



JAMES STEPHAN
Securities America, Inc.
Financial Advisor
2801 55th Street NW, suite
#1
Rochester, MN 55901
507-287-6160
jim@jimstephan.com
www.jimstephan.com

529 Plans and Financial Aid Eligibility

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If you're thinking about joining a 529 plan, or if you've already opened an account, you might be concerned about how 529 funds will affect your child's chances of receiving financial aid. Of all the areas related to 529 plans, financial aid is perhaps the most uncertain, and the one most likely to change in the future. But here's where things stand now.

First, why should you be concerned?

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 institutions that offer financial aid 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 college savings plan account or your prepaid tuition plan account will be classified, because this will affect the amount of your child's financial aid award.

A general word about financial aid

Financial aid is money given to a student to help that student pay for college or graduate school. This money can consist of one or more of the following:

- A loan (which must be repaid in the future)
- A grant (which doesn't need to be repaid)
- A scholarship
- A work-study job (where the student gets a part-time job either on campus or in the community and earns money for tuition)

The typical financial aid package contains all of these types of aid. Obviously, grants are more favorable than loans because they don't need to be repaid. However, over the past few decades, the percentage of loans in the average aid package has been steadily increasing, while the percentage of grants has been steadily decreasing. This trend puts into perspective what qualifying for more financial aid can mean. There are no guarantees that a larger financial aid award will consist of favorable grants and scholarships--your child may simply get (and have to pay back) 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 your 529 plan may differ, depending on the formula used.

How is your child's 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 and income (exactly what assets must be listed will depend on the formula used). The federal application is known as the FAFSA (Free Application for Federal Student Aid); colleges generally use an application known as the PROFILE.

Your family's asset and income information is run through a specific formula to determine your expected family contribution (EFC). The 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; a college uses its EFC figure in distributing its own private 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 tuition,

fees, room and board, books, supplies, 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 a student will then attempt to craft a financial aid package to meet that student's financial need. In addition to the federal EFC figure, the college has its own EFC figure to work with. Eventually, the financial aid administrator will create an aid package made up of loans, grants, scholarships, and work-study jobs. Some of the aid will be from federal programs (e.g., Stafford Loan, Perkins Loan, Pell Grant), and the rest will be from the college's own endowment 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 federal methodology and 529 plans

Now let's see how a 529 account will affect federal financial aid. Under the federal methodology, 529 plans--both college savings plans and prepaid tuition plans--are considered an asset of the parent, if the parent is the account owner.

So, if you're the parent and the account owner of a 529 plan, you must list the value of the account as an asset on the FAFSA. Under the federal formula, a parent's assets are assessed (or counted) at a rate of no more than 5.6 percent. This means that every year, the federal government treats 5.6 percent of a parent's assets as available to help pay college costs. By contrast, student assets are currently assessed at a rate of 20 percent.

There are two points to keep in mind regarding the classification of 529 plans as a parental 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, other relative, or friend is the account owner, then the 529 plan doesn't need to be listed on the FAFSA. Similarly, if the student is considered the account owner (as may be the case with a "custodial 529 account," which results when UGMA/UTMA assets are transferred to an existing 529 account), then the 529 plan doesn't need to be listed on the FAFSA.
- 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 plan wouldn't affect financial aid eligibility at all.

Distributions (withdrawals) from a 529 plan that are used to pay the beneficiary's qualified education expenses aren't classified as either parent or student income on the FAFSA.

The federal methodology and other college savings options

How do other college savings options fare under the federal system? Coverdell education savings accounts, mutual funds, and U.S. savings bonds (e.g., Series EE and Series I) owned by a parent are considered parental assets and counted at a rate of 5.6 percent. However, UGMA/UTMA custodial accounts and trusts are considered student assets. Under the federal methodology, student assets are assessed at a rate of 20 percent in calculating the EFC.

Also, distributions (withdrawals) from a Coverdell ESA that are used to pay qualified education expenses are treated the same as distributions from a 529 plan--they aren't counted as either parent or student income on the FAFSA, so they don't reduce financial aid eligibility.

One final point to note is that the federal government excludes some assets entirely from consideration in the financial aid process. These assets include all retirement accounts (e.g., traditional IRAs, Roth IRAs, employer-sponsored retirement plans), cash value life insurance, home equity, and annuities.

The institutional methodology and 529 plans

When distributing aid from their own endowment funds, colleges aren't required to use the federal methodology.

As noted, most colleges use the PROFILE application (a few colleges use their own individual application). Generally speaking, the PROFILE digs a bit deeper into your family finances than the FAFSA.

Regarding 529 plans, the PROFILE treats both college savings plans and prepaid tuition plans as a parental asset. And once funds are withdrawn, colleges generally treat the entire amount (contributions plus earnings) from either type of plan as student income.

Note: *Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing. More information about specific 529 plans is available in the issuer's official statement, which should be read carefully before investing. Also, before investing, consider whether your state offers a 529 plan that provides residents with favorable state tax benefits.*



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2801 55th Street NW, suite
#1
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jim@jimstephan.com
www.jimstephan.com

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