The College Planning Smorgasbord

by Paula H. Hogan, CFP®, CFA, and Bret Kroeger

Executive Summary

- College financing is a continuously changing landscape. One change that is making such planning difficult for planners, according to the authors, is a shift at some schools away from loans and toward grants, and that the various education-related tax breaks aren't available to the very taxpayers who can most afford to pay tuition.
- The article first explains the underlying concepts of financial aid calculations, which can result in the recognition that a public school education is not necessarily the least expensive option for every family. Also, some highly selective schools offer not just need-based financial aid, but merit-based as well.
- The aid calculation and these changing trends require the planner and the client to make early decisions about whether financial aid should be considered and whether and how to save for college education.
- Planning for a family likely to need financial aid—a sometimes difficult decision to call since college may be more than a decade away—generally emphasizes minimizing wealth stored in the child's name. Unfortunately, under the plethora of aid rules regarding 529 plans and other savings options, this can be a complicated choice.
- A family not likely to qualify for financial aid should generally focus on maximizing the tax advantages of saving for college, such as saving in the child's name and gifting capital-gain assets.
- The authors provide several scenarios of families who will and will not likely qualify for financial aid, and who have plenty or little time to plan.

Paula H. Hogan, CFP®, CFA, is a fee-only planner practicing in Milwaukee, Wisconsin.

Bret Kroeger is a candidate for a master's degree in economics from New York University.

A continuously shifting landscape in the area of college financing is causing confusion, an increased risk of giving bad planning advice, and high liability exposure for advisors across the country. Factors confounding the simple use of the various financing options for college expenses include the shift in financial aid away from loans toward grants, especially in the private sector, that do not need to be repaid, and the paradox that the various education-related tax breaks are typically not available to the taxpayers who can actually afford to pay tuition. Thus, it is becoming increasingly important to have a more nuanced understanding of both financial aid and of the tax code in order to plan optimally for college financing. This more nuanced understanding becomes particularly helpful when, for example, the advisor works with families in which wealthy grandparents want to help their less well-off children pay college costs in the most effective manner. This article offers a conceptual framework for evaluating the various college financing options in a multigenerational context.

The key driver to determining the optimal mix of college investment options is whether the child's family is eligible for financial aid. College savings strategies vary greatly depending on whether the family is trying to maximize financial aid, or is clearly ineligible for financial aid and so instead will be concentrating on the most tax-efficient way to pay for college.

An important concept is that financial aid calculations, such as the standard financial aid formula, actually compute not financial aid, but the amount the family is expected to contribute, expressed as a per-child expected family contribution. As you might expect, the per-child EFC rises with family income and wealth, and falls with such family circumstances as the number of children in college. Schools following a "100 percent-of-need" financial aid policy commit to developing a package of grants, loans, and work-study opportunities sufficient to make up the difference between the calculated EFC and total costs.

Table 1 shows how the expected family contribution changes with various family circumstances. For example, Line 1 shows that the EFC for a family with one child in college, $100,000 of earned income, $100,000 of investments, and $150,000 of home equity is estimated to be $16,777 a year.

