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Financial Aid Strategies

12 Terrible Financial Aid Mistakes and How to Avoid Them

If you're calculating your expected family contribution (EFC) and planning to apply for future financial aid, it's crucial to avoid the mistakes that many families make.

There are 12 common mistakes that can cost you thousands of dollars in potential aid by lowering your aid eligibility and decreasing the amount of aid you receive.

Understanding the FAFSA Form, Income and Assets

Avoiding financial aid mistakes begins with understanding the Federal Application for Federal Student Aid (FAFSA) and how aid eligibility is determined.

To apply for financial aid, you'll submit a FAFSA form, where you report all income and assets considered assessable for determining aid eligibility.

Here is how your income and assets are defined:

- **Income is based on your adjusted gross income on your tax return.**
- **Assets are things you own and are generally your "true assets," consisting mostly of financial assets and real estate.** They don't include depreciating assets or consumer goods such as cars, clothes, furniture, and appliances.

It's also important to understand a few key FAFSA ground rules:

- **Income and assets are assessed if they belong to students, two married parents, or a primary parent in the case of divorce.**
- **Income and assets in a student's name are assessed more heavily than assets in a parent's name.** For example, 50% of student income is considered available for potential college costs if it's above a certain protected amount. The amount changes from year to year and is currently set at $6,660 for the 2019-20 school year. In contrast, parental income and assets are only assessed at up to 5.6%.
- **Income and assets belonging to people other than the student or parents are not assessed at all.** This income and these assets might be owned by grandparents, aunts and uncles, and even a non-primary parent in the case of a divorce. I call these individuals "outside owners."

  Caution: Assets may not be assessed if they are owned by outside owners. However, once they are used for college, they may be assessed as student income, which is often far worse. This is because 50% of student income is assessed for college aid eligibility once that income rises above the protected threshold. We'll explore this in more detail later.

The 12 terrible financial aid mistakes are often made long before the FAFSA form is completed, when students and families often fail to properly manage, use, invest and shift their income and assets. This results in a higher EFC and lower aid eligibility or no financial aid at all.

However, these mistakes are easily avoidable if you know how to use the right income and asset strategies ahead of time. We'll take a look at these momentarily, but here are two important reminders:

! Reminder #1: You will need to report all assets that are owned by parents and students as of the day you sign the form. To minimize assessments, you need to shift assets at some point before you sign the FAFSA form.

! Reminder #2: When shifting assets, be careful about creating additional income that could have a negative effect on financial aid in future years. For example, if you shift an investment or savings bond, you may have to pay taxes on the growth so far, and that growth income could have an impact on future financial aid awards.

The 12 Terrible Financial Aid Mistakes

Asset Mistakes

1. **Putting assets in the name of the student.** This one is simple to understand because student assets are assessed more heavily than parental assets for the purposes of determining financial need. If you're a parent and your student has assessable assets, your student will be expected to contribute more of that money toward college costs than you would.

2. **Accruing too many student-owned assets.** Since they're assessed more heavily than parental assets, you want to minimize the amount of assets currently owned by your student. There are two primary ways to do this:
   - Spend the money on student expenses, such as tuition at private K-12 schools, extracurricular activities, college visits, college test preparation services, cars, cell phones, or even vacations.
   - Invest the student's money in a college savings plan, such as a 529 plan. Even if a student owns his or her own college savings plan, it's still considered a parental asset for FAFSA purposes.

3. **Putting financial contributions by grandparents or other "outside owners" in a student's or primary parent's name.**

   "Outside owners" are people such as grandparents, aunts and uncles, and a non-primary parent in a divorce situation.

   The student, two married parents, or the primary parent in a divorce are not considered outside owners. Just about everyone else will be considered one.

   Assets belonging to outside owners are not assessed in determining a student's financial aid eligibility. These assets don't have to be reported, as long as they're in the name of the outside owners and not in the name the student, parents, or the primary parent in the case of a divorce.

   If any of these outside owners have assets intended to help pay for your student's college costs, don't put them in the student's name. Keep them under the names of the outside owners.

   However, you still need to use the assets carefully, to make sure they don't inflate your student's income for future financial aid applications. One of questions on the FAFSA form is whether any recent college expenses have been paid on the student's behalf. Once outside owners have contributed to those expenses, the contributions can be considered income.

Students can have income up to the student's income protection allowance without impacting financial aid. The student income protection allowance for the 2019-20 academic year is $6,660. Contributions beyond this allowance will likely be considered income for future financial aid assessments.

Another useful strategy is to use assets from outside owners at a time when the student will no longer be applying for financial aid, such as during a student's senior year in college.

4. **Leaving too much of your money in cash savings.**

Consumer debt and auto loans are not assessed on the FAFSA form, so you never have to report them. However, cash savings in the bank are counted as an asset, and they can be counted against you for determining financial need. To avoid cash assessment, you can use some of your savings to pay off credit cards, auto loans, and other consumer debt. This will also boost your financial aid eligibility.

You can also use cash to pay off or pay down your mortgage or a second mortgage, especially because home equity is not assessed on the FAFSA form, and most colleges don't count home equity against you. However, there are some colleges that do, and these are typically schools that use the College Board's College Scholarship Service (CSS) profile or have their own home equity financial aid form.

Generally, if you contact the financial aid office at a college, the school will explain how it treats home equity. Even if it uses the CSS profile and asks about your home equity, some colleges will only count a portion of it, or they'll cap it. Others may assess all of it.

