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"A STORY THAT SEIZES YOU WITH A VISCERAL FORCE." The New York Times

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College on the House

By LISA PREVOST

Parents who want to pay for their children's college education but haven't saved enough may consider tapping into either their home equity or their retirement accounts. Which is the smarter way to go?

"In an ideal world, you would not need to do either," said Ann Minnium, the principal at Concierge Financial Planning in Scotch Plains, N.J.

And the truth is, only 5 percent of families use home-equity lines, retirement accounts and other forms of parent credit to help pay for college, according to an annual survey of families with undergraduates by Sallie Mae, the nation's largest private student lender. Grants and scholarships are the most common funding source. Some 65 percent of families of college students rely on them, up from 50 percent five years ago, according to Sallie Mae.

If alternative sources aren't enough, however, Ms. Minnium said, "the home equity is less bad than the retirement."

Her reasoning is that people are unlikely to return what they take from retirement savings. "Then they don't have what they need to retire," she said, "and end up being a burden on their children, who they were trying to help in the first place."

Better to draw on the home equity — either by refinancing to a larger amount and taking out cash, or taking a home-equity loan or a home-equity line of credit (Heloc) — provided that it is well timed. But don't borrow any cash before the student applies for federal financial aid, because once it's in the bank, it will count as an asset, Ms. Minnium noted. Home equity, on the other hand, is not considered an asset on the Free Application for Federal Student Aid, or Fafsa, so long as the equity is in a principal place of residence.

Lauren Lyons Cole, a financial planner in Manhattan, agrees that retirement funds should be off limits (unless the savings are more than adequate). She recommends that parents see their child's departure to college as an opportunity to begin separating out their finances, and that they require the student to take out loans.

Then, if the parents want to draw on their equity, she advises getting a home-equity line of credit, “probably at a slightly lower rate than the student loan, use that to pay down the loan and then gradually pay back the Heloc.”

Robert B. Walsh, a partner of Lighthouse Financial Advisors in Red Bank, N.J., believes that the decision on which asset source to tap into should be based on the individual’s priorities. “I have clients who sit down and lament that they haven’t saved enough for retirement,” Mr. Walsh said. “But then they say the thing they’re most proud of is that they’ve paid for their kids’ education.”

When it comes to drawing on home equity, he, too, favors using a Heloc to cover tuition costs, so long as the parents have a plan for how to pay it off, preferably within 10 years.

A cash-out refinance, meanwhile, offers the advantage of a fixed interest rate, versus the variable rate on Helocs. The interest on both the mortgage and the line of credit is tax deductible for those filers who itemize. But, Mr. Walsh noted, home-equity indebtedness — as opposed to a mortgage used only to buy or build a home — is only deductible on amounts up to $100,000.

Regardless of how they draw on their assets, parents should not fall into the trap of taking on more than they can reasonably afford, Ms. Minnium advised.

The same goes for college debt. “People have to give up the chase for Harvard and get a dose of reality,” she said. “If people cannot afford the education, then they should go for the state school.”