

LLC and Partnership Purchases: Entity Interests vs. Asset Sales

TUESDAY, NOVEMBER 28, 2017, 1:00-2:50 pm Eastern

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LLC and Partnership Purchases

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Eric J. Michaels, Partner
Fox Rothschild, Morristown, N.J.
emichaels@foxrothschild.com

Alexander Morgan, CPA, Partner, Tax Services
Fiondella Milone & LaSaracina, Glastonbury, Conn.
amorgan@fmlcpas.com

Angelina Milo, CPA, Vice President, Tax Services Group
Meaden & Moore, Cleveland
amilo@meadenmoore.com

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STRAFFORD WEBINAR LLC AND PARTNERSHIP PURCHASES: ENTITY INTERESTS VS. ASSET SALES

Eric J. Michaels, Esq

Seller and Buyer Considerations

- Threshold Issues - Who is Seller and Who is the Buyer
 - Possible Sellers
 - Partnership
 - Partner
 - Possible Buyers
 - Partnership
 - Existing Partner
 - Stranger



Seller and Buyer Considerations

- What is being Sold?
 - All Assets of the Entity
 - Some Assets of the Entity
 - All Interests in the Entity
 - Some Fractional Interest in the Entity
- Assumptions
 - Purchase and sale of a Partnership Interest
 - Transaction does not terminate Partnership
 - US Taxpayers
 - If an LLC, it is taxed as a partnership for Federal and State tax purposes



Seller and Buyer Considerations

Non-Tax Issues

- Common Issues to Buyer and Seller
 - Internal Consent Requirements
 - Who must consent
 - Tag-along and Drag- along
 - Rights of First Refusal and Rights of First Offer
 - External Consent Requirements
 - Governmental
 - Licensing
 - Compliance
 - Contractual



Seller and Buyer Considerations

Non-Tax Issues

- Seller Concerns

- How much am I getting?
- How is it being paid?
 - Cash
 - Note
 - Holdbacks
- How do I ensure I keep what I am being paid?
 - Indemnification obligations
 - Security for Installment Payments



Seller and Buyer Considerations

Non-Tax Issues

- Buyer Concerns
 - How much am I paying?
 - How am I paying for it?
 - Cash
 - Note
 - Holdbacks
 - How do I know I am getting what I am paying for
 - Due Diligence
 - Partnership Agreement
 - Indemnification



Seller and Buyer Considerations

Tax Issues

- Overview
 - Aggregate versus Entity Concepts
 - Statutory Framework
- Seller Concerns
 - IRC Section 741 – Sale of capital asset except as provided in IRC Section 751.
 - IRC Section 752
 - IRC Section 453



Seller and Buyer Considerations

Tax Issues

- Buyer Concerns
 - Capital Accounts (Tax and Book)
 - IRC Section 752
 - Inside Basis versus Outside Basis
 - What is the problem?
 - IRC Section 743(b) Adjustment
- Partnership Concerns
 - Closing of Partnership Year
 - Termination of Partnership



Thank You

Eric J. Michaels
Fox Rothschild
Morristown, N.J.

emichaels@foxrothschild.com



Fox Rothschild LLP
ATTORNEYS AT LAW

Strafford Webinar

Hot Assets - IRC § 751

Angelina L Milo, CPA
November 28, 2017



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Importance of IRC § 751

- Increase in LLC entities classified as partnerships.
- Converts capital gain to ordinary income upon sale or redemption of a partner's interest.
 - **Rate Differential between ordinary income rates (39.6%) and capital gain rates (20%).**
 - **Selling partner may recognize ordinary income offset by a non-utilizable capital loss.**

Example

Tom's basis for his 50% interest in TKM Partnership is \$100,000. He sells his interest for \$200,000, resulting in an overall gain of \$100,000. The partnership assets consist of an IRC Section 751 asset with a value of \$400,000 and a basis of zero, and a non-Section 751 asset with a value of zero and a basis of \$200,000. Tom is treated as having separately sold his 50% share of the IRC Section 751 asset for its value of \$200,000 ($\$400,000 * 50\%$) and will realize **\$200,000 in ordinary income**. The remaining proceeds (zero) are then applied to the remaining basis of \$100,000 ($\$200,000 * 50\%$), producing a **\$100,000 capital loss**.

Applicable Upon

- Sale or exchange of an interest in a partnership owning IRC § 751(a) property.
- Redemption of a partnership interest - Certain distributions of a partnership interest treated as a sale or exchange of IRC § 751(b) property.
- *Regardless if a complete or partial sale, exchange or redemption*

Two Categories of IRC § 751 Assets

(“Hot Assets”)

**Sale or exchange of partnership interest –
IRC § 751(a)**

- 1) Unrealized Receivables
- 2) Inventory Items

**Redemptions or certain distributions treated as
sale or exchange – IRC § 751(b)**

- 1) Unrealized Receivables
- 2) Substantially Appreciated Inventory Items
(FMV >120% of Adjusted Basis)

Unrealized Receivables...

- 1) Goods**
- 2) Services**
- 3) Recapture Items**

- 3 Categories
- Defined by IRC § 751(c)

Unrealized Receivables - GOODS

Right to payment for goods **delivered** or **to be delivered**, to the extent that proceeds from the sale of goods would **not** be treated as a sale or exchange of a **capital asset**.

Unrealized Receivables - GOODS

Excludes Capital Gain Property

Exclusion applies to both short-term and long-term capital gain property.

Unrealized Receivables - GOODS

Includes all rights, contractual or otherwise, **not previously includible in income** under the method of accounting used by the partnership. **Including** rights to payment for work begun but not complete.

Example:

- Contracts whereby partnership uses completed-contract method of accounting.

Unrealized Receivables Services

Includes all rights, contractual or otherwise, **not previously includible in income** under the method of accounting used by the partnership.

Example:

Accounts receivables of a service partnership using cash basis of accounting

Unrealized Receivables - Services

Includes payments for services that have not yet been performed and that partnership is not obligated to perform.

Example:

Management or sales contract where the contract gives the partnership the right to receive payment for services rendered.

Does not include contracts for future services where contract may be terminated at will by the party whom the services are to be rendered for.

Unrealized Receivables - Services

Caution...there is a difference between:

- **Right** to earn future income = unrealized receivable = **ordinary income**
- **Expectation** of future earnings = goodwill = **capital gain**
(Income based on the partnership's relationship with its clients or customers.)

(Because of subjective elements of Reg. 1.751-1(c)(3) it is important for agreement between buyer and seller to explicitly state allocation of purchase price.)

Unrealized Receivables Recapture Items

- IRC § 1245 Property
- IRC § 1250 Property
- Understated Rent – IRC §467(c)
- Farm Land & Land Clearance Deductions – