Saving for college: Tax breaks and strategies your family should know

As higher education costs continue to rise, you may be concerned about how to save and pay for college. Fortunately, several tools and strategies offered in the U.S. tax code may help ease the financial burden. Below is an overview of some of the most beneficial tax breaks and planning options for funding your child's or grandchild's education.

Qualified tuition programs or 529 plans

A 529 plan allows you to buy tuition credits or contribute to an account set up to meet your child's future higher education expenses. State governments or private institutions establish 529 plans.

Contributions aren't deductible. They're treated as taxable gifts to the child, but they're eligible for the annual gift tax exclusion ($19,000 in 2025). If you contribute more than the annual exclusion limit for the year, you can elect to treat the gift as if it is spread out over five years. By taking advantage of the five-year gift tax election, a grandparent (or anyone else) can contribute up to $95,000 ($19,000 × 5) per beneficiary this year, free of gift tax.

Earnings on 529 plan contributions accumulate tax-free until the education costs are paid with the funds. Distributions are tax-free to the extent they're used to pay "qualified higher education expenses," which can include up to $10,000 in tuition per beneficiary for an elementary or secondary school. Distributions of earnings that aren't used for qualified higher education expenses are generally subject to income tax plus a 10% penalty.

Coverdell education savings accounts (ESAs)

You can establish a Coverdell ESA and make contributions of up to $2,000 for each child under age 18. This age limitation doesn't apply to beneficiaries with special needs.

The right to make contributions begins to phase out once AGI is over $190,000 for married couples filing jointly ($95,000 for singles). If income is too high, the child can contribute to his or her own account. These thresholds haven't been adjusted for inflation in many years.

Although Coverdell ESA contributions aren't deductible, income in the account isn't taxed, and distributions are tax-free if spent on qualified education expenses. If the child doesn't attend college, you must withdraw the money when the child turns 30, and any earnings will be subject to tax plus a penalty. However, you can transfer unused funds tax-free to a Coverdell ESA of another family member who isn't 30 yet. The age 30 requirement doesn't apply to individuals with special needs.

Savings bonds

Series EE U.S. savings bonds offer two tax-saving opportunities when used for college expenses:

- You don't have to report the interest on the bonds for federal tax purposes until the bonds are cashed in, and
- Interest on "qualified" Series EE (and Series I) bonds may be exempt from federal tax if the proceeds are used for qualified college expenses.

To qualify for the college tax exemption, you must purchase the bonds in your name (not the child's) or jointly with your spouse. The proceeds must be used for tuition, fees, etc. — not room and board. If only some proceeds are used for qualified expenses, only that part of the interest is exempt. The exemption is phased out if your modified adjusted gross income exceeds certain amounts.

Education tax credits

Beyond saving vehicles, there are also tax credits you may be able to claim while paying college expenses:

- **American Opportunity Tax Credit (AOTC).** This is worth up to $2,500 per eligible student each year for the first four years of undergraduate study. It is subject to income limits and is partially refundable (up to $1,000). That means you could receive a refund even if you owe no tax.
- **Lifetime Learning Credit (LLC).** This is worth up to $2,000 per tax return (20% of up to $10,000 of qualified education expenses). There's no limit on how many years you can claim it, so this credit can benefit graduate studies or professional development courses. It's also subject to income limits.

You can't claim the AOTC and the LLC for the same student in the same year. However, you can claim each credit for different students in the same household if you meet eligibility requirements.

Plan ahead

These are just some of the tax-wise ways to save and pay for college. Contact us to discuss the best path forward in your situation.