Finding Money to Pay College Bills Out of Pocket

You've saved for your child's college education through the years, helped your child research schools, and supervised the application process. Now, thankfully, your child is in college. But you probably can't disappear just yet — there are still bills to pay. Maybe you underestimated exactly how much financial aid would cover. Or perhaps you knew all along that you'd have to use some of your own resources or take out more loans. In any case, you'll need to come up with some money soon. So where should you look?

Your paycheck

If you can afford it, applying part of your paycheck to your child's college bills is probably the easiest route. You won't have any paperwork to fill out or messy calculations at tax time, and you can leave your retirement accounts and life insurance intact.

Most colleges bill once each semester. To have enough money saved to meet each semester's bill, consider setting aside an amount from each paycheck as soon as you get it, rather than saving whatever is left at the end of the month. As you accumulate money, you should put it somewhere safe (e.g., a savings account, money market account, or certificate of deposit) because of your short time frame. Some colleges, however, offer quarterly or monthly bills in an effort to make payment easier for you. Colleges may even offer you a tuition discount if you allow them to debit your account directly. In addition, some private companies now offer a 10-month payment plan coordinated with individual colleges.

The main drawback to using your paycheck as a source of cash for college bills is that this consistent outflow of cash over a period of months or years may leave you financially strapped to invest for other goals. To determine how much of a contribution you can manage (if any), you'll need to prepare a detailed budget of your household income and expenses.

Your savings and investments

The next logical place to look for spare funds is your savings and investments. This category encompasses everything from savings accounts and money market accounts to stocks, mutual funds, and real estate holdings. Not surprisingly, it can be difficult to figure out which source to use. Generally speaking, withdrawing from your savings accounts is the easier route. Again, no applications or independent approvals are necessary (except perhaps from your spouse!). Also, no tax penalties are associated with such withdrawals. And the fact that savings accounts generally earn the lowest rates of return means that you don't have to worry about missing out on high returns. However, try to keep at least three to six months' worth of savings on hand for emergencies.

The process is a bit more complicated with investments. Though most investments are easily liquidated (i.e., converted to cash), it's not always easy to know which ones to liquidate. The answer depends in part on each investment's rate of return, future prospects, and potential capital gain (or loss) if sold and the tax consequences. If you're unsure which investments to liquidate, a professional financial planner can help you sort through the possibilities.

If you have a 529 savings plan or a 529 prepaid tuition plan, you'll need to notify the plan administrator before you make a withdrawal. Check the specific rules of your plan for more information. If you have a Coverdell education savings account, keep in mind that all withdrawals must be made before the beneficiary reaches age 30 (unless the beneficiary has special needs).

Your home

If you're one of the lucky ones whose home has increased in value over the years, you can usually tap this equity for college bills by taking out a home equity loan. The loan can be structured as either a revolving line of credit (you're approved for a certain amount and you tap the funds periodically as you need them) or a second mortgage (you receive one lump sum). The main advantage of a home equity loan is that interest payments are usually tax deductible. And because your home serves as collateral for the loan, the interest rate is likely to be lower than on an unsecured loan. However, because the loan is now tied to your house, your lender can foreclose on your home if you default.

Your life insurance

If you have a cash value life insurance policy, you might decide to use part of the cash value that has built up inside the policy by making a withdrawal or taking out a loan, or using some combination of the two. For withdrawals, the amount that you withdraw is generally limited to a percentage of your cash value and varies by policy and company. The main drawback is that such withdrawals decrease your death benefit (i.e., the sum of cash that the insurance company pays at your death). For policy loans, you are likewise allowed to borrow up to a specified percentage of your cash value. However, if you die with an outstanding loan against your policy, your death benefit is reduced by the amount of the outstanding loan and interest. For more information, contact your insurance agent.

Private loan/PLUS Loan

If the idea of putting your home at risk with a home equity loan scares you, then you might consider obtaining a personal (unsecured) loan from a private financial institution. To get approved, you'll likely need a good credit history.

If you're looking for a loan that's college-specific, the federal government's Parent PLUS Loan may be a good option. Under this program, parents can borrow up to the full cost of their child's college education, less any financial aid received. The loan is obtained directly from the federal government. Importantly, PLUS Loans aren't based on your child's financial need. However, you'll need to pass a credit check.

Your retirement plans

By the time your child's in college, it's likely that you'll have at least some money saved in one or more retirement accounts, such as an IRA or an employer-sponsored plan like a 401(k). Should you tap these funds? As a general rule, most planners don't recommend using your retirement funds to pay college bills. You'll need the money in retirement, and you'll miss out on the growth that would have occurred had you not withdrawn the money.

However, there may be instances where you need (or want) to use your retirement funds. With IRAs (traditional IRAs and Roth IRAs), you can withdraw funds at any age, penalty free, to pay your child's college bills ("qualified higher education expenses," as the IRS likes to call them). However, you may owe income tax on your withdrawals; consult the appropriate IRS publication on your type of IRA, or speak with a tax professional. Be aware that once you withdraw the money, it can't be paid back like a loan.

Unfortunately, if you withdraw funds from an employer-sponsored retirement plan like a 401(k) or 403(b) and you're under age 59½, you'll pay a 10 percent early withdrawal penalty. Keep in mind, too, that all withdrawals will be added to your taxable income for the year. Instead of withdrawing funds, another option is to borrow the money, assuming your company's plan allows it (check with your human resources manager). By borrowing instead of withdrawing, you avoid taxes and penalties. However, most plans require you to pay back the entire loan within five years (you can start to repay right away through a payroll deduction) or immediately if you leave the company.

Your child's savings

In finding spare change for college bills, leave no stone unturned. Does your child have any income or assets that could be used? Earnings from a part-time or summer job? What about that vintage lunch box collection collecting dust in your child's closet, or those $100 savings bonds that your child receives from Aunt Agnes every year? By contributing even a portion of the cost, your child is likely to feel more invested in his or her education.

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