
Paying for college? Don't flunk retirement

BY JEFF WUORIO, FIDELITY INTERACTIVE CONTENT SERVICES — 05/20/10

Sure, college is expensive. But the cost of borrowing from a 401(k) or an IRA might be more so.

College is becoming more expensive all the time — a lesson every parent learns. But tapping retirement savings to help meet that steep price tag is almost certainly a financial "F."

For the 2009-2010 school year, the College Board put the average one-year cost of tuition and fees at a private four-year college at \$26,273, up 4.4% from the prior year. Public four-year public schools for in-state students checked in at \$7,020, a one-year increase of 6.5%. If those numbers seem low, that's because they don't include room and board, which adds another \$9,000 a year. And remember, those are averages. The bill at some prestigious private schools routinely tops \$50,000 a year.

With a four-year degree costing more than what some of us paid for our first homes, and a stock market that's shrunk the balances in 529s and other college savings plans, it's easy to eye what is most people's biggest pile of cash—your retirement account.

A word of advice: Don't.

The most obvious reason may seem, well, obvious, but it's still valid: There are a number of ways to pay for college but your options are limited when it comes to funding your retirement.

"There are no retirement scholarships that I know of," says Warwick, R.I., financial planner Kevin Worthley. "Nor are there any retirement loans, except a reverse mortgage. And most parents do not want to be financially dependent on their children during retirement."

Stay away from your 401(k)

It's not just about depleting your savings: Withdrawing from a tax-advantaged account such as an IRA or 401(k) can be a costly maneuver. True, they both grant allowances for withdrawals for college expenses, but that's hardly free money. You'll still owe income tax and, if you're not yet 59 ½, likely a 10% penalty.

401(k) withdrawals can be particularly pricey. A \$10,000 withdrawal could amount to just \$6,200 if you're in the 28% bracket and not 59 ½. And that's before state and local taxes. So you can settle for the lower amount or pull even more from your 401(k) to net the \$10,000 for school.

What's more, any withdrawal from a 401(k) is added to your annual income. Take out too much and you can push yourself into a higher tax bracket.

There's no way around paying tax on a 401(k) withdrawal.

"Some people will mention 'hardship withdrawals' thinking that prevents having to pay tax or penalty," says Chevy Chase, Md., financial planner Glenn McGregor. "That's incorrect."

A hardship withdrawal is just a feature of some—not all—plans that merely allows a withdrawal for medical costs, college expenses and other reasons. It doesn't prevent the tax or penalty.

Tapping your IRA

Traditional and Roth IRAs are a bit more forgiving. Both make allowances for withdrawals to pay college expenses, though it's hardly free money.

With a traditional IRA, you can avoid the 10% early withdrawal penalty, but you're still obligated to pay income taxes. With a

5 steps to securing financial aid today

How you can benefit as colleges boost financial aid for higher-income families.



Roth IRA, you can withdraw all your contributions tax-free, but any portion of a withdrawal that derives from earnings is taxed. (The IRS treats all withdrawals as coming from contributions first.)

But even a modest withdrawal can carry prohibitive long-term consequences. And the younger you are, the more benefit you're relinquishing in terms of tax-free growth.

Say you have \$100,000 in a retirement account and, at age 45, you withdraw \$10,000 to pay for your kid's college expenses. Assuming an 8% annual return and no additional contributions, that \$90,000 in your account could grow to \$443,412 by age 65. Had the \$10,000 remained in place, your final total would have been \$492,680—a difference of nearly \$50,000.

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KEVIN WORTHLEY, FINANCIAL PLANNER

"In general, people are not saving enough for retirement as it is," says Worthley. "When you take out money, you lose the effect of compounding over time. This can be substantial over five or 10 years or a longer period of time."

You can't just pay yourself back, either. "If the parent withdraws a sizeable amount, the money usually cannot just be 'put back'," says Worthley. "If you take \$15,000 from a traditional IRA for college expenses, only \$5,000 may normally be contributed each year, so it takes three years to replace the withdrawal. And, given human psychology, it's less probable that a parent would catch up with extra contributions – more likely than not, they'll just contribute as they normally would."

Other options

In what might seem the crowning insult, withdrawing funds from a retirement account could compromise what may be your best bet for paying for school—financial aid. Under current aid guidelines, withdrawals from retirement accounts increase the parents' assessable income in the year of the withdrawal. In turn, that can increase the Estimated Family Contribution (EFC) for the year, potentially lowering financial aid eligibility.

"Parental income is usually the primary factor in the EFC," says Worthley. "Strategies to limit or lower parental and student reported income will be important. Withdrawals from retirement accounts are simply counterproductive to increasing financial aid eligibility."

Even if you think you're not eligible for financial aid, it's worth looking into. There's a lot of help out there. More than \$168 billion in financial aid is available to students and their families, according to the College Board. Students attending the most expensive private schools received grants and tax benefits totaling more than \$14,000, on average. For more on maximizing your chances for financial aid, see "5 steps to securing financial aid today."


Lastly, don't dismiss the value of involving students in paying for college, be it through loans, work-study, or some other arrangement, other than happily accepting a check from their parents — particularly if that check might compromise Mom and Dad's retirement.

Says McGregor: "I've heard clients say their child respects their education more if they have to take out some sort of loan. But retirement plans are set up to fund retirement, not as an extra checkbook for college or other needs."

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