Planning for the Costs of Higher Education

FINANCIAL PLANNING ASSOCIATION

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The bad news and the good news about the high cost of college

It's no secret that the cost of advanced education can be very steep. Outside of buying a home and saving for retirement, probably no single expense hits families harder.

The average annual tuition cost alone at a four-year private institution in 2005-2006 was $21,235, according to the College Board, but some ran well above that. Annual tuition at a four-year public institution averaged $5,491 for in-state residents.

These costs do not include room and board, books and supplies, transportation, or miscellaneous expenses ranging from laundry to Friday night pizza. Total college expenses can easily run higher than $40,000 a year at some private schools.

Furthermore, tuition costs have been rising faster than inflation rates — between 4 and 11 percent a year. An average annual increase of five percent would push a $16,000 tuition bill to more than $33,000 in 15 years.

The good news? There are excellent, less-expensive top-notch state universities, colleges and private school alternatives. Tuition at "great value" two-year community colleges averaged only $2,191 in 2005–2006.

Higher-priced private institutions often provide significant student aid on an as-needed basis and sometimes based on merit. Tax laws in recent years have also helped underwrite costs. Don't eliminate consideration of pricier, private schools without looking closely at financial aid. Careful planning, even if your child is getting close to college age, can whittle some of the costs down to a manageable size.

Many more strategies for meeting college costs

Numerous tax breaks and college savings vehicles have emerged in recent years to help make college more affordable for more families. However, the mushrooming number of options — some of which conflict with each other — make the task of deciding which strategies to pursue a frustrating challenge. A CFP professional can help you weigh and select the best strategies for your situation.

Why save for college

Before tackling the task of funding college for your children, first make sure it's worth the money and the effort. Not everyone wants, needs or is qualified to go to college. Some will do fine in a trade school, perhaps join the military or pursue other career avenues.

Still, college does, on average, provide significant financial advantages, in addition to the direct educational benefits. A college graduate earns an annual average of over 62 percent more than a high school graduate, according to the U.S. Census Bureau.

College versus retirement

Many CFP professionals believe that parents shouldn't sacrifice their efforts to save for retirement on the altar of college. Your children will find a way through college, even if your help is limited. Parents who fail to save enough for retirement risk poverty and reliance on Social Security as a sole means of income.

So, the first step when calculating how much you can save for college is to be sure you're already saving enough for retirement. Some trade-off may be acceptable, such as delaying retirement two or three years. Just be sure to weigh the costs and benefits in a rational, not emotional, manner as you make decisions.

Let your children know what you can realistically afford. They may have to choose a less expensive school, fund more of it themselves or borrow more heavily. In general, it's a good idea to have your children earn at least some of their own college money, even if you can afford to pay the entire bill. It increases their feeling of ownership, and hopefully, their commitment.

Start saving now

Some families assume they shouldn't save for college because they think it will reduce financial aid. Not a good idea, say planners.

First, the vast majority of financial aid these days is in the form of loans, which you and your student must pay back. Thus, it's better from a financial standpoint to save money and earn a return on it rather than borrow that money and pay interest on it later.

Saving also gives you more flexibility. You are less likely to be forced to pick a second-choice school because it has a better financial aid package than your first choice.

Future financial aid might be tighter or unavailable, or current tax breaks may have disappeared. Carefully saved or invested money will be there regardless.

As with any form of investing, time is your ally. The sooner you start to save, the better off you are. Consider cash gifts for your newborn as a great way to jump-start their college fund. If you start early, the power of "compounding" is on your side.

How much do I need to save each month?

As with saving for any goal, you'll need to determine the cost of college, how much time you have to save and what kind of realistic return you can earn on the money you save.

Keep in mind, the cost is not just for tuition. Figure in room and board, transportation, books and supplies, and miscellaneous expenses.

How should I save?

That, too, depends on your individual circumstances.

Time is a big factor, as well as your willingness to take some risk. If your child is entering high school, you'll probably want to become more conservative with your investment strategy by reducing exposure to the stock market and mixing certificates of deposit (CDs), money market funds or short-term bonds into your portfolio. Returns will be lower, but you don't have the time to weather an investment setback.

With a younger child, you might feel comfortable taking more risk, such as investing in stocks or stock mutual funds. Over time, market based investments usually offer a better rate of return than fixed ones. However, the bear market of 2000-2002 reminds us that stock market values can fall rapidly.

Keep in mind, having a flexible strategy that will allow alternate choices for unused money previously earmarked for college may be useful in cases where college education is not pursued.

As many state-supported schools fight for fewer and fewer federal and state funds, it is also important to note that the traditional four-year college term has gradually lengthened to five, or even six years.

What are my investment choices?

The challenge today is that there are so many options for saving, and one size does not fit all. Some of the vehicles to implement your college planning strategy include:

Cash and cash equivalents. CDs, money market funds, short-term bonds or bond funds, and savings accounts are good options when you'll need the money soon for college, within five years or less.

U.S. savings bonds. The interest earned is free of federal tax if the money is used to pay for qualified college expenses, and if your income qualifies. Be certain to check about issuing requirements.

