POINTS TO **REMEMBER**

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COLLEGE SAVINGS PLANS ADMINISTERED BY STATES GAIN MOMENTUM

by David L. Silverman, Great Neck, NY

Recent changes to Code provisions that prescribe the tax treatment of state-sponsored college savings plans have made investment in such plans more attractive than ever. Section 529 provides favorable income tax treatment for accounts used to pay future college expenses, which are established and funded by parents or other benefactors and administered by individual states. The expenses can be incurred at any accredited degree-granting school, whether private, public, undergraduate or graduate. Like contributions to a Roth IRA, contributions to such an account (often referred to as a "529 Plan") are not deductible, but neither are undistributed investment earnings subject to federal income tax.

Under prior law, qualified distributions from section 529 Plans consisted of two elements: (1) return of contributions, and (2) withdrawal of earnings. Under prior law, return of contributions was exempt from tax as a return of basis; however, the portion of the distribution representing withdrawal of earnings was taxed to the student at the student's income tax rate. *Pursuant to EGTRRA 2001, as of January 1, 2002, withdrawal of earnings from such plans will no longer be taxed to the student, provided the amounts are used for qualified higher education expenses.* Under EGTRRA 2001, contributions may now be made to both an Education IRA and a 529 Plan without incurring an excise tax. These recent changes should spur the growth of section 529 Plans.

Because qualified higher education expenses generally include tuition, fees, supplies, books and equipment required for enrollment, as well as most room and board expenses, 529 Plans can provide an effective means of saving for higher education. Although the amount of qualified expenses will be reduced by expenses used to claim tax credits, and by scholarships or allowances, many of the high-bracket individuals who are the most likely users of 529 Plans may not be eligible for such tax benefits anyway. In addition, many states impose no income tax on qualified withdrawals, thus increasing the benefits of such plans.

The tax-free compounding within a 529 Plan is, of course, most advantageous to higher bracket taxpayers. While lower tax bracket taxpayers will also benefit from tax-free compounding and distribution, such taxpayers need to weigh the benefits of a 529 Plan carefully if the child may apply for need-based financial aid. This is because Plan assets are generally considered to be the parents' assets until money is withdrawn, at which point they are considered the student's assets. Accordingly, a 529 Plan may be unattractive for a child who might otherwise qualify for aid, particularly if the Plan is established with assets that would not otherwise be considered parental assets (e.g., contributions by a grandparent.)

Thirty-five states currently offer 529 Plans. Most states' plans are open to nonresidents. Nevertheless, some states offer income tax incentives only to residents. For example, New York allows an annual $5,000 income tax deduction ($10,000 for a couple) for contributions. States' plans also differ with respect to the administrator chosen to manage the plans, as well as with respect to fees charged for plan administration. Firms such as Morgan Stanley, Fidelity, Merrill Lynch, and TIAA-CREF have been chosen by some states to manage their 529 Plans, and their fees range from that of Utah, 0.31%, to that of Oregon, 2.24%. As states compete for investment capital, a greater variety of age-based and non age-based investment options (discussed below) appear to be emerging. Management rates should also be sensitive to increased competition among states' plans.

Establishing and contributing to a new 529 Plan is simple and can be accomplished by contacting the company managing the state's plan directly by phone or through its website. Most states' plans permit multiple accounts to be opened by multiple account owners for a single designated beneficiary. No age restrictions are placed upon who may be the beneficiary of a 529 Plan: a parent can open an account for a high school age child or even for himself or herself. However, at least 36 months must elapse before taking qualified withdrawals from a newly established plan.

Section 529 Plans are also attractive because there is no large minimum contribution requirement. Typically, as little as $25 may be all that is required to open a 529 Plan.

To qualify under Section 529, the plan must prohibit contributions in excess of qualified higher education costs at a private a four-year college. Thus, the maximum amount that may be contributed to various states' plans

ranges from a low of $100,000 (NY, TN, VA) to a high of $246,000 (WI, RI). Once the "maximum account balance" threshold has been reached, no further contributions may be made to the Plan, even if the maximum contribution amount has not been reached. To illustrate the interaction of "maximum account balance" and "maximum contribution amount," assume a 529 Plan has been set up in New York with an initial contribution of $80,000. After year four, the account balance has reached $300,000. New York will permit no further contributions, even though the maximum contribution amount of $100,000 was not exceeded. (Although it is not entirely clear, it might still be possible in this situation to make another contribution to another states' plan.)

