This Smart Savings Trick Can Help Teenagers Qualify for More College Financial Aid

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Sam Island for Money

Pop quiz: Does it make more sense for your teen to put aside money for college or for their future retirement?

Answer: You don't necessarily have to choose one or the other.

A Roth IRA, which lets you invest after-tax dollars and take tax-free distributions when you reach age 59 ½, is typically considered

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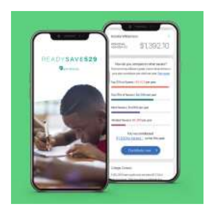
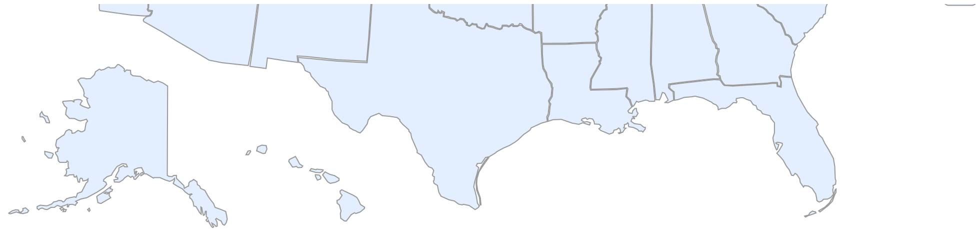


a retirement investment. But if you're smart about using a Roth, this kind of retirement account can also help your student get more financial aid for college.

To understand how, it's important to understand how the Free Application for Federal Student Aid, or FAFSA, works. Families who plan to have a child in college during the coming academic year fill out the FAFSA to apply for federal college aid. Schools, states and scholarship programs also rely on the FAFSA, which determines a student's eligibility for programs that lower higher education's sticker price: grants, loans, work-study jobs, need-based aid and merit-based aid.

The FAFSA uses a series of questions and mathematical formulas to calculate how much the federal government (and, by extension, schools and other scholarship programs) thinks a family can pay for college. The math assumes that 20% of a student's assets and 5.64% of parents' assets are available to pay college expenses in any given year. The FAFSA counts bank accounts and investments as assets, but not annuities, life insurance policies, equity in the family home or retirement accounts.



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So, it’s a smart move for parents to fund their retirement accounts by as much as they can, up to a limit of $6,000 for an IRA or $19,500 for a 401(k) plan in 2021. That money won’t count as an asset on an eventual FAFSA application.

An even more interesting strategy is possible for a teenager who is old enough to work. A high school student who has a summer job might earn $15 an hour, or $4,500 if she works thirty hours a week over ten weeks. A kid who starts working during the summers at age 14 might get in three summers of work before filling out the FAFSA. She won’t earn enough to pay income tax and if her parents are paying her living expenses, those three summers might give her a nest egg of $13,500.

If the teenager puts that money in a savings account, the FAFSA will calculate that $2,700 is available to spend on tuition and other expenses for each year that she attends college. But if she puts the money in a custodial Roth IRA, that money is invisible to the FAFSA calculations. All other things being equal, her aid eligibility will go up by $2,700.

Perhaps even more important, this student will get an enormous head start on saving for her eventual retirement. Even if she never puts another cent into the Roth, it will grow to nearly $105,000 if she earns an average 5% return over the next 42 years. At 8%, it would grow to just over $340,000. (She becomes the account’s sole owner at either age 18 or 21, depending where in the U.S. she lives.)

"You can put up to $6,000 a year in a Roth, though you can't go beyond the kid's income," says Catherine Valega, a financial planner at Bay Financial Associates in Waltham, Massachusetts. "You can invest it aggressively, because they have so much time until retirement."

Sean Pearson, an advisor in Conshohocken, Pennsylvania, cautions that families who use this strategy should be sure that students won't need the money for other expenses.

"You might need this money to buy tires for the car that gets you to and from school, to buy a computer or textbooks, or even to help pay for tuition" he says. "Don't forget the value of financial flexibility."

After a five-year waiting period, a student could take the principal — the money your family deposited — back out of the Roth without penalty. However, the FAFSA would count this withdrawal as student income and reduce aid accordingly. If you must take money out, do it after receiving a financial aid award for the student's last year of school, Pearson suggests. A family wouldn't report it as income, because they would not be filling out a FAFSA for the following year of school.