time when he has not received it. Finally, if the salary or bonus is deferred the executive subjects himself to higher FICA taxes. For these reasons, most executives will be well advised to choose immediate full cash payment as their method of compensation.

RONALD J. RUSSO

THE EFFECT OF RECAPTURE PROPERTY ON THE SALE OF A PARTNERSHIP INTEREST

INTRODUCTION

On the sale by a partner of his interest in a partnership, Internal Revenue Code section 741 applies and gain or loss is recognized to the transferor partner. Except as otherwise provided in section 751,[1] such gain or loss is considered as resulting from the sale or exchange of a capital asset. Section 751 provides that the amount of any money or the fair market value of any property received by a transferor partner in exchange for all or a part of his interest in the partnership, which is attributable either to unrealized receivables of the partnership, or inventory items that have substantially appreciated in value, shall be considered as an amount realized from the sale or exchange of property other than a capital asset.[2]

If on the sale of a partnership interest a section 754 election by the partnership is in effect,[3] then to the extent of the difference between the transferee partner's basis in his partnership interest[4] and his proportionate share of the adjusted basis of the partnership property,[5] a commensurate

1. INT. REV. CODE OF 1954, §741. All section references in the text are to the 1954 Code unless otherwise indicated.

2. TREAS. REG. §1.751-1(a)(3)(ii) requires the transferor partner to submit (with his income tax return for the taxable year in which the sale or exchange occurs) a statement setting forth the amount of "any money and the fair market value of any other property received or to be received for the transferred interest in the . . . partnership . . . and the portion thereof attributable to section 751 property." In the absence of an arm's length agreement between seller and purchaser, the seller will determine the amount of any money and the fair market value of any property which he has received in exchange for his interest in the partnership's section 751 assets. This does not mean that the Treasury cannot or will not challenge either determination.

3. INT. REV. CODE OF 1954, §754 provides in part that if a partnership has filed an election in accordance with regulations prescribed by the Treasury, then in the event of a transfer of a partnership interest, the basis of the partnership property shall be adjusted in the manner provided in §743.

4. INT. REV. CODE OF 1954, §742 provides: "The basis of an interest in a partnership acquired other than by contribution shall be determined under part II of subchapter 0 (sec. 1011 and following)." Therefore, under §1012, a purchasing partner will take a cost basis in his acquired partnership interest.

5. Generally, a partner's share of the adjusted basis of partnership property will be determined by his interest in partnership capital and profits. If a partner has a one-third interest in partnership capital and profits, his share of the adjusted basis of partnership property will most likely be one-third of such basis. However, the effect of any partnership

adjustment to the basis of partnership property must be made with respect to the transferee partner.[6] Section 743(c) provides that if section 743(b) is applicable, the allocation of basis among partnership properties shall be made in accordance with the rules provided in section 755.[7]

On the sale of an interest in a partnership owning recapture property,[8] problems can occur in the treatment of gain or loss and adjustments to basis. These problems derive from uncertainty regarding the classification of the recapture assets for purposes of sections 751 and 755. Section 751(c) categorizes recapture assets as unrealized receivables to the extent of the hypothetical gain to which the recapture provisions would apply if, at the time of the section 751 or 741 transaction, such property had been sold by the partnership at its fair market value.[9] The question is whether these assets are also to be classified as inventory items within the meaning of subsection 751(d)(2).[10] If so, the classification could cause the partnership's inventory items to be treated as having appreciated substantially in value, whereas such treatment may be avoided without the inventory classification of the recapture property.[11]

If the recapture assets are considered for basis allocation purposes as property totally within section 755(b)(1) (capital assets and property described in section 1231(b)), the resulting basis allocation might be different from that which would occur if those portions of the assets deemed unrealized receivables were treated as being "other property" of the partnership within the meaning of section 755(b)(2).[12]

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agreement with respect to contributed property as described in section 704(c)(2) shall be accounted for in determining a partner's share of the adjusted basis of partnership property. *See* TREAS. REG. §§1.743-1(b)(1), 1.743-1(b)(2)(i).

6. INT. REV. CODE OF 1954, §743(b).

7. INT. REV. CODE OF 1954, §743(c).

8. The term "recapture property" refers to property which if sold would result in the recognition of either capital gain or §1231 gain if it were not for the existence of statutory provisions requiring the recognition of ordinary gain upon such sale.

