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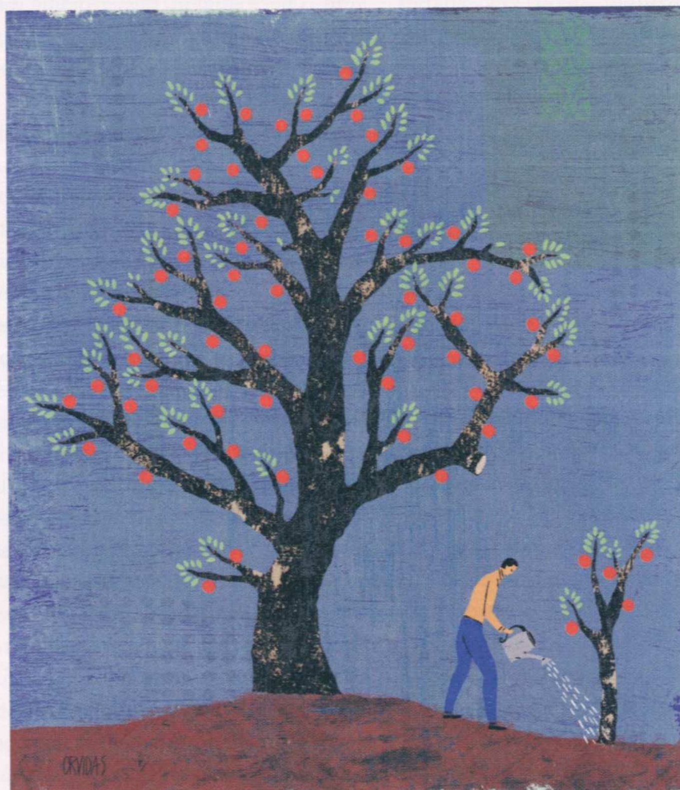
PATRICK ROONEY,
DIRECTOR OF RESEARCH AT INDIANA UNIVERSITY'S CENTER ON PHILANTHROPY

TUITION MAGICIANS

When financial-aid prospects are dim, some parents find smart ways to boost their children's college funds. BY MARIE LEONE



FOR MANY PARENTS, anxiety about paying for their children's college educations sets in at about the same time the "+" sign on the pregnancy test comes into view. The cost of college has outpaced the rate of inflation for years, and many experts expect that trend to continue. And while a higher percentage of students today do receive various forms of financial aid, when household income exceeds $80,000, the odds of receiving need-based aid begin to fall dramatically.

There is a big difference, of course, between not qualifying for aid and being comfortably able to write a check for $26,000 (the average cost of a year at a private college in 2005). But there are a number of strategies that families can employ so that Mom and Dad don't have to hitchhike to Parents Weekend.

Rick Jarvis, for example, plans to foot the bill with other people's money. Jarvis does have an advantage: his strategy is built around real estate, and he is a realtor. But his approach could be modeled by almost anyone. Jarvis owns a modest portfolio of residential and commercial buildings in and around Glen Allen, Virginia, and has designated two single-family homes as "College Education I and College Education II." He says the two homes, which are currently worth about $175,000 and $250,000, respectively, are a better place to stash cash for college for his grade-school-aged kids than, say, government-sponsored 529 plans, mutual funds, or savings bonds.

Four years ago, he used 100 percent bank debt to purchase two rental properties, with the assumption that the value of the homes would increase in step with the cost of a college education. Jarvis says that by the time his children, ages eight and six, are ready for college, the debt will be minimal (thanks to the steady stream of rental income) and he will either refinance

Ken Orvidas

By putting Junior on the payroll and using his income to fund a Roth IRA, parents benefit in two ways: the business receives a payroll-expense deduction and college funds grow tax free.

to free up cash or use what is known as a tax-deferred Internal Revenue Code Section 1031 exchange.

The 1031 exchange allows property owners to enter into a tax-deferred exchange of like kind and reinvest the proceeds without incurring current income tax such as the capital-gains tax. For example, a parent making a 1031 exchange could use the deferred gains reaped as a big down payment on a larger rental property, which would boost cash flow via higher rental income just in time to pay for college.

