EDUCATIONAL BENEFITS GROUP

Providing solutions to make college an affordable reality

Creative Borrowing Strategies

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CREATIVE BORROWING

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Creative Borrowing Strategies

While most families would rather not borrow money to pay college expenses, there are some advantages of using college loans and creative strategies for reducing the intrinsic cost of those loans. There are advantages to considering college loans when:

Your assets are tied up in high-yielding investments
If your family does not qualify for financial aid there are advantages to not accessing investments to pay college expenses, especially if there is a considerable spread between the interest earned on the investment and cost of the loan. A 2% spread on $25,000 is equal to $500, which yields the same benefit as a **$500** scholarship. There are also other costs incurred when selling an investment, such as income tax and capital gains tax.

Your assets are tied up in a business
If your family owns a business and the assets are tied up in income producing capital, it may not be feasible to sell, or borrow against, those capital assets. Here, the earning power of those assets is much greater than the cost of the loan.

You require the student to have some financial responsibility for their education
Students may become more serious about achieving their degree, if they are given the financial responsibility of paying for some of their education.

You can obtain a tax benefit
The Tax Reform Act of 1997 allows college loan interest to be deductible, within certain income phase-out limits. The income phase-out limit is $40,000 to $55,000 in Adjusted Gross Income (AGI) for single or head-of-household taxpayers and $60,000 to $75,000 for married taxpayers. If loans are a viable college-funding alternative, those loans should be structured to achieve the maximum tax benefit.

This section will discuss the advantages and disadvantages of loans used for college, as well as, creative strategies and planning tips to reduce the cost of those loans. Before borrowing or using any of the strategies listed in this guidebook, we recommend you weight all the pluses and minuses of the strategies. It is also recommended you consult with your CPA or financial advisor before implementing any of these ideas.

Federal Unsubsidized Stafford Loans

Federal Unsubsidized Stafford loans are not need-based loans. Therefore, a student can get this loan, regardless of whether the family qualifies for financial aid. The Unsubsidized Stafford loan is a now a fixed rate loan, with a maximum interest rate of 6.8%. These loans are taken out in the student's name and therefore, the student will be entitled to the student loan interest tax deduction.

The amount that can be borrowed by the student ranges from $3,500 for freshman, $4,500 for sophomores and $5,500 for juniors, seniors and 5th year students. The total undergraduate amount of Unsubsidized Stafford loans that a dependent student can have is $23,000. An independent undergraduate student can borrow up to $46,000.

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If the student is a dependent student whose parents are unable to get a Federal PLUS loan (discussed in the next section), he can borrow up to $4,000 for the freshman year, $4,000 for the sophomore year, and $5,000 for the junior, senior, and 5th year of college. Graduate students can borrow up to $18,500 for each academic year. The total amount of Unsubsidized Stafford loans that graduate students can borrow is $138,000.

The repayment of the Unsubsidized Stafford loan interest begins within 60 days after the final loan disbursement, however this interest can be deferred. The principal repayment does not start until six months after the student graduates, leaves college, or drops below half-time enrollment.

Planning Tip: Under certain circumstances the student can receive a deferment or forbearance on the loan (e.g., resident of a Federally declared disaster area, unable to find full-time employment, economic hardship, or study in an approved graduate fellowship program or in an approved rehabilitation training program for the disabled).

Planning Tip: Under certain circumstances the student can have his loan cancelled (e.g., the student's total and permanent disability or death, the college closed before the student could complete his program of study, or in some bankruptcy cases where the repayment would cause undue hardship).

Federal Stafford loans carry both life and disability insurance on the student to cover the repayment of the loan should one of these events occur. These loans can be consolidated and repaid over a 30-year period.

There is a minimum of a 4% loan fee for an Unsubsidized Stafford loan. If the loan payments are not made on time the student may be charged collection and late fees.

Planning Tip: It may be more beneficial for the student to borrow an Unsubsidized Stafford Loan, rather than the parents borrow a PLUS loan. The interest rate is lower plus, when the student leaves college and claims himself on his tax return, his income will probably be lower than the income phase-out limits. The student can then deduct the interest paid on the Unsubsidized Stafford loan, up to a maximum of $2,500 for each of the 5 years the interest is paid. This $1,875 tax saving ($2,500 x 5 years x 15% student tax rate) can then be used to help pay back the loan.

