



How Do Grandparent-Owned 529 College Savings Plans Affect Financial Aid Eligibility?

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529 Plan Owner	Treatment of Asset	Treatment of Qualified Distributions	Treatment of Non-Qualified Distributions
Dependent Student	Parent Asset	Ignored	Taxable Income to Beneficiary (AGI)
Parent of Dependent Student	Parent Asset	Ignored	Taxable Income to Beneficiary (AGI)
Independent Student	Student Asset	Ignored	Taxable Income to Beneficiary (AGI)
Grandparent	Ignored	Untaxed Income to Beneficiary	Taxable Income to Beneficiary (AGI)

Rules for Treatment of 529 College Savings Plans as Income and Assets

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Only 529 college savings plans that are owned by the student or the student's parents are reported as assets on the Free Application for Federal Student Aid (FAFSA). So a 529 plan owned by a grandparent or other third party will not be reported as an *asset* on the FAFSA. However, qualified distributions from such a 529 plan are treated as *untaxed income* to the beneficiary on the subsequent year's FAFSA, potentially having a big impact on eligibility for need-based financial aid. (Non-qualified distributions are included in the adjusted gross income of the beneficiary regardless of who owns the 529 plan.)

This can have a big impact on eligibility for need-based financial aid. Student assets will reduce aid eligibility by 20% of the asset value (minus a small asset protection allowance) and parent assets will reduce aid eligibility by as much as 5.64% of the asset value. However, student income, including untaxed income, will reduce aid eligibility by 50% of the distribution amount (minus a small income protection allowance). Usually the treatment of 529 plan distributions as income will have a much more severe impact on aid eligibility than the treatment of 529 plans as assets.

Inaccurate Information Common

Many web sites, including those of a few 529 plan administrators, contain inaccurate information about the impact of a grandparent-owned 529 plan on eligibility for need-based financial aid. These web sites often incorrectly state that grandparent-owned 529 plans have no effect on financial aid eligibility. The misinformation is surprisingly persistent.

Here are a few examples of such errors:

There's also an interesting strategy if you have relatives who want to contribute to your child's education: A grandparent or someone else can open a 529 plan in their name, with the child as beneficiary, instead of depositing money in your plan. Since the contributor "owns" the account, it has zero impact on FAFSA financial aid calculations.

... accounts that are owned by a grandparent have no impact when determining eligibility for financial aid on the FAFSA, and the value of a 529 plan is generally excluded from the grandparent's estate.

Another attractive feature of 529 plans is that under current law, grandparent-owned 529 accounts are excluded by the federal government's financial aid formula — only parent-owned 529 plans count. So a grandparent-owned 529 plan won't impact a grandchild's chances of qualifying for federal aid.

Q: I'm considering a 529 plan for my grandchild but will I hurt my grandchild's chances of receiving financial aid?

A: 529 accounts owned by grandparents (or other non-parent) are not reportable as an asset on the FAFSA financial aid application. ... Grandparent owned 529 accounts are not counted in determining financial aid eligibility; all the more reasons for grandparents to make gifts to their grandchild's 529 plan.

To help debunk this misinformation, this article documents the treatment of 529 plans as encoded in the statute and subregulatory guidance.

Correct Treatment of 529 Plans as Income and Assets

The College Cost Reduction and Access Act of 2007 (CCRAA) (P.L. 110-84) amended subsection 480(a)(2) of the Higher Education Act of 1965 to change the treatment of 529 plans on the FAFSA, effective July 1, 2009. The statutory language as amended by the CCRAA reads as follows:

and no distribution from any qualified education benefit described in subsection (f)(3) that is not subject to Federal income tax, shall be included as income or assets in the computation of expected family contribution for any program funded in whole or in part under this chapter

This section of the Higher Education Act of 1965 is often misinterpreted as indicating that all distributions from 529 plans are ignored on the FAFSA. However, the language "described in subsection (f)(3)" is important because it limits the scope of the 529 plans for which distributions are excluded from income to just those plans described in subsection 480(f)(3) of the Higher Education Act of 1965. Distributions from plans that are not described in subsection 480(f)(3) may still be counted as income on the FAFSA.

Subsection 480(f)(3) of the Higher Education Act of 1965 reads as follows:

A qualified education benefit shall be considered an asset of —
(A) the student if the student is an independent student; or
(B) the parent if the student is a dependent student, regardless of whether the owner of the account is the student or the parent.