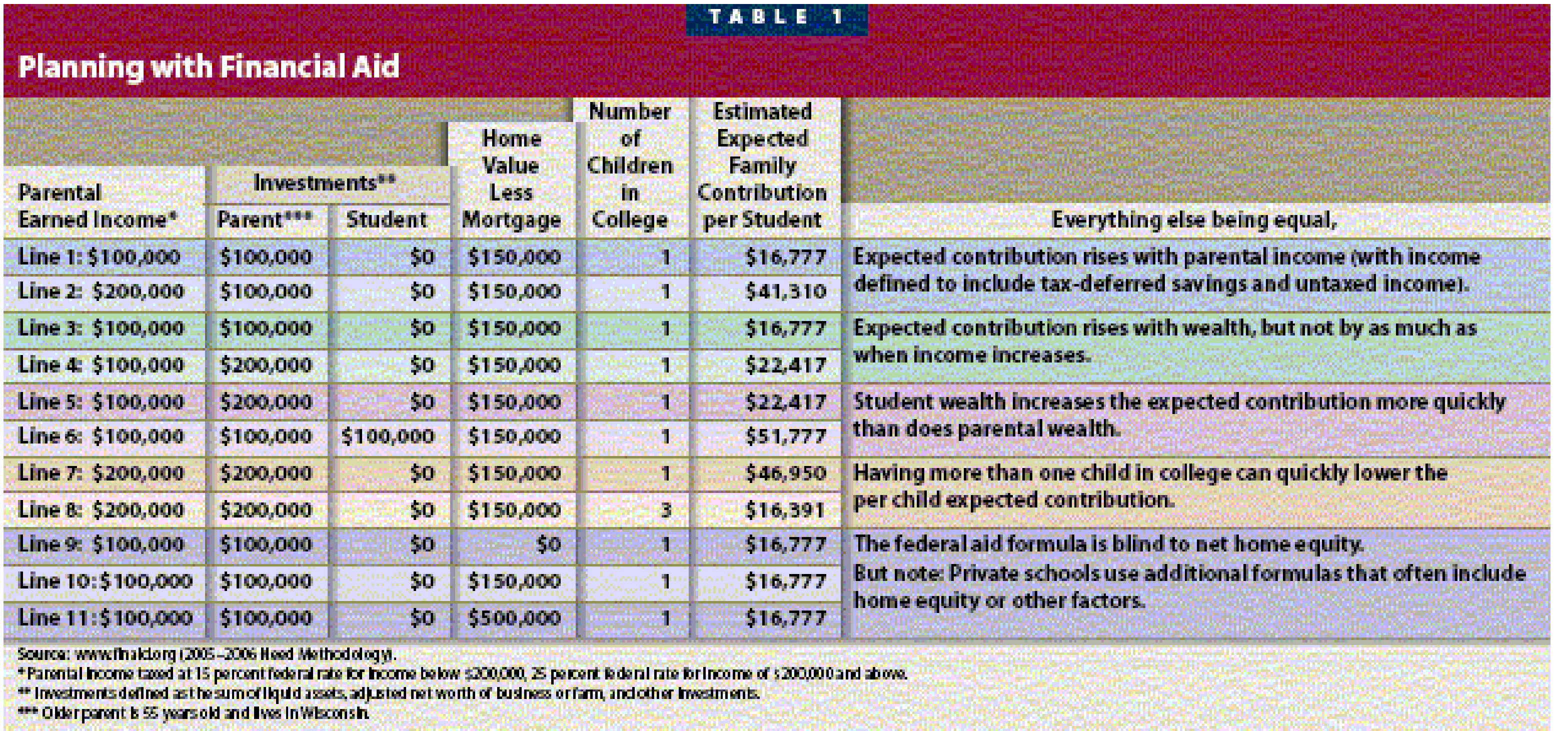


TABLE 1

Planning with Financial Aid

Parental Earned Income*	Investments**		Home Value Less Mortgage	Number of Children in College	Estimated Expected Family Contribution per Student	Everything else being equal,
	Parent***	Student				
Line 1: $100,000	$100,000	$0	$150,000	1	$16,777	Expected contribution rises with parental income (with income defined to include tax-deferred savings and untaxed income).
Line 2: $200,000	$100,000	$0	$150,000	1	$41,310	
Line 3: $100,000	$100,000	$0	$150,000	1	$16,777	Expected contribution rises with wealth, but not by as much as when income increases.
Line 4: $100,000	$200,000	$0	$150,000	1	$22,417	
Line 5: $100,000	$200,000	$0	$150,000	1	$22,417	Student wealth increases the expected contribution more quickly than does parental wealth.
Line 6: $100,000	$100,000	$100,000	$150,000	1	$51,777	
Line 7: $200,000	$200,000	$0	$150,000	1	$46,950	Having more than one child in college can quickly lower the per child expected contribution.
Line 8: $200,000	$200,000	$0	$150,000	3	$16,391	
Line 9: $100,000	$100,000	$0	$0	1	$16,777	The federal aid formula is blind to net home equity. But note: Private schools use additional formulas that often include home equity or other factors.
Line 10: $100,000	$100,000	$0	$150,000	1	$16,777	
Line 11: $100,000	$100,000	$0	$500,000	1	$16,777	

Source: www.finaid.org (2005–2006 Need Methodology).
*Parental income taxed at 15 percent federal rate for income below $200,000, 25 percent federal rate for income of $200,000 and above.
** Investments defined as the sum of liquid assets, adjusted net worth of business or farm, and other investments.
*** Older parent is 55 years old and lives in Wisconsin.

This amount would pay most of the typical costs for a public school, but only a fraction of the typical $40,000-a-year cost for a private school. One planning implication is that financial aid might substantially erase the difference in price between a state school and a private school for such a family.

Hence, the common advice is true: do not assume that a public school education is necessarily the least expensive option for every family. A further complicating factor is that, in general, the most highly selective schools offer only need-based financial aid, but other schools offer financial aid based on both need and merit. In fact, need-based financial aid (at a highly selective private school), or a combination of need- and merit-based aid (at a still excellent but not highly selective private school) could make the cost of attending a private school comparable to the cost of attending a public school.

