.
- A loan from an educational organization described in section 170(b)(1)(A)(ii).
- A loan from an organization exempt from tax under section 501(a) to refinance a student loan.

Loan for Postsecondary Educational Expenses

This is any loan provided expressly for postsecondary education, regardless of whether provided through the educational institution or directly to the borrower, if such loan was made, insured, or guaranteed by one of the following.

- The United States, or an instrumentality or agency thereof.
- A state or territory of the United States; or the District of Columbia; or any political subdivision thereof.

- An eligible educational institution.

Eligible educational institution. An eligible educational institution 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. Virtually all accredited public, nonprofit, and proprietary (privately owned profitmaking) postsecondary institutions meet this definition.

An eligible educational institution also includes certain educational institutions located outside the United States that are eligible to participate in a student aid program administered by the U.S. Department of Education.

TIP *The educational institution should be able to tell you if it is an eligible educational institution.*

Private Education Loan

A private education loan is a loan provided by a private educational lender that:

- Is not made, insured, or guaranteed under Title IV of the Higher Education Act of 1965; and
- Is issued expressly for postsecondary educational expenses to a borrower, regardless of whether the loan is provided through the educational institution that the student attends or directly to the borrower from the private educational lender. A private education loan does not include an extension of credit under an open-end consumer credit plan, a reverse mortgage transaction, a residential mortgage transaction, or any other loan that is secured by real property or a dwelling.

Private educational lender. A private educational lender is one of the following.

- A financial institution that solicits, makes, or extends private education loans.
- A federal credit union that solicits, makes, or extends private education loans.
- Any other person engaged in the business of soliciting, making, or extending private education loans.

The cancellation of your loan won't qualify for tax-free treatment if it is canceled because of services you performed for the private educational lender that made the loan or other organization that provided the funds.

Loan From an Educational Organization Described in Section 170(b)(1)(A)(ii)

This is any loan made by the organization if the loan is made:

- As part of an agreement with an entity described earlier under which the funds to make the loan were provided to the educational organization, or
- Under a program of the educational organization that is designed to encourage its students to serve in occupations with unmet needs or in areas with unmet needs where the services provided by the students (or former students) are for or under the direction of a governmental unit or a tax-exempt section 501(c)(3) organization.

Educational organization described in section 170(b) (1)(A)(ii). This is an educational institution that maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where it carries on its educational activities.

Section 501(c)(3) organization. This is any corporation, community chest, fund, or foundation organized and operated exclusively for one or more of the following purposes.

- Charitable.
- Religious.
- Educational.
- Scientific.
- Literary.
- Testing for public safety.
- Fostering national or international amateur sports competition (but only if

none of its activities involve providing athletic facilities or equipment).

- The prevention of cruelty to children or animals.

CAUTION

The cancellation of your loan won't qualify for tax-free treatment if it is canceled because of services you performed for the educational organization that made the loan or other organization that provided the funds.

Refinanced Loan

If you refinanced a student loan with another loan from an educational organization or a tax-exempt organization, the cancellation of that loan may also be treated as discussed above. This applies if the new loan is made under a program of the refinancing organization that is designed to encourage students to serve in occupations with unmet needs or in areas with unmet needs where the services required of the students are for or under the direction of a governmental unit or a tax-exempt section 501(c)(3) organization (defined earlier).

Student Loan Repayment Assistance

Student loan repayments made to you are tax free if you received them for any of the following.

- The National Health Service Corps Loan Repayment Program (NHSC Loan Repayment Program).
- A state education loan repayment program eligible for funds under the Public Health Service Act.

  Any other state loan repayment or loan forgiveness program that is intended to provide for the increased availability of health services in underserved or health professional shortage areas (as determined by such state).

You can't deduct the interest you paid on a student loan to the extent payments were made through your participation in the above programs.

6.

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 (AGI) as figured on their federal income tax return.