Planning Tip: Some private lenders (e.g., Sallie Mae), who purchase Federal Unsubsidized Stafford and PLUS loans, will lower the interest rate by 2% if the borrower makes 48 payments on time. These lenders may also refund the borrower's 3% loan origination fee, or lower the interest rate an additional .25%, if the payments are made by using automatic monthly bank transfers. Therefore, to insure the borrower can take advantage of these benefits, he may consider having overdraft protection on his checking account so that he will make all of his payments on time. If a borrower were eligible for the above rate reduction, he would save approximately **$850** on a $10,000 loan balance.

Federal Plus Loans

Federal PLUS (Parents' Loans for Undergraduate Students) loans are not need-based loans. Therefore, a parent (This includes a non-custodial parent.) can take out this type of loan even if the student has no financial need. These are now fixed-rate loans capped at an 8.5% interest

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rate. These loans are taken out in the parent's name and therefore, the parent will be entitled to the student loan interest deduction, if applicable.

The amount that can be borrowed by the parent is capped by the cost of attendance at the student's college, less any tax-free scholarship money.

Example: If the cost of attendance at the student's college was $30,000 per year and the student was offered a $1,000 scholarship, the parents could borrow $29,000 in PLUS loans each year. These loans can only be taken out to pay the student's undergraduate college expenses and do not cover graduate school expenses.

If the parent is not credit worthy and cannot obtain a PLUS loan, the student can borrow an additional $4,000 per year in Federal unsubsidized loans for the first and second years of college and $5,000 per year for the third, fourth, and fifth years of college.

PLUS loans are signature loans (no collateral required). Only one parent must sign the loan application. If the signatory parent dies or becomes permanently disabled during the repayment period, the remaining loan principal balance is forgiven.

Repayment of a PLUS loan begins within 60 days after the final loan disbursement for the academic year. However, if the signatory parent is enrolled in college on a half-time basis (six credits) the repayment may be deferred. PLUS loans can be consolidated and repaid over a 30-year period.

There is up to a 4% loan fee for a PLUS loan. Also, if the loan payments are not made on time, the parents may be charged collection and late fees.

Special Student Loans

Over the past year, banks and other lenders across the country have waged a campaign to lure colleges out of the Department of Education's direct lending program. They have found an effective tactic; making loans cheaper for borrowers. In many states, lenders are offering one generous incentive after another, such as offering to pay off a percentage of the loan for each year that a student is in repayment.

The Vermont Student Assistance Corporation, a guarantee agency and non-profit lender, has a program where students receive annual interest rebates on their loans, equivalent to 1% of the principal balance each year. In addition, the agency does not charge interest for the first year on a PLUS loan. The Maine Education Service, another non-profit lender, cuts interest rates by 3% for Maine residents who are on time with repayments during the first 36 months of repayment.

Sallie Mae has a "student Plus loan" program called the "Signature Student Loan". These loans are similar to a PLUS loan, but are recorded in the student's name. However, the parents must co-sign this loan.

Planning Tip: Since the repayment of the "Signature Student Loan" can be deferred until after his college years, a student can borrow a significant amount of money to pay college expenses without making payments. After college, the principal and accrued interest becomes due and the student can then take a $2,500 tax deduction for each of the first 5 years the interest is paid

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on the loan. This $1,875 tax saving ($2,500 x 5 years x 15% student tax rate) can then be used to help pay back the loan. For details on the Signature Student Loan program, the student can contact Sallie Mae at 1-888-2-SALLIE.

Personal Residence Loans

A personal residence loan may be a source of funds for college. Although many parents do not want to mortgage their home to pay for college costs, it may be a better source of funds than borrowing on their business assets or from their retirement accounts.

If a home equity line of credit is used to fund college expenses, the parent has the option to borrow only the amount of money that is needed for that year. Therefore, he will pay interest on only the amount borrowed. The parent may also be able to make minimum monthly payments while the student is in college and larger payments after college. Since the interest rate is variable, the monthly payments will vary. There may also be high loan fees associated with this type of loan.

If the parent uses a second mortgage to fund college expenses, he will borrow a fixed amount. Generally, there is involves a fixed interest rate, a fixed repayment schedule and a fixed monthly payment amount. Since the parent will borrow a lump sum, which he probably will not be using all at once, he will be paying interest on money he does not currently need. Therefore, the parent should consider investing the excess funds in a short-term investment until the funds are needed. Note: There may also be high loan fees with this type of loan.

For parents whose income is too high to take advantage of the student loan interest deduction, a personal residence loan can give them an itemized income tax deduction (subject to the phase-out rules for high income). This deduction would not be limited to a maximum of $2,500, as would be the case for student loan interest.

