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Financial Planning Perspectives

Tackling the tuition bill: Managing higher education expenses

As parents prepare to send their children off to college, distinct financial challenges may arise. Although many families take advantage of 529 plans and other education-specific savings accounts, most will finance college using a variety of sources and account types. It's important for parents and students to understand how their spending decisions will affect their broader financial situation and to plan strategically. Those spending decisions will have implications for financial aid eligibility in future years, for tax costs, and for the ability to meet other financial goals, particularly retirement.

Three actions to take when considering college spending options:

■ Evaluate factors for financial aid eligibility.

When seeking financial aid, parental and student income and assets can significantly influence eligibility. Identify the income sources and assets that most affect eligibility and create a spending strategy that maximizes the student's chances of obtaining aid. Spending student assets early and delaying spending that will count as income can boost the amount of aid a student may be eligible for in later years.

■ Use tax benefits to offset college costs.

Various tax credits and deductions are available for most families as they pay higher education expenses. Understand what tax benefits are available and create a spending plan that takes full advantage of them. This can substantially lower the after-tax cost of college. Be aware, too, of tax implications when tapping various account types. Spending from tax-deferred accounts can increase taxable income, and spending from taxable accounts can mean realizing gains or losses.

■ Spend strategically from 529 savings.

Plan to spend flexibly from 529 savings throughout a student's college years to ensure that the benefits these accounts provide are maximized. Understand which expenses qualify for tax-free 529 spending, and plan to deplete the account over the student's college career if the assets can't be used by another eligible beneficiary. Smart spending from 529 accounts can also help take the most advantage of tax benefits and aid opportunities.

Spending decisions can make a difference to a student's future aid eligibility.

Understand the factors that affect financial aid

A college education is one of the most expensive investments most families will make. Fortunately, significant financial aid packages are often available. Aid can come in various forms, with some types more valuable than others. Grants and scholarships, for example, do not have to be repaid. Student loans or work-study programs can be helpful but are obviously less attractive than outright grants.

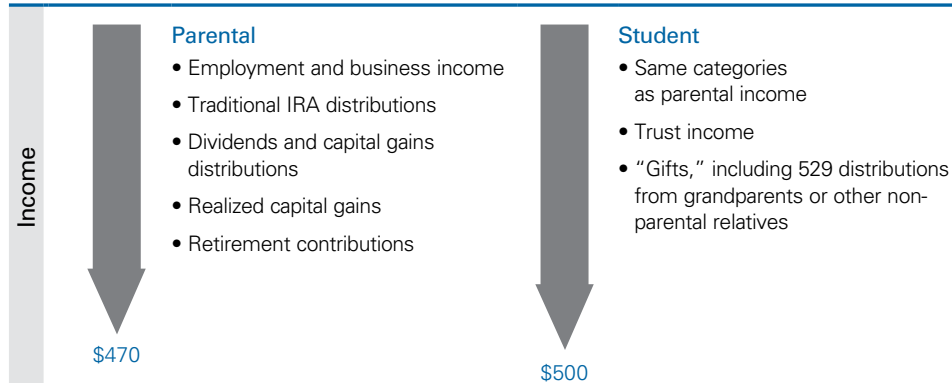
According to Sallie Mae, the vast majority of college students report receiving some type of financial aid, and 70% receive it in grants or scholarships.¹ The College Board estimates that for the 2014–2015 school year, the average full-time undergraduate student received \$14,210 in financial aid, 66% of it in grants, scholarships, or tax benefits.²

Because financial aid can be such a key component of college financing, it's important that families understand how their savings and spending decisions can affect the availability and amount of aid. There are two main financial aid applications: the Free Application for Federal Student Aid (FAFSA) and the CSS/Financial Aid PROFILE®, which is administered by the College Board and required by some institutions and scholarship programs. Each application uses a formula to evaluate a student's and parents' financial situation to determine the expected family contribution for each year of higher education.

