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From TaxLogic and Better Business Services we wish you the best for the Holiday Season and a Prosperous New Year.

While thoughts at this time turn to family, we need to be aware that the New Year brings tax changes and complexity. While you are with family this week you may reflect on education and the enormous cost this now accounts for in a family budget. Congress has made a number of changes in the Code this year – in this issue we will review the Education IRA.

Education IRA (Coverdell Education Savings Account)

In 2002 this was called the Education IRA - most people passed on it, as the limit was $500 per beneficiary - hardly significant when annual costs can approach $20,000 a year and more.

But effective January 1, 2002 the Education IRA has been renamed the Coverdell Education Savings Account (ESA).

The changes are basically:

a) The name change to Coverdell Education Savings Account (ESA).

b) An increase in the contribution limit from $500 / year to $2,000 per year per beneficiary.

c) An extended contribution deadline (contribute for a year up until April 15th of the following year).

d) Expanded federal income tax free distributions - basically you can use the account to fund primary and secondary education as well as higher education costs.

e) The ability to contribute to both a Coverdell ESA and a 529 college savings plan for the same beneficiary in the same year.

Remember that the ESA is not deductible to the contributor but the earnings accumulate tax-free and the distributions for qualified expenses will be tax-free

There are some drawbacks that you should be aware of in considering using a Coverdell Education Savings Account:

a) There are certain eligibility requirements in the year you wish to contribute to the Coverdell account, which means that not everyone will find them useful. For example, the age limits mean that older adults with college plans may not be eligible.

b) Starting in 2002, the contribution limit is increased from $500 per child to the much more reasonable level of $2,000. However, you need to be careful - accounts established by different family members for the same child do not cause total contributions to exceed $2,000 or else a penalty will be owed.

c) The relatively low contribution caps mean that even a small annual maintenance fee charged by the financial institution holding your Coverdell education savings account could significantly affect your overall investment return.

d) Your contribution goes into an account that will eventually go to your child if not used for college. You cannot simply refund the account back to yourself like you can with most 529 plans. This means you lose some degree of control.

e) The Coverdell education savings account can be a disadvantage when applying for federal financial aid. The account is considered an asset of the student, not the parent. Withdrawals while in college can also produce a harsh effect on the following year's aid eligibility because it is counted as student's income.

f) Coordinating withdrawals with other tax benefits, especially the Hope or Lifetime Learning credits, can be tricky. The 2002 changes are certainly an improvement over the 2001 rules, but you still need to pay close attention. The same situation applies to a 529 account starting in 2002.

g) The account must be fully withdrawn by the time the beneficiary reaches age 30, or else it will be subject to tax and penalties.

h) The rules are somewhat confusing and the tax forms are complicated. The new tax law will not be much help here. In fact, even the 529 plan will become more difficult to handle on your tax returns beginning with 2002 because of the changes.

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