Planning Tip: Parents in high-income brackets may want to maximize their tax deductions by splitting college loans between themselves (home loan) and the student (student loans). The appropriate mix between these loans can maximize tax savings, which can then be used to help pay college expenses and/or loan costs.

The repayment term on residence loans is usually longer than retirement account loans and other types of loans, which makes the monthly payments smaller.

Planning Tip: Many families find themselves with a shortfall of funds to pay the entire cost of college. To increase cash flow the family can either increase their amount of assets, or decrease their liabilities (debt). One method used by many corporations to decrease liabilities and increase cash flow is called debt restructure or debt consolidation. Companies do this by refinancing their assets and consolidating all their debt into one smaller payment over a longer period of time. This allows them to make their assets more productive and establish a new budget for expenditures.

Families can significantly increase their cash flow by applying the same debt restructure methodology to their liabilities; such as home mortgage, car loans and credit card debt. By consolidating their debt payments into one lower cost payment, they can increase cash flow to pay college expenses, fund their retirement and even pay off their home mortgage earlier than anticipated.

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Example: The following is a simple debt restructure formula that demonstrates the opportunity to consolidate your high cost debt into one lower cost payment; thereby, increasing your monthly cash flow:

	Before Consolidation		**After Consolidation**	
	Monthly Payment	Balance	Monthly Payment	Balance
Mortgage	$1,071	$ 84,500	$1,035	$120,000
Car Loans	$ 420	$ 22,500	0	0
Credit Cards	$ 220	$ 7,860	0	0
Furniture Loan	$ 150	$ 5,140	0	0
Totals	**$1,861**	**$120,000**	**$1,035**	**$120,000**

Improved Monthly Cash Flow = $826

In the above example, by refinancing the home, the old mortgage and all other high interest - high cost debt has been paid off with a new mortgage and the monthly cash flow availability has increased by $826. This extra cash can then be used to pay college expenses. After the children have finished college, the $826 per month can be used to help pay down the mortgage, or invested in their retirement fund. Furthermore, there may be additional tax deductions available with the new mortgage, further increasing the cash flow availability.

The theory behind this formula is simple. Home equity is one of the family's main assets. However, home equity is a very unproductive (does not earn interest) asset. You can only increase home equity by increasing the value of your home, or by decreasing the debt owed on it. Otherwise, the home equity asset remains dormant and unproductive until you sell your home. The only method to make home equity productive, during the time you own the home, is to borrow the excess equity and use the increased cash flow for productive purposes; such as paying off your costly, high interest installment or credit card debt.

Planning Tip: For conservative long-term investors, aggressively prepaying their home mortgage to avoid high interest costs can pay big dividends as a college and retirement strategy. The longer the parent stays in his home, the larger the cash-flow savings.

Example: A parent has 15 years to go before his son attends college. He has a 30-year, $200,000 mortgage at an 8% rate. If he pays an extra $500 per month towards his loan, he'll pay off the mortgage in 14 years and save $193,000 in interest (cash flow). Plus, he will have created a minimum $200,000 in equity (line of credit) to borrow against when his son goes to college. If he pays an extra $200 per month, he will pay off his mortgage in 20 years and save $125,000 in interest costs. Regardless of the amount of prepayment, once the mortgage is paid off, the monthly payments can now be used to pay college costs or invest for retirement.

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Planning Tip: For parents with a business, IRC Regulation 1.163-10T(o)(5) could be made for personal residence interest to be treated as a business expense. In addition to a tax deduction that would not be subject to the itemized deduction phase-out at high-income levels, this deduction would reduce the social security and Medicare tax liability for a self-employed parent.

Parents should be sure to compare the benefit of a federal student loan vs. a home loan. For example, a federal student loan at 6% is equal to a home loan of 8.3% for someone in the 28% tax bracket, because of the tax-deductible nature of home loan interest.

Life Insurance Loans

Some families use life insurance loans as a source of college funding. However, the loan balance can consume all the cash value and the policy may terminate, unless the parent pays back the loan. If the policy terminates, the parent must then recognize the accrued interest owed on the loan as taxable income. Life insurance loans can give the family a tremendous option of paying for college, but they should beware of the pitfalls of borrowing too much and causing the policy to terminate. Please consult a financial professional regarding the borrowing of funds from a cash-value life insurance policy.

