How to Prioritize Retirement Versus College Savings

Many parents need to save for their own retirementwhile also helping their children pay for college. But it can be difficult to save for both at the same time. Here are some tips for coordinating your retirement and college savings goals.

Examine your priorities. While some parents feel an obligation or desire to pay for college for their children, others think it's more important to improve their own finances so they won't become a burden to their children later. A recent T. Rowe Price survey of 2,000 parents with a retirement account found that about half would be willing to delay retirement or take on a second or part-time job to pay for college for their children. "Parents should save for their own retirement first before saving for a kid's college education," says Beth Kobliner, author of "Make Your Kid a Money Genius (Even If You're Not)" and a member of the President's Advisory Council on Financial Capability for Young Americans. "Kids can borrow for college, and they also have a range of options for costs when it comes to what school they go to, but parents can't borrow for retirement."

Get a 401(k) match. A 401(k) match is likely to be the best return you will ever get on an investment. "If you've got an employer who will match your contributions dollar for dollar up to 6 percent, you can't beat that," says Mark Kantrowitz, senior vice president and publisher of Edvisors.com. "It is effectively doubling your investment right then and there." In addition to the employer contribution, you will also get a tax break and investment returns on that savings.

Consider a 529 plan. Once you have gotten your 401(k) match, you can do a side-by-side comparison of the benefits of saving more in your 401(k), contributing to an individual retirement account or Roth IRA or funding a 529 college savings plan. Make sure to examine the fees and tax implications of investing in each type of account. Contributing to a 529 plan won't qualify you for a tax deduction on your federal taxes, but it might get you a deduction on your state income tax bill. The money in a 529 plan grows tax-deferred, and distributions used to pay for college are tax-exempt.

Fund your retirement accounts. A recent Sallie Mae and Ipsos survey of 1,988 parents found that 12 percent of those who are saving for retirement are planning to use at least part of their retirement savings to help their children pay for college. "Some people have

consciously mixed in their college savings into their retirement fund," says Marie O'Malley, director of consumer research for Sallie Mae. Traditional 401(k)s and IRAs allow you to defer paying taxes on your savings, but income tax will be due when you withdraw the money from the account. Roth IRAs and Roth 401(k)s are funded with after-tax dollars, and no income tax will typically be due on distributions after age 59½.

Each type of retirement account has different rules about early withdrawals for college costs. Your 401(k) distributions for higher education expenses will incur income tax and, if you are under age 59½, a 10 percent early withdrawal penalty. IRA withdrawals that are used to pay for college costswill not trigger the 10 percent early withdrawal penalty, but income tax will be due on the distribution. Roth IRA withdrawals for college expenses taken by people under age 59½ will be subject to income tax only on the portion of the withdrawal that comes from investment earnings.

Compare loan interest rates to your investment returns. The T. Rowe Price survey found that about half (53 percent) of parents would rather dip into their retirement money for college costs than let their children take on student loans. When making this decision, compare the interest rate and fees you would be charged for a loan to the returns you are earning on your investments. "If the interest rate on the loan is higher than the interest rate on your retirement savings, you are better off if you minimize the debt," Kantrowitz says. However, if your child qualifies for federally subsidized loans or the loan interest rate is lower than your investment returns, it might make financial sense to borrow for college.

Consider your child's financial aid package. Retirement account balances are not considered when calculating how much financial aid your child qualifies for. "The federal form does not look at retirement money," Kobliner says. "If you have money in a retirement account, it is not going to hurt you when the colleges are assessing you for how much financial aid you are eligible for." However, money in a 529 college savings plan is factored into financial aid eligibility. And withdrawals from retirement accounts, including Roth IRAs, are considered income and could reduce the amount of financial aid your child qualifies for in future years. "Distributions from retirement plans count as income on the FAFSA, and that includes tax-free distributions from a Roth IRA, which gets reported on the FAFSA as untaxed income," Kantrowitz says. "If you're going to take a distribution from a Roth IRA, you might want to wait until after the student's senior year in college, assuming they are not going on to grad school."

http://finance.yahoo.com/news/prioritize-retirement-versus-college-savings-130000953.html