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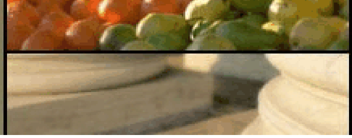

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The Problem of Hot Assets in Farm Partnerships

by

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The Problem of Hot Assets in Farm Partnerships

David Joy, Randall Hahn, and Allan Karnes*

I. Introduction

During the past decade, partnerships have become popular tax planning vehicles. The flexibility which the tax law affords partnerships has allowed tax promoters to implement innovative approaches for using partnerships.

Flips, flip-flops and triple flips are examples of some of the techniques that have been used to facilitate the allocation of partnership profits and losses among general and limited partners to maximize cash flows according to investor preference.[1] General partnerships that are convertible into limited partnerships provide another example of the innovative use of the partnership form to satisfy the needs and preferences of the sophisticated investor.[2] Still another example is the frozen partnership which is used to stabilize partnership values for estate tax purposes.[3] Finally, family partnerships have been used to spread taxable income over a

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1. Flips, flip-flops and triple flips are partnership devices used to allocate losses differently than profits to the individual partners. These devices are generally based on the partnership's aggregate net profits or losses. Flips are commonly used to allocate the net losses to partners based on the capital each partner respectively contributed while the profit allocation takes into consideration the value of services rendered by individual partners. Flip-flops are used to allocate losses which limited partners cannot deduct solely to the general partners. A triple flip is a combination of a flip and a flip-flop. For further discussion, see A. Willis, J. Pennell & P. Pastlewaite, 1 Partnership Taxation §§ 46.01-46.08 (3d ed. 1984) [hereinafter cited as Partnership Taxation].

2. Priv. Let. Rul. 7948063 permits a tax free conversion of a general partnership into a limited partnership. Even though partners may be unwilling to take responsibility for the partnership liabilities over an extended time period, they sometimes are willing to assume responsibility for partnership liabilities for a limited time period to obtain tax benefits for partnership losses in excess of their capital contribution. After obtaining the benefits afforded by the tax losses, these general partnership interests can automatically be converted into limited partnership interests at a subsequent date.

3. Frozen partnership interests are partnership interests which have fixed call prices and are allocated a fixed annual rate of return, and resemble preferred stock. Frozen partnership interests can be useful tools when substantial appreciation in a partnership's value is anticipated. D. Kelly & D. Ludtke, Estate Planning for Farmers and Ranchers §§ 7.28-7.48 (1980).

number of taxpayers to achieve a lower effective tax rate.[4]

The ultimate success of such innovative uses of partnerships may depend on the tax planners' ability to avoid the clutches of section 751(a) of the Internal Revenue Code. This section states that a partner will recognize ordinary income whenever he sells or exchanges unrealized receivables or substantially appreciated inventory.[5] These are known as "hot assets." Subsections (c) and (d) of section 751 define unrealized receivables and substantially appreciated inventory so broadly that almost any asset which has, does or will require recognition as ordinary income can be included in one of two definitions.[6] Moreover, the concepts "sell or exchange" include a wide assortment of partnership events.[7]

Farmers have traditionally used the cash basis method of accounting to report their taxable incomes. On the cash basis, income is generally not recognized until the receipt of cash and expenses (e.g., fertilizer) are reported as cash is paid. Cash basis farm partnerships are particularly exposed to the unrealized receivables and substantial appreciation problems of section 751, and the authors have chosen cash basis farm partnerships as a vehicle for the discussion of the various issues associated with "hot assets."

This article will address the following issues:

1) Types of farm assets classified as hot assets,

2) The impact of section 751 on:

   a) admission of a new partner,

   b) liquidation of an existing partner's interest,

   c) various types of exchanges,

   d) partnership distributions,

   e) change of partner status,

3) Suggestions for avoiding or minimizing section 751 problems, and

4) Suggestions for utilizing section 751 to one's advantage.

4. I.R.C. § 704(e) (1982), states that a person shall be recognized as a partner if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person. Thus, a parent may gift a partnership interest in his business income provided that the partnership is not a service organization.

5. I.R.C. § 751(a) (1982).

6. I.R.C. § 751(d) & (c) (1982).

7. Rev. Rul. 57-588, 1957-2 C.B. 305, grants farmers the choice to report their income for tax purposes on either the "cash" basis or the "accrual" basis. However, § 447 denies the use of the cash method of accounting to partnerships engaged in the trade or business of farming if a corporation other than a qualified closely held corporation is a partner.

A. *What Are Farm "Hot Assets"?*

Section 751(a) separates "hot assets" into two types, unrealized receivables and substantially appreciated inventory.[8] The two types of "hot assets" are not subject to the same rules. For example, unrealized receivables represent ordinary income which will always be accorded "hot asset" treatment.[9] On the other hand, depending on a mechanical test under section 751, inventory items may or may not be substantially appreciated inventory.[10] Because inventory items can potentially avoid "hot aset" treatment, they will be discussed separately.

II. UNREALIZED RECEIVABLES

Unrealized receivables represent the portion of unrealized appreciation in the receivables consisting of ordinary income.[11] For example, assume that an unrealized receivable has a tax basis of $100 and a fair market value of $500. Furthermore, assume that ordinary income of $300 and capital gain of $100 would be recognized if the asset was sold. In this situation only $300 of the asset is an unrealized receivable.

There are four major categories of unrealized receivables. They are as follows:

1) the unrecognized ordinary income attributable to any receivable as defined by the partnership's accounting method,
2) the fair market value of rights to receive income from goods whole sale will be treated as one other than that of a capital asset, or the fair market value of the rights to receive income from the rendering of services,
3) potential depreciation recapture,
4) potential recapture for capital expenditures prematurely expensed.[12]

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8. I.R.C. § 751(a) (1982).

9. I.R.C. § 751(c) (1982). *See infra* note 11.

10. I.R.C. § 751(d) (1982). *See infra* text accompanying notes 68-72.

11. I.R.C. § 751(c) (1982) provides the following definition for unrealized receivables:

> [T]he term "unrealized receivables" includes, to the extent not previously includible in income under the method of accounting used by the partnership, any rights (contractual or otherwise) to payment for
>
> (1) goods delivered, or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or
>
> (2) services rendered or to be rendered.
>
> [S]uch term also includes mining property . . . § 1245 property . . . farmland (as described in section 1252(a)) . . . and an oil, gas or geothermal property (as described in section 1254) but only to the extent of the amount which would be treated as gain to which section 617(d)(1), 995(c), 1245(a), 1248(a), 1250(a), 1251(c), 1252(a), 1253(a), or 1254(a) would apply if such property had been sold at its fair market value.

12. I.R.C. § 751(c) (1982).

A. *Examples of Farm Unrealized Receivables*

Farm partnerships using the cash basis to report their taxable income will normally have receivables with a zero tax basis. These receivables may have originated from a grain or livestock sale under a deferred payment contract, or from the use of the partnership's machinery, or from partner services. Farm partnerships which aggressively defer taxable income typically have large amounts of such receivables at year-end.

Other receivables may include items normally referred to as accrued receivables. These accrued receivables could be from land rentals or interest from farm notes, savings accounts, or marketable securities.

Finally, the partnership may have installment notes from the sale of farm assets that are being reported on the installment method.[13] Any ordinary income which has been deferred is an unrealized receivable, whether the ordinary income treatment is due to a recapture provision or to the character of the property sold.[14]

B. *Present Value of Contracts*

Section 751 goes beyond the normal scope of accounting by including (as an unrealized receivable) the present value of the ordinary income attributable to contractual rights to future payments for either goods *to be* delivered or for services *to be* rendered.[15] Such contracts have become common in agriculture. For example, sugar manufacturers frequently enter into contractual agreements with farmers to grow sugar beets. Similar contracts are common for poultry, pork, dairy and citrus farmers. Other farmers can subject themselves to hot asset rules by entering into contractual agreements to provide farm machinery or labor to other farms or to rent farmland.

Unfortunately, section 751 does not clearly define which contracts are unrealized receivables. The courts and the Treasury Department have provided some guidelines, however. First, such contractual rights must not be contingent upon any acts on the part of the party who is to receive the goods or services covered by the contracts,[16] and the amount

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13. I.R.C. § 453(d) (1982) states that a taxpayer is subject to installment sales provisions unless he or she elects not to be subject to these provisions.

14. Prior to June 7, 1984, the § 1245 and § 1250 gain portions of an installment sale were recognized as cash or property was received, based on the percentage that those gains bore to the total sales price. Section 435(i) was amended in 1984, however, and provides that subsequent to June 6, 1984, all § 1245 and § 1250 gain is reported in the year of sale regardless of the amount of payments received in that year. As a result, only installment sales prior to June 7, 1984, will be unrealized receivables due to § 1245 and § 1250.

15. I.R.C. § 751(c) (1982).

16. W. McKee, W. Nelson, & R. Whitmire, Federal Taxation of Partnerships and Partners 16-24, n.69 (Student ed. 1978).

of revenue which will be realized from such contracts must be reasonably ascertainable.[17] Thus, any contracts which provide considerable options to either party may be excludable from unrealized receivables.

