

StrategicPoint of View[®]

CRAMMING FOR COLLEGE

Planning for college funding is a process that can span decades. It begins when your child is born and doesn't end until that last bill is paid long after graduation day. In between, parents struggle with saving for college, applying for financial aid and paying the college bills. This report takes the mystery out of college planning and offers strategies to help you take control of the process.

Saving for College

With college costs soaring 7% annually, parents everywhere are wondering, "How can we possibly afford it?" The numbers are scary: tuition, room and board for a four-year degree now costs an average of \$60,000 to \$160,000 per student. The bill could reach over \$500,000 per student when it comes time for today's newborns to enroll. Who can afford such an outrageous expense?

Although the best time to begin saving for college is when your child is still small, it is never too late

to start. The first step is to figure out how much you need to save, which involves determining how much you are willing to pay for each year of college education. Remember, you do not have to pay it all. Most people can expect their children to contribute to a portion of the cost through financial aid, student loans and earned income.

Families with multiple children attending college face other issues. To treat their children equitably requires forethought. The first child often receives the greatest benefit from parental income or borrowing. Without planning, parents can over extend their debt balances before the last child finishes college, challenging cash flow and the ability to save for retirement. It is important to map out a strategy for paying for college for all children before the first tuition bill arrives.

The calculation for how much you need to save per child is based on what kind of school you expect each child to attend, education costs, years until college and how much of the bill you are willing (and able) to pay.

Once you have determined the amount you need to save on a regular basis, the next step is to create an investment plan for funding college. It can be overwhelming to sort through all of the education

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savings options that are available, so here is a summary of the pros and cons of possible education funding options:

State 529 Plans: These college savings plans are available in every state and are typically open to residents and non-residents alike. The major benefit is that 529 plans are tax-advantaged and allow you to save a sizeable amount of money for education expenses (over \$300,000 per child in most cases). If the money is used for qualified higher education expenses (529 plans cannot be used for private high school), it can be withdrawn *tax free*. Otherwise, income taxes and a 10% penalty are assessed on the earnings portion of withdrawals. 529 Plans offer flexibility in case your child decides to forgo college: the beneficiary of the account can easily be changed or the parents may use the funds to finance their own education costs. Also many states offer a state income tax deduction for contributions made into the plans. 529 Plans are considered parental assets for financial aid purposes.

Roth IRAs: Roth IRAs work best when the owner is over 59½ at the start of the student's college career. Withdrawals made after five years and age 59½ are tax-free. But even if the owner is under 59½, Roth distributions can be used for education with some tax advantages—they are subject to income taxation, but escape the 10% penalty for early distributions. Roths also have flexibility because they can be used for college or for retirement and because they provide a wide range of investment choices.

The downside to the Roth is that it can hurt financial aid applications—the principal and the earnings from distributions are included as income on the FAFSA application, impacting eligibility. Additionally, Roths do not have the state income tax deduction for contributions. That said, don't ignore Roths because their broader investment options and

potentially lower costs make them a viable option for college savings.

Coverdell Savings Accounts: These so-called “education IRAs” used to be considered a good savings vehicle for education funding. Distributions applied to education costs are tax-free. However, recently Coverdells have lost their luster: beginning in 2010, the annual contribution limit will fall from \$2,000 a year to \$500, while distributions will no longer be eligible for primary and secondary education—a nice advantage over 529 plans that the Coverdell previously enjoyed. If you have a Coverdell IRA, you can hold it and use it for college or you can roll it into a 529 plan.

Custodial Accounts: These accounts offer extensive flexibility. There are no limits on how much can be invested into the account and no early withdrawal penalties. However, there are no tax benefits and a custodial account could affect a family's eligibility for financial aid. In addition, this account will be completely owned by the child at the age of majority, which means that it does not necessarily have to be used for education. If your child owns an UTMA/UGMA account, you can transfer it to an UTMA 529 plan and eliminate the financial aid disadvantage.

Savings Bonds: Earnings on certain Education EE and I Savings Bonds are tax-exempt if used for college expenses and the tax payer must meet certain income limitations. In order to qualify for tax-exempt status, the bonds must be issued after 1989, issued in the name of the taxpayer or in the name of the taxpayer and spouse, *not in the name of the student/child* (although the child may be named as a beneficiary).