Lines 1–4 in Table 1 show that the expected family contribution rises with parental wealth, but not by as much as with parental income. Lines 5 and 6 highlight that having wealth in a child's name instead of the parent's name can be expensive in terms of the potential loss in financial aid. Lines 7 and 8 show that even upper-income families with several children in college might get some need-based aid. And finally, Lines 9–11 show how the federal aid formula is blind to net home equity, but that private schools often use supplemental calculations that take into account home equity, as well as other factors not used in the federal aid formula. In particular, many private schools require the completion of the College Scholarship Service Profile as a supplement to the standard Free Application for Federal Student Aid (FAFSA) form. (See www.collegeboard.com.)

These examples show in a general way the impact of various factors determining the expected family contribution under the federal formula. Several other factors, including the amount of federal and state taxes paid, the age of the older parent, whether the family owns a closely held business, and whether both parents work, are smaller but still relevant factors. The only way to know if a family will qualify for aid is to complete the FAFSA form, which is available at www.fafsa.ed.gov. (Applicants will need to have a recent tax return and balance sheet handy when they fill out this form.)

Planning with Financial Aid

If financial aid is an option, financial planning can be complicated. (For details, see www.finaid.org and http://ifap.ed.gov.) Basically, the planning goal is to minimize wealth stored in the child's name; but there are other, less obvious, considerations. For example, the rules relating to 529 plans are particularly confusing and in flux, and thus not surprisingly, there is great variation in the quality of reported financial data from students applying for financial aid.

529 prepaid tuition plans are not considered an asset in the calculation of the expected family contribution; yet distributions are considered a resource for the student and thus decrease the assumed cost of attendance. This in turn decreases financial aid if the school becomes aware of the distribution. The school becomes aware of the distribution via self-reporting by the student or when the school matches checks received from the plan to the financial aid file of the particular recipient student. Thus, there is incentive to hold back the use of 529 prepaid tuition plans until the student's senior year to protect financial aid in the earlier years.

In contrast, 529 savings plans are reported as an asset of the account owner and can muffle financial aid if the owner is either the student or the parent, with ownership by the student having a greater impact than ownership by a parent. Thus, for families eligible for financial aid, having a grandparent own the 529 savings plan, all else being equal, could protect financial aid eligibility. Distributions from 529 savings plans that are not subject to federal income tax (that is, all plans as of January 1, 2004) are not counted as either parent or student income for purposes of financial aid calculations. Further, they do not reduce the assumed cost of attendance, unless in particular instances a school becomes aware of a 529 savings plan distribution and decides to invoke the "professional judgment rules." These rules provide some latitude in how financial aid calculations are made. Similarly, since capital gains are counted as income in the financial aid calculations, there is incentive to realize capital gains during the student's sophomore year in high school and then not again until after April of the student's junior year in college, when the final financial aid application has been submitted.

A further complication is how financial aid changes with student-earned income. On the one hand, the first $2,440 of income earned by a student is protected by an "income protection allowance," but income earned by the student beyond this limit is deemed to be 50 percent available for school expenses. Thus, the financial aid calculations in their present form motivate families to weigh the possible negative impact the student's working could have (if they exceed the income limit) on financial aid against reasons why a student should work. As we shall see, the changing mix between loans and grants that do not need to be paid back in the financial aid packages now offered by many colleges could affect the weighing of these factors. Interestingly, the U.S. Senate is considering the College Quality, Affordability, and Diversity Act, which includes an increase in the income protection allowance for dependent students from $2,440 to $9,000.

Planning Without Financial Aid

Alternatively, if a family does not qualify for financial aid, then a different set of planning options becomes appropriate, most of which focus on maximizing tax advantages. Here the key point is that the tax breaks for education expenses are designed so that the families who can afford to pay tuition usually do not qualify for the related tax breaks (see www.irs.gov, Publication 970: Tax Benefits for Education).

Families who do not qualify for financial aid, however, can plan around these rules by arranging for their children to have sufficient income to capture the education tax breaks for their family. Thus, for wealthy families, planning for college often centers on getting income over to the child's tax return, by having the parents not claim the child as a dependent, and shifting wealth to the child. (Note: Not claiming the child as a dependent is usually acceptable because high-income parents either have personal exemptions trimmed or, if they are subject to the alternative minimum tax, completely eliminated. The caveat to this tax strategy is that some group health insurance plans include college-age students only if they are also claimed as dependents on their parents' tax return.)

How do you create income for a college-age student? By gifting a capital-gain asset that is then sold by the child, or by having the college-age child liquidate savings bonds that had been bought in his or her name in earlier years. The family also might fund a deductible IRA for the child in earlier years that is then drained during college years, or shift an income-producing asset to the child.