After identifying which contracts constitute unrealized receivables, the value of the particular receivable must be determined. The projected gross revenues are first reduced by the out-of-pocket expenses to be incurred plus an allocation of expenses attributable to buildings, machinery and equipment used in generating revenues.[18] It would appear that expenses requiring future cash outlays can be adjusted for inflation effects. The law, however, has not established firm guidelines whether or not the fair market value of the partner's labor can be included in such expenses. After establishing the net income for the contractual rights, such net income should be discounted to provide the fair market value of the contracts.[19] Although it is not clear what discount rate should be used, the partnership's normal cost of capital, the rate of return for similar or dissimilar investments, or the inflation rate could be looked to for the discount rate. The best solution for such problems is to simply have the parties agree as to their value.[20]

C. *Recapture of Depreciation*

Section 751 states that a partnership's unrealized receivables include the portion of the fair market value for property held for trade or business which would be deemed to be section 1245 or section 1250 gains if such property had been sold.[21] The following discussion presents an outline for the computation of section 1245 and section 1250 gains and a delineation of the types of farm property subject to both sections.

1. Section 1245 Property

If property used in a trade or business subject to the provisions of section 1245 is sold, the gain recognized from those sales will be ordinary income to the extent depreciation deductions have been taken since January 1, 1962.[22] In addition, any amounts deducted as a section 179 expense election,[23] and the basis reduction for the investment tax credit (for property placed in service after December 31, 1982) are also subject to section 1245 recapture.[24]

17. Treas. Reg. § 1.751-1(c)(3), [1985] 6 STAND. FED. TAX REP. (CCH) ¶ 3981.
18. *Id.*
19. *Id.*
20. Major v. Comm'r, 76 T.C. 239 (1981); Lucas v. Comm'r, 58 T.C. 1022 (1972).
21. I.R.C. § 751(c) (1982).
22. I.R.C. § 1245(a)(1) (1982).
23. I.R.C. § 1245(a)(2) (1982).
24. I.R.C. § 48(q)(5)(A) (1982).

The definition of section 1245 property and section 1245 recovery property is quite complex and reference must be made to several code sections and Treasury Regulations. The following is a list of typical farm property that is subject to the recapture provisions of section 1245.

1) Personal property used in a trade or business and subject to depreciation or amortization. Examples include tractors, plows, livestock feeding equipment, pick-up trucks and grain dryers.[25]

2) Livestock, but only with respect to taxable years beginning after December 31, 1969, irrespective of their use or the purpose for which they are held. For purposes of section 1245, the term livestock includes horses, cattle, sheep, hogs, goats, mink, and other furbearing animals.[26]

3) Real property used as an integral part of production held for more than six months from date of acquisition. Examples are fences, irrigation drainage ditches and dams.[27]

4) Real property used for bulk storage of fungible commodities held for more than six months from date of acquisition. Examples are silos and potato storage facilities.[28]

5) Reforestation expenditures which are being amortized over seven years under the provisions of section 194. Qualified timber property is a woodland or other site which contains trees in significant commercial quantities and which has been held by the taxpayer for the planting, cultivating, caring for, and cutting for sale or use in the commercial production of timber products.[29]

6) Single purpose agricultural or horticulture structures held for more than six months from date of acquisition. Examples are hog production facilities, greenhouses used solely for raising plants and chicken production facilities.[30]

7) Other nonresidential real property depreciated by ACRS rules held for more than six months from date of acquisition. Examples are barns and work sheds which are being depreciated under ACRS rules.[31]

2. Section 1250 Property

Section 1250 applies to all other depreciable property used in a trade or business that is not subject to section 1245's rules.[32] The principal form of farm assets covered under section 1250 are barns, work sheds

25. I.R.C. § 1245(a)(3)(A) (1982).
26. Treas. Reg. § 1.1245-3(a)(4), [1985] 8 STAND. FED. TAX REP. (CCH) ¶ 4773AC.
27. I.R.C. § 1245(a)(3)(B)(i) (1982).
28. I.R.C. § 1245(a)(3)(B)(iii) (1982).
29. I.R.C. § 1245(a)(3)(D) and I.R.C. § 194(c)(1) (1982).
30. I.R.C. § 1245(a)(3)(E) and I.R.C. § 48(p) (1982).
31. I.R.C. § 1245(a)(5) (1982).
32. I.R.C. § 1250(c) (1982).

and general storage sheds which are not being depreciated under ACRS rules.

Section 1250 gain is the ordinary income which would be recognized if the section 1250 property was sold. With the exception of the farm house, the section 1250 gain on unrealized receivables is the lower of the difference between the property's fair market value and its adjusted net tax basis or the amount of accelerated depreciation taken for tax purposes after 1969 in excess of the straight-line depreciation which would have been allowed if the property had been depreciated using straight-line depreciation (excess depreciation).[33] In the case of the farm house, the excess depreciation from 1970-1975 would be multiplied by a percent (100 minus the number of months which the farm house had been held in excess of 100 months)[34] and added to the excess depreciation taken after 1975.[35]

3. Recapture for Direct Expensing of Capital Expenditures

In addition to depreciation recapture items, unrealized receivables can include recovery of certain expenses related to either the farmland or the underlying mineral rights.[36] Unrealized receivables may include recovery of tax deductions for either land clearing or soil conservation expenditures. The amount of unrealized receivables depends on how long the land has been held by the partnership and its partners prior to being transferred to the partnership. If the farmland has been held five years or less, 100% of such expenditures would normally be deemed to be unrealized receivables. The percentage of such expenditures deemed to be unrealized receivables would decrease by 20% for each complete year that the partnership holds the land in excess of five years.[37] No recapture for these expenses will occur after the farmland has been held for ten years. Moreover, the amount of unrealized receivables for such items are limited to the potential gain that would be realized if the land was sold.[38]

A farmer who provides cash or other assets to a drilling program for oil on his property may have an unrealized receivable, depending upon whether the partnership receives a tax deduction for the intangible drill-

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33. I.R.C. § 1250(a)(3) (1982) is no longer applicable to accelerated depreciation taken for real property before 1969. The applicable percent for this purpose was 100 percent minus 1 percentage point for each full month the property was held after the date on which the property was held for 20 months. This percentage became zero for all such property on December 31, 1979.

34. I.R.C. § 1250(a)(2) (1982).

35. I.R.C. § 1250(a)(1) (1982).

36. I.R.C. § 751(c) (1982).

37. I.R.C. § 1252(a)(3) (1982).

38. I.R.C. § 1252(a)(1) (1982).

ing costs related to the oil well.[39] If the partnership has taken a tax deduction for the intangible drilling costs, a designated percentage of these expenses must be recaptured if the well is sold. This percentage is 100% less 10% times each complete year elapsing since the drilling date. Again, this amount is limited to the potential gain which would be realized if the oil interest was sold.[40] Similar provisions exist for recovery of immediate deductions for exploration for minerals such as coal, sand, and gravel.[41]

D. *Substantially Appreciated Inventory*

There are two primary differences in treatment afforded to inventory assets as compared with unrealized receivables under section 751. First, the entire fair market value of inventory may be deemed a "hot asset."[42] Second, the determination whether inventory assets are substantially appreciated depends upon the results of a mechanical test.[43] If the fair market value of the inventory items are greater than 10% of the fair market value of the aggregate partnership assets other than cash and greater than 120% of the tax basis of the inventory items, the assets are considered to be substantially appreciated.[44]

The two principal categories of inventory items relevant to farm partnerships are:

1) inventory items as defined by IRC section 1221(1),[45] and

2) any other property of the partnership which upon sale or exchange would be considered property other than a capital asset and other than property described in section 1231.[46]

After identifying typical farming inventory items, suggestions for avoiding "hot asset" treatment for inventory items will be discussed.

1. Inventory Items per Section 1221(1)

IRC section 1221 defines a capital asset by exclusion.[47] Section 1221(1), which section 751(d)(2)(A) incorporates as part of its definition of inventory items, includes stock in trade or other property which would be properly includible in the taxpayer's year-end inventory or property

39. I.R.C. § 751(c) (1982).
40. I.R.C. § 1254 (1982).
41. I.R.C. § 617(d)(1) (1982).
42. I.R.C. § 751(d) (1982) subjects the total value of substantially appreciated inventory items to the noncapital gain treatment prescribed by § 751(a).
43. I.R.C. § 751(d)(1) (1982).
44. *Id.*
45. I.R.C. § 751(d)(2)(A) (1982).
46. I.R.C. § 751(d)(2)(B) (1982).
47. I.R.C. § 1221 (1982).

held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's business.[48]

Stock in trade as property held primarily for sale for a farm partnership would include such items as raised grains, vegetables, fruits, and feeder livestock. Because most farm partnerships are on the cash basis, these inventory items will generally have a zero basis.

The following have been held to be "other property which would be properly includable in the taxpayer's year-end inventory":

1) Supplies such as insecticides, veterinarian supplies, herbicides, seed, fertilizer and feed,[49]
2) Repair parts such as tractor parts, lumber and nails,[50]
3) Tools such as rakes, pitchforks, hammers, screwdrivers, wrenches and power saws,[51]
4) Gas and oil,[52]
5) Commodity futures used for hedging purposes.[53]

Again, these items frequently have a zero tax basis. Furthermore, they are not as readily identifiable as basic agriculture commodities.