9. Mining property (as defined in §617(f)(2)), stock in a DISC (as defined in §992(a)), §1245 property (as defined in §1245(a)(3)), stock in certain foreign corporations (as defined in §1248), §1250 property (as defined in §1250(c)), farm recapture property (as defined in §1251(e)(1)), farm land (as defined in §1252(a)(2), and franchises, trademarks or trade names (referred to in §1253(a)) are the recapture assets categorized by §751(c) as unrealized receivables.

10. INT. REV. CODE OF 1954, §751(d)(2)(B) indicates that the term "inventory items" includes "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 §1231." Since the recapture provisions provide that gain to the extent of the recapture will be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in §1231, the argument can be made that §751(d)(2)(B) encompasses this gain. *See* §§617(d)(1), 992, 1245(a), 1248, 1250(a), 1251(c), 1252(a) and 1253.

11. The inclusion of additional inventory items in the two-prong test of §751(d)(1) could result in a different outcome. This is especially likely since those unrealized receivables which are recapture gains will have zero bases. *See* TREAS. REG. §1.751-1(c)(5).

12. For purposes of applying the allocation rules of §755(a), §755(b) divides partnership property into two categories: (1) capital assets and property described in §1231(b),

This commentary will explore the difficulties in applying the relevant code sections to the sale of an interest in a partnership holding assets with potential recapture gain. Through the discussion of a hypothetical sale, the differential impacts of the classification of the potential recapture gain on both the selling and purchasing partners will be illustrated. The commentary will then analyze the relevant code provisions and regulations against the background of the legislative history to argue for the appropriate classification of the potential recapture gain. In conclusion, practical suggestions for the tax planner and desirable remedial action by Congress will be outlined.

AN EXAMPLE

The following example will be used to illustrate the different results which can occur when the recapture property is treated in the different manners outlined previously.

Assume that *A* sells his interest in the ABC partnership to *D* for $190,000, and the ABC partnership records show the following:

Assets	Adjusted Basis	Value
Cash	$ 60,000	$ 60,000
Land	120,000	330,000
Inventory	90,000	50,000
Machinery (Section 1245 potential income — $70,000)	60,000	130,000
	$330,000	$570,000
Capital		
A	$110,000	$190,000
B	110,000	190,000
C	110,000	190,000
	$330,000	$570,000

Results to Selling Partner

The $70,000 potential section 1245 income is an unrealized receivable within the scope of section 751(c)[13] and has a basis of zero.[14] Assuming that

or (2) any other property of the partnership. Since the recapture provisions provide that gain to the extent of the recapture will be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in §1231, this gain is arguably within the scope of §755(b)(2) (any other property of the partnership).

13. The last sentence of §751(c) states that the term "unrealized receivables" includes §1245 property to the extent of the amount which would be treated as gain to which §1245(a) would apply if such property had been sold by the partnership at its fair market value. If the machinery had been sold at its fair market value of $130,000, $70,000 would have been treated as gain to which §1245(a) would apply.

14. TREAS. REG. §1.751-1(c)(5).

the unrealized receivable is *not* considered to be an inventory item for purposes of section 751(d), the inventory items of the partnership will not be substantially appreciated in value.[15] Of the $190,000 received by *A* on the sale of his partnership interest, $23,333 will most likely be attributed to his share of the unrealized receivables of the partnership.[16] Applying section 751(a), this sum will be considered an amount realized from the sale of property other than a capital asset. Since the basis of this property is zero, *A* will realize an ordinary gain of $23,333.

Except to the extent section 751(a) applies, the sale of *A*'s interest is treated as the sale of a capital asset, and the resulting capital gain or loss is measured by the difference between the amount realized and the adjusted basis of the partnership interest.[17] Since *A* has realized $166,667 and the adjusted basis of his partnership interest is $110,000,[18] he realizes a capital gain of $56,667.

If the unrealized receivable in the example is considered to be an inventory item, a different result occurs. The inventory items of the partnership will now be considered to have substantially appreciated in value since their fair market value of $120,000 will exceed their adjusted basis of $90,000 by more than 120 percent.[19] Of the $190,000 received by *A* on the sale of his partnership interest, $40,000 is most likely attributable to his share of the unrealized receivables and the inventory items of the partnership that have substantially appreciated in value.[20] Since the basis of these properties is $30,000,[21] *A* realizes an ordinary gain of $10,000.

