

How does a 529 plan compare with investing in a mutual fund in my name?

Answer:

Section 529 plans are often a more powerful tool than mutual funds because of the favorable federal tax treatment given to these plans. First of all, assets in a 529 are tax deferred. Plus, withdrawals from a 529 plan that are used to pay qualified education expenses avoid federal income tax. States may also offer income tax breaks for 529 plans, such as tax-free withdrawals and tax-deductible contributions.

In contrast, most mutual funds are taxable investments. This generally means that the income earned by the fund (e.g., dividends and capital gain distributions paid by the fund) will be taxable to you in the year it is paid. The result will be the same whether you receive the income in cash or have it reinvested into your mutual fund account. Also, when you sell your mutual fund shares to raise money for your child's education, you'll have to pay capital gains tax on any appreciation. Long-term capital gains rates are more favorable than income tax rates, but the bite can still be painful if your fund has appreciated dramatically.

But mutual funds do have certain advantages over 529 plans. Mutual funds do not impose any restrictions or penalties if you need to sell your shares before your child is ready for college. However, if you withdraw assets from a 529 plan and use the money for noneducational expenses, the earnings part of the withdrawal will be taxed and penalized. You keep more control over your investment decisions because you can choose from a wide range of mutual funds, and you're typically free to move money among a company's funds, or from one family of funds to another, as you see fit.

By contrast, you can't choose your investments with a prepaid tuition plan, though you are generally guaranteed a certain rate of return or that a certain amount of tuition expenses will be covered in the future. And with a college savings plan, you may be able to choose your investment portfolio at the time you join the plan, but your ability to make investment changes is limited. Some plans may let you direct future contributions to a new investment portfolio. States may also allow you to change the investment option for your existing contributions once per calendar year or when you change the beneficiary. But it's not a federal requirement, so check with your specific college savings plan for more details.

Keep in mind that both college savings plans and mutual funds entail risk--your ultimate college fund could be worth more or less than the principal you invested.