Only Start a College Fund If…

Nothing — and I mean nothing — will change your life as dramatically as the birth of your first child. It's a wonderful moment and one that I hope everyone gets to experience. But it will turn your life upside down.

That chic apartment downtown no longer makes sense… nor does that sporty two-seater car. And enjoying that cappuccino on your patio after sleeping in late on Saturday? Yeah, maybe you can do that again in 18 years.

My wife and I decided to move to Peru, where she's originally from, for the birth of our first son. And, let me tell you, being a Peruvian dad is great. It's like being an American dad circa 1950. For the first three months of my son's life, I wasn't even aware that babies could smell bad. He was always perfectly clean and presented to me like a trophy.

My, how it all went downhill when we moved back to Texas, had no more nannies, and my wife actually expected me to get off my lazy butt and help. It suddenly wasn't "acceptable" for me to lounge around smoking cigars, chatting it up all day with the neighbors. Oh, well… it was great while it lasted.

An Open-Checkbook Kind of Thing

Perhaps more than anything, starting a family changes your financial priorities. You have expenses you never knew existed… and that massive looming liability of college education.

I routinely get questions about financial priorities following the birth of a child, but without a doubt this is the most common:

Should I start a college fund?

Absolutely, you should start a college fund.

But only after you have already maxed out any 401(k) or IRA contributions for the year.

You ordinarily might look to Educational Savings Accounts (ESAs) and state 529 plans to put some of your income away for your child’s future. These are fantastic ways to save for college.

With them, your dividends, interest and capital gains grow tax-free, so long as you eventually use them for college expenses.

But unlike a traditional IRA or 401(k) plan, you get no tax break for the contribution itself.

Then there’s this dirty little secret: IRA funds can be withdrawn penalty-free to pay for the educational expenses of a child, though you may still owe taxes. If it is a traditional IRA, you would have to pay taxes on any withdrawals. And with a Roth IRA, you would only owe taxes on the part of the withdrawal that was considered “earnings.” In either case, there are no penalties.

Avoiding the Tax Man

As for your 401(k), these funds cannot be withdrawn penalty-free for educational expenses (unless you are age 59.5 or older). But you can roll your 401(k) balance into a Rollover IRA and then use those funds, penalty-free, for your kids’ college expenses. And while I don’t generally recommend borrowing against your retirement plans, the option is there, and it would have the added bonus of not incurring any taxes.

But if ESA and 529 balances can be used tax-free, isn’t that still better than using IRA money?

Based on taxes alone, yes. But there are other factors to consider.

To start, you know you need money for retirement. This is an absolute certainty… as certain as death and taxes. But your son or daughter may or may not need money for college.

They may get a scholarship…

Or may choose to forgo college and start their own business…

Or join the military…

Or, for all you know, join a roving carnival circus!

Besides, at the rate things are changing, who knows if going to college will make economic sense 18 years from now. Or if, as is the case in most of the rest of the developed world, a university education becomes “free,” in the same sense that public high schools are free today. (OK, “free” means funded by the taxpayers – you and me – but you get my point.)

The fact is, there are a lot of unknowns when it comes to educational expenses, so it makes sense to prioritize your savings in your retirement plan first. And you also want to make sure you’re allocating those savings to the right funds. I run a service called *Dent 401k Advisor* designed to help you position your retirement funds, as well as *Peak Income*, where I recommend low-risk investments in undervalued parts of the market in order to [generate consistent monthly income.]()

Once you’ve maxed out your 401(k) plan for the year ($ 18,500 in salary deferral in 2018) and taken advantage of any employer matching, save that next marginal dollar in an ESA or 529 plan. Both are fine savings vehicles. But again, they only make sense once you’ve exhausted your tax-advantaged retirement options.

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P.S. IRA distributions are considered “income” and thus may affect your kids’ eligibility for financial aid. So, make sure you consider that when the time comes.

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