Table 2 shows how wealthy families can save taxes by shifting assets to their children. It shows a family with three children and college savings that include a stock with an unrealized gain of $36,000 plus inflation-indexed savings bonds that will trigger $60,000 of ordinary income when liquidated. Option A assumes that the parents hold the assets. Option B assumes that the stock is gifted to the children, and that the savings bonds had been bought in the children's names when they were young. The resulting estimated tax savings for just the one year illustrated is $18,155. The tax savings come from two sources: (1) the children are in a lower tax bracket than are their parents, and (2) the children, unlike their parents, are eligible for the Hope and Lifetime Learning education tax credits during their college years.

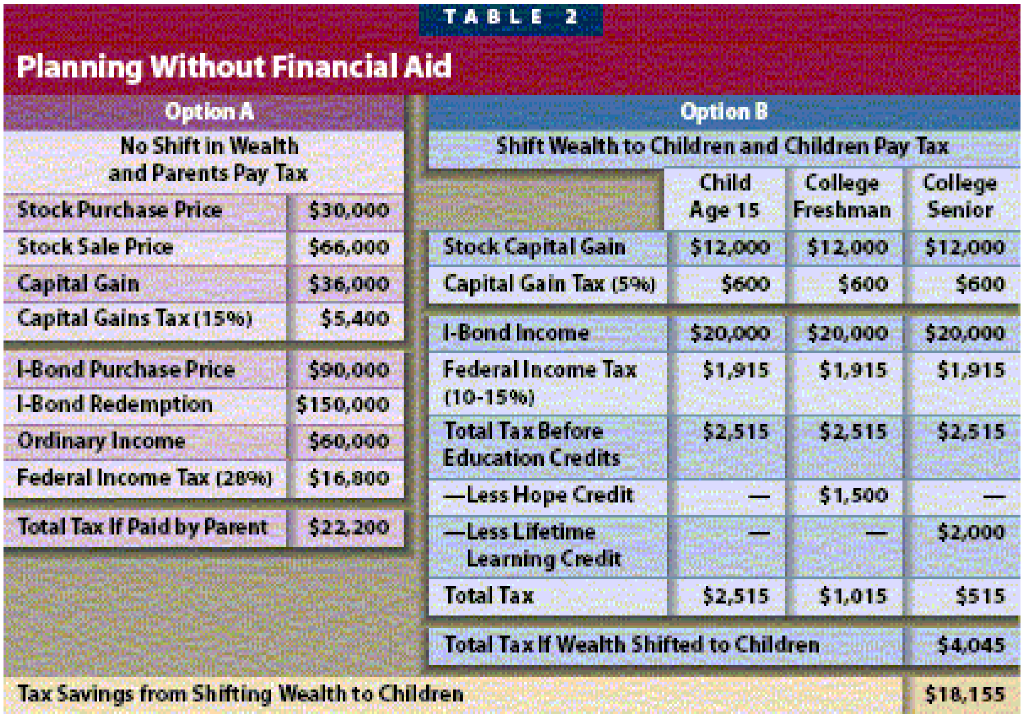


TABLE 2

Planning Without Financial Aid

Option A	
No Shift in Wealth and Parents Pay Tax	
Stock Purchase Price	$30,000
Stock Sale Price	$66,000
Capital Gain	$36,000
Capital Gains Tax (15%)	$5,400
I-Bond Purchase Price	$90,000
I-Bond Redemption	$150,000
Ordinary Income	$60,000
Federal Income Tax (28%)	$16,800
Total Tax If Paid by Parent	$22,200

Option B			
Shift Wealth to Children and Children Pay Tax			
	Child Age 15	College Freshman	College Senior
Stock Capital Gain	$12,000	$12,000	$12,000
Capital Gain Tax (5%)	$600	$600	$600
I-Bond Income	$20,000	$20,000	$20,000
Federal Income Tax (10-15%)	$1,915	$1,915	$1,915
Total Tax Before Education Credits	$2,515	$2,515	$2,515
—Less Hope Credit	—	$1,500	—
—Less Lifetime Learning Credit	—	—	$2,000
Total Tax	$2,515	$1,015	$515
Total Tax If Wealth Shifted to Children			$4,045

Tax Savings from Shifting Wealth to Children	$18,155

Key assumptions include that the high school age student is over the age of 14 (the age when the child's tax rate becomes applicable), that the capital-gain asset has been held for at least one year (to get the low capital-gain rate), that the parents make a joint gift of the stock (so that the gift does not exceed the annual $11,000-per-person exclusion allowance), and that the savings bonds have been held at least five years (so that the early liquidation penalty is avoided). We also assume that the parents are not subject to the alternative minimum tax, an assumption that likely underestimates the tax savings, and that the children do not take a personal exemption for themselves on their own tax returns. (The tax code provides that parents may waive the dependency exemption to allow their student dependent to claim an education credit, but this does not entitle the student dependent to claim a personal exemption on his or her own tax return. (See 2004 US Master Tax Guide, Paragraph 1303.)