Coverdell education savings accounts. You can now contribute up to $2,000 a year to what was formerly called the education IRA, though some income restrictions remain. Earnings are federal income tax-exempt as long as they are used for qualified education expenses, which now include K-12 private school costs.

Pre-paid state tuition plans. Some states offer programs in which you pay for tuition in advance with the promise that tuition costs will be covered when your child enrolls regardless of how much tuition costs climb between now and then. It's a good option for conservative investors or in the event that tuition costs increase dramatically. Some plans are limited to schools within the state and do not include private universities.

529 college savings plans. Individual states administer these plans, while the investment management is usually outsourced to an investment firm or mutual fund company. 529 Plans offer some unique features, which vary by state. Some plans allow:

- Up to $12,000 in contributions annually
- Investor control when the student reaches the age of majority
- Tax-deferred growth
- No income restriction to open a plan
- No age-limit to open a plan or to start or complete withdrawals
- Qualified withdrawals are federally-tax free through the year 2010, some states allow limited state income tax deductions for in-state contributions
- Ability to change beneficiaries or account owners as needs change

Taxable investments. You can invest in anything you choose — stocks, mutual funds, bonds, real estate — with the potential of earning a higher return than some other college investment options. Income from the assets is taxed at your rate. You can minimize any capital-gains taxes on the investments by gifting the property to your child when it's time for college and having your child sell the property (though you could face gift taxes).

Roth IRAs. You can choose your investments. Earnings grow tax deferred, and early withdrawals are not subject to penalties if used for college expenses. Earnings are subject to income tax, however.

Should I save in my child's name?

Many families establish custodial accounts in their children's name, but most experts advise against this, especially with the emergence of other alternatives such as 529 savings plans. However, the decision ultimately depends on individual circumstances.

With a custodial account, investments are held in the name of a minor, but are managed by the custodian (such as a parent). This arrangement provides tax benefits, especially for higher-income families where the minor is at least 14 years old.

An advantage of a custodial account is the fact that distributions can be used for many purposes on behalf of the child, not just for higher education.

However, custodial accounts generally present two major drawbacks. One, when the child turns 18 or 21, depending on the state, he or she assumes control of the assets, which thus may not necessarily be spent on college. Second, assets held in a minor's name typically count more heavily when it comes to calculating financial aid. However, some colleges are changing their policies in this area, which may diminish this drawback in some cases.

When there is little time to save

Any savings at this point should be in low-risk vehicles such as money markets or CDs. Other options include:

- Increase cash flow by reducing expenses with a personal spending plan
- Take advanced placement classes in high school or a heavier college load in order to shorten the time — and thus, expenses — in school
- Consider less expensive alternatives, such as community college for the first two years, or attend a state university
- Some employers supply education assistance (some of which is tax free to the employee)
- Consider the military, which provides education assistance upon completion of active duty
- Make use of tax breaks. Taxpayers below certain income levels can claim the (1) Hope Scholarship or (2) Lifetime Learning credits
- Consider borrowing from private sources
- The student can work at college, either in on-campus or off-campus jobs
- Finally, apply for financial aid

Tell me more about financial aid

Financial aid is a broad term that covers financial help through the college your child attends. Financial aid includes merit and needs-based scholarships and grants, as well as work study. However, loans are the most prevalent form of financial aid today. There are federally guaranteed, private college-sponsored loan programs.

How much aid can I get?

That depends on your assets, income, how many children you have simultaneously in college, and other factors. In general, schools expect parents to contribute a maximum of 5.64 percent of assets and income. Schools tend to exclude family assets and income from the calculation if they are low.

Students are expected to contribute 35 percent of their assets and 50 percent of their income, though some schools are beginning to reduce the student's commitment to that of the parent. Financial aid is designed to make up the difference between what the family can afford and the cost of the school.

Even families with relatively high income should consider applying for financial aid. They may qualify for low-interest loans or merit scholarships.

Borrowing options

Students may qualify for federally backed Stafford or Perkins loan programs. Other loan options are available to parents:

- Federal PLUS loan
- Private college loans
- Home-equity loan
- Cash-value life insurance
- Some Retirement accounts

Many planners discourage borrowing from retirement plans because you are taking away from your priority retirement efforts, and there is the risk of income taxes and penalties if you don't repay on time. Also, the income from them may reduce financial aid.

Keep in mind that too much college debt can delay or hurt other family financial goals, such as retirement, or saddle the graduating student with debt that might alter plans or career options.

Teach your student finances

Students can help minimize the cost of college by managing their finances wisely. Prepare a realistic budget with your child before he or she goes off to college. Be clear about which expenses you will pay for and for which ones they will be responsible. Have your child track spending, and, together, review the budget periodically.

Students must be especially careful with credit cards, which are pushed heavily on college campuses these days. Students frequently graduate with too much credit card debt, and in some cases students are forced to quit school because of debt problems. Companies promise cool prizes and premium gifts for students who sign up for their credit cards, but this can hurt your child's credit and lead to a slippery slope of negative spending habits.

A college education is achievable

For the majority of families, a college education is a goal worth the financial effort. Working toward that goal can be complex and expensive. Yet with careful planning, families can provide a good, affordable education for their children.

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