529 Plans and Financial Aid Eligibility

If you're thinking about opening a 529 account, or if you've already opened one, you might be wondering how 529 funds will affect your child's financial aid eligibility.

A general word about financial aid

The financial aid process is all about assessing what a family can afford to pay for college and trying to fill the gap. To do this, the federal government and colleges examine a family's income and assets to determine how much a family should be expected to contribute before receiving financial aid. Financial aid formulas weigh assets differently, depending on whether they are owned by the parent or the child. So, it's important to know how your 529 account will be classified, because this will affect the amount of your child's financial aid award.

Financial aid can consist of loans (which must be repaid in the future), grants or scholarships, and/or a work-study job. The typical financial aid package contains all of these types of aid. There are no guarantees that a larger financial aid award will consist of favorable grants and scholarships — your child may simply get more loans.

The two main sources of financial aid are the federal government and colleges. In determining a student's financial need, the federal government uses a formula known as the federal methodology, while colleges use a formula known as the institutional methodology. The treatment of 529 accounts may differ, depending on the formula used.

How is financial need determined?

Though the federal government and colleges use different formulas to assess financial need, the basic process is the same. You and your child fill out a financial aid application by listing your current assets, income, and personal family information (exactly what assets must be listed will depend on the formula used). The federal application is called the FAFSA, which stands for Free Application for Federal Student Aid; colleges generally use an application known as the CSS Profile.

Your family's asset and income information are run through a specific formula to determine your expected family contribution, or EFC. Your EFC represents the amount of money that your family is considered to have available to put toward college costs for that year. The federal government uses its EFC figure in distributing federal aid; colleges uses their own EFC figure when distributing their own institutional aid.

The difference between your EFC and the cost of attendance (COA) at your child's college equals your child's financial need. The COA generally includes billed costs for tuition, fees, room and board and a designated sum for non-billed costs for books, transportation, and personal expenses. It's important to remember that the amount of your child's financial need will vary, depending on the cost of a particular school.

The results of your FAFSA are sent to every college that your child applies to. Every college that accepts your child will then attempt to craft a financial aid package to meet your child's financial need. In addition to the federal EFC figure, colleges that use the CSS Profile form will have that EFC figure too. Eventually, the financial aid administrator will create an aid package made up of loans, grants, scholarships, and/or a work-study job. Some of the aid will be from federal programs and the rest will be from the college's own funds. Keep in mind that colleges aren't obligated to meet all of your child's financial need. If they don't, you're responsible for the shortfall.

The financial aid treatment of 529 plans

Now let's see how a 529 account affects federal financial aid.

Under the federal methodology, 529 plans — both savings plans and prepaid tuition plans — are considered an asset of the parent if the parent is the account owner. In this case, the value of the account is listed as an asset on the FAFSA. Under the federal formula, a parent's assets are assessed (counted) at a rate of no more than 5.6%. This means that every year, the federal government treats 5.6% of a parent's assets as available to help pay college costs. (By contrast, student assets are assessed at a rate of 20%.)

There are a few points to keep in mind regarding the classification of 529 plans as a parent asset:

- A parent is required to list a 529 plan as an asset only if he or she is the account owner of the plan. If a grandparent is the account owner, then the 529 plan doesn't need to be listed as an asset on the FAFSA (this doesn't seem fair, but grandparent-owned 529 accounts are counted in a different way, discussed below.)
- Any student-owned or UTMA/UGMA-owned 529 account is also reported as a parent asset if the student files the FAFSA as a dependent student. A 529 account is considered an UTMA/UGMA-owned account when UTMA/UGMA assets are transferred to a 529 account on behalf of the same beneficiary.
- If your adjusted gross income is less than $50,000 and you meet a few other requirements, the federal government doesn't count any of your assets in determining your EFC. So your 529 account wouldn't affect your child's financial aid eligibility at all.

Withdrawals from a parent-owned 529 account that are used to pay the beneficiary's qualified education expenses aren't classified as either parent or student income on the FAFSA the following year.

Now, what about grandparent-owned 529 accounts? Grandparent-owned accounts are not listed as an asset on the FAFSA. However, withdrawals from a grandparent-owned 529 account are counted as student income on the FAFSA the following year. Student income is assessed at 50%, which means that a student's eligibility for financial aid could decrease by 50% in the year following the withdrawal. As a result, grandparents may want to wait until the spring of their grandchild's junior year of college to make a withdrawal if they are concerned about the potential impact on financial aid.

Regarding the institutional methodology, 529 plans are generally treated the same as under the federal methodology. But check with your child's individual college for more information.

Note: Before investing in a 529 plan, please consider the investment objectives, risks, charges, and expenses carefully. The official disclosure statements and applicable prospectuses - which contain this and other information about the investment options, underlying investments, and investment company - can be obtained by contacting your financial professional. You should read these materials carefully before investing. As with other investments, there are generally fees and expenses associated with participation in a 529 plan. There is also the risk that the investments may lose money or not perform well enough to cover college costs as anticipated. Investment earnings accumulate on a tax-deferred basis, and withdrawals are tax-free as long as they are used for qualified higher-education expenses. For withdrawals not used for qualified higher-education expenses, earnings may be subject to taxation as ordinary income and possibly a 10% federal income tax penalty. The tax implications of a 529 plan should be discussed with your legal and/or tax advisors because they can vary significantly from state to state. Also be aware that most states offer their own 529 plans, which may provide advantages and benefits exclusively for their residents and taxpayers. These other state benefits may include financial aid, scholarship funds, and protection from creditors.