Why Most Doctors Shouldn’t Bother With Financial Aid Planning

I occasionally get an email or see a comment from a reader about how to properly plan for financial aid for their children’s college. Most high-income professional readers of this site shouldn’t bother, since their children aren’t going to qualify for need-based aid anyway, and what aid they will qualify for is mostly loans, which in my view aren’t real aid anyway since these folks generally have tons of opportunities to borrow on better terms already. That said, the financial aid system, including the Free Application for Federal Student Aid (FAFSA) and the CSS is pretty complex and it is possible you have some kind of unique situation where this matters to you. At any rate, I thought this would be a great opportunity to do a big long post about how the need-based financial aid system, particularly with regards to the FAFSA, works.

What Is The FAFSA Used For?

Most people going to college should fill out a FAFSA, even if there is little chance of the child of a high-income professional getting any meaningful need-based aid. It isn’t that hard and can be done online or with paper. The FAFSA is used by the federal government to determine your Expected Family Contribution (EFC), or the amount that you and your family “should” be able to pay toward your education. The gap between the Cost of Attendance (COA), which is determined by the school by adding tuition and fees to room and board, and the EFC is your financial need. That is the maximum amount of financial aid (grants and loans) you can get. The FAFSA must
be filled out if you wish to qualify for federal aid including

- Pell Grants (up to $5,185 per year for up to six years)
- Federal Supplemental Educational Opportunity Grants for undergrads only
- TEACH grants (for teachers only, but turns into a loan if service obligation isn’t met)
- Iraq and Afghanistan Service Grants (if your parent died serving in the Middle East while you were in college)
- Work-Study Program (a job for those who apparently can’t get one the regular way)
- Perkins Loans for undergrads and graduate students
- William D. Ford Federal Direct Loan Program (including subsidized Stafford loans for undergrads, unsubsidized Stafford loans for undergrads and grad students, and Direct PLUS loans for the parents of dependent students)

In addition to these federal programs, many states, colleges, and private organizations require the FAFSA be filled out in order for you to be considered for grants, scholarships, and loans, even merit-based ones. The WSJ even argues that well-to-do families should fill out the FAFSA to give their kid an admissions edge by demonstrating they have the ability to pay the tuition themselves. They also note that you could lose your job this year, allowing your child to qualify. So consider filling out the FAFSA despite what I write here.

Dependent or Not?

The first issue to determine when filling out a FAFSA is whether the student is a dependent or not. Ideally, they are not, because then you do not have to take the parent’s assets into consideration. Here are the ways the student can become independent:

- Be 24 or older (for 2016-2017, that means born before
Jan 1, 1993.

- Be married (on the date of application)
- Enroll in a masters or doctorate program
- Be on active duty
- Be a veteran
- Have and support a child or other dependent
- Lose both parents
- Be declared an emancipated minor
- Be homeless

There is also a third FAFSA formula for an independent student with a dependent other than a spouse, which gives you a little smaller expected family (personal really) contribution.

**What Goes On The FAFSA?**

Just to keep things simple, we’re going to concentrate on the FAFSA for a dependent student. Here is the application, and here is the formula. Let’s concentrate on the formula for now. Here’s page 1.

As you can see, page 1 includes the parent’s income, a section for allowances (think deductions) to parent’s income, and the parent’s assets. There are a few interesting things to note. First, it starts with AGI, line 38 on your 1040. (Starting in 2017-2018, it’s not last year’s AGI, it’s the year before.) So anything that decreases your AGI (like putting money into retirement accounts like 401(k)s, individual 401(k)s, SEP-IRA, contributing to HSAs, or business expenses) reduces this number. However, you also have to add in “untaxed income and benefits” on line 4. What is that, exactly? Well, it includes

- Workers Comp
- Black Lung Benefits
- Untaxed portions of Railroad Retirement Benefits
- Disability Benefits
HSA Contributions (yup, that’s right, they got you.)

It specifically excludes:

- Foster Care Benefits
- Student Aid
- Earned Income Credit
- Child Tax Credit
- Welfare Payments
- Untaxed Social Security Benefits
- Supplemental Security Income
- Workforce Innovation and Opportunity Act Benefits
- On-base Housing
- Military Allowances (BAH, BAS)
- Combat Pay
- FSA Benefits
- Foreign Income Exclusion
- Credit For Federal Tax on Special Fuels

Guess what else counts? Distributions from Roth accounts. Bummer eh? However, there is a special provision for the taxable income that results from a Roth conversion. That doesn’t count toward your income.

