

The topic of this article is Roth IRAs and how they can be used for more than just retirement.

What is a Roth IRA?

In many ways, a Roth IRA is the opposite, after tax version of the Traditional IRA. To be specific, whereas a regular IRA allows for tax-deductible contributions up to \$4,000 annually (depending on AGI and other pension/profit-sharing plan coverage), all distributions from Traditional IRAs are fully taxable for both state and federal income tax purposes. On the other hand, Roth IRA contributions are made with after-tax dollars but all distributions are (state and federal) income tax-free. (subject to the 5 year holding rule). Roth IRAs also provide for special hardship withdrawals for such things as: first-time purchase of a home, medical expenses, and higher education expenses. These withdrawals are NOT subject to income taxes provided that the account has been established for a minimum of five (5) years. In other words, it is possible to earmark funds for retirement, benefit from tax deferral, possibly shield income/assets from college financial aid forms, and still have funds available for a future “hardship” withdrawal.

Why is this important?

One strategy advocated by college financial planning advisers calls for maximizing annual Roth IRA contributions. First, qualified retirement plan assets are favorably viewed on financial aid forms. Other non-qualified parent-owned assets are subject to a 5.6% figure under FAFSA whether those assets are intended to be used for college expenses or not. Accordingly, by moving assets into Roth IRAs, parents can help their child(ren) receive the maximum financial aid benefit possible.

Secondly, if the parents “need” funds to help pay for tuition, they have the right to a “hardship” withdrawal from their Roth. They will have benefited from five or more years of tax free growth. On the other hand, if assets are individually-registered, the assets must be sold or redeemed and would be subject to taxes in addition to negative treatment under FAFSA.

Does withdrawing funds hurt retirement funding?

The simple answer is “Yes, of course.” However, there are two other things to consider. First, Coverdell and Individual 529 Savings Plan assets MUST be used for college funding. Assets in these plans CANNOT be used for retirement savings. If the child decides not to attend college, there are financial consequences. On the other hand, Roth IRA assets are earmarked for retirement but MAY be withdrawn for higher education expenses. Secondly, as a result of the liberalization in allowable contributions in both Roth and Traditional IRAs and the “catch up provision” for individuals over 50, parents can set aside more money every year and have “time” later to replenish their accounts.

## What Other Advice Can We Offer?

Nonqualified deferred annuities do not allow for hardship withdrawals. Any full/partial surrender is subject to both federal and state income taxes and to a 10% excise penalty tax if the withdrawal is made prior to the owner's reaching age 59.5.

"Hardship withdrawals" can be made from a Traditional IRA for college education expenses. However, these distributions will be treated as ordinary income for tax purposes AND will distort a parent's income. If the child is applying for financial aid, FAFSA will treat these distributions as income and may result in a reduced financial aid grant.

Roth and Traditional IRA contributions are limited to \$4,000 for tax year 2005 for individuals under age 50. That amount increases to \$4,500 as a result of the "catch up" provision for individuals 50 and over.

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