Thinking about using your retirement savings to pay for college? Think again.

BY FIDELITY LEARNING CENTER

Intermediate College Planning 529 Plan

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Balancing the competing goals of saving for your children's future college education expenses while saving for your own retirement can be a thorny challenge for most parents. On the one hand, you want your children to get a solid education and establish a successful career. But on the other hand, you also want to make sure you will have the financial resources to enjoy your own retirement years, without becoming a financial burden on your children.

To help increase your odds of achieving both goals, financial planning professionals often suggest establishing dedicated college savings accounts. While some people may choose to concentrate all of their efforts on maximizing their retirement savings and then tap those accounts to cover college expenses, lumping savings together in this manner can cause confusion.

For example, when you hold your college savings and retirement savings in the same account, it's difficult, if not impossible, to really know how close you are to meeting either goal. If you had $250,000 in your retirement savings account, how much of that money would be available after paying for college? It's virtually impossible to know. Moreover, if you end up spending too much on college, you could find yourself facing a severe retirement savings shortfall. For this reason, you may want to consider keeping your retirement savings and college savings in separate accounts.

The following are some other considerations when thinking about retirement vehicles for college savings.

Different time horizons require a different investment approach

When your children are toddlers, college can seem like a distant goal. In reality, however, a 5-year-old is only 13 years away from his or her first year in college. That's a much shorter time horizon than your retirement, which is likely 20 years away or more.

For this reason, it may be wise to maintain a less aggressive asset allocation for your college savings. And as that first year approaches, you may want to consider gradually moving toward an even more conservative allocation to help minimize the odds of losing a chunk of your savings to a stock market downturn.

These portfolio management moves are easier to make when you have a dedicated college savings account. In fact, most 529 college savings plans offer age-based portfolios that automatically become less aggressive as your child's high school graduation date approaches. If, however, you are managing your family's college savings on your own, be sure to revisit your asset allocation and risk exposure as your children get closer to their first year of college.

Maximizing tax advantages

There are several types of college savings accounts, and each offers tax benefits that make it easier to save more for college while reducing your tax burden.

With 529 college savings plans and Coverdell Education Savings Accounts (ESAs), any earnings grow federal income tax–deferred. Withdrawals taken to pay for qualified higher education expenses, such as tuition, fees, and room and board, are free from federal income taxes. Many states also offer additional tax benefits to residents who invest in their home state's 529 plan.

With a custodial account, such as a Uniform Gift to Minor Account (UGMA) or a Uniform Transfer to Minor Account (UTMA), at least part of the investment earnings may be exempt from federal income tax, and some or all may be taxed at the child's generally lower tax rate.

It's easier to enlist the help of family and friends

Gifts from family and friends may provide a serious boost to your child's college savings accounts. With a dedicated college savings account, it is relatively simple to deposit gifts from family and friends into the account or to allow them to gift directly to the account.

That's not the case with retirement accounts. Depositing cash contributions from others into your own retirement accounts can be difficult, if not impossible, to do. For example, with a 401(k) plan, the only way to contribute is through salary deferral.

Retirement account rules can be complicated

If you are still thinking about tapping your retirement savings when the time comes to pay for college, the IRS will permit you to take penalty-free early distributions from IRAs for qualified higher education expenses. Of course, doing so will reduce the funds you will have available to pay for your own future retirement expenses.

If you take a distribution from a traditional IRA or Roth IRA to pay for college before age 59½, you're generally exempt from the 10 percent early withdrawal penalty. If the proceeds of your distribution represent contributions (rather than earnings) from a Roth IRA, the distribution is usually not subject to taxes. If you're already 59½ or older and your Roth IRA has met the five year aging requirement, your entire distribution would be tax free. A distribution from a Roth IRA is tax free and penalty free, provided the five-year aging requirement has been satisfied and one of the following conditions is met: age 59 ½, disability, qualified first-time home purchase, or death. However, if you make an early withdrawal of earnings from a Roth IRA, or any early withdrawal from a traditional IRA, taxes would still be due on the portion of the distribution that would normally be taxed as part of an early withdrawal.

In addition, colleges will treat distributions from IRAs as income when calculating financial aid packages. Because income weighs more heavily than assets in these calculations, IRA distributions may actually reduce the amount of financial aid your child may receive.

Depending on your employer's workplace retirement plan rules, you may be able to borrow against the value of the assets in your 401(k), 403(b), or 457 plan. The loan proceeds will not be taxed as ordinary income, and there is no 10 percent early withdrawal penalty. In addition, your loan proceeds won't be counted as income in financial aid calculations.

However, loans come with several risks. If you change employers or lose your job, you may be required to pay back the loan immediately, with interest. In cases where that money has already been spent on college expenses, you may not have the financial means to pay off the loan. When that happens and you are under the age of 55, the loan proceeds would be treated as taxable income and would also be subject to a 10 percent early withdrawal penalty. If you're older than 55, no penalty would be applied, but the loan would still be taxed as ordinary income.

