College Planning: Know the Rules for Education Funding

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By Amy E. Buttell

As college tuition continues to skyrocket, it's becoming more important than ever to know how the various savings plans work. This handy reference outlines the latest rules on the most popular college savings programs, and how to use them to save money on your children's education.

Aside from retirement, saving for a child's college education is one of the biggest expenses a family encounters. And with college savings vehicles multiplying all the time and tax laws changing, the landscape of college education funding rules can be downright bewildering.

In deciding how much to contribute to college savings accounts, when to contribute, and where to invest those contributions, you'll need to remain aware of all your options and their accompanying rules. Hence, this handy guide.

College savings plans

The biggest college savings plans are the Qualified Tuition Programs (QTPs) or Section 529 plans, education savings accounts (ESAs) or Coverdell savings accounts, and the Education Savings Bond program.

As the cost of college continues to climb, these college savings vehicles keep gathering assets. The College Savings Plan Network reported that 529 saving plan assets reached $328.9 billion in 2018. Fiscal Cliff legislation enacted in 2013 permanently extended what were previous temporary enhancements to Coverdell savings accounts. Parents and grandparents can continue to contribute up to $2,000 a year to a Coverdell account and use those funds for kindergarten through 12th grade expenses.

College Savings Programs

	Section 529 Plans (Qualified Tuition Programs)		Coverdell Savings Accounts	Education Savings Bond Program
	529 College Savings Plans	529 Prepaid Plans		Series EE or Series I
Contribution limit	Amount necessary to pay for qualified educational expenses	Amount necessary to pay for qualified educational expenses	$2,000 a year per beneficiary	$10,000 face value per year per owner per type of bond
Who can contribute or purchase	Anyone	Anyone	Anyone whose MAGI is less than $110,000 single or $220,000 joint for the year; also organizations, such as corporations and trusts (no income-related requirement)	Parent, spouse of student, or student; must be at least age 24 on bond issue date; married parents must file jointly
Account ownership	Parent or guardian	Parent or guardian	"Responsible individual" (generally the parent or guardian)	If purchased by parents, must be registered in parents' names (child cannot be listed as co-owner)
Tax deductibility	Not on federal level; state deduction depends on plan	Not on federal level; state deduction depends on plan	No federal or state tax deduction	Income exempt from state and local taxes; federal exemption phases out at MAGI of $97,350 single, $153,550 joint
Beneficiary change	Can be changed to any relative of initial beneficiary	Can be changed to relative of initial beneficiary	Can be changed to relative of initial beneficiary	Can be changed to another beneficiary
Financial aid treatment	Asset of parent	Asset of parent	Asset of account holder; low impact on dependent student owners	Asset of bond owner
Contribution income limits	None, although states set limits on total contributions ranging from $200,000 on up	None, although often limited to current cost of 4-year degree program	Contribution limit reduced for MAGI between $95,000-$110,000 single, $190,000-$220,000 joint	Income phaseouts based on year redeemed—not purchased. Contribution limit begins to phase out for MAGI of $83,200 single and head of household, $123,550 joint
Rollover eligibility	Can be rolled over to another 529 plan without penalty once every 12 months	Can be rolled over to another 529 plan without penalty once every 12 months	Can be rolled over to a 529 plan or another Coverdell for same beneficiary or another in beneficiary's family who is under age 30	Can redeem and roll proceeds over to 529 plan
Distributions/ Interest	Not taxed if used for qualified purpose; non-qualified subject to income tax and 10% penalty	Not taxed if used for qualified purpose; non-qualified subject to income tax, 10% penalty	Not taxed if used for qualified purpose; non-qualified subject to income tax and 10% penalty; distributions must be taken by the time beneficiary reaches age 30	Interest exempt from state and local taxes; no federal tax if used for qualified purpose and MAGI is below $98,200 single, $154,800 joint

Sources: "IRS Publication 970; "Tax Benefits for Education," IRS; FinAid; SavingforCollege.com; Sallie Mae

Student loan availability and limits

For many children of high-net-worth families, much of a financial aid package from colleges comes in the form of student loans. These loans take a variety of forms and have limits on how much a student or parent can borrow, the interest rates charged, and repayment terms.

An important distinction with student loans is whether they are "subsidized" or not. Interest on unsubsidized loans starts accruing when the loan is disbursed, although no payments are required while the student is enrolled in school at least half time (unpaid interest is capitalized at the end of the grace period). Interest on