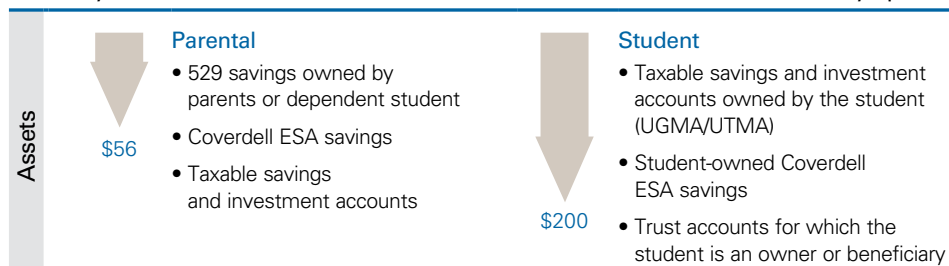
Although some classifications of income and assets are straightforward, others are not. For example, distributions from a grandparent-owned 529 are considered student income, while 529 savings owned by a dependent student are considered parental assets. **Figure 1** shows the potential impact of student and parent income and assets on financial aid eligibility.

Figure 1: When it comes to financial aid, income counts more than assets

For every additional \$1,000 of income, need-based financial aid could be reduced by up to:



For every additional \$1,000 of assets, need-based financial aid could be reduced by up to:



Notes: Asset and income categories and how they affect aid eligibility are based on FAFSA methodology. CSS/Financial Aid PROFILE institutional methodology takes additional asset categories into account and assesses student assets at 25%. Coverdell ESA refers to Coverdell Education Savings Accounts, UGMA savings refer to Uniform Gifts to Minors Act accounts, and UTMA savings refer to Uniform Transfers to Minors Act accounts.

Sources: Vanguard calculations, based on information from the U.S. Department of Education and the College Board.

¹ Sallie Mae, *How America Pays for College 2016*, available at http://news.salliemae.com/files/doc_library/file/HowAmericaPaysforCollege2016FNL.pdf.

² College Board, *Trends in Student Aid 2015*, available at <http://trends.collegeboard.org/sites/default/files/trends-student-aid-web-final-508-2.pdf>.

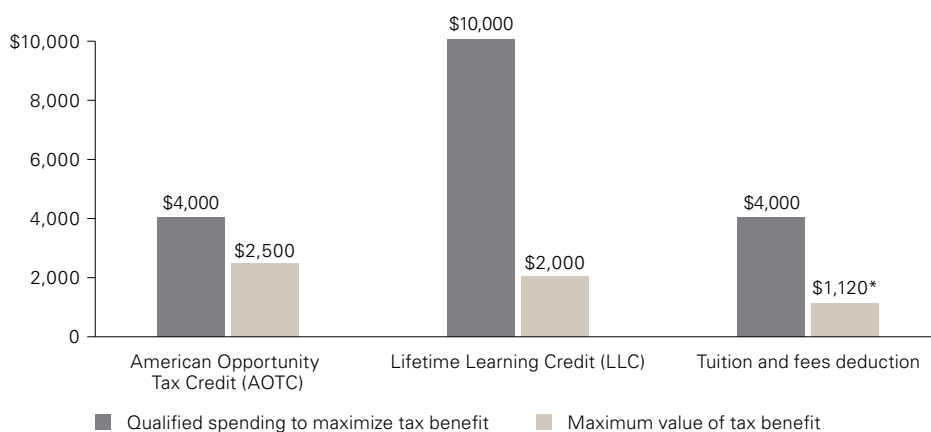
Explore tax incentives—and be mindful of tax-sensitive withdrawals

It might seem ideal to accumulate 529 assets that fully cover the costs of a student's education, but for most families, this won't be realistic. The upside of this likely deficit is the potential for more tax savings. Because 529 assets already receive favorable tax treatment, spending from these accounts will not qualify for potentially valuable deductions or credits. At the federal level, taxpayers can use only one education credit or deduction per student in a given tax year. Generally, for those who qualify, the American Opportunity Tax Credit (AOTC) is the most beneficial, providing a credit of up to \$2,500 on \$4,000 of qualified spending. Otherwise, depending on the situation, the Lifetime Learning Credit (LLC) or the tuition and fees deduction may apply. **Figure 2** shows the potential benefits of each credit or deduction and the spending needed to qualify.

Tax credits and deductions for educational spending generally target lower- and middle-income taxpayers. The 2016 limits on modified adjustable gross income to take advantage of the AOTC, for example, are \$90,000 for single filers and \$180,000 for married taxpayers filing jointly. For higher earners, the tax impacts of spending from various account types will be more important. Spending from tax-deferred retirement accounts is taxed at ordinary income rates, and gains realized from taxable investment accounts are subject to capital gains rates.

Keep sight of the tax savings—and tax consequences—when weighing spending options for college costs.

Figure 2: Tax incentives can reduce college costs for some



*Assumes 28% marginal tax bracket.