5. **Failing to realize you can invest in non-assessable investments.**

You can reduce your potential asset assessment by maxing out your contributions to retirement plans and IRAs, as well as Roth IRAs. None of these are assessed in determining your EFC or financial need.

Another potential strategy is to invest in annuities and life insurance products, as these are not assessed. However, many annuities and life insurance products are very expensive and may cost substantially more in fees than the benefit you receive.

Also, some annuity and life insurance agents have been known to push these because the agents collect a commission on the products. Thus, before you consider any investments in these assets, you want to be sure there will be a true payoff.

Additionally, some colleges are now aware of these strategies and they're starting to ask more questions about whether families own annuities or life insurance. Although they don't count for FAFSA purposes, some colleges will include these when calculating their own scholarships and grant packages.

6. **In a divorce situation, failing to pay attention to which parent owns the assessable versus non-assessable assets.**

In a divorce, it can make a difference which parent gets non-assessable assets, such as retirement plans and the primary residence, compared to who gets assessable assets, such as bank accounts, non-retirement assets and college saving plans. This is why it's often important to determine who gets what during a divorce process, especially when you have children who may be attending college in the future.

For example, on the FAFSA, only one parent may be listed, whereas the other parent may be considered an outside owner, so assets owned by the other parent may not be assessed until they're actually used for contributions to student expenses, at which point they are considered student income.

Income Mistakes

To maximize financial aid eligibility, you want to manage your income and keep it low.

Income for FAFSA purposes is reported based on your tax return from two years ago. For example, if you have a 2020 graduate, you'll be using your 2018 tax return.

Thus, income planning needs to happen much sooner than asset planning, to account for that earlier timeline.

As another example, if you have a high school senior who's filling out the FAFSA and will be an incoming college freshman, the tax year in question starts in the sophomore year of high school (January) and ends in the junior year of high school (December). And that tax return would have been due in April of the student's junior year.

Here are some common income mistakes to avoid as you look to maximize your financial aid eligibility:

7. **Making financial transactions that increase your income in years that will be reported.**

   You want to avoid stock options and selling depreciated assets such as stocks and real estate. You also want to avoid taking withdrawals from your retirement plans.

   All of these transactions will likely increase your income for tax reporting purposes, which means you'll be assessed at higher income on the FAFSA.

8. **Failing to exercise control over your self-employed or business income.**

   If you're self-employed or own your own business, you may have control over the years when you receive your income.

   Of course, it doesn't make sense to forfeit income solely to increase financial aid eligibility. The income you would give up is likely more than the aid you'll receive.

   However, if you can shift the year in which you receive income or use some of it to invest in business expenses, you can potentially still receive that income and get a financial aid benefit as well.

9. **Forgetting to take advantage of work or business benefits that may lower your taxable income.**

   If you receive certain benefits in the workplace or you can create similar benefits for yourself through a business you own, you can decrease your taxable income and thereby increase financial aid eligibility.

   Examples of these benefits include health savings accounts, flexible spending accounts, tuition reimbursement, and deferred compensation.

If you've retired or will be retired during your student's college years, you'll want to manage your income sources to reduce your taxable income during college years.

10. **Drawing on retirement income sources that can increase your taxable income.**

In general, there are a number of tax-deferred retirement investment vehicles, such as 401K, IRAs, and a 403b, where you defer paying taxes until you take the money out.

Now we also have a Roth IRA option as well as Roth options inside our 401Ks and other retirement plans. With a Roth IRA or Roth option, we don't get a tax deduction when we put the money into the investment. But that advantage is that we don't pay taxes when we take the money out in retirement, assuming we follow the rules.

If we have both types of investments, we can potentially manipulate our income for taxable college years.

For example, you could take out an IRA for year one and pay the required taxes, but then it won't be assessed by the FAFSA as income in future years.

To minimize your taxable income, you can also sell assets that haven't appreciated, such as stocks that haven't grown much, or a balanced mix of winners and losers so you don't impact your income.

If you retired recently, you might be able to live on a severance or a line of credit so you don't take retirement income. Or you could choose to start collecting Social Security or not, depending on whether the income will be taxable.

Timing Mistakes

11. **Overlooking the potential "alternate year" strategy.**

In some cases, it may be beneficial to use an alternate year strategy and make some years better for financial aid purposes by shifting income and assets into the year before or after the taxable year for FAFSA purposes.

With this strategy, you can have a "good" year every other year by intentionally shifting things into the alternating year. For example, you could defer or move up income in 2020, 2022 and 2024, and move it into 2021 and 2023. This could make the even-numbered years friendlier for financial aid purposes, while you might not qualify for aid during the others.

This may be a beneficial strategy, particularly if it can help you qualify for aid in at least some years, whereas you might not qualify for any if you didn't shift your income. You might also combine this approach with other timing strategies to maximize your aid eligibility.

12. **Forgetting to focus on the years when you have the most students in college.**

If there are years when you happen to have multiple students in college at the same time, your EFC is reduced and you're much more likely to qualify for aid during that time.

Thus, it may make sense to time your income and asset management accordingly, to help maximize your aid eligibility and potential benefits during those years compared to others.

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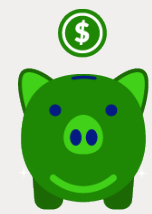

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A leading expert in college funding, Brad Baldridge, CFP®, is the owner of Baldridge College Solutions and chief podcaster and blogger at Taming the High Cost of College.