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Saving for College and Retirement

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What is it?

These days it's not uncommon for parents to postpone starting a family until both spouses are settled in their marriage and careers, often well into their 30s and 40s. Though this financial security can be an advantage, it can also present a dilemma--the need to save for college and retirement at the same time.

The prevailing wisdom has parents saving for both goals at the same time. The reason is that older parents can't afford to put off saving for retirement until the college years are over, because to do so means missing out on years of tax-deferred growth. Moreover, because generous corporate pensions (and lifetime job security) are now the exception rather than the rule, employees must take greater responsibility for funding their own retirements.

First, determine your monetary needs

The first step is to determine your projected monetary needs, both for retirement and college. This analysis will reveal whether you are on a savings course to meet both goals, or whether some modifications will be necessary.

You've come up short: what are your options?

You've run the numbers on both your anticipated retirement and college expenses, and you've come up short. The numbers say you won't be able to afford to educate your children and retire with the lifestyle you expected based on your current earnings. Now what? It's time to sit down and make some tough decisions about your expectations and, ultimately, how to compromise.

The following options can help you in that effort. Some parents may need to combine more than one strategy to meet their goals.

Defer retirement

Staying in the workforce longer is one way of meeting your retirement and education goals. The longer you wait to dip into your retirement funds, the longer the money will last.

Reduce standard of living now or in retirement

You may be able to adjust your spending habits now in order to have more money later. Consider making a written budget to track your monthly income and expenses. If your monetary needs have fallen far short of the mark, you will need to make a bigger spending adjustment than you would with a lesser shortfall. The following are some suggested changes:

- Move to a less-expensive home or apartment
- Sell your second car and carpool whenever possible
- Reduce your entertainment budget (e.g., bring your lunch to work, eat out once a month instead of every week, rent movies instead of going to the cinema)
- Get books and magazines from the library instead of the bookstore
- Cancel any club memberships (e.g., golf club, health club)
- Set a limit on birthday and holiday gifts for family members
- Forgo expensive vacations
- Shop for clothes in the off-season, when they're likely to be on sale
- Buy used furniture and used big-ticket items
- Limit your child's extracurricular activities, like music lessons or hockey camp

If you're unable or unwilling to lower your standard of living now, perhaps you can lower it in retirement. This may mean revising your expectations about a luxurious, vacation-filled retirement. The key is to recognize the difference between the things you want and the things you need. The following are a few suggestions to help reduce your standard of living in retirement:

- Reduce your housing expectations

- Cut back on travel plans
- Own a less-expensive automobile
- Lower household expenses

Note: There's a difference between reducing your standard of living in retirement and drastically reducing your standard of living in retirement. Most professionals discourage the use of retirement funds for your child's education if paying college bills will leave you high and dry in your retirement years.

Work part-time during retirement

About 25 percent of retirees work part-time. You may find that the extra income enables you to enjoy the kind of retirement you had anticipated.

Increase earnings (i.e., spouse returns to work)

Increasing earnings may be another way to meet both your education and retirement goals. The usual scenario is that a stay-at-home spouse returns to the workforce. This has the benefit of increasing the family's earnings so there's more money available to save for education and/or retirement. However, there are drawbacks. The additional income may push the family into a higher tax bracket, and incidental expenses like day care and commuting costs may eat into your overall take-home pay.

In addition to a spouse returning to work, one spouse may decide to increase his or her hours at work, take another job with better compensation, or moonlight at a second job. Factors to consider here include the expectation of increased job pressure, less availability for child rearing and household management, the amount of extra income, the opportunity for advancement, and job security. Another way to create extra income is for a spouse to turn a hobby into a business.

Be more aggressive in investments

Your analysis has shown that your current savings (and the accompanying investment vehicles) will leave you short of your education and retirement goals. One option is to try to earn a greater rate of return on your savings. This may mean choosing more aggressive investments (e.g., growth stocks) over more conservative investments (e.g., bonds, certificates of deposit, savings accounts). This strategy works best the more years you have until retirement.

