Bypassing Scholarship Displacement with 529 College Savings Plans

By Mark Kantrowitz, Publisher and VP of Strategy, Cappex.com

Scholarship displacement prevents students from using the full financial value of their scholarships to pay for college costs. Scholarship providers may wish to consider contributing the money to a student- or parent-owned 529 college savings plan instead, as this may yield a more favorable impact on financial aid eligibility and tax liability.

Tax and Financial Aid Impact of Scholarships

The financial value of a scholarship is affected by two factors:

- The **tax treatment** of scholarships
- The impact of scholarships on **eligibility for need-based financial aid**

Scholarships are tax-free if used to pay for tuition and textbooks, but not living expenses. If the student is pursuing a degree, scholarships are excluded from income to the extent that they are used to pay for tuition and required fees, plus required textbooks, supplies and equipment.

There are two scenarios in which all or part of the scholarship may be considered taxable income to the student:

- The portion of a scholarship that represents payment for teaching, research or other services by the student is taxable, if the services are required as a condition for receiving the scholarship, even if the scholarship is used to pay for tuition and textbooks.
- The portion of a scholarship that is used (or required to be used) to pay for room and board and other living expenses is taxable, even if the student is degree-seeking.

Scholarships are considered to be *estimated financial assistance*, which reduces eligibility for need-based financial aid dollar-for-dollar. Colleges have some flexibility in how to reduce need-based aid. Some colleges reduce student loans first, yielding a reduction in the net price. Other colleges reduce institutional grants first, yielding no net financial benefit to the student. Some state grant programs require colleges to treat the state grants as last dollar aid, meaning that the state grants get reduced first.

Even when a college has a favorable displacement policy that does not reduce institutional grants, some colleges will consider the amount of a renewable scholarship in subsequent years, leading to a reduction in the institutional grant as compared with the first year. In effect, the college takes the scholarship for granted. (Pun intended!)

Tax and Financial Aid Impact of 529 College Savings Plans

Earnings in a 529 college savings plan are tax-deferred and may be entirely tax-free if distributions are used to pay for the beneficiary's qualified higher education expenses. Qualified higher education expenses include room and board (if the student is enrolled at least half-time) and expenses for special needs services, not just tuition, fees, books, supplies and equipment. This is a broader set of qualified higher education expenses than for the tax-free treatment of scholarships.

The impact of a 529 college savings plan on eligibility for need-based financial aid depends on the account owner and whether the student beneficiary is a dependent or independent student.

- **Dependent Student, 529 Plan Owned by Student or Custodial Parent.** If a 529 college savings plan is owned by a dependent student or the dependent student's custodial parent, it is reported as a parent asset on the student's Free Application for Federal Student Aid (FAFSA). Qualified distributions from such a 529 plan are ignored on the FAFSA. Parent assets are assessed on a bracketed scale on the FAFSA, up to a top bracket of 5.64% of the asset value.
- **Dependent Student, 529 Plan Owned by Someone Other than the Student or Custodial Parent.** If a 529 college savings plan is owned by someone other than a dependent student or the dependent student's custodial parent, such as a grandparent, aunt, uncle, cousin, sibling or the non-custodial parent, it is not reported as an asset on the FAFSA. However, qualified distributions from such a 529 plan are reported as untaxed income to the student on the FAFSA, reducing eligibility for need-based aid by as much as half the distribution amount.
- **Independent Student.** If the student is an independent student, the 529 college savings plan is reported as a student asset. If an independent student does not have dependents other than a spouse, student assets are assessed at a 20% rate. If an independent student has dependents other than a spouse, student assets are assessed on a bracketed scale on the FAFSA, up to a top bracket of 3.29%.

Non-qualified distributions from a 529 plan that is owned by a dependent or independent student or by a dependent student's custodial parent are included in adjusted gross income (AGI), reducing eligibility for need-based aid by as much as half of the distribution amount.

The earnings portion of a non-qualified distribution from a 529 plan is subject to ordinary income tax at the beneficiary's rate, plus a 10% tax penalty. If the money was contributed recently to the 529 plan, there may be little or no earnings, so the tax liability may be low.

Although the impact of a 529 plan on aid eligibility varies from 3.29% to 5.64% to 50%, in each case money in a 529 college savings plan has a less severe impact on aid eligibility than the dollar-for-dollar reduction that occurs when a student receives a scholarship. Generally, the lowest impact is realized when the money is in a student- or parent-owned 529 plan.

The CSS/Financial Aid PROFILE form, which is used by about 200 mostly private colleges for awarding their own grants, counts all 529 plans that list the student as a beneficiary, assessing them at a 25% rate after subtracting a modest allowance for college savings. These colleges must still use the FAFSA for federal and state aid.

529 Plans Offer Superior Financial Aid and Tax Treatment

Thus, if a scholarship provider contributes money to a student- or custodial-parent-owned 529 college savings plan, it may yield a more favorable financial aid and tax treatment than awarding the money to the student as a scholarship.

There are several other benefits of contributing the money to a 529 plan. Research has shown that low-income students with a 529 plan are more likely to enroll in college, since it sets up an expectation that the student will enroll in college. (There is, however, no research comparing the impact of a 529 plan versus a scholarship on college matriculation rates.) Depending on when the student wins the award, the money in a 529 plan may have time to grow before the student enrolls in college.

There are, however, some potential drawbacks to awarding money through a 529 plan, mostly concerning a loss of control by the scholarship provider.

- The money in a 529 plan is no longer conditioned on the student's enrollment in a college or university. The parents could take a non-qualified distribution to use the money for any purpose. The prospect of paying taxes on the distribution may not be sufficient disincentive.
- The parents could decide to change the beneficiary of the 529 plan to a sibling or to themselves, thwarting the scholarship provider's intentions.

Despite these caveats, a 529 plan is unlikely to be abused.

One possible workaround that allows the scholarship provider to retain some control is to contribute the money to a student-owned 529 plan. If the student is a minor, the scholarship provider could serve as custodian of the student's custodial 529 plan. This would allow the scholarship provider to retain control over the 529 plan until the student reached the age of majority. Also, the beneficiary of a custodial 529 plan cannot be changed.

Examples Comparing 529 Plans with Scholarships

This table provides examples of the financial aid and tax treatment of a $10,000 scholarship vs. a $10,000 contribution to a 529 college savings plan owned by a dependent student or the student's custodial parent. The examples assume that the student is in the 25% tax bracket.

Scenario	Scholarship	529 Plan	Differences
Tuition and Textbooks	Taxes: $0 Financial Aid: $10,000	Taxes: $0 Financial Aid: $564	Taxes: $0 Financial Aid: $9,436
Living Expenses	Taxes: $2,500 Financial Aid: $5,000	Taxes: $0 Financial Aid: $564	Taxes: $2,500 Financial Aid: $4,436

This table shows the impact when the student is an independent student.

Scenario	Scholarship	529 Plan	Differences
Tuition and Textbooks	Taxes: $0 Financial Aid: $10,000	Taxes: $0 Financial Aid: $2,000	Taxes: $0 Financial Aid: $8,000
Living Expenses	Taxes: $2,500 Financial Aid: $5,000	Taxes: $0 Financial Aid: $2,000	Taxes: $2,500 Financial Aid: $3,000

These tables demonstrate that the financial aid and tax treatment of a 529 plan is less severe than the treatment of a scholarship. They also show that using a scholarship to pay for costs other than qualified higher education expenses may yield a greater net financial benefit to the student than using it to pay for tuition and textbooks, despite the increased tax liability, if the college has an unfavorable outside scholarship policy.