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YOUR MONEY

With a Tax Deduction Gone, Is Home Equity a Smart Way to Pay for College?

Your Money

By RON LIEBER JAN. 12, 2018

For parents facing the prospect of six-figure college bills, every bit of savings and every last tax break helps.

So as Americans digested the details of the tax bill that passed last month, it was natural to lament the end of deductions for interest people pay on home equity loans. After all, if you don't have enough savings but have been paying down your mortgage, it's awfully tempting to borrow against your house to help pay for college.

Many colleges know this and seem to count on it. In fact, scores of the more expensive private ones ask about home equity during the financial aid process and factor it into what they ask you to pay.

The change in the tax bill raises two questions then, one immediate and one that is timeless. Will the colleges ask less of some families now that the home equity deduction is no longer available? And was borrowing against the value of your home to pay college tuition a good idea in the first place?

As always with college aid and family financial behavior, there is a big difference between what the schools' formulas say about a family's ability to pay and what that family does in practice. The federal financial aid system, which governs things like Pell grants and federal loans — and which families access by filling out the Free Application for Federal Student Aid, or Fafsa — does not take home equity into account.

A few hundred colleges, mostly the more expensive private ones, ask families applying for financial aid to fill out an additional form, known as the CSS Profile. It does ask about home equity. The schools take different approaches to baking that number into their overall equations for making financial aid offers, though many will also use your income to place a cap on the amount of home equity they factor in.

It isn't always easy to figure out how or if any individual college runs your home equity numbers, but if it doesn't provide a clear explanation on its financial aid website, you can try using the customized net price calculator that all schools provide. Start by entering all your information honestly, including your home equity. Then, do it again while setting your home equity to zero to see how or if the results differ.

Paula Bishop, an accountant and financial aid consultant, has also assembled a spreadsheet listing many colleges' policies. You can find it and a detailed explanation of home equity financial aid formulas on the College Solution website, run by the educator and journalist Lynn O'Shaughnessy.

Is it heartless for the schools to even consider home equity? After all, not every family has the income or creditworthiness to qualify for a home-equity loan or line of credit. Still, financial aid experts repeat the following like a mantra: An asset is an asset is an asset.

"If we have two families with the same income, and one has no home equity and the other has $100,000 in their home, it's very clear that the family with home equity is better off," said Sandy Baum, a senior fellow at the Urban Institute and a former consultant for the College Board, which produces the CSS Profile. "You've got to make them pay more."

Colleges that consider home equity when determining what a family can pay each year don't come right out and demand that you use it. There is no line item for equity loans on financial aid award letters, for instance.

But families that don't get much or any financial aid from schools and lack a pile of savings and copious disposable income are often tempted to tap into home equity if they have it. This is especially true when interest rates are as low as they have been the last several years.

And if you have $20,000 outstanding on a home equity line of credit and are paying 4.5 percent interest on that annually, that's $900 in annual interest that used to be tax deductible for many people. Now it won't be, which could cost families thousands of dollars over many years of repayment.

So will schools change their financial aid formulas so they ask a bit less of families with home equity? Justin Draeger, president of the National Association of Student Financial Aid Administrators, said he was not aware of any colleges that were preparing to change their approach. His organization has not issued an opinion on whether members should do so.

Not every family will be hurt by the lost deduction, and some borrowers could come out ahead over all because of other tax changes. Meanwhile, home equity lines of credit for people with good credit histories might cost 4.5 percent in annual interest right now. Even absent the tax deduction, that remains a good deal compared with one other alternative that colleges often recommend: federal PLUS loans, which come with a 7 percent interest rate.

It's a tricky comparison, though. Home equity lines of credit have variable interest rates, and they are likely to head up in the next year or two. The PLUS loans have fixed rates and may be easier for people with somewhat blemished credit histories to get.

Moreover, only one of those loans puts your home at risk. Buz Livingston, a financial planner in Santa Rosa Beach, Fla., recalls counseling two families that approached him after borrowing against their homes in part to pay for college, only to have the home values drop significantly. "I don't recommend using home equity to fund college," he said. Both families lost their homes after unemployment compounded the problem.

Indeed, a home equity line of credit can often serve as gateway debt that threatens retirement goals, according to Milo M. Benningfield, a financial planner in San Francisco. He recalls one couple who drew down an equity line for college; the husband was self-employed. Then, they used the line for other things, even as their income fluctuated and they refinanced the entire mortgage to try to keep up. By the time they came to see him, they had to sell their home and move into an apartment in order to retire at all.

Perhaps you have more self-control and work in a reasonably secure field. Then, you might follow the example of Jen Mouer, the mother of twin 16-year-old girls who are high school juniors. She and her husband are both government employees living in Richmond, Va., and they've been saving in a 529 account since the girls were young.

Their college budget is about $20,000 per year, per daughter. Half of that will come from those 529 savings, another $4,000 to $6,000 per child will come from Ms. Mouer and her husband, and the girls will cover the rest with federal student loans.

The parents had planned to use a home equity line of credit to pay their share of the annual college bills all at once, and then repay the debt in full each year. They would capture one deduction on their home equity interest while getting another for deposits in their state's 529 plan.

The removal of the home equity deduction takes a bit of wind out of the Mouers' sails, but the family hopes to stick with the plan. At the same time, they are resolute about not threatening their own retirement security by reaching too high for expensive private schools that don't offer merit scholarships.

As for their daughters and their debt, it will be cheap, flexible federal student loans for them and nothing else, in part because one of the family's goals is to promote independence once college is over. So how much debt is acceptable for the twins? "Not so much that they have to live with us after graduation," Ms. Mouer said.

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