Subsection 480(f)(3) describes the 529 plans that are reported as assets on the FAFSA as including only plans that are owned by the student or parent. Grandparent-owned 529 plans (and all other 529 plans owned by someone other than the student or parent) are not reported as assets on the FAFSA because they do not fall within the scope of subsection 480(f)(3).

But it is also precisely because such 529 plans do not fall within the scope of subsection 480(f)(3) that distributions from such 529 plans count as untaxed income on the subsequent year's FAFSA. The reference to subsection 480(f)(3) in subsection 480(a)(2) restricts the exclusion of 529 plan distributions from income on the FAFSA to just the 529 plans described by subsection 480(f)(3), namely the 529 plans that are reported as an asset on the FAFSA.

Thus, if a 529 plan is not reported as an asset on the FAFSA, distributions from the 529 plan count as untaxed income to the beneficiary on the subsequent year's FAFSA. The treatment of a 529 plan as an asset cannot be separated from treatment of distributions as income. The two are inextricably linked.

For example, distributions from a grandparent-owned 529 plan are counted as untaxed income to the beneficiary on the subsequent year's FAFSA because the grandparent-owned 529 plan is not reported as an asset on the FAFSA.

A similar treatment also applies to other qualified education benefits, such as prepaid tuition plans and Coverdell education savings accounts.

Note that if a student's parents are divorced, the income and assets of the non-custodial parent are not reported on the student's FAFSA. In particular, if the student's 529 plan is owned by the non-custodial parent, the 529 plan is not reported as an asset on the FAFSA, but any distributions from the 529 plan count as untaxed income to the student on the subsequent year's FAFSA.

US Department of Education Guidance

The US Department of Education has published guidance that is consistent with this interpretation of the statute in the 2009-10 and 2010-11 Application and Verification Guides. According to the US Department of Education, distributions from a 529 plan owned by someone other than the student or parent are reported as untaxed income on the subsequent year's FAFSA. The following is an excerpt from page AVG-18

of the 2010–11 Application and Verification Guide (emphasis added):

Qualified education benefits

Qualified tuition programs (QTPs, also known as section 529 plans because they are covered in section 529 of the IRS tax code) and Coverdell education savings accounts are grouped together in the law as qualified education benefits and have the same treatment: they are an asset of the owner (not the beneficiary because the owner can change the beneficiary at any time), except when the owner is a dependent student, in which case they are an asset of the parent. **When the owner is some other person (including a non-custodial parent), distributions from these plans to the student count as untaxed income, as “money received.”**

...

As long as distributions from QTPs and ESAs do not exceed the qualified education expenses for which they are intended, they are tax-free, so they will not appear in the next year’s AGI. They should not be treated as untaxed income (**except in the cases mentioned above**) or as estimated financial assistance. For more information on these benefits, see the IRS’s Publication 970, Tax Benefits for Education.

Workarounds

A 529 plan owned by the grandparent or other third party can hurt the student’s eligibility for need-based financial aid. There are a few workarounds to address the treatment of such a 529 plan.

1. Wait until the senior year in college to take a distribution from the 529 plan. Since there will be no subsequent year’s FAFSA to be affected (assuming the student does not plan on enrolling in graduate school), it will not affect eligibility for need-based aid. Technically, the distribution can happen as early as the spring of the junior year in college, since that will occur after the calendar year upon which the senior year’s FAFSA is based.
2. Change the account owner to the student or the student’s parent. However, some state plans do not permit a change in ownership, so it may be necessary to move the money to a different state’s plan before changing the account owner.
3. Wait until after the student has graduated to take a non-qualified distribution (say, to pay down student loan debt). The income tax and tax penalty on the earnings portion of a non-qualified distribution are not as severe as the loss of need-based aid eligibility from treating the distribution as untaxed income to the student.

PROFILE Form Counts Grandparent-Owned 529 Plans as Assets

The CSS/Financial Aid PROFILE Form has a different treatment of 529 plans. All 529 plans that name the student as a beneficiary are reported as assets on the PROFILE. (The PROFILE also considers assets in the name of siblings who are under age 19 and not yet enrolled in college.) So a grandparent-owned 529 plan will be reported as an asset on the PROFILE.