Total contributions for the beneficiary in any year can't be more than $2,000, no matter how many separate Coverdell ESAs have been established for the beneficiary. 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 aren't deductible, but amounts deposited in the account grow tax free until distributed.

If, for a year, distributions from an account aren't more than a designated beneficiary's adjusted qualified education expenses (AQEE) at an eligible educational institution, the beneficiary won't owe tax on the distributions. See *Tax-Free Distributions*, later.

Table 6-1 summarizes the main features of the Cover-dell ESA.

Table 6-1. **Coverdell ESA at a Glance**

Don't rely on this table alone. It provides only general highlights. See the text for definitions of terms 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 MAGI 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 aren't more than the beneficiary's AQEE 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 later) 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 wouldn't result in total contributions for the year (not including rollover contributions) being more than $2,000.

3. Money in the account can't be invested in life insurance contracts.

4. Money in the account can't be combined with other property except in a common trust fund or common investment fund.

5. The balance in the account must generally 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. 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 7.

Eligible Educational Institution

An eligible educational institution can be either an eligible postsecondary school or an eligible elementary or secondary school.

Eligible postsecondary school. An eligible postsecondary school is generally any accredited public, nonprofit, or proprietary (privately owned profitmaking) college, university, vocational school, or other postsecondary educational institution. Also, the institution must be eligible to participate in a student aid program administered by the U.S. Department of Education. Virtually all accredited postsecondary institutions meet this definition. The educational institution should be able to tell you if it is an eligible educational institution.

An eligible educational institution also includes certain educational institutions located outside the United States that are eligible to participate in a student aid program administered by the U.S. Department of Education.

Eligible elementary or secondary school. An eligible elementary or secondary school 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 halftime.

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 halftime (defined below).

   The expense for room and board qualifies only to the extent that it isn't 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.

You may need to contact the eligible educational institution for qualified room and board costs.

4. The purchase of computer or peripheral equipment, computer software, or Internet access and related services if it is to be used primarily by the beneficiary during any of the years the beneficiary is enrolled at an eligible postsecondary school. (This doesn’t include expenses for computer software for sports, games,

or hobbies unless the software is predominantly educational in nature.)

Half-time student. A student is enrolled “at least half-time” if he or she is enrolled for at least half the fulltime academic workload 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 or peripheral equipment, computer software, fiber optic cables related to computer use, 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 doesn't 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 can't be made after the beneficiary reaches age 18, unless the beneficiary is a special needs beneficiary.
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 aren't 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 6-2 summarizes many of the features of contributing to a Coverdell ESA.

Table 6-2. **Coverdell ESA Contributions at a Glance**

Don't 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.

When contributions are 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 2024, and you designate it as a contribution for 2023, you are considered to have made that contribution on December 31, 2023.

Contribution Limits

There are two yearly limits.

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

Limit for each designated beneficiary. For 2023, the total of all contributions to all Coverdell ESAs set up for the benefit of any one designated beneficiary can't 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 a beneficiary was born in 2022, three separate Coverdell ESAs were set up, one by the parents, one by a grandparent, and one by an aunt. In 2023, the total of all contributions to the three Coverdell ESAs can't be more than $2,000. For example, if the grandparent contributed $2,000 to one of the Coverdell ESAs, no one else could contribute to any of the three accounts. Or, if the parents contributed $1,000 and the aunt $600, the grandparent or someone else could contribute no more than $400. These contributions could be put into any of the beneficiary's Coverdell ESA accounts.

Limit for each contributor. Generally, you can contribute up to $2,000 for each designated beneficiary for 2023. 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 the beneficiary's older sibling also has a Coverdell

ESA. If the grandparent contributed $2,000 to the beneficiary's Coverdell ESA in 2023, the grandparent could also contribute $2,000 to the sibling's Coverdell ESA.

Reduced limit. Your contribution limit may be reduced. If your MAGI (defined later) 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 can't contribute to anyone's Coverdell ESA.

