SAGE Scholars, Inc.

Ten Minute Professor

For Advisors: Financial Aid 101

Start with a Strategy: 'LIFE 211'

If you're helping your client through the financial aid process, the FIRST step is to create a strategy. People need goals. What your clients want to know is: Exactly how much money should we be saving for college? We recommend a plan that we call LIFE 211.

"**LIFE**" stands for **Lifetime Investing for Education**. We advocate creating a college funding plan with three components to cover four years of undergraduate study:

• **2 Years of College -- funded by 2 hours per week of Parental Income.** Clients should dedicate 2 hours of wages per week (5% of wages) for 10 years to build a college savings fund.

• **1 Year of College -- funded by Student Income:** Work before and during college, with the remainder funded by loans (paid off by 5% of the graduate's wages for 10 years).

• **1 Year of College -- funded by non-need aid**. Use Tuition Rewards® (and other aid) to pay for one year of college!

Next: The Financial Aid Process

Next Step: You need to integrate "LIFE 211" with an estimate of how much financial aid is the family is likely to qualify for. This is important no matter what age the child is now. Once you know this, you can discuss how the family is going to pay for and/or finance the balance.

To determine a "**Quick EFC**" – an estimated "**Expected Family Contribution**" (**EFC**) -- use the calculator at http://www.finaid.org/calculators/quickefcchart.phtml.

We've found that families with annual incomes below $150,000 have a reasonable chance of qualifying for some financial aid at a private college. With two students in college at the same time, eligibility for financial aid is possible with even higher income. When the student applies to college, we recommend filling out the **F**ree **A**pplication for **F**ederal **S**tudent **A**id even if the family does not expect to receive "need-based" financial aid. The EFC is derived from the FAFSA form.

After a family completes the **FAFSA** form, it's sent to a college. Next, it's transmitted to a federal processor who determines what is called the "**Expected Family Contribution**" (**EFC**).

Graduation ceremony at Southwestern College (KS)

The EFC Formula

ALL colleges and universities, public or private, must use the EFC figure when awarding **government** scholarships, loans or work-study money to students. This government-created and approved formula most heavily counts family income (especially student income), places somewhat less emphasis on assets and pays very little attention to family debt.

The EFC indicates how much money, on an annual basis, parents and the student are considered to be able to afford to pay for college education.

The percentage of income that parents are expected to contribute varies by age. Younger parents are expected to pay slightly more; as parents get closer to retirement age, the

(continued on page 2)

(continued from page 1)
percentage keeps decreasing.

Parents are expected to contribute a maximum of**5.64%** of non-excluded assets to a beneficiary's college costs every year.

Students are expected to contribute **20%** of assets annually.

The Cost of Attendance

Colleges then take the EFC figure and subtract it from the **TOTAL cost of attendance** -- including tuition, fees, room, board, books, supplies, personal and travel expenses. The result of this calculation represents the demonstrated financial need. This is the amount that determines eligibility for need-based awards.

Colleges use the EFC amount to help families explore ways of bridging the gap between what they can afford and what it will cost to send students to that college. Options include state and federal grants, federal loans, work study employment and merit aid.

If a family has two children in college at the same time, the EFC remains the same – meaning that if the older student did not qualify for financial aid, the younger student may qualify for extensive aid during the "overlap" period.

An EFC Example

Note that the EFC determination remains the same – regardless of the college choice.

For example: Let's assume the EFC determination concludes that "Family X" is expected to contribute $17,000. At "College A" (this could either be a private college -- or out-of-state tuition at a public university), the cost of attendance might be $34,000 per year -- $25,000 for tuition and $9,000 for room, board and expenses. Therefore, the student qualifies for $17,000 in financial aid.

At "College B" (an in-state public college), the cost to attend is $17,000 -- $8,000 for tuition and $9,000 for everything else. Since the EFC is $17,000, the family is not eligible for **any** financial aid.

Fairleigh Dickinson University Seal

Thus, the cost to the family to attend "College A" is $17,000 – and, the cost to attend "College B" is **also** $17,000. It's the **SAME PRICE** -- even though the tuition at one school is $25,000 and $8,000 at the other school (omitting, for now, components of the $17,000 in aid, such as loans, at "College A").

The EFC Calculation, Part 2

In the standard determination of financial need, **the EFC formula ignores certain assets** – for example, home value, retirement plan value, annuities (considered to be retirement assets), life insurance cash values, etc. The EFC formula also ignores debt & loan obligations. However, some private colleges use a supplemental family financial aid form (usually, the "**CSS Profile**") that considers many of these assets (and debts). This is known as "**institutional methodology**" (as each college that uses the CSS Profile may add or delete questions).

As a general rule, the more selective the private college, the more likely it is to require parents to fill out the CSS Profile; public colleges and universities are much less likely to require the CSS Profile.

When only the FAFSA form is required, the EFC is the same at all colleges. When the **CSS Profile** is used, a family's EFC can vary significantly by college.

