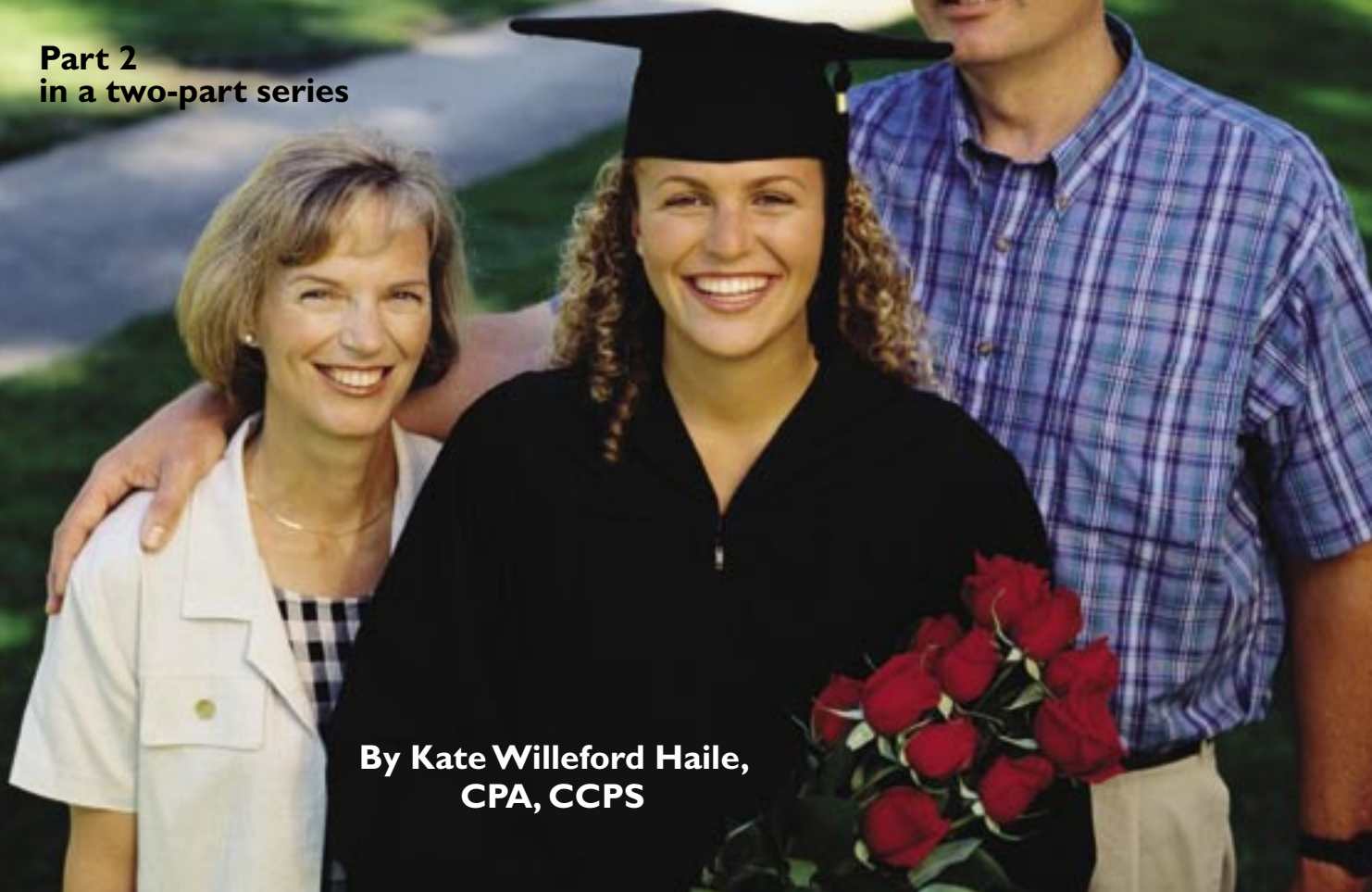


# College crisis: Are you ready for the bills?

Part 2  
in a two-part series



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*Here's how to pay for your child's college expenses without ruining your finances.*

**C**ongratulations! Your oldest child just fulfilled a lifelong dream and was accepted into Harvard. Can you write a check today for \$45,000? That's the cost of just one year at an elite college such as Harvard. This means you will need to shell out a cool \$180,000 for four years at such a prestigious school. But wait. The College Board has discovered that about 47 percent of students now take five years to graduate from college. At many private universities, the fifth year is costing at least \$35,000. This computes to a five-year total of \$175,000 in college expenses. And this is just for starters. You did want your child to go to graduate school, right?