For the purpose of applying section 741, *A* has realized $150,000 for the remainder of his partnership interest, the adjusted basis of which is $80,000.[22] Therefore, *A* realizes a capital gain of $70,000.

Although in the fact situation given, selling partner *A* benefits from the treatment of the unrealized receivable as an inventory item, a disadvantageous result will be reached in those instances in which the value of the inventory exceeds its basis.[23]

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15. The fair market value of the inventory ($50,000) does not exceed 120 percent of the adjusted basis to the partnership of such property ($90,000). *See* INT. REV. CODE OF 1954, §751(d)(1)(A).

16. See note 2 *supra*.

17. TREAS. REG. §1.741-1.

18. Treas. Reg. §1.741-1(a) states: "Where the provisions of section 751 require the recognition of ordinary income or loss with respect to a portion of the amount realized from such sale or exchange, the amount realized shall be reduced by the amount attributable under section 751 to unrealized receivables and substantially appreciated inventory items, and the adjusted basis of the transferor partner's interest in the partnership shall be reduced by the portion of such basis attributable to such unrealized receivables and substantially appreciated inventory items."

19. INT. REV. CODE OF 1954, §751(d)(1).

20. See note 2 *supra*.

21. The basis of one-third of the inventory is $30,000 and the basis of the unrealized receivable is zero.

22. See note 18 *supra*.

23. If in the example discussed in the text, the inventory had been worth $95,000 instead of $50,000, the treatment of the unrealized receivable as an inventory item would

Results to Purchasing Partner

Assuming the partnership has made a section 754 election in the example, section 743(b)(1) requires the partnership to "increase the adjusted basis of the partnership property by the excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property."[24] *D* has a cost basis in his partnership interest of $190,000,[25] and his proportionate share of the adjusted basis of the partnership property is $110,000. The partnership must increase the adjusted basis of the partnership property by $80,000, but the increase constitutes an adjustment to the basis of partnership property with respect to *D* only.[26]

Section 755 provides the rules for allocating this increase in basis among the partnership properties. The regulations state that in applying section 755, "all partnership property must be classified into two categories: capital assets and property described in section 1231(b) . . . or any other property of the partnership."[27] In the example the question is whether the unrealized receivable — the section 1245 potential income — is to be classified as "other property of the partnership" or whether it will be considered indistinguishable from the machine, which would classify it as property described in section 1231(b).[28] Assuming the latter treatment is required, the entire basis adjustment will be allocated to the capital assets and the 1231(b) property. The $240,000 difference between the value and the adjusted basis of all partnership property is attributable to the class of capital assets and section 1231(b) property. Section 755(b) provides that in applying the basis allocation rules, the increases in the adjusted basis that arise from a transfer of an interest and that are attributable to property consisting of capital assets and 1231(b) property, shall be allocated to partnership property of a like character. Therefore, the entire $80,000 increase must be allocated to the land and machine. The regulations further provide that the increase allocated to this class of property must be further allocated within the class in a manner that will reduce the difference between the fair market value and the adjusted basis of partnership properties.[29] Furthermore, the allocation should be in proportion to the

have been disadvantageous to *A*. Assume that *A* would then have sold his partnership interest for $205,000. If the unrealized receivable were *not* considered to be an inventory item for purposes of §751(d), the inventory items of the partnership would still not be substantially appreciated in value. Therefore, *A* would again realize an ordinary gain of $23,333; however, he would realize a capital gain of $71,667.

But if the unrealized receivable were considered an inventory item, the partnership's inventory items would now have substantially appreciated in value. Of the $205,000 received by *A* on the sale of his partnership interest, $55,000 would be attributable to his share of the unrealized receivables of the partnership and the inventory items which have substantially appreciated in value. Since the basis of these properties is $30,000, *A* would realize an ordinary gain of $25,000 and a capital gain of $70,000.

