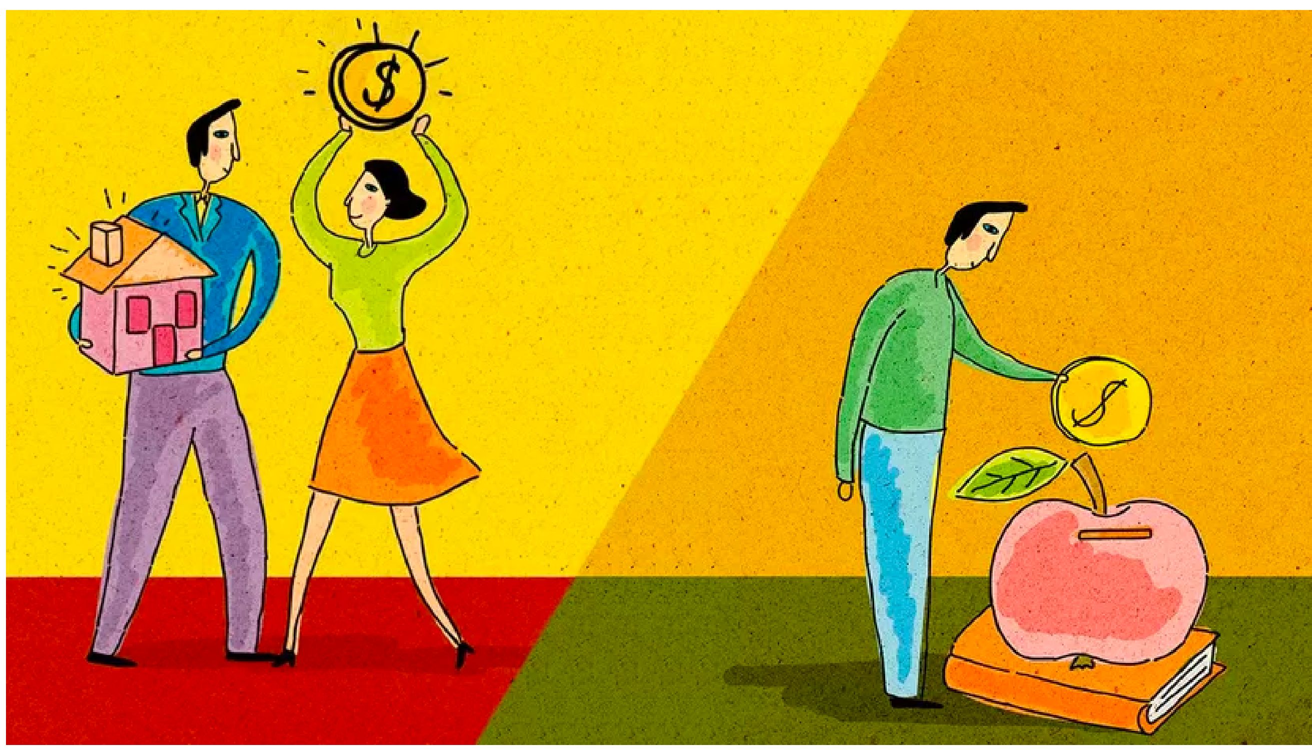
Pay Off Your Mortgage or Save for Your Kid's College: How To Make the Choice



Purchasing a home and paying for a child's college education are some of the biggest expenses parents will face. So if you come into some extra cash, such as an inheritance or major bonus at work, you might wonder how to best use the windfall. Should you pay off your mortgage or invest in a 529 college savings plan?

A 529 plan lets you contribute money to a savings account where the withdrawals are tax-free if that money is used for certain educational expenses. These include tuition for two-year or four-year colleges and apprenticeship programs.

"Saving for college or paying off your mortgage are both going to improve your net worth," says Nick Holeman, director of financial planning at Betterment. "From that standpoint, it's kind of a win-win."

Still, you may find yourself having to choose just one option—and deciding which is the better use for an influx of money depends on several factors. Here are the questions to ask yourself if you're faced with paying off your mortgage or saving for college.

How old is your child?

Is your child in elementary school or younger? Then paying off your mortgage with a lump sum of money is likely the better choice for most homeowners,

"If you pay off the mortgage, you can then open a 529 and grow it tax-free during the next 11 or 12 years," says Brian Blonder, senior vice president of mortgages at Capital Bank Home Loans.

If there's a shortfall come high school graduation, Blonder suggests taking out a student loan to cover the remaining costs.

But if you're a parent of teenagers who will be going to college in the next couple of years, Blonder advises that a 529 might make more sense because that major expense is in the near future.

How much home equity do you have?

If you have less than 20% equity in your home, Holeman suggests paying off your mortgage with a cash windfall. Many homeowners pay private mortgage insurance, or PMI, which some lenders require if your down payment is less than 20%.

PMI is usually 0.5% to 1% of your total loan amount that's added to your monthly mortgage bill. Federal law requires that your PMI be automatically terminated once the mortgage balance reaches the point where you have 22% equity in your home. You can also request its removal once you reach 20% equity.

"If you have less than 20% equity in your home, paying down your mortgage faster is more beneficial because you're also getting closer to no longer having to pay that PMI each month," Holeman says.

What's your mortgage interest rate?

The higher your mortgage interest rate, the better it is to pay off your mortgage. This is especially true if your rate is higher than 3%.

"You want to compare your mortgage interest rate to what your money could earn if you were to invest it," says Holeman. He points out that a 529 plan often doesn't earn much interest. So if you're paying more mortgage interest than you're earning in the plan, paying off your home loan is a smarter financial move.

Can you get a tax deduction for the 529 plan?

For years, homeowners could deduct mortgage interest on their tax returns. That changed when the Tax Cuts and Jobs Act went into effect and increased the standard deduction.

"Before your home mortgage interest might have been a big tax benefit to you," says Holeman. "Now that the standard deduction is higher, it's less of a benefit for most people."

But depending on where you live, you might get a tax break for the 529 plan since some states offer a tax deduction on contributions. Other states offer tax credits for contributions. Check the IRS guidelines to see if your state offers tax breaks.

You also don't have to pay taxes on interest or dividends related to the 529's growth. "I would probably tilt the scales toward 529s having more tax benefits in general than owning a home," says Holeman.

Do you need liquidity in your assets?

Paying off your mortgage and contributing to a 529 plan both come with liquidity restrictions, says Holeman. But in general, a 529 account is more liquid than your house.

Property is typically considered an illiquid asset, meaning it contributes to your wealth but you can't easily access the cash it represents. Selling the home to cash in on its equity could take months.

With a 529 plan, your money is tied up for a time and has some limitations. You can withdraw it tax-free to pay for educational expenses such as tuition, apprenticeship programs, textbooks, equipment, and room and board. But if your child decides not to go to college or you need to withdraw the money for other purposes, you can easily access the cash. Just keep in mind you'll have to pay a 10% penalty plus income tax on the account's gains.

Bottom line? The decision to pay off your home loan or save for your child's education should be based on your situation and financial goals.

"It's going to be different for everyone," explains Holeman. "Defining your goals, projecting them out, and prioritizing them will help you get a more personalized plan so you're getting the most financial bang for your buck."