a. Compute the partnership's taxable income, and discuss the mechanism for taxing the partners.

Under § 701, the partnership is not a separate tax-paying entity. Pursuant to § 702(a), the partners are required to take into account separately their distributive shares of the partnership's income, gains, losses, deductions, and credits, whether or not any amount is distributed to them. In addition, such items retain the same character in the partners' hands as they had in the partnership's hands. *See* § 702(b). Although the partnership does not pay tax, § 703(a) states that it must separately compute its taxable income in the same manner as an individual with a few modifications. First, the items described in § 702(a) must be separately stated. Second, § 703(a)(2) lists certain deductions that are not permitted. The partnership would compute its income by separately stating its $90,000 net short-term capital loss ($120,000 short-term capital loss netted against a $30,000 short-term capital gain), its $30,000 net long-term capital gain ($40,000 long-term capital gain netted against a $10,000 long-term capital loss), the $60,000 of dividends, the $30,000 charitable contribution (which is not allowed as a deduction to the partnership), and the partnership's ordinary income from its business, or its "bottom-line" income, of $300,000 ($380,000 gross income minus $80,000 of business expenses). Consequently, under § 702(a), Barbara, Bill, and Tom each take into account their one-third distributive share of those items. Thus, each partner will report $10,000 of long-term capital gains, $30,000 of short-term capital losses, $20,000 of dividends, a $10,000 charitable contribution (the rules of § 170 must be applied separately to each partner), and $100,00 of ordinary business income.

b. Provide examples of elections that may be important to this partnership, and identify whether the partnership or the partners make those elections.

Any election affecting the computation of taxable income is made by the partnership unless specified in § 703(b). Some common tax elections

that are made by the partnership include the method to compute depreciation, the choice of inventory method, the election to reinvest condemnation proceeds, the election not to use the installment-sale method, the election under § 709 to amortize organizational expenses, and the election under § 754 to adjust the basis of the partnership's assets upon the transfer of a partnership interest or certain distributions. The election to deduct or take a credit for certain foreign taxes, however, is an example of an election that must be made by each partner.

c. Explain how the computation of the partnership's taxable income changes if the partnership specially allocates $100,000 of gross income from operations to Barbara. All the other items are shared equally between the three partners.

The $100,000 of gross income specially allocated to Barbara is removed from the bottom line and is allocated to Barbara as part of her distributive share. Consequently, the partnership realizes $120,000 of net ordinary income ($200,000 of gross income netted against $80,000 of business expenses). Each partner reports $40,000 as his or her distributive share. The distributive shares of the other items remain the same.

d. Suppose in addition to the items above, the partnership recognizes $3,000,000 of gain from the sale of a Vincent Van Gogh original painting. The partnership purchased the painting many years ago at a nominal price. (At the time of the purchase, the partners and the seller believed the painting was a copy.) Although Barbara deals in antique art in her spare time, the partnership strictly held the painting for investment.

This question raises the issue of whether character of income is determined with reference to the partnership or the partner. If the partner's status were relevant, Barbara's share of the $3,000,000 of income would be ordinary income since she is an art dealer. However, because the partnership does not deal in art, the income would be long-term capital gain. Characterization of income is resolved at the partnership level, allowing Barbara to report a long-term capital gain for her share of the income even though she would have recognized ordinary income had she sold the painting directly. *See* Rev. Rul. 68-79, 1968-1 CB 216 (partner's distributive share of gain from sale of capital asset was long-term capital gain even though partner held partnership interest for less than six months). Note that, if Barbara had contributed the painting and the partnership had sold it within five years of its contribution, the partnership's income would have been ordinary income. *See* § 724(b).

e. What method of accounting can be used by the partnership?

This partnership is entitled to choose any method of accounting specified in § 446(c). The accounting method does not have to be consistent with the partners' accounting methods. Section 448 prevents the use of the cash method of accounting if a C corporation is a partner (unless the "$5,000,000 gross receipts test" is satisfied for all prior years) or if the partnership is a "tax shelter." Note that "tax shelter" is broadly defined.

2. Assume general partnership *DEF* is a calendar-year taxpayer that has a C corporation as a partner and was formed on July 1, 1994, for valid business reasons. May *DEF* use the cash method of accounting for 1999? Assume *DEF*'s gross receipts were as follows: