Alternative Uses for IRAs

The Motley Fool

By Elizabeth Brokamp

We all know that an IRA is meant to build a tidy little nest egg for retirement. After all, it's not called an "Individual *Retirement* Arrangement" for nothing. (Yes, the A stands for Arrangement, not Account — ask the IRS.)

And most of us also know that if we try to use that money before we reach retirement age (59 1/2 in this case), then we might pay a 10% penalty. That might scare some people away from IRAs, especially younger investors who fear they might need the money some time during the intervening decades.

If that's you, then we have good news. In some cases, you can get your hands on your IRA money before age 59 1/2 and not pay a penalty. In fact, some financial planners actually recommend using an IRA for a financial goal other than retirement. What are some of these alternative uses for an IRA?

1. Pay for college.

IRA assets used to pay for qualified higher-education expenses - such as tuition, fees, books, room, and board - are exempt from the 10% penalty. However, the money may be subject to ordinary income taxes. With a traditional IRA, tax-deductible contributions and any earnings on those contributions will be taxed when withdrawn.

If you made after-tax contributions to a traditional IRA (i.e., you weren't able to take a deduction on your tax return in the year you made the contribution), then that money will come out tax-free. In that case, a formula is used to determine exactly how much of your withdrawal is attributable to the after-tax contribution and how much is due to earnings. It's no big deal if you drain the entire account. But if you only spend part of it, then the IRS will consider it a partial withdrawal of earnings and a partial withdrawl of the after-tax contribution.

Roth IRAs, which are always funded with after-tax money, are less complicated. The first dollars that come out are attributable to contributions. So if you contributed a total of $8,000 to a Roth IRA that is now worth $14,000, the first $8,000 you take out is tax-free. After that, you'll have to pay ordinary income tax. Again, you won't have to pay the 10% penalty as long as the money is spent in the pursuit of a post-secondary education.

2. Pay for a house.

You can use your IRA to help put a roof over your head, as long as you're considered a first-time homebuyer, which according to the IRS, includes anyone who hasn't owned a home in the past two years. Go figure.

There is a $10,000 lifetime limit on how much can be withdrawn penalty-free, and, as in the case of college expenses above, the withdrawals might still be taxable. There are a few other caveats, so before you tap your next egg to feather your nest, read this article by Fool tax guru Roy Lewis.

Continued on back

3. A backup emergency fund.

As mentioned earlier, *contributions* to a Roth IRA can be withdrawn tax- and penalty-free. It doesn't even matter how you use that money - college, a house, a hot tub, whatever. Therefore, as *Rule Your Retirement* editor Robert Brokamp explains, a Roth IRA might make for a backup emergency fund in some cases. We say "backup" because you should still have an emergency stash to cover three to six months' worth of expenses in a safe place, such as a money market. But if a really big-ticket emergency befalls you, know that part of your Roth IRA is available without any consequences from Uncle Sam.

4. An estate-planning tool.

Let's say you're still working, which means you can still contribute to an IRA. (Folks who don't earn a paycheck can't contribute to an IRA.) However, let's also say that you've already saved enough for your own retirement, but you'd like to help your kids, grandkids, or favorite Motley Fool writers. What should you do?

Contribute to a Roth IRA and name your relative(s) as the beneficiaries. When you retire from this world to the next, your heirs will receive that money income tax-free (though it may be subject to estate taxes).

A Roth IRA is better than a traditional IRA for this purpose for a few reasons. You can't contribute to a traditional IRA past age 70, even if you're still working. In fact, at that point, you must begin taking money out (known as required minimum distributions, or RMDs). Not so with the Roth; there's no age limit, and no RMDs. Plus, heirs must pay income taxes on inherited traditional IRAs.

That said, not everyone is eligible for the Roth. Single taxpayers with a modified adjusted gross income above $99,000 see their contribution limits begin to decline to zero; that magic number is $156,000 for married taxpayers.

You should certainly do all you can to resist tapping your IRA until you retire. But if an emergency arises, knowing that there are circumstances in which you can access the money may set your mind at ease.

This article is adapted from the Motley Fool Green Light *"Money Answers" archive, which features more than 100 articles on personal finance topics ranging from taxes to credit to beginning investing, organized by subject and life stage. For access to this content - plus the current newsletter, back issues, members-only discussion boards, and advisor blogs - take a free 30-day trial today!*

Fool contributor Elizabeth Brokamp is a licensed professional counselor with a special interest in Robert Brokamp, editor of The Motley Fool's Rule Your Retirement *newsletter.*