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Learning Center

Financial Aid Strategies with 529 Plans

Sixty percent of parents surveyed say that the economy is affecting their ability to save for college, a nearly 20% increase from 2008 to 2009.[1]

As fantastic as it may sound, many parents believe that not saving for college is a strategy for meeting their children's higher education expenses — a strategy they feel will guarantee a large financial aid package. On the opposite end of the spectrum are those families who diligently save for college through the years, and come to believe they won't qualify for financial aid because they have accumulated too much. Both camps would benefit from having a clear understanding of how the financial aid system works, because there are effective ways to save and invest for college that won't significantly reduce a child's chances of receiving financial aid.

Paying for College

Most families meet college expenses from three main sources: investments and savings, current income and loans. Some families are fortunate enough to have a fourth pillar in the form of grants and scholarships.

Based on information gathered by the College Board in its 2009 survey entitled *Trends in Student Aid*, remarkably, students and their families pay only a fraction of the cost of higher education; funding for the remainder comes from a variety of sources. Still, the cost to families is high, and over half of the funds on which students rely to supplement family resources is in the form of loans. Some loans, particularly federally subsidized Stafford Loans and Perkins Loans, which do not accrue interest until the payment period begins, do provide valuable subsidies and are clearly a form of student aid. At the other end of the spectrum, the rapidly expanding private bank loans for education are not subsidized at all. Their value is only in providing liquidity for students and parents who have no other means of accessing funds. Between these two extremes are unsubsidized Stafford Loans, which are federally guaranteed and which do accrue interest from the time they are issued, and are not based on need.

Types of Financial Aid

The two largest suppliers of financial aid are the federal government and institutions (schools and universities). The two primary categories of financial aid for college are need-based and merit-based.

Need-Based Financial Aid

Need-based financial aid is strictly based on a student's demonstrated financial need. Federal financial aid, which is the single largest source of financial aid, is completely need-based. Obtaining federal aid requires a completed Free Application for Federal Student Aid (FAFSA) form, which is submitted to each school to which the student has applied for financial aid consideration. The FAFSA must be completed and submitted every year that the student attends an educational institution and requests financial aid consideration. The financial aid office of each school makes an initial determination of financial need based on the Expected Family Contribution (EFC), which is the final output of the FAFSA. Because federal financial aid is awarded based purely on need using set formulas, most affluent families will not qualify for federal grants, regardless of how much financial need may exist (the gap between the Cost of Attendance (COA) and the EFC). But they may qualify for federal loans and work study. And even very affluent families, if they have overlapping children in school at one time, may qualify for the most advantaged federal loan programs.

[1] FutureTrust and Harris Interactive, *2009 Hopes & Dreams Survey*

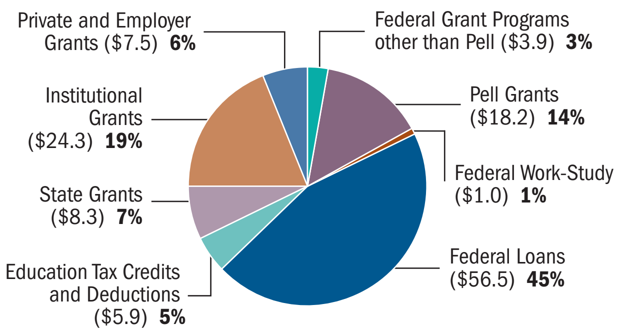
Merit-Based Financial Aid

Merit-based financial aid is typically awarded without regard to a family's financial need by the college or university of choice, or by an outside philanthropic organization. The college, university or organization typically awards merit-based aid to recognize one or more of the following accomplishments and/or qualities:

- Outstanding academic achievements
- Special talents (for example, athletic, musical, artistic, etc.)
- Leadership potential
- Other personal characteristics (for example, specialized field of study)

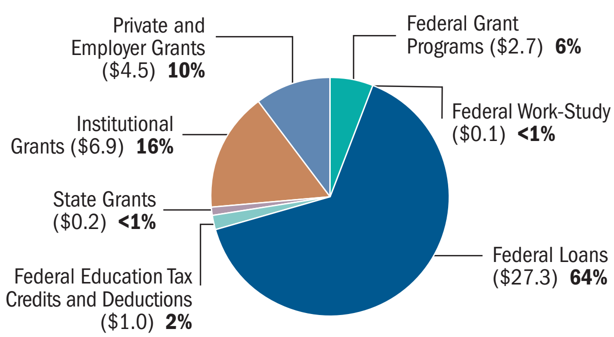
An example of a merit award is a state university providing a scholarship grant to any attending state resident who meets certain academic qualifications (for example, student is in the top 10% of his or her class or attains a certain grade point average). This type of scholarship grant typically is given regardless of the family's EFC figure or financial need.

Undergraduate Aid ($125.7 Billion)



Note: Components may not sum to 100% due to rounding.
Source: The College Board, *Trends in Student Aid,* 2009

Graduate Aid ($42.7 Billion)



Source: The College Board, *Trends in Student Aid,* 2009

Institutional Aid

Private institutional aid can be need-based, merit-based or a combination of both. The school takes into account FAFSA information and will often seek additional financial information through either the CSS/Financial Aid Profile® (which is the College Board's financial aid application service) or the institution's own customized aid form. The institutional formula is typically aligned with the federal formula, but for any given institution it may vary in what it includes and how categories of income and assets are treated.

How Need-Based Federal Financial Aid Eligibility Is Determined

Starting with a high-level understanding of the basic formula that determines a family's EFC, which is the basis of financial need, is important, so that families do not mistakenly fail to save and invest in the most advantageous way for higher education expenses.