Sources: Vanguard calculations, based on data from the Internal Revenue Service.

Care should be taken when selling assets from taxable accounts. If there are positions that can be sold at a loss, the realized loss can offset gains elsewhere or can partly offset taxable income. Realized gains, beyond being subject to taxes, can also affect financial aid eligibility, because the sales of these investments will not only reduce assets (a positive factor for aid eligibility) but also increase income (a negative factor for aid eligibility). **Figure 3** explains the tax and financial aid implications of spending from various sources.

Figure 3: It matters which account type is tapped

	Account type	Impact on future financial aid	Tax implications	Eligible for tax credits or deductions	Additional considerations
Educational savings accounts	Parent- or student-owned 529	▲	—	—	Withdrawals must be used to pay for qualified educational expenses to avoid taxes and penalties
	Parent- or student-owned ESA	▲	—	—	
	Grandparent-owned 529	▼	—	—	
Retirement savings accounts	Parent-owned tax-deferred account (traditional IRA, 401(k) plan)	▼	Distributions are taxed as income	●	—
	Student-owned tax-deferred account	▼	Distributions are taxed as income	●	—
	Parent-owned Roth IRA	◀▶	None for contributions	●	Earnings are taxable as income if younger than 59½
	Student-owned Roth IRA	◀▶	None for contributions	—	Earnings are taxable as income if younger than 59½
Taxable savings accounts	Parent-owned investment accounts	▲* ▼	Taxes on capital gains; deductible losses	●	—
	Student-owned investment accounts (UGMA/UTMA)	▲† ▼	Taxes on capital gains; deductible losses	●	—
	Checking/savings/money market accounts	▲	—	●	—
Other sources	Current income	◀▶	—	●	—
	Spending from home equity	◀▶	—	●	Borrowing costs (interest may be deductible)
	401(k) borrowing	◀▶	—	●	Borrowing costs and impact on retirement savings goal
	Educational borrowing	◀▶	—	●	Borrowing costs (interest may be deductible)

▲ Positive impact ◀▶ Neutral impact ▼ Negative impact ● Eligible

Notes: The “parent- or student-owned 529” account type assumes the student is claimed as a dependent for tax purposes, in which case the account holdings are treated as parental assets for financial aid purposes. Holdings in a student-owned 529 account for a student who is considered independent for tax purposes are treated as student assets for financial aid purposes. Educational borrowing encompasses private and federally subsidized loans.

* Positive impact if the embedded gain is less than 11.91%.

† Positive impact if the embedded gain is less than 40%.

Sources: IRS Publication 970 and Vanguard.

Craft a plan for college spending

Once the costs of education for the coming year are known, it's important to make a plan that will meet the liability as efficiently as possible. The following framework for creating a college spending plan takes into account financial aid impacts and tax efficiency. The case study on pages 6–7 shows how a typical family may benefit from such a plan.

- **Take inventory.** Take stock of savings that are available for college spending. These may include education-specific accounts, such as 529s, or savings in other account types. Include expected contributions from grandparents and other relatives. Estimate what you can afford to spend from current income each year and to what extent loans will be used to finance college costs. Understand which expenses qualify to offset 529 withdrawals and which can be applied toward tax credits.
- **Financial aid: Do no harm.** It's important to understand how the timing of certain spending can affect financial aid in subsequent years. Beginning with the 2017–2018 school year, applicants will use two years' prior tax return information when filling out the FAFSA.³ Aid status can be maintained—and possibly improved—by spending from sources such as student assets in the early years of college, and by delaying spending that would count as student income (such as from grandparent-owned 529s) until the last two years of school, when it will no longer count against the student from an aid standpoint. Even if there is no expectation of need-based aid, the FAFSA should be submitted each year to maintain eligibility for federally subsidized student loans.
- **Evaluate available tax credits or deductions.** Tax benefits can offset a significant portion of out-of-pocket education spending. Determine which benefit is the most advantageous, and plan to spend from current income or taxable savings to the extent that the spending will qualify for the targeted benefit.
- **Spend flexibly from 529s.** Because 529 accounts are set up explicitly for college savings, it's logical to tap them first when paying tuition and other qualifying expenses. Although that may make sense for some, it's useful to consider 529 accounts as just one asset in the larger context of college funding. Spreading out spending from 529s will allow for continued tax-deferred growth and will relieve pressure on other sources, such as loans or out-of-pocket spending, that may be required in a given year. Continued contributions to 529s throughout a student's college years may be beneficial as well, especially in states that offer tax savings for these contributions. Plan to deplete 529 assets over a student's school years, or transfer assets to another beneficiary to avoid taxes and penalties on earnings. Although 529s may be used to pay for graduate studies, keep in mind that assets in 529 accounts cannot be used to pay down student loans.
- **Fill in the gaps.** After spending to qualify for targeted tax benefits and spending as planned from 529 accounts, a family may need additional funds. When spending from other accounts, be mindful of associated taxes. Determine as early as possible what loans will be needed, and take advantage of federally subsidized loans if available. Avoid spending from accounts dedicated to retirement goals.

