THE TAX ADVISER

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The ruling for an LLC can be obtained by:

- Providing a copy of U.S. tax law indicating that it is treated as a flowthrough entity and that the income derived by the LLC is subject to tax in the hands of its U.S. owner; and
- Demonstrating that the income derived is subject to tax in the hands of its U.S. owner.

Accordingly, it is recommended that the members of LLCs (single-member or multiple members) seek a ruling from the Mexican tax authorities prior to the receipt of any payment from Mexico granting LLCs benefits under the treaty on the basis of the U.S. residency of the LLC owner(s).

The Philadelphia Service Center processes U.S. certification requests. LLCs should send requests to:

Internal Revenue Service
U.S. Residency Certification
DP 8121
P.O. Box 16347
Philadelphia, PA 19114-0447

LLCs can obtain more information by calling the U.S. Residency Certification Unit at (215) 516-7135. The Service Center issues Form 6166, Certification of Filing a Tax Returm, stating that the person requesting the certification is a U.S. resident. Legal entities treated as flowthrough or disregarded entities are generally unable to obtain IRS certification, because they are not subject to income tax.

FROM SADIA NAZIR, CPA, OAK BROOK, IL

INDIVIDUALS

Sec. 529 Plans—Qualified Tuition Programs

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) can lead to many planning opportunities for qualified tuition programs (Sec. 529 plans). Qualified tuition programs generally fall into two categories:

1. Prepaid tuition plans, which allow a person to purchase tuition credits that entitle a beneficiary to the waiver or payment of qualified higher education expenses (QHEEs); and
2. Savings plans, which allow a taxpayer to make contributions to an account established to meet a beneficiary's QHEEs.

Many states have established these programs to provide a vehicle for parents, grandparents or others to help fund and save for a beneficiary's college education. Because of the increasing popularity of these programs, it is important for practitioners to understand their basic mechanics, as well as the changes made by the EGTRRA.

Qualified Distributions Now Tax-Free

Under prior law, the earnings portion of distributions from tuition programs for QHEEs was included in a beneficiary's gross income. The EGTRRA excludes from gross income distributions for QHEEs occurring after 2001, making them tax-free.

If post-2001 distributions exceed qualified expenses, however, the earnings excluded from the beneficiary's gross income are limited to an amount calculated by multiplying the earnings portion of the distribution by the percentage of the total distribution used for qualified expenses.

Example: In 2002, beneficiary *B* withdraws $12,000 ($7,000 in earnings and $5,000 in capital) from a tuition program, and uses only $9,000 for qualified expenses. Because only 75% ($9,000/$12,000) of the distribution was used to pay qualified expenses, only 75% of the earnings will be excluded from gross income. As such, only $5,250 ($7,000 × 75%) will be excluded from his gross income, while $1,750 will be taxable. In addition, a 10% penalty ($175) will be imposed on the taxable amount.

Limits on Exclusion and Coordination with Other Provisions

The amount of the distribution excluded from gross income is generally reduced by qualified scholarships and employer-provided educational assistance (excludible from income) and QHEEs taken into account in determining the Hope scholarship and Lifetime Learning credits allowed the taxpayer *or any other person* (i.e., a parent claiming the student as a dependent). In addition, tax-exempt distributions from qualified tuition programs reduce the income exclusion amount for U.S. savings bond interest and the deduction for interest on education loans. Finally, if a taxpayer uses distributions from both a qualified tuition program and an Education IRA, and if the sum of the distributions exceeds the total of the QHEEs, any QHEEs must be prorated (using a reasonable method determined by the taxpayer) between the two programs.

Private Educational Institutions Can Now Establish Programs

Previously, only states could establish qualified state tuition programs. The EGTRRA removed the word "state," allowing private educational institutions to establish and maintain prepaid tuition programs. *Note:* The tax-free distribution rule discussed does not apply to private programs until Jan. 1, 2004.

Additional QHEEs Added, Modified

QHEEs generally include tuition, fees, books, supplies and equipment necessary for attendance. In addition, the EGTRRA added expenses for special-needs services. Congress wants IRS regulations to define a "special needs" beneficiary as including an individual who, because of a physical, mental or emotional condition, requires additional time to complete his education. Qualified expenses also include expenses for room and board. The EGTRRA replaces the $2,500 limit on room and board expenses with a rule that requires reasonable expenses, adjusted to reflect current costs for students who live off-campus and not at home. The educational institution that the individual attends will determine the amount. If the student lives on campus and the amount determined by the institution is less than invoiced, the student can use the actual invoiced amount.