Now, check out the allowance section. The allowances include taxes (Federal, State and Social Security), an “income protection” allowance, (which varies from $15-38K depending on how many people in the household and how many are in college,) and what amounts to a $4K “employment expense” allowance if you don’t have a stay at home parent. Yes, that’s right, the formula discriminates against stay at home parents.

You subtract the allowances from the income, and that leaves you with Line 15, “Available Income.” Now, for a doc with an AGI of $200K, that available income number is likely to be a six figure amount.

Now, we move on to the part you’ve all been waiting for. This
is where you see how your assets count against you in this formula. The following are included:

- Cash (green stuff, checking, and savings)
- Taxable Investments
- Real Estate except the primary residence
- Trusts
- 529s and ESAs owned by the parent or the student

The following is NOT included:

- Retirement Accounts and Pensions
- HSAs
- Cash Value Life Insurance
- Annuities

The value of these is determined by the value on the day you submit the application. There is some potential for market timing there, of course. The moral of the story, like the stories of early retirement, tax reduction, asset protection, and estate planning, is max out your retirement accounts. If you REALLY want to try to lower your assets, you could move all your taxable stuff into an annuity or life insurance policy just before applying, but that seems pretty silly given the likely tax cost, the downsides of annuities and life insurance as investments, and the fact that if you have all this income and assets your kid isn’t getting anything good anyway.

After including the value of your investments, you move on to the value of any small businesses you may own. This section is pretty cool, since it basically allows you to minimize the value of the business. As little as 40% of the value of the business might be included, although for businesses worth millions there isn’t going to be much of a discount there.

You also get another allowance, the education saving and asset protection allowance, which ranges from $0 to $30,000. It
won’t have much of an effect for most long-time readers of this site. Then you multiply the assets that count by 12%. Add this amount to the “available income” number to get an “adjusted available income.” Now, you have to run it through another chart, which for high earners basically boils down to multiplying the adjusted available income by 47% and calling it the Total Parent’s Contribution from Adjusted Available Income. You divide this number by the number of kids in college, and you get the parent’s contribution for this child.

Whew! You survived page 1 of the FAFSA calculation, which is the parent’s page. What did we learn? Several things.

- Income matters more than five times as much as assets for most high-income professionals.
- Only taxable and education-directed investments count, and they don’t even count that much.
- The number of kids in college matters a lot.

Let’s move on to page 2, the student’s page.

You basically repeat the income exercise that you did for the parent, but for the student’s income. If the student is like most, this isn’t going to be a big contribution. That $6,400 income protection allowance plus the tax allowances will probably wipe out most or all of the student’s earnings.

Moving on to the assets, everything is the same as the parent’s page except that the student’s multiplier is 20% instead of 12%. The student also doesn’t get that sweet 47% multiplier, which effectively reduces the parent’s asset rate from 12% to 5.6% and cuts their contribute from income in half. Add it all up and you get the EFC. Subtract that from the school’s Cost of Attendance to get your financial need, if any. Even if, by some miracle or because
you have multiple kids attending expensive schools at the same time, you actually have a financial need, that doesn’t mean there will be a financial aid package available to fill it. And that financial aid package is still likely to be mostly loans and a job, rather than any type of need-based grant or scholarship.

**An Example**

Let’s run the numbers for a typical physician family. Let’s say the married 50 year old doc has an AGI of $200,000, no untaxed income, $60K worth of tax allowances, cash and taxable assets of $500,000, two kids but only one in college, $100,000 saved for college in 529s ($50K for each kid), and the kid is attending a school with a COA of $30,000 per year.

\[
\begin{align*}
\text{Parent’s Available Income:} & \quad \$200,000 - \$60,000 - \$27,440 \\
\text{Income protection allowance) =} & \quad \$112,560 \\
\text{Parent’s Contribution from Assets ($600,000 - asset} & \quad \$19,700)* \quad 12\% = \quad \$69,636 \\
\text{protection allowance of $19,700)* 12%} & \quad = \quad \$69,636 \\
\text{Parent’s Adjustable Available Income =} & \quad \$112,560 + \\
\text{$69,636 =} & \quad \$182,196 \\
\text{Total Parent’s Contribution =} & \quad \$8,706 + \ 47\% \ (\$182,196 - \$32,200) = \quad \$79,204
\end{align*}
\]

I think we can stop there. It doesn’t really matter what the kid’s income and assets are. The total parent’s contribution is almost three times the cost of attendance.