Create a plan to cover each year's college costs as efficiently as possible.

Conclusion

Although the challenges of meeting college expenses can be daunting, proper planning—and, perhaps for some, consulting with a financial planner—can ease this often financially stressful period. Spending with an eye toward financial aid eligibility while targeting available tax benefits can result in substantial savings over a student's college years.

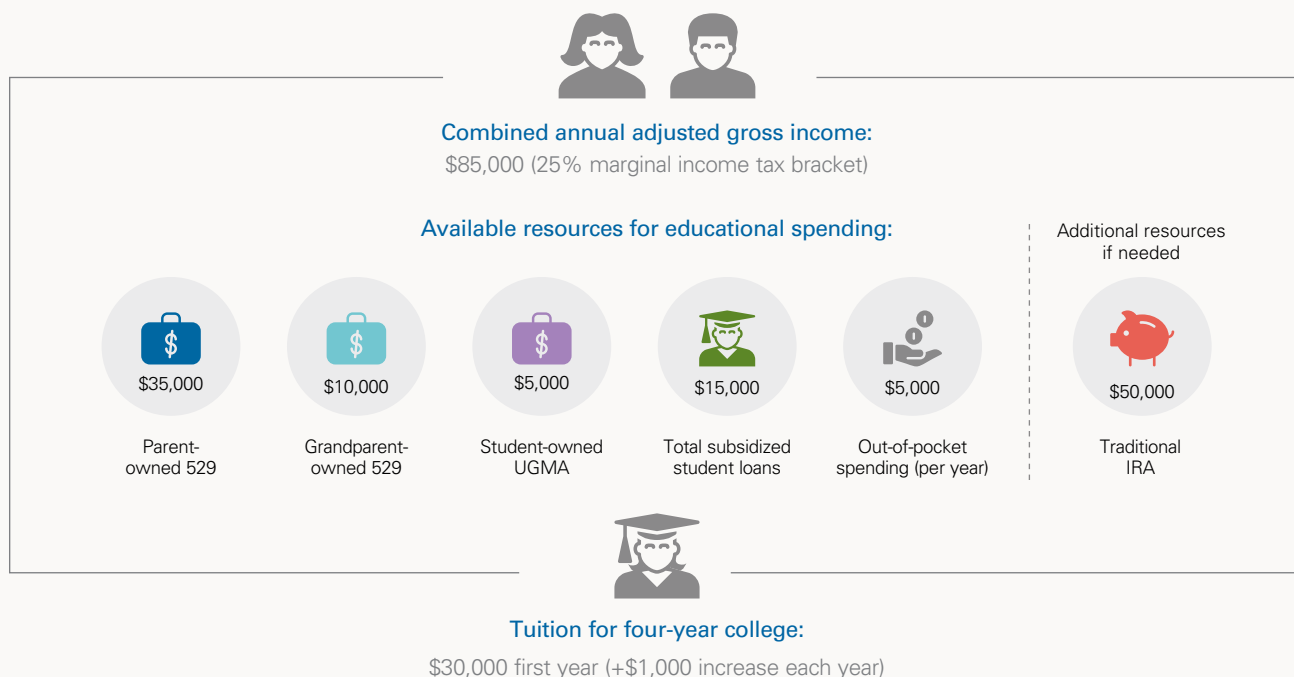
The role of traditional college savings accounts, such as 529s, should be considered in the broader context of a family's financial situation. A smart, holistic plan can maximize the benefits unique to these accounts and ensure that these assets are deployed in a way that meets college spending needs as efficiently as possible.

³ For example, applicants in early 2017 could use tax return information from 2015.