Another option is to use the 1031 exchange to buy a house or condo for your college student, thus avoiding room and board costs and creating some flexibility. For example, by renting the property to their child, parents can write off ordinary expenses associated with a rental property, such as visiting the site, repairs, and management fees. To make sure the business deductions are legitimate, the student would have to pay rent at fair-market prices. But the Internal Revenue Service allows a parent or any other individual to dole out a tax-free gift of up to $12,000 ($24,000 for couples) annually. Such a gift to a student could then be used to pay the landlord.

"The tax benefits shouldn't wag the dog," when it comes to real estate investments, says Ryan Losi, a tax accountant, CPA, and director at Piascik & Associates who advises Jarvis. Losi, who is also a realtor, contends that buying and selling real estate has to make economic sense before the college-funding strategy pays off. Still, he points out that owning rental properties also gives parents the opportunity to use built-up equity to secure a low-cost line of credit, which in turn can be used to pay for college. The line of credit may have a lower interest rate than an unsecured loan, and like most student loans, many revolving credit lines allow repayment to be stretched out over 10 years.

For parents who own a business, Losi suggests the unorthodox move of opening up Roth IRAs for the kids as a way to save for college. The money in the individual retirement account grows tax-free, and a large portion of it can be distributed without penalty to pay for qualified education expenses. Since IRAs are available only to workers who have "earned income," parents would need to determine a business reason (that is, accounting, administrative, marketing, or the like) to hire their children and provide them with a paycheck. By putting Junior on the payroll and using his income to fund a Roth, parents benefit in two ways: the business receives a payroll-expense deduction and college funds grow tax free (see "Pay the Kids, They're Worth It," facing page).

PUMPING UP 529s

For parents who prefer a simpler approach, state-sponsored 529 plans offer

Tuition Without Taxation

If you've got an Auntie Mame who has the wherewithal to pay for a child's college education, let her know she can do it tax-free if she pays the school directly. **The Internal Revenue Service allows any relative to give the gift of tuition without subjecting the benefactor to any transfer taxes (currently as high as 46 percent).** While the IRS limits tax-free gifts to $12,000 annually, gifts of tuition are limitless when prepaid directly to a qualified educational institution—and they don't count toward the annual gifting total. Room and board, books, fees, computers, and other college expenses, however, are not covered under the tax-free status of the rule.

The direct contribution also gives the grantor more breathing room for estate planning, says Ralph Wileczek of Wilmington Trust, since the value of tuition gifts can be omitted from their taxable asset base. Even better, the gifting can all be done without the help of an attorney or complicated paperwork. (There are no tax-reporting requirements for this type of gift.) To let the government know they have made such a gift, grantors need only note it on their annual tax returns. —M.L.

BURSAR-ITIS

Average one-year costs of four-year colleges, 1976–2004*

YEAR	PUBLIC	PRIVATE
1976–77	$1,935	$3,997
1980–81	2,550	5,594
1984–85	3,682	8,451
1988–89	4,678	11,474
1992–93	6,020	15,009
1996–97	7,334	18,442
2000–01	8,653	21,856
2004–05	$11,441	$26,489

*Tuition, fees, and room and board, based on full-time attendance. Source: U.S. Department of Education, National Center for Education Statistics, Higher Education General Information Survey

AID IN AMERICA

Average aid per full-time equivalent (FTE) student in constant (2005) dollars, five-year intervals, 1985–86 to 2005–06 (in $ millions)

YEAR	AVERAGE AID PER FTE
1985-86	$4,108
1990-91	4,669
1995-96	6,700
2000-01	8,159
2005-06	$10,113

Source: The College Board

some notable advantages, especially if you're aware of some of the fine print that affects how they operate. These plans, which were created in the 1980s and became popular in the 1990s after a key court case assured their tax advantages, allow parents and other relatives to invest aftertax money in a managed fund without incurring taxes on the earnings. The fund can be used to pay for qualified college expenses, including tuition, books, room and board, computers, and school fees. In some cases, state residents receive tax deductions if they open a 529 that is sponsored by their home state; in a few states, 529s are protected from bankruptcy creditors. Anyone can contribute to the accounts, and the funds can be transferred to other family members at any time.

