Traditional IRAs and Roth IRAs

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What are traditional IRAs and Roth IRAs?

A traditional IRA is a personal savings plan that offers tax benefits to encourage retirement savings. In 2023, you can contribute up to $6,500 per year (additional “catch-up” contributions are allowed if you are age 50 or older). You and your spouse together may contribute double the annual limit, even if your spouse has little or no compensation. Contributions may be fully or partially tax deductible, depending on certain factors. Investment earnings in a traditional IRA grow tax deferred, but distributions will be subject to federal and possibly state income tax (excluding the portion that represents nondeductible contributions).

The Roth IRA is another type of personal savings plan that offers tax benefits to encourage retirement savings. The same contribution limits that apply to traditional IRAs also apply to Roth IRAs. With a Roth IRA, however, your allowable contribution may be reduced or eliminated if your annual income exceeds certain limits. Contributions to a Roth IRA are never tax deductible, but if certain conditions are met, distributions will be completely income tax free.

Traditional IRAs and Roth IRAs are not themselves investments, but rather tax-advantaged vehicles in which you can hold your retirement investments. You can open a traditional IRA or Roth IRA with a financial institution, such as a bank, mutual fund company, life insurance company or brokerage. Once you open an IRA, you then need to select the specific investments to fund the IRA.

Tip: The annual IRA contribution limit for any year (including the catch-up amount) is a combined limit that applies to all your IRAs. For example, if you have both traditional IRAs and Roth IRAs, your total contribution to all your IRAs cannot exceed $6,500 (plus catch-up contributions if you are eligible to make those).

How can traditional IRAs and Roth IRAs be used to fund college expenses?

The premature distribution tax (also known as the early withdrawal penalty tax) is a 10% federal penalty tax that may apply when you take money from a traditional or Roth IRA. This penalty tax is generally imposed on the taxable portion of any IRA distribution made prior to age 59½, and is in addition to ordinary federal income tax. However, federal law provides a number of exceptions to the penalty tax. One of these exceptions allows you to withdraw money for qualified higher education expenses. The money that you withdraw must be used to pay the qualified higher education expenses of you or your spouse, or the children or grandchildren of you or your spouse.

Prerequisites

You must have or be eligible to establish an IRA
Clearly, to use IRA dollars to meet college expenses, you must either have an existing traditional IRA or a Roth IRA, or be eligible to establish and fund one. Anyone who has taxable compensation can set up and contribute to a traditional IRA, but there are eligibility requirements that must be met to make tax-deductible contributions. As for a Roth IRA, the amount of your allowable contribution (if any) depends on your annual income and federal income tax filing status.

Your withdrawals must be used to pay qualified higher education expenses
To qualify for the exception to the premature distribution tax, your IRA withdrawals must be used to fund qualified higher education expenses. Qualified higher education expenses include tuition, room and board (if the student attends at least half-time), fees, books, supplies and equipment required for enrollment at a post-secondary school, including graduate school.

In addition, the education expenses in question must be actual out-of-pocket costs. Consequently, education expenses paid with any type of tax-free resources (e.g., scholarships, distributions from a Coverdell Education Savings account or employer-provided assistance) will not count as qualified higher education expenses for this purpose.

Example: Judy's daughter's total tuition, room and board, and other qualified education expenses total $25,000 for the school year. All but $5,000 of that total is paid using a tax-free federal grant, a tax-free scholarship, a tax-free distribution from a Coverdell Education Savings Account and tax-free employer-provided educational assistance. The result is that all these amounts reduce the $25,000 that Judy's 50-year-old father could otherwise withdraw from his traditional IRA without incurring the 10% premature distribution tax. Because there are only $5,000 worth of qualified education expenses left to be paid for the year, Judy's father can withdraw no more than $5,000 from his traditional IRA penalty free. If he withdraws more than $5,000, the excess amount will be subject to the premature distribution tax.

The education expenses must be incurred by you, your spouse, your children or grandchildren, or your spouse's children or grandchildren
The child or grandchild does not have to be your dependent. Also, if a grandparent withdraws money from an IRA to help pay the education expenses of a grandchild, it is likely that the grandparent will be over the age of 59½, in which case the premature distribution tax would not apply anyway.

Strengths

Premature distribution tax is waived
As discussed, money you withdraw from a traditional IRA or Roth IRA to pay qualified education expenses is not subject to the 10% premature distribution tax that normally applies to IRA distributions made before the age of 59½. However, some or all of the IRA money you withdraw may still be subject to ordinary federal (and possibly state) income tax.

The federal government does not consider the value of your traditional IRA or Roth IRA in determining your child's financial aid eligibility
In its formula for financial aid, the federal government counts some assets and excludes others in determining a family's total available assets to contribute toward college costs. One type of asset the government excludes from this formula is retirement assets, including IRAs and most employer-sponsored retirement plans.

Example: Assume the Smith family has $10,000 in a savings account and a traditional IRA currently worth $80,000. Under the federal government's formula for financial aid, the Smith family's total assets are considered to be only $10,000.

Caution: Though the federal government does not count your IRA accounts among your assets when determining financial aid eligibility, it does consider how much money you contribute to your IRAs in the year before you fill out its Free Application for Federal Student Aid (FAFSA). If you contribute money to an IRA in the year prior to the year you complete the FAFSA, this contribution is considered discretionary and is added to your total income for the year.

Tradeoffs

Your retirement nest egg is reduced

Most financial professionals recommend that you avoid using your IRAs and other retirement dollars if other assets are available to meet college expenses. This is because the primary purpose of IRAs and other retirement accounts should be to help fund your retirement years, not to finance your children's education. There is a risk that using retirement money for education or other expenses could jeopardize your ability to achieve your retirement goals. Why? Any money that you withdraw from your traditional IRA or Roth IRA reduces the size of your retirement nest egg and leaves less money in the account that receives the benefits of tax deferral.

Colleges may consider the value of your traditional IRA and Roth IRA before awarding their own financial aid

Although the federal government does not count the value of your traditional IRA or Roth IRA in determining your child's eligibility for financial aid, individual colleges may consider the value of such accounts in determining your child's eligibility for campus-based financial aid. Many colleges consider the value of retirement accounts crucial in accurately measuring your family's ability to pay, and may expect you to use some of that money before institutional aid is forthcoming.

Tax considerations

With a Roth IRA, qualifying distributions are income tax free at the federal level. A qualifying distribution is one that is made five years after your first contribution to the account, and that satisfies one of the following conditions: (1) you are at least the age of 59½ at the time of distribution, (2) the distribution is made due to disability, (3) the distribution is made to pay first-time homebuyer expenses or (4) the distribution is made by your beneficiary after your death. If your distribution is not a qualifying distribution, then the distribution is taxable to the extent that it consists of investment earnings. Contributions to a Roth IRA are never subject to income tax when distributed because all contributions are made with after-tax dollars.

With a traditional IRA, the income tax treatment of distributions depends on whether or not your contributions to the IRA were tax deductible at the time you made them. If the traditional IRA was entirely funded with tax-deductible contributions, then the full amount of any distribution from the IRA (both contributions and investment earnings) will be included in your taxable income for federal income tax purposes. However, if your traditional IRA was funded with any nondeductible (after-tax) contributions, then only the portion of a distribution that represents earnings and deductible contributions will be included in your taxable income for federal income tax purposes.

Caution: IRA withdrawals that are included in your taxable income might push you into a higher federal income tax bracket for the year.

Can your child contribute to a traditional IRA or Roth IRA?

It depends. If your child has taxable compensation (e.g., earnings from a part-time job), then they can contribute to a traditional or Roth IRA. It is critical that your child has taxable compensation. If you give your child money as a gift and the child has no taxable compensation, then they are ineligible to contribute to an IRA. If your child qualifies to have a traditional or Roth IRA, they can reap the same benefits as you if the money is used to meet college expenses. Specifically, the 10% premature distribution tax does not apply to IRA distributions that are used to pay qualified higher education expenses. The main benefit of setting up an IRA in your child's name is that any taxable distributions from the IRA will be taxed at the child's rate, which is typically lower than your tax rate.