24. INT. REV. CODE OF 1954, §743(b)(1).
25. INT. REV. CODE OF 1954, §1012.
26. INT. REV. CODE OF 1954, §743(b).
27. TREAS. REG. §1.755-1(b).
28. See note 12 *supra*.
29. TREAS. REG. §1.755-1(a)(1)(i).

difference between the value and the basis of each asset so as to reduce the difference between the value and basis of each.[30] In the example, three-fourths of the increase or $60,000 must be allocated to the land and one-fourth or $20,000 to the machine.[31]

If the unrealized receivable in the example is classified as "other property of the partnership," a different allocation of basis will occur. $210,000 of the difference between the value and the adjusted basis of the partnership property is attributable to the class of capital assets and section 1231(b) property. The remaining $30,000 difference is attributable to other property of the partnership.[32] Therefore, purchaser *D*'s special basis adjustment of $80,000 must be allocated seven-eighths to capital assets and section 1231(b) property and one-eighth to other property,[33] resulting in an allocation of $70,000 to the land. Since the regulations require that no increase shall be made to the basis of any asset for which the adjusted basis equals or exceeds its fair market value, there is no allocation to the inventory and the remaining $10,000 basis increase must be allocated to the machine.[34]

A difference in results to the purchasing partner will not occur if the partnership assets have values lower than their adjusted bases. In that case the allocation of the special basis adjustment among the partnership assets will be the same regardless of whether the unrealized receivable is classified as other property.

CLASSIFYING RECAPTURE PROPERTY FOR PURPOSES OF I.R.C. SECTION 751

The diversity of results caused by the varying classifications of recapture property renders it crucial to determine precisely how this property should be categorized. Significantly, the structure of section 751 and its legislative history indicate that Congress did not intend that accounts receivable, either unrealized or realized, should be considered inventory items for the purpose of applying section 751.

Sections 751(a) and (b) refer to unrealized receivables and substantially appreciated inventory as two separate and distinct types of property,[35] a

30. TREAS. REG. §1.755-1(c)(2).

31. The difference between the value and the basis of the land is $210,000. The difference between the value and the basis of the machinery is $70,000. 210,000/280,000 or three-fourths of the $80,000 adjustment is allocable to the land. 70,000/280,000 or one-fourth of the $80,000 adjustment is allocable to the machine.

32. The other property of the partnership (the inventory and the unrealized receivable) have a combined value of $120,000, and a combined basis of $90,000. Therefore, the difference between the value and the basis of the other property is $30,000.

33. *See* TREAS. REG. §1.755-1(b)(2).

34. *See* TREAS. REG. §1.754-1(a)(1)(ii).

35. INT. REV. CODE OF 1954, §751(a) refers to an interest in the partnership attributable to: "(1) . . . unrealized receivables of the partnership, or (2) . . . inventory items of the partnership which have appreciated substantially in value." Section 751(b) refers to "partnership property described in subsection (a)(1) or (2)." Subsection (a)(1) property is unrealized receivables, and subsection (a)(2) property is substantially appreciated inventory items.

treatment consistent with the definitional provisions of that section.[36] The legislative history of the 1954 tax legislation also treats inventory items separately from receivables. Reporting on the 1954 tax bill, the Senate Finance Committee presented a hypothetical situation in which a partnership had the following balance sheet:

Assets	Adjusted Basis	Market Value
Cash	$10,000	$10,000
Account receivable	15,000	15,000
Inventory	30,000	39,000
Capital assets	40,000	46,000
	$95,000	$110,000

The dual test of section 751(d)(1) was applied to determine whether the partnership inventory had substantially appreciated in value. The determination was that since the fair market value of the inventory, $39,000, exceeded 120 percent of its adjusted basis (120 percent of $30,000, or $36,000) and also exceeded 10 percent of the fair market value of all partnership property other than money, the inventory had substantially appreciated in value.[37]

The report did not include the account receivable in its hypothetical computation. If the account receivable had been included, the fair market value of all the inventory items ($54,000) would not have exceeded 120 percent of the items' adjusted bases (120 percent of $45,000 or $54,000) and the inventory would not have been substantially appreciated in value. The House Ways and Means Committee report which accompanied the 1954 tax legislation presented a similar hypothetical and also did not consider accounts receivable as an inventory item.[38]

Although apparently not intending to include accounts receivable within the scope of the term "inventory item," Congress enacted a poorly written provision[39] that inadvertently opened the door for the Treasury's interpretation, which includes receivables as an inventory item.[40] Although it has never been judicially tested, the regulation adopting this interpretation may well

36. INT. REV. CODE OF 1954, §751(c) defines unrealized receivables; §751(d) defines inventory items.

37. S. REP. No. 1622, 83d Cong., 2d Sess. 404 (1954).

38. H.R. REP. No. 1337, 83d Cong., 2d Sess. A235 (1954).

39. INT. REV. CODE OF 1954, §751(d)(2). Section 751 (d)(2)(B) includes within the meaning of the term inventory items "any 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 section 1231." Section 1221(4) excludes from the definition of capital asset, accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Section 1231(b) excludes from its definition of §1231 property any property which is not depreciable or which is not real property used in a trade or business. Therefore, the literal language of §751(d)(2)(B) includes accounts receivable and unrealized receivables.

