A **Strategy Spotlight**
for Individuals

Unlocking the mystery of financial aid eligibility and asset ownership

Many parents would like to be able to pay for some or all of their children's college education. They save money in accounts, such as Uniform Gift To Minors Act (UGMA) and Uniform Transfer to Minors Act (UTMA), and specific college planning custodial accounts like Coverdell Savings Accounts, and state-based college plans. While this money will be useful when it comes to paying the cost of college tuition, how will it affect your child's financial aid? When faced with filling out the Free Application for Federal Student Aid (FAFSA) form, parents may wonder if they have saved for college in an efficient manner and whether some of their other assets can be counted against them for financial aid eligibility.

There are many choices for a parent who would like to save for college. Is there a "right" place to save for all situations? No. Can knowing how your assets count for financial aid be useful in deciding where and how to save? Yes. Let's look at some of the common saving strategies and whether they count as a parent's asset or a child's asset and why that makes a difference for financial aid purposes.

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Parental assets

1 **Savings/Checking/Money Market Account –** considered to be 100% includable as an asset on the FAFSA.

2 **Retirement accounts –**

- **Traditional IRA –** Not considered an asset for FAFSA. However, a choice could be made to withdraw from a traditional IRA to pay qualified education expenses and it would be exempt from the 10% penalty assessed for withdrawals prior to 59½. The withdrawals, though not penalized, will be subject to income tax.
- **Roth IRA –** Not considered an asset for FAFSA. A withdrawal from the Roth IRA is tax free up to the amount of contributions, but earning would still be taxed as income if withdrawn prior to 59½. While the Roth IRA is not an asset for FAFSA, withdrawals need to be reported as untaxed income on the next year's FAFSA, potentially reducing eligibility for need based on financial aid.
- **Employer-sponsored retirement plan (401(k), SEP, SIMPLE, 403b) –** Not an asset for FAFSA. Borrowing could potentially be done from the retirement plan for college expenses, but you will be charged interest on the loan until it is repaid. Loans from these plans unlike IRAs, are not subject to income tax. The savings that you are borrowing from are still tax deferred. The disadvantage of using these dollars is that in many plans the loan must be repaid in five years and if it is not, the remaining balance will be considered a taxable distribution. Also, if you leave the employer, the loan may be due all at once.

3 **Permanent life insurance –** Not considered an asset for FAFSA. While life insurance is primarily purchased for the death benefit protection, parents could choose to take a loan[1] out of the accumulated cash value of their life insurance policies to pay for or help pay for the cost of college. Permanent life insurance has the potential to build a cash value, which can be accessed through distribution[2] or loan[1]. Policy loans are not considered to be distributions. It is important to note that policy distributions are treated as a return of your investment in the contract and reduce your tax basis. Once your basis is reduced to zero, distributions will be taxable. Therefore, it is important to talk with your financial professional when you decide to utilize your life insurance policy cash value.

4 **State-based college plans (sometimes called Section 529 Plans) –** These plans are state-based college savings plans that have a low impact[3] on financial aid though they are considered an asset for FAFSA. The money in these plans is controlled by the owner of the account, not the child. So, if the child does not go to college, he or she does not automatically receive the money at a specific age like an UGMA/UTMA account. Anyone can contribute to these plans on behalf of the child. Currently, contributions to state-based plans are usually tax exempt.

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[1] Distributions under the policy (including cash dividends and partial/full surrenders) are not subject to taxation up to the amount paid into the policy (cost basis). If the policy is a Modified Endowment Contract, policy loans and/or distributions are taxable to the extent of gain and are subject to a 10% tax penalty. Access to cash values through borrowing or partial surrenders will reduce the policy's cash value and death benefit, increase the chance the policy will lapse, and may result in a tax liability if the policy terminates before the death of the insured.

Loan interest is charged when a policy loan is taken. If you take additional policy loans to pay loan interest, your policy's cash/account value will be reduced. At some point, no policy values may be available to pay additional loan interest and out-of-pocket payments will be required to prevent the policy from lapsing. Failure to pay out-of-pocket amounts will result in the loss of life insurance coverage and a tax liability in the year of lapse.

[2] Distributions can come from current dividend distribution, surrender of paid up additions, and/or partial surrenders.

[3] http://www.savingforcollege.com/intro_to_529s/does-a-529-plan-affect-financial-aid.php

Tax benefits may be subject to certain restrictions. Since the account owner is in control of the account, the assets in the account are treated as parent assets rather than that of the child. Some states offer favorable tax treatments to their residents only if they invest in the state's own plan. You should consult your tax advisor.

Child assets

1. **Savings/Checking/Money Market Account –** Considered an asset for FAFSA. High impact on eligibility.
2. **UGMA/UTMA Account –** Considered an asset for FAFSA. This type of account is also referred to as a custodial account in many states. Children cannot own investment assets or life insurance policies; therefore, a custodian will be required to own it on the child's behalf until they are considered of the age of majority and able to own investments and insurance. A donor makes an irrevocable gift to the trust and the money is then controlled by the custodian until the child reaches 18 or 21 depending on the state. This type of account will be considered the child's asset for financial aid, so it can have a high impact on eligibility. Also important to know, this asset will pass to the child at 18 or 21 whether or not the child attends college.
3. **Section 2503(c) Minor's Trust –** Considered an asset for FAFSA. This trust is a separate entity that holds gifts for a child until the child reaches the age of 21. The trustee is allowed to spend the trust's funds to pay for college expenses for the child. Since this trust is considered an asset of the child, it will have a higher impact on eligibility. If the donor acts as trustee, the trust will be included in the donor's taxable estate until the child takes over the trust at 21.
4. **Coverdell Education Savings Account –** Considered an asset for FAFSA. A Coverdell is a trust created exclusively for the purpose of paying qualified education expenses. This account can be owned by the parent or child. If owned by the child, it can have a high impact on eligibility as it is considered able to be contributed 100% towards the cost of college. These accounts are also referred to as education IRAs.

Not one planning strategy is right for all situations and parents can utilize multiple strategies to accomplish the goal of college funding. Out of the parents' asset list, permanent life insurance and retirement accounts are not countable for financial aid purposes. Of course, there should be a need for life insurance to purchase a policy as utilizing access to policy cash value is a benefit but the purpose of the insurance purchase should be primarily for death benefit protection. Retirement plans and IRAs have advantages and disadvantages when utilizing them for college planning.

It is clear that an asset in the name of a child has a higher impact on financial aid eligibility than a parent's asset. Does that mean you should not use any of the strategies where the child is the named owner of the asset? No. This is simply intended to make the parents aware of the need to plan ahead. Meet with a financial services professional and a tax advisor to look at different strategies that may work for a specific family situation. Awareness of how assets are owned prior to applying for financial aid can make a difference in eligibility for aid, so be aware and plan ahead.

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