Intra-family Loans

Generally, a disparity exists between the rate of earnings on an investment and the interest rate a borrower must pay on a loan. Loaning money to a child for college costs can offer savings opportunities for both the parents and the child. The parents may be able to both increase their rate of return on investments and assist their child in paying college. The child may increase his cash flow for college due to the lower interest rate on the loan than could be obtained from other financing.

Planning Tip: Both parties can benefit in a situation where the child is in need of college funds but the interest rate is high, and the parents have funds available that are currently invested in a low interest rate saving's account.

Example: The parents have $150,000 in their saving's account that earns 5% annually. Their child will need $125,000 for college; however, the 9% rate he will have to pay to a lending institution is higher than he would like. The parents want to loan the student the money, however, they need the income generated from their saving's account to live on. The parties agree on a 7% interest rate on the loan.

The parents' marginal tax rate is 28% and the child's tax rate is 15%. In this case, the parents will have an increase in earnings of $2,500 [(7% - 5%) x $125,000], less the increased tax liability of $1,050, or a net after-tax increase to cash flow of $1,450. The student will decrease his interest expense of $2,500 [(9% - 7%) x ($125,000]. The combined increase in family cash flow would be $3,950 ($1,450 + $2,500).

Planning Tip: Another interfamily loan strategy a business owner parent can use to pay for college is where the parent borrows funds from a bank, then gifts this money back to his child. The child loans the borrowed funds back to the parent and the parent pays back the bank with the money he borrowed from his child. The parent can then deduct the interest expense paid to the child and the child would have funds for college.

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Example: A parent borrowed $20,000 per year for four years from a bank through his sole-proprietorship business. The parent then gifts the $20,000 to his child (who was attending college). Since the gift was a joint gift with his spouse there were no gift tax ramifications. The parent then borrows the money (a total of $80,000) from his child to pay off the business bank loan. The parent pays the child a yearly interest on the loan and deducts it as a business expense. The child pays taxes on the interest income, at his lower tax rates, and uses the interest income and the principal to pay for college expenses.

Retirement Account Loans

Borrowing from retirement accounts may also be considered as a source for college funding. The advantages of borrowing from these sources are a generally favorable interest rate and repayment terms and ease of obtaining the loan. However, if these loans are not repaid within a certain period of time, usually five years, the outstanding principal balance will become taxable income and subject to a 10% penalty if the borrower is under age 59 1/2.

Warning: If a parent loses his job, the outstanding balance must be immediately repaid on a retirement loan, or it will become taxable income, subject to ordinary taxes plus penalties. Furthermore, even though the retirement fund is earning interest on the college loan, it is foregoing the higher rate of return it was earning when invested in a mutual fund.

Some retirement plans prohibit or restrict distributions before retirement. However, hardship distributions from 401(k) plans (subject to the 10% penalty) are allowed to meet certain college expenses. Taking a hardship distribution precludes the plan participant from contributing to the plan for 12 months.

Warning: Due to the extraordinary limitations and penalties, borrowing from your retirement funds to pay for college should be avoided, if possible.

Loan Costs

Remember that with every loan there are processing fees. These charges should be considered as well when comparing loans.

Keep an eye open for origination, guarantee, insurance or application fees. Typically, commercial loans carry an origination or guarantee fee that levies a one-time charge (typically three to seven percent on the total loan amount). Beware, sometimes lenders establish special low interest rates "for a limited time only," but neglect to advertise that they have increased the origination fees to compensate.

Planning Tip: When shopping for loans, be sure to itemize the various processing fees of each loan on a spreadsheet. This will allow you to compare each loan.

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Example:

<u>**Loan Fees**</u>	**Loan #1**	**Loan #2**	**Loan #3**	**Loan #4**
+ Interest Cost				
+ Origination Fee				
+ Guarantee Fee				
+ Application Fee				
+ Insurance Fee				
- Less Discount for Timely Payment				
= Total Cost of Loan				

Also, some lenders capitalize-once at the beginning of repayment, others capitalize yearly, and others quarterly. The less frequently interest is capitalized, the better. Students with subsidized Stafford loans need not worry about interest capitalization, since Uncle Sam takes over interest payment during deferments.

Loan Shopping

The college should notify a family of their eligibility for a Stafford or PLUS loan during the spring or summer before the college freshman year. At this point, it is time to start loan shopping. Banks, credit unions, savings and loans and even insurance companies can make student loans. If, for some reason you cannot find a lender, you can go to our College Loan page and complete the loan information and we will put you in contact with a reputable lender.

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