Putting it all together: A case study

To illustrate the impact of a well-ordered college spending plan, let's look at the options available to a hypothetical family. The scenarios detailed below show that a family's spending decisions can both increase expected financial aid and decrease tax bills by several thousand dollars.

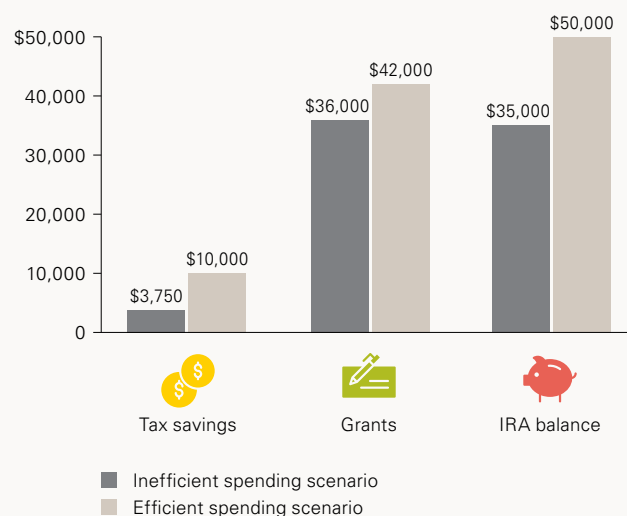
Michelle and Chris have a daughter who will start at a four-year college in the fall. They plan on filling out the FAFSA each year to maintain loan eligibility and to take advantage of grant aid that may be available. Here is their financial picture:



This study details two possibilities for their spending down of assets to meet college costs. The first scenario prioritizes delaying out-of-pocket spending as long as possible and ignores the potential tax and financial aid impacts such spending may have. The second scenario follows the efficient spending strategy laid out in the previous section.

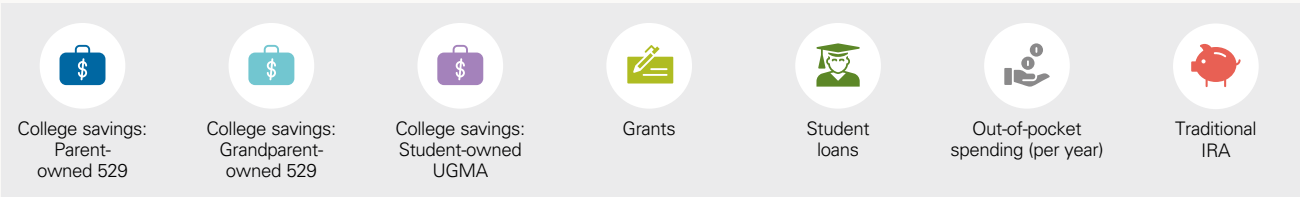
Figure 4 details the benefits that Michelle and Chris can expect from a thoughtful college spending strategy. Although they spend more out of pocket over the four years, they stay within budget and take full advantage of available tax credits. This allows them to avoid spending from the traditional IRA, saving \$6,250 in potential taxes. Spending early from the student-owned UGMA and delaying spending from the grandparent-owned 529 results in an estimated \$6,000 more in total grant aid. Thanks to these spending considerations, Chris and Michelle's retirement savings are \$15,000 greater, and the total effect on their net worth is an additional \$11,750 relative to the alternate scenario. **Figure 5** displays year-by-year spending decisions for each of the hypothetical scenarios.

Figure 4: Smart spending can reduce the effective cost of college

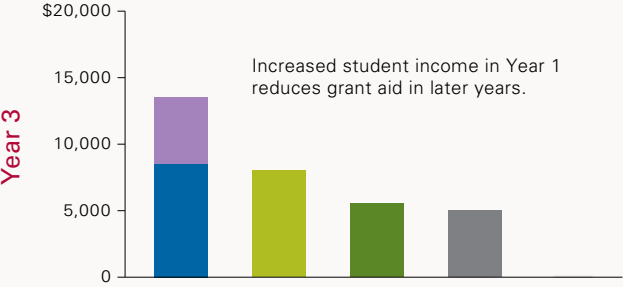
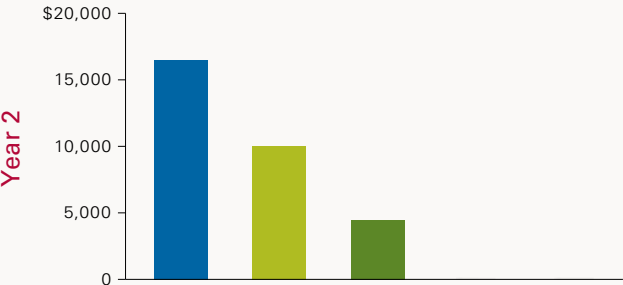
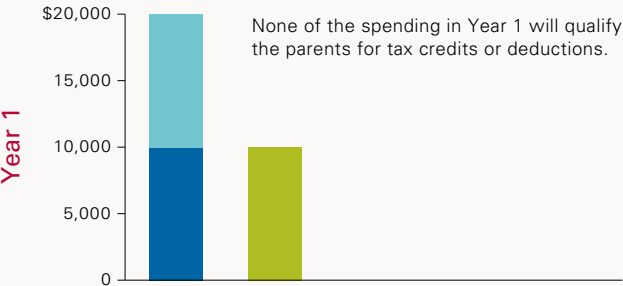