To increase eligibility for financial aid, it's common for advisors to tell a family to move money out of mutual funds, for example, and into a life insurance policy. Note: If the family still has the mutual fund during the calendar year that includes the last part of 10th grade and the first part of 11th grade, any interest and dividends from the mutual fund will show up on the tax return for the year that the FAFSA is completed.

Merit Aid

Private colleges are free to: (a) modify or (b) ignore the EFC formula when giving out their own money -- or provide discounts off the "list price" of tuition. **Private colleges may offer non-need based financial aid.** 96% of private colleges – 100% of the schools in the SAGE Tuition Rewards consortium -- award "merit aid" (tuition discounts); the percentage of students given merit aid varies considerably by college.

For example, one college might offer merit aid to 20% of the incoming class; at another institution, 40% of the incoming freshman class might receive merit aid. The more desirable students -- from the perspective of the enrollment staff – are offered larger merit aid awards.

With non-need aid (including Tuition Rewards discounts), it is possible for the cost of attending a private college to actually be <u>less</u> than the cost of a public college.

How Long to Graduate? 4 Years? 5 Years? 6 Years?

A UCLA study has found that the **four-year graduation rates** for **private** universities average **67%** -- versus **28%** for **public** universities. That's why attending a private college or university may actually be **LESS EXPENSIVE** than a state school, despite the enormous differences in the "list price" of tuition.

Be sure to mention this to your clients!

Note: There tends to be minimal difference in expenses – room, board, books – at private colleges versus state schools, assuming that the student is not commuting.

(continued on page 3)

(continued from page 2)

The Best Advice to Parents

The best advice that you can give a family is to "step up to the plate" – apply to private colleges of interest & find out what the costs will actually be. Don't assume that private colleges are unaffordable.

Advise clients to explore the "qualitative" benefits of attending a private college: Smaller, more involving classes; more faculty interaction; more community service opportunities; more internships; superior career guidance and job placement.

Private colleges spend approximately $21,000 per student per year on faculty and staff; at public colleges, the comparable figure is $10,000. It's cheaper to fill a lecture hall with 250 students than to offer a full professor for a class of 15-to-30 students. The average private institution has 2,200 students; the average public institution, 9,700 undergraduates.

The parties might be better (and more frequent) at large universities, but the dropout rate is higher – and the time to graduate longer. If the student decides to change his/her major at a public college, this can be the "kiss of death" to the possibility of on-time graduation.

Advise clients that certain types of students do graduate in four years from a public college: Students who are self-motivated, somewhat immune to peer pressure and are sure of their intended major. But, if this doesn't describe their child, then it's healthy to discuss, in advance, what the student intends to do about paying for a fifth or sixth year of college.

Savings Vehicles

Insurance

If you're a financial advisor, you're probably already very well aware of the advantages of whole life or universal life policies as college savings vehicles. Clients can build up cash value -- and, when the time comes, borrow against the cash value to fund a year or more of college costs. Certain types of insurance have guaranteed returns.

Borrowing off the cash value is a tax-free event. The interest rates on the "loan" (to yourself) are very favorable. The cash value of the policy is not included in financial aid calculations derived from the FAFSA form. And, there's a death benefit -- which every parent should have as part of his/her college savings plan.

The use of cash value life insurance as a college funding vehicle is often recommended for grandparents as an "intergenerational funding" method.

529 Plans

A "qualified" 529 plan is an IRS-approved program set up, almost always by a state government, to allow families either to pre-pay -- or to contribute to an account established for paying -- a student's qualified education expenses at an eligible institution. 529 Plans allow families to save for college without paying taxes on dividends, interest and profits earned so long

A fall day at Elmira College (NY).

as the money invested in the 529 account is used for qualified education expenses (tuition, room, board, books, etc.).

"Guaranteed" 529 Plans are state-backed savings programs. Only 12 states, including Pennsylvania, offer Guaranteed 529 Plans; these plans often limit participation to in-state residents. The benefit is that clients can purchase tomorrow's tuition at today's price. The State guarantees that account assets will keep pace with the rising cost of tuition.

"Investment" 529 Plans look and act like traditional mutual funds. Investors buy shares of the 529 Plan, which can either go up or down in value. Plans can be bought through an advisor or directly by the public. Wisconsin, for example, offers both options; in Pennsylvania, only direct investment is available. With Investment 529 Plans, although profits are tax-exempt, restrictions or penalties exist as far as deduction of losses and removal of assets for non-qualified educational expenses.

Factors to consider when evaluating 529 Plans include: In-state tax benefits, fund performance and management fees. A great source of 529 information is www.savingforcollege.com. This excellent website contains detailed information on all state-sponsored 529 Plans.

Your clients do need to list 529 Plan assets on the FAFSA form if the account-holder is either the parent or the student. If the account-holder is the parent, families are expected to use 5.64% of the value every year -- meaning that total financial aid is reduced $564 per year for an account that's worth $10,000. Don't let set up the account in the student's name, because aid eligibility is reduced at a rate of 20% per year ($2,000 less in aid eligibility per year).