These assumptions make clear that in the modern world a detailed knowledge of the tax code is, unfortunately, almost a prerequisite for optimal planning for college expenses. But with a good understanding of the tax code, substantial savings are potentially available.

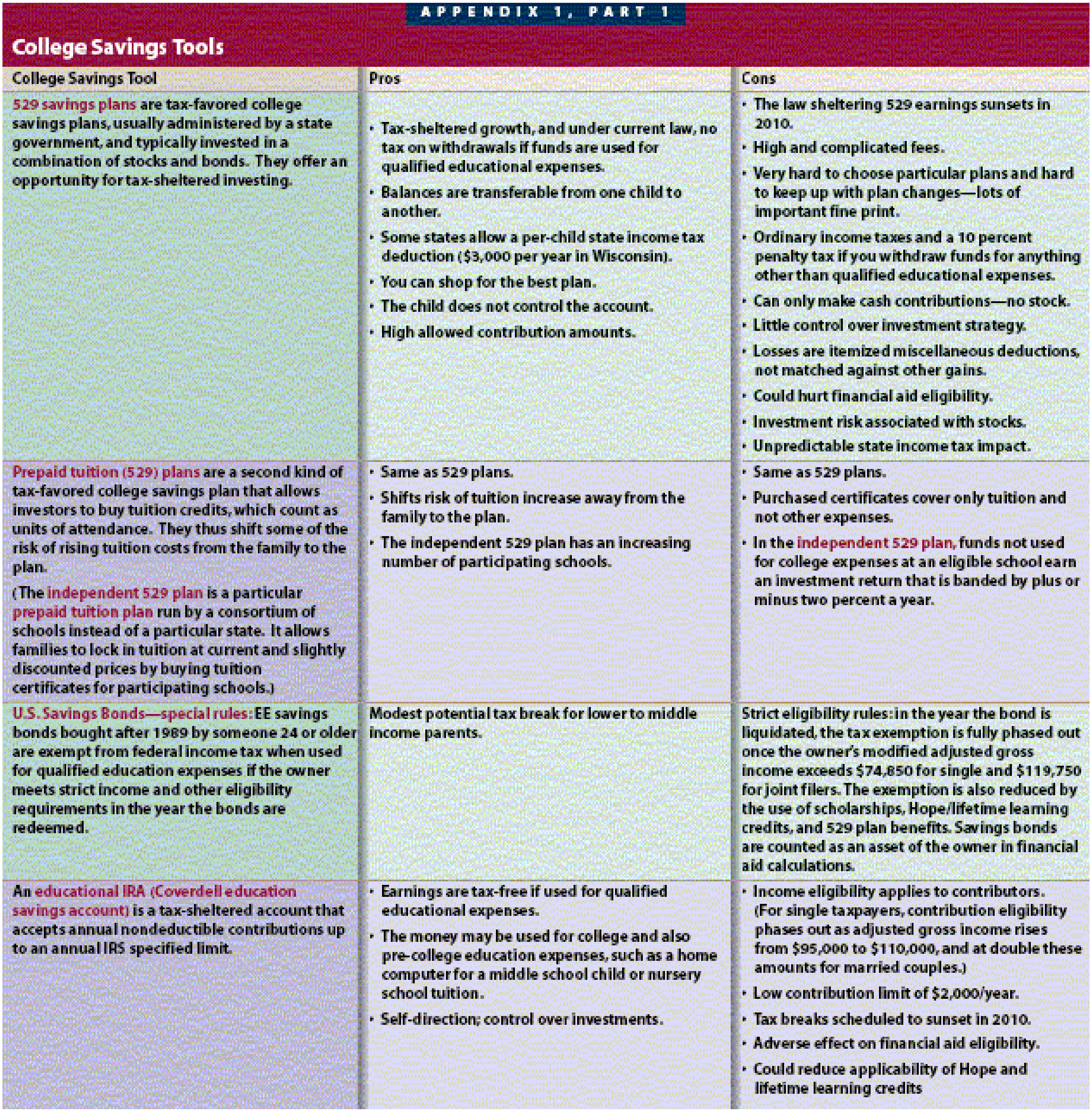
The main feature of the college savings landscape, however, is uncertainty. For example, several tax breaks in effect now are scheduled to lapse in 2010, and 529 rules change by the day (see appendix). Plus, there are changes afoot in the world of financial aid. In 2001, Princeton University startled the world by announcing that instead of loans it would henceforth offer only grants that do not need to be repaid. Harvard followed recently by announcing that families with income less than $40,000 a year will not have to pay tuition. And it is as yet unknown whether Congress will increase the income protection allowance for dependent students. But most of all, few families know for certain what kind of college will be appropriate until their children are of college age, nor are families typically able to predict what their financial status will be many years hence when their children are ready to enroll in college.

