Financial Planning

By Roger Lorelle

Help Your Clients Save On the Cost of a College Education

Here is a little-known fact about the cost of college: There are two very different prices—one for the informed buyer and one for the uninformed buyer. Guess which one generally pays thousands of dollars more?

You can help your clients become informed buyers of a college education and save them significant amounts of money in the process. However, in order to do so, you'll need to move beyond simply recommending savings strategies.

Fidelity's annual College Savings Survey revealed that a majority of parents who work with financial advisors wish they could get more assistance with their college-related financial decisions. Parents identified their top areas of need as the grants process, the financial aid process, and efficient college savings methods. All three of these are just another way of saying that parents want help in reducing their out-of-pocket costs for college – not just ways to save for college.

In order to meet this need, specialized expertise is required by the advisor beyond what is available through standard financial planning software. In this article, I will focus on the financial aid process and illustrate why planning for financial aid is so important. We'll start by defining a few critically important financial aid concepts, and then we'll look at specific strategies that can yield significant benefits.

Key College Cost Terms

Cost of Attendance:
COA includes tuition and fees, room and board, books and supplies, personal expenses, and travel. A good online resource for finding the cost of attendance for a particular college is www.collegeboard.com.

Expected Family Contribution:
EFC is the amount that a family is "expected" to contribute toward the cost of college. In other words, it's how much the government thinks the family can afford, and it's adjusted each year. EFC is used to determine a student's eligibility for federal aid and, in most cases state aid, too. The formula takes into account a family's (parents' and student's) income, assets, and other relevant variables. The information used to determine the EFC is submitted on the FAFSA (Free Application for Federal Student Aid) form. A good resource for learning more about the EFC, how it is calculated, and a simple tool for estimating your client's EFC is www.finaid.org.

Starting Point: Eligibility

Advisors should start by determining whether or not their client is a candidate for financial aid. This might sound obvious, but it's surprising how often this basic step is skipped, which can result in wasted time and effort, as well as unnecessary expenditures on college.

The basic formula for determining whether or not a client is a financial aid candidate is:

Financial Need = Cost of Attendance (COA) – Expected Family Contribution (EFC)

See definitions in text box

Basically, if a family's financial need is a positive number for the school in question, it is likely a candidate for need-based financial aid. Otherwise, it's not.

For determining financial aid eligibility for the student's freshman year, EFC is based on the calendar year that runs from the January of the student's junior year in high school through December of his or her senior year in high school. This is referred to as the first "base year" for determining need-based financial aid eligibility.

Think about the first base year for a moment: The most effective financial aid planning occurs *before* the family enters into this period. Otherwise, a number of potential strategies may no longer be available to the family or will have diminished effect.

Even if a family doesn't look like it will qualify for need-based financial aid, the advisor's job isn't complete. There may be prudent strategies that the family can implement that will make it a financial aid candidate—such as reducing its EFC below the COA or by selecting a school with a COA higher than the family's EFC.

EFC-Reduction Strategies

For many families, opportunities exist to reduce their EFC. Before discussing them, it should be noted that financial aid administrators wield significant influence over the amount and type of financial aid that a family will receive. It's not as cut-and-dried as you might think. Administrators can use the family's EFC as more of a guideline than a rule, especially as they weigh factors such as the student's test scores, GPA, class rank, legacy issues, etc.—really anything that reflects how much the school wants to enroll the student.

However, this fact of life doesn't mean that a family shouldn't at least attempt to put itself in a position to effect a best outcome, while using strategies that are consistent with the primary retirement-planning objectives of the parents, fiduciary responsibility of the advisor, etc. It's also why many advisors' lack of knowledge about financial aid planning can result in ineffective, if not disastrous, results for the client.

Advisors need to answer two fundamental questions about their client's situation before they consider suggesting a strategy:

- What benefit could reasonably be expected by implementing the strategy under consideration?
- What is the cost to the family of implementing the strategy? What are the downsides, if any, of implementing the strategy in question (tax ramifications, liquidity, retirement savings, etc.)?

While weighing the benefits and costs, advisors also need to keep in mind that EFC formulas include income- and asset-protection allowances. These restrict the ability of strategies to reduce EFC.

Income-protection allowance. A family is "allowed" up to a certain amount of adjusted gross income before it is assessed in the EFC. The income-protection allowance is determined by family size and number of children in college. For example, if the parents' income is $80,000 and the income-protection allowance is $30,000, then $50,000 of income will be included in the EFC calculations.

Asset-protection allowance. A family is "allowed" up to a certain amount of assets before the amount above the allowable limit is assessed in the EFC. The asset-protection allowance is determined by the age of the older parent (for a dependent student). For example, if the oldest parent is 48 years old, the asset-protection allowance is about $50,000 (married couple). The value of assets above the allowance will be assessed.

For families below the asset-protection allowance limit, shifting assets will not improve financial aid prospects. Repeat: It will have no effect. Even worse, shifting those assets could negatively affect some other part of the family's financial plan.

Problems occur when a financial advisor assumes that shifting income or assets will change the EFC but he or she does not use an EFC calculator to verify the benefit. Advisors should download the Free Application for Federal Student Aid worksheet that includes the protection-allowance amounts. Visit: www.ifap.ed.gov and type "EFC 2010-2011" in the search tool.

