



Tax Talk & Financial Planning

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Higher Education Planning...You mean I can use a Roth IRA?

A Roth IRA offers federal tax-free earnings if certain conditions are met. Earnings are tax-free at the federal level if the distribution is “qualified.” A distribution is qualified if a five-year holding period requirement is met and one of the following conditions is met:

- you are at least age 59 1/2
- distribution is made due to a qualifying disability
- usage for certain first-time homebuyer expenses
- by your beneficiary after your death

If you are younger than age 59 1/2 and you have a taxable distribution, you will also pay a premature distribution tax (also called an early withdrawal penalty) equal to 10% of the earnings portion of the distribution. However, one of the exceptions to this penalty is if the money withdrawn is used to **pay for qualified higher education expenses.**

If you withdraw money before age 59 1/2 to pay for higher education expenses, you’ll generally owe income tax on the earnings, but not an early withdrawal penalty. However, you may not end up owing income tax on the earnings, because Roth IRA distributions generally aren’t taxed as earnings until the principal has been fully withdrawn. By contrast, a distribution from a 529 plan is considered part principal and part earnings.

Another potential benefit to a Roth IRA is that the federal aid methodology doesn’t count retirement assets in determining aid eligibility. So a Roth IRA won’t impact the amount of federal aid you, your child or your grandchildren may be eligible for. However, although Uncle Sam doesn’t count retirement assets, colleges typically do when awarding their own institutional aid.

Roth IRAs have a contribution limit in 2010 of \$5,000 (\$6,000 for individuals age 50 or older). And your ability to contribute to a Roth IRA depends on your income level. However, with new rules in place beginning in 2010, it is now easier than ever to convert your traditional IRA into a Roth. With a Roth IRA you have a wide range of investment choices and you can buy and sell whenever you like. With a 529 plan you are limited to the investment options offered by the plan.

If you have a child or grandchild that will be attending college, now is the time to start planning regardless of their age. It is highly recommended to do a full review of your college planning along with an analysis and comparison of the different types of planning opportunities available (529 Investment plans, prepaid college plans, UTMA’s, Educational IRAs, Roth IRAs) to make sure you are in the most appropriate investment and tax efficient plan for you.

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