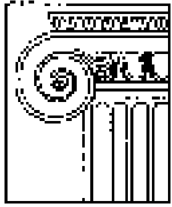

Back Bay Financial Group, Inc.

Fee-Only Financial Planning, Investment Advisory and Wealth Management Services

Main Office: 745 Boylston Street, Suite 503, Boston, MA 02116
Branch Offices: Wakefield and South Yarmouth, MA
617 • 247 • 0518 www.backbayfinancial.com

Helping Clients Build and Manage Wealth

THE BACK BAY ADVISOR **SUMMER 2005**

Tips for Your College Education Fund

No one disputes the fact that the cost of a college education is high. For the 2004-05 school year, the average annual cost of a four-year public university is $14,640 and for a four-year private university is $30,295 (Source: *Trends in College Pricing*, 2004). While those prices are sure to increase in the future, that doesn't mean you should just give up and ignore the entire subject. There are a number of strategies to help you fund that college education:

- **Start investing as much as you can now.** The sooner you start saving, the more time you'll have to let those savings grow. Figure out how much you need to save annually to meet your goal. Don't panic if you can't afford to save the entire amount. There are other sources to help fund a college education, such as borrowing and financial aid. Your goal may be to save 30%, 50%, or some other percentage of the total cost.
- **Adjust your investment mix over time.** For years, college costs have been increasing by more than the overall inflation rate. Just for the 2004-05 school year, tuition at four-year public colleges increased by 10.5% compared to overall inflation of 2.2% (Source: *Trends in College Pricing*, 2004). Thus, you should select investments that are likely to stay ahead of increases in college costs. However, as your child nears college age, protect your principal by shifting to more conservative investments.
- **Become familiar with the financial aid system.** If you think you'll qualify for financial aid, learn about the system now, no matter what your child's age. Calculate your expected family contribution to get an idea of how much aid you might receive and research what types of aid are available. Many families are surprised to find out a significant portion of most aid packages comes in the form of loans.
- **Decide whether to save in your name or your child's name.** If

Continued on page 2

Withdrawing College Funds

Once your child starts college, you'll want to use funds set aside for college to maximize tax advantages as well as your financial aid awards. Which investments should you withdraw first — money from personal savings, section 529 plan assets, or funds from Coverdell education savings accounts (ESAs)? How will those withdrawals affect education deductions and credits for tax purposes? And then, what impact will all of this have on your financial aid award?

From a financial aid standpoint, you typically want to use your child's assets first. In financial aid calculations, 35% of your child's assets are expected to be used for college purposes, while only a maximum of 5.6% of your assets are considered. Thus, if your child has money set aside for college in a custodial or personal savings account, spend that money first, possibly even before your child enters college. For instance, you could use those funds for a computer or a car.

ESA assets can be either your assets or your child's assets, depending on how the account was set up. If they are your child's assets, realize that they can be used to pay many education expenses while your child is in high school. You may even want to roll that child's ESA over to a younger sibling, so the funds won't be considered your older child's asset.

Payments for prepaid tuition plans reduce financial aid on a dollar-for-dollar basis. If permitted by the plan, you may want to transfer the funds to a section 529 savings plan, since tax-free distributions are not considered at all in financial aid calculations.

You also need to consider the impact of withdrawals on tax deductions and credits. The deductions and credits available include:

- In 2005, a maximum above-the-

Continued on page 3

FR2004-1213-0036

College Education Fund

Continued from page 1

you expect to qualify for financial aid, you may want to save in your name, since only 5.6% of your assets are considered available for college costs, while 35% of your child's assets are considered. If you don't expect to qualify for aid, you can make annual gifts, up to $11,000 in 2005 ($22,000 if the gift is split with your spouse), to your child without paying federal gift taxes. Those assets are then removed from your taxable estate and any income becomes taxable to your child.

- **Look into section 529 plans, which include prepaid tuition programs and college savings plans.** Prepaid tuition programs guarantee funds to cover tuition at your state's public colleges and universities, although some private colleges also offer these plans. College savings plans invest your money in stocks, bonds, or mutual funds. You can use distributions to pay higher-education expenses at any college or university. Qualified distributions taken before 2011 are tax free.
- **Examine Coverdell education savings accounts (ESAs).** You can make annual contributions of $2,000 per beneficiary under age 18. While contributions aren't tax deductible, earnings grow tax free as long as proceeds are used for qualified education expenses. In addition to college expenses, proceeds can be used for elementary and secondary school tuition and expenses and computer technology and equipment. Eligibility to make contributions is phased out at adjusted gross income (AGI) levels of $95,000 to $110,000 for single taxpayers and $190,000 to $220,000 for married taxpayers filing jointly. If your income exceeds those limits, however, your child or other relatives can make the contribution.
- **Consider using a Roth individual retirement account (IRA) to help fund college costs.** However, only consider this strategy if you have other means to save for retirement. Your contributions to a Roth IRA can be withdrawn at any time without paying federal income taxes or the 10% early withdrawal penalty. If you're under age 59 1/2 when distributions for qualified education expenses are taken, you'll have to pay ordinary income taxes on earnings, but not the 10% federal income tax penalty. If you're over age 59 1/2 and opened the Roth IRA at least five years before the distribution, you may not have to pay federal income taxes on the earnings.
- **Realize that education credits and deductions may reduce the cost of college.** See the article "Withdrawing College Funds" for more details.
- **Investigate borrowing options.** Borrowing can put a significant strain on your finances, usually at a time when you should be concentrating on saving for retirement. However, if you need to borrow, there are a variety of loan options available, with the federal government offering several attractive alternatives to students and their parents.
- **Encourage your child to participate in the process.** Maintaining good grades and participating in extracurricular activities may make your child a more desirable candidate for college. He/she may then be eligible for a wider range of grants and scholarships. You may also expect your child to work part time to fund part of his/her college education.