In this context, the best approach to planning for college expenses is first of all to make a guess about whether financial aid is possible, then set in place a variety of strategies designed to diversify the risk of the changing landscape, and to keep planning options open.

For illustrative purposes, the following scenarios describe financing strategies for a few generic family situations, with details on the referenced savings tools offered in the appendix.

- **Scenario 1: A family that will probably not qualify for financial aid, and has time to plan.** In the first few years of the child's life, buy mainly inflation-indexed savings bonds in the child's name. To diversify your strategy, perhaps make small deposits into two 529 accounts, but only after careful consideration of the potential disadvantages of 529 plans, as listed in the appendix. As the child grows older, add new deposits to a high-credit-quality, short-term tax-exempt bond fund. Also fund a Coverdell IRA with maximized contributions from a lower-tax-bracket family member.
- **Scenario 2: A family that probably will not qualify for financial aid and has little time before college.** Give appreciated assets to the child each year up to the annual exclusion amount, and plan to have the child sell the assets during college.
- **Scenario 3: A family that may qualify for financial aid and has time to plan.** Try to maximize financial aid because missing out on financial aid is not, as it was in past years, just missing out on an 8 percent loan. Instead, it could be missing out on a grant of several thousand dollars a year. Avoid custodial accounts in the children's names (including, therefore, 529 accounts in the name of your minor child) by not starting them, or by using the funds before applying for aid. Do not gift appreciated assets to the child. Maximize use of government-subsidized loans. (Subsidized loans have lower interest rates and do not accrue interest until after graduation.)
- **Scenario 4: A family that may qualify for financial aid and has little time to plan.** Maximize use of government-subsidized education loans. Use the student's tenure in college as a time to plan for loan payments. Remember that interest on qualifying education loans is deductible subject to certain income and other limits, up to $2,500 a year. Plus, students who make timely payments on student debt go a long way toward establishing their own excellent credit record.
- **Scenario 5: A family that might be eligible for financial aid, but the grandparents want to help finance college.** Apply for aid and loans, and arrange for loans to be paid by the grandparents after graduation via annual gifts that do not exceed the exclusion allowance.
- **Scenario 6: A family that will not be eligible for financial aid and grandparents want to help finance college.** Make use of the tax fact that grandparents can gift up to the annual exclusion allowance with no gift-tax liability in addition to unlimited amounts paid directly for education expenses.