40. TREAS. REG. §1.751-1(d)(2)(ii) states that "accounts receivable acquired in the ordinary course of business for services or from the sale of stock in trade constitute inventory items . . . as do any unrealized receivables."

be invalid.[41] It is inconsistent with the overall structure of section 751, which recognizes a distinction between receivables and inventory items, and with the section's legislative history, which also supports the distinction.

Regardless of whether the regulation is invalid, it should not be applied to potential recapture income. The regulation was adopted before the enactment of the amendments to section 751(c) that reflected the enactment of the recapture provisions.[42] Thus, the regulation could not have been intended to apply to unrealized receivables, which are potential recapture items. Additionally, the language of section 751(d)(2)(B) does not appear to encompass potential recapture income. Although recapture gain is treated as gain from the sale or exchange of property that is neither a capital asset nor property described in section 1231,[43] the underlying property that is being sold or exchanged is either section 1231 property or a capital asset.[44] Therefore, an unrealized receivable of this type is not property that on a sale or exchange by the partnership should be considered property other than a capital asset or property described in section 1231(b). It is not an asset separate and distinct from the property within which it lurks as ordinary gain, but rather is an integral part of this property. It should not be forced into the section 751(d)(2)(B) category of an inventory item.

CLASSIFYING RECAPTURE PROPERTY FOR PURPOSE OF I.R.C. SECTION 755

The section 755 provisions involving rules for the allocation of basis are fraught with uncertainties. Section 755(a) specifies two ways in which the optional adjustments to basis can be allocated to partnership property.[45] The first is to allocate the adjustment in a manner which has the effect of reducing the difference between the fair market value and the adjusted basis of partnership properties;[46] the second is in any other manner permitted by regulations prescribed by the Secretary or his delegate.[47] The regulations allow the partnership to file an application proposing that adjustments be made in a manner that will increase the bases of some partnership properties and decrease the bases of other partnership properties.[48] Each increase or

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41. A Treasury regulation (especially an interpretative regulation) cannot be sustained if it is unreasonable or plainly inconsistent with the revenue statutes. *See, e.g.*, Joseph T. Lykes v. United States, 343 U.S. 118, 1952-1 U.S.T.C. ¶9259 (1952).

42. TREAS. REG. §1.751-1 was adopted in 1956 by T.D. 6175, 1956-1 CUM. BULL. 211. The first amendment to §751(c) became effective for taxable years beginning after December 31, 1962. *See* Revenue Act of 1962, PUB. L. No. 87-834, §13(f)(1), 76 Stat. 1035 (1963), 1962-3 CUM. BULL. 111, 175-76.

43. *See* INT. REV. CODE OF 1954, §§617(d)(1), 992, 1245(a)(1, 1248, 1250(a)(1), 1251(c)(1), 1252(a)(1), and 1253.

44. *See* INT. REV. CODE OF 1954, §§617(f)(2), 992(a), 1245(a)(3), 1248, 1250(c)(1), 1251(e)(1), 1252(a)(2), and 1253(a).

45. INT. REV. CODE OF 1954, §§755(a)(1) and 755(a)(2).

46. INT. REV. CODE OF 1954, §755(a)(1).

47. INT. REV. CODE OF 1954, §755(a)(2).

48. TREAS. REG. §1.755-1(a)(2).

decrease to the basis of an asset must reduce or eliminate the difference between such basis and the value of the asset. The net amount of all such adjustments must equal the amount of the adjustment under section 743(b).[49] The net effect of this procedure is to permit the transferee, with the consent of the Treasury, to take a cost basis in the partnership property.