Last year, college costs increased by 11 percent. They are rising at two to three times the rate of inflation. The numbers are simply astounding. What is a dentist to do? The current crisis facing you, and almost every dentist with a college-aged child, is a cash flow problem. You may wish to pay for college — without sacrificing current lifestyle — then discover down the road that what you now have is a retirement shortfall.

The key to building a successful financial future — a solid net worth — is to begin saving for retirement as soon as possible, setting aside money for college only after maximizing your retirement savings. Remember, if

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push comes to shove, there are a number of ways to pay for college, including washing dishes. But *no one* will pay for your retirement except *you*.

If you are tempted to put your child's education needs in front of your retirement needs, consider how this strategy might affect your net worth. Let's assume that your child is going to attend a private college with a total cost of \$140,000, and that you hope to retire in 20 years. Paying that \$140,000 yourself will rob your retirement of \$448,994! What's more, this scenario assumes you have only one child in college and you are earning only 6 percent per year in your retirement investments. If your retirement fund is earning a higher rate of return, then your retirement account suffers an even larger hit.

### How much do colleges expect me to pay?

Despite your income level, you or your child may qualify for some kind of financial aid, such as merit aid. Even so, this may mean only some kind of *partial* aid. To calculate how much need-based aid for which you might qualify, colleges will run the numbers and determine how much money they think you should pay out-of-pocket for their tuition, room, and board. This is called your Expected Family Contribution (EFC). As a general rule, your EFC is going to be a lot higher than what you think you can *afford*. If you do not know how to calculate your EFC, you are not alone! Most families have no idea how colleges compute a family's contribution amount. But, armed with an understanding of the basics and with the help of a Certified College Planning Specialist, you can predict your EFC and even change its value.

✦ **Methodology:** Your EFC is calculated once a year by using either the Federal Method or the Institutional Method. The Federal Method is used by all accredited schools as a way to determine how much federal money may be given by the school to cover a student's Cost of Attendance (COA). The Institutional Method is used by some private schools. It is more strict since it counts more assets than the Federal Method.

✦ **Financial need:** The difference between a school's COA, your EFC, and any student resources (such as private or local scholarships, 529 plans, cash from grandparents, etc.) is the amount of financial need the school thinks a child deserves. Student resources reduce a child's financial need on a dollar-for-dollar basis.

✦ **The calculation:** Student income and assets, as well as parent income and assets, are figured into — or assessed — when calculating an EFC. This is a complicated formula. To simplify it, let's say a school expects a student to use almost 50 percent of his or her income and 35 percent of his or her assets to contribute toward college expenses. A school expects parents to contribute 47 percent of their income and 5.6 percent of their assets toward the COA. Again, this is a gross oversimplification. The college does

make some allowances for living expenses, taxes, and some types of assets.

✦ **Living allowance:** The "living allowance" a college grants a family in the EFC calculation is the amount of money the college thinks the family needs to live on per year. Consequently, the school does not expect you to use this cash to pay for college. Before you breathe a sigh of relief, however, realize that the living allowance for a family of four for 2005 is only \$21,330!

✦ **Nonassessable assets and income:** These do exist and often they include such items as annuities, life insurance, retirement accounts, personal items, a family's principal personal residence, sibling assets, student loan proceeds, rollover pensions, and nonmonetary gifts. Again, this is a complex area. The Institutional Method does assess some of the above items, and can choose to change what it will and will not assess each year.

✦ **Assets and earnings:** The EFC is calculated on a family's current year assets and earnings. So, the EFC for the upcoming 2006-07 school year will be based on a family's income and assets as of Dec. 31, 2005. A college collects these numbers on the Free Application for Federal Student Aid (FAFSA) form, which you should try to complete and submit as soon as possible after the beginning of January each year.

✦ **FAFSA:** *Always* fill out the FAFSA form — even if you think you will not qualify for financial aid! Unforeseen changes in income or assets can occur, but a school can only reassess your financial situation if an FAFSA has been filed in a timely manner with the financial aid office.

