Securities America
Michael Sullivan, CFP
41 West Bridge St.
Suite D
Dublin, OH 43017
(614) 734-WLTH(9584)
mikes@wealthcoachfinancial.com
wealthcoachfinancial.com

Employer-Sponsored Retirement Plans for Education Savings

Employer-Sponsored Retirement Plans for Education Savings

What is it?

As the name suggests, an employer-sponsored retirement plan is a plan that an employer sets up and maintains for its employees' retirement. A qualified retirement plan is an employer-sponsored retirement plan that receives special tax treatment under federal law. 401(k) plans and profit-sharing plans are common examples of qualified employer-sponsored retirement plans. The tax benefits of a qualified plan generally include pretax contributions and tax-deferred growth of investment earnings. In return for such benefits, qualified plans generally must comply with specific federal rules set forth under the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code (IRC).

If your employer offers a retirement plan and you are eligible to participate in the plan, this may be a way for you to save for your child's college education. However, it is usually not advisable to do so. Most financial professionals will tell you that the primary purpose of retirement accounts should be to save for and eventually fund your retirement. Consequently, you should consider using your employer's retirement plan as an educational savings tool only as a last resort, and only after you have consulted your financial advisor.

Accessing the money

If you have decided to use your employer's retirement plan to save for your child's college education, you will need to access your money in the plan when the time comes to pay college-related expenses. There are generally two possible ways to access your savings in an employer-sponsored retirement plan: (1) borrowing money from the plan, or (2) withdrawing money from the plan. However, the specific options available to you will be determined largely by the rules of your employer's retirement plan.

Plan loans

Some employer-sponsored plans allow you to borrow against the funds in your plan, as long as you have a vested balance in the plan. The amount of the loan you can take is generally limited to the lesser of $50,000 or one-half of your vested plan benefits. The advantage of plan loans is that they are not taxed or penalized like withdrawals, as long as the loan is repaid on time. Also, the interest rate is usually reasonable (e.g., one or two points above the prime rate), and the interest you pay is credited to your own plan account.

Drawbacks? If you do not repay a plan loan when required, it will generally be treated as a taxable distribution. Typically, you have to repay the loan within five years by making regular payments, at least quarterly. (The repayment period can be longer if the funds are used to purchase a primary residence.) Even worse, if you leave your employer's service (whether voluntarily or not) and still have an outstanding balance on a plan loan, you may have to immediately repay the loan in full. Other disadvantages are that the interest is usually not tax deductible, and the borrowed funds miss out on tax-deferred growth opportunities.

Plan distributions

In addition to plan loans, in limited circumstances, you may be able to withdraw funds from your employer-sponsored retirement plan. Your first step should be to find out your distributions options. Your plan may offer several methods of taking distributions, or your choices may be very limited. Consult your plan administrator to find out which distribution options (if any) are available to you.

In general, you can take distributions from your employer's plan upon certain specified events. For example, you may be entitled to take distributions when you retire, or when you reach the plan's normal retirement age. You may also be entitled to take a distribution upon job termination, disability, plan termination, or financial hardship. Depending upon the type of retirement plan and the provisions of the plan, you may be eligible to receive certain distributions while you are still working for your employer as well as after your employment has ended. However, some plans may only allow distributions after your employment has ended.

Unlike plan loans that are repaid on time, distributions you take from an employer-sponsored retirement plan generally must be included in your taxable income for federal (and possibly) income tax purpose. Any plan distribution you receive will increase your taxable income for the year of the distribution, possibly even pushing you into a higher federal income tax bracket. In addition to ordinary income tax, you must also pay a 10 percent premature distribution penalty tax if you are under age 59½ at the time of the distribution (unless an exception applies).

> **Tip:** If you have ever made any after-tax contributions to your employer's retirement plan, those amounts will not be included in your taxable income when distributed from the plan. Consult a tax advisor for further details.

Strengths

Your employer may contribute to the plan on your behalf

Some employer-sponsored retirement plans (e.g., profit-sharing plans) are funded entirely by the employer. In this case, it generally costs you nothing to participate in the plan, so there is no reason not to.

