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Managing College Costs: Integrating Savings and Tax Strategies

A HOLISTIC APPROACH TO FINANCIAL PLANNING CAN HELP HIGH-NET-WORTH PEOPLE FUND COLLEGE COSTS.

The cost of a college education seems to be skyrocketing with no end in sight. In the past seven years alone, the ten most expensive schools increased tuition by an average of 52% from 1999 to 2006—nearly triple the 21% rise in the U.S. cost of living during the same period.¹ “By the time today’s infants pack for college, parents can expect to pay well over \$100,000 for a four-year public college and closer to \$300,000 if they’re eyeing an Ivy League education,” says Gen Tanabe, author of *1001 Ways to Pay for College* and founder of supercollege.com.

No one could have anticipated how much tuition would increase, and “many high-net-worth (HNW) families who may have expected to use savings to pay for college are looking for ways to save on costs,” says Deborah Fox, director and founder of Fox College Funding LLC of San Diego, Calif.

TAKING A COMPREHENSIVE APPROACH

HNW families are ineligible for need-based financial aid but can use numerous strategies to reduce college costs. “A holistic approach to financial planning can integrate college savings with tax strategies and retirement planning,” suggests Fox. Any money that you save can be used to pay for college, and any college savings can be invested for growth to support your retirement and other goals.

For example, HNW families are eligible to use low-interest federal loans to pay for college. Consider the potential benefits of taking a loan at a fixed rate of 6% and investing the money in a portfolio returning 10%—earning more than enough to pay back the loan, suggests Fox.

Other possible college savings strategies involve creating “tax scholarships,” explains Fox. “This refers to any tax deduction that can generate money to pay for college.” She cautions that educational tax strategies should be customized to the family’s needs, with the help of a team of tax, financial and college planning advisors. Three strategies can be used together to help create tax efficiency: gifting, shifting income to use the tax capacity of the child and earning discounted tuition.

GIFTING STRATEGIES

A couple using their annual gifting exclusion of \$12,000 per person (\$24,000) can contribute five years of gifts (\$120,000) at a time to a college savings plan, such as a 529 plan, increasing the growth through compounding over time. The benefits of this type of plan include:

- Investments grow tax-free.
- Withdrawals used for qualified education expenses may be entirely tax-free. The IRS determines if a portion of the earnings is taxable. (Keep in mind, however, that withdrawals for nonqualified educational expenses, including if you overfund the account, are taxable and incur a 10% penalty.)

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- Moves assets out of your estate, reducing exposure to estate taxes.
- The account-holder controls the money for the life of the account.

HNW families may be able to create savings for college by gifting highly appreciated assets that generate ordinary income or capital gains to their children, says Fox. The savings are created when the gift is sold and taxed at the child's tax rate rather than the parents. As of January 2008, the tax law states that a full-time student, under the age of 24, earn-

ing less than 50% of his/her support, qualifies for the “kiddie tax rate” and is not subject to more than a 5% tax on capital gains on assets sold.

SHIFTING INCOME

If you are a business owner and are in a position to hire your child for a reasonable wage, you can shift income that can be taxed at a lower rate. This money can then be saved and invested for future college expenses. Once your child is in college and filing a tax return, he or she can claim a standard deduction plus education tax credits, possibly zeroing out any taxes owed. Additionally, the business can open an Education Assistance Plan that allows you to contribute \$5,250 per year, tax-free, for college expenses.

SCHOLARSHIPS AND DISCOUNTS

A good strategy for HNW families to save money is through academic planning, suggests Tanabe. By drafting a list of good colleges that are looking for the qualities your student has, you can create a competition between schools, resulting in discount offers of \$5,000 to \$15,000 per year—tax-free. Colleges are looking to build well-rounded communities with a diverse student body, so students with passionate interests, community service and extracurricular activities are attractive.

“I know of a female student who was looking for an engineering program,” says Tanabe. She was not in the top 2% of her class, but Duke accepted her and offered a \$15,000 tuition discount because they wanted to meet their diversity goal. “It takes work to track down and apply for merit scholarships and grants, but they can be quite valuable,” he says.

“College planning needs to be strategic and comprehensive,” explains Fox. Financial advisors may want to provide their HNW clients with customized strategies in addition to the college savings to help their clients maximize their resources and protect their retirement planning. Additionally, financial advisors seeking expertise in college savings for HNW families should consider the benefits of developing an alliance with tax and college planning specialists. ■

¹Tom Riper, “America's Most Expensive Colleges.” http://www.forbes.com/2007/01/19/most-expensive-colleges-biz-cx_tvr_0119college. January 19, 2007.

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