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 1040 or 1040-SR. If you file Form 1040 or 1040SR, your MAGI is the AGI on line 11 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.

If you have any of these adjustments, you can use Worksheet 6-1 to figure your MAGI for Form 1040 or 1040SR.

MAGI when using Form 1040-NR. If you file Form 1040NR, your MAGI is the AGI on line 11 of that form.

Worksheet 6-1. **MAGI for a Coverdell ESA**

1.	Enter your AGI (Form 1040 or 1040-SR, line 11)		**1.** ________
2.	Enter your foreign earned income exclusion and/or housing exclusion (Form 2555, line 45)	**2.** ________	
3.	Enter your foreign housing deduction (Form 2555, line 50)	**3.** ________	
4.	Enter the amount of income from Puerto Rico you're excluding	**4.** ________	
5.	Enter the amount of income from American Samoa you're excluding (Form 4563, line 15)	**5.** ________	
6.	Add lines 2, 3, 4, and 5		**6.** ________
7.	Add lines 1 and 6. This is your **MAGI**		**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 part) is your MAGI minus $95,000 ($190,000 if filing a joint return). The denominator (bottom part) 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 6-2 to figure the limit on contributions.

Worksheet 6-2. **Coverdell ESA Contribution Limit**

1.	Maximum contribution	**1.**	$ 2,000
2.	Enter your MAGI for purposes of figuring the contribution limit to a Coverdell ESA (see definition or Worksheet 6-1)	**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	**5.**	
	Note. If the amount on line 4 is greater than or equal to the amount on line 5, **stop here**. You aren't allowed to contribute to a Coverdell ESA for 2023.		
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. A taxpayer filing as single had MAGI of $96,500 for 2023. The taxpayer can contribute up to $1,800 in 2023 for each beneficiary, as shown in the illustrated Worksheet 6-2.

Worksheet 6-2. **Coverdell ESA Contribution Limit—Illustrated**

1.	Maximum contribution	**1.** $ 2,000
2.	Enter your MAGI for purposes of figuring the contribution limit to a Coverdell ESA (see definition or Worksheet 6-1)	**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	**5.** 15,000
	Note. If the amount on line 4 is greater than or equal to the amount on line 5, **stop here**. You aren't allowed to contribute to a Coverdell ESA for 2023.	
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 may owe 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.

b. The contribution limit for the current year minus the amount contributed for the current year.

Exceptions. The excise tax doesn't apply if excess contributions made during 2023 (and any earnings on them) are distributed before the first day of the sixth month of the following tax year (June 1, 2024, 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 1099Q, Payments From Qualified Education Programs, 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 indicates the year in which the earnings are taxable. See *Instructions for Recipient* of your Form 1099Q, on the back of Copy B. Enter the amount of earnings on Schedule 1 (Form 1040), line 8z, for the applicable tax year. For more information, see *Taxable Distributions*, later.

The excise tax doesn't 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 2022, your parents and grandparents contributed a total of $2,300 to your Coverdell ESA—an excess contribution of $300. Because you didn't withdraw the excess before June 1, 2023, you had to pay an additional tax of $18 (6% × $300) when you filed your 2022 tax return.

In 2023, excess contributions of $500 were made to your account; however, you withdrew $250 from that account to use for qualified education expenses. Using the steps shown earlier under *Additional Tax on Excess Contributions*, you figure the excess contribution in your account at the end of 2023 as follows.

(1)	$500 excess contributions made in 2023		
+ (2)	$300 excess contributions in ESA at end of 2022		
– (2a)	$250 distribution during 2023		
	$550 excess at end of 2023	× 6% =	$33

If you limit 2024 contributions to $1,450 ($2,000 maximum allowed − $550 excess contributions from 2023), you won't owe any additional tax in 2024 for excess contributions.

Figuring and reporting the additional tax. You figure this excise tax on Form 5329, Part V. Report the additional tax on Schedule 2 (Form 1040), line 8.

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 isn't 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 doesn't 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.

