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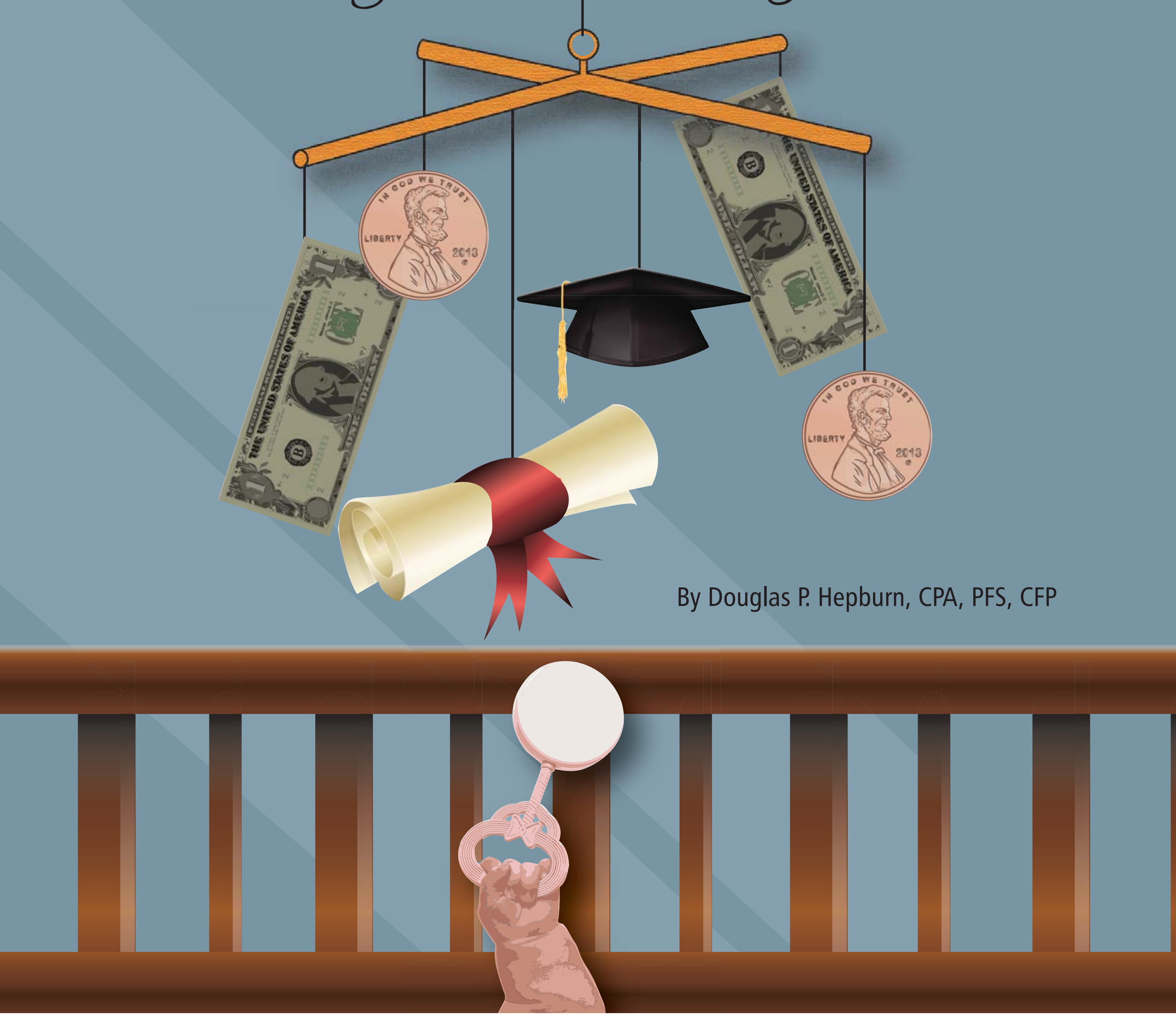
Best Plan for College Savings Is an Early Start



By Douglas P. Hepburn, CPA, PFS, CFP

Parents of high school children have every right to be terrified about the potential cost of college, and personal financial planners can play an important role in assuaging their clients' fears by working with them to develop a comprehensive college savings plan.