**The College Scholarship Service (CSS)**

To make matters worse, some schools have opted to use the CSS instead of the FAFSA in determining who gets aid, especially aid from the school. There are some minor differences between the two, which could possibly matter to you, but probably not if you’re a typical reader of this blog. These guys give a [good summary](#) of the differences.
Bottom line, everything works out a little worse for you with CSS than with FAFSA. Your home counts, your business counts more, even the sibling’s assets are counted. (WTH?)

Lessons Learned

Unless sending more than one kid at a time to expensive schools, the typical high income professional reader of this site and her children are going to be on their own as far as paying for school. The upside of this is that you can skip all this crazy planning people do to try to get their EFC down. You know, stuff like buying annuities and insurance they don’t need, avoiding Roth IRA withdrawals etc. What you do need to do, however, is have a plan to pay for school without any help. That means choosing a school you can afford, saving money for college in advance using some combination of 529s, ESAs, and a taxable account, cash flowing some of the expense with current earnings, and expecting the child to generate some kind of income during school and in the summers. Having your child get typical student loans, however, may not be an option since the EFC will probably be higher than the COA.

Possible exceptions to the above advice include:

- A really expensive school (Columbia Medical School for instance)
- A really poorly-paid doctor with few assets and a large family (although note you don’t get to subtract YOUR student loans from your investments)
- Many kids in school at once
- Kids in college AFTER you retire on a fraction of your prior income
Twelve Potential Techniques For Exceptions and Lower Earners

As you can see, your high income dramatically simplifies this process (by allowing you to mostly ignore it.) But I thought it might be fun to illustrate some of the techniques that lower earners can use to maximize the potential for creating a large gap between the COA and the EFC.

# 1 Max Out Retirement Accounts

This one helps you in two ways on the FAFSA- it lowers your AGI and the assets don’t count against you.

# 2 Max out the HSA

While this still counts as income, once it is in there it doesn’t count as an asset

# 3 Grandparent 529s

The parent’s assets and the child’s assets count against you, but the grandparent’s don’t. Distributions from the grandparent’s 529 does count as income the next year, however. The workaround? Have the grandparent 529 pay for the last year of college. (Actually, with recent changes, the grandparent’s 529 can be used for both Junior and Senior years.)

# 4 Bunching

If retired, you can take a double distribution from a Roth IRA
(or any retirement account really) one year and then take none the next year, which could potentially make the COA-EFC gap larger. Just like with your taxes, you can bunch income or deductions in unique ways to try to minimize your tax burden and EFC.

# 5 Move Cash and Taxable Assets into Annuities and Life Insurance

I see more downsides than upsides to this one, but it is a potential technique. Perhaps if you were going to buy a 5 year deferred income annuity anyway similar to how many use a SPIA.

# 6 Pay for college with loans against your assets

You can borrow against your house, your life insurance, or your investments and none of it counts as income.

# 7 Get More Kids Into College At Once

One child could delay his enrollment by a year, or another could take summer classes, or graduate from high school early etc.

# 8 Get Kids Independent

Military service, early marriage, having a child, grad school— it all makes the student independent and parental assets no longer count.

# 9 Have Your Child Save In A 529 Instead of an UGMA

529s count as parental assets, but an UGMA is the kid’s, and subject to the higher percentage multiple (~4 times higher).

# 10 Get Rid of Your Cash

Buy stuff, pay down the mortgage, pay off your student loans,
make your retirement contributions early, whatever. The less you have, the less that goes into the calculation.

# 11 Hold Earnings in a C Corp

C corporations can retain earnings. I don’t generally recommend docs use these, since it causes double taxation, but it does allow you to delay income until after the kids finish college.

# 12 Make the Custodial Parent the Poor One

After divorce, only the custodial parent’s assets are taken into account. So have the custodial parent take the house and larger retirement account, while the non-custodial parent gets the larger taxable account.

This post is getting long enough. Time to cut it off. What do you think? Do you expect to see a gap between your EFC and COA? Why or why not? Did your kids receive any aid? How are you saving for college? Are you doing any financial aid planning whatsoever? What financial aid hacks did I miss? Comment below!