Most states' plans have multiple investment options. For example, New York now has four investment options: (1) one guaranteeing a three percent rate of return; (2) two age-based managed allocation options that shift from stocks to bonds as the child nears college age; and (3) one high equity option. Section 529 provides that neither the contributor nor the beneficiary may directly or indirectly direct the investment of any contributions to the plan. Therefore, once an investment option is chosen, it may not be changed. Although proposed regulations had taken the position that this requirement precluded any change in the investment option, the Service recently changed its position on this issue. In Notice 2001-55, the Service announced that participants will be able to change investment options once a year and upon a change in beneficiary. The added flexibility provided by the ability to make annual changes in investment strategy should increase the attractiveness of 529 Plans.

Section 529 Plans compare favorably to trusts created under a state's Uniform Transfer to Minors Act (UTMA) or Uniform Gifts to Minors Act (UGMA) to pay for college expenses. UTMA assets must generally be distributed at age 21. By contrast, 529 Plan assets need not be distributed unless the child matriculates college. Therefore, section 529 Plans may eclipse UTMA or UGMA trusts as the preferred vehicle for college saving. In addition, it is apparently possible to roll UTMA funds into a 529 Plan.

Another advantage of 529 Plans is that if no matriculation occurs, the funds can be rolled over without adverse tax consequences to another family member, a term that is broadly defined to include even parents and first cousins. If the child dies or becomes disabled, funds can also be withdrawn without tax or penalty. However, except in the case of death or disability, if no matriculation or rollover occurs, federal and some state income tax will be imposed on the earnings portion of what then becomes a "nonqualified distribution," together with a ten percent penalty on those earnings.

Contributions to 529 Plans are also treated favorably for federal gift tax purposes. Up to $50,000 ($100,000 for a married couple) (both indexed for inflation) may be contributed every five years without current gift tax consequences, provided such gift is spread out over a five-year period. Therefore, if a $50,000 contribution were made in year one, no further contributions could be made until year six. Section 529 Plans therefore complement an estate plan seeking to maximize gifts at little or no transfer tax cost.

The flexibility of 529 Plans alone would make them attractive candidates for college savings. Since they are endowed with extremely favorable income tax attributes, it would be surprising if 529 Plans did not emerge as the vehicle of choice for college savings.

E-COMMERCE: NEW ISSUES AND WHERE TO LEARN ABOUT THEM

by Nancy Beckner, Washington, DC

Expanding global markets, the ability to access markets via the Internet, the pervasiveness of technology in substantially all aspects of commerce, and burgeoning new forms of business and functions pose novel and complex challenges for tax practitioners seeking to serve clients engaged in international e-commerce. This Point describes briefly several tax issues posed by global e-commerce and identifies resources to which practitioners can turn for further guidance. For practitioners new to this area I recommend Llewellyn, *U.S. Tax Regime for Taxing Foreign Persons Conducting E-Tail Operations with U.S. Customers*, 30 TAX MGMT INT'L J. 315 (July 13, 2001), which provides a good discussion of the U.S. tax rules applicable to global e-commerce outside the context of the U.S. bilateral treaty network.

1. Analyzing the Transaction

The first and often most difficult step in determining the taxation of a transaction is to develop and implement an analytic approach which will ultimately permit relevant tax provisions to be applied to various types of income generated in the transaction. Before relevant tax provisions or types of income can be identified, however, other analyses are necessary, such as identifying the functions of the various participants in the transaction and the components of these functions (e.g., are goods being sold, services provided, intangible property licensed, etc.), and formulating relevant tax and jurisdictional questions. Tyrrell, Heiselman and Greenwald, *An Analytical Framework for E-Commerce Tax Implications in Multiple Jurisdictions*, 10 J. INT'L TAX'N 50 (July 1999), offers an excellent description of an analytic