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Common College Funding Pitfalls

Even families with substantial assets need to take care to avoid common pitfalls in funding higher education. When college financing strategies go wrong, families may end up losing substantial tax benefits and/or paying far higher bills than they anticipated.

The sheer magnitude of college expenses demands careful strategizing. In 2018-19, families paid an average of $26,226 toward college expenses from current income and existing assets.[1] That figure represented about 43% of total college costs, with another 24% of total college expenses paid with borrowed money, much of which is owed by students themselves. Total U.S. student loan debt hit a record $1.5 trillion in 2018—and even students from high-net-worth families may be heavily weighed down by debt.[2]

To help families get oriented toward an optimal college-financing strategy, this article touches on three of the most common mistakes people make.

Making mistakes with the FAFSA—or not filing at all

Many high-net-worth families might think they won't qualify for need-based aid and don't need to spend time completing and filing a Free Application for Federal Student Aid (FAFSA). However, in many cases the FAFSA must be filed for the student to be eligible for merit-based aid. It also provides to other forms of federal aid that may be helpful as part of an integrated college-financing strategy. For example, federal student loans may carry lower interest rates than many other types of debt that might be tapped.

The formula used by the U.S. Department of Education to determine financial need is:
Cost of Attendance (COA) - Expected Family Contribution (EFC) = NEED
COA includes the total cost of attending school, considering tuition, room and board, books and more. EFC calculations include both parent and student income and assets, as well as family size and other contributing factors; view the EFC formula guide for more details.

Strategic restructuring of assets may help reduce the impact on families' existing assets, given the formulaic nature of the EFC. For example:

> The first $20,000 of parental assets fall under an "asset protection allowance" on the EFC and aren't counted.

> Beyond that, the FAFSA (as well as many other aid applications) counts a maximum of 5.64% of parental assets.

> On the other hand, 20% of the value of a dependent student's assets are considered funds available to pay for college and factor into aid eligibility.

For these and other reasons, shifting reportable assets from student to parent can reduce those assets' impact on aid eligibility. If assets need to be spent down, consider starting with the child's assets first.

Assets may also be shifted from "reportable" (required to be listed on FAFSA) to "non-reportable." Non-reportable assets include the family's principal place of residence, certain qualified retirement plans, life insurance policies, any small business owned by the family, and more.

Misusing 529 plans

529 plans have grown in popularity, with total investment by American families in 529 plans reaching a record level of $328.9 billion in 2018, according to the College Savings Plans Network.

Exempt from federal taxes, 529 plans are administered by the states, but a buyer can select any state's plan. However, it's worth checking if your state offers tax benefits or other reduction in expenses for in-state residents.

[1]https://www.salliemae.com/assets/research/HAP/HowAmericaPaysforCollege2019.pdf
[2]https://www.cnbc.com/2018/12/27/student-debt-levels-set-a-new-record-in-2018-heres-how-much-the-typical-borrower-owes.html

The annual contribution limits for 529 plans are tied to the federal gift tax limit, which is up to $15,000 for 2019 (up to $30,000 for a married couple). If contributions go beyond these limits, the excess will count against lifetime estate and gift tax exemption of $11.4 million in 2019. The maximum contribution limit for each plan is set by the state administering it.

529 plans also have a special feature called accelerated gifting that allows lump-sum contributions (up to a max of $75,000 for individuals or $150,000 for married filing jointly) that are then treated as if they were made evenly over a five-year period. Affluent parents looking to reduce an estate may want to take advantage of this feature.

It's best to have 529 plans owned by parents, with the child listed as the beneficiary—again, because parental assets are subject to 5.64% contributions versus 20% for the student asset.

Also avoid having the 529 plan owned by a grandparent or other family member, as in that case FAFSA-based aid eligibility may be reduced even more dramatically than if the plan were student-owned.

If grandparents do wish to help fund education, they might consider a direct transfer to the school. Transfers made directly to education providers for tuition are not considered gifts for gift tax purposes, according to Sec 2503(e). in the tax code.

Jeopardizing your own financial future

Some parents may worry about the long-term impact of student loan debt on their children and come to believe using their own retirement funds is a better alternative. In 2018, 10% of parents planned to use their retirement funds to pay for education, with a further 21% earmarking some funds for college use "if needed."[3]

But this is, in most cases, an ill-advised strategy. With careful FAFSA filing, students may be eligible for federal loans with low interest rates—but you can't "borrow for retirement." Furthermore, withdrawals from retirement accounts (even Roth IRAs) may be counted as untaxed income, impacting your child's FAFSA calculation in the next year and potentially increasing the student contribution portion of your EFC.

In the past, borrowing from home equity to cover college costs may have been a favorable strategy in some circumstances, but the Tax Cut and Job Act (TCJA) of 2017 removed the ability to deduct interest paid on home equity unless it's used for home improvements. With no tax benefits and the potential to weigh on retirement-saving progress, opening a home equity line of credit for college-financing purposes is unlikely to make financial sense.

So, consider alternatives such as grants and scholarships, 529 plans and more affordable schools before tapping into your retirement savings or the value of your home.

And as with all life goals, it's important to start planning and saving early when it comes to your child's education. Work with an advisor to ensure your plan works for your children while keeping you on track toward your retirement goals. An advisor can also help maximize tax and other benefits.

[3]https://www.salliemae.com/assets/about/who_we_are/HAS2018_Full_Report.pdf

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