Source: Vanguard.

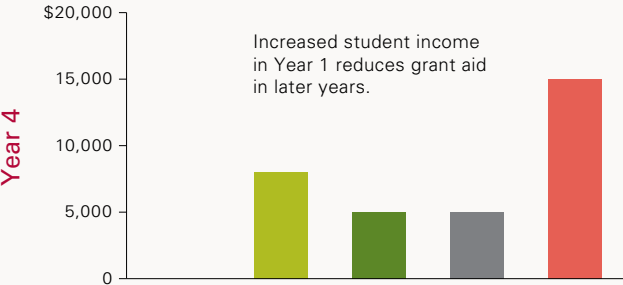
Figure 5: A comprehensive college spending plan can help keep retirement savings intact



Scenario 1: Inefficient spending strategy

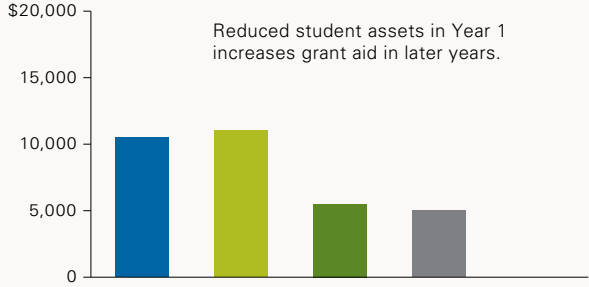
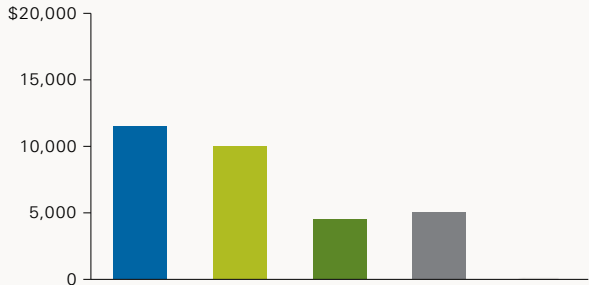
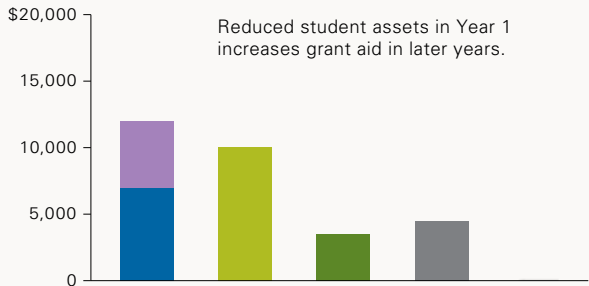


Inadequate planning leads to a heavy reliance on retirement assets in Year 4.

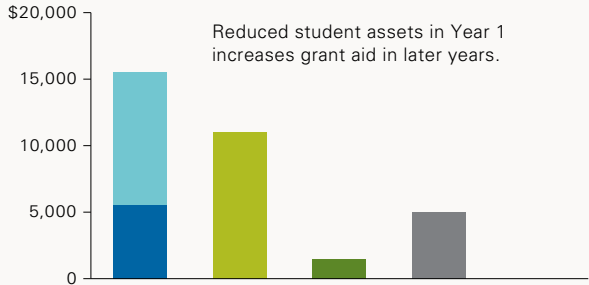


Source: Vanguard.

Scenario 2: Efficient spending strategy



Spending from the grandparent-owned 529 is delayed to Year 4, when it won't reduce financial aid.



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