12 Terrible Financial Aid Mistakes and How to Avoid Them

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If you're like most parents, you're worried about the cost of college and how to pay for your kids' education without sacrificing your finances or retirement. However, many parents make the financial challenges far worse. They make terrible mistakes that cost their student tens of thousands of dollars in financial aid, they end up increasing their college costs dramatically.

As a financial planner and college funding specialist for over 20 years, I've helped many families avoid these mistakes by learning the right ways to plan, save, and invest for college. I've identified 12 common financial aid mistakes you need to avoid, and you can do it easily with some smart college planning and decision-making.

Let's start with a quick overview of how financial aid works. We'll take a look at how your income and assets are assessed and how these assessments are used to determine how much you might be expected to pay toward college costs.

Once you understand this, you can work on avoiding the big mistakes that can cause you to receive less financial aid and end up paying way too much for college.

Understanding the FAFSA Form, Income and Assets

Avoiding the 12 terrible 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 an online FAFSA form, where you report all income and assets that are used to determine your aid eligibility.

When you submit your FAFSA, the U.S. Department of Education will calculate something called the Student Aid Index (SAI). This is the amount that the federal government believes that you're able to contribute toward annual college costs. Ultimately, it determines how much federal financial aid you're eligible to receive.

Your SAI is shared with any colleges where your student applies, as long as they use the FAFSA as part of their financial aid process. The vast majority of colleges do, and many use your SAI as a key reference point in deciding how much aid to offer your family.

Here is how your income and assets are defined:

- **Your income is based on your adjusted gross income (AGI) on your tax return.**
- **Assets are things that you own. They 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 a student's income is considered available for potential college costs if it's above a certain protected amount. The protected amount changes from year to year and was set at $9,410 as of 2023. Any student income above this amount will be assessed at 50% of its value. Student assets, such as bank accounts or other financial accounts in their name, are assessed at 20% of their value on the FAFSA, so that proportion is considered available to contribute toward college costs. In contrast, parental income is assessed at up to 47%, and parental assets are assessed at only up to 5.6%.
- **Income and assets belonging to people other than the student or parents are not assessed at all.** Income and assets owned by grandparents, aunts and uncles, and even a non-primary parent in the case of a divorce are not assessed as part of financial aid. If any income or assets are owned by someone other than the student, parents, or a divorced primary parent, and they're not in any of those individuals' names, then they're not involved in the financial aid process.

Financial aid mistakes are often made long before the FAFSA form is completed, when students and families fail to properly manage, use, invest and shift their income and assets. This results in a higher student aid index (SAI) 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 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 affect your future financial aid awards.

The 12 Terrible Financial Aid Mistakes

Asset Mistakes

1. **Putting or accruing financial assets in your student's name.**

   Avoid placing or building up financial assets in your student's name. Money and assets in your student's name are assessed at a higher rate for financial aid purposes than those in a parent's name. Hence, you want to minimize the amount of money or assets currently in your student's name. There are two primary ways to do this:

   - Spend the money. You can use student money and assets to pay for current expenses, such as tuition at private K-12 schools, extracurricular activities, college visits, college test preparation services, cars, cell phones, or even vacations.

- Move the student's money into an asset or account that's not assessed for need-based financial aid, or an asset that is assessed at the parental rate. Retirement plans and college savings plans are two such options.

2. Putting financial contributions by grandparents or other family members in the student's or parents' names.

Financial assets are not assessed for financial aid if they belong to grandparents, aunts and uncles, other family members, or anyone else outside of the student and the student's parents. These assets don't have to be reported, as long as they're in the name of those outside owners.

Don't make the mistake of allowing grandparents or other outsiders to contribute to college savings in the student's or parents' names. This can have a negative impact on financial aid, so generally it's better to have them keep the assets in their own names. Then, once your student is actually in college, they can help your student pay expenses, and none of this has to be reported or has any negative impact on financial aid.

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

Sometimes, in a divorce, assets owned by one of a student's parents might not be assessed for financial aid purposes. 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 might not be assessed.

In a divorce, this can make a *big* difference in financial aid, based on which parent gets non-assessable assets, such as retirement plans and the primary residence, and who gets assessable assets, such as bank accounts, non-retirement assets, and college saving plans.

It's often important to work together during a divorce process, to determine who will get each type of asset, especially when you have children who may attend college in the future. This strategy works well when parents are cooperating, but it can be a challenge if they're not.

For example, the owner of financial assets gets to decide if and when the money will be spent on college or other needs. In a divorce, giving up control and ownership over certain financial assets might potentially increase your student's financial aid eligibility, but if you can't count on those assets actually being used toward college, it might be better to keep them in your name. Otherwise, you might be trying to negotiate for more contributions from someone who's uncooperative.