Student Loan Options

Loan Type	Source	Limits		Interest rates (2020–21 school year)	Repayment
Undergraduate Stafford, dependent students	Federal government	1st year	$5,500 ($3,500 subsidized, $2,000 unsubsidized)	2.75% subsidized; 2.75% unsubsidized, plus 1.057% loan fee	6 months following graduation or if enrollment drops below half time
		2nd year	$6,500 ($4,500 subsidized, $2,000 unsubsidized)		
		3rd & 4th year	$7,500 ($5,500 subsidized, $2,000 unsubsidized)		
		Lifetime limit	$31,000 (up to $23,000 subsidized)		
Undergraduate Stafford, independent students	Federal government	1st year	$9,500 ($3,500 subsidized, $6,000 unsubsidized)	2.75%, subsidized; 2.75% unsubsidized, plus 1.057% loan fee	6 months following graduation or if enrollment drops below half time
		2nd year	$10,500 ($4,500 subsidized, $6,000 unsubsidized)		
		3rd & 4th year	$12,500 ($5,500 subsidized, $7,000 unsubsidized)		
		Lifetime limit	$57,500 (up to $23,000 subsized)		
Graduate Stafford, subsidized and unsubsidized	Federal government	Graduate	$20,500 per year (unsubsidized only)	4.30%	6 months following graduation or if enrollment drops below half time
		Lifetime limit	$138,500 (up to $65,500 subsidized) or $224,000 (health professionals)		
Perkins loans	Federal government	Undergrad limit per year	$5,500	5%	9 months following graduation or if enrollment drops below half time; repayment assistance available in exchange for service (i.e., certain teaching positions, military, etc.)
		Grad limit per year	$8,000		
		Undergrad limit	$27,500		
		Combined undergrad and grad limit	$60,000		
PLUS loans for parents and grad students	Federal government	Student's cost of attendance minus other financial aid		5.30% plus 4.228% loan origination fee	Can make payments during school or defer to graduation; interest accrues on disbursement
Private or alternative loans	Financial services companies incl. banks, credit unions	Student's cost of attendance		Variable rates (Prime or Libor plus or minus a margin) depending on credit score, origination, and other fees	Immediate or deferred, depending on lender and terms

Sources: FinAid; SavingforCollege; Sallie Mae subsidized loans does not accrue while the student is enrolled at least half time.

Monthly interest that accrues on a student loan can be calculated with a daily interest formula. Current loan balance x number of days since last payment x interest rate factor, which you determine by dividing the loan's interest rate by the number of days in the year.

For example, an undergraduate student has a $5,500 Stafford subsidized loan balance at a 2.75% interest rate and now plans to make his third payment. He calculates $5,500 x 25 (days since last payment) x 0.008 (interest rate factor) = $11 (interest owed since last payment).

Unlike undergraduates, graduate students are not eligible for new subsidized loans after July 1, 2012. But they may continue to use the subsidized loans they received prior to this date. The graduate student's $65,500 cumulative subsidized loan limit takes into account pre-2012 subsidized loans for graduate and undergraduate coursework.

With subsidized and unsubsidized loans, payments must start six months after graduation (nine months for Perkins loans) or after dropping to less than half-time status.

In 2013, Congress agreed to market-based rates for loans. Student loans are now tied to the 10-year treasury note which means interest rates are likely in increase.

Education tax credits

Fiscal cliff legislation extended the American Opportunity Tax Credit for 2021 tax returns. Eligible taxpayers can claim only one of these credits in a given tax year for a single student. However, if a taxpayer claims two eligible students on a return, one credit can be claimed for each student.

Credits can be selected on a per-student, per-year basis, which means taxpayers can switch between the American Opportunity Credit and the Lifetime Learning Credit for their children in different tax years, if they desire to do so.

Education Tax Credits

	American Opportunity Credit			Lifetime Learning Credit		
Income limits	Single & HOH	Credit phases out with MAGI between $80,000 and $90,000	Credit can't be claimed with MAGI of $90,000 or more	Single & HOH	Credit phases out with MAGI between $59,000 and $69,000	Credit can't be claimed with MAGI of $69,000 or more
	Joint	Credit phases out with MAGI between $160,000 and $180,000	Credit can't be claimed with MAGI of $180,000 or more	Joint	Credit phases out with MAGI between $119,000 and $139,000	Credit can't be claimed with MAGI of $139,000 or more
Applies to	Students pursuing a degree or federally recognized educational credential; must be enrolled at least half time; can't also claim Lifetime Learning credit for same student			Students enrolled in postsecondary education classes or those to acquire or improve job skills		
Qualified expenses	Tuition, fees, course materials			Tuition, fees, supplies, and equipment		
Availability	Only for first 4 years of postsecondary education			No limit		
Maximum amount of credit	100% of first $2,000 plus 25% of next $2,000 for maximum credit of $2,500 per eligible student per year; 40% of credit is refundable (up to $1,000)			20% of qualified expenses up to $10,000 for maximum $2,000 credit per tax return		
Filing status	Ineligible if married filing separately			Ineligible if married filing separately		

Sources: "IRS Publication 970; "Tax Benefits for Education," IRS; FinAid; SavingforCollege.com; Sallie Mae

Student loan interest deduction

Eligible taxpayers are permitted to deduct a certain amount of student loan interest. You may take this deduction if the interest is eligible—that is, from a qualified educational institution and the purpose was education—and if your modified adjusted gross income is less than $85,000 (phaseout between $70,000 and $85,000) for a single taxpayer and $170,000 (phaseout between $140,000 and $170,000) for married filing jointly.

The maximum deduction is $2,500 and claimed directly from gross income. The student must be the taxpayer, the taxpayer's spouse, or a dependent enrolled at least half time in a degree program. Qualified educational expenses include tuition, room and board, books, supplies, equipment, and other necessary expenses.

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