Section 755(a) and its corresponding regulation seem to comport with the congressional intent to permit adjustments to the bases of partnership assets that achieve the same effect as if the partnership had dissolved and been reformed with the transferee of the interest as a member of the partnership.[50] But an ambiguity lurks within section 755(a) — the apparent section 755(b) override. Section 755(a) specifically states that its allocation rules shall apply except as provided in subsection (b). This language seems to warrant the application of subsection (b) before subsection (a) can be applied. The problem inherent in this procedure arises in the example discussed earlier. Applying subsection (b), the increases or decreases in basis attributable to capital assets and property described in section 1231(b) must be allocated to those properties, and the increases or decreases attributable to any other partnership property must be allocated to those other properties.[51] After these initial allocations have been made, subsection (a) can apply to further allocate the adjustments to basis.[52] The resulting allocation is con-

49. *Id.*

50. H.R. REP. No. 1337, 83d Cong., 2d Sess. 70 (1954); S. REP. No. 1622, 83d Cong., 2d Sess. 97 (1954).

51. *See* TREAS. REG. §1.755-1(c). Example (3) illustrates the operation of this provision. It assumes that partnership EFG had the following assets:

Assets	Adjusted Basis	Value
Capital asset	$1,000	$1,500
Depreciable asset	1,000	700
Inventory	700	800
	$2,700	$3,000

H purchased a one-third interest in the partnership for $1,000 (1/3 of $3,000, the total value of the partnership assets). His share of the adjusted basis of partnership property is $900 (1/3 of $2,700). Therefore, *H* has a special basis adjustment of $100 ($1,000 minus $900) under section 743(b). Of the total $300 difference between the value and the adjusted basis of all partnership property, $200 ($500 appreciation in value of the capital asset minus $300 depreciation in value of the depreciable asset) is attributable to the class of capital assets and depreciable property, and the remaining $100 (appreciation in value of the inventory item) to the class of other property; therefore, *H*'s special basis adjustment of $100 must be allocated two-thirds to capital assets and depreciable property and one-third to other property (inventory).

52. See note 51 *supra* and accompanying text. In the example discussed in note 47, the $67 increase (2/3 of $100) to be allocated to capital assets and depreciable property would further be allocated so as to reduce the difference between the value and basis of such assets. This would require allocation of the entire $67 increase to the capital asset (the basis of which is less than its value), and no part of the increase to the depreciable property (the basis of which exceeds its value). *See* TREAS. REG. §1.755-1(c), Example (3). With the consent of the Treasury, a $167 increase (1/3 of the the $500 difference between the value and basis of the capital asset) could be allocated to the capital asset, and a $100 decrease (1/3 of the $300 difference between the basis and value of the depreciable asset) could

trary to the intent of Congress. In the example, if the basis of the partnership property with respect to the transferee partner were a cost basis, the basis with respect to him of the land would be $110,000, the basis of the inventory would be $16,667, and that of the machinery would be $43,333.[53] If the section 1245 unrealized receivable is treated as other property, it has previously been shown that $70,000 of the increase in basis will be allocated to the land and the remaining $10,000 increase will be allocated to the other property of the partnership.[54] The land would then have a basis of $110,000 with respect to the transferee partner[55] and by applying section 755(a)(2), the basis of the machinery could be increased by $23,333 and that of the inventory decreased by $13,333.[56] This result would be consistent with the congressional intent in enacting section 755. However, if the section 1245 unrealized receivable were considered to be section 1231(b) property, a different and inconsistent result would occur. The entire $80,000 increase would be allocated to the land and machinery and no decrease in basis could be allocated to the inventory.[57] Section 755(b) imposes this limitation upon the application of section 755(a)(2).

Despite section 755's statement that the provisions of subsection (a) are subordinate to those of subsection (b), the regulations indicate that any increase or decrease to the basis of partnership properties may be allocated in any manner approved by the district director, provided each increase or decrease reduces or eliminates the difference between the basis and the value of the asset.[58] The Treasury's position is unassailable. The reports of both the House Ways and Means Committee and the Senate Finance Committee agree that the increase or decrease in the bases of partnership assets may be allocated to such assets in any equitable manner approved by the Secretary or his delegate.[59]

Applying the construction given section 755 by the regulations, the difficulty in categorizing potential recapture unrealized receivables is reduced. Classifying the receivables as capital assets and section 1231(b) property or as other property will obviate inconsistent allocations to basis, provided the Treasury approves a plan of allocation that gives the transferee partner a

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be allocated to the depreciable asset. *See* TREAS. REG. §1.755-1(a)(2).

53. *D* has purchased a one-third interest in the partnership assets. One-third of the value of the land is $110,000; one-third of the value of the inventory is $16,667, and one-third of the value of the machinery is $43,333.

