Bringing Colleges & Students Together

Financial Aid VS College Funding

College is the biggest investment you will make. We are here to help you plan for it.

College Funding is not Financial Aid. Financial aid reduces the Cost of Attendance (COA). College Funding addresses the family's Expected Family Contribution (EFC).

College funding consists of three strategies:

1. Tax
2. Cash flow
3. Asset management (investments)

These strategies are used to help pay the portion of total college costs for which **families** are responsible – and generally speaking, require a CPA's understanding of tax codes, and the asset and cash flow management of financial planners.

Financial Aid consists of:

- Scholarships
- Loans
- Work-study

High school counselors and college Financial Aid officers typically provide financial aid advice – loans, scholarships and work-study – but the problem is that those are all components of what the **college**, not the **family** is supposed to provide.

Here's an example: suppose the current Cost of Attendance (COA) at a college is $55,000, and the family Expected Family Contribution (EFC) is $15,000 (assuming about $100,000 annual Adjusted Gross Income and few eligible assets), then the college would hopefully provide $40,000 annually in Financial Aid (scholarship, loan, work). But for the family, an overriding question is: where to find the annual $15,000 they are expected to provide?

Now that we understand the difference, below are short explanations of these college funding strategies. For a more detailed discussion check out Dr. James B. Johnston's book "Beyond Financial Aid" on ReadySetCollege.org's Funding section.

Asset Management

Asset management is the management of money and other financial assets, including tangible assets such as real estate, and intangible assets such as cash-value life insurance policies. Done properly, it can help families save enough for college while minimizing the drawdown in these assets.

An important concept is understanding the true difference between saving and borrowing – the miracle of compound interest. Many people are not aware of the effect of investment returns compounding on themselves, of interest compounding on interest, to accumulate larger total sums of money than would seem to be obvious. For example, if an investment has a 10% annual return (or interest rate) compounded, it would be logical to assume that the investment would double in 10 years – that is, 10% per year equals 100%. Right? Wrong! A 10% compounded rate of return, or investment rate, will actually double in about 7 years. Dividing annual interest into 72 gives an approximate doubling time, so an 8% return doubles in 9 years, not 12.5 years, and a 5% return doubles in about 14 years, not 20 years. This has the effect of dramatically increasing the amount of funding a family can accumulate the farther they are from college. Conversely, dividing the number of years an investment takes to double, say 12 years, into 72 yields a 6% annual rate of return.

In this example, assume a 25 year old couple with an infant child:

Monthly Investment	Annual Rate of Return	5 Years	10 Years	18 Years
$150	8%	$11,022	$27,447	$72,013
$250	8%	$18,369	$45,737	$120,022
$150	10%	$11,616	$30,727	$90,084
$250	10%	$19,359	$51,211	$150,141

Due to compounding, a 10% investment in this scenario will almost triple if $150 monthly contributions are made for 18 years instead of 10 years ($90,084 vs $30,727).

In other words, the table shows that if a family invests $250 per month for 18 years, the investment at a 10% annual return would be $119,414 larger than a $150 per month investment for 10 years, yet the family only invested $36,000 more. An additional investment of $36,000 can produce $119,414 extra funding for college.

The problem is, saving is hard, and borrowing is easy. For most folks, there are many reasons, some absolutely necessary, some not so much, to spend – all of which assume less saving. College loans, however, are easily available to students or parents from Federal or private sources, backed by assets (homes, life insurance, etc.) or not.

But…in the long run, because of the Rule of 72, it costs a lot more to borrow a specific amount than it does to save for the same amount.

Here's another example:

- Amount needed for college: $100,000
- Age of child: 8 (10 years until college)
- Savings rate: 10%
- Borrowing rate: 6.5%

There are two ways to get $100,000:

1. Save $488.17 per month for 10 years. That's $58,581 actually put away, and it accumulates at 10% to $100,000.
2. Borrow $100,000. The repayment schedule (10 years at 6.5.%) will be $1135.48/month.

In 10 years, you will repay $136,258 to borrow $100,000. Or … you could invest $58,581 in savings for 10 years to accumulate $100,000.

The difference? $136,258 - $58,581 = $77,677

So, yes, saving is hard. But is some sacrifice worth $77,6777; the out of pocket difference between accumulating $100,000 in savings versus borrowing $100,000?

Tax Strategies

Everyone should talk to their financial advisor about tax considerations when planning to college. Below are three common strategies that utilize provide tax-advantaged savings for college. For a more detailed discussion see "Beyond Financial Aid" Intergenerational Funding Chapter.

