Overview

When a partner sells or exchanges his partnership interest, the partner generally recognizes a capital gain or loss on the sale.\textsuperscript{1} The exception to this rule is where the amount received by the partner is attributed to \textit{unrealized receivables}\textsuperscript{2} or \textit{inventory}.\textsuperscript{3} If the partnership were to sell these assets, also known as "hot assets," it would recognize ordinary income or loss on the sale. Therefore, in the sale or exchange of a partnership interest, amounts attributed to the partner’s share of hot assets are generally subject to ordinary income tax treatment.\textsuperscript{4} This prevents a partner from transforming ordinary income to capital gain through the sale of the partnership interest.

Because of the special tax treatment reserved for hot assets, it is crucial that practitioners and producers clearly understand which assets fall into these categories of hot assets. This article sets forth general guidelines for identifying and categorizing unrealized receivables and inventory in a farm partnership. It does not attempt to provide a detailed roadmap for this process. Nor does it attempt to address the complex allocation rules accompanying partnership distributions, disproportionate distributions, or liquidations.

Unrealized Receivables

Unrealized receivables include the right to payment (to the extent payments were not previously includable in partnership income) for:

1. Goods delivered or to be delivered (to the extent the proceeds 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.\textsuperscript{5}

In the farming context, unrealized receivables falling into the first category would include property used in a trade or business subject to depreciation or amortization (as defined by IRC §1245) or any real property that has been depreciated (including as defined by IRC §1250), including:

- Farming equipment such as machinery\textsuperscript{6}
- Livestock (defined as horses, cattle, hogs, sheep, goats, and mink, but not poultry)\textsuperscript{7}
- Fences and drainage tile\textsuperscript{8}
- Property used for bulk storage of fungible commodities (grain bins)\textsuperscript{9}

\textsuperscript{1} IRC §741.
\textsuperscript{2} IRC §751(c).
\textsuperscript{3} IRC §751(d).
\textsuperscript{4} IRC §751(a). This rule applies when the partnership interest is sold to other partners as well as to outsiders. Treas. Reg. §1.741-1(b).
\textsuperscript{5} IRC §751(c).
\textsuperscript{6} IRC §1245(a)(3)(A).
\textsuperscript{7} Treas. Reg §1.1245-3(a)(4).
\textsuperscript{8} IRC §1245(a)(3)(C).
\textsuperscript{9} IRC §1245(a)(3)(B)(iii).
• Silos¹⁰
• Single purpose agriculture or horticulture buildings (hog production facility or greenhouse)¹¹
• Barns, storage sheds, or work sheds¹²
• Recapture of soil and water conservation expenditures with respect to farmland¹³

Unrealized receivables falling into the category of services rendered or to be rendered would include the present value of ordinary income attributable to contract rights to future payments for either goods to be delivered or for services to be rendered.¹⁴ Such rights must have arisen under contracts or agreements in existence at the time of sale or distribution, even if the partnership could not enforce payment until a later time. Unrealized receivables would include the rights to payment for work or goods begun but incomplete at the time of the sale or distribution.¹⁵ This category of unrealized receivables could include the present value of ordinary income attributable to contract rights from the following agriculture-related contracts:

• Grain or livestock deferred payment contracts
• Accounts receivable of a cash method partnership
• Installment notes from the sale of assets reported under the installment method
• Lease contracts, including those for the cash rent of farmland
• Contracts for the production of commodities

Courts have clarified that unrealized receivables include binding long-term management contracts not terminable at the will of the party for whom the partnership is performing the services.¹⁶

**Inventory**

The other category of hot goods, “inventory items,” includes:

1. Property of the partnership of the kind described in IRC §1221(a)(1), and
2. Any other property of the partnership which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in IRC §1231.¹⁷

**IRC §1221(a)(1) Assets**

IRC §1221(a)(1) states that the term “capital asset” means property held by the taxpayer (whether or not connected with his trade or business), but does not include:

1. Stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or
2. Property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

Under this definition, inventory items in the context of a farm partnership could include:

• Harvested crops
• Feeder Livestock
• Poultry
• Tools
• Repair parts
• Supplies
• Seed
• Feed

¹¹ IRC §1245(a)(3)(D).
¹² IRC §1250.
¹³ IRC §751(c); IRC §1252(a).
¹⁴ Treas. Reg. §1.751-1.
¹⁵ Treas. Reg. §1.751-1.
¹⁶ See e.g., United States v. Woolsey, 326 F.2d 287, 291 (5th Cir. 1963).
¹⁷ IRC §751(d).
• Fertilizer

Property not Subject to Capital Gain or IRC §1231

The second category of inventory items is extremely broad, encompassing any “any other” property that, upon sale by the partnership, would not be considered a capital asset or §1231 property. The following farm partnership assets would be considered inventory items because they are excluded under the §1231 definition:

• Single purpose agricultural or horticultural structures, grain bins, or farm buildings held for more than one year.
• Personal property (other than livestock) not held for more than one year from the date of acquisition.
• Cows and horses held for less than 24 months from the date of acquisition.
• Other livestock (regardless of age, but not including poultry) held by the taxpayer for less than 12 months from the date of acquisition.

Other property considered to be inventory assets under §751(d) because they are generally not capital assets would include:

• Poultry
• Farmland held for less than one year from the date of acquisition

Specifically excluded from the definition of inventory are unharvested crops on land used in a trade or business and held for more than one year, if the crop and the land are sold or exchanged (or compulsorily or involuntarily converted) at the same time and to the same person. It is likely that unharvested crops and unsold livestock would not be considered inventory in the hands of a partner selling a partnership interest for a farming partnership, even if such criteria were not met.

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19 I.R.C. §1231(b)(1).
20 I.R.C. §1231(b)(1).
23 I.R.C. §1231(b)(3) (poultry is excluded from the definition of livestock, subject to §1231 rules).
24 I.R.C. §1231(b)(1); I.R.C. §751(d)(2)(b).
25 I.R.C. §1231(b)(4).