Student Date

Class Instructor

CHAPTER 30 Savings Accounts

How to Cash Out Junior's College Fund

The tricky part is curbing taxes and boosting aid

by Mike MacNamee

Congratulations! You've been saving ever since Junior was a toddler, and now that he's a strapping high schooler, you have a hefty sum stashed away in growth stocks for college. You're among a tiny elite: By some estimates, only 2% of families with children have $5,000 or more saved for college expenses.

Now, how are you going to get those funds out of your account, or your child's, and into Wattsamatta U's? College planning focuses so much on the first phase—saving—that few parents are aware of the hurdles that await during the endgame. Market risks, taxes, and financial-aid considerations can cost you thousands of dollars come time to write tuition checks. And these considerations come into play sooner than you might think: Decisions you make for a high school sophomore can be critical. "Parents of juniors come in so pleased that they're planning ahead, and I have to tell them, `It's too late to make the most of your money,"' says Judy Miller, a certified financial planner who runs College Solutions in Alameda, Calif.

The biggest variable in your planning is financial-aid eligibility. Before you set aside a dime for your child's college, go online and calculate your prospects (table). "If you're eligible when your child is 8, you'll probably qualify when she's 18, because tuition has been going up faster than income," says Rick Darvis of College Funding Inc. in Plentywood, Mont. The College Board provides detailed cost figures for hundreds of institutions, and offers a useful aid calculator. Of course, even when Janie's in high school, you can't predict whether she'll eventually enroll in State U or Brown University (annual cost: $35,800). But run the numbers for a range of colleges, and you'll get a sense of whether FAFSA (the Free Application for Federal Student Aid) is in your future or not.

SEEKING SAFETY. If you're not likely to qualify for aid—probably because your annual income exceeds $125,000 and you'll only have one child in college at a time—your costs will be higher, but your planning is simpler. Your challenge is to reduce taxes and to guarantee that the stock market doesn't take your college fund south just when it's time to start writing checks.

To avoid market risk, start shifting college funds away from growth and toward security when your child is a high school sophomore. "If you're going to need a dollar anytime in the next three years," says Raymond Loewe, president of College Money, a planning firm in Marlton, N.J., "that dollar shouldn't be in the stock market." Take advantage of market highs to sell stocks or stock funds and move one quarter of your college money each year to safe investments—money-market funds, high-grade bonds, or certificates of deposit timed to mature when tuition is due. Your goal: Never get trapped selling stocks in a down market to meet a college payment.

If you want real safety, model your endgame portfolio on the asset mix offered by state-sponsored college savings plans. These 529 plans adjust their investments to reduce risk as the student approaches college. Tim Lane, vice-president of TIAA-CREF's Tuition Financing subsidiary, defends the conservative mix—for a 16-year-old, only 20% of the fund would be invested in stocks—in the 12 state plans his company runs: "You're saving for a target, so you've got to be sure the money is there when you want it."

As you cash out your stocks, you naturally want to pay as little tax as possible. Certified financial planner Mari Adam of Boca Raton, Fla., was horrified when she recently discovered a client was selling his IBM stock to give his children college money. If he gave his kids the stock and let them sell it, he'd cut the tax tab in half—from his 20% capital-gains rate to their 10% (or, for assets held five years or longer, 8%). But you'll have to gauge whether the funds will make it to the bursar's office if they pass through your child's hands first.

What if your early check shows that you are likely to qualify for aid? Now you have a new set of risks: Mishandle your assets, and every $100 you've sweated to save for your child's education can cost you $85 in potential financial assistance.

TOO RICH. First, recognize that aid formulas hit students' assets much harder than parental assets. Students are expected to put 35% of their assets toward education, while a parent's account is only nicked for 5.6%. (Federal aid formulas exempt home equity, retirement accounts, and an asset allowance

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based on the older parent's age—about $45,000 at age 45. Some private colleges do count those assets when they figure their own aid awards.) A $10,000 account in your child's name will cost $3,500 a year in aid. If you hold the funds, you'll be hit only $560.

What's the lesson? Don't put your savings in your kids' name if you have any hope of getting college aid. The small tax advantages of putting money in a custodial account (often called an UTMA, for Uniform Transfer to Minors Act) are far outweighed by the hit you'll take at the aid window. If your student has such an account, start spending it on camps, private-school tuition—even a car for your teen—and keep new savings in your name.

What if your child is just too rich? You can shelter assets by investing them in variable annuities or life insurance (preferably a variable universal life policy, which offers more control over how the funds are invested). Those accounts aren't assessed for aid, and your student can cash annuities (with a penalty) or borrow against a life policy to pay tuition. But get professional advice—ideally from someone other than the agent who's selling the policy—before you take this course.

The biggest way to boost your aid is to reduce your income—or at least avoid increasing it—during the years when aid is calculated. Every extra $100 you earn costs $47 dollars in aid. For a student, $100 in earnings reduces aid by $50.

THE TRAP. Remember the stock portfolio you've built up to pay for tuition? When you sell those shares, the capital gains count as income—and cut into your aid. And the impact starts early: Your child's freshman aid award is based on income you earn after Jan. 1 of his junior year in high school, before he visits any campuses. The worst situation is what Miller calls "the UTMA trap": If a high school senior, say, sells stocks from a UTMA account for a $100 gain, her aid will be reduced $35 for the value of the asset and $50 for the income—an 85% financial-aid tax.

To cash out your college account without killing your aid prospects, you'd like to take as many capital gains as possible by the fall of your child's junior year—and then avoid selling stocks for the next four years. But that might mean taking money out of the market, and giving up on growth, sooner than you'd like.

Loans can be the answer. A home-equity loan, with tax-deductible interest, is a cheap source of financing. Uncle Sam also offers parents funds through PLUS need to take out a PLUS loan. When your child hits her last year of college—by the way, the average college stay now is five years—tap the college account to pay off the loans. If you've invested well, the gains should more than cover the loans' interest.

You knew saving for college would take discipline, sacrifice, and skill. Who thought you'd need a grad course in finance to spend the money? But the time you spend mastering the risks will pay off big—in your child's education and your own.

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