APPENDIX A

IM - WHAT IS IT?

By Sandy Baum and Kathleen Little

Institutional Methodology (IM) is a formula developed by financial aid professionals, in consultation with economists, to measure a family's ability to pay for college. The result of the formula is an expected family contribution (EFC)—the family's share of college costs. The EFC produced by the IM is not the same as the figure calculated by the federal government to determine eligibility for federal student aid dollars. The family contribution is not something most families can realistically take out of one year's income—most families finance their share of college costs through a combination of saving, paying out of current income, and borrowing.

A basic principle of IM is the idea that a family's capacity to pay is a function of income and assets. The first step in calculating the family contribution is to define income in a reasonable way. After subtracting appropriate allowances from income, a portion of the remainder is available to pay college costs. The same process takes place for assets.

HOW DOES IM DEFINE INCOME?

IM uses AGI from the federal income tax form as a basis to determine family income. However, IM adjusts the parents' AGI, disallowing certain losses and adjustments that are permitted in the federal tax system but that don't affect a family's ability to pay for college. Untaxed income from social security, child support, and other sources is also considered in determining a family's total income. Both the parents' and the student's incomes are taken into account. If parents are divorced or separated, information from the custodial parent, the parent with whom the student lives, and information from the custodial parent's spouse (if remarried) is used to calculate expected family contribution. Some colleges require financial information from both biological parents and expect both to contribute to college costs. These colleges believe that both parents, regardless of their current marital status, have the primary responsibility for paying for their child's education and should be expected to provide reasonable financial support before college resources are used.

WHAT ALLOWANCES ARE SUBTRACTED FROM INCOME?

IM subtracts the following six allowances from income before determining how much of the parents' income should be earmarked for college expenses:

- Mandatory taxes
  - Federal income taxes paid
  - State and local income, sales, and property taxes
  - FICA tax
- **Medical and dental expense allowance** to account for exceptionally high medical and dental expenses reported by the family.
- **Employment expense allowance** to account for expenses related to working outside the home if both parents are employed or if the parent is single.

- **Annual Education Savings Allowance (AESA)** recognizes that a family must save for the educational expenses of younger children at the same time they are sending older children to college. The allowance is designed so that families that save the specified fraction of their income each year —currently about 1.5%—will have accumulated about one-third of their expected parent contribution for a private four-year college by the time their child enrolls. IM assumes that the family will finance the remaining expected contribution from current income, assets, and/or borrowing.
- **Income Protection Allowance (IPA)** represents the median expenses of families living at the lower living standard defined by the U.S. Department of Commerce. The IPA does not define the amount of money required by most families to cover their living expenses—in fact, it is much lower than that. Instead, it represents the income level below which a family has no discretion about how it spends its income. Parents with incomes at or below the IPA are not asked to make any contribution at all to their children's educational costs. Those with higher incomes have more choices about how they spend their income and are expected to use some fraction of their discretionary income to pay for their children's education.
- **Elementary/Secondary Tuition Allowance** to account for expenses paid by the family for private elementary or secondary school tuition. Not all institutions apply this allowance since they consider these expenses discretionary.

How Much of Their Income Are Families Expected to Contribute?

After subtracting taxes and other appropriate allowances from total income, a portion of the remaining available income is considered available for college expenses. Similar to the federal income tax rate structure, the IM assessment rate structure applies a lower rate — 22% — to the first dollars of available income and progressively higher rates to additional dollars of discretionary income. Even families subject to the highest rate — 46%—are asked to pay that rate only on their last dollars of available income.

The student's income is assessed at the same rate as the parental income. In addition, the base IM will cap the student income contribution at 50% of the IM parental contribution. This cap recognizes the fact that students from low income families are often providing support for their families.

How Does IM Define Assets?

IM considers assets in determining a family's ability to pay for education because families with assets are in a stronger financial position than families with the same income but no assets. This is true whether a family's assets are liquid or tied up in the family's home. While no one wants a family to sell their home in order to pay for college, a homeowner is in a stronger financial position than is a renter. A homeowner pays lower income taxes, has stable mortgage payments, and may be able to tap into the equity in the home to finance a portion of college expenses.

It is true that a family's expected contribution is somewhat higher if there are assets than it would be if the family had not saved at all. However, a family who has saved is in a much better position than a family who must finance the expected contribution out of current income and loans. IM considers only a very small percentage of a family's assets as available to pay for college.

It is not practical for IM to include all categories of assets, but the definition is as comprehensive as possible. Most colleges do not collect precise information about pension assets because many families have difficulty knowing the value of these assets. As a result, these are not generally considered available to pay for college expenses. However, savings and investments, including parents' assets held in the names of the student's siblings, are taken into account, as is the equity in other financial assets such as the home, other real estate, and business and farm assets. It is important to remember that IM does not expect a family to deplete its assets, but assets are important in measuring the family's overall financial strength.

What Allowances Are Subtracted from Assets?

Two major allowances — the Emergency Reserve Allowance and the Cumulative Education Savings Protection Allowance — are subtracted from assets before determining how much of a family's net worth should be available to pay for college expenses.

- *The Emergency Reserve Allowance (ERA)* protects assets for unanticipated expenses such as illness or unemployment. The amount is based on family size and represents six months of average family expenses as reported in the federal Consumer Expenditure Survey.
- *The Cumulative Education Savings Allowance (CESA)* recognizes a family's need to save to finance their children's college expenses. The CESA protects an amount of assets equal to the amount the family would have accumulated if they had saved a specified percentage of their income each year for each child. The CESA is designed to prevent a family's expected contribution from increasing as a result of saving conscientiously for college.

The Low Income Asset Allowance recognizes that a family with very low income needs additional asset protection because that family may need to draw on assets to cover basic living expenses.

What Portion of Assets Are Families Expected to Contribute?

Only a small portion of a family's net assets is expected for college expenses. Assets are assessed using a graduated rate structure as is income. IM asks families to contribute between 3 and 5% of their net worth (total assets worth minus appropriate allowances).

Student's Assets

Student's assets are assessed more heavily than parents' assets. Because education should be the first priority for students, they are expected to contribute 25% of the value of their assets to pay for educational expenses.

Is the Contribution the Same If More Than One Child Is Enrolled?

Families who have more than one child, regardless of the spacing of those children, have to pay more for college than families who have one child. However, IM recognizes the particular strain on families who have two children in college at the same time and reduces the expected contribution for each child when more than one is enrolled. If two children are enrolled, IM expects the family to pay 60% of the parent contribution for each child; if three children are enrolled, IM expects the family to pay 45% of the parent contribution for each child.

Who Makes the Final Determination of How Much the Family Will Be Asked to Pay?

IM cannot account for all of the circumstances affecting a particular family, but it can provide to the financial aid administrator the best available indicator of how each family's financial strength compares to that of other families in the applicant pool. Responsibility for the final determination of the family's share of college expenses rests with the college financial aid administrator, after taking into account all available information about the family's income, assets, and circumstances. IM tries to treat each family equitably.

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