What does all of this mean to a family in real dollars? As an example, for the 2005-06 school year, for a family of five with parental income of \$200,000 a year, assets of at least \$100,000, and only one child in college, the family's EFC would be \$53,800 per year! If a family has two children in college, the EFC drops to \$26,900 per student.

Even if your out-of-pocket expense is \$40,000 a year per child, most dentists will do whatever it takes to find a way to help a child pay for college. While higher education is valuable in many ways, did you know studies have shown that someone who earns a bachelor's degree earns at least \$2.1 million dollars in a lifetime — almost \$1 million more than a friend who earned only a high school diploma?

### I have the bill as low as possible; now how do I pay it?

So, it's August and your child's dream college has determined that your EFC exceeds its tuition. In other words, you received no free money, and your son or daughter received little in scholarship money. Now you have the bill for the first semester of college. How do you scrape together enough cash to pay it?

In Part 1 of this series on funding a child's college education (entitled "Do Your Kids Own Your Assets? They

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Should.”), I described some ways to slide some earned income to your children to create an education fund from your tax savings. During the college years, you can continue using most of these strategies, if the logic still applies. But now that you have a child of college age, you also have some more advanced strategies that will help you pay for college using the least amount of cash.

■ **Section 529 plans:** A 529 plan is a qualified tuition program that is designed to help families save for post-secondary education. I often hear the basic question, “Should I put money into a 529 plan?” The answer is, “It depends.” Despite all the hype it receives, a 529 plan is not always the best way to go. If you have a low EFC, and are on the cusp of qualifying for need-based financial aid from schools, then 529 plans are probably not your best investment vehicle. If you have a high EFC and will never qualify for need-based aid, then 529 plans cannot hurt your aid package. So 529 plans might be a good way for you to set aside money for college.

A 529 plan may be either a “prepaid tuition” program or a “savings” program:

- In a **prepaid tuition program**, each state determines how much you need to contribute to the plan per year. This is to guarantee that future tuition is covered in spite of inflation. Be sure, though, to read the fine print carefully! If your child decides not to attend the state school with which you have established a prepaid tuition account, you can use the money at another school. However, it can be costly to do so. Expect to see prepaid tuition programs under scrutiny during the next few months as more of these state plans become bankrupt.

- In a **savings type program**, money is typically invested in a variety of mutual funds held in a state-owned trust. Although there is no tax deduction for money put into the plan, the assets grow tax-free. Each state has different regulations regarding these accounts. Some offer a state income tax deduction for contributions. If set up by a parent, the parent retains ownership of the account, but designates a beneficiary for whom the money is to be used. There are no income limitations on who can contribute, and almost anyone can contribute on behalf of a beneficiary. Beware of gift tax limitations, though. A special election exists so one can fund the plan in one lump sum. But treat this as if it was developed during a five-year period. This gives you the flexibility to contribute up to \$55,000 tax-free.

- **Tip:** You may change beneficiaries on the account (e.g., if one child decides not to go to college), and you even can use the money for your higher education needs.

□ **Whose asset is it?** According to the Department of Education, a 529 savings plan is an asset of the parent, and should be assessed at 5.6 percent instead of a student’s 35 percent assessment rate. That being said, there is a

growing trend for *private* colleges using the Institutional Method to consider the 529 plan a resource of the student. This results in a dollar-for-dollar reduction in the student’s financial aid package. If your child could have qualified for financial aid, a 529 plan would cost you a lot of free money from the school!

□ **Is the withdrawal really tax-free?** Not necessarily! One of the biggest misconceptions about 529 plans is that all withdrawals are tax-free. The fact is that only the return of your contributions, or basis, is tax-free. All earnings distributed in excess of that year’s qualified educational expenses are subject to taxation. A specialist should be consulted to ensure that withdrawals made are actually tax-free, and the tax-free portion of the qualified withdrawals is scheduled to expire at the end of 2010. (Congress is already considering a bill that would make current 529 plan provisions permanent.) Most nonqualified distributions are subject to federal taxes as well as a 10 percent penalty.

- **Tip:** To learn more about specific state plans, as well as any state tax benefits you may receive for setting up a 529 plan, visit [www.savingforcollege.com](http://www.savingforcollege.com).