Trusts: often a college savings vehicle for wealthier individuals. They can serve a dual role: providing funds for college (and other purposes) as well as

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presenting gifting opportunities to reduce future estate tax liabilities. Special trusts, known as 2503(b) and 2503(c) trusts allow parents, grandparents and others to gift up to \$12,000 a year to any child. The trusts can specify how the money should be used. They differ in the timing of distributions and when the child gains control over the assets, but do not provide any tax-deferral benefit. Those considering trusts should consult with an experienced estate planning attorney.

Financial Aid

College planning is not just about developing a college savings plan. It also involves developing and implementing strategies that will enhance the family's ability to pay and positioning income and assets to place the family in the best position to receive financial aid. Financial Aid is meant to help families who would not otherwise be able to afford a college education for their children. While StrategicPoint does not support hiding assets in an attempt to increase eligibility for aid, we do believe that families can legally and ethically position their finances in ways that take advantage of how the FAFSA and Profile financial aid applications view assets, income and debt. Many families inadvertently position their assets or structure their expenses in ways that disadvantage their chances of receiving aid.

A word of caution: every financial planning issue must be considered within the context of an overall financial plan. While it may seem like a good idea to reposition assets to qualify for financial aid, it may not be appropriate for your overall situation. Be sure to speak with your advisor to review all of your planning needs before making any changes to your income or assets.

To improve your financial health with respect to financial aid, we offer the following:

Financial Aid Terms You Should Know

Base Year: Colleges make their financial aid eligibility decisions based on information provided for the base year: January 1st of the student's junior year through December 31st of his senior year. The base year determines the level of aid for the entire time the student is expected to be enrolled in college. Upon acceptance, the student receives the aid award only for the freshman year, but then the college places the student in its budget for all four years. Parents can submit requests and updated information for increased awards in subsequent years, but once the money is in the budget, it may be hard to increase the aid.

The Expected Family Contribution (EFC): EFC is the minimum amount of education expenses a family is expected to pay. It is a number produced by the FAFSA calculations or the Profile calculations and is used by the colleges to determine financial aid awards.

Free Application for Federal Student Aid (FAFSA): FAFSA is a form used to determine eligibility for federal and state student aid.

www.fafsa.ed.gov

Profile: This is a form sponsored by the College Board that is used by colleges to determine eligibility for the college's grant, loan and work study programs.

www.collegeboard.com

Financial Aid Recommendations

Careful planning is vital. Parental income can be assessed as high as 47% and student income by as much as 50%. Moreover, college financial aid officers view up to 20% of student assets and 5.6% of non-retirement parental assets available for college expenses each year.

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- 1) **Pay attention to your income.** Reducing parental income during the base year can improve your child's chances of qualifying for financial aid.
 - Postpone activities that might increase your taxable income such as taking a bonus, converting a traditional IRA to a Roth IRA, filing tax refunds or selling your home. Remember that distributions from IRAs to pay for education costs also boost your income.
 - Be careful of incurring capital gains, which are reported as income and deemed to be available for college expenses. You can use up to \$3,000 of carried-forward capital losses to reduce your income on a dollar-for-dollar basis.
- 2) **Retirement plan assets work for you.** Money saved in retirement plans, IRAs and annuities are not counted as available parental assets by financial aid formulas.
- 3) **Pay down debt with available cash.** If you have money in cash and savings that will be assessed for financial aid, consider paying down outstanding debt on credit cards and car loans. Debt does not work in your favor for financial aid.
- 4) **Manage your tax deductions.** Schedule A deductions, including gifts to charity and mortgage interest deductions, do not reduce the income considered in the financial aid process. Deductions on Schedule C (self-employment) and Schedule E (supplemental income and loss) work for you in determining your EFC. For example, if you have a second home, consider renting it. You can report expenses or losses associated with the rental on Schedule E. Or if you have unreimbursed business expenses, consider becoming an independent contractor and taking your deductions on Schedule C.
- 5) **Be careful about gifts for college funding.** Isn't it great if your family and friends want to help you pay for your children's college? Maybe. The way they make their gifts can affect the ability to qualify for aid. Accounts in the student's name, such as custodial accounts, will be weighed more heavily against you than accounts in the parents' names. Gifts made directly to the college will be viewed as scholarships and will likely reduce your award in future years. If the person making the gift is open to the idea, your financial aid package would benefit the most if he or she gave the money directly to you or if they offered to help pay off student loans after college.
- 6) **Keep assets in the parents' names.** Parental assets (including 529 plans) are assessed only at 5.6%, while 20% of student assets are deemed to be available for education expenses, according to financial aid formulas.
- 7) **Use assets in custodial accounts *before* entering the base year.** Assets in custodial accounts should be used to benefit the student, so, you may want to purchase the college laptop early.