Don't report qualifying rollovers (those that meet the above criteria) anywhere on Form

1040, 1040-SR, or 1040-NR. These aren't 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 you graduated from college in January last year, you had $5,000 left in your Coverdell ESA. You wanted to give this money to your younger sibling, who was still in high school. In order to avoid paying tax on the distribution of the amount remaining in your account, you contributed the same amount to your sibling’s Coverdell ESA within 60 days of the distribution.

You can make only one rollover from a Coverdell ESA to another Coverdell ESA in any 12-month period regardless of the number of Coverdell ESAs you own. However, you can make unlimited transfers from one Coverdell ESA trustee directly to another Coverdell ESA trustee because such transfers aren't considered to be distributions or rollovers. The limit of one rollover during any 12-month period doesn't *apply to the rollover of a military death gratuity or Servicemembers' Group Life Insurance (SGLI) payment.*

Military death gratuity. If you received a military death gratuity or a payment from SGLI, 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 *Members of the beneficiary's family*, earlier). Such payments are made to an eligible survivor upon the death of a member of the U.S. Armed Forces. The contribution to a Coverdell ESA from survivor benefits received can't be made later than 1 year after the date on which you receive the gratuity or SGLI payment.

This rollover contribution isn't subject to (but is in addition to) the contribution limits discussed earlier under *Contribution Limits*. The amount you roll over can't exceed the total survivor benefits you received, reduced by contributions from these benefits to a Roth IRA or other Coverdell ESAs.

The amount contributed from the survivor benefits is treated as part of your basis (cost) in the Coverdell ESA, and won't be taxed when distributed. See *Distributions*, later.

The limit of one rollover during any 12-month period doesn't apply to the rollover of a military death gratuity or SGLI payment.

Changing the Designated Beneficiary

The designated beneficiary can be changed. See *Members of the beneficiary's family*, earlier. There aren't any tax consequences if, at the time of the change, the new beneficiary is under age 30 or is a special needs beneficiary.

Example. Assume the same situation as in the last example (see *Rollovers*, earlier). Instead of closing your Coverdell ESA and paying the distribution into your sibling’s

Coverdell ESA, you could have instructed the trustee of your account to simply change the name of the beneficiary on your account to that of your sibling.

Transfer Because of Divorce

If a spouse or former spouse receives a Coverdell ESA under a divorce or separation instrument, it isn't a taxable transfer. After the transfer, the spouse or former spouse treats the Coverdell ESA as their own.

Example. In their divorce settlement, Taxpayer A received Taxpayer B’s Coverdell ESA. In this process, the account was transferred into Taxpayer A’s name. Taxpayer A now treats the funds in this Coverdell ESA as if they 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 (AQEE)* (defined later) the beneficiary has in the same tax year.

See Table 6-3 for highlights.

Table 6-3. **Coverdell ESA Distributions at a Glance**

Don't rely on this table alone. It provides only general highlights. See the text for definitions of terms 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 isn't more than the designated beneficiary's AQEE.
After the designated beneficiary completes	Yes. Amounts must be distributed when

the educational requirements at an eligible educational institution, can amounts remaining in the Coverdell ESA be distributed?	the designated beneficiary reaches age 30, unless the beneficiary 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 claim tax-free distribution?	No.

Adjusted qualified education expenses (AQEE). 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 fellowship grants (see *Tax-Free Scholarships and Fellowship Grants* in chapter 1);
- Veterans' educational assistance (see *Veterans' Benefits* in chapter 1);
- The tax-free part of Pell grants (see Pell Grants and Other Title IV Need-Based Education Grants in chapter 1);
- Employer-provided educational assistance (see chapter 10); 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 AQEE.

Tax-Free Distributions

Generally, distributions are tax free if they aren't more than the beneficiary's AQEE for the year. Don't 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 total distributions are more than the beneficiary's AQEE for the year.

Excess distribution. This is the part of the total distribution that is more than the beneficiary's AQEE for the year.