If you participate in a 401(k) plan, you will have to contribute a portion of your salary to the plan, but some employers will "match" their employees' contributions up to a certain level (e.g., 50 cents on the dollar up to 3 percent of an employee's compensation). If your 401(k) plan offers this feature, you should try to take full advantage of it by at least contributing to the plan up to the level your employer will match. The reason: employer-matching contributions are essentially free money, once you are vested in those amounts.

Contributions are pretax

When your employer contributes to a 401(k) or other qualified retirement plan on your behalf, those contributions are generally not currently included in your taxable income. Similarly, depending on the type of plan, you may be able to make pretax employee contributions to your employer's qualified plan. (401(k) plans have this feature, as do Section 403(b) and Section 457 plans.) These contributions are taken from your pretax salary and invested in the plan before income tax is withheld. This has the effect of reducing your taxable income for the year, allowing you to pay less income tax. Like employer contributions on your behalf, your pretax employee contributions will not be subject to income tax until you begin to take distributions from the plan.

Growth is tax deferred

Another significant advantage of a qualified retirement plan is that your contributions to such a plan grow on a tax-deferred basis. This means that any earnings from your plan investments are not included in your taxable income as long as they remain in the plan. Those earnings will be taxed only when you begin to take distributions from the plan. Tax-deferred growth creates the potential for more rapid growth (and a larger retirement fund) than if the funds were invested in identical investments outside the plan.

The federal government does not consider the value of your plan assets in determining your child's financial aid eligibility

In its formula for financial aid, the federal government counts some assets and excludes others in determining a family's total available assets to contribute toward college costs. One type of asset the government excludes from this formula is retirement assets, including IRAs and most employer-sponsored retirement plans.

> **Example(s):** Assume the Jones family has $10,000 in a savings account and $80,000 in Mr. Jones's 401(k) plan account. Under the federal government's formula for financial aid, the Jones family's total assets are considered to be only $10,000.

> **Caution:** Though the federal government generally does not count your retirement accounts among your assets when determining financial aid eligibility, it does consider how much money you contribute to such accounts in the year before you fill out its Free Application for Federal Student Aid (FAFSA). If you contribute money to an employer's retirement plan in the year prior to the year you complete the FAFSA, this contribution is considered discretionary and is added to your total income for the year.

Tradeoffs

Most retirement plan distributions will be taxed and possibly penalized

If you take a distribution from your employer-sponsored retirement plan prior to age 59½ for college-related expenses, the taxable portion of the distribution will typically be subject to the 10 percent premature distribution penalty tax. This penalty tax would be in addition to ordinary federal (and possibly state) income tax on the distribution. As noted, if the amount of a distribution is large, it could result in a significant income tax liability, possibly even pushing you into a higher federal income tax bracket for the year of the distribution.

Due to the potential tax consequences of plan distributions, if faced with the choice between taking a distribution or borrowing from your plan, borrowing is almost always the better of the two options. As noted, a plan loan that is repaid on time is not treated as a taxable distribution.

> **Tip:** If you take a distribution from an IRA prior to age 59 ½ to pay qualified higher education expenses, the 10 percent premature distribution penalty tax will not apply. (For more information, see Traditional IRAs and Roth IRAs.) This favorable treatment does not, however, apply to premature distributions from employer-sponsored retirement plans.

Plan distributions and loans reduce your retirement nest egg

Any money that you take as a distribution from your employer-sponsored retirement plan cannot be paid back, and reduces the amount of money that will be available to you when you retire. Depending on your financial situation, the reduced balance could jeopardize your ability to reach your retirement goals. Even when you borrow money from a retirement plan and pay back the loan, you are temporarily removing the money from a tax-deferred environment, leaving less money in the plan to reap the potential benefits of tax-deferred growth.

For these reasons, if at all possible, you should try to use non-retirement accounts or sources of funding to finance your child's college education.

Colleges may consider the value of your traditional IRA and Roth IRA before awarding their own financial aid

Although the federal government does not count the value of your retirement accounts in determining your child's eligibility for financial aid, individual colleges may consider the value of such accounts in determining your child's eligibility for campus-based financial aid. Many colleges consider the value of retirement accounts crucial in accurately measuring your family's ability to pay, and may expect you to use some of that money before institutional aid is forthcoming.

Securities America
Michael Sullivan, CFP
41 West Bridge St.
Suite D
Dublin, OH 43017
(614) 734-WLTH(9584)
mikes@wealthcoachfinancial.com
wealthcoachfinancial.com