Paying for College

Most parents believe that college planning starts with a strategic savings plan and ends with the student's college acceptance and the awarding of financial aid. But there exists another important planning step that needs to be completed—how to pay the bill once it arrives. Even with financial aid, most people can't simply write a check for the balance due. Fortunately there are a variety of sources upon which parents can draw to foot the bill.

Parents and students can pay for college costs from a variety of sources: financial aid packages, 529 plans, Coverdell accounts, savings bonds, current income,

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parental accounts, student savings, gifts, mortgages and student and parent loans. If financial aid is a consideration, some sources are better used later in the student's college career while others should be depleted in the freshman year. In addition, the issue of debt is a complex one—who takes out a loan and for how much? Finally, there is the issue of how to coordinate payments with retirement planning or tax strategies.

Paying for College Recommendations

If the student is applying for financial aid:

- Deplete all of the student's assets as soon as possible. If this occurs after college enrollment, reapply for financial aid, informing the financial aid office of the reduction of available assets.
- Postpone cashing in savings bonds (education or regular) until the last year of college. Earnings reported on the parents' Form-1040 (whether taxable or not) are considered income in the year after the bonds are cashed and therefore can reduce future financial aid.
- Paying college bills with IRAs (Roths included) should be delayed until the final years of college as well, since distributions are deemed as available income in the year after the money is withdrawn (and already spent!).
- Use gifts from friends and family (which are viewed as scholarships) in the later years of college when aid is no longer an issue. Conversely, if financial aid is not an issue, use direct payments and other gifts up front to delay the potential need to borrow and incur an interest expense.
- Use 529 plan assets or Coverdell assets at any point in the tuition cycle. 529 withdrawals are not considered income the year following their use. According to Education Department rules, both are assessed as a parental asset,

with financial aid officers looking at only 5.6% as available each year.

When financial aid is not an issue:

- Pay for college expenses as much as possible out of income, particularly if the trade-off is between income and assets that could be used for retirement. This may involve making sacrifices in your current lifestyle, if their future well-being calls for it.
- Use parental non-retirement assets, set aside for college, anytime.
- There is nothing wrong with student loans. In fact, students often value the college experience more if they assume some of the financial responsibility for shouldering costs. College packages include subsidized Perkins loans and subsidized and unsubsidized Stafford Loans, which are low interest rate loans with reasonable repayment periods. Student loans are also available through commercial or state-sponsored loan programs.
- Borrow if need be. Families with minimal assets and lean budgets will need to investigate borrowing. However, the adage "You can always borrow for college, but you can't borrow for retirement" applies here. It is very important for parents not to lose sight of their own needs when planning for the costs of college.

That said, banks and colleges (as well as state higher education agencies) offer parents adjustable rate loans that allow parents to borrow the cost of education, less any financial aid received. In addition, your home (or other real estate) is also a potential source for paying college bills. However, because home mortgages use the real estate as collateral for loans, it is important to limit the amount of equity taken out of a

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home and to coordinate monthly payments with expected cash flow.

- Remember that the Hope and Lifetime Learning Credits, as well as the Higher Education Expenses Deduction can only be taken against expenses paid for directly by the taxpayer. Moneys from 529 plans, Coverdell accounts or scholarships cannot be used when calculating how much credit or deduction to take.

Finally, college funding is only one aspect of your financial life. It is preferable to begin with an overall financial plan, focusing on net worth and cash flow, retirement planning, insurance planning, tax strategies, estate planning and investment planning. You should weave college planning into the fabric of that plan.

Questions about this article:

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