Paying for the Costs of Higher Education

It's no secret that the cost of paying for higher education can be very steep.

What is a secret—or at least where there's a lot of confusion among families—is how best to pay for higher education. How much do I need to save? Which savings vehicles are best? Which tax breaks? What about financial aid?

While the answers can be complex, financial planners say one key stands out: saving as much as you can realistically afford to save before your child enters school. This brochure explains why saving has become so important and how best to go about it.

College costs skyrocketing

Tuition costs at public and private four-year institutions have been rising steadily between four and eight percent a year for the last decade or more, and recently state schools saw a jump nationwide of nearly ten percent.

At a six percent annual average increase, yearly tuition at a four-year public school will be nearly $10,000 and nearly $44,000 at private schools by the start of the 2017 school year. These costs do not include room and board, books and supplies, transportation, and miscellaneous expenses ranging from laundry to Friday night pizza.

The good news? There are excellent, less-expensive alternatives that include top-notch state universities and colleges, as well as good private schools. Higher-priced private institutions often provide significant student aid, including scholarships, on an as-needed or merit basis.

Federal tax laws in recent years have also helped underwrite costs. But most of all, careful planning, even if your child is nearing college age, can whittle costs down to a manageable size.

College versus retirement

Before making significant financial sacrifices to fund a potentially mind-numbing college bill, however, many CERTIFIED FINANCIAL PLANNER™ professionals recommend that parents take a hard look at something planners consider a more important funding obligation: retirement.

Your children will find a way through college, they point out, even if your help is limited. On the other hand, parents who fail to save enough for retirement risk poverty and overreliance on Social Security.

So, the first step when calculating how much you can save for college is to be sure you're first saving enough for retirement. Some trade-offs may be acceptable to you, such as delaying retirement two or three years. Just be sure to weigh the trade-offs in an objective manner.

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. Perhaps you'll fund undergraduate school and they'll be responsible for post-graduate studies. In general, it's a good idea to have your children pay at least some of their college expenses, even if you can afford to pay the entire bill. It increases their commitment.

Start saving now

Many families don't bother to save for education because they assume their child will receive financial aid and they believe savings will reduce financial aid. Not a wise strategy for several reasons, 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. It's usually 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. Furthermore, experts say that colleges are increasingly factoring in a student's ability to pay when it comes to making acceptance decisions.

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, the greater the power of "compounding." For example, to save $100,000 (pretax) by the time your newborn child enters college in 18 years, you'll need to save $210 a month. Wait until the child turns nine before starting and you'll need to save $640 a month to reach the same goal.

How should I save?

That depends on your individual circumstances. Time is a big factor—and your willingness to take some investment risk.

With a younger child, you might feel comfortable taking higher risks, such as investing in stocks or stock mutual funds. Over time, market-based investments usually offer a better rate of return than fixed ones. But as the bear market has painfully reminded us, stock market values can fall rapidly, so stay diversified.

If your child is already in high school, you'll probably want to invest more conservatively 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.

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 within the next few years for college.

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 isn't too high.

Coverdell education savings accounts- You can contribute up to $2,000 a year, though there are some income restrictions. Earnings are federal income tax-exempt as long as you use them for qualified education expenses.

Pre-paid tuition plans- Under this plan, you can buy part or all of a school's future tuition bill at today's prices. It's a good option for conservative investors or in the event that tuition costs increase dramatically. Once offered only by some states, a coalition of private schools also has set up a prepaid tuition program.

529 college savings plans- Individual states sponsor these plans, while the investment management is usually outsourced to an investment firm or mutual fund company. 529 Plans offer some unique features:

- Investments grow tax deferred, and qualified withdrawals are free of federal tax through the year 2010.
- Over $200,000 can be invested in a plan in most cases, and as much as $110,000 at one time.
- Investors control when students reach the age of majority, and you can change beneficiaries.
- No income restriction to open a plan.
- Generally, no age-limit to open a plan or to start or complete withdrawals.

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. You can minimize any capital-gains taxes on the investments by gifting the assets to your child when it's time for college and have your child sell the assets (though you could face gift taxes).

Custodial accounts - With the rise of alternatives, this once popular option for college planning is losing favor. 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.

But custodial accounts 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 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, though some colleges are changing their policies in this area.

Additional tax breaks

The federal government offers several additional tax breaks beyond those offered for 529 plans, prepaid tuition plans, and other vehicles mentioned above:

- Most taxpayers can now deduct up to $3,000 a year in tuition expenses ($4,000 in 2004 and 2005), even if they don't itemize. The deduction ends after 2005, and you can't take the deduction if you claim a HOPE or Lifetime Learning deduction the same year for the same student.
- Qualified taxpayers also can deduct up to $2,500 in student loan interest every year.
- Taxpayers can exclude from income up to $5,000 a year in employer-provided education assistance.
- Taxpayers whose income is not too high can claim the Hope Scholarship Credit of up to

$1,500 per student, or the Lifetime Learning Credit of up to $1,000 per return, though both credits can conflict with other educational tax benefits.

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 creating and implementing a personal spending plan.
- Have your child 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.
- Consider the military, which provides education assistance upon completion of active duty.
- 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. But federally backed loans are the most prevalent form of financial aid today.

How much aid you receive will depend on your assets, income, how many students 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 available to parents:

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

Many planners discourage borrowing from retirement plans because you are taking away from your 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 which ones they will be responsible for. 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.

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, but with careful planning, families can provide an excellent, affordable education for their children.