An Urban Institute Project Exploring Upward Mobility

Opportunity and Ownership Facts

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The Effect of Alternative Savings Approaches on College Aid

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To pay for college, many low- and moderate-income students and their families rely on financial aid and savings. But how students and families save—and in whose name—affects both the tax consequences and the impact of savings on financial aid. Choosing the wrong way to save can raise the out-of-pocket costs of college by thousands of dollars. Alternately, saving for college can result in tax penalties if families do not use tax-preferred savings for education.

Students and their families may use various tax-favored plans to save for college. Most popular is the 529 plan, open to everyone regardless of income.[1] Investments in such plans grow tax free and incur no tax if used to pay for college—a benefit that typically favors higher-income families that face higher tax rates.[2] In contrast, returns on ordinary investment accounts face annual taxation, leaving less principal investment for future growth. Because children pay no tax on the first $900 in unearned income (interest, dividends, capital gains) and typically face lower tax rates than their parents, accounts in children's names grow faster. For example, if a family invests $2,000 each year in a child's account until the student turns 17, a tax-free 529 fund would grow to $65,520, a taxable account in the child's name to $63,600, and a taxable account in the parents' names to just $59,690.[3]

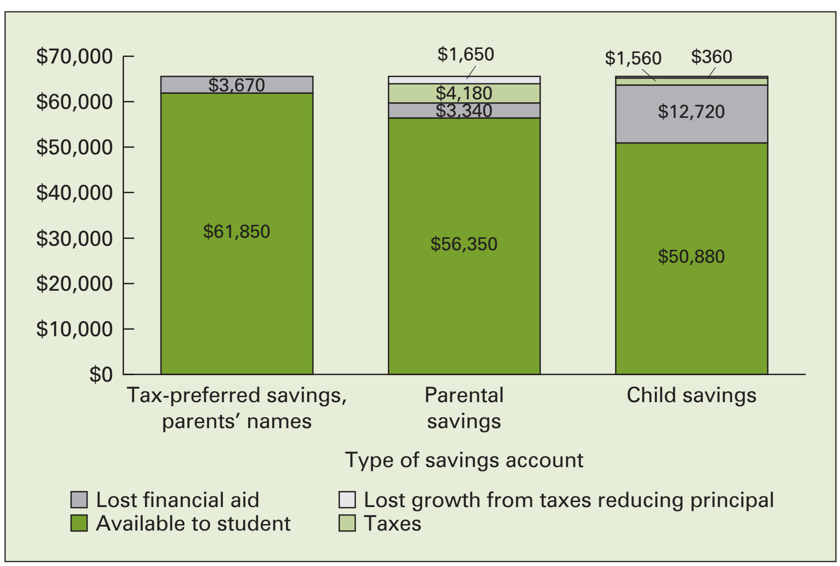
Another "tax" affects all three accounts: schools consider students' and their families' savings when determining financial aid. Schools typically assume that students should spend 20 percent of their savings each year but parents should use only 5.6 percent of theirs. Schools treat 529 plans as parental savings.

The expectation that students contribute more of their savings reverses the tax advantage of saving in the student's name: net of the reduction in financial aid, the student's regular investment account yields just $50,880, compared to $61,850 from the 529 plan and $56,350 from the parents' account. This means that if students draw down the account in equal annual increments for four years, net of the reduced financial aid, each year they could have $16,840 (529 plan), $13,920 (parent accounts), or $9,625 (student account). But tax-deferred accounts come with a warning: funds taken from a tax-preferred account to pay for noncollege expenses face tax on account earnings plus a 10 percent penalty.

Notes

1. Subject to income limits, eligible families may also invest in Coverdell Education Savings Accounts and Education Savings Bonds and reap similar tax benefits.
2. The value of not taxing a benefit is a person's marginal tax rate multiplied by the amount of income sheltered from taxation.
3. Calculations assume a 6 percent annual rate of return, that all interest remains in the account, that the parents' and student's marginal tax rates are 15 percent and 10 percent, respectively, and that financial aid is reduced by 5.6 percent of parental savings and 20 percent of student savings. Students are eligible for federal financial aid.

FIGURE 1. How Taxes and Financial Aid Formulas Affect College Savings



Sources: Author's calculations. See note 3 in text for calculation assumptions.

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