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Meaning of “Unrealized Receivables” and “Inventory Items” in Partnership Transactions

-by Neil E. Harl*

In general, no gain is incurred by a partner on liquidation of a partnership except to the extent money distributed exceeds the income tax basis of the partner’s partnership interest *and except for amounts received attributed to unrealized receivables and inventory.*¹ Whenever “unrealized receivables” and “inventory items” are involved, those amounts produce ordinary income.² That rule applies also to sales of partnership interests to outsiders as well as sales to one or more of the partners.³

A major question, for farm and ranch partnerships, is what is meant by “unrealized receivables” and “inventory items”?⁴

The meaning of “unrealized receivables”

The statute provides some guidance in terms of what is meant by “unrealized receivables” in stating that the term “. . . includes, to the extent not previously included in income under the method of accounting used by the partnership, any rights (contractual or otherwise) to payment for . . . 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 . . . services rendered, or to be rendered.”⁵ There is no question, for a cash basis partnership, about crops or livestock that have been sold and not yet delivered as of the date of the transaction. The amounts involved appear to be “unrealized receivables.”⁶ The same would seem to be the case with crops or livestock that have been “forward sold” even though the date of delivery may lie in the future.⁷ But what about crops yet to be harvested some time in the future (and sold at some later date) or livestock to be delivered at a future date with sale occurring at that time? Do those transactions fall within the definition of “unrealized receivables? It appears that the answer is no.

The regulations provide only modest assistance. The regulations⁸ state that the term “unrealized receivables” includes “. . . trade accounts receivable of a cash method taxpayer, *and rights to payment for work or goods begun but incomplete at the time of sale.*”⁹ That would seem to include, clearly, crops or livestock that had been sold by the date of the sale of the partnership interest but not ready for delivery until some future date. But does that language embrace crops or livestock that have not been sold as of the date of sale or exchange of the partnership interest? That is not entirely clear. Certainly, a producer of crops or livestock who contemplates sale or exchange of the items has a right to payment at the time of sale or exchange but arguably has no right to payment *as of the closing date for sale of the partnership interest.*

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In a 1965 Tax Court case,¹⁰ partners in a home construction project completed work on 70 houses in a 94-building project and proceeded to sell their partnership interests to their attorney. The agreement was to complete the remaining 24 houses, all of which were under contract of sale, as a part of the consideration for the transfers. The Tax Court held that the contracts for the sale of the houses that had not been completed were unrealized receivables and the amounts received which were attributable to those houses were ordinary income. The case may have been influenced by the fact that uncompleted contracts of a taxpayer on the completed contracts method of accounting are unrealized receivables.¹¹ Note, however, that the 24 houses were sold as of the date of the sale of the partnership interest.

In another case, which was appealed to the Eleventh Circuit Court of Appeals,¹² a management–employment contract to run a dog track was held to be an unrealized receivable. The case involved the sale by one partner of that partner’s 25 percent interest in the partnership to the other partners.¹³

In a case appealed to the Second Circuit Court of Appeals,¹⁴ amounts received by a lawyer for a share of unbilled work who withdrew from the practice partnership was properly treated as “unrealized receivables.”

Inventory items

Inventory items include all items held for sale and all property that is not a capital asset or a Section 1231 asset.¹⁵ For sales or exchanges occurring before August 5, 1997, the inventory had to be substantially appreciated to bring these rules into effect.¹⁶ Effective on August 5, 1997, the amended rule applies to sales or exchanges but not to partnership distributions.

Valuing immature crops and livestock not ready for sale

In the event unsold crops or livestock are deemed to be within the scope of “unrealized receivables or “inventory,” the valuation would seem to parallel the valuation of such assets at death for federal estate tax purposes and for purposes of income-in-respect-of decedent.¹⁷ That is to say, growing crops and immature livestock would likely be valued on a discounted basis as of the date of the closing with the discount based on the probabilities of inclement weather, fire or other casualty that might diminish or destroy the crop and factors that could adversely affect livestock in terms of death loss or weight.

ENDNOTES

¹ See I.R.C. §§ 731(a)(1), 751. See generally 8 Harl, *Agricultural Law* § 60.05[6][b][iii] (2014); Harl, *Agricultural Law Manual* § 7.02[4][b] (2013); 2 Harl, *Farm Income Tax Manual* § 6.04[2] (2014 ed.).

² I.R.C. § 751(a), (c).

³ Treas. Reg. § 1.741-1(b).

⁴ See Treas. Reg. § 1.751-1(c)(1)(ii).

⁵ I.R.C. § 751(c).

⁶ *Id.*

⁷ *Id.*

⁸ Treas. Reg. § 1.751-1(c)(1)(ii).

⁹ *Id.* (emphasis added). The passage “at the time of sale” would

appear to mean the time of sale of the partnership interest, not the sale of the crops or livestock, for example.

¹⁰ *Glazer v. Comm’r*, 44 T.C. 541 (1965).

¹¹ Rev. Rul. 79-51, 1979-1 C.B. 225.

¹² *Ledoux v. Comm’r*, 695 F.2d 1320 (11th Cir. 1983), *aff’g per curiam*, 77 T.C. 293 (1981).

¹³ *Id.*

¹⁴ *Ware v. Comm’r*, 906 F.2d 62 (2d Cir. 1990), *aff’g*, 92 T.C. 1267 (1989).

¹⁵ I.R.C. § 751(a)(2).

¹⁶ See Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1062(a), 111 Stat. 788 (1997).

¹⁷ See Rev. Rul. 64-289, 1964-2 C.B. 173.

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