One additional option is to take a “hardship withdrawal” from your workplace retirement plan. The rules vary from one employer to the next, but in many cases, you cannot qualify for a hardship withdrawal for higher education expenses until you have first taken any available loans.

Any amount you withdraw as a hardship distribution will be taxed as ordinary income, and a 10 percent penalty will apply if you are younger than 59½. These taxes and penalties will take a serious cut from the amount you will have available to pay for college costs. For example, consider what would happen to a 50-year-old in the 28 percent federal tax bracket who takes a $20,000 hardship withdrawal. He would owe $5,600 in federal taxes and a $2,000 penalty. That would reduce the $20,000 distribution to just $12,400, not counting any state or local taxes that may apply.

Prioritizing retirement savings

With longevity on the rise, many Americans will need to live off their retirement savings for 20 to 30 years or more. And, while you or your children can borrow money to finance the cost of college, there is no such thing as a retirement loan. That's why financial planning professionals often suggest that saving for retirement should be a higher priority than saving for college.

While a college education for your children is also a priority, there are many other ways to finance the cost without skipping your annual retirement contributions, which could jeopardize your retirement security. These include home equity loans, student loans, work-study programs, grants and scholarships. To reduce college costs, your child might also consider attending a local community college or living at home and commuting to a nearby college.

Even if your children do have to take on a reasonable amount of debt to cover college expenses, think of it as an investment in their future. Studies have consistently shown that college graduates have higher lifetime earnings than those who do not earn a college degree. Those earnings can be applied toward paying off college loans. Meanwhile, by establishing dedicated college savings accounts and resisting the urge to tap your retirement savings, you will reduce the odds of becoming a financial burden on your children after you retire.

529 college savings plans versus retirement savings accounts

Goal/Feature	**529 College Savings Plan**	**Traditional IRA**	**Roth IRA**	**401K**
Investments grow tax deferred				
Withdrawals prior to age 59 1/2 are federal income tax free when used for qualified higher education expenses		Withdrawals of tax deducted contributions are taxed as ordinary income and withdrawals of any earnings are taxed as ordinary income	Withdrawals of contributions are tax-free. Withdrawals of any earnings are taxed as ordinary income	Distributions taxed as ordinary income
Withdrawals are				No - 10% penalty

penalty free prior to age 59 1/2 when used for qualified higher education expenses				
No income thresholds for contributions		For non-tax deductible contributions: None For tax deductible contributions, certain income thresholds apply. To determine if you can deduct your IRA contribution, use Fidelity's IRA Contribution Calculator	Income thresholds apply: $131,000 or less for single tax filers; $193,000 or less for married couples filing jointly (phase-outs begin at $116,000 and $183,000, respectively)	None
No annual contribution limit	Note, overall balance caps may apply, but are often above $300,000.[1]	Annual contribution limit is $5,500 ($6,500 if age 50 or older)	Annual contribution limit is $5,500 ($6,500 if age 50 or older)	Annual contribution limit from employee is $18,000 ($24,000 if age 50 or older)
Ability to take a loan against account balance	No	No	No	But if you leave employer, balance must be paid in full. Otherwise, distribution taxed as ordinary income and 10% penalty applied if age 55 or younger.

Impact on Federal financial aid calculation	Overall, impact is low. 529 accounts, even if owned by a dependent student, are considered an asset of the parent. Up to 5.64% of balance of the 529 is applied toward the annual expected family contribution. Note: Distributions for qualified higher education expenses are not counted toward the expected family contribution.	Balances in retirement accounts are not considered in federal financial aid formulas. However, withdrawals, even for qualified higher education expenses, are considered income. If from a parent owned account, 0% to 47% of the withdrawal is applied to expected family contribution the next year. If from a student owned account, 0% to 50% of the withdrawal may be applied. The exact percentages are depend on multiple factors associated with family and student income.		
Wide investment selection	Investments limited to those made available by the specific 529 plan. Most popular selections are age-based investment portfolios that become more conservative as the student approaches college age.	Typically, very wide range of options, including individual stocks and bonds as well as mutual funds and ETFs.	Typically, very wide range of options, including individual stocks and bonds as well as mutual funds and ETFs.	If not a self-directed brokerage account arrangement, options typically limited to those made available in the plan.
Clarity on progress toward college savings goal	Dedicated account helps you know exactly how much is available for college versus how much you have saved for retirement	Low. Saving for college using a retirement account makes it more difficult to know what you can put toward college without risking your retirement security		

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1. 529 plans typically have balance limits, above which further contributions are no longer permitted. These limits vary by 529 plan but are often above $300,000.

Keep in mind that investing involves risk. The value of your investment will fluctuate over time, and you may gain or lose money.

Diversification and asset allocation do not ensure a profit or guarantee against loss.

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