Financial Advice I Would Give My Younger Self – Planning for Education Funding

College 529 plans vs. Roth IRAs: A financial expert shares what she wishes she had known when saving for her own law school and her son's college. Taking her advice could put you years ahead of the game.

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At the end of most lectures I give, the moderator usually asks, "What else should our audience know?" I always look at the younger members in the room or on the screen and think — if only I knew this when I was your age.

While my business is in providing financial and wealth planning advice to clients who have already built a significant amount of wealth, there are many fundamental planning strategies that apply to those just starting out in their careers, things, which frankly, I wish I knew when I was growing up. Therefore, I am penning this four-part series on planning advice I would give to my younger self. The topics will range from planning for college savings, young families, retirement, to caring for aging parents. This first article focuses on planning for college savings.

Saving for college is often thought of from the perspective of the parent saving for the child, and if you are one of the lucky ones whose parents can afford to have done that for you, good for you. However, college savings, or more appropriately education savings, is not a dominion strictly reserved from parent to child. As a young adult, you can start thinking about saving for higher education and how to do that in a tax-efficient manner.   Specifically, I am referring to a 529 college savings plan and Roth individual retirement account (IRA).

529 College Savings Plans Aren't Just for Kids

The 529 college savings plan is a tax-advantaged vehicle designed for education savings. Money held inside these accounts can grow income-tax-deferred, and when money is ultimately distributed for the use of qualified education expenses, it will also be income-tax-free. In other words, earnings and appreciation from investments held in a 529 account can be completely income-tax-free if used for education needs.

For many, the first experience with a 529 account is when a young parent opens one for a newborn child — that was certainly my case as my first 529 account was opened for my son a few months after his birth. Here's the advice that I wish I had known years before — you can open an account for yourself. Instead of putting your extra savings early on in your career into a savings or investment account where interest and growth would be taxable, consider instead putting those savings into a 529 account for your own benefit. If you go to graduate school, you can then use that money to pay for tuition, books and room and board. As with any tax-advantaged account, the value of compounded income-tax-free growth can be a good boost to the bottom line. In addition, certain states also offer a tax deduction or credit on contributions to a 529 account.

You may wonder — what if I don't go to graduate school or I receive outside funding like a scholarship? Money from a 529 plan can still be withdrawn for any use (i.e., non-educational use), but the withdrawal will be subject to income tax at the time of distribution and a 10% penalty if it is not used for qualifying education expenses. Even so, you still may come out ahead, because depending on the investment growth and the length of time the 529 account has been opened, the value of the compounded income-tax-free growth throughout the years may outweigh the tax and penalty imposed for taking a non-qualifying withdrawal.

What is more likely, and where the long-term view comes in, is to think of the 529 account as a tax-advantaged vehicle not only for *your* education, but for *any loved one's* education. You can rename the beneficiary of a 529 account to a qualifying family member (e.g., another child, niece, nephew, in-laws), which means that if you ultimately do not need the money for your own education needs, you can effectively "transfer" those funds to another for his or her own education, all while earning the same income tax benefits.

In retrospect, not only should I have opened a 529 account for my own law school education, I should have continued to contribute to the account and "transferred" it to my son when he was born as the new beneficiary. Had I done that, I would have jump-started my son's college education savings by a good 15 years of tax-free compounded growth.

Roth IRAs Aren’t Just for Retirement

Another tax-advantaged vehicle that may be used for education savings is a Roth IRA. These accounts are often thought of for retirement purposes, which is how they are primarily used. The advice I would give to my younger self is to consider using this strategy for education funding as well and not only for retirement.

Similar to a 529 plan, earnings and appreciation earned from investments held in a Roth IRA are income-tax-deferred, with the potential of ultimately being tax-free. The contributions you make to a Roth IRA can be accessed at any time without tax or penalty. Furthermore, when earnings and growth are distributed out of the Roth IRA, it is also income-tax-free (provided it is a qualified distribution – more on that in a bit), regardless of the use.

The Internal Revenue Service (IRS) also provides a *penalty-free* distribution from the Roth IRA to pay for higher education expenses for yourself, spouse, children, or grandchildren, provided that the distribution does not exceed the expenses for the year. Of course, if the assets are ultimately not needed for education, the Roth IRA can ultimately be used for retirement.

There are some key differences between 529 plans and Roth IRAs that one should consider when planning to use either for education savings purposes. The first is in timing. While you may make a distribution out of a Roth IRA at any time, there will be a 10% early withdrawal penalty if the distribution was made before age 59½, unless an exception applies. If a distribution was made within the first five years after a contribution to a Roth IRA, there will also be an income tax imposed at the time on the earnings (withdrawal of principal is income-tax-free). Therefore, the Roth IRA strategy is likely better viewed as a saving strategy for a child's education when you'll make the withdrawal after the five-year time frame from the first contribution and over age 59½ (of course, it is also available if one was to obtain higher education at a later age).

Another critical difference is on income limits. In order to qualify for contributions to a Roth IRA, one's income must be under a certain threshold. In 2022, that threshold is $144,000 for single individuals and $214,000 for those married filing jointly. A 529 plan, on the other hand, has no income limitations, so one may make contributions regardless of income level. Therefore, one should be mindful of one's income potential, because if your income starts to exceed the stated threshold amount, the Roth IRA strategy may not be available.

Of course, these two strategies are not mutually exclusive and if there is sufficient excess savings, you can always contribute to both a 529 plan *and* a Roth IRA.

When considering which option is right for you, there are many other factors that are beyond the scope of this article, such as:

- **Investment options offered in the plan:** 529 college savings plans may offer different investment options compared to Roths and generally may be more limited.
- **Contribution limits:** If you're younger than 50, you can only contribute up to $6,000 per year to a Roth IRA for 2022. Meanwhile, with 529 plans there are no limits, although gift taxes could come into play when contributions hit more than $30,000 per couple per year.
- **Impact on financial aid:** Eligibility and income qualification vary between 529 and Roth and will depend on many factors such as timing and ownership.

While you should always consider consulting with a financial adviser before making any final decision, I wish I knew to even ask the question when I was younger.

NYSUT NOTE: It's never too early to start saving, whether it's for college, retirement, or anything in between. With the help of the NYSUT Member Benefits Corporation-endorsed Financial Counseling Program, NYSUT members can get advice customized specifically for their financial situation from a team of Certified Financial Planners® and Registered Investment Advisors. For more information or to enroll in the Financial Counseling Program, visit the website today.

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About The Author

Alvina Lo
Chief Wealth Strategist, Wilmington Trust
Alvina Lo is responsible for family office and strategic wealth planning at Wilmington Trust, part of M&T Bank. Alvina was previously with Citi Private Bank, Credit Suisse Private Wealth and a practicing attorney at Milbank, Tweed, Hadley & McCloy, LLC. She holds a B.S. in civil engineering from the University of Virginia and a JD from the University of Pennsylvania. She is a published author, frequent lecturer and has been quoted in major outlets such as "The New York Times."

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