2. Property Not Subject to Capital Gains and Section 1231 Rules

Subpart (B) of IRC section 751(d)(2) includes as an inventory item any other partnership property which upon a sale or exchange by the partnership would be considered other than a capital asset or section 1231 property.[54]

The regulations provide that accounts receivable acquired in the ordinary course of business or from the sale or exchange of stock in trade constitute inventory items, as do any unrealized receivables.[55]

Accounts receivable are also included in the definition of unrealized receivables; however, such receivables are not counted twice as "hot assets." The first reason for including these receivables is for conducting the test whether or not the inventory is substantially appreciated. The second reason is that if the taxpayer has a tax basis in such assets which is greater than zero, *the tax basis* of the receivables becomes "hot assets" as a result of section 751(d)(2)(B). Finally, section 751(d)(2)(B) is not as inclusive as the definition of unrealized receivables. For example, install-

48. I.R.C. § 1221(1) (1982).

49. *M. Levine*, 21 T.C.M. 363, Dec. 25,421(M), T.C. Memo. 1962-68, *aff'd on another issue*, 324 F.2d 298, 632 U.S. Tax. Cas. (CCH) ¶ 9785 (1963).

50. *Id.*

51. *Id.*

52. *Id.*

53. Monfort of Colorado, Inc. v. United States, 561 F.2d 190, 77-2 U.S. Tax. Cas. (CCH) ¶ 9572 (10th Cir. 1977).

54. I.R.C. § 751(d)(2)(B) (1982).

55. Treas. Reg. § 1.751-1(d)(2)(ii), [1985] 6 STAND. FED. TAX REP. (CCH) § 3981.

ment sales of section 1245 and section 1250 property and the present value of future contracts are not includable under section 751(d)(2). Only those receivables which arise from the sale of the partnership's products, raw materials, supplies, repair parts, tools, gas and oil, employee's labor and machine hire are included.[56]

Section 751(d)(2) also catches as inventory items all other noncapital asset or non-section 1231 property. As a result, the following farm assets are deemed to be inventory items:

1) Personal property, other than livestock, not held for more than six months from date of acquisition,[57]
2) Cows and horses not held for more than 24 months from date of acquisition,[58]
3) Other livestock not held for more than 12 months from date of acquisition,[59]
4) Single purpose agriculture or horticulture structures, storage facilities for fungible goods, real estate used as an integral part of production or any farm building not held for more than six months.[60]

In addition to including depreciable farm assets not subject to section 1245 and section 1250, section 751(d)(2)(B) also makes other farm assets inventory items. These assets include the following:

1) Poultry,[61]
2) Land not held for more than six months from date of acquisition,[62]
3) Depletable assets other than timber, coal, and iron ore held for more than six months. Examples are oil and gas and sand and gravel.[63]

Unharvested crops on land used in a trade or business and held for more than six months would not be a "hot asset" if the crop and the land are sold or exchanged at the same time to the same person.[64] IRC section 751(b)(1) deems a sale of "nonhot" assets when there has been an exchange of "hot" for "nonhot" assets;[65] thus, it would appear that un-

56. *Id.*
57. I.R.C. § 1231(b)(1) (1982).
58. I.R.C. § 1231(b)(3)(A) (1982).
59. I.R.C. § 1231(b)(3)(B) (1982).
60. I.R.C. § 1231(b)(1) (1982).
61. I.R.C. § 1231(b)(3) (1982) excludes poultry from the definition of livestock. Furthermore, the estimated useful life for chickens is less than three years, which is the minimum life necessary for an asset used in trade or business to be subject to § 167 rules and regulations.
62. I.R.C. § 1231(b)(1) (1982) states that real property used in a trade or business, which has been held for more than six months is 1231 property unless it is being held as inventory. Thus farm land which has been held for less than six months is an inventory item under the definition of § 751(d)(2)(b).
63. I.R.C. § 1231(b)(2) (1982).
64. I.R.C. § 1231(b)(4) (1982) and Treas. Reg. § 1-1231-1(f) (1985) 7 STAND. FED. TAX REP. (CCH) ¶ 4727.
65. I.R.C. § 751(b)(1) (1982).

harvested crops would not be considered inventory items.[66] Section 268 mandates that no expenses associated with that crop may be deducted.[67]

3. Substantially Appreciated Test

Once all inventory items have been identified, the mechanical test of section 751(d)(1) is applied to determine whether the inventory items are substantially appreciated. The test provided in section 751 (d)(1) is as follows:

"Inventory items of the partnership shall be considered to have substantially appreciated in value if their fair market value exceeds

(A) 120 percent of the adjusted basis to the partnership of such property, and

(B) 10 percent of the fair market value of all partnership property, other than money."[68]

Under normal circumstances, cash basis farm partnerships will pass the first test. Nevertheless, if a farmer has expanded his operation during the last six months, an excellent opportunity may exist to purposely fail this test. For example, assume a farm partnership acquires farm land for $500,000 and a farm machinery for $200,000. The farmer could hold up to $140,000 of other inventory items having a zero tax basis without having substantially appreciated inventory.[69] This situation can facilitate the shifting of ordinary income from one partner to another.

The second test normally offers cash basis farm partnerships the best opportunity to avoid the reach of section 751. Since this test does not take liabilities into consideration,[70] the partnership could borrow sufficient capital and invest in nonmonetary assets so that this test is failed. Cash does not include U.S. Government Bonds or other investments of a like manner.[71] Accordingly, one could convert money into U.S. Treas-

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66. Additional support can be found in *J.F. Nutt Estate*, 447 F.2d 1109, 71-2 U.S.T.C. ¶ 9607 (9th Cir. 1971), where the Court held that gain on the sale of land with unharvested crops to a corporation controlled by the taxpayer's husband was not ordinary income, since the taxpayer did not have the right to reacquire the land.

67. I.R.C. § 268 (1982) and Teget v. United States, 407 F. Supp. 681, 76-1 U.S. Tax. Cas. (CCH) ¶ 9252 (D.S.D. 1976), *rev'd on other grounds*, 552 F.2d 236, 77-1 U.S. Tax. Cas. (CCH) ¶ 9315 (8th Cir. 1977).

68. I.R.C. § 751(d)(1) (1982).

69. I.R.C. § 751(d)(2)(B) (1982) defines inventory to be any other property of the partnership which on sale or exchange by the partnership, would be considered property other than a capital asset or property described in § 1231. Farm land and farm machinery are deemed to be property other than a capital asset by § 1221(2). Section 1231(b)(1) only includes such property which has been held for more than six months. Consequently, any farm land and buildings purchased during the last six months of a partnership's tax year would be treated as inventory.

70. A. WILLIS, J. PENNELL & P. POSTLEWAITE, 2 PARTNERSHIP TAXATION § 102.08 (3d ed. 1984).

71. *Id.* § 102.09.

ury Bonds to increase the value of "all partnership property other than money." One should be wary of the sham or step-transaction doctrines in doing so, however. Another method is to reduce inventory items to less than 10% through sales.[72] These strategies offer planning opportunities which can allow taxpayers to shift potential ordinary income from one taxpayer to another if due care and diligence are utilized.

Sale or Exchange

Having identified the principal form of assets which could be considered "hot assets," the definition of a sale or exchange for purposes of section 751 should be examined. Neither the Internal Revenue Code nor Treasury Regulations applicable to section 751 provide extensive coverage as to what types of partnership events trigger a sale or exchange. Moreover, the courts have not extensively examined the range of partnership transactions subject to section 751. Consequently, one must examine the decisions and other authority that exist and make appropriate extrapolations.

The cases that exist relating to sales and exchanges suggest that section 751 may affect a wide range of partnership transactions. However, one should note that, although based on existing tax law, the following commentary represents interpretations that will ultimately be subject to future clarification provided by Congress, the U.S. Treasury Department and the judicial system. Nevertheless, it is believed that the following at a minimum provides food for future thought and is replete with warnings that the failure to consider section 751 may result in the ultimate failure of otherwise successful tax planning.

The principal classifications of transactions which are to be addressed are:

1) Admission of a New Partner
2) Liquidation of a Partner's Interest
3) Exchanges of Property for Partnership Interests
4) Beneficial Transfers of Partnership Interests
5) Distributions Triggering section 751 Income
6) Changes in Partners' Status

Admission of a New Partner

Section 721 states that no gain or loss shall be recognized to a partnership or to any of its partners upon the contribution of property to the partnership in exchange for an interest in the partnership.[73] Once a partnership is formed, however, it must be determined how a new partner

72. *Id.*
73. I.R.C. § 721(a) (1982).

should be allowed to acquire his interest. One dilemma facing existing partners is whether or not to recognize income upon admitting a partner. If the existing partners recognize the income for tax purposes, the incoming partner can elect to increase the tax basis for his interest in the partnership assets.[74] The issues surrounding the admission of a new partner become more questionable when the new partner contributes property to the partnership for his partnership interest. Proper planning can prevent unpredictable results, however.

If a new partner purchases a partnership interest in an existing partnership, the aggregate theory of partnership tax theory proposes that the new partner has purchased an indentical percentage in the various partnership assets.[75] The selling partner will be deemed to have sold his share of the partnership's "hot assets." The selling partner would then recognize ordinary gain in the amount of appreciation that his percent-

74. I.R.C. § 754 (1982) provides partnerships the right to elect to adjust the tax basis of a new partner's interest in the partnership assets to reflect his or her proportionate share of the fair market value as reflected by the purchase price.