Earnings and basis. You will receive a Form 1099Q for each of the Coverdell ESAs from which money was distributed in 2023. The amount of your gross distribution will be shown in box 1. For 2023, instead of dividing the gross distribution between your earnings (box 2) and your basis (amount already taxed) (box 3), the payer or trustee may report the fair market value (account balance) of the Coverdell ESA as of December 31, 2023. This will be shown in the blank box below boxes 5 and 6.

The amount contributed from survivor benefits (see *Military death gratuity*, earlier) is treated as part of your basis and won't be taxed when distributed.

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 2023 as shown in the following steps.

1. Multiply the total amount distributed by a fraction. The numerator (top part) is the basis (contributions not previously distributed) at the end of

2022, plus total contributions for 2023, and the denominator (bottom part) is the value (balance) of the account at the end of 2023 plus the amount distributed during 2023.

2. Subtract the amount figured in (1) from the total amount distributed during 2023. 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 (top part) is the AQEE paid during 2023, and the denominator (bottom part) is the total amount distributed during 2023.

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 Schedule 1 (Form 1040), line 8z.

Example. You received an $850 distribution from your Coverdell ESA, to which $1,500 had been contributed before 2023. There were no contributions in 2023. This is your first distribution from the account, so your basis in the account on December 31, 2022, was $1,500. The value (balance) of your account on December 31, 2023, was $950. You had $700 of AQEE for the year. Using the steps in *Figuring the Taxable Portion of a Distribution*, earlier, 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 Schedule 1 (Form 1040), line 8z, listing the type and amount of income.

Worksheet 6-3, at the end of this chapter, can help you figure your AQEE, how much of your distribution must be included in income, and the remaining basis in your Coverdell ESA(s).

Worksheet 6-3 Instructions. **Coverdell ESA—Taxable Distributions and Basis**

Line G.	Enter the total distributions received from **all** Coverdell ESAs during 2023. Don't include amounts rolled over to another ESA within 60 days (only one rollover is allowed during any 12-month period). Also, don't 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, 2022, is the total of: • All contributions to this Coverdell ESA before 2023, minus • The tax-free portion of any distributions from this Coverdell ESA before 2023. If your last distribution from this Coverdell ESA was before 2023, 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 Pub. 970 for that year. You can determine your basis in this Coverdell ESA as of December 31, 2022, 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 2023.
Line 4.	Enter the total distributions received from **this** Coverdell ESA in 2023. Don't include amounts rolled over to another Coverdell ESA within 60 days (only one rollover is allowed during any 12-month period). Also, don't 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, 2023, plus any outstanding rollovers contributed to the account after 2022, but before the end of the 60-day rollover period. A statement should be sent to you by January 31, 2024, for this Coverdell ESA showing the value on December 31, 2023. 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 2023 (November 2 through December 31) that was rolled over after December 31, 2023, but within the 60-day rollover period.

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Coordination With American Opportunity and Lifetime Learning Credits

The American opportunity 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 aren't used for both benefits. This means the beneficiary must reduce qualified higher education expenses (QHEE) by tax-free educational assistance, and then further reduce them by any expenses taken into account in determining an American opportunity or lifetime learning credit.

Example. In 2023, during your first year in college you had $5,800 of QHEE. You paid your 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 the $5,800 of QHEE, $4,000 was tuition and related expenses that also qualified for an American opportunity credit. Your parents claimed a $2,500 American opportunity credit (based on $4,000 expenses) on their tax return.

Before you can determine the taxable portion of your Coverdell ESA distribution, you must reduce your total QHEE.

Total QHEE	$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 AQHEE ($300) are less than the Coverdell ESA distribution ($1,000), part of the distribution will be taxable. The balance in your account was $1,800 on December 31, 2023. Prior to 2023, $2,100 had been contributed to this account. Contributions for 2023 totaled $400. Using the four steps outlined earlier, you figure the taxable portion of your distribution as shown below.

