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Things to consider when considering a 529 college savings plan

By Holly Nicholson

Q. I have been contributing to my grandchildren's 529 plan for over 10 years. Now, my son is telling me that I've probably just ruined their chances of obtaining financial aid. He says that the 529 plan assets owned by the grandparent are now counted as a parental asset, and since I've saved so much they probably won't qualify for any aid. Now he is mad at me for doing what I thought would be appreciated! I thought the 529 plans I owned were my assets and shouldn't affect financial aid.

Who's correct, and if my son is correct, do you have any advice?

A. Talk about looking a gift horse in the mouth!

I for one think that saving for your grandchildren's college education was very thoughtful. With that said, there are some things to watch out for if your grandchildren are seeking financial aid.

Eligibility for need-based financial aid depends on both family income and savings, including 529 plans. Schools use the expected family contribution to determine how much aid a student qualifies for. They use various formulas to determine how much a family can afford to contribute to the child's education, and compare this to the cost of attending the school.

If a family's income is such that its EFC is higher than the cost to attend the school, no aid will be awarded even if the family has no other countable assets. If the family has a large amount of savings in nonretirement accounts, this will weigh against financial aid. Assets owned by the parents, including 529 plans, will reduce need-based aid by a maximum of 5.64 percent.

Example: A parent owns a 529 plan for his son containing $30,000; his aid will be reduced by approximately $1,692. Assets, including 529 plans, owned by the student will reduce need-based aid by a maximum of 20 percent. Same example as above but the student owns the plan, his aid will be reduced by approximately $6,000.

If the 529 plan is held by someone other than the parent or student, such as grandparent, the money in the plan will not appear as an asset on the financial aid applications. This sounds like a good thing, but there's a catch: Once money is withdrawn to pay for eligible higher education costs for the grandchild, the amount withdrawn must be reported on the next year's financial aid forms as untaxed income to the student. Such income can reduce the amount of aid by 50 percent! A $10,000 withdrawal could increase the EFC by $5,000, effectively reducing any financial aid by $5,000.

What's a well-meaning grandparent to do? One option is to transfer ownership of the 529 plan to the parent if your state allows such transfers (North Carolina does). It will still affect financial aid as a parental asset, but the impact is much less than that of untaxed income. You could also wait until the final year of college to spend down your 529 plan. Financial aid awards are based on the previous year's income and assets, so withdrawals in the final year will have no impact on aid.

If you have grandchildren from a more financially well-to-do family that won't qualify for aid based on income or assets, consider changing the beneficiary to grandchildren from that family. Depending on the aid package, withdrawing the money, paying the income tax plus the 10 percent penalty on the earnings, and gifting to the grandchild once he or she graduates may make sense.

For those unfamiliar with these plans, the major advantages of the 529 are:

• Investment gains within these savings plans enjoy the benefit of tax-deferred growth and tax exemption if used for qualified college expenses.

• Unlike custodial accounts, the money in the plans doesn't become the child's property at legal age (usually 18 or 21). The named beneficiary has no rights to the funds in the account.

• If the beneficiary doesn't go to college, several options are available: You could name another beneficiary. You could withdraw the money for your own use. This would be a nonqualified withdrawal, and income tax and a 10 percent penalty would be owed on the earnings.

• The maximum contribution to a 529 college savings plan varies by state. All contributions qualify for the annual gift tax exclusion (currently $14,000). The plans allow a gift as great as five times the gift tax exclusion ($70,000 in 2013) in a one-year period to be treated as if it were made over a five year period.

North Carolina's plan is currently one of the most highly rated in the nation. Information about the plan can be found at www.cfnc.org, or by calling 800-600-3453.

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