

529 or ESA? Choosing a College Savings Vehicle

If you have young children, you probably realize you ought to start saving for their college education. And you should start saving as soon as possible to give that money time to grow. But maybe you haven't begun because you're not sure where to put those funds. A savings account? U.S. savings bonds? A mutual fund? A trust account? Or one of the tax-advantaged vehicles provided by recent legislation—a 529 plan or an education savings account (ESA)?

All of those choices have advantages and disadvantages. But if you've narrowed your list down to a 529 plan and an ESA, consider the following in your analysis. An ESA allows you to save up to \$2,000 a year for your child's education. The investment is self-directed (as with an IRA). A 529 plan allows you to either purchase tuition credits at today's prices (a prepaid plan) or invest among certain mutual funds [as with a 401(k) plan] that will (hopefully) grow into a large enough sum to pay for college (a savings plan).

Since prepaid 529 plans have limited appeal (and because some have closed to new investors because of poor performance), we'll limit our comparison to 529 savings plans and ESAs. Both are considered tax-advantaged for two reasons. First, they allow your money to grow tax-deferred. Second, you won't pay taxes on money that is spent on "qualified education expenses." (Note that there is no federal income tax deduction for contributions as with a qualifying traditional IRA.) So what's the difference and how do you decide? Here are some questions to ask:

1. Am I eligible? Almost everyone can open up a 529 account, but ESAs have income limitations. The ESA annual contribution limit of \$2,000 is phased out for joint filers whose modified adjusted gross income is between \$190,000 and \$220,000. If your income exceeds that range, an ESA is not an option for you. Enjoy your 529 account!

2. What if my children incur pre-college education expenses? A significant advantage for ESAs is that some primary and secondary school costs are considered qualified education expenses. Thus, tuition at a private school and the cost of a computer may qualify.

3. Am I comfortable making my own investment choices? Choices with 529 plans are limited and some provide age-based tracks that automatically move your money into "appropriate" funds as your children get older. ESAs are completely self-directed. You choose the investments.

Some additional items to keep in mind. If you are concerned about financial aid implications, don't worry. An ESA is no longer treated as an asset of the student/beneficiary and so is no longer assessed at the student rate. Now, ESAs and 529 plans owned by the parent (with the child/student as the beneficiary) are both assessed at the lower parental rate for federal financial aid computations. That said, if you have enough available money, you can contribute to both. You can put up to \$2,000 in an ESA for your child, and then stash more money in a 529 account. Most 529 plans allow account balances to exceed \$200,000. (Just be aware of the gift tax implications.)

Call us. We can help you make a good decision about college planning.