Why Almost Everybody Should Apply for College Financial Aid

It pays to fill out Fafsa even if you think your income is too high

By

CHANA R. SCHOENBERGER

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7 COMMENTS

Readers continue to ask questions about paying for college, and we again answer their queries with the help of experts.

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I’m told I should fill out financial-aid forms for college, even if I think I don’t qualify. But realistically, how much income is the likely cutoff?

There is no firm cutoff, but unless you can pay the full tuition cost out of pocket for every child you have in college, you ought to file the federal financial-aid form known as Fafsa, says education-savings expert Mark Kantrowitz, publisher of Cappex.com.

ASK US A QUESTION

- Have a question about college finance in general? We’ll be answering them in future funds reports. Send them to reports@wsj.com.

Except for the wealthiest families, most college-goers will qualify for some kind of aid, especially if a family has more than one child in college, because of the way the formulas are calculated, Mr. Kantrowitz says. They’re dependent on income, and to a lesser extent on assets, but also on the number of college students in a household. You can qualify for more aid either by having a lower expected family contribution (which gauges how much your family can afford to pay), or by attending a school with a higher cost of attendance. That’s why expensive private colleges sometimes give financial aid to families whose incomes you might think would be too high, he says. “At some of the most selective colleges with ‘no loans’ financial-aid policies, even families with income up to $180,000 can qualify for institutional grants,” he says.
INVESTING IN FUNDS & ETFS
A family with one child enrolled at an in-state public college, with household income over $350,000 a year and assets of more than $1 million (aside from retirement accounts and the family home), shouldn’t bother filing the Fafsa unless they want to take out loans, he says. But if you make less than that, have fewer assets, have a student at a more expensive school or have more than one child in college, you should fill out the form.

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My grandson has graduated from college with student loans. If he cashes in savings bonds to repay the loans, would that be considered an education expense for which savings-bond interest isn’t taxable?
You can’t use this money in a tax-free manner to pay off student loans. “The exemption for excluding savings-bond interest is for qualified education expenses, which the payback of loans isn't,” says Robert Schmansky, a certified financial planner with Clear Financial Advisors in Livonia, Mich. What’s more, he says, the bondholder must have been 24 years old before the bond’s issue date.

One potential bright spot: Student-loan interest can be reported as a tax deduction on your tax return. “This has the potential to lower your tax liability,” says Bob Meighan, a vice president at Intuit’s TurboTax unit.

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Is it possible to set up a Upromise 529 account for future grandchildren not yet born? In that way, the account could benefit from my purchases without me having to put any personal money in until I have grandchildren.
Upromise, a product offered by Sallie Mae, incorporates both your contributions and loyalty bonuses based on your purchases from participating shopping partners to fund either a regular savings account or a 529 account, Mr. Meighan says. However, you’ll need a living beneficiary—not a future grandchild—before you can establish a 529. “While you cannot set up a 529 for anyone not currently alive, you can set up a 529 for yourself as the beneficiary and make a change of beneficiary at some point in the future,” Mr. Schmansky says.
My children are three years apart, so they will overlap at college for one year. I have a 529 for my older child. In the year they overlap, can I use that account to pay senior-year tuition for the older one, then retitle the beneficiary to the younger one and pay freshman-year tuition?

“One of the great benefits of 529 plans is that they allow you to change the beneficiary to another family member without tax consequences,” Mr. Meighan says. In this case, you can change the plan’s beneficiary to your younger child once you pay the older student’s tuition. This can happen in the same year. Just be careful that you make the payment for each child while that child is named as the beneficiary on the account, as one 529 account cannot serve two beneficiaries at the same time.

“It can be a wise move with multiple children to see if there may be any ‘leftovers’ for an older child before fully funding [529s] for your younger children,” says Mr. Schmansky. He tells clients that it isn’t always smart to max out your children’s 529 plans, even if you plan to pay for four years of undergraduate education. You can’t tell the future: Your children may receive a scholarship, or may not complete college.

Are 529 withdrawals equal to the amount of a merit scholarship considered taxable income?

If you take money out of a 529 up to the amount of a scholarship the student has received, you won’t have to pay the 10% penalty on that withdrawal, as you would for nonqualified expenditures. But you’ll have to pay ordinary income tax on any amount you withdraw that represents a gain, Mr. Meighan says.

Here’s an example he cites: If you contributed $20,000 to a 529 plan that is now worth $22,250, and the beneficiary received a $25,000 scholarship, you can withdraw up to $22,500 penalty-free. However, $20,000 is a tax-free distribution of your contribution, and the $2,250 gain is taxed at your regular income-tax rates.
“If you have a scholarship paying for a part of your expenses, you simply would want to use your 529 plan for other eligible expenses,” Mr. Schmansky says.

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I have a New York state 529 college-savings plan for my daughter, who is now attending school in Michigan. Should I transfer the money to a Michigan plan first and then to the school, or pay the school directly from the New York plan?

Leave your money in the New York plan, and pay it directly from there, says Mr. Schmansky. The federal tax deferral isn’t dependent on the state where you hold the account or the state where your student goes to school. But “the tax benefits you received as a New York taxpayer may be lost if you transfer your plan,” he says. For example, some states require account holders who transfer funds to another state’s plan to pay back past deductions, as well as state income taxes on the earnings with the plan, he says.

In general, don’t move 529 money around from account to account other than to pay college expenses, says Mr. Meighan. “Paying the education expenses directly from the plan mitigates potential questions later about what the money was spent on.”

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We are longtime retirees in our 80s. Can we use one of our existing IRAs to fund a 529 for our new grandson?

Yes. Since you’re older than 59½ years old, you won’t pay a penalty on the distribution, but you’ll still have to pay taxes on the withdrawal, Mr. Meighan says. What’s left after paying
income taxes can be contributed to your grandson’s 529 account, where it will grow tax-free. You may also get a state tax deduction when you move the money into the 529, depending on where you live.

“Depending on your personal circumstances, this still may be a smart move if those who would inherit the IRA otherwise would pay at a higher rate than you would,” says Mr. Schmansky. Or consider converting your regular IRA into a Roth IRA that you pass down to future generations, he says: “An inherited Roth IRA will be tax-free to the recipient, can be used for any purpose, and won’t have the investment restrictions of a 529 plan.”

Check with your tax adviser to make sure you’ve thought through the estate-planning implications of such a move.

*Ms. Schoenberger is a writer in New York. She can be reached at reports@wsj.com*