529 plans

529 plans are savings plans that are used only to pay for college and related expenses. They are run by individual states. There are two types of 529 plans: Prepaid plans and College Savings Plans.

Prepaid plans allow a family to pay future tuition at present prices. If tuition is currently $20,000 a year, a family that puts $20,000 in a prepaid plan will guarantee a year of tuition in the future, regardless of what it costs. With tuition costs still rising at an average of 3-4%/year, this provides a measure of certainty. Even though the future value of the plan will be higher than what you contributed, no taxes will be owed.

College Savings Plans work a lot like a 401(k) or IRA – you put aside whatever you're able to save in the plan, and you can use the money for any college or college-related expense without having to pay federal, and state (depending on the state) taxes on any profits earned. Most plans have a variety of investment options, depending on your how much risk you can tolerate.

Cash Value Life Insurance

In addition to the death benefit, life insurance can be used to help fund college.

Unless you are in the top five percent of income earners there is an excellent chance you will qualify for financial aid. When it comes time to fill out the FAFSA or CSS profile (a supplement to the FAFSA used by some highly selective private colleges), money in 529 plans or other savings or investment accounts will count against the grants and scholarships your children might otherwise be eligible for. Approximately $5,000 of every $100,000 in savings in the parent's name and $20,000 of every $100,000 in the student's name is expected to be used to pay for college.

The good news is that 401(K), other qualified retirement accounts and life insurance are not part of this calculation. You do not have to report them on the FAFSA, and while the CSS asks about them, they are not considered an assessable asset. This makes them an excellent vehicle for college funding since they don't detract from potential grants, scholarships, and other financial aid.

Additionally, Cash Value Life Insurance policies accumulate cash value on a tax-deferred basis. These funds can then be accessed up to the amount of paid in premiums tax-free or, as a tax-free loan when it comes time to pay your child's college tuition costs. There are no loan applications and no approval process with a policy loan.

Putting money into a whole life insurance policy can provide guaranteed protection for their family's future, utilize the policy's cash value to achieve their college funding goals, and you're not required to include the value for FAFSA and CSS calculation purposes.

Education Tax Credits:

There are two tax credits available to help finance the cost of higher education: The American Opportunity Credit (AOC) and the Lifetime Learning Credit (LLC). Tax credits reduce your tax bill dollar-for-dollar, sometimes below zero.

Of the two, the AOC is the more valuable. The maximum annual AOC is $2,500.00. Forty percent of the AOC is refundable, meaning even if you don't owe any taxes you can get up to $1,000.00 back if you qualify for the full AOC.

Who is eligible? Students with eligible expenses can claim the credit if they are not dependents on someone else's tax return. If your student is a dependent on your tax return, you can take the credit against your tax liability. To be eligible students must be enrolled at least half-time and be pursuing a degree. Any felony drug conviction will disqualify students from receiving this credit.

The credit is intended to offset qualified educational expenses. This includes tuition, fees, and books. Payments for room and board do not qualify. Beware that you cannot claim a tax credit for expenses paid from scholarships, grants or from a tax-advantaged account, like a 529 plan.

The annual tax credit is equal to 100% of the first $2,000.00 of qualified expenses plus 25% of the next $2,000.00 of qualified expenses.

You can claim the credit for every child in college. There are income limits and eligibility qualifiers for students to take the credit. Consult your tax advisor at tax time.

Saving $2,500.00 on the cost of college may not sound like a lot of money but it's free money, courtesy of the government, and it adds up every year you qualify for the credit.

The Lifetime Learning Credit (LLC), while less valuable, is far less restrictive. The credit is available without going to school full-time or even if not seeking a degree. As the name implies, there is no limit on the number of years you can use this credit.

The credit is equal to 20% of the first $10,000.00 of qualifying expenses. As with the AOC room and board are not qualifying expenses. Also, unlike the AOC, the LLC is not refundable. If you do not have a tax liability you may not take the credit. Unlike the AOC, a felony drug conviction does not make the student ineligible.

Cash Flow

If parents wake up one day, their child, a high school senior, has been admitted to her dream college, and it's going to cost, after scholarships, a net COA (Cost of Attendance) of about $35,000 annually, is all lost? Not necessarily.

There are a variety of ways to improve cash flow to help pay for college expenses. These include:

- Utilizing home equity
- Tapping into cash-value life insurance, either your own or a relative's
- Paying off higher-interest credit cards; use proceeds from home equity or cash-value life insurance if available

For a real-life example of how a family with no college savings and $20,000 in credit card debt can use home equity to pay off the credit card debt and pay for their child to attend private college, and further discussion of cash flow, see "Beyond Financial Aid", "Getting Started" chapter.