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

approach to this problem. Of course, to develop and apply the necessary analyses, some basic knowledge of the Internet and the workings of e-commerce are also essential. Abrahams & Doernberg, *How Electronic Commerce Works,* 14 Tax Notes Int'l 1573 (1997), remains one of the best discussions of this topic.

2. **U.S. E-Commerce Concerns and Software Transfers**

On November 21, 1996, the Treasury Department issued its discussion paper, *Selected Tax Policy Implications of Global Electronic Commerce*, 226 Daily Tax Rep. (BNA), Nov. 22, 1996, at L-1, introducing certain tax policy and administrative issues presented by developments in communication and e-commerce. This paper includes technical background on the Internet and e-commerce, security, encryption and payment mechanisms, as well as an overview of tax policy and administration issues, such as the impact of e-commerce on substantive principles of taxation.

Shortly before publication of the discussion paper, Treasury had issued proposed regulations classifying transactions involving computer programs and the character of income from such transactions. These regulations (the "Computer Regs.") were finalized on September 30, 1998 (Reg. Sec. 1.861-18, T.D. 8785, 1998-42 I.R.B. 5). The Computer Regs. seek to harmonize the taxation of software with existing principles of U.S. tax laws, regulations and treaties. Under the Computer Regs., an international transaction relating to computer programs is to be classified in one of four ways: (1) the transfer of a copyright in the program, (2) the transfer of a copyrighted article (i.e., a copy of the computer program), (3) the provision of services for the development or modification of a computer program, or (4) the provision of know-how relating to computer programming techniques. If the transaction is determined to be the transfer of a copyright, the Computer Regs. further characterize the rights transferred as: (1) the right to make copies for distribution, (2) the right to prepare derivative programs, (3) the right to make public performances of the program, or (4) the right publicly to display the program. The transfer of one or more of these rights in the copyright generally produces royalty income unless substantially all such rights are transferred, in which case the transaction is treated as a sale. The transfer of a copyrighted article is generally a sale; however, if insufficient benefits and burdens of ownership have not been transferred, the transaction is a lease.

The U.S. tax consequences of a transaction differ significantly depending on the characterization of the software transaction. One major difference is that royalties paid to a foreign licensor are subject to a 30 percent U.S. withholding tax (if such royalties are not effectively connected with a U.S. trade or business) unless the tax is reduced or eliminated under an applicable income tax treaty. By contrast, a foreign person's gain from a sale of intangible property is frequently not subject to U.S. tax unless effectively connected with a U.S. trade or business. For U.S. persons, the characterization can also be important, particularly in the context of certain outbound transfers of intangible property to a foreign corporation in a section 351 or 361 context. Under section 367(d), such transfers are deemed to give rise to royalty income but deemed royalty treatment may not be imposed if the intangible is a copyright. Temp. Reg. Sec. 1.367(d)-1T(b).

3. **Proposed Space, Ocean and Communications Income Regulations**

Sections 863(d) and (e), as added by the Tax Reform Act of 1986, provide source rules for space and ocean activities and for international communications income. Proposed regulations under these sourcing provisions are intended to take into account the "...rapid technological evolution in the space and communications industries since Congress enacted section 863(d) and (e) in 1986... as well as changes in space and communications industries and business practices and business models." Preamble to the Proposed Regulations, Notice of Proposed Rulemaking and Notice of Public Hearing, REG-106030-98, 66 Fed. Reg. 3906 (January 17, 2001). Although further discussion of the proposed regulations is beyond the scope of this Point, there are good discussions in Litman, *Space, Ocean and Communications Income – The Final Frontier?* 30 Tax Mgmt Int'l J. 195 (May 11, 2001), and Ellis, *Satellites and the Proposed Regulations on Space and Communications Activities*, 30 Tax Mgmt Int'l J. 347 (August 10, 2001).

4. **OECD Developments**

On February 1, 2001 the OECD Technical Advisory Group ("TAG") issued its final report on the tax treaty characterization of 28 categories of e-commerce transactions and finalized the e-commerce Commentary on the Permanent Establishment Article of the OECD Model Treaty (the December 22, 2000 amendments to the commentary from the OECD's Committee on Fiscal Affairs). Notably, the OECD took the position that the operation of a website alone does not give rise to a permanent establishment, but noted that under certain circumstances, a server could be a permanent establishment. Although further discussion of the TAG final report and the permanent establishment Commentary on the Model Treaty are beyond the scope of this Point, any practitioner representing clients in cross-border e-commerce transactions should become familiar with these developments. For further discussion see, e.g., Klitgaard, *OECD Finalizes E-Commerce Commentary on Permanent Establishment Article of Model Tax Convention*, 10 Cal. Tax

LAWYER 16 (Spring 2001); Levine & Weintraub, *When Does E-Commerce Result in a Permanent Establishment: The OECD's Response*, 29 TAX MGMT INT'L J. 220 (April 14, 2000), and Sprague & Schindler, *Another Step Towards Uniformity: Relative Consensus of the OECD TAG on Income Characterization of E-Commerce Transactions,* 30 TAX MGMT INT'L J. (June 8, 2001).