■ **Section 127 plans:** If there is a magic bullet I can offer the dentist, it would be to open a Section 127 plan if possible. A Section 127 plan is a qualified employer educational assistance plan that allows you, as an employer, to provide up to \$5,250 per year, per employee, with tax-free educational assistance. Consider these two factors:

□ **Discrimination:** Although you cannot discriminate in favor of highly compensated employees or their dependents, by nature of the definition of a qualified plan, you may discriminate according to “classification.” Therefore, you can choose to offer educational assistance to only part-time employees — and the only part-time employees may just happen to be your children!

□ **Benefit limitation:** Take note that you may offer only more than 5 percent of total educational assistance to dependents in a situation in which the dependent is: older than 21, is an actual employee of the dental practice, and is not claimed as a dependent on his or her parents’ tax return. Business owners who are grandparents can avoid the 5 percent limitation if offering educational assistance to a grandchild.

- **Tip:** Consider using a Section 127 plan for the final two years of a child’s undergraduate education as well as for graduate school. For every year the plan is used, your practice receives a deduction for the educational assistance, thereby reducing your taxable income.

■ **Grandparents’ gifts:** An increasing number of grandparents are choosing to help their grandchildren pay for college. Because college funding is such a complex issue, it is important for grandparents to be a part of a college-education funding plan.

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❑ **Inheritance from grandparents:** I have quite a few clients who want to use inheritance money their children received from a grandparent to pay for college. On one hand, this makes sense because it is probable that the grandparent set aside this money specifically for education. On the other hand, this money may be earning such a high rate of return that it would be wise to keep this inheritance account intact and either pay for college using “cheaper” money, or consider taking out a low-interest college loan, then using this money to pay off the loan at your convenience.

❑ **Outright gifts from grandparents:** Beware of the advantages and disadvantages grandparental gifting may have on your education funding plan. For instance, if grandparents send money directly to the school, the gift will not reduce their annual \$11,000 gift tax exclusion. This is an advantage to them. However, the money reduces the child’s financial aid on a dollar-for-dollar basis.

☛ **Tip:** A cash gift from a grandparent is assessable whereas a gift of a car or computer is not. Also, a loan from a grandparent is not assessable and, after the college years, the grandparent could choose to forgive the loan if so desired. A simple change in the manner in which a grandparent gives a graduation gift can dramatically change the value of your EFC.

### ■ Loans

❑ **Federal and private:** Numerous federal and private college loans exist solely to help you and your child pay for college expenses. There are loans you can take out in your name, such as PLUS loans, or loans your child can take out in his or her name, such as Stafford loans. Because of a July 1, 2005, rate increase — as well as the next rate increase scheduled for July 1, 2006 — other means of financing may be more desirable than federal loans.

❑ **Home equity line of credit/mortgage refinancing:** Always consider using a home equity line of credit to pay for college. If interest rates are low, consider taking out a line of credit even if you did not already have one. Most of the time you will be able to deduct the interest paid on Schedule A of your tax return, and you will have avoided paying the higher student loan interest rates. Another option that should be on the table is the refinancing of a mortgage. Such a refinancing might free up some cash by reducing your monthly mortgage payment. It also could give you the flexibility to take out a home equity line of credit that you might need.

❑ **Insurance loans:** Another way to find some cash to pay for college is to borrow against the cash value of your life insurance policy. Although this must be done carefully so as not to terminate the policy, you may be able to use the money on a tax-deferred basis and have a guarantee against repayment in the event of a child’s death or disability. There are high cash value policies that you may want to consider while the child is young in anticipation of such policy loans later.

■ **Other options:** Don’t forget to investigate merit-based and athletic or talent-based scholarships as well as local scholarships offered by community organizations.

A high level of income does not preclude you from pursuing financial aid opportunities for your college-aged children. In fact, your unique circumstance gives you the freedom and flexibility to use numerous strategies to plan and pay for college. If you would like to learn how to minimize your EFC, or unravel other pieces of the college puzzle, I recommend contacting a CCPS (check [www.niccp.com](http://www.niccp.com)). A CCPS can begin helping you with this type of planning from the time a child is born. If you have children in high school and do not have an education plan in place, it is never too late to start! Ideally, you should begin creating a plan no later than the fall of your child’s junior year in high school.

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