According to a report from The College Board, average tuition rates for 2012-2013 ranged from $3,131 for a two-year degree at a public college to $29,056 for a four-year degree at a private institution.[1] These figures do not include room, board, books, and transportation, which can drive the annual price to over $60,000 for students at elite schools. As with most financial planning opportunities, the options are typically determined by three drivers: resources, time, and risk tolerance. Individually, each factor plays a different role in developing the solution, so it's important to evaluate each in relation to the other when crafting a plan.

By far the greatest determinant of success is resources. For clients with a surplus, time and risk tolerance become less important as the likelihood of failure is significantly reduced. In these cases, taxes would be the greatest penalty for failing to plan. For those where resources are constrained, time and risk tolerance take on greater importance.

As with most challenges, time can be the great equalizer. The more time that is available, the fewer resources are necessary, provided assets can grow at a rate faster than inflation. With college tuition costs rising at a rate greater than 5 percent above inflation, planning should begin as soon as one has children, if not before.[2]

The luxury of time permits investors to take on greater risk in exchange for potentially greater returns. As the time horizon gets shorter, though, the need for liquidity and lower volatility dictate a lower risk strategy likely to result in lower returns.

Funding Options

The most flexible way to fund college tuition is through taxable savings since assets are liquid and the parent maintains control. The downside is that it can be extremely inefficient for those in higher tax brackets. The resurrection of the 39.6 percent tax bracket and the addition of the net investment income tax means clients could end up paying 43.4 percent in federal tax alone on each marginal dollar of investment income.

One strategy to avoid this is to transfer income-producing assets to children through custodial accounts, such as Uniform Gift to Minors Act (UGMA) or Uniform Transfers to Minors Act (UTMA) accounts. Under "Kiddie Tax" rules, it is possible for dependent children to receive up to $2,000 in unearned income, tax free. Depending on the minor's state of residence and the type of account, the custodian has full control over the funds while the child is under the age of termination (18, 19, or 21). Once that age is reached, the child will have full access without restrictions. An uncomfortable thought for many parents.

Section 529 plans are a good choice because the assets can grow tax-deferred and distributions used to pay qualified expenses are tax-free. These plans are offered as either prepaid tuition or investment plans.

Prepaid tuition plans permit contributors to purchase college credits in advance to offset future tuition costs. Credit values are designed to grow at the rate of tuition inflation as defined by the plan, and the sponsor bears much of the risk in meeting the intended goals.

Alternatively, 529 investment plans are similar to defined contribution plans, in that the contributor decides how much and how often to contribute. Performance is dictated by the choice of the underlying mutual funds, and the investor bears all of the risk.

Generally 529 plans are sponsored by state governments. A key consideration in choosing a 529 plan is whether state-specific laws favor in-state plans by providing greater benefits. The 529 plans generally have fees and expenses associated with them, and are sold by prospectus/disclosure document. The primary restriction on 529s is that the earnings on distributions not used for qualifying higher education expenses are subject to income tax and a 10 percent penalty.

Another benefit of 529 plans is the ability to place five years of gifts into the plan in one lump sum. For those who have access to such large gifts, this presents a significant opportunity for generational planning. Considering the annual gift exclusion is $14,000 for 2014, two grandparents could fund $140,000 in one year through gift splitting. If all four grandparents are alive, they could fund up to $280,000 or the maximum permitted by the plan sponsor, whichever is less. The caveat is that the contributors must survive the full five years following the gift.

For children entering or already in college, direct payments of tuition by grandparents is one of the most powerful planning tools as tuition payments are not subject to gift or generation skipping taxes. This strategy can also work for prepayment of tuition, provided the prepayments are nonrefundable and become the sole property of the school.[3]

Other tax-advantaged savings options include Coverdell Education Savings Accounts (CESA) and Education Savings Bonds. CESA accounts are similar to 529 accounts in that they are funded with after-tax money and the gains can be distributed tax-free when used for qualifying education expenses, but that is where the similarities end.

CESA contributions are limited to a maximum of $2,000 per year per beneficiary, and the contributor's ability to gift is phased out when modified adjusted gross income (MAGI) reaches $220,000 for joint filers and $110,000 for single filers.

One advantage CESAs have over 529 plans is that the assets can be used for elementary or secondary education as well as college expenses. But the restrictions have made these accounts less advantageous.