You can pump up 529s if you have extra cash. That is, family members can front-load 529s to get more bang for their compounded buck, says Susan Black, director of financial planning at eMoney Advisor. The government allows an individual to stuff 529 plans with $60,000 in one year (couples can invest $120,000) without paying gift taxes. The catch: the one-time boost uses up five years' worth of gift-tax exclusions. Still, if you have the cash, the power of compounding makes the move worthwhile. Assuming an 8 percent return for 18 years, a 529 front-loaded with $60,000 has an approximate future value of $239,700. If you were to invest the same $60,000 at $3,333 per year for 18 years, the fund would amount to only $124,800.

Another 529 technique that works well in conjunction with estate planning is to have a trust "own" the 529 plan. The advantage is that if the trust owner dies or is disabled, the administration of the plan can continue without interruption. Regardless of ownership, 529 plans allow individuals to pull $60,000 ($120,000 if gift-splitting is used with a spouse) from their estates. If, however, the individual passes away within five years of the gift, a prorated amount is pulled back into his or her estate. The financial-aid advantages of using a trust are generally the same as if a parent or grandparent owned the 529 plan. In general, says Michael Kozak, director of wealth management for Salem, Massachusetts-based Cabot Money Management, schools expect parents to contribute less of their net worth to their children's education than the children themselves.

Establishing an education trust typically costs $8,000 to $10,000, plus annual fees, but the advantages are notable. For example, assets held by the trust may be taxed at the 15 percent capital-gains tax and there are no real funding limits on a trust. Also, careful drafting and funding may avoid gift and estate taxes. Trusts can also be set up to protect the funds from creditors and divorce settlements. The beauty of trusts, says Ralph Wileczek, senior private client adviser for Wilmington Trust, is that "with a properly drafted trust, the grantor (the person funding the trust) avoids gift taxes or pays a very nominal tax and doesn't have to pay any additional transfer taxes, ever." CFO

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>
> MICHAEL KOZAK, CABOT MONEY MANAGEMENT

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>> For an expanded version of this story, see www.cfo.com yourmoney

FOR OWNERS OF FAMILY BUSINESSES, NEPOTISM CAN BOOST THE COLLEGE FUND

Pay the Kids, They're Worth It

Hiring your kids to work in the family business can do more than build their characters: it can really boost their college funds as well. Consider a scenario in which a mother who owns a small graphic-design studio pays her 11-year-old son $4,000 a year to file and clean up the office. The business's income is reduced by $4,000 for the payroll outlay, which means the business pays $1,400 less in federal income tax ($4,000 x 35 percent federal income tax rate). The son receives his pay as tax-free income based on current limits and restrictions.

For seven years Mom deposits the son's paychecks into a Roth IRA in his name. If the investment grows tax-free at 6.25 percent a year, the IRA will be worth about $34,000. Her son could then begin distributing the funds to pay for qualified education expenses without having to include the distributions as taxable income or incurring an early-withdrawal penalty. The mother can parcel out funds yearly, allowing the balance to grow. She can also keep her son on the payroll to continue funding the Roth IRA. Over 10 years, the mother will have contributed $40,000 to her son's education, while earning $40,000 of income-tax deductions for her business and about $10,000 of tax-free investment income.

At graduation, the son would be left with around $10,000 in the IRA. In most circumstances, the son would be penalized if he invaded that remaining balance before he turned 59½. But not if he uses the funds to buy his first house, because another key Internal Revenue Service exception applies to first-time homebuyers. So that Roth IRA does double-duty as a college fund and a first-house fund. If that doesn't earn the parents a sweet Silver Anniversary present, then let's hope they have the good sense to cut Junior out of the will. —M.L.