Planning Considerations

An individual who contributes funds to a qualified tuition program can enjoy many benefits, such as tax-free savings for a beneficiary's education. However, the contributor should address a few considerations before writing any checks. For example, can he establish a brokerage account using stocks, municipal bonds and index funds that will achieve a higher after-tax return than the qualified tuition program would earn? In addition, some individuals may be concerned because they will not have unlimited control over the investment of funds contributed to a qualified tuition program. These individuals may want to consider using an Education IRA (subject to its contribution and income limits) in lieu of (or as a supplement to) a qualified tuition program. The bottom line is that there are many considerations, and the prudent individual should consider all of the issues before investing in a qualified tuition program.
FROM KENNETH WILSON, CPA, M.B.A., MERRILLVILLE, IN

PARTNERS & PARTNERSHIPS

Sale of Partnership Interests with Open-Service or Construction Contracts

Under Sec. 741, generally, the gain or loss resulting from the sale or exchange of a partnership interest is capital. The one exception to this general rule is Sec. 751(a), which states that the amount of consideration received by a partner in exchange for his partnership interest—attributable to unrealized receivables or inventory items—is considered as an amount received from the sale or exchange of property other than a capital asset. For this reason, the sale of partnership interests versus the sale of partnership assets can result in similar (if not identical) tax consequences.

The Sec. 751 rules have been part of the Code for almost 50 years, and over the last few years have seen relatively few changes. However, under Regs. Sec. 1.751-1(c)(3), transactions occurring after Dec. 14, 1999 may result in substantially different tax treatment between the sale of a partnership interest and the sale of the partnership's assets.

Service and Construction Contracts as Unrealized Receivables under Sec. 751(c)

Unrealized receivables are defined by Sec. 751(c) and Regs. Sec. 1.751-1(c)(1)(ii), in pertinent part, as any rights (contractual or otherwise) to payment for:

1. Goods delivered, or to be delivered (to the extent that such payment would be treated as received for property other than a capital asset) or
2. Services rendered, or to be rendered, to the extent that income arising from such rights to payment was not previously includible in income under the partnership's accounting method.

Such rights must have arisen under contracts or agreements in existence at the time of the sale or exchange of a partnership interest, although the partnership may not be able to enforce payment until a later time. For example, the term includes rights to payment for work or goods begun but incomplete at the time of the sale or distribution. Based on this definition, any fees or revenues to be collected subsequent to the sale or exchange of service or construction contracts (entered into before the sale or exchange) are considered unrealized receivables.

Effects of Sec. 751(c)

In an applicable asset sale as defined in Sec. 1060, the allocation of the sales price agreed to by the buyer and seller is generally binding on them (although not the IRS) under Regs. Sec. 1.1060-1(c)(4). Therefore, if the assets of a partnership were sold, the seller might avoid additional ordinary income recognition by agreeing with the buyer to allocate to open-service and construction contracts a portion of the sales price equal to the income already recognized under the contracts. This method would result in an allocation of the sales price equal to the seller's basis in any open-service or construction contract, yielding no gain or loss on the sale. This would seem like a reasonable conclusion, especially as:

- The performance and profitability of the open contracts subsequent to the sale are reflective of the buyer's performance and
- Sec. 197 intangibles amortizable over 15 years include customer-based intangibles that consist of any value resulting from the future provision of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with customers.

However, the allocation of the sales price on the sale of a partnership interest attributable to unrealized receivables is governed by Sec. 751, not by Sec. 1060. For transactions prior to Dec. 15, 1999, under Regs. Sec. 1.751-1(c)(3), in determining the amount of the sales price attributable to unrealized receivables, any arm's-length agreement between the buyer and seller would generally establish the value.

For transactions occurring after Dec. 14, 1999, Regs. Sec. 1.751-1(c)(3) provides that in determining the amount of the sales price attributable to unrealized receivables, full account shall be taken not only of the estimated cost of completing performance of the contract or agreement, but also the time between the sale and the payment. Thus, the amount of the sales price attributable to open-service and construction contracts would appear to be the discounted value of revenue expected to be received on the contracts by the buyer subsequent to the sale. This amount would be offset by the discounted value of estimated costs and administrative expenses expected to be incurred by the buyer and allocable to the contract. The difference between these two amounts would