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The Dangers of Saving for College Instead of Retirement

Parents need to focus on their own goals first.

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According to the T. Rowe Price's 2018 Parents, Kids & Money Survey, 74 percent of respondents with younger children are prioritizing by saving for the kids' college costs over saving for the parents' retirement.

The primary vehicle the respondents are using to save for higher education expenses is (rightly) a 529 college savings plan. But as great as 529s are, funding them instead of saving for retirement might be jeopardizing the parents' long-term financial security, and costing them money and opportunities right now. Here's how putting cash towards college and 529s instead of retirement can be a costly mistake.

Higher Current Tax Bills

Some 529 accounts offer tax breaks to depositors, but those breaks are often limited to a low dollar amount and then limited to only state income taxes. But clients who save pre-tax money into 401(k)s and IRAs can cut their income tax bills by anywhere from 10 to 40 cents for every dollar they deposit.

The negatives of foregoing deposits to their work retirement accounts are exacerbated even more if the clients are missing out on any matching contributions offered by their employers.

Limited Investment Choices

529 plans have more investment options and are more cost-friendly than ever. But both factors still don't compare to the reduced expenses and larger investment menus offered by most employer-sponsored plans. And funds held in IRAs or Roth IRAs have even more flexibility, as they can not only be used to purchase any one of tens of thousands of mutual funds, but also individual stocks, bonds and certificates of deposits. Yes, a 529 depositor can usually pick from one of dozens of state-sponsored plans in an attempt to find the best investment option. But doing so may cost the depositor a tax break from their state plan, which could offset the lower-cost or better-performing investment option offered by a different 529 account.

Shorter Investment Horizon

In the majority of scenarios, parents make 529 deposits over no more than the first 18 years of a child's life and then liquidate the account over the four or five years it takes for the child to earn a higher education degree. But the accumulation phase of saving for retirement is (hopefully) three or four decades, and the subsequent withdrawal period will (hopefully) last two or three more decades.

The shorter college savings time frame means parents are compelled to be more conservative with the investments in the 529 plan than they would be with their retirement accounts, especially right before and while the kid attends college. That need to err on the side of caution means that the overall annualized returns on the college savings plan investments will likely be lower than what the parents would earn on money saved for retirement.

Less Liquidity

Assets in 529 plans can be withdrawn at any time. However, if the clients don't have qualified higher education expenses to match the withdrawn amounts, the earnings can be taxable income, and there could be an additional 10 percent penalty imposed on the income portion. But clients have several ways to tap retirement accounts with little or no taxes, penalties or costs.

First, they may be able to borrow from their work retirement plans, with no application necessary and at a relatively low interest rate. They can also withdraw the contributions to their Roth IRAs at any time, for any reason (including paying for college), with no taxes or penalties If the withdrawal occurs when the owner is over 59½, there will usually be no taxes or penalties on the earnings portion of the Roth IRA withdrawal. If the client is under 59½ and withdraws the earnings portion of the Roth IRA, or any part of an IRA, the earnings will be taxed as ordinary income. But, if the withdrawals are used to pay qualified higher education expenses, the IRA or Roth IRA owner may be able to avoid the 10 percent penalty that would otherwise apply to the earnings. Keep in mind that any distributions from a parent's retirement account may count as income when calculating subsequent years' financial aid packages and therefore may reduce any needs-based awards.

Less Financial Aid

Assets held in parent-owned 529 accounts are generally treated very favorably by the various financial aid formulas. Usually no more than 5.64 percent of the account value will be considered each year before any need-based aid is awarded. But retirement account assets usually aren't counted at all in the formulas to calculate need-based aid. Furthermore, contributions made by parents to their retirement accounts during the year in consideration for the financial aid decision are often added back into the "parental income" portion of the aid calculation. So, parents who don't save enough for retirement now but then need to catch up later while their children are in college could see smaller need-based financial aid packages than if they saved for retirement now instead of later.

Double-Duty Savings Strategies

If clients are trying to choose between saving for their own retirement and saving for their kids' college, here are two ways to combine both goals. First, if they're eligible, have the parents maximize their contributions to pre-tax retirement plan accounts, like 401(k)s, 403(b)s and IRAs. Then, calculate how much they saved in income taxes by making those contributions, and use that amount to fund deposits to 529 college savings plans. For instance, if the clients deferred $10,000 of income into a 401(k) and they're in a 25 percent marginal income tax bracket, the 401(k) deposits saved them $2,500 in taxes that year, which could then be put into the 529 plan. The second strategy is to maximize contributions to Roth IRAs every year, if the clients are eligible. Then, if the money is needed to fund the clients' retirement, it can generally be withdrawn tax-free at any time after reaching age 59½. But, if the clients are ahead of their

retirement savings schedule when their children reach college age, as mentioned previously, the contribution portion of the Roth IRAs can be withdrawn with no taxes or penalties.

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