75. Treas. Reg. § 1.751-1(g) (1985) 6 Stand. Fed. Tax Rep. (CCH) ¶ 3981. Example 1 provides the following illustration: C buys B's interest in personal service partnership AB for $15,000 when the balance sheet of the firm (reflecting a cash receipts and disbursements method of accounting) is as follows:

Assets	Adj. Basis Per Books	Market Value
Cash	$ 3,000	$ 3,000
Loans receivables	10,000	10,000
Other assets	7,000	7,000
Unrealized receivables	-0-	12,000
Total Assets	$20,000	$32,000
Liabilities and Capital		
Loans payable	$ 2,000	$ 2,000
Capital:		
A	9,000	15,000
B	9,000	15,000
	$20,000	$32,000

Section 751(a) applies to the sale. The total amount realized by B is $16,000, consisting of the cash received, $15,000 plus $1,000, B's share of the partnership liabilities assumed by C, see § 752. B's undivided half interest in the partnership property includes a half-interest in the partnership's unrealized receivables which are worth $12,000. Consequently, $6,000 of the $16,000 realized by B shall be considered received in exchange for B's interest in the partnership attributable to its unrealized receivables. The remaining $10,000 realized by B is in exchange for a capital asset. B's basis for his partnership interest is $10,000 ($9,000, plus $1,000, B's share of partnership liabilities). No portion of his basis is attributable to B's share of the unrealized receivables of the partnership since such property has a zero basis in the hands of the partnership; therefore, B has a basis of zero for the unrealized receivables because the partnership basis for such receivables would have carried over to him under § 732 had they been distributed to him. The difference between the zero basis and the $6,000 realized for the unrealized receivables is ordinary income to him. The entire $10,000 of B's basis is the basis for his interest in partnership property other than unrealized receivables and is applied against the remaining $10,000 ($16,000 minus $6,000) received from the sale of his interest. Therefore, B has no capital gain or loss. (If B's basis for his interest in partnership property, other than unrealized receivables, were $9,000, he would realize capital gain of $1,000. If his basis were $11,000, he would sustain a capital loss of $1,000.)

age of the "hot assets" has sustained. The remainder of the related gain would be treated as capital gain. The two parties should be able to come to a mutual agreement in writing as to the values assigned to each asset.[76] By doing so, the parties could shift ordinary income to capital gain and vice versa, dependent upon the existence of an arms-length transaction. Moreover, the purchasing partner could increase his percentage of each asset to the agreed upon values.[77]

The issues involved with having a new partner contribute property to the existing partnership are not as clear. At first glance, it would appear that there would be no income tax consequences based upon section 721(a).[78] If the partnership has liabilities, the rules of section 751 may supercede section 721(a)[79] because the decrease in a partner's share of the partnership's liabilities is considered to be a distribution of money to the partner by the partnership.[80] As will be explained further, distributions are deemed to be exchanges to which section 751 will apply. The code does not clearly indicate whether section 721(a) or section 751 is to govern if the money which the existing partners receive is in exchange for "hot assets."[81] It is clear that since the new partner receives profit-loss sharing rights, there has been an exchange of "hot assets" from the old partners to the new partner. To date the courts have only ruled that when a partner's tax basis is less than the face amount of such liabilities, gains must be recognized in the amount of this difference.[82] Until the courts rule or Congress clarifies the issue, one should proceed with caution.[83]

The sale of a limited partnership to a new partner may be used to limit unexpected exchanges of "hot assets." Since limited partners do not share in recourse liabilities, there would be no distribution of money

76. Treas. Reg. § 1.751-1(c)(3) [1985] 6 STAND. FED. TAX REP. (CCH) § 3981 states that in determining the allocation of the sales price to the § 751 property "any arm's length agreement between the buyer and the seller . . . will generally establish the amount or value."

77. I.R.C. § 754 (1982).

78. I.R.C. § 721(a) (1982) states that no gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.

79. The existing partners are treated as having received distributions when a new partner joins a partnership that has liabilities and unrealized receivables, A. WILLIS, J. PENNELL & P. POSTLEWAITE, 2 PARTNERSHIP TAXATION § 32.04.

80. I.R.C. § 752(b) (1982).

81. 2 PARTNERSHIP TAXATION § 32.04.

82. Crane v. Comm'r, 331 U.S. 1 (1947); Johnson v. Comm'r, 59 T.C. 791 (1973), *aff'd*, 495 F.2d 1079 (6th Cir. 1974); Parker v. Delaney, 186 F.2d 455 (1st Cir. 1950); Evangelisto v. Comm'r, 71 T.C. 1057 (1979).

83. In Rev. Rul. 84-102, 1984-28 I.R.B. 6, the Treasury takes the position that § 751 has precedence over § 721.

unless the partnership has nonrecourse notes.[84] The same result may be achieved by specifically stating that the new partner assumes no responsibility for the liabilities as of that date.

Another approach is to have current partners assume responsibility for all existing deferred taxes.[85] The old partnership could also form a new partnership with the new incoming partner.[86] Section 724 states that a partner who contributes unrealized receivables or inventory items is not subject to tax upon their transfer, but the partnership incurs ordinary income upon a disposition of the "hot assets" for the first five years that they are held by the partnership.[87] The only time tax should be triggered is when liabilities assumed by the new partnership exceed the tax basis of the property being transferred by an individual partner.[88] The courts could refuse to recognize the newly formed partnership as a new partnership,[89] but at the very least, the partners would be in no worse position than they would have been without using this device, except for out-of-pocket expenses.

Liquidation of a Partnership Interest

Section 751 rules and regulations are applicable to situations where

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84. Treas. Reg. § 1.752-1(e) [1985] 6 FED. STAND. TAX REP. (CCH) ¶ 3987 states that a partner's share of partnership liabilities shall be determined in accordance with his ratio for sharing losses under the partnership agreement. In the case of a limited partnership, a limited partner's share of partnership liabilities shall not exceed the difference between the actual contribution and the total contribution which he is obligated to make under the limited partnership agreement. However, where none of the partners have any personal liability with respect to a partnership, then all partners, including limited partners, shall be considered as sharing such liability under § 752(c) in the same proportion as they share the profits.

85. Example (4) of Treas. Reg. § 1.704-1(b)(2) [1985] 6 FED. STAND. TAX REP. (CCH) ¶ 3914, deals with partnership KL, a brokerage partnership with assets consisting of securities with a tax basis of $20,000 and a value of $50,000. M makes a $25,000 cash contribution to the partnership in order to become an equal partner. Subsequently, when the value of the securities has appreciated to $74,000, they are sold. The $30,000 gain resulting from the appreciation prior to admitting M to the partnership, is allocated to K and L in the profit and loss ratio existing before M became a partner. This allocation is deemed to have a substantial economic effect. Accordingly, such allocations should be recognized in the absence of other circumstances showing that the principal purpose was tax avoidance or evasion.

86. *H.E. Oliver*, 13 T.C.M. 67 (1954), *aff'd per curium*, 356 F.2d 352 (5th Cir. 1955), indicates that a partnership which contributes property to another partnership shall be treated as a new partner that contributed capital.

87. I.R.C. § 724(a) & (b) (1982).

88. *See supra* note 83.

89. Rev. Rul. 1968-2 C.B. 143 considered this issue in the corporate area. The ruling involved an individual who transferred appreciated property to a new corporation for its stock, while a corporation simultaneously transferred all of its assets to the new corporation and then liquidated. The Service ruled that the transaction constituted a taxable exchange of property by the individual for stock of an uncontrolled corporation, and that the alleged corporate transferor had merely reincorporated in a reverse Type F reorganization. The Service could reach an analogous conclusion through the imposition of the step transaction doctrine to partnerships.

an existing partner liquidates his partnership interest.[90] This segment will examine the flexibility afforded the partnership liquidating individual partnership interests.

If an entire partnership is liquidated, each partner is deemed to receive a distribution of his or her proportionate share of each partnership asset.[91] If the actual distribution from the partnership consists of different assets, the regulations deem that the individual partner has exchanged his or her interest in the partnership assets which were not received for the additional interest in the partnership assets that are actually received.[92] This exchange is deemed nontaxable unless either the money distributed exceeds the liquidating partner's partnership interest[93] or the liquidating partner does not receive his proportionate share of "hot assets."[94]

Under the latter situation, it is assumed that there has been a simultaneous sale between the various partners who also do not receive exactly their proportionate share of "hot assets." Those partners that receive

90. In Example (2) of Treas. Reg. § 1.751-1(g) [1985] 6 STAND. FED. TAX REP. (CCH) ¶ 3981, partnership ABC makes a distribution to partner C in liquidation of his entire one-third interest in the partnership. At the time of the distribution, the balance sheet of the partnership, which uses the accrual method of accounting, is as follows:

Assets	Adjusted Basis Per Books	Market Value
Cash	$15,000	$ 15,000
Accounts Receivable	9,000	9,000
Inventory	21,000	30,000
Depreciable Property	42,000	48,000
Land	9,000	9,000
Total	$96,000	$111,000

Liabilities and Capital	Adjusted Basis Per Books	Market Value
Current liabilities	$15,000	$ 15,000
Mortgage Payable	21,000	21,000
Capital:		
A	20,000	25,000
B	20,000	25,000
C	20,000	25,000
	$96,000	$111,000

The distribution received by C consists of $10,000 cash and depreciable property with a fair market value of $15,000 and an adjusted basis to the partnership of $15,000.