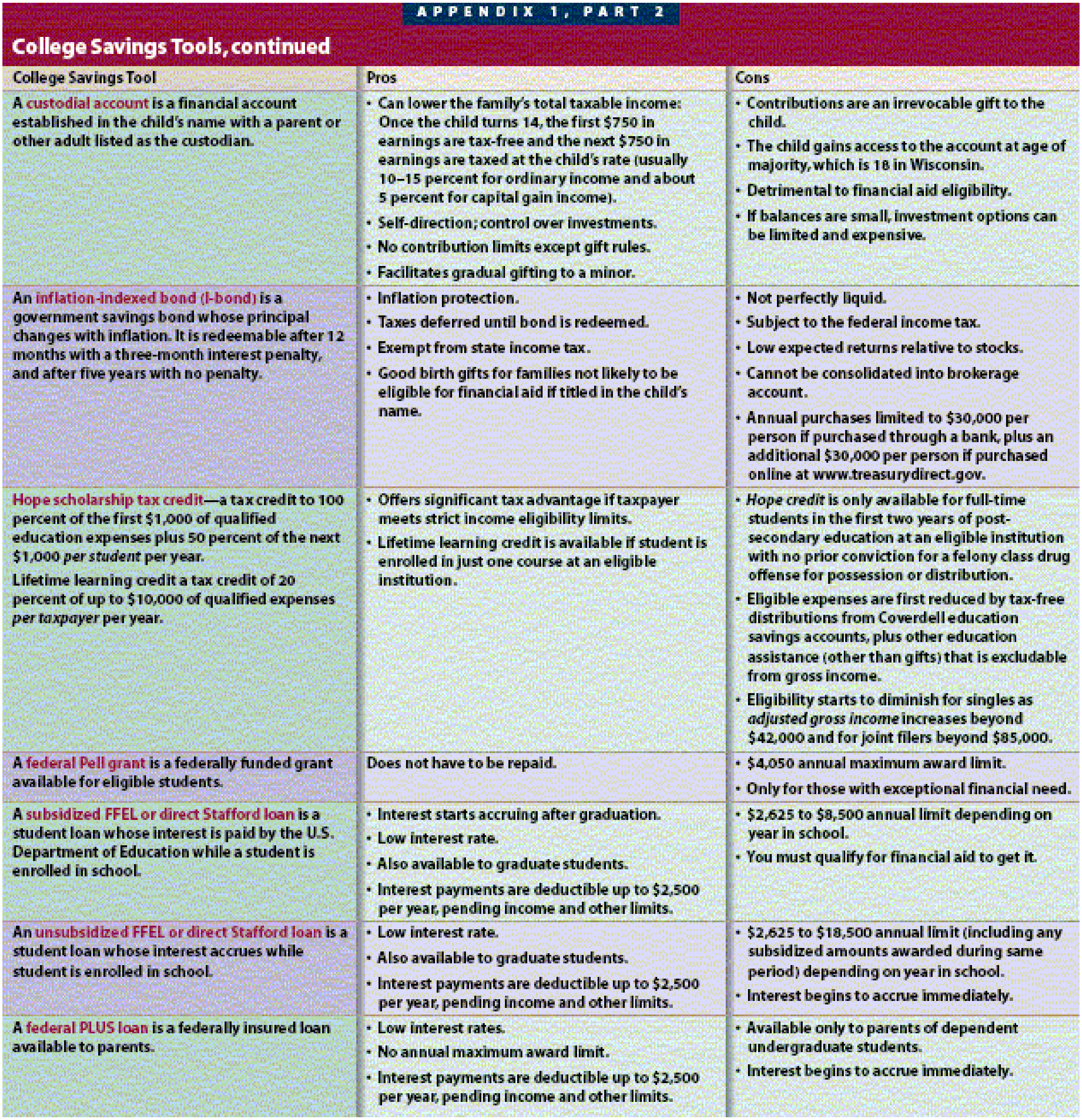
Whether or not a child is eligible for financial aid, what is not changing is the investment opportunity of attending college. According to a 2003 report prepared by the College Board (www.collegeboard.com), "The median annual income for recipients of a bachelor's degree is 80 percent higher than the median income for those with only a high school diploma. Over a lifetime, the gap in earnings between those with a high school diploma and a B.A. (or higher) exceeds $1,000,000 [in real terms]. While the cost of college may be imposing, the cost of not going to college is likely to be much greater." Yet, regardless of a family's particular financial situation, it takes some careful forethought to plan optimally for college expenses.



APPENDIX 1, PART 1

College Savings Tools

College Savings Tool	Pros	Cons
529 savings plans are tax-favored college savings plans, usually administered by a state government, and typically invested in a combination of stocks and bonds. They offer an opportunity for tax-sheltered investing.	• Tax-sheltered growth, and under current law, no tax on withdrawals if funds are used for qualified educational expenses. • Balances are transferable from one child to another. • Some states allow a per-child state income tax deduction ($3,000 per year in Wisconsin). • You can shop for the best plan. • The child does not control the account. • High allowed contribution amounts.	• The law sheltering 529 earnings sunsets in 2010. • High and complicated fees. • Very hard to choose particular plans and hard to keep up with plan changes—lots of important fine print. • Ordinary income taxes and a 10 percent penalty tax if you withdraw funds for anything other than qualified educational expenses. • Can only make cash contributions—no stock. • Little control over investment strategy. • Losses are itemized miscellaneous deductions, not matched against other gains. • Could hurt financial aid eligibility. • Investment risk associated with stocks. • Unpredictable state income tax impact.
Prepaid tuition (529) plans are a second kind of tax-favored college savings plan that allows investors to buy tuition credits, which count as units of attendance. They thus shift some of the risk of rising tuition costs from the family to the plan. (The independent 529 plan is a particular prepaid tuition plan run by a consortium of schools instead of a particular state. It allows families to lock in tuition at current and slightly discounted prices by buying tuition certificates for participating schools.)	• Same as 529 plans. • Shifts risk of tuition increase away from the family to the plan. • The independent 529 plan has an increasing number of participating schools.	• Same as 529 plans. • Purchased certificates cover only tuition and not other expenses. • In the independent 529 plan, funds not used for college expenses at an eligible school earn an investment return that is banded by plus or minus two percent a year.
U.S. Savings Bonds—special rules: EE savings bonds bought after 1989 by someone 24 or older are exempt from federal income tax when used for qualified education expenses if the owner meets strict income and other eligibility requirements in the year the bonds are redeemed.	Modest potential tax break for lower to middle income parents.	Strict eligibility rules: in the year the bond is liquidated, the tax exemption is fully phased out once the owner's modified adjusted gross income exceeds $74,850 for single and $119,750 for joint filers. The exemption is also reduced by the use of scholarships, Hope/lifetime learning credits, and 529 plan benefits. Savings bonds are counted as an asset of the owner in financial aid calculations.
An educational IRA (Coverdell education savings account) is a tax-sheltered account that accepts annual nondeductible contributions up to an annual IRS specified limit.	• Earnings are tax-free if used for qualified educational expenses. • The money may be used for college and also pre-college education expenses, such as a home computer for a middle school child or nursery school tuition. • Self-direction; control over investments.	• Income eligibility applies to contributors. (For single taxpayers, contribution eligibility phases out as adjusted gross income rises from $95,000 to $110,000, and at double these amounts for married couples.) • Low contribution limit of $2,000/year. • Tax breaks scheduled to sunset in 2010. • Adverse effect on financial aid eligibility. • Could reduce applicability of Hope and lifetime learning credits



