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Save for college prudently, and aid may save you later on

Eileen Ambrose -- Personal Finance

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NOT EVERY dollar saved for college is created equal.

Salting away money in a 529 college savings plan or tapping a child's custodial account to foot a tuition bill will have a different impact on how much need-based financial aid a student receives.

Need-based aid, made up of grants, subsidized loans and work study, is determined by a complicated formula that weighs the assets and income of students and parents. Low-income families will likely qualify for the maximum amount of need-based aid, experts said. The rich won't.

But there are plenty of families in between that might be eligible for some financial assistance. And these families need to figure the best way to save for college that will have the least impact on aid.

Just how different investment accounts can affect aid for these families is shown by a recent study by Susan Dynarski, an assistant professor of public policy at Harvard University.

Among families with incomes of $50,000 and $100,000, Dynarski found:

- For every $1 in a 529 college savings account or a Coverdell Education Savings Account at the time a child enters college, the family can lose a total of 15 cents of aid over four years.

• Aid would be reduced by 41 cents (for those with $100,000 income) and 44 cents (for $50,000 incomes) per dollar held in a non-tax-sheltered account in the parent's name.

• The biggest reduction comes with a custodial account that belongs to the child. Under aid formulas, students are expected to contribute a larger percentage of their assets and income for college than parents. So, each dollar in a custodial account would reduce aid by $1.24.

"You don't want to put anything in the kid's name, given the way the rules are written," Dynarski said.

Some parents might be wondering why the should bother to save if it will mean less financial aid.

"The point is not that saving is bad; the point is that you have to save carefully," Dynarski said.

Saving gives families more options in a world of rapidly escalating college tuition. Tuition, fees, room and board at a 4-year public school this year average $10,636, a 9.8 percent jump over last year, the College Board reports. For a private college, those costs average $26,854, or 5.7 percent more than a year ago.

Having money set aside could allow children to go to the school they want, rather than the one they can afford if aid falls short, experts said. It can mean a student won't have to juggle work and school at the same time.

And more savings could reduce the amount of debt at graduation. The average undergraduate debt in 2002 was $18,900, a 66 percent increase from five years ago, according to Nellie Mae, a student loan provider.

To apply for aid from the federal government, families fill out the Free Application for Federal Student Aid, also known as FAFSA. The formula includes income and assets, but excludes items such as retirement accounts and home equity.

Schools also give out money based on need. Some colleges use the federal formula, others develop their own.

Families can get an idea of what aid they might qualify for by trying an online aid calculator, such as one at www.finaid.org, said Ellen Frishberg, director of student financial services for the Johns Hopkins University in Baltimore.

"Parents' expectations are way out of line with how much [college] costs and how much aid they can receive," said Frishberg, adding that some overestimate costs and aid, while others underestimate.

"It's all over the board," she said. "There's a lot of confusion."

A lot of factors influence aid, but even families with a $100,000 income or more may qualify for some need-based aid, especially if a student attends a pricey school or the family has more than one child in college at the same time, experts said.

Dynarski's study is based on current tax laws and financial aid regulations, which are bound to change by the time today's youngsters are ready for college. That can make planning a moving target. For example, custodial accounts were once recommended, but are now in disfavor.

Based on how things stand now, Dynarski said, one of the better ways for parents to save is through a state-sponsored 529 college savings plan, which is considered the parents' asset under the financial aid formula. Invested money grows tax-deferred and the earnings won't be taxed later if the cash is used for college. Tax-free withdrawals are set to disappear in 2011, unless Congress makes changes.

Parents should first check out their home state plan to see if it offers residents any tax breaks on contributions, Dynarski said. If there aren't any tax perks, shop other states' plans, she said.

Check out fees, which widely differ from plan to plan and can have a significant impact on returns, she said.

Another option is the Coverdell account, which allows those within certain income limits to contribute up to $2,000 a year in a tax-deferred account, Dynarski said.

Withdrawals won't be taxed if used for qualified education expenses from kindergarten through college. Tax-free withdrawals don't expire with a Coverdell. Until recently, Coverdells were always considered a child's asset under aid formulas, said Kalman A. Chany, author of Paying for College Without Going Broke. Now, if the account is owned by parents, it will be considered their asset, which is a more favorable treatment for aid, he said.

But when opening a Coverdell, check how it's set up by the investment firm, Chany advised. In some cases, the account could revert to ownership by the child once he or she reaches, say, 18 or 21, which can reduce aid, Chany said.

If money from a college savings plan and Coverdell is used for something other than education, withdrawals will be subject to taxes and penalties.

If there's uncertainty over whether a child is college material, parents have other savings options.

One is for parents to pay down their mortgage, and if a child goes to college, they can tap the equity in their home through a line of credit after filling out the financial aid forms, Dynarski said. Of course, this option would be attractive only if parents can handle the loan repayment, she said.

Parents might also be tempted to take money out of retirement accounts for tuition. Besides the potential tax consequences of such a move, some financial experts advise against raiding retirement funds that may be hard to replace later.

"Save for retirement and borrow if you have to pay for college," Chany said. "If retirement is taken care of, there's less pressure if you have to borrow."

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