> (1) The § 751(b) sale or exchange—C's share of the inventory items is treated as if he received them in a current distribution, and his basis for such items is $10,000 ($7,000 for inventory and $3,000 for accounts receivable). Then C is considered as having sold his share of inventory items to the partnership for $13,000. Thus, on the sale of his share of inventory items, C realizes $3,000 of ordinary income.

91. *Id.*

92. Treas. Reg. § 1.751-1(b)(2) [1985] 6 FED. STAND. TAX REP. (CCH) ¶ 3981.

93. I.R.C. § 731(a)(1) (1982).

94. I.R.C. § 751(a) (1982).

less than their share of "hot assets" will recognize ordinary taxable income as a result.[95] Partners who receive more than their share of "hot assets" may recognize capital gain if the "non-hot assets" (deemed to have been exchanged for the "hot assets") have also appreciated in value.[96] Finally, the partners should be entitled to a step-up in basis as a result of the exchange.

Partnerships are afforded greater flexibility to determine how to liquidate a single partner's interest. First, the partnership can elect to make payments to the retiring partner under the provisions of section 736.[97] If such an election is made, the partner is deemed to receive liquidating payments for his interest in the partnership property (other than unrealized receivables and goodwill),[98] except to the extent that the partnership agreement provides for a payment with respect to goodwill.[99] The liquidation is hence deemed to be subject to section 751 rules only if the liquidating partner does not receive his or her share of the inventory items that are substantially appreciated.

It could be advantageous to distribute the retiring partner's share of inventory items. Since the tax basis of inventory items is also classified as a "hot asset," this distribution does not necessarily have to reflect the amount of ordinary income which the partner would have to recognize if the partnership continued as is.[100] The distribution could shift the ultimate taxation for the appreciated property between the individual partners. The choice of which inventory items should be distributed can be based upon the individual partner's tax rates.

In addition, the regulations under section 736 provide considerable latitude to the sales price assigned to partnership assets. The regulations imply that generally, the valuation placed by the partners upon a partner's interest in partnership property in an arms-length agreement will be respected.[101] The partners may be provided an excellent opportunity to exchange places whether they are subject to ordinary income tax rules or capital gain rules. It should be noted that the arms-length requirement may deny these planning opportunities to family farm partnerships.

Another planning opportunity arises from the observation that neither unrealized receivables nor goodwill are considered to be partner-

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95. Treas. Reg. § 1.751-1(g), *supra* note 91.

96. *Id.*

97. I.R.C. § 736 (1982).

98. I.R.C. § 736(b)(1) (1982).

99. I.R.C. § 736(b)(2) (1982).

100. I.R.C. § 751(a) (1982) only requires that the same amount of "hot assets," in this case inventory, be held by each partner after such distributions as before the distributions.

101. Treas. Reg. § 1.736-1(b)(5)(iii) [1985] 6 STAND. FED. TAX REP. (CCH) ¶ 3969.

ship property being sold as a result of a liquidation.[102] The parties to a liquidation may choose between treating the remainder of the sales price as either a distribution of partnership profits or for the partner's share of goodwill, and the regulations recognize the validity of a value assigned to goodwill when it is determined in an arms-length transaction;[103] thus, the partners can again arrange the tax consequences of the liquidation depending upon their individual tax status.

The opportunity to treat payments for unrealized receivables include income from section 1245 and section 1250 recapture.[104] Whereas these payments are immediately deductible for tax purposes, the surviving partners would only receive cost recovery deductions over an extended time period if they were deemed to originate from the purchase of a retiring partner's interest in property used for farming. This opportunity can be beneficial to family farm partnerships which may not have the availablitiy of the flexibility which the section 736 regulations afford arms-length transactions.

Finally, the section 736 regulations also provide flexibility as to planning the tax consequences of section 751. Section 736 payments must segregate the portion which is determined to be in exchange for the partner's interest in partnership property from the portion treated as a distribution of partnership profits.[105] If the agreement states a contingent value, the sale of the partnership property is deemed to occur before any profit distributions occur.[106] On the other hand, if a fixed amount (whether or not supplemented by any additional amounts) is to be received over a fixed number of years, the portion of each payment attributed to the sale of partnership property is normally deemed to be the same ratio as the sales price of the partnership property bears to the fixed price.[107]

The partners may also simply agree as to the allocation of payments between partnership property and profits or quaranteed payments.[108] As

102. Treas. Reg. § 1.736-1(a)(3) [1985] 6 STAND. FED. TAX REP. (CCH) ¶ 3969 states that under § 736(a) the portion of the payments made to a withdrawing partner for his share of unrealized receivables, goodwill (in the absence of an agreement to the contrary), or otherwise not in exchange for his interest in partnership property shall be considered either a distributive share of partnership income or a guaranteed payment.

103. *See supra* note 102.

104. I.R.C. § 751(c) (1982).

105. Treas. Reg. § 1.736-1(b)(5) [1985] 6 FED. STAND. TAX REP. (CCH) ¶ 3969.

106. Treas. Reg. § 1.736-1(b)(5)(ii) [1985] 6 FED. STAND. TAX REP. (CCH) ¶ 3969.

107. Treas. Reg. § 1.736-1(b)(5)(i) [1985] 6 FED. STAND. TAX REP. (CCH) ¶ 3969.

108. Treas. Reg. § 1.736(b)(5)(iii) [1985] 6 FED. STAND. TAX REP. (CCH) ¶ 3969, states that in lieu of the general rules provided by Treas. Reg. § 1.736(b)(5), the allocation of each annual payment between either a distributive share of profits or guaranteed payments and payments for partnership property may be made in any manner to which all of the remaining partners and the withdrawing partner or his successor in interests agree, provided that the total amount allocated to payments for

a consequence, the partners have considerable latitude as to when the tax implications, if any, of section 751 are actually triggered. The flexibility of the application of section 736 provides substantial opportunities to plan for tax deferral and shifting of tax consequences when a partner's interest is being liquidated.

Exchanges

In addition to sales and liquidations discussed above, the exchange of a partnership interest for other property will normally be treated as a sale of a partnership interest, with certain exceptions.[109] If the exchange is a taxable event, treatment similar to that previously given for a sale of a partnership is in order. This segment will focus on the identification of the types of exchanges considered exceptions to the general rule.

A partnership interest may not be exchanged for an interest in another partnership and excape taxation subsequent to July 18, 1984 as a like-kind exchange.[110] Further, section 751 will apply. A partner could, however, transfer his interest to another partnership and receive a partnership interest in the second partnership without being subject to section 751 unless such interest is in an investment partnership.[111]

Other exchanges avoiding section 751 treatment are:

1) Transfer of a partnership interest and other property to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control of the corporation,[112]

2) Transfer of a partnership interest between spouses or incident to divorce,[113]

3) Transfer of partnership interest to a trust, unless the trust sells or exchanges the partnership interest at a gain not more than two years after the date of the initial transfer of the partnership interest.[114]

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the partnership property does not exceed the fair market value of such property at the date of death or retirement.

109. I.R.C. § 751(a) (1982).

110. I.R.C. § 1031(a)(2)(D) (1982).

111. I.R.C. § 721 (1982).

112. I.R.C. § 351 (1982) provides that no gain or loss shall be recognized if property is transferred to a corporation by *one or more* persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control of the corporation. Section 368 defines control as possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation. I.R.C. § 368 (1982).

113. I.R.C. § 1041 (1982) states that no gain or loss will be recognized on transfer of property from an individual to a former spouse, but only if the transfer is incident to the divorce. Transfers to former spouses are incident to the divorce if such transfers 1) occur within one year after the date on which the marriage ceases, or 2) is related to the cessation of the marriage.

114. I.R.C. § 644 (1982).

The significance of these exceptions is that they represent opportunities to shift the taxability from the individual partner to another taxable entity. For example, the trust or corporate tax rates may be lower than the individual taxpayer's marginal rate. On the other hand, the partner could transfer the potential tax liability for "hot assets" to a former spouse upon divorce, while compensating the spouse for his or her property rights at the same time. Potential tax liability may also be spread among other shareholders of a Subchapter S Corporation. If the transferee individuals are subject to lower tax rates, the mutually agreed upon after-tax sales price may be more favorable under such conditions.

Beneficial Transfers of Partnership Interests

Farmers do not always sell or exchange their partnership interests with a profit motive. For example, they could donate a partnership interest to a charitable organization. More often they gift a share of the partnership assets to their children. These gifts are often an integral part of estate planning. Other transfers can occur at death. At other times farmers may make such gifts for motivational purposes. Section 751 should be considered before making such transfers.

A charitable contribution of a partnership interest can trigger unsuspected income tax consequences as a result of section 751, depending upon the liabilities assumed (if any) by the charitable organization. The donor of such a partnership interest is deemed to have sold a share of the donated partnership interest for the liabilities assumed by the charitable organization.[115] The percentage of the partnership interest sold is the percentage that the liabilities assumed by the charitable organization bears to the fair market value of the donated partnership interest.[116] The tax burden increases as the partnership liabilities increase. It would be beneficial to minimize the liabilities at the time when the gift is made. An even more effective approach would be to contribute a limited partnership interest, provided there are no nonrecourse notes.[117]

The preceding rules are not applicable to gifts of partnership interests to one's children. Instead, gain is recognized only to the extent that the liabilities assumed by the donee exceed the tax basis of the partnership assets transferred to the donee.[118] This situation occurs frequently

115. Rev. Rul. 75-194, 1975-1 C.B. 80, states that the charitable donation of a limited partnership interest should be treated as a bargain sale to the extent of the limited partner's share of the partnership nonrecourse liabilities. Thus, the excess of the limited partner's share of liabilities over an allowable portion (under Code § 1011(b)) of the basis of his partnership interest will be recognized gain.