APPENDIX 1, PART 2

College Savings Tools, continued

College Savings Tool	Pros	Cons
A custodial account is a financial account established in the child's name with a parent or other adult listed as the custodian.	• Can lower the family's total taxable income: Once the child turns 14, the first $750 in earnings are tax-free and the next $750 in earnings are taxed at the child's rate (usually 10–15 percent for ordinary income and about 5 percent for capital gain income). • Self-direction; control over investments. • No contribution limits except gift rules. • Facilitates gradual gifting to a minor.	• Contributions are an irrevocable gift to the child. • The child gains access to the account at age of majority, which is 18 in Wisconsin. • Detrimental to financial aid eligibility. • If balances are small, investment options can be limited and expensive.
An inflation-indexed bond (I-bond) is a government savings bond whose principal changes with inflation. It is redeemable after 12 months with a three-month interest penalty, and after five years with no penalty.	• Inflation protection. • Taxes deferred until bond is redeemed. • Exempt from state income tax. • Good birth gifts for families not likely to be eligible for financial aid if titled in the child's name.	• Not perfectly liquid. • Subject to the federal income tax. • Low expected returns relative to stocks. • Cannot be consolidated into brokerage account. • Annual purchases limited to $30,000 per person if purchased through a bank, plus an additional $30,000 per person if purchased online at www.treasurydirect.gov.
Hope scholarship tax credit—a tax credit to 100 percent of the first $1,000 of qualified education expenses plus 50 percent of the next $1,000 *per student* per year. Lifetime learning credit a tax credit of 20 percent of up to $10,000 of qualified expenses *per taxpayer* per year.	• Offers significant tax advantage if taxpayer meets strict income eligibility limits. • Lifetime learning credit is available if student is enrolled in just one course at an eligible institution.	• *Hope credit* is only available for full-time students in the first two years of post-secondary education at an eligible institution with no prior conviction for a felony class drug offense for possession or distribution. • Eligible expenses are first reduced by tax-free distributions from Coverdell education savings accounts, plus other education assistance (other than gifts) that is excludable from gross income. • Eligibility starts to diminish for singles as *adjusted gross income* increases beyond $42,000 and for joint filers beyond $85,000.
A federal Pell grant is a federally funded grant available for eligible students.	Does not have to be repaid.	• $4,050 annual maximum award limit. • Only for those with exceptional financial need.
A subsidized FFEL or direct Stafford loan is a student loan whose interest is paid by the U.S. Department of Education while a student is enrolled in school.	• Interest starts accruing after graduation. • Low interest rate. • Also available to graduate students. • Interest payments are deductible up to $2,500 per year, pending income and other limits.	• $2,625 to $8,500 annual limit depending on year in school. • You must qualify for financial aid to get it.
An unsubsidized FFEL or direct Stafford loan is a student loan whose interest accrues while student is enrolled in school.	• Low interest rate. • Also available to graduate students. • Interest payments are deductible up to $2,500 per year, pending income and other limits.	• $2,625 to $18,500 annual limit (including any subsidized amounts awarded during same period) depending on year in school. • Interest begins to accrue immediately.
A federal PLUS loan is a federally insured loan available to parents.	• Low interest rates. • No annual maximum award limit. • Interest payments are deductible up to $2,500 per year, pending income and other limits.	• Available only to parents of dependent undergraduate students. • Interest begins to accrue immediately.