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Education IRAs vs. 529s Tax-advantaged savings plans both improved for 2002

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SAN FRANCISCO (CBS.MW) -Americans have greater incentive to save for education in 2002, but the choice of which tax-free savings plan to use has gotten tougher -- especially since it's now possible to contribute to both starting next year.

Both the Education IRA and state-sponsored Section 529 plans were greatly expanded under the \$1.35 trillion tax law signed in June, allowing parents and grandparents to set aside thousands more. Deciding which plan suits your needs has become trickier as well.

Under the new rules, distributions from 529 plans will be made tax-free rather than being taxed at the student's rate. The Education IRA contribution limit jumps fourfold to \$2,000 annually for a couple earning less than \$190,000, from \$500 for those making less than \$150,000.

"These new changes have made both plans very attractive investment vehicles," said Brian Henderson, a principal at the Vanguard Group.

Families now have a better chance of achieving one of life's most important financial goals, said Rich Chambers, a certified financial planner in Palo Alto, Calif. "Neither one gets taxed on the way out -- as long as you pay for education expenses -- starting next year."

Testing the limits

Contribution limits are a major factor in choosing which plan is right for you, experts said. In this sense, the education IRA comes up short.

At an 8 percent annual gain, the old limit generated about \$20,000 at the end of 18 years -- a quarter of the \$80,000 projected cost for a four-year state school starting in 2019. Under the new limit, families that max out an education IRA at that return would cover the full projected cost, Chambers said.

"These new changes have made both plans very attractive investment vehicles."

"This change will encourage more people to participate," Henderson said.

Brian Henderson, The Vanguard Group

The 529 plan is the better option, in terms of contributions, because people of all income levels can put in as much money as they want, said Charles Failla, a certified financial planner and principal at Raymond James Financial in New York.

Under some state plans, investors can contribute as much as \$250,000 compared with the flat \$2,000 annual limit for the Education IRA.

"The 529 is great because grandparents, uncles and other people can contribute to the child's fund over any period of time," Failla said. "With the Ed-IRA, it's capped at such a small amount."

Trade-offs of the 529

While you can contribute more to a 529 plan, your ability to direct those funds is far less flexible than with an education IRA.

Ed-IRAs can be opened at numerous mutual fund companies, many of which make most or all of their various funds available to such investments.

People also can open Education IRAs at multiple fund families, so long as they hold to the contribution limits. They're also available through so-called fund supermarkets, offered by the likes of Charles Schwab, that give investors access to thousands of funds.

With 529 plans, participants are stuck with a limited number of state-sponsored investment funds designed to discourage people from timing the market, Chambers said. States typically have a few bundled options that range in risk.

For families who crave more control over 529 assets, an option called aged-based allocation requires the state to limit risk exposure as the student approaches transition time.

"By Dec. 31st of your junior year, you want to have that (Education IRA) account spent."

"If you choose that, it would act like a good financial planner and move (the portfolio) into more conservative investments the closer the child is to college age," Chambers said. "With an education IRA, you'd have to do that on your own."

Rich Chambers, Financial planner

Here's the ringer: Families can choose a 529 plan from any state, regardless of where they live or where the child plans to go to school. That means they can choose to invest in one of the 37 states that allow income tax deductions on at least some amount of 529 contributions, Chambers said.

It pays to shop around and evaluate different states' plans, Failla said. "New York, Kansas, California, Utah and Michigan are some of the best ones."

Grammar school, financial aid considerations

Where the Education IRA also comes out ahead under the new rules is in the ability to use the funds for pre-college academic pursuits, both inside and outside school walls.

Parents can apply the IRAs to a child's elementary and secondary school expenses -- including private school tuition and school supplies -- while 529 monies are to be used exclusively for higher

education.

Yet because the Education IRA is a custodial account that must be registered in the beneficiary's name, it can work against students applying for financial aid, Chambers said.

Families looking for financial aid should aim to have a zero balance on the education IRA by the time the student is halfway through high school, he said. "By Dec. 31st of your junior year, you want to have that account spent."

The 529 plan, on the other hand, is less of a concern for financial aid, especially if grandparents own it, Chambers said.

Estate-planning caveats

Under ordinary circumstances, cash gifts exceeding \$10,000 incur gift taxes, but not when applied to 529 plan contributions.

In that case, investors can reduce their estates and prepay \$50,000, for example, to a 529 plan without paying gift tax -- as long as they don't contribute for five years, Chambers said. "It's a good estate-planning tool for those wealthy grandparents who like to help out."

The differences between the two plans also become evident when a child decides not to go to college. With an Education IRA, the beneficiary has to withdraw the funds by age 30 or pay tax on the earnings plus a 10 percent penalty.

The 529 plan is more flexible because you can change the beneficiary within the same family, including cousins.

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