116. I.R.C. § 1011(b) (1982).

117. *See supra* note 85.

118. Malone v. United States, 326 F. Supp. 106 (N.D. Miss. 1971), *aff'd per curium*, 455 F.2d

in the case of farm assets.

In a similar manner, the donee's payment of the donor's gift tax liability also constitutes income to the donor to the extent that it exceeds the donor's basis in the transferred property.[119] The cases do not establish how to determine the nature of income to be taxed. It could be deemed to be only for the appreciation for "hot assets", for the appreciation of "non-hot assets," or based on the fair market value or tax basis of both.[120]

Regardless of the solution to the preceding issue, the use of such gifts can provide an opportunity to transfer the tax burden for the appreciation of farm property to family members subject to lower marginal tax rates. This is especially effective when coupled with allocating maximum tax deductions to the partner before gifting the partnership interest. In fact, partnership interests which have a tax basis equal to the liabilities allocated to the interest make excellent gifts assuming there is or will be substantial appreciation in the future.

A partner can also defer transferring his partnership interest until after his or her death. Among the many advantages to this alternative is that the legatee will receive a step-up in basis. There are no tax consequences, even if the face amount of liabilities exceed the decedent's predeath tax basis of all the farm assets.[121]

As a partner approaches death, proper tax planning would include consideration of deferring the transfer of a farm partnership interest until after death. An after death transfer eliminates any income tax for appreciated assets except for receivables;[122] thus, only "hot assets" whose tax basis can be written up to their fair market value should be transferred upon the decedent's death. Nevertheless, one should note that the IRS could contend that such actions have no economic substance. While the strength of this argument undoubtedly becomes stronger as the partner's

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502 (5th Cir. 1972) held that when the taxpayer, after mortgaging farm land and using the loan proceeds for other business purposes, transferred the land to a trust for the benefit of his grandchildren subject to the mortgage, the transaction was part sale and part gift. Treas. Reg. § 1.1001-2 [1985] 7 FED. STAND. TAX REP. (CCH) ¶ 4455A is in agreement with *Malone*. In *Guest v. C.I.R.*, 77 T.C. 9 (1981), the Court held that a charitable contribution of property subject to a nonrecourse liability was a taxable gain to the extent the liability exceeded the taxpayers basis, thus *Malone* would seem to apply whether the liability is recourse or nonrecourse. *See also* I.R.C. § 108 (1982).

119. Diedrich v. C.I.R., 457 U.S. 191 (1982), Estate of Weeden v. C.I.R., 685 F.2d 1160 (9th Cir. 1982).

120. The latter approach would be consistent with the treatment provided for charitable contributions of property subject to a liability which exceeds its tax basis as discussed in footnote 119.

121. I.R.C. § 1014 (1982).

122. I.R.C. § 1014(c) states that § 1014 does not apply to property which constitutes a right to receive an item of income in respect of a decedent under § 691. Section 691 applies to any income arising from sale, exchange, or other disposition, occurring during the dececent's lifetime. Such income is included when received by the beneficiaries of the decedent's estate or the estate itself.

death approaches, the downside risk of such tax devices is that the partner's status would only revert to the status which would exist if nothing had transpired.

Distributions

IRC section 751(b) subjects the following distributions to "hot asset" treatment:

1) the extent to which a partner receives "hot assets" in exchange for all or part of his or her interest in "non-hot assets", or

2) the extent to which a partner receives "non-hot assets" in exchange for all or part of his or her interest in "hot assets."[123]

To avoid section 751(b) treatment, then, a distribution must not affect the ratio between the "hot assets" and "non-hot assets."

All distributions are deemed to occur on the last day of the year.[124] Based upon this assumption, a pro forma balance sheet should apparently be constructed consisting of the ending balances of the partnership plus the assets distributed throughout the year. No problem as to valuation of distributed assets is created if only money is distributed; however, it is unclear if assets subject to substantial appreciation should be valued at their fair market value as of the date of distribution or as of the last day of the partnership year. Since no guidelines have been established, one can only hope that his choice will not be overturned.

Assuming that a proper balance sheet for section 751 is constructed the next apparent step is to establish the amount of both "hot assets" and "non-hot assets" owned by each partner. First, the tax basis of such assets should probably be allocated to each partner based upon their pro rata share of the aggregate liabilities and capital accounts.[125] Recourse liabilities are allocated to general partners based on their respective loss-sharing ratios and nonrecourse notes are allocated to all partners based upon their profit-sharing ratios.[126]

The next step would appear to be an allocation of the excess of fair market value over the tax basis of the assets for which there is a special allocation agreement.[127] The amount by which the fair market value of

123. I.R.C. § 751(b) (1982).

124. Treas. Reg. § 1.731-(1)(a)(1)(ii) [1985] 6 FED. STAND. TAX REP. (CCH) ¶ 3952.

125. A. WILLIS, J. PENNELL & P. POSTLEWAITE, 2 PARTNERSHIP TAXATION § 102.11.

126. Treas. Reg. §.752-1(e) [1985] 6 FED. STAND. TAX REP. (CCH) ¶ 3984.

127. I.R.C. § 704(c) (1982) provides that regulations are to be established. These regulations should prescribe procedures for allocating income, gain, loss, and deduction attributable to appreciated property contributed to the partnership by a partner. These allocations should take into account the variation between the tax basis of the property to the partnership and its fair market value at the date of contribution. Such allocations are mandatory as of March 31, 1984. To date, the new regulations have not yet been issued. Until the new regulations are issued, partnerships may con-

each partnership asset exceeds its tax basis and specially allocated appreciation is allocated to each partner based upon his pro rata share for profit-sharing purposes. Finally, these allocations are categorized as either "hot" or "non-hot assets", using the criteria established earlier.

The next step is to determine 1) the aggregate amount of "hot assets" distributed to an individual partner and 2) his partnership interest in the partnership "hot assets" at the end of the year. If the individual partner does not own an identical amount of "hot assets" before and after the distributions, a sale or exchange is deemed to have occurred.[128]

Before proceeding on to discussing the tax ramifications of a section 751 sale or exchange, several observations should be noted. First, the triggering of section 751 income is not readily apparent unless the profit-loss sharing ratio is not based on each partner's pro rata share of partnership capital. If each partner receives a distribution consisting of solely "hot" or "non-hot assets," or the same percentage of each and the relationship between the various distributions is identical with each partner's share of capital, section 751 is not applicable to such distributions.[129] If the distributions are disproportionate with the partners capital accounts (disproportionate distributions), or if each distribution does not consist of identical percentages of hot assets (disequalibrium distributions), section 751 is applicable.[130]

When the profit-loss sharing ratio is not identical with each partner's pro rata share of partnership capital, it is more difficult to identify distributions to which section 751 applies.[131] The applicable percentage is neither the pro rata share that each partner has of the capital account,

tinue to rely on existing regulations under I.R.C. § 704(c)(2), Sen. Comm. Rep. on P.L. 98-369 [1985] 6 FED. STAND. TAX REP. (CCH) ¶ 3912.

128. I.R.C. § 751(b) (1982).

129. Treas. Reg. § 1.751-1(b)(1)(ii) [1985] 6 FED. STAND. TAX REP. (CCH) ¶ 3981.

130. Treas. Reg. § 1.75-1(b) [1985] 6 FED. STAND. TAX REP. (CCH) ¶ 3981.

131. For example, assume profit and losses are shared equally by A, B, and C. Given the following balance sheet:

Assets	Adjusted Basis	Market Value
Cash	$ 7,000	$ 7,000
Accounts Receivable	-0-	1,000
Inventory	8,000	11,000
Fixed Assets (net accumulated depreciation	15,000	18,000
	$30,000	$42,000
Capital:		
A	12,000	
B	6,000	
C	6,000	
	24,000	
C's share of each asset would be as follows:	25%	33 1/3%

nor the profit-loss sharing ratios, but a weighted average of the two. The profit-loss sharing ratio will have a greater influence whenever partnership liabilities or the appreciation of assets increases. Thus, it is recommended that the pro forma balance sheet be constructed when the profit-loss sharing ratios are not based on the relationship between the individual partnership accounts to protect against section 751 treatment.

Another type of distribution subject to section 751 is the proportionate but disequalibrium distribution, which is a distribution where each partner's distribution is equal to each partner's share of the aggregate partnership assets, but some or all partners do not own the same amount of "hot assets" after the distribution as before.[132] In this case the share of "hot assets" and "non-hot assets" between the individual partners is either increased or decreased after the distributions. Section 751 application is based upon that if the "hot assets" distributed to each of these partners is based upon the percentage each partner owned before the distribution occurred, no tax consequence would be triggered. Then, if each partner exchanged these assets to reach the actual results, section 751 effects would be created.

The courts could reach conflicting results if they address the issue using a different approach; thus, it would be judicious for partners and partnerships to elect this outcome whenever it is favorable to them.

