IRAs and "Higher Education Expenses"

January 23, 2024

Take-Away: A traditional IRA can be used to help pay for post-high school education expenses without incurring a penalty. But that is not the best use of those retirement funds.

Background: Many students and those in the workforce who are pursuing advanced degrees are focused on how to pay for their higher education expenses in the face of rampant inflation. While using retirement funds to pay those education expenses is not the best use of those accumulated funds, some individuals will not have the luxury of having access to other financial resources with which to pay those education expenses and they are thus left looking solely at their retirement account balance. A short summary of the rules that apply to paying higher education expenses with retirement account funds follow.

Penalty-Free: If the retirement account owner is under the age of 59 ½, he/she can access their retirement funds to pay for higher education expenses without incurring a 10% penalty for the early distribution, but only if the following rules are followed. If the retirement account owner is over the age 59 ½, there will be no penalty with regard to the IRA distribution that is then used to pay higher education expenses.

IRA-Only: Penalty-free withdrawals for higher education expenses can only be taken from an IRA, including SEP IRAs and SIMPLE IRAs. Distributions taken from a qualified plan, like a 401(k) account, are not eligible for the penalty-free distribution.

Taxation: While a penalty can be avoided by taking the distribution from an IRA to pay higher education expenses, that distribution will still be subject to taxation as ordinary income.

No Dollar Limit: There is no dollar limit on a penalty-free distribution from an IRA that is then used to pay higher education expenses. However, there is a limit in the sense that the distribution cannot exceed the higher education expenses that are actually paid. Consequently, there is a timing issue in that the distribution from the IRA must match the higher education expenses that are paid for that same calendar year. For example, if Marge has tentatively enrolled in a course of study that is set to begin in January 2024, but she withdraws tuition funds from her IRA in early December 2023, the education expense she incurred is not in the same calendar year that she is formally enrolled in her course of study. The IRA distribution and the education expense paid must be in the same calendar year to constitute a qualified higher education expense.

Qualified Student: The identity of the student is important. The higher education expense that is paid using IRA funds must be for the education of the IRA owner, the IRA owner's spouse, or any child or grandchild of either the IRA owner or his/her spouse. Siblings, nephews, nieces, and cousins will not qualify as a qualified student.

Qualified School: Any accredited post-secondary, i.e., post-high school) educational institution qualifies. This also includes a foreign educational institution so long as the institution is eligible to participate in a student aid program that is administered by the U.S. Department of Education.

Qualified Higher Education Expenses: A qualified higher education expense includes tuition, fees, books, supplies and equipment that is required by the school. The student must be considered at least a half-time student in order for room and board expenses to qualify. Expenses for computers and software used by the student at the school will also qualify, even though the computer and software are not required by the school. However, expenses paid for with tax-free educational assistance, like scholarships, Pell grants, Coverdell education account distributions, are not eligible when calculating the higher education expense limit.

Reporting: If distributions are taken from an IRA and used to pay for qualified higher education expenses, the IRA custodian will issue a Form 1099-R that shows an early distribution to the IRA owner. However, that Form will not show the higher education expense exception to the 10% penalty for the ‘early distribution’ from the traditional IRA. As such, the IRA owner will have to file Form 5329 with their income tax return in order to claim the exemption from the 10% penalty. Accordingly, it is incumbent on the IRA owner to keep good records with regard to the higher education expenses that are paid using the IRA distribution.

Conclusion: While these rules authorize the use of IRA dollars to pay for higher education expenses without incurring a penalty, they are still taxable dollars that will cause income taxes to be paid. In addition, using IRA funds to pay for higher education expenses currently means that the IRA owner will also lose out on the tax-deferred growth of their IRA over the several years that follow the distribution. Accordingly, if there are other funds available to pay a qualifying student’s higher education expenses, those other funds should always be used first.