WEALTH MANAGEMENT

FAFSA + Secure Act Changes Offer Opportunity + Flexibility for 529s

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WEALTH PLANNING

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The college financing landscape has seen significant upheaval related to the FAFSA (Free Application for Federal Student Aid) in 2023-2024. Two changes to 529 plans and their implications for financial aid eligibility are a bright light in an otherwise challenging year for families navigating the complexities of funding higher education.

Changes to FAFSA Creates "Grandparent Loophole" [1]

Recent modifications to the FAFSA have changed the way student untaxed income is treated, creating a "grandparent loophole." Under this new rule, **distributions from 529 plans owned by anyone who is not the student's parent will not affect the student's financial aid eligibility.**

Previously, withdrawals from 529s funded by non-parents were reported as untaxed student income where 50% of the gift was counted as available funds for college - thus reducing a student's eligibility for financial aid. The trickle-down effect was a reduction in use of 529s in the early years of higher education. Because the FASFA calculations are based on two prior years of financial information, withdrawals from non-parent 529s were often held until the last two years of college to avoid reducing student's financial aid eligibility. The new rules allow for non-parent 529 assets to be used at anytime without reducing financial aid eligibility.

The new rule offers non-parent 529 owners a double opportunity. Support their loved ones' higher education pursuits without impacting their ability to receive financial aid, and reduce their taxable estate with gifts to a 529[2] that can be put to use immediately. And, while called the "grandparent loophole" due to the likeliest usage, the new rule applies to 529s held by any non-parent – friends, aunts, uncles, etc.

Non-Parent Owned 529 Plan

	Assets	Distributions	Withdrawal Timing
Old FAFSA Rules	Not Reported	Reported as untaxed student income, 50% of gift counted as available funds for college	Usually taken in last two years to avoid reducing financial aid eligibility
New FAFSA Rules	Not Reported	Not reported	Can be used at any time without affecting financial aid eligibility

Converting 529 to Roth IRA Now an Option

As a non-parent, your 529 plan funds can now be used freely without impacting your loved one's FAFSA eligibility. But what happens when the next generation gets a scholarship? Or pursues activities outside of a qualified higher education facility? In the past, your only options were to pay a 10% penalty to use the funds for non-educational purposes, or transition the 529 beneficiary to another eligible recipient.

As of January 1, 2024, however, any 529 owner can **convert up to $35,000 of their 529's value into a Roth IRA for the beneficiary** – tax- and penalty-free – thanks to changes in the SECURE Act 2.0[3]. The new provision allows families to repurpose funds originally intended for education expenses into early retirement savings that continue to grow tax-free. Importantly, Roth IRA assets are not included in FAFSA calculations, so if the beneficiary chooses to pursue higher education in the future, their eligibility will not be impacted.

1 "Grandparent Loophole" encompasses any 529 with a non-parent owner. This could be a friend or more distant relative.
2 If the gift if revoked from the beneficiary the value will be added back into the donor's estate value.
3 Secure Act 2.0 of 2022; Section 126

Now is the Ideal Time to Review Your Plan

These changes have the potential to impact the way 529s are considered for both immediate and long-term education and estate planning. Whether you are a parent deciding how to fund your child's education, or a non-parent looking to gift assets, now may be an ideal time to review how 529s may best fit in your plan.

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