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How a Grandparent's '529' Account Affects Financial Aid

For Fafsa purposes, it is best to have an account owned by a parent or a dependent student



There are some ways to get around the problem of grandparent-owned 529s. You can switch the account owner to the parent, for example. PHOTO: ISTOCKPHOTO/GETTY IMAGES

By Chana R. Schoenberger

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Readers continue to send in questions about the smart way to save and pay for college. We asked experts to help us answer them.

How is financial aid affected if parents or grandparents own 529 college-savings accounts for the benefit of students?

If you're trying to get the maximum amount of financial aid, it is generally better to have a tax-advantaged 529 account owned by a parent or dependent student, rather than by a grandparent. Both parent- or student-owned plans are considered parent assets on the Fafsa (the federal financial-aid filing), says Mark Kantrowitz, publisher of the educational site Savingforcollege.com. When money sits in those accounts, the assets are considered at up to 5.64% of their value for financial-aid purposes.

Grandparent-owned accounts, by contrast, don't count at all—until the student takes a distribution for school expenses. At that point, the money withdrawn is considered at up to 50% of its value for aid purposes, he says.

(Note that all nonqualified distributions—money taken out to pay for any expense that doesn't qualify under the IRS rules—are considered part of a student's income.)

In other words, Mr. Kantrowitz says, "\$10,000 in a student- or parent-owned 529 plan will reduce eligibility for need-based aid by as much as \$564, while \$10,000 in a grandparent-owned 529 plan will reduce aid eligibility by as much as \$5,000."

Be aware, he says, that the rules for grandparents' 529 accounts apply to anyone other than the dependent student or the student's custodial parents. This means noncustodial parents don't get a break, so make sure the account owner is the parent with whom the student lived most in the 12 months before filling out the Fafsa, he says.

There are some ways to get around this problem if you hold your college fund in a grandparent-owned account. You can switch the account owner to the parent, if your plan allows this (some don't). Because the Fafsa looks back two years to take a snapshot of your income and assets, you can also wait until the student has two years of school left before distributing money from a grandparent-owned account, Mr. Kantrowitz says.

It is also possible to roll a year's worth of 529 funds from a grandparent-owned account into a parent-owned account for the same beneficiary, after you file that year's Fafsa.

“Since the distribution to pay for college costs will be from a parent-owned 529 plan, it won’t be reported as income on the Fafsa,” he says. Make sure both plans are in the same state, so you don’t face state income-tax repercussions.

You can also wait until the student finishes school to use the grandparent-owned fund, and take a nonqualified distribution to pay down student loans. You’ll owe income tax on the earnings portion of the money you withdraw, as well as a 10% penalty on the whole amount you take out, he says.

If you can, keep all college funds in a parent’s name from the beginning.

“If grandparents want to contribute to a child’s college savings, the smarter strategy is for them to contribute to a parent-owned 529 plan,” says Jordan Lee, co-founder and CEO of 529-plan operator CollegeBacker.

Our son will be attending college in the fall of 2019, so his Fafsa application to be filled out this fall will be based on 2016 income. My dilemma is that in 2016, I received a large settlement award that greatly inflated my income. My husband has since retired, and our sole income is my disability payments, as reflected on 2017 tax returns. What should be our approach with Fafsa?

Actually, because it is a two-year look back, this Fafsa will be based on your 2017 income, so your settlement in 2016 won’t affect it, says Abby Chao, CollegeBacker’s co-founder and chief operating officer.

Colleges take into account the family’s entire financial picture, Mr. Kantrowitz says: “If you lost your job but also won the Powerball jackpot, both factors will be considered.”

Even if a student is already in college, there may be more discretion to change your financial-aid package than you realize. “If a parent’s employment status has changed or there’s been an irregular increase in family income, you should explain these circumstances in your financial-aid application and contact the school’s financial-aid office,” Ms. Chao says.

As a grandparent, I set up a trust for my step-granddaughter, who is now 19. Under the terms of the trust, no income is required to be distributed until the beneficiary is age 21, at which time all income will be distributed. Does this potential income have to be disclosed now when applying for financial aid?

Yes. Even if your step-granddaughter isn't permitted to touch the money now, the trust can affect her financial aid.

"The Fafsa requires a student who is a trust beneficiary to report the trust's present value as an asset, and this may increase the family's expected contribution by 20% of that value," Mr. Lee says.

A friend told me that she liquidated her son's UGMA/UTMA account and used the proceeds to buy a life-insurance policy, because the UGMA would reduce her son's financial-aid qualification while a life-insurance policy wouldn't. I am skeptical. Does this work?

Your skepticism is well-placed. It is true that a Uniform Gifts to Minors Act/Uniform Transfers to Minors Act account—which lets you save for a child's education—does count as an asset of the student. And it reduces qualification for aid by 20% of the account's value for the Fafsa and by 25% on the CSS Profile, which some colleges use.

It is also true that financial-aid calculations don't count money in cash-value or whole-life insurance policies, although distributions from these policies are considered income, Mr. Kantrowitz says.

However, it isn't usually in a family's best interest to use one of these insurance policies in this way, he says: "The return on investment is lousy, and the commissions, fees, redemption and surrender charges are high."

A financial adviser who isn't making a cut of the insurance policy sold will likely tell you that you should buy term life insurance if your goal is to replace a wage earner's income (which it isn't, in this scenario), he says. There is also no guarantee that the rules on how these policies are treated for financial-aid purposes won't change.

In general, Mr. Kantrowitz says, “people who have sufficient assets to have a big impact on eligibility for need-based aid usually have sufficient income to eliminate eligibility for need-based aid even if there were no assets.”

Your best strategy? It may be to make sure your child has the highest grades possible to qualify for merit-based scholarships.

Is New York state planning to change its views on using 529 funds for K-12 educational expenses?

Not likely, says Mr. Kantrowitz. The state is one of 10 that don’t consider 529 distributions for K-12 purposes to be qualified expenses. And the state 529 plan’s rules are fairly strict.

“Accordingly, it seems unlikely that New York will allow 529 plan distributions for K-12 tuition to be considered a qualified distribution under state law unless constituents pressure lawmakers to pass legislation changing the treatment of such distributions,” he says.

If we set up a 529 account for our Canadian grandchildren, can they use it at Canadian universities?

As long as your grandchildren are U.S. citizens or permanent residents (whether or not they also have another nationality), they can use 529 funds at any university, in the U.S. or overseas, that qualifies for federal student aid, Ms. Chao says.

In Canada, there are 70 schools on the list, which is available at the [Savingforcollege](#) website, Mr. Kantrowitz says.

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