Weighing Benefits and Costs

The next consideration is to what extent the increase in financial aid eligibility actually will result in lower out-of-pocket costs for the family. Ideally, the family would like to receive more aid in the form of scholarships and grants than as subsidized loans.

Each school is different, and private schools are generally better-positioned (with larger endowments) than are public universities to include a higher percentage of grants and scholarships as part of an overall financial aid package. Furthermore, public schools treat students coming from within the state much more generously than they do out-of-state students. Out-of-state students will find that financial aid is very difficult to obtain, and it usually comes in the form of a work-study loan.

Advisors and parents can get a sense of how a school distributes aid by checking publicly available sources, starting with information provided by the school's admissions office. Take a careful look at the following: what percentage of financial need the school met; what percentage was in the form of scholarships or grants; and how much was in the form of loans/work study.

From that point, an advisor can develop a strategy, while keeping in mind these questions:

- Is the strategy complicated or simple to implement?
- Is the client comfortable with the strategy?
- How will the client's liquidity be affected?
- What is the effect (if any) on retirement planning?
- What are the tax consequences?

Case Study

The following case study gives one fact pattern and shows how three different financial aid planning strategies can be employed. (For a fuller explanation of the case study, contact Collegiate Funding Solutions at 919 469-1996.)

Facts of the case:

- Small-business owner
- AGI: $115,000
- Student is a high school junior
- $15,000 in UGMA account
- Grandparents plan to gift money to student for college costs
- College choice – St. John's University in New York City
- Cost of attendance – $51,000
- EFC – $36,000
- Income Protection Allowance - $30,000
- Asset Protection Allowance - $46,000

Strategy 1: Income shifting

The client is a business owner with a non-working spouse, so the family can engage in shifting income so that it can raise the financial aid eligibility of the child. The business owner should hire the non-working spouse at $10,000 per year, thus making the spouse's income a key part of the financial aid calculation. The income allowance is calculated by multiplying the lesser of the spouse's income by 35 percent, up to a maximum of $3,500. By hiring the spouse at $10,000, the maximum allowance can be claimed. Thus, financial aid eligibility may be increased by $1,089 for the freshman year.

Also, the student herself can be employed up to the income-protection allowance, which is $4,500 for 2010. Both strategies will shift income away from the business owner. The child's income is not counted on the FAFSA as part of the parents' EFC. So the reduction of AGI by $4,500 may increase financial aid eligibility at St. John's by $1,400.

Strategy 2: UGMA to 529 Account

College savings 529 plans are classified as Qualified Education Benefits. They are considered assets of the parent in the EFC calculations, even if the owner of the account or the plan is the dependent student. Rolling over an UGMA into a 529 will shift its financial aid treatment from a student-owned asset to a parent-owned asset. Since parent-owned assets are assessed at a lower rate than student-owned assets, the transaction might increase financial aid eligibility. Establishing a 529 using $15,000 from the student's UGMA account could increase financial aid eligibility by $1,550.

But the advisor needs to consider other factors. Since a 529 plan is funded with cash, an advisor also should consider the tax consequences of liquidating assets in order to fund the plan. If this is done during any EFC base years, any income generated by liquidating assets will be assessed at 50 percent in the financial aid formulas for the base year in which the investment income was incurred. This is a prime example of a strategy that should be performed prior to the beginning of the base year for calculating EFC (prior to January of a student's junior year in high school).

Taxes on dependent children, commonly known as "kiddie-taxes," also must be considered. Any assets in the child's name that are liquidated in order to be rolled into a 529 savings plan may result in a tax obligation for the student. Therefore, any potential increase in financial aid eligibility resulting from this strategy could be offset by the tax due to the reallocation. An advisor should make this calculation.

One way to avoid the kiddie tax may be to incrementally reallocate the asset into the 529 plan over a period of years so that the tax is not triggered. As indicated above, reallocation is best performed prior to the beginning of the base year.

Strategy 3: Grandparents

Beware that any monetary gifts to the student will be assessed in the EFC. A $10,000 gift can reduce financial need by as much as $7,000, because it is counted as a student's asset (20-percent aid reduction) and as income (50-percent aid reduction).

If grandparents want to help the student, they should consider giving the gift to the student after college to help pay off student loans, such as private student loans taken out by the student that were deferred during college. To make this gift, the grandparents can open a 529 plan, which can be used to pay for the grandchild's college expenses in any year without jeopardizing any financial aid opportunities. They also can pay the student's tuition directly to the college, without it being considered a gift.

There are additional reasons for waiting until after college years for the grandparents to help with college costs. First, their assets can continue to grow (possibly tax-deferred and potentially with tax-free withdrawals). Second, if the student does not graduate or leaves college, then the grandparents have the flexibility of not paying for the loans.

Conclusion

All families with college-bound children can benefit from specialized college planning expertise. Just the three strategies in the example above could save many clients thousands of dollars in out-of-pocket college costs. There are hundreds of college planning strategies for clients of all financial circumstances.

As full-service, Fee-Only financial planning professionals, NAPFA advisors should be known as the college planning experts in the professional advisory world. But to provide that level of service, advisors will have to become educated about a wide range of college planning and funding strategies for clients of all financial circumstances with children of all ages and carefully consider them in light of a client's overall financial plan. NA

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