When partners receive distributions that are in proportion to their share of partnership assets, the tax consequences often become even more

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	Tax Basis	+	Appreciation	=	Share of Assets
Cash	$1,750				$1,750
Accounts Rec.			$2,000		2,000
Inventory	2,000		1,000		3,000
Fixed Assets	3,750		1,000		4,750
	$7,500		$4,000		$11,500

Assuming that the $3,000 appreciation for the fixed assets is potential § "1245" income, the partnership's hot assets would be Accounts Receivable ($6,000) + Inventory (11,000) + § 1245 gain (3,000) or $20,000. C's share of hot assets would be Accounts Receivable (2,000) + Inventory (3,000) + § 1245 gain (1,000) = $6,000. C's share of the partnership hot assets would be $6,000 divided by 20,000 or 30%. Note this percentage is not identified with either C's share of capital (25%) or share of profits (33 1/3%), A. WILLIS, J. PENNEL & P. POSTELWAITE, 2 PARTNERSHIP TAXATION § 102.11.

132. An example of such distribution using the example given in footnote 132 is as follows. Also assume profit and loss sharing is based on capital account balances.

	Asset Distributed	Amount of Distribution
	A B	C
Cash	$1,900	$1,150
Accounts Receivable		$1,150

Although these distributions are in proportion to their share in partnership assets, A and B receive "nonhot assets" in the form of cash while C received "hot assets" in the form of accounts receivable. Thus, A and B here deemed to have sold their interest in the accounts receivables distributed to C.

muddied. First, distributions which consist solely of either "hot" or "non-hot assets" may be disproportionate with each partner's share of the total assets without triggering taxable income.[133] In fact, such distributions do not change a partner's share of "hot assets" when the distribution of "hot assets" or "non-hot assets" is in the same proportion as their share in partnership "hot" or "non-hot assets" before the distribution.[134] This proportion will equal their proportion of total partnership assets only when the percentage of appreciation for both "hot" and "non-hot assets" is equal. This rarely happens in farm partnerships. Under these circumstances, the partners receiving distributions larger than their share of either "hot" or "non-hot assets" probably will be treated as having made a sale or exchange between the partnership and themselves.[135] Unless the partnership elects to designate specific assets being sold, the

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133. For example, A, B, and C's ownership in hot and nonhot assets and aggregate assets are as follows:

	Hot Assets	Nonhot Assets	Total Assets
A	$12,000	$ 7,000	$19,000
B	5,500	6,000	11,500
C	5,500	6,000	11,500
	$23,000	$19,000	$42,000

If A receives 1,900 of cash while B and C receive 1,150 of cash, the distributions would reduce cash by 4,200. The new capital accounts for A, B, and C would become $19,100, 4,350, and 4,350 respectively. Whereas, the new proportions for allocating tax basis would become 53.72%, 23.14%, and 23.14% respectively. Thus the allocation of hot assets would be as follows:

	A	B	C
Accounts Receivable	$2,000	$2,000	$2,000
Inventory — Tax Basis	4,298	1,851	1,851
Inventory — Appreciation	1,000	1,000	1,000
1245 Recapture — Fixed Assets	1,000	1,000	1,000
	7,298	5,851	5,851

As a result, B and C are deemed to have sold hot assets in the amount of $149 each to A.

On the other hand, assume accounts receivable in the amount of 1,900, 1,150, and 1,150 are distributed to A, B, and C respectively. The accounts receivable held by the partnership then have a fair market value of $1,800. The capital account balances are not reduced since the accounts receivable have a zero balance, the capital accounts are unaffected by the distribution. However, the ownership of hot assets are changed as follows.

	A	B	C
Accounts Receivable Distributed	$1,900	$1,150	$1,150
Undistributed Accounts Receivable	600	600	600
Inventory	5,000	3,000	3,000
§ 1245 Recapture — Fixed Assets	1,000	1,000	1,000
	$8,500	$5,750	$5,750

B and C are deemed to have sold or gifted hot assets in the amount of $250 to A. The code, however, does not address how to identify what was exchanged when fair market value exceeds tax basis for distributed property.

134. Treas. Reg. § 1.751-1(b)(1)(i) (1985) 6 Fed. Stand. Tax Rep. (CCH) ¶ 3981 states that § 751(b) applies only to the extent that a partner either receives § 751 property in exchange for his interest in other property, or receives other property in exchange for his relinquishing any part of his interest in § 751 property.

135. Treas. Reg. § 1.751-1(b)(2)(i) [1985] 6 Fed. Stand. Tax Rep. (CCH) ¶ 3981.

partner will be deemed to have sold a fraction of his interest in either all the "hot" or "non-hot assets," depending upon the category of excess assets received by the distributee. For example, if the partner receives excess "hot assets," the distributee partner is treated as having sold a share of each "non-hot asset"[136] with the applicable fraction being the percent that the fair market value of each individual "non-hot asset" bears to the fair market value of the total "non-hot assets."[137] At the

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136. Treas. Reg. 1.751-1(g) (Example 5) (1985) 6 Fed. Stand. Tax Rep. (CCH) ¶ 3981, Facts—Assume that partner C agrees to reduce his interest in capital and profits from one-third to one-fifth for a current distribution consisting of $5,000 in cash, and $7,500 of accounts receivable with a basis to the partnership of $7,500. At the same time, the total liabilities of the partnership are not reduced. Therefore, after the distribution, C's share of the partnership liabilities has been reduced by $4,800 from $12,000 (1/3 of $36,000) to $7,200 (1/5 of $36,000). Presence of § 751 property—Assume that the partnership inventory items have substantially appreciated in value. The properties exchanged—C's interest in the fair market value of the partnership properties before and after the distribution can be illustrated by the following table:

Cash	$ 5,000	$ 2,000	$3,000	$ 2,000	—
Liabilities Assumed	(12,000)	(7,200)	—	4,800	—
Inventory Items:					
Accounts Rec.	3,000	300	2,700	4,800	—
Inventory	10,000	6,000	—	—	$ 4,000
Depreciable Property	16,000	9,600	—	—	6,400
Land	3,000	1,800	—	—	1,200
Total	$25,000	$12,000	$5,700	$11,600	$11,600

Although C relinquished his interest in $4,000 of inventory and received $4,800 of accounts receivable, both items constitute § 751 property and C has received only $800 worth of accounts receivable for $800 worth of depreciable property or for an $800 undivided interest in land. In the absence of an agreement identifying the properties exchanged, it is presumed C received $800 for proportionate shares of his interests in both depreciable property and land. To the extent that inventory was exchanged for accounts receivable, or to the extent cash was distributed for the release of C's interest in the balance of the depreciable property and land, the transaction does not fall within § 751(b) and § 732(a). Thus, the remaining $6,700 of accounts receivable are received in a current distribution.

Distributee partners's tax consequences—C's tax consequences on the distribution are as follows:

The § 751(b) sale or exchange—Assuming that the partners paid $800 worth of depreciable property, C is treated as if he received the depreciable in a current distribution, and his basis for the $800 worth of depreciable property is $700 (42,000/48,000 of $800, its fair market value), as determined under paragraph (b)(2)(ii) of this section. Then C is considered as having sold his $800 share of depreciable property to the partnership for $800. On the sale of the depreciable property, C realizes a gain of $100. If, on the other hand, the partners had agreed that C exchanged an $800 interest in the land for $800 worth of accounts receivable. C would realize no gain or loss, because under paragraph (b)(2)(iii) of this section his basis for the land sold would be $800. In the absence of an agreement, the basis for the depreciable property and land (which C is considered as having received in a current distribution and then sold back to the partnership) would be $716 (51,000/57,000 of $800). In that case, on the sale of the balance of the $800 share of depreciable property and land, C would realize $84 of gain ($800 less $716).

137. The partnership tax consequences for footnote 137 is as follows: the § 751(b) sale or exchange—The partnership realizes no gain or loss in the § 751 sale or exchange because it had a basis of $800 for the accounts receivable for which it received $800 worth of other property. If the partnership agreed to purchase $800 worth of depreciable property, the partnership basis of depreciable property becomes $42,100 ($42,000 less $700 basis of property constructively distributed to C, plus

same time, the other partners will be deemed to have sold their interest in the "hot assets" received by the distributee partner.[138] If the distributee partner receives more than one "hot asset" item, the law does not provide any assistance as to which "hot assets" have been sold. It could be allocated to each "hot asset" based upon their relative fair market values or their respective tax basis.

Distributions which are disproportionate and do not consist of sole "hot" or "non-hot assets" are even more perplexing. It can be argued that a combination of the two approaches previously described should be used. Accordingly, it could be imperative that the partners identify specifically the assets being sold or exchanged under such conditions.[139]

From the preceding discussion, it is apparent that farm partnerships should avoid such taxable events. For example, payments could be identified as payments to the partners for services rendered[140] or for use of their capital.[141] Distributions of assets to the partners who originally contribute them are not subject to section 751 rules.[142] Finally, the partners could agree to equalize the distributions to avoid section 751 by designating undesirable distributions to be loans rather than distributions.[143] If a loan is properly structured and payments made consistent with the loan provisions, this device should protect against the consequences of section 751.