While college costs are a significant expense, there are a wide variety of strategies you can use to save for this expense. If you'd like help deciding which are best for your situation, please call.

Is a College Degree a Worthwhile Investment?

With the high cost of a college education, you may wonder whether your child really needs to go to college. While deep down you know the answer is yes, take a look at median earnings by level of education for 2003:

Professional degree	$95,700
Doctorate degree	79,400
Master's degree	59,500
Bachelor's degree	49,900
Associate degree	37,600
Some college, no degree	35,700
High school diploma	30,800
Less than a high school diploma	21,600

(Source: *Education Pays,* 2004)

The Census Bureau estimates that college graduates will earn approximately $1 million more over their working lives than high school graduates.

In terms of paying back college costs, the College Board estimates the typical college graduate who started college at age 18 will earn enough by age 33 to compensate for tuition and fees at the average four-year public university as well as for foregone earnings during the college years (Source: *Education Pays*, 2004).

The College Board reports that a college degree provides other benefits to both the individual and society. College graduates have lower unemployment rates, lower poverty rates, better perceived health, lower smoking rates, lower incarceration rates, higher cognitive skills of their children, higher volunteer rates, higher voting percentages, and higher blood donation rates (Source: *Education Pays*, 2004).

Now do you feel better? Despite the high costs, college really is a good investment for your children.

Withdrawing

Continued from page 1

line deduction of $4,000 of qualified higher-education expenses is available for single taxpayers with adjusted gross income (AGI) not exceeding $65,000 and for married taxpayers filing jointly with AGI not exceeding $130,000. Single taxpayers with AGI between $65,000 and $80,000 and married taxpayers with AGI between $130,000 and $160,000 are entitled to a maximum deduction of $2,000.

- The Hope scholarship credit is a nonrefundable tax credit equal to 100% of the first $1,000 of tuition and fees and 50% of the next $1,000 of tuition and fees (for a maximum credit of $1,500) paid for a taxpayer, spouse, or dependent for the first two years of post-secondary education. The credit can be claimed for more than one student in a given year. The credit is phased out for single taxpayers with modified AGI between $43,000 and $53,000 and for married taxpayers filing jointly with modified AGI between $87,000 and $107,000.
- The lifetime learning credit is a nonrefundable tax credit equal to 20% of up to $10,000 of tuition and fees (for a maximum credit of $2,000) for post-secondary education, including courses to acquire or improve job skills. The credit can be claimed for an unlimited number of years. The credit is phased out based on the same modified AGI limits as the Hope scholarship credit.

The deduction cannot be claimed in the same year for the same student as the Hope scholarship or lifetime learning credit. Also, these credits and deductions cannot be claimed for amounts paid with tax-free distributions from section 529 plans and ESAs.

If you'd like help determining how to withdraw college funds, please call. ▮

Coping with the Financial Aid Process

Almost $122 billion of financial aid was distributed during the 2003-04 school year, with an average award of $10,472 per full-time student. Of that total, approximately 56% was loans and 38% was grants (Source: *Trends in Student Aid*, 2004). With so much money at stake, you should understand the financial aid process.

The first step is filling out the appropriate forms so colleges can determine your financial need. After January 1 of the year your child enters college, you must complete the "Free Application for Federal Student Aid" form as well as any forms required by colleges your child applied to. These forms are used to determine your expected family contribution (EFC), which is the amount you're expected to pay annually toward college costs. If college costs exceed your EFC, financial aid officers try to fund that difference, using grants, scholarships, work study programs, and student loans.

Be prepared — most families are surprised by how much they're expected to contribute toward college. The calculation is based on a formula, not your actual expenses. After some adjustments, your EFC equals 5.6% of your eligible assets and up to 47% of income plus 35% of your child's assets and up to 50% of his/her income. Your EFC is the same no matter how many children are attending college, so you can expect more aid if you have more than one child in college.

Consider these tips to help maximize your financial aid award:

- **Understand how the financial aid system classifies income and assets.** Your net worth, as defined by the financial aid system, includes bank accounts, stocks, bonds, and mutual funds, but not retirement funds, insurance, or annuities. However, individual colleges may have different criteria for certain assets. Loans against assets, such as mortgages, home-equity lines of credit, and margin loans, are deducted from your net worth, but consumer loans are not. Capital gains are included in income.
- **Consider using your child's assets to pay school expenses before college.** You might want to purchase a computer or car for commuting to college with your child's money.
- **Apply to several colleges, evaluating each financial aid package.** Your awards can vary significantly among colleges. Don't just look at the total amount of the award — evaluate the composition of that aid. Grants, which are not repaid, are more desirable than loans. Even the types of loans offered can make a big difference.
- **Don't automatically rule out more expensive colleges.** Your EFC will remain the same, no matter where you child goes to college. Many private and Ivy League colleges have more merit aid and discretion when making offers.
- **Make sure to adhere to application deadlines.** Typically, colleges first evaluate applications submitted on time. Anyone filing late is evaluated later, after a significant portion of aid has been awarded.
- **Talk to the financial aid officer if you aren't satisfied with the financial aid package.** Financial aid officers are often willing to reevaluate a financial aid package. If there have been significant changes in your financial situation since the forms were filled out, call and explain. ▮

Copyright © Integrated Concepts 2005. This newsletter intends to offer factual and up-to-date information on the subjects discussed, but should not be regarded as a complete analysis of these subjects. The appropriate professional advisers should be consulted before implementing any options presented. No party assumes liability for any loss or damage resulting from errors or omissions or reliance on or use of this material.

FR2004-1213-0036