1. $$\$1{,}000 \text{ (distribution)} \times \frac{\$2{,}100 \text{ basis} + \$400 \text{ contributions}}{\$1{,}800 \text{ value} + \$1{,}000 \text{ distribution}}$$
$$= \$893 \text{ (basis portion of distribution)}$$

2. $$\$1{,}000 \text{ (distribution)} - \$893 \text{ (basis portion of distribution)}$$
$$= \$107 \text{ (earnings included in distribution)}$$

3. $$\$107 \text{ (earnings)} \times \frac{\$300 \text{ AQHEE}}{\$1{,}000 \text{ distribution}}$$
$$= \$32 \text{ (tax-free earnings)}$$

4. $$\$107 \text{ (earnings)} - \$32 \text{ (tax-free earnings)}$$
$$= \$75 \text{ (taxable earnings)}$$

You must include $75 in income (Schedule 1 (Form 1040), line 8z). This is the amount of distributed earnings not used for AQHEE.

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 AQEE, 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 2023, you graduated from high school and began your first semester of college. That year, you had $1,000 of qualified elementary and secondary education expenses (QESEE) for high school and $3,000 of QHEE for college. Your QESEE doesn't include tuition. To pay these expenses, you withdrew $800 from your Coverdell ESA and $4,200 from your QTP. No one claimed you as a dependent, nor were you eligible for an education credit. You didn't receive any tax-free educational assistance in 2023. You must allocate your total qualified education expenses between the two distributions.

1. You know that tax-free treatment will be available if you apply your $800 Coverdell ESA distribution toward your $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, you match your $4,200 QTP distribution to your $3,000 of QHEE, and find you have an excess QTP distribution of $1,200 ($4,200 QTP − $3,000 QHEE). You can't use the extra $200 of high school expenses (from (1) above) against the QTP distribution because those expenses are not high school tuition expenses and don't qualify a QTP for tax-free treatment.

3. Finally, you figure the taxable and tax-free portions of your QTP distribution based on your $3,000 of QHEE. (See *Figuring the Taxable Portion of a Distribution* in chapter 7 for more information.)

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

1. Using the same reasoning as in *Example 1*, you match $1,000 of your Coverdell ESA distribution to your $1,000 of QESEE—you have $800 of your distribution remaining.

2. Because higher education expenses can also qualify a Coverdell ESA distribution for tax-free treatment, you allocate your $3,000 of QHEE between the remaining $800 Coverdell ESA and

the $3,200 QTP distributions ($4,000 total).

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

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

3. You then figure the taxable part of the following.

   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 7).

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

Losses on Coverdell ESA Investments

For tax years beginning after 2017 and before 2026, if you have a loss on your investment in a Coverdell ESA, you can’t deduct the loss on your income tax return. You have a 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.

Additional Tax on Taxable Distributions

Generally, if you receive a taxable distribution, you must also pay a 10%

additional tax on the amount included in income.

Exceptions. The 10% additional tax doesn't apply to the following 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 proof is provided showing there is a physical or mental impairment that substantially limits any gainful activity. A physician must determine that the person's 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 grant (see Tax-Free Scholarships and Fellowship Grants in chapter 1);

b. Veterans' educational assistance (see *Veterans' Benefits* in chapter 1);

c. Employer-provided educational assistance (see chapter 10); or

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

This exception applies only to the extent the distribution isn't more than the scholarship, allowance, or payment.

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 doesn't 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 or lifetime learning credit (see *Coordination With American Opportunity and Lifetime Learning Credits*, earlier).

6. Made before June 1, 2024, of an excess 2023 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.

Figuring the additional tax. Use Part II of Form 5329 to figure any additional tax. Report the amount on Schedule 2 (Form 1040), line 8.

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 doesn't apply if the beneficiary is a special needs beneficiary.
2. The designated beneficiary dies. In this case, the remaining assets must generally be distributed within 30 days after the date of death.