If the account-owner is a grandparent or other relative, the good news is that the account isn't listed on the FAFSA form. The bad news is that the year of redemption reduces aid eligibility by 50% of the redemption amount. So, grandparent 529s should either be redeemed for the final year of college -- or, account ownership should be transferred to a parent before redemption.

(For more detailed knowledge, see our "10-Minute Professor" on 529 Plans.)

(continued on page 4)

(continued from page 3)

Coverdell Accounts

A Coverdell Education Savings Account (**ESA**) is a savings account created as an incentive to help parents and students save for education expenses. The total contributions for any one beneficiary (who must be under age 18 or a special-needs beneficiary) in any year cannot exceed $2,000 -- no matter how many accounts for the beneficiary are established. Contributions must be made in cash and cannot be invested in a life insurance policy or contract.

Distributions are tax-free as long as used for qualified education expenses (tuition, books, fees, etc.) at an eligible educational institution . This includes any public, private or religious school that provides elementary or secondary education (as determined under state law), not only a college!

The Coverdale ESA legislation, however, is set to e**xpire on Dec. 31, 2012** unless Congress takes action.

Contributions to a Coverdell ESA are not tax-deductible, but the beneficiary will not owe tax on the distributions so long as that year's distributions do not exceed the beneficiary's qualified education expenses. This benefit applies to educational expenses from kindergarten thru 12th grade, including tutoring and transportation.

Generally, any individual (including the beneficiary) can contribute to a Coverdell ESA if the individual's modified adjusted gross income is less than $110,000 ($220,000 if filing a joint return). Contributions to a Coverdell ESA may be made until the due date of the contributor's tax return, without extensions.

If there is a balance in the Coverdell ESA at the time the beneficiary reaches age 30, it must be distributed within 30 days. A portion representing earnings on the account will be taxable and subject to an additional 10% tax. The beneficiary may avoid these taxes by rolling over the full balance to another Coverdell ESA for another family member under the age of 30.

Tax Credits: AOC (Hope) & Lifetime Learning

The American Opportunity Credit (previously known as the Hope Credit) and the Lifetime Learning Credit are two additional college savings incentives. The AOC tax credit now has a maximum of $2,500 per student and can be claimed for the first four years of post-secondary education (previously, two years). The credit is "phased out" (gradually reduced) if a taxpayer's modified adjusted gross income (MAGI) is between $80,000 and $90,000 ($160,000 and $180,000 if filing jointly). Students must be attending college at least "half-time." Congressional action is needed to extend the AOC past its scheduled expiration at the end of 2012 (deductible on tax returns due 4/15/13).

The Lifelong Learning Credit cannot be claimed in the same tax year as the AOC credit. Unlike the AOC credit, students are not required to be enrolled at least half-time. The Lifetime Learning Credit, unlike the AOC, is calculated per family rather than per student, with a maximum of $4,000 per year (if incomes are below $65,000 (single) or below $130,000 (married filing jointly). The deduction is limited to $2,000 if your income is between $65,000 and $80,000 (unmarried taxpayers) or is between $130,000 and $160,000 (married filing jointly).

Either of these two tax credits can be claimed in the same year that the beneficiary takes a tax-free distribution from a Coverdell ESA -- so long as the same expenses are not used for both benefits.

If the distribution exceeds education expenses, a portion will be taxable to the beneficiary and will be subject to an additional 10% tax. Exceptions to the additional 10% tax include the death or disability of the beneficiary -- or if the beneficiary receives a qualified scholarship. For more information, please see Publication 970, Tax Benefits for Higher Education. Download the publication or order it by calling toll free 1-800-TAX-FORM (1- 800-829-3676).

Parent & Student Loans

Student loans are an acceptible way to finance a portion of a college education -- as long as the loan balance doesn't reach an unmanageable level. Advise your clients that, ideally, a family should use student loans to finance **no more than 25%** of a student's education.

The most common types of student loans are:

1. **PLUS Loans** (**P**arent **L**oan for **U**ndergraduate **S**tudents) – These are federally-backed loans to parents of children in college. At today's low rates, PLUS loans are a great way to help finance education. Families qualify for a PLUS regardless of income; there is no collateral requirement or prepayment penalty.

2. **Stafford Loans Program** – These are direct loans from the federal government to a student. All Stafford Loans are either **subsidized**, with the government paying the interest on the loan while the student is still in school, or **unsubsidized**, in which case the student pays all the interest. Payments on unsubsidized loans can be deferred until after graduation. A student must show financial need to receive a subsidized Stafford Loan.

3. **Federal Perkins Loans** – These are low-interest student loans given **by colleges** on the basis of need. The college financial aid office determines who qualifies for Federal Perkins Loans as well as the amount of the loan. Colleges that participate are limited in the amount of Perkins Loan money that they can distribute, so the awards are very selective.

SAGE Scholars, Inc.
21 South 12th Street, 9th Floor
Philadelphia, PA 19107
Phone: 1-888-222-0550 Fax: 215-564-9934
Email: info@sagescholars.com
www.tuitionrewards.com
www.marketcapandgown.com

(updated July, 2012)