Tax-saving ways to help pay for college — once your child starts attending

If you have a child or grandchild in college — congratulations! To help pay for the expenses, many parents and grandparents saved for years in tax-favored accounts, such as 529 plans. But there are also a number of tax breaks that you may be able to claim once your child begins attending college or post-secondary school.

Tuition tax credits

You can take the American Opportunity Tax Credit (AOTC) of up to $2,500 per student for the first four years of college — a 100% credit for the first $2,000 in tuition, fees, and books, and a 25% credit for the second $2,000. You can take a Lifetime Learning Credit (LLC) of up to $2,000 per family for every additional year of college or graduate school — a 20% credit for up to $10,000 in tuition and fees.

The AOTC is 40% refundable up to $1,000 (meaning you can get a refund if the credit amount is greater than your tax liability). Both credits are phased out for married couples filing jointly with modified adjusted gross income (MAGI) between $160,000 and $180,000, and for singles with MAGI between $80,000 and $90,000.

Only one credit can be claimed per eligible student in any given year. To claim the education tax credits, a taxpayer must receive a Form 1098-T statement from the school. Other rules may apply.

Scholarships

Scholarships are exempt from income tax if certain conditions are satisfied. The most important is that the scholarship generally can't be compensation for services, and it must be used for tuition, fees, books and supplies (not for room and board).

However, a tax-free scholarship reduces the amount of expenses that may be taken into account in computing the AOTC and LLC and may reduce or eliminate those credits.

Employer educational assistance

If your employer pays your child's college expenses, the payment is a fringe benefit, and is taxable to you as compensation, unless it's part of a scholarship program that's "outside of the pattern of employment." Then, the payment will be treated as a scholarship (if the requirements for scholarships are satisfied).

Tuition payments by grandparents and others

If someone gives you money to pay your child's college expenses, the person is generally subject to gift tax, to the extent the payments exceed the annual exclusion of $17,000 per recipient for 2023. Married donors who split gifts may exclude gifts of up to $34,000 for 2023.

However, if the person (say, a grandparent) pays your child's tuition directly to an educational institution, there's an unlimited exclusion from gift tax for the payment. This unlimited gift tax exclusion applies only to direct tuition costs (not room and board, books, supplies, etc.).

Retirement account withdrawals

You can take money out of your IRA or Roth IRA any time to pay college costs without incurring the 10% early withdrawal penalty that usually applies to distributions before age 59½. However, the distributions are subject to tax under the usual IRA rules.

You also may be able to borrow against your employer retirement plan or take withdrawals from it to pay for college. But before you do so, make sure you understand the tax implications, including any penalties that you may incur.

Plan ahead

Not all of the above breaks may be used in the same year, and some of them reduce the amounts that qualify for other breaks. So it takes planning to determine which should be used in any given situation. Contact us if you'd like to discuss any of the above options, or other alternatives.