PROBLEM 20P

Prior to finalizing the arrangements for Annabelle's withdrawal from Gemstone Galleries, as set forth in Problem 19P, she suffered a stroke and died, despite the heroic efforts of the emergency room personnel at General Hospital. It is now Annabelle's successor-in-interest who wants to withdraw from the partnership. Annabelle's successor-in-interest is Alicia Bloomberg, Annabelle's cousin, who is a very successful corporate attorney without the slightest appreciation of art. Alicia plans to dispose of all the art objects owned by Annabelle as soon as she can. The same methods of "buying out" the partnership interest now held by Alicia, as suggested in Problem 19P, are being considered.

Advise Jacob, Derrick and Alicia with respect to the tax implications to each of them and the partnership resulting from each of the methods of "buying out" Alicia's interest as described in Problem 19P.

PROBLEM 19P

Daniel Yang, one of your associates who specializes in labor law, recently received the letter set out below. Mr. Yang has asked you, as the office income tax expert, to tell him what advice he should give to his friend Jacob Henderschmidt. Mr. Yang anticipates that he will see Mr. Henderschmidt over the weekend and would like to meet with you beforehand in order to learn what advice should be given to Mr. Henderschmidt.

Jacob Henderschmidt
Gemstone Galleries
Sedona, Arizona 86336

October 1, Year*

Daniel Yang, Esq.
Marshall, Tulre & Goins
1412 Court Street
Tucson, AZ 85701

Dear Dan:

Some matters have come up with respect to Gemstone Galleries which have me a bit concerned. I would like your advice with respect to these matters. As you know, Gemstone Galleries is a partnership, which was formed a number of years ago by Annabelle Flick, Derrick Gemstone

* See explanatory footnote in Introduction, page vii, note 1.

and me. Each one of us contributed, in cash, one-third of the capital needed to start the business. The partnership agreement provides that Annabelle, Derrick and I each own a one-third interest in capital, profits and losses. The partnership agreement does not contain any provisions concerning the procedure to be followed upon the withdrawal of a partner. There have been no special allocations of income, gain, loss, deduction or credit, nor has there ever been a transfer of part, or all, of a partnership interest. Each year, each of us withdraws an amount of cash equal to that withdrawn by each of the other partners, and the total of such withdrawals during any year has never exceeded the profits of the partnership for that year.

Gemstone Galleries rents space to artists for the exhibition of their work and sells art work on consignment for artists. It has never bought, sold or dealt in art work for its own account. Its income is derived solely from the rental of space to artists and the commissions received when an artist's work held on consignment is sold. The art work listed on Gemstone Galleries' balance sheet, which I have enclosed, was bought for the purpose of providing a gracious setting for the display of other artists' work either on exhibition or held on consignment for sale.

Annabelle is a prominent art dealer. She buys, sells and generally deals in art objects including sculpture, graphics and paintings. She derives a substantial part of her income from the sale of art objects. Derrick is the curator of the local museum of modern art. Although he is an art collector, he has never sold any of his personal art collection. He derives his income from his salary as curator and his share of Gemstone Galleries' profits. As you know, I am a well-known public speaker, raconteur and patron of the arts. I, too, have a personal art collection and have never sold any of the art objects in the collection. My income is derived from fees for public speaking engagements and my share of Gemstone Galleries' profits.

Annabelle is getting on in years and would like to limit the demands on her time. As a result, she would like to withdraw from Gemstone Galleries. The three of us have agreed upon the value of the assets as shown on the enclosed balance sheet. We have discussed three different methods of providing Annabelle with the value of her interest. First, Derrick and I might assume Annabelle's share of partnership liabilities and pay her \$80,000 a year plus appropriate interest for the next three years. Second, the partnership might hold Annabelle harmless against the liabilities of the partnership and pay her \$80,000 a year plus appropriate interest for the next three years. Third, the partnership might hold Annabelle harmless against the liabilities of the partnership and this year distribute to her the George Woodman Collection, which is a collection of graphics and prints created by George Woodman.

I would like your advice with respect to the tax implications to each of us and the partnership resulting from each of the three alternatives for "buying out" Annabelle's interest.

Say hello to Molly and your children for me. I look forward to seeing them.

Sincerely,

Jake

Jake

Gemstone Galleries

Assets

		Basis (x 1000)	Fair Market Value (x 1000)
Cash		$ 36	$ 36
North African Sculpture Collection		36	72
George Woodman Collection		120	240
Miscellaneous Paintings		12	48
Miscellaneous Sculpture		36	72
Furniture & Fixtures	$120		
(Depreciation)	(72)*	48	72
Gemstone Building	200		
(Depreciation)	(68)*	132	156
Gemstone Building Land		60	84
Goodwill		-	120
Total		$480	$900

Liabilities

	Book (x 1000)	Fair Market Value (x 1000)
Trade Accounts Payable**	$ 12	$ 12
Loan for Furniture and Fixtures	36	36
Mortgage Liability on Gemstone Land and Building	132	132
Capital		
Annabelle	100	240
Derrick	100	240
Jacob	100	240
Total	$480	$900

* Depreciation has been computed using the straight-line method.

** The partnership uses the accrual method of accounting.