Caution: *The more aggressive the investment, the greater the risk of loss of your principal. This strategy isn't for people who shudder at the slightest downturn in the stock market. If you'll have trouble sleeping at night, you probably shouldn't take on greater risk in your investment portfolio.*

Reduce education goal

One of the realities parents may have to face is that they can't afford to fund 100 percent (or 75 percent, or 50 percent, as the case may be) of their child's college education. This is often an emotional issue. Parents naturally want the best for their children. For many parents, this translates into sending them to (and paying for) college (especially in cases where one or both parents didn't have such an opportunity).

You may have dreamed that your child would go to a prestigious Ivy League school. Well, with a year's cost at such a school hovering at the $40,000 mark, maybe you need to lower your expectations. That small liberal arts college or the big state school may challenge your child just as much and at a far lower cost. Remember, there are loans available for college, but none for retirement.

Children pay more and/or assume more responsibility for loans

With college costs continuing to increase at a rate faster than most family incomes, and with perhaps more than one child in the family picture, chances are that more responsibility will fall on your child to help fund college costs. This money can come from part-time jobs or gifts, though the majority of your child's contribution is likely to come from student loans.

Though student loans can be a financial burden in the early years, when graduates are just starting out in their careers, many loan providers offer flexible repayment options in anticipation of this common situation. In addition, if your child meets certain income limits, he or she can deduct the interest paid on qualified student loans.

When children take out student loans, parents can always decide to help financially rather than mortgaging their house before college. Students who take out student loans to pay for college may have a more vested interest in their education than students who receive help from their parents.

Other ways to lower cost of college

In addition to reducing your education goal and having your child pay a portion of college costs, there are other ways to lower the cost of college. For example, your child can choose a college with an accelerated program that allows students to graduate in three years instead of four. Likewise, your child may choose to attend a community college for two years and then transfer to a four-year private institution. The diploma will reflect the four-year college, but your pocketbook won't.

How do you decide what strategy is best for you?

This decision must be made on a case-by-case basis. What works for one family may not work for another family. In some cases, more than one strategy will be necessary to deal with the demands of educating children and retiring successfully. Factors influencing your decision may include the following:

- The amount of your financial need
- Your current income and assets and any expectation of significant future income (e.g., a bonus at work, exercise of stock options, an inheritance)
- The number of years you have until retirement
- Your willingness to reduce your standard of living (now or in the future) for the sake of your children
- The number of children in your family who plan on attending college
- The academic, athletic, or other notable skills of your child that may raise the possibility of a college scholarship

Can retirement accounts be used to save for college?

Yes. But should you? Probably not. Many financial advisors recommend against dipping into your retirement account to pay college expenses as a preferred strategy. But if you must, there are some tax breaks available.

It's now possible to withdraw money from either a traditional IRA or Roth IRA before age 59½ to pay college expenses without incurring the 10 percent early withdrawal penalty that normally applies to such withdrawals. However, any distributions of earnings and deductible contributions from a traditional IRA and any nonqualified distributions of earnings from a Roth IRA may be included in your income for the year, which may push you into a higher tax bracket.

Tip: *This college exception to the 10 percent early withdrawal penalty is a good reason to funnel your child's income from a part-time job into an IRA.*

Unfortunately, there's no similar college exception for employer-sponsored retirement plans, such as a 401(k) plan. So, if you're under age 59½, you'll pay a 10 percent early withdrawal penalty on any withdrawals. As with an IRA, any withdrawals are added into your income for the year, which may push you into a higher tax bracket. Nevertheless, saving in a 401(k) plan can be an attractive option for some parents because the company may match employee contributions and because most employer plans allow you to borrow against your contributions (and possibly earnings) before age 59½ without penalty.

Tip: *Some parents who have built a college fund within their 401(k) accounts, but who are not yet 59½ when the kids are in college, take out what's called a bridge loan (such as a home equity loan) to pay their child's college bills. A bridge loan is a source of funds that tides you over until it's more economical to tap your retirement account. Although you pay interest on a bridge loan, it may still cost less than what your 401(k) funds can earn. Then, when you turn 59½, you can start tapping your 401(k) plan to pay off the bridge loan with no early withdrawal penalty.*

A benefit of using retirement accounts to save for college is that the federal government doesn't consider the value of your retirement accounts in awarding financial aid (the federal formula also excludes annuities, cash value life insurance, and home equity from consideration). However, most private colleges do consider the value of your retirement accounts in deciding which students are the most deserving of campus-based aid.

To schedule an appointment with Faye Sykes, click here .

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