Education Savings Bonds (Series EE and I) are issued by the U.S. Treasury, and interest on the bonds is tax-free if used for qualifying education expenses. The interest exclusion is phased out for families with MAGI between $113,950 and $143,950. Traditionally this has been the option for more risk-averse clients. Other limitations such as an annual maximum purchase amount also apply.

Determining Need

For most Americans, one or more of the key factors (resources, time, or risk tolerance) is significantly constrained. This results in a funding gap that is usually filled by student aid in the form of scholarships, grants, and loans. According to The College Board's *Trends in Student Aid 2013*, over the past 30 years total student aid from all sources has increased from $36 billion to $238 billion (2012 dollars). This includes government, institutional, and private grants as well as loan subsidies, tax credits, and deductions.

There are two types of scholarships available to students: merit-based scholarships and need-based scholarships. If a child has a unique skill or attribute that a particular college or university would like to have as part of its student body, that could work to your client's benefit. For example, a child who is gifted in mathematics may qualify for merit-based aid. But not all schools give merit aid. For instance, many highly competitive schools do not give merit scholarships since, presumably, all of their students would qualify. A family doesn't have to be financially needy to qualify for merit-based scholarships, so it makes sense to advise a client to go through the financial aid process to see what they qualify for.

The first step in the financial aid process is to determine the Effective Family Contribution (EFC). This is the dollar amount of education expenses that is expected to be borne by the family. There are two ways to calculate EFC: the federal methodology, which is accomplished through the Free Application for Federal Student Aid (FAFSA) form, and the institutional methodology (IM), which is a variation often used by private institutions. The FAFSA will be essential in determining whether the student qualifies for federally sponsored financial aid programs. The IM was developed to get a clearer picture of the family's need by adding some income and assets that the FAFSA ignores, and it can vary from one institution to another. Schools that use the IM will often require the CSS Financial Aid PROFILE. Because the information that goes into both models is derived from the client's balance sheet and Form 1040, tax planning and advanced preparation can play a key role in determining the EFC each year the student is enrolled and applies for aid.

The first step is to calculate available income (AI), which consists of adjusted gross income (Form 1040, Line 37) plus untaxed income and benefits (retirement plan contributions, child support, tax-exempt interest, etc.) minus taxes and an income-protection allowance.

Discretionary net worth is then calculated by adding cash, savings, investments, and the adjusted value of business/farm interests to arrive at net worth, which is then adjusted for the education savings and asset protection allowance to arrive at discretionary net worth. This total is multiplied by an asset conversion rate to arrive at the contribution from assets, which gets added to AI to arrive at adjusted available income (AAI). The parents' contribution is then determined from a table.

Added to the parent's contribution is 50 percent of the student's income, less taxes and income allowance, plus 20 percent of the student's assets.

Other factors that affect EFC include the size of the family, age of the oldest parent, and other students in college at the time the FAFSA is completed.

The need calculation is somewhat easier, beginning with the annual cost of attendance (tuition, room, board, fees, books, etc.), minus EFC and other resources, such as merit-based and private scholarships, and the net result is adjusted need. Depending on the institution and its desire for a particular student to attend, the financial aid department may come up with additional sweeteners to fill this gap. Chances that they will eliminate your EFC, however, are low.

Free Money

The best aid that students can receive is in the form of grants and scholarships because these don't need to be paid back. In addition, if they are not conditioned on employment or service, they are not subject to income tax.

Federal grants are based on need and require recipients to maintain a minimum GPA. The most commonly recognized is the Pell Grant, which is awarded to undergraduate students and has a maximum value of $5,645 for the 2013-2014 award year. For the 2011-2012 academic year, dependent students whose parents earned less than $30,000 received 60 percent of all Pell Grants. Only 5 percent of recipients in the same category had parents with incomes over $60,001.[4]

Scholarships, on the other hand, are often merit-based and can be offered through the institution, the state, or other organizations such as corporations, private or community foundations, and religious and fraternal organizations. In virtually all cases, recipients are required to meet minimum qualifications and apply for the scholarship. Getting information on scholarships used to be challenging, but in recent years websites such as www.fastweb.com and www.scholarships.com have sprung up to meet demand.

Self-Funding

After determining the actual cost of attendance and deducting the benefit of any aid, the remainder needs to be funded by the family. This will either be paid out of current income, liquidation of assets, or loans.

