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Grandparents' college help, even savings plans, could end up hurting students

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By Tim Grant / Pittsburgh Post-Gazette

Grandparents want the best for their grandchildren, but sometimes their good intentions can wreak havoc with a student's financial aid package.

Students could become less eligible for federal financial aid when grandparents help them pay college expenses — even when the distributions come from 529 savings plans, which are usually marketed as a tax-friendly way for grandparents to help fill the college savings gap.

"Various assets, including college savings plans such as 529 plans, must be reported on the [Free Application for Federal Student Aid] when required," said Lynnette Khalfani Cox, CEO of AskTheMoneyCoach.com and author of "College Secrets: How to Save Money, Cut College Costs and Graduate Debt Free."

"In fact, a failure to list a reportable asset on the FAFSA is considered fraud. You must also list a variety of income sources when required," she said. "But how 529 plans are treated for FAFSA purposes depends on who owns the plan."

The plans are actually college savings trusts that are set up under Section 529 of the Internal Revenue Service code. Their primary benefit has to do with income taxes on the account's earnings. As long as the money is used for qualified college expenses, a 529 plan is a tax-free investment. Families can put aside up to $14,000 per child each year and pay no taxes on the money while it's growing and no taxes when they withdraw the money to pay college bills.

According to the College Savings Plans Network, there are 12 million 529 college savings plans open with $244 billion that families have put aside for college costs.

If a dependent student or a custodial parent owns a 529 plan, it must be listed as a parental asset on the FAFSA. But any qualified distributions from the accounts are ignored in the FAFSA formula, meaning those distributions are not reported as income — not to the parent nor to the student.

If an independent student owns a 529 plan, it's treated as a student asset, but qualified distributions from the account also are ignored in the FAFSA calculations.

But it's a different story if a grandparent or another relative or third party owns a 529 plan.

"In that case, that account is ignored as an asset altogether," Ms. Cox said. "This means the 529 account does not have to be even listed on the FAFSA — not as a parent asset and not as a student asset.

"However — from an income standpoint — when a third party owns a 529 plan, any qualified distributions from that 529 plan would be considered as untaxed income to the beneficiary. This is why money taken out of a 529 plan owned by a grandparent can, indeed, have serious financial aid implications."

As an illustration, Ms. Cox said, assume a student's parent owned a 529 plan and the student received a distribution of $20,000 from the plan. Under FAFSA rules, this would be counted as a parent asset, and at most a student's aid would be reduced by 5.64 percent, or $1,128.

But if a grandparent owned the 529 plan, that $20,000 would have to be reported as untaxed income and the student's aid could be cut by up to 50 percent of the distribution amount, or $10,000.

It makes no difference if the child were actually raised by the grandparent, said Mark Kantrowitz, senior vice president and publisher of the student financial aid website Edvisors.com, based in Las Vegas.

"Unless the child is adopted by the grandparent, the grandparent cannot provide their income and assets information on the FAFSA instead of the parents," Mr. Kantrowitz said. "If he is in a legal guardianship that was court-ordered, then he is considered independent, in which case the parents' information is not required. Otherwise, parent information is required even if he doesn't live with them."

When circumstances are sufficiently unusual, Mr. Kantrowitz said, the student could appeal to an institution's financial aid administrator and request a so-called dependency override.

Cases where this is successful typically include when both parents are incarcerated or institutionalized, or their whereabouts are unknown.

Obtaining an independent status would allow the student to avoid using parent information on the financial aid form. Still, any support received from a grandparent must be reported as untaxed income, including distributions from a grandparent-owned 529 plan.

Ms. Cox said there are ways to avoid having a grandparent's contribution create a world of hurt for a student.

"What some savvy parents do, often on the recommendation of financial advisers with expertise in college planning, is to implement a two-fold strategy to maximize the student's financial aid," she said.

"First, if a grandparent owns the 529 plan, they keep that asset in the grandparent's name until after the FAFSA is filed. That way it doesn't have to be reported as an asset.

"Second, after the FAFSA is completed, the family will transfer the 529 plan from the grandparent's name to the parent's name," Ms. Cox said. "By transferring ownership, the parent is now the account owner of the 529 plan, so any distributions taken from it will not have to be treated as income."

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