5. **EU & VAT**

E-commerce raises significant concerns under the Value Added Tax ("VAT") system operative in the EU. The European Commission proposed important changes in the VAT system effective January 1, 2001; the focus of these changes is on-line or electronic services sold by businesses from non-EU countries to EU consumers. For U.S. sellers in what are known as B2C (business-to-consumer) transactions, these changes could result in a significant loss of a competitive advantage they previously enjoyed.

6. **Internet Tax Freedom Act (ITFA), P.L. No. 105-277, Title XI, 112**

State business taxation of e-commerce is a highly controversial issue. Currently, ITFA imposes a three year moratorium to prevent the taxation of internet access (with the exception of certain pre-October 1, 1998 taxes) and multiple or discriminatory taxes on e-commerce. Recent legislation has been introduced to extend the October 21, 2001 sunset of this moratorium (H.R. 1552). Other legislation (H.R. 2526) which would exempt various internet-related activities from state business taxes is being considered; H.R. 2526 would limit such state taxes if: (1) the company's internet site is accessed by residents of the state, (2) the company leases property in the state for less than 30 days, (3) the company only uses an internet service provider that is physically located in the state, or (4) the company's employees are physically present in the state for less than 30 days. The Senate Finance and Commerce Committees also are focusing on the question, with the Commerce Committee seeking to combine the extension of ITFA with the grant of authority to states to collect sales and use taxes for out-of-state transactions, provided the states agree to certain simplifications of their tax rates and administration. How these issues and differences between the House and Senate approaches will be resolved is uncertain.

7. **Staying Current**

Staying abreast of both U.S. and foreign developments in e-commerce taxation has become daunting. Kuntz and Peroni, U.S. INTERNATIONAL TAXATION (WG&L), ¶ A1.01, footnote 34, provides a relatively current bibliography for the taxation of global e-commerce, and BNA International Inc.'s TAX PLANNING INTERNATIONAL E-COMMERCE is a specialized monthly publication that will allow you to keep up with current developments. Several issues needing Treasury guidance are addressed in Jensen, *Selected Issues in Cross-Border Electronic Commerce Transactions*, 24 TAX NOTES INT'L, 157 (2001).

SURPRISE: THE MARITAL DEDUCTION IS NOT ALWAYS AVAILABLE

by Alexander Drapatsky, Chicago, IL

Section 2056 provides an unlimited federal estate tax marital deduction for qualifying dispositions of property to or for the benefit of a decedent's surviving spouse. Through optimum use of this deduction, a married couple can usually defer all federal estate transfer taxes until the death of the surviving spouse. Nevertheless, the marital deduction is not always available when it might appear to taxpayers that it should be.

In order for an estate to take advantage of the marital deduction, the property passing to the surviving spouse must: (1) be included in the decedent's gross estate, (2) actually "pass", (3) to a "surviving spouse," and (4) not be a terminable interest. The "passing" requirement is broadly defined to include interests that a surviving spouse acquired by will, intestate succession, elective share, right of survivorship, or pursuant to a beneficiary designation.

Not surprisingly, for the marital deduction to apply a marriage must exist. In a recently issued technical advice memorandum, PLR 200132004 (Apr. 25, 2001), the Service followed its traditional rule that state law will determine whether a marriage exists. The facts leading up to this TAM were that a decedent participated in a 33-year cohabitation relationship with a person of the opposite sex. During the course of their relationship, they sometimes presented themselves in public as a married couple, but they filed separate income tax returns (although some claimed married filing separately status), and there was no evidence they were ever formally married. Shortly prior to the decedent's death, his companion suffered a stroke. While she was recuperating, the decedent notified her that she was no longer welcome at his house, where she had been living for 33 years. The decedent's will did not make any provisions for his companion.

After the companion's guardians sued the estate, the parties reached a settlement, which the executrix of the estate attempted to deduct under section 2056(a), as an amount passing to a decedent's spouse. The Service disagreed, ultimately concluding that since the decedent was not married under state law, the marital deduction was unavailable.

In PLR 200132004, the Service took the position that it will look to the law of the state where the decedent resides to determine whether a marriage existed for purposes of the marital deduction. Thus, the Service will look to the highest court of that state to determine whether a particular arrangement will be classified as a