For clients with sufficient cash flow, paying the remaining costs out of income may be the easiest solution, provided it doesn't negatively impact other goals such as retirement. The primary consideration in these cases is opportunity cost. If the client didn't use those funds to pay education-related costs, would the alternative have been a more productive use of capital?

Liquidating assets can be an acceptable strategy if close attention is paid to the tax ramifications of any sales, as well as the opportunity cost of not keeping the asset. In this case, 529 accounts, CESAs, and education bonds would make the most sense to liquidate first since distributions used for qualified expenses are tax-free.

The next items for liquidation would be assets in the child's name where long-term capital gains can be taken without paying tax. Under the American Taxpayer Relief Act of 2012, long-term capital gains that would otherwise be taxed at a rate below 25 percent are taxed at a 0 percent rate. Considering the 25 percent tax bracket for single taxpayers begins at income over $36,900, a long-term gain beneath that limit could result in a tax savings of up to $7,380, assuming the gain would otherwise be taxed 20 percent if the asset was owned by the parent.

For many years, parents were advised to overfund permanent life insurance policies as a way to accumulate savings that do not need to be reported on the FAFSA form. For clients in this situation, borrowing against the policy's cash value can be a source of dollars for education, but great care needs to be taken to make sure the policy doesn't collapse, leaving the owner with a large tax bill on untaxed earnings inside the policy.

Loans

For most parents, borrowing ends up being the first, if not the only, option that they look at. Here, too, there are many choices. The two types of federal student loans are Stafford and Perkins.

Stafford loans can either be subsidized or unsubsidized. For subsidized Stafford loans, the government pays the interest while the student is enrolled. There is a six-month grace period before payments begin after graduation, and the principal can be repaid over 10 to 25 years. To qualify for a subsidized Stafford loan the student must have a financial need and be enrolled at least half-time.

Students who don't qualify for this subsidy can get an unsubsidized Stafford loan. The difference is that the student must repay all of the interest, including interest accrued during the college years. The current interest rate on both Stafford loans is 3.86 percent, with annual and cumulative borrowing limits for each.

Perkins loans are made through, and repaid to, the school the student is attending. While interest rates can vary on these loans, the repayment term is generally 10 years with a nine-month grace period following graduation. To qualify, a student must attend at least part-time and have an exceptional financial need. The annual borrowing limit on Perkins loans is $5,500, for a total of $27,500 as an undergraduate.

In each case, the student is the borrower and is responsible for repayment of the loan. For parents unconcerned about cosigning for their dependent children, PLUS loans are often used to fill any gaps remaining after Stafford or Perkins loans have been maximized. These generally carry a higher interest rate than Stafford loans and have no annual limits. Payment begins 60 days after disbursement, but parents have the option to defer interest payments while the student is enrolled at least half-time.

Many parents have opted to pay for college education with home equity loans or lines of credit. This strategy may have merit due to the home mortgage interest deduction, but your clients will have to weigh this advantage against the additional debt burden that they will be solely responsible for and the tax benefits that the child will forego.

Parents unable or unwilling to use home equity loans can opt for private loans. Depending on the lender, they may be able to get better terms than direct federal student loans and avoid cosigning.

Even if a client doesn't qualify for need-based financial aid, there are subsidies available for education through the tax code, including the Tuition and Fees Deduction, the American Opportunity Credit, and the Lifetime Learning Credit. While the benefits are limited, every bit counts.

Conclusion

There are numerous strategies available to help clients either reduce their reportable assets/income so that they can reduce their EFC or find other ways to pay for education that may be deductible. These strategies often focus on income shifting, asset shifting, or employment in the family business.

Each client's facts and circumstances present different opportunities that can be applied to solve their tuition-funding need. Invariably, the solution is likely to be a combination of strategies working together to achieve their goals. The only way to determine which ones will work is to ask clients if college education for their children is important to them, and then model the solutions to show what works best for their specific situation.

[1] *The College Board,* Trends in College Pricing 2013*, pp. 3, 11. http://trends.collegeboard.org/college-pricing*

[2] *Ibid., p. 14.*

[3] *Private Letter Ruling 20060200.*

[4] *The College Board,* Trends in Student Aid 2013, *figure 15B. http://trends.collegeboard.org/student-aid*

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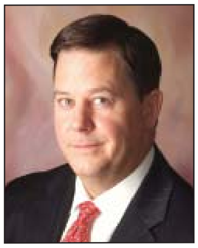

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