Paying for College: Four Tax Advantages to Consider

A coordinated plan to tackle the costs of college can provide you with peace of mind as your child marches toward graduation.

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KEY INSIGHTS

- A 529 college savings plan goes beyond tuition and fees and extends to covering expenses related to room and board.
- A 529 account isn't limited to colleges within your state.
- Some tax credits such as the American opportunity tax credit and the lifetime learning credit have income restrictions, so it's important to know if you qualify.
- The interest on federal student loans may be tax-deductible.
- Grants and scholarships are generally tax-free as long as certain conditions are met.

The college experience may be different for many students as colleges adapt during this unique environment due to the coronavirus pandemic. Some college costs may be affected, especially those related to room and board. Paying for college is still a substantial investment for many families.

The average total cost for four years at a public, in-state institution was about $87,800—and at private colleges, around $199,500—according to the College Board's Trends in College Pricing 2019. Families may find a combination of savings, income, and loans are needed to fully fund a child's college experience. Each of these sources has tax benefits that are important for you to know.

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Grants and scholarships

It is very beneficial for your child to explore all grant and scholarship possibilities as they don't need to be paid back. Typically, the term "grant" refers to need-based financial aid, whereas scholarships are usually based on merit. Grants and scholarships could cover about 25% of college costs according to Sallie Mae's How America Pays for College 2020.

Generally, this money is tax-free as long as certain conditions are met:

- The student must be in a degree or vocational program.

- The money is going toward qualified education expenses, including tuition and course-related expenses, such as fees, books, and supplies. (Note: Room and board is not considered a qualified education expense.)

529 education savings plans

You may be aware of 529 education savings plans. These accounts are a great way to save for your child's college education because of the potential tax benefits. Important tips to know include:

- Any growth of the money you save in a 529 education savings account is tax-deferred.
- Distributions are tax-free when used for qualified expenses. Qualified expenses go beyond tuition and related fees and include room and board, which could be as much as or more than tuition.
- You may receive a state income tax deduction or other state benefits for your contributions.

Keep in mind that you can use money from your 529 account to cover the costs of nearly any college across the country. You aren't limited to colleges within your state.

Saving in a 529 account has relatively little impact on financial aid eligibility if the account is held in the parent's name (with the child as the beneficiary). Using a 529 account is a good way to reduce reliance on loans.

If all of the funds aren't needed to pay for undergraduate school, they can be used for graduate school or transferred to another family member.

Tax credits and deductions

A tax credit reduces your tax bill dollar for dollar, whereas deductions are subtracted from your taxable income. They each have different benefits and may be helpful if using regular savings or income to pay for college costs while the child is enrolled.

No double-dipping! Wouldn't it be great if we could take a tax-free distribution from our 529 account and then claim a tax credit for college expenses? Of course it would be—but it's not allowed. You can't take more than one education tax benefit for the same student and the same expenses.

It's important to have a coordinated plan and consider which option(s) might provide the best tax advantage for you.

Student loans

Many college kids today are graduating with large amounts of student loan debt. According to the College Board, 58% of bachelor's degree recipients in 2018 had student loan debt. The average debt was about $29,000. That's a payment of $250 to $300 a month over a 10-year term.

Credit/Deduction	Annual Benefit*	Highest Income Eligible
American Opportunity Tax Credit	Federal income tax credit up to $2,500 per eligible student, per year. Can be claimed for only four tax years of postsecondary education for qualified expenses such as tuition, course-related books, supplies, and equipment. The credit is refundable, meaning if the credit pays your tax down to zero, you can have 40% of the remaining amount of the credit (up to $1,000) refunded to you.	Modified adjusted gross income (MAGI) is less than $90,000 for single filers, $180,000 for joint filers.
Lifetime Learning Tax Credit	Federal income tax credit up to $2,000 per tax return. No limit on the number of years you can claim the credit for qualified tuition and related expenses. The credit is not refundable.	MAGI is less than $68,000 for single filers, $136,000 for joint filers.

* Tax-free grants and scholarships may reduce qualified education expenses.

If possible, limit debt to federal student loans and stay away from private loans.

Starting out in debt is certainly not ideal; however, it may take a small loan amount to help fund college. If possible, limit debt to federal student loans and stay away from private loans. Federal loans offer more consumer protection and flexible repayment options.

When paying back these loans, the interest may be tax-deductible up to $2,500 if MAGI is less than $85,000 for single filers or $170,000 for joint filers. You can claim this deduction even if you don't typically itemize deductions.

Multiple sources, multiple benefits

While this is by no means an exhaustive list with every conditional detail included, it's certainly a start. It usually takes multiple resources to invest in your child's future. Understanding these benefits may help make the cost of college more manageable.

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Important Information

Please note that a 529 plan's disclosure document includes investment objectives, risks, fees, expenses, and other information that you should read and consider carefully before investing. You should compare these plans with any 529 college savings plans offered by your home state or your beneficiary's home state. Before investing, consider any tax or other state benefits, such as financial aid, scholarship funds, and protection from creditors that are only available for investments in the home state's plan. Tax benefits may be conditioned on meeting certain requirements, such as residency, purpose for or timing of distributions, or other factors, as applicable.

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