Although section 751 was originally enacted to prevent partners from shifting the taxation of ordinary income between each other, opportunities to do just that remain. For example, distributions of "hot assets" to partners in the same proportion as their ownership in the partnerships

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$800, price of property purchased). If the partnership purchased land with the accounts receivable, there would be no change in the basis of the land to the partnership because the basis of land distributed was equal to its purchase price. If there were no agreement, the basis of the depreciable property and land would be $51,084 (depreciable property, $42,084 and land $9,000). The basis for the depreciable property is computed as follows: The common partnership basis of $42,000 is reduced by the $590 basis (42,000/48,000 of $674) for C's $674 interest constructively distributed, and increased by $674 (6,400/7,600 or $800), the part of the purchase price allocated to the depreciable property. The basis of the land would be computed in the same way. The $9,000 original partnership basis is reduced by $126 basis (9,000/9,000 of $126) of the land constructively distributed to C, and increased by $126 (1,200/7,600 or $800), the portion of the purchase price allocated to the land.

138. *Id.*

139. Treas. Reg. § 1.751-1(g) (Example 3) [1985] 6 FED. STAND. TAX REP. (CCH) ¶ 3981, provides an illustration whereby partners mutually agree as to which assets have been purchased and sold. Accordingly, the Treasury appears to warrant the use of special identification of property sold or exchanged among a partnership's assets.

140. Treas. Reg. § 1.751-1(b)(1)(ii) [1985] 6 FED. STAND. TAX REP (CCH) ¶ 3981 states that § 751(b) does not apply to a payment for services or for use of capital.

141. I.R.C. § 751(b)(2)(A) (1982).

142. *Id.*

143. Treas. Reg. § 1.707-1(a) [1985] 6 FED. STAND. TAX REP. (CCH) ¶ 3932, states that when a partner loans money to the partnership, he is not acting in his role as a member of the partnership.

"hot assets" prior to the distribution do not trigger recognition of ordinary income under section 751.[144] This is true even when certain partners receive "hot assets" which are unappreciated while other partners receive highly appreciated "hot assets." This approach can allow shifting of ordinary income between partners despite the original intentions of section 751. Note, however, that one should avoid the pitfalls of sham and step-transaction doctrines.

The tax consequences for section 751 are not always undesirable. For example, assume certain partners have sustained net operating losses for a given tax year. These partners may stand to lose such tax benefits as personal exemptions, excess nonbusiness deductions, or the long term capital gain exclusion as a result of the loss,[145] if they do not generate current income. It would be advantageous for partners in such a loss situation to accelerate the recognition of income for tax purposes. Any distribution which would increase or decrease a partner's share or "hot assets" would trigger the desired ordinary income and give the partner a step-up in the basis of the assets received.

Other Partnership Events

Other events may trigger section 751 for on-going partnerships. As previously mentioned, a decrease in a partner's partnership liabilities is deemed to be a distribution of money to the partner.[146] Two events which may effect a partner's share of liabilities are:

1) conversion of general partnership interest to a limited partnership interest, and
2) change in profit and loss sharing percentage.

Conversion of Partnership Interest

The mere change from a general partnership interest to a limited partnership interest affects a partner's share of partnership liabilities.

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144. Treas. Reg. § 1.751-1(b)(1)(i) (1985) 6 Fed. Stand. Tax Rep. (CCH) ¶ 3981, states that § 751 applies only to the extent that a partner either receives § 751 property in exchange for his relinquishing any part of his interest in other property, or receives other property in exchange for his relinquishing any part of his interest in § 751 property.

145. I.R.C. § 172(d) (1982) lists the following modifications which must be added to net operating losses before they can be carried either back or forward for individual taxpayers:

(1) Net operating loss deduction
(2) Capital losses in excess of capital gains
(3) The long-term capital gain deduction
(4) Personal exemptions
(5) Tax deductions not attributable to a taxpayer's trade or business except for casualty loss deductions shall be allowed only to the extent of the amount of the gross income derived from nontrade or business.

146. I.R.C. § 752(b) (1982).

First, recourse liabilities are shared only by general partners;[147] thus, when a general partner becomes a limited partner, he is relieved of recourse liabilities. As previously pointed out, this relief from liabilities is deemed to be a distribution of money.[148] Unfortunately, neither the IRS nor the courts have ruled on the applicability of section 751 to such conversions.

The IRS has issued a private letter ruling holding that the conversion of a general partnership interest to a limited partnership interest is a nontaxable event, however.[149] Unless the liability relieved is a monetary distribution treated as a sale or exchange of "hot assets," these rulings are consistent with the general rule that a gain or loss is not recognized on distributions of cash except to the extent that the money exceeds the partner's adjusted tax basis for this partnership interest,[150] however, this rule is subject to an exception under section 751. Accordingly, tax planners should not rely on the applicability of these rulings for issues involving "hot assets."

A second argument for nontaxability is that such conversions would not result in the transfer of ordinary taxable income from one partner to another unless the profit and loss sharing ratio was changed as a consequence. Section 751 does not differentiate between the tax basis and appreciation of "hot assets." In fact, one could easily infer that the money distribution was in exchange for a pro rata share of each partnership asset which wasn't distributed.[151] Under these circumstances, the distributee partner would recognize taxable income as a result; thus, an election to specifically identify either unappreciated "hot assets" or "non-hot assets" as being the partnership assets being sold may be desirable.[152]

Change in Profit-Loss Sharing Ratios

Partnerships have the flexibility to change profit and loss sharing ratios annually provided that such allocations have substantial economic effect. The change in profit-loss sharing ratios will result in a reallocation of partnership liabilities.[153] The liabilities reallocated to those partners

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147. Treas. Reg. § 1.752-1(e) [1985] 6 FED. STAND TAX REP. (CCH) ¶ 3984.

148. I.R.C. § 752(b) (1982).

149. Priv. Let. Rul. 7948063, permitted a tax free conversion of a general partnership into a limited partnership. Banoff suggests in *New Opportunities Now Exist for General and Limited Partnership Conversions*, 52 J. TAX 120 (1980), that the Service's expanded doctrine should be equally applicable to a conversion from a limited to a general partnership.

150. I.R.C. § 731 (1982).

151. Treas. Reg. § 1.751-1(a)(2) [1985] 6 FED. STAND. TAX REP. (CCH) ¶ 3981.

152. Treas. Reg. § 1.751-1(g), *supra* note 140.

153. Treas. Reg. § 1.752-1(e) [1985] 6 FED. STAND. TAX REP. (CCH) ¶ 3984 states that a partner's share of partnership liabilities shall be determined in accordance with his ratio for sharing losses under the partnership agreement.

whose share of the profits and losses decrease are reduced, which is a deemed distribution of money.[154] These partners are deemed to have sold or exchanged their interest in "hot assets" when their profit-loss sharing ratio was reduced.

Based on the preceding discussions, one should not capriciously change such ratios. Farm family partnerships, however, may not be able to avoid constantly adjusting ratios. This is attributable to the fact the section 704(e) requires that an allowance of reasonable compensation must be given for sevices rendered to the partnership.[155] Thus, the ratios will normally vary annually for such partnerships. Although the actual payment for such services is not a distribution, the partnership liabilities are changed and the allocation of appreciation for "hot assets" is changed.[156] Consequently, the farm family partnerships can present undesirable situations.

Although the triggering of section 751 consequences may be undesirable, the partners may still desire to change the profit-loss sharing ratios. It is incumbent on taxpayers to avoid distributions through change in partnership liabilities. If there are no nonrecourse liabilities, a change in the profit and loss ratios will not result in a deemed distribution. For this reason, the best form of farm family partnerships may be the limited partnership.

Conclusion

The flexibility provided by the Internal Revenue Code to partnerships has its advantages and disadvantages. The flexibility provides a greater range of choices to taxpayers, but the success for many of these choices depends upon whether or not section 751 is applicable. If section 751 is applicable, caution is advised to avoid the pitfalls which the section creates. The perils of section 751 are not clearly defined by existing tax law. The Internal Revenue Code only provides a framework for the Treasury Department to prevent the shifting of ordinary income.

The Treasury Department has not provided sufficient guidance in the regulations or other administrative authority to inform the taxpayer

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154. I.R.C. § 752(b) (1982).

155. I.R.C. § 704(e) (1982).

156. I.R.C. § 707(b) (1982) states that payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of § 61(a) (relating to gross income) and, subject to § 2163, for purposes of § 162(a) (relating to trade or business expense). Treas. Reg. § 1.707-1(c) also states that guaranteed payments do not constitute an interest in partnership profits for purposes of §§ 706(b)(3), 707(b) and 708. For the purposes of other provisions of the code, guaranteed payments are regarded as a partner's distributive share of ordinary income. Thus, it is deemed a distributive share of ordinary income for § 704. Consequently, it appears that § 752 considers such payments as distributive shares of profits and losses.

as to their intent in applying section 751's rules. The courts have only considered a limited range of issues related to section 751. As a result, tax planners do not have a clearly defined skeleton as to which transactions summon section 751.

Despite this current state, tax articles continue to focus upon general rules. These rules clearly indicate that possibilities do exist for effective and efficient tax planning for partnerships. Unfortunately, they rarely caution as to the dangers which section 751 creates. As indicated earlier, some partnerships such as cash-basis farm partnerships can and are subject to substantial exceptions to the general partnership rules due to the mere existence of section 751. Such partnerships should approach tax planning with deliberation and discretion.