COVERDELL EDUCATION SAVINGS ACCOUNTS (FORMERLY EDUCATION IRAS)

A Coverdell Education Savings Account (named for the late Senator Paul Coverdell of Georgia who championed them) may be established for a child under age 18. The amount that can be contributed each year is $2,000. Earnings accumulate tax-free.

Money taken from one of these accounts is not taxable to the individual provided it is used for qualifying higher education expenses and does not exceed the actual expenses for the year. Qualifying expenses include tuition, fees, room and board, books, supplies, and equipment at a post-secondary educational institution. Account funds can also be used to pay elementary and secondary school expenses, including the purchase of a computer system, educational software, and internet access for the child.

If the individual who is the beneficiary of the account decides not to pursue higher education, the account can be transferred to another member of the family. All funds must be used before reaching age 30. Any unused funds will then become taxable income. The phaseout rule for funding the Coverdell Savings Account is the same as the rule for the Roth IRA.

Enrolled Agents (EAs) are federally-authorized tax practitioners who have technical expertise in the field of taxation and are licensed to represent taxpayers before the Internal Revenue Service at all administrative levels for audits, collections, and appeals. In addition, Enrolled Agents are the only tax practitioners required by federal law to maintain their expertise through continuing professional education. When you need up-to-date tax assistance, see an Enrolled Agent.

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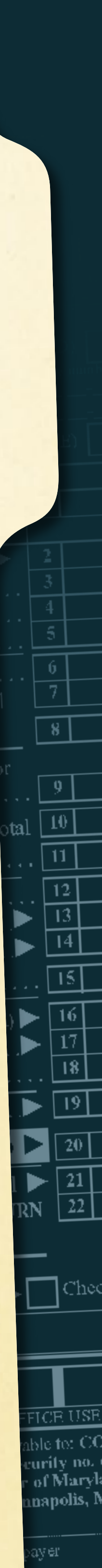
The Truth about IRAs and Their Deductibility



National Association of Enrolled Agents

The Truth about IRAs and Their Deductibility

WHAT IS AN IRA?

An IRA (Individual Retirement Account) is a tax-advantaged personal savings plan used to set aside money for retirement. There are two types of retirement IRAs—a traditional IRA and a Roth IRA.

There is also a special savings account for education, formerly known as an Education IRA. It is now called a Coverdell Education Savings Account.

CAN EVERYONE CONTRIBUTE?

Every gainfully employed individual, whether an employee or self-employed, is eligible to contribute to an IRA. Alimony may also be counted as wages for the purpose of computing an IRA. The contribution may or may not be tax deductible, depending on your circumstances.

HOW MUCH CAN I CONTRIBUTE?

For 2004, the maximum contribution is limited to $3,000 per person per year. If the person's earned income is less than $3,000, the amount of earned income is the limit. Non-working spouses can contribute up to $3,000 to their own IRA.

The contribution limit is $4,000 in 2005, 2006, and 2007; and reaches $5,000 in 2008.

IS THERE A LIMIT TO THE DEDUCTIBILITY OF MY CONTRIBUTION TO A REGULAR IRA?

There is a limit to the deductibility of your contribution to an IRA based on your Adjusted Gross Income (AGI). For a married couple, the 2004 AGI phaseout is between $65,000 to $75,000. This means that your deduction will be limited as a deductible contribution based on your income. With an AGI of $65,000, you begin losing part of your deduction until it's all gone at $75,000 AGI. You can still make a non-deductible contribution. If one spouse is covered by a pension plan and the other spouse is not covered, the non-covered spouse can make a deductible contribution of up to $3,000.

In 2003 and thereafter, taxpayers age 50 and over may contribute additional amounts to their traditional and Roth IRAs up to $500.

WHEN MUST WITHDRAWALS FROM TRADITIONAL IRAS BEGIN?

Taxpayers may begin to make withdrawals without being subject to an early withdrawal penalty when they reach age 59½. Taxpayers must begin to take distributions no later than April 1 of the year following the year in which the taxpayer reaches age 70½.

PENALTY-FREE WITHDRAWALS FROM IRAS

There are three exceptions to the 10% penalty for early withdrawal from traditional IRAs:

- Qualifying higher education expenses for the taxpayer, spouse, or taxpayer's child or grandchild are not subject to the early withdrawal penalty.
- First-time home purchases qualify for the exception. First time home-buyers include the taxpayer, spouse, children, grandchildren, and ancestors who have not owned a home for the prior 2-year period. These distributions are limited to a lifetime $10,000 per individual IRA owner.
- The third exception allows qualifying unemployed individuals to withdraw IRA funds without penalty in order to pay for medical insurance for the individual and his or her spouse and dependents. The individual must have received federal or state unemployment compensation for 12 consecutive weeks. This includes self-employed individuals who would be eligible for unemployment if he or she were an employee. IRA funds may be withdrawn to pay for medical insurance until the individual is re-employed for 60 days (not necessarily consecutive).

If you plan to withdraw IRA funds for any of the three exceptions, remember that the exceptions are only on the penalties, and not on the tax. You must report the distribution and pay tax at your normal rate on all distributions.

THE ROTH IRA

Taxpayers may also contribute to a nondeductible IRA called the Roth IRA. Earnings grow tax-free and can be withdrawn tax-free, provided the Roth IRA has been open and funded for at least 5 years and one of the following events has occurred:

- You have reached age 59½;
- You become disabled; or distribution is made to a beneficiary on or after your death; or
- You are using the money for a first-time home purchase ($10,000 lifetime maximum).

Combined contributions to traditional and Roth IRAs cannot exceed $3,000 per person per year, subject to phaseout rules. The current phaseouts are between $95,000–$110,000 for singles, and $150,000–$160,000 for married couples. The contribution limit is $3,000 in 2004; $4,000 in 2005, 2006, and 2007; and reaches $5,000 in 2008.

Taxpayers are not required to begin taking distributions after reaching age 70½. In fact, the taxpayer may continue to contribute to the Roth IRA as long as he or she has earned income, and the taxpayer never has to take any distributions from the account.

Taxpayers with AGIs less than $100,000 can roll over traditional IRAs into Roth IRAs with no penalty. Proceeds from qualified retirement plans such as a 401(k) plan or a 403(b) cannot be rolled over directly into a Roth IRA. The income level applies to all taxpayers, single or married. Married taxpayers must file a joint return. While there is no penalty associated with this rollover, income tax must be paid on the taxable income in the rollover.