Financial Aid Formula Illustration

Cost of Attendance (COA)	–	Expected Family Contribution (EFC)	=	Financial Need
$40,000	–	$25,000	=	$15,000

For illustrative purposes only.

It is important to realize that having a financial need does not mean that it will be met completely through financial aid. Federal loans and work study have caps on the amount that can be awarded, and in any given year, there may be more or less competition for any available institutional aid. Therefore, it is a good idea to create an estimate for what the EFC and financial need could be for each child, and use that as well as the anticipated cost of attendance to target an investment and savings goal.

All Schools Require the FAFSA

Every school to which a student applies will need a completed copy of the FAFSA and will require this form to be submitted each year for which a student attends. For private schools, the CSS/Financial Aid Profile® or its own custom aid form may be required the first year.

Determining Expected Family Contribution (EFC)

	Parents	Students
Income	22%–47% of available income[2]	50% of adjusted gross income over $3,750 for 2009–2010*
Assets	0%–5.64% of assets[3]	20% of assets held in student's name

* $4,500 for 2010–2011

The table above shows the approximate percentages of income and assets that are considered when determining the EFC based on ownership attribution.

As one can see from the chart, income, not assets, is the driver of EFC. A $150,000 figure of adjusted gross income for the parents will count far more heavily than $150,000 of assets in the parents' names. And assets held in the student's name are factored more heavily in the formula than parental assets. The following is a list of financial aid tips that may help families improve their financial aid profile.

- Any student-owned assets, including money in irrevocable trusts, or Uniform Gifts to Minors Act (UGMA) and Uniform Transfers to Minors Act (UTMA) custodial accounts, are heavily factored in the EFC formula (inclusion rate of 20%).
- Student assets that were placed in a 529 plan were not treated as student assets through the 2008–2009 academic year. Effective for the 2009–2010 academic year, 529 plans owned by a student or parent are treated as parental assets in the federal financial aid calculation.[4]
- Assets in UGMA and UTMA accounts can be transferred to 529 plans that accept transfers if they are liquidated to cash. In some cases, the liquidation may result in capital gains taxation on any unrealized gain in the year of the liquidation, but the transfer itself will be tax-free. Investors should take into account any potential expenses, sales charges and/or penalties for selling or buying investments.
- Parental assets are not heavily weighted in the EFC formula (inclusion rate of no more than 5.64% with an asset protection allowance based on the age of the oldest parent). Consequently, if money is being set aside for college, investors should consider keeping it in non-student-owned vehicles, such as a 529 account, which can be owned and controlled by the parents or grandparents.
- The parental contribution to the EFC is a set number based on income and assets. If there is more than one child in school, the parental EFC is divided by the number of students in attendance.
- The student contribution to the EFC, also based on income and assets, applies only to that particular student.
- In situations where a family may have more than one child attending college at the same time, assets held in the student's name will factor more heavily in a financial aid profile.
- A 529 plan owned by a grandparent or other nonparent relative does not count toward the federal EFC. (Note: For institutional aid, certain schools may ask if there are 529 assets held in accounts where the student is the beneficiary.)
- Even clients who say they are not planning on addressing their children's educational goals right now need to understand that, at a minimum, their EFC numbers should become their target savings goal — per student, per years of attendance.

[2] Available income is the amount of parental adjusted gross income after allowances for federal, state, local and FICA taxes, as well as income protection allowance based on the number of people in the household. The percentage of parental assets considered in determining EFC will vary based on the amount of assets, the age of the eldest parent and whether there are one or two parents.

[3] Assets held in qualified retirement plans, IRAs, insurance contracts, or the equity in a home that is the primary residence of the student are not considered in determining eligibility for federal student aid. Prior to the 2009–2010 academic year, assets held in a 529 plan were not counted as student assets for federal financial aid purposes. Effective for the 2009–2010 academic year, 529 plans owned by a student or parent are treated as parental assets in the federal financial aid calculation.

Sources: U.S. Department of Education, "The EFC Formula 2009–2010," and www.finaid.org.

[4] U.S. Department of Education Letter GEN-06-05, issued April 27, 2006, and the College Cost Reduction and Access Act of 2007

NOTE: This paper is written from the viewpoint of parents of dependent students. There are formulas for independent students without dependents (other than a spouse), or independent students with nonspouse dependents. These are generally graduate degree students. Also, some students may be eligible to use a simplified formula or be eligible for an automatic zero EFC calculation. Because of the number of variables involved, it is important to read the FAFSA directions carefully. (More information is available at www.fafsa.ed.gov.)

Help Is Available

How many times in life have you heard, "If I only knew then what I know now." Most parents don't really learn how the financial aid system works until they start filling out the FAFSA, usually in January or February of the year their first child will attend college. Extensive information on financial aid is available from the following online sources.

www.ed.gov

Main Web site for the U.S. Department of Education

www.fafsa.ed.gov

Free Application for Federal Student Aid (FAFSA) on the Web, a Department of Education Web site. Provides comprehensive information on federal student aid and allows users to apply for federal student aid online.

www.studentaid.ed.gov

Web site for the Department of Education's Federal Student Aid (FSA) programs

www.collegeboard.com

Web site sponsored by the College Board, a national nonprofit membership association composed of more than 4,500 schools, colleges, universities and other educational organizations

Also, students and their parents can try to estimate their future EFC by using the Quick EFC Approximation Calculator available on www.finaid.org. This tool allows families to see what effect varying levels of adjusted gross income, assets and number of children in school at the same time have on the EFC calculation. The tool could be used on a yearly basis to update the benchmark for saving as the prospective students approach college age.

Conclusion

When armed with a clear understanding of how the financial aid system works, students and their parents can more realistically plan to meet college expenses in a way that best preserves their ability to qualify for financial aid.

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