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Protect Your Child's College Savings

January 22, 2010

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In a contested divorce there are precious few matters to which everyone can agree. Yet even the most contentious litigants can usually agree that the children's college funds – usually kept in an IRS §529 Qualified Tuition Program - should be set aside for the children's benefit.

Protecting a child's financial interests and future education is a smart and admirable course of action to which all parents should strive. But spouses in contested financial litigation need to understand that just because money is sequestered in a 529 educational savings account, it could still be considered a marital asset subject to distribution and is, therefore, not out of reach of the account holder or the court.

A 529 educational account is an asset of the account owner (usually a parent) and is established for the benefit of a named beneficiary (usually the child). The child beneficiary has no present interest in the account or its proceeds. According to IRS Reg. Sec. 1.529-1(c), the account owner is entitled to "select or change the designated beneficiary of the account, to designate the funds to any person beside the designated beneficiary, or to just receive funds from the account."

There are qualified purposes for use of distributed 529 funds. Those qualified purposes vary from state to state and plan to plan, but generally include the payment of tuition, room and board (with limitations), books, fees and equipment for enrollment or attendance at an eligible post-secondary school. However, 529 funds are not required by law to be utilized for qualified purposes. An account owner may also distribute funds for any non-qualified purpose. There are adverse tax consequences for withdrawing funds for a non-qualified purpose. All gains on the account are taxable as gross income, and there is an additional 10% penalty for distributions not used for educational expenses.

Nonetheless, a 529 educational savings account is accessible by the account owner for use at his or her discretion; and because the proceeds of these accounts are the property of account owner, and not the child beneficiary, those proceeds are subject to the Section 503 factors of the Illinois Marriage and Dissolution of Marriage Act for allocation as marital or non-marital assets. These funds may be a part of the marital estate and subject to the court's jurisdiction to divide and allocate between parties or utilized to pay debts such as credit cards or attorney fees.

Litigants should be conscious of a spouse harboring money in a 529 educational savings account which was agreeably set outside the marital estate, only to have that spouse liquidate the account for his or her personal benefit after the divorce proceedings are concluded. In order to protect against this contingency, parties to a divorce seeking to set aside funds for their child's education should consider building protective language into their judgments creating a fiduciary duty between the parent/account owner and the child/beneficiary, such that the parent is enjoined from utilizing the 529 educational savings account after the divorce for any purpose other than the child's educational costs. Quarterly or annual statements on the account should also be directed to the

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non-account holding parent in order to verify the proper maintenance and usage of those funds.

At the end of the day, if the funds are held and utilized properly, everyone can rest assured knowing the child's education is at least partially paid for; and if the funds are misappropriated by the account owner, then the non-account holding parent retains the remedy of contempt charges for breach of the court order or fiduciary duty.