

PROBLEM 14P

With the normalization of trade and diplomatic relations in Asia, three of your good clients took advantage of the opportunity to engage in some profitable transactions in Asian art objects (art objects). The three clients pooled their resources in a general partnership (The Partnership) to exploit the potential market for art objects. The three clients are: (1) Hiram Walker (Hiram), an art dealer who buys and sells art objects as an occupation; (2) Indira Garratt (Indira), who is the owner of an art gallery and makes her living on the amounts she charges to exhibit art objects in her gallery and the commissions made on art objects which are sold when on exhibit in her gallery; and (3) Fredrick Tomarees (Fred), a well-to-do art connoisseur who is a partner in an investment banking firm.

During the last five years Hiram, Indira and Fred have sent three expeditions to Asia, led by Hiram, in order to locate and acquire various Asian art objects. Fred provided the start-up financing for the expeditions, Hiram provided his services to lead the expeditions, and Indira contributed the use of her gallery to store, display and sell the art objects to customers in the United States. Each one also contributed \$20,000 to The Partnership. The \$60,000 was used for the general overhead of The Partnership and certain equipment.

The Partnership has been quite successful. The balance sheet of The Partnership, which also shows the fair market value of its assets, is set out below. The participants are quite pleased with the success of The Partnership and have decided that they would like to continue working with each other in the business of selling art objects. They, however, would like to diversify into other than Asian art objects. In order to do this the participants feel they must reduce The Partnership's inventory of Asian art objects.

Hiram is willing to take \$40,000 in fair market value of the remaining inventory as part of his share of The Partnership's profits since he feels that he has the contacts necessary to dispose of this part of the inventory. Fred is also willing to take \$40,000 in fair market value of the remaining inventory as part of his share of The Partnership's profits since he would like to use the inventory to decorate the stately country mansion he recently acquired. Indira does not want any of the remaining inventory. Since the distribution of inventory by The Partnership to Hiram and Fred will sufficiently reduce The Partnership's inventory, the participants have agreed that The Partnership should distribute \$40,000 of cash to Indira in order to equalize the distributions made to the participants.

Fred, Hiram and Indira have asked you whether there are income tax consequences to them as a result of the distributions described above. Please advise your clients with respect to the income tax effects of the proposed distributions.

Balance Sheet of the Partnership ¹			
Assets			
(x 1000)			
		<u>Adjusted Basis</u>	<u>Fair Market Value</u>
Cash		\$ 60	\$ 60
Inventory of art objects		120	200
Equipment: cost	40		
dep. ²	(28)	12	20
Goodwill ³		<u>18</u>	<u>20</u>
		\$210	\$300
Liabilities			
(x 1000)			
		<u>Adjusted Basis</u>	<u>Fair Market Value</u>
Trade accounts payable		\$ 30	\$ 30
Capital accounts			
Hiram Walker		60	90
Indira Garratt		60	90
Frederick Tomarees		<u>60</u>	<u>90</u>
		\$210	\$300

1. The Partnership uses the accrual method of accounting.
2. Depreciation is computed using the most accelerated method available.
3. This amount represents the nondeductible cost to The Partnership of certain customer lists.