54. See text accompanying note 34 *supra*.

55. One-third of the adjusted basis of the land, or $40,000, plus the $70,000 increased in basis equals $110,000.

56. See text accompanying note 49 *supra*. The basis of the machinery with regard to partner *D* would be $43,333 which equals *D*'s interest in the machinery. The basis of the inventory with regard to *D* would be $16,667 which equals his interest in the inventory. The net amount of all three adjustments ($80,000) would equal the amount of the adjustment under §743(b) of $80,000.

57. See notes 27-31 *supra* and accompanying text.

58. TREAS. REG. §1.755-1(a)(1)(i).

59. H.R. REP. No. 1337, 83d Cong., 2d Sess. 70 (1954); S. REP. No. 1622, 83d Cong., 2d Sess. 97 (1954).

cost basis in the partnership assets. Nevertheless, other problems remain. The characterization of the potential recapture[60] as either section 755(b)(1) or (b)(2) property still can have an effect on the treatment of partnership assets with respect to a transferee partner. First, section 755(a)(2) might not be applied in the allocation of basis since transferee partner may not elect to use section 755(a)(2) or the Treasury might disapprove the proposed adjustments made under the section.

Second, a partner might receive a distribution of recapture property with respect to which a transferee partner has a special basis adjustment resulting from the application of section 743(b). In this situation, the partner with the special basis adjustment must reallocate it to remaining partnership property of a like kind.[61] If the potential recapture is considered to be either a capital asset or a section 1231(b) asset, the special basis adjustment will be reallocated to property of a like kind. However, if it is treated as other property of the partnership, the special basis adjustment will be reallocated to other property.

Finally, if a transferee partner with a special basis adjustment in partnership property receives a distribution of like property in exchange for the property with the special basis adjustment, he is permitted to reallocate the special basis adjustment to the distributed property.[62] If the special basis property is recapture property, the classification of the potential recapture as either a capital asset, or property described in section 1231(b), or as any other property of the partnership will determine whether there has been a distribution of like property. In all three situations, the classification of the unrealized receivable is critical to the determination of the bases of the properties involved.

By applying the analysis utilized in the section 751(d) situation, the conclusion must be that the unrealized receivable is inseparable from the section 1231(b) asset within which it exists and therefore should not be characterized as other property.

CONCLUSION

Although it appears that recapture property will be treated totally as capital assets or as section 1231(b) property for purposes of sections 751(d) and 755, the only real certainty is that there is uncertainty. Prior to the sale of a partnership interest, if the partnership owns section 1231(b) property or capital assets burdened with potential recapture gain, and if the classification of that potential recapture as an inventory item would cause the inventory to be considered to have substantially appreciated in value, measures should be taken to avoid that result if it is detrimental to the parties involved. Additional inventory should be purchased, appreciated inventory should be distributed, or any other action that will prevent the inventory from being

60. Potential recapture gain is characterized as an unrealized receivable by §751(c). See note 9 *supra* and accompanying text.

61. TREAS. REG. §1.743-1(b)(2)(ii).

62. *Id.*

treated as substantially appreciated should be taken. Tax planning to avoid potential litigation is always desirable when possible. If not, then the selling partner can retreat to a position of strength by asserting that the potential recapture is a section 1231(b) asset or a capital asset.

With regard to the purchasing partner, he treads on dangerous ground in attempting to assert that the potential recapture is section 755(b)(2) "other property." If the application of section 755(a)(1) is not advantageous, his best alternative would be to apply section 755(a)(2) and take a cost basis in the partnership property.

Corrective congressional action is warranted to clarify the ambiguities inherent in sections 751(d) and 755. The definition of the term "inventory items" should be rewritten to clearly indicate whether it includes receivables. The section 755(b)(2) term "any other property of the partnership" should be more clearly expressed to remove the doubt as to whether it was intended to include potential recapture gain.

Additionally, the general rule of section 755(a) should be restructured to allow the transferee partner to take a cost basis in the partnership property in all situations and to eliminate the ambiguous language that seems to require a subsection (b) override. Since the intent of Congress was to permit adjustments to be made to the bases of partnership assets to give the transferee partner a cost basis in the partnership property,[63] it should be unnecessary to require Treasury approval to achieve this result.

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63. See note 50 *supra*.