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

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. These are typically schools that use the College Board's College Scholarship Service (CSS) profile, or they 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 that 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 SAI 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 products because the agents collect a commission on them. Thus, before you consider any investments in these assets, you want to be sure that 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.

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 2026 high school graduate, you'll be using your 2024 tax return when they apply for financial aid.

This is because students typically apply for financial aid during the fall of their senior year in high school. At that point, your most recent full-year tax return would be from one year earlier. That means you're using a tax return from two years before your student will enroll in college. Thus, income planning needs to happen much sooner than asset planning, to account for that earlier timeline.

To further illustrate why you need to start early, if you have a high school senior who's filling out the FAFSA in the fall of their senior year, the tax year in question will be the one that started during their sophomore year of high school (January) and ended halfway through their junior year of high school (December). That tax return is due in April of the student's senior year, so ideally you need to make adjustments very early, so they're taking place during the second-half of your student's sophomore year and the first half of their junior year.

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

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

   During the years when your student will be submitting the FAFSA for college financial aid, don't take stock options or sell 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 AGI for tax reporting purposes, which means you'll be assessed at a higher income on the FAFSA.

7. **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. So be careful about how much income you receive and when you receive it.

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.

8. 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. Don't forget to take advantage of these opportunities.

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

9. Failing to Save for Retirement in Ways That Increase Your Financial Aid Eligibility.

The right contributions to your retirement can reduce your overall adjusted gross income (AGI) and therefore increase your eligibility for federal financial aid. This is because your AGI is a big factor in determining your eligibility, and a lower AGI will potentially qualify you for financial aid or a greater award.

This is why it's so important to review and choose your options carefully, and look for ways to balance your retirement planning and tax planning with your financial aid planning. Ideally, you want to choose options that provide the most combined benefits.

For example, from a tax perspective, it might make sense to choose Roth options for your IRAs or other retirement plans. But Roth contributions don't lower your AGI, so they don't provide benefits for financial aid eligibility.

In contrast, retirement investments such as 401K contributions lower your AGI and are tax-deferred, so they might provide overall financial aid and tax benefits that outweigh the benefits of using Roth options. But everything depends on your unique situation. As a financial advisor and college planning specialist who works with many parents, I've found that there are different answers for different families.

Ultimately, you need to weigh your different options and determine which will maximize your overall benefits in terms of retirement, taxes *and* financial aid.

Timing Mistakes

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

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.

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 the advantage is that we don't pay taxes when we take the money out in retirement, assuming that 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.

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 2024, 2026 and 2028, and move it into 2025 and 2027. 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 don't shift your income. You might also combine this approach with other timing strategies to maximize your aid eligibility.

12. Forgetting to focus on your "magic" Pell number.

Depending on your family income and the number of dependent children you have, your student may qualify for a federal Pell grant. These grants can potentially provide over $7,000 per year in free financial aid to help cover your college costs. These grants are not student loans, so you don't have to pay anything back. It's truly free money.

However, some families miss out on a potential Pell grant, or they get significantly less money, because they're just outside the income thresholds to qualify for a minimum or maximum award. This is why it's crucial to know your "magic" Pell number.

Your magic Pell number is the adjusted gross income (AGI) that will allow your family to qualify for a maximum Pell grant or get you from a lower grant amount to the maximum. If you're able to make adjustments to your finances and get your adjusted gross income to the right level, then you could qualify for the maximum Pell grant of well over $7,000.

One way you can do this is by adjusting your retirement contributions. You can put more of your gross income toward your retirement, which lowers your AGI for the given tax year. Since your AGI is the main factor in determining your

Pell grant qualification and how much you'll receive, getting to the right number is where the magic can happen. That's where you can potentially qualify for thousands of dollars in free money.

But you need to know you what that magic Pell number is. You could be far away from the mark, or you could be as little as $10 away. You can start by using my Student Aid Index calculator to calculate your federal financial aid eligibility. Once you have your numbers, feel free to contact me with your results, and I can let you know if you're within range of hitting a magic Pell number or if you're already there. If you're within range, we can talk about strategies to help you get a maximum Pell award.

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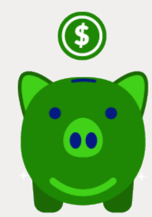

As a Certified Financial Planner®, I'm also available to help your family develop a complete college savings plan and walk you through the entire college planning process. Contact me now to learn more about my advising plans and schedule a free consultation.

About Brad Baldridge

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.