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College Planning and Funding Insights

It's the time of year when high school seniors file their college applications. Increasingly, many will choose to apply to college "early decision" in November and receive a decision by year-end, rather than learn their fate in the traditional spring timeframe. These "ED" decisions are binding; when students are accepted they must withdraw outstanding applications to other schools and enroll in the college that accepted them.

As reported by Nick Anderson in A College-Admissions Edge for the Wealthy: Early Decision, many of the nation's top colleges draw more than 40 percent of their incoming freshmen through early decision programs. And analysis of admissions patterns shows that students applying early decision are accepted at a higher rate than those in the regular admissions pool. At University of Pennsylvania, the admission rate for early applicants was 24 percent for the class that entered in 2015, compared to just 10 percent for regular decision.

Some will argue that it's a more qualified and confident candidate that gets an application submitted months in advance. I'll add that it is also a more financially prepared family because often the ED acceptance decision comes well in advance of the financial aid award. That is, as a parent, it would not be a wise decision to encourage your student to apply early decision if you needed to shop around for the best financial aid package.

How can a family best save for college? A 529 college savings plan offers triple tax advantages. Your money grows tax-free while inside the account, withdrawals for qualified higher education expenses are tax free, and in many cases you can get a state income tax deduction if you contribute to your own state's 529 plan. Other 529 benefits are that there are no income limitations on who can open a 529 plan and states set the maximum total contribution amounts, some as high as $400,000. For 2016, each parent can contribute up to $14,000 for each child without gift tax implications. For a married couple, that means up to $28,000 per year per child. And, in a special 529 provision, it's possible to make five years of contributions at once. (That's a great estate planning tool.)

If you find that you overfund a 529 account, or that the child you were saving for decides not to go to college, you can change the beneficiary of the 529 plan to another member of the first beneficiary's family. Generally, that is a sibling, but a parent could also put the 529 in their own name to support additional education. Of course, if you simply withdraw the money in the 529 account and don't use it to pay for college, the *earnings* in the account will be taxed and assessed a 10 percent penalty.

Importantly, if you are hoping for some federal financial aid, assets in 529 accounts owned by a dependent student or one of their parents are considered parental assets on the Free Application for Federal Student Aid (FAFSA). When a school calculates the student's Expected Family Contribution (EFC), a maximum of 5.64 percent of parental assets are counted. Students, on the other hand, are expected to contribute 20 percent of their assets to the EFC. And the higher the EFC, the lower amount of federal financial aid you can expect.

Perhaps even more importantly, 529 plan distributions receive favorable treatment. Qualified distributions from a student-owned or parent-owned 529 account to pay for this year's college expenses are not included in the "base-year income" that reduces next year's financial aid eligibility. One caveat to watch for is that if a grandparent owns a 529 with your student listed as the beneficiary, withdrawals to pay for college expenses will be counted as student *income* on the following year's FAFSA. Student income is assessed at 50 percent, which means if a grandparent pays $10,000 toward college costs it would reduce the student's eligibility for aid next year by $5,000.For that reason, many families use the grandparents' account to fund senior year, when the FAFSA will not have to be completed the following year.

Some will argue that the Roth IRA can also be effective way to save for college. Remember, older parents, Roth IRA withdrawals are 100 percent tax-free once you reach age 59.5. However, you can also withdraw what you've contributed to the Roth without taxes or penalties at any time and for any reason. For example, if you've contributed $60,000 to your Roth IRA and it's grown to $80,000, you can withdraw up to $60,000 whenever you like without tax consequences. Also, you can withdraw the earnings penalty-free (but not tax-free) if the money is used for college expenses for you, your spouse, your children, or your grandchildren.

Note that while savings inside a Roth IRA or other retirement savings vehicles do not count against you in the EFC calculation, withdrawals from a Roth IRA are counted as income. And those withdrawals can have a negative impact on financial aid. Also, while Roths obviously offer a wider array of investment options and investment costs can be lower, the contribution limits are low. You can contribute up to $5,500 per year to a Roth IRA. And, if you are over age 50, you can contribute an additional $1,000 per year as a "catch-up contribution." Also, keep in mind that not everybody can open a Roth. Roth contributions are reduced or "phased out" as your modified adjusted gross income (MAGI) approaches the upper limits of the applicable phase-out ranges. For a married couple filing jointly, the MAGI range for reductions and phase-outs is $184,000 to $194,000. Bottom line: In many cases the 529 will be the most effective college savings vehicle. Of course, we are always happy to discuss your personal situation.

Finally, there are two changes to the FAFSA process this year. The 2017—18 FAFSA can be filed as early as October 1, 2016, rather than January 1, 2017. The earlier submission date is a permanent change. Of course, that means you use earlier income and tax information. For the FAFSA for the upcoming 2017—18 school year, you'll be required to report income and tax information from the 2015 tax year, not 2016. If your income changed significantly since the 2015 tax year, you must complete the FAFSA with the 2015 information it requires, then contact the financial aid office at your school to explain your situation. The school has the ability to make any necessary adjustments to your FAFSA. Help is available at StudentAid.gov/fafsa/filling-out and as you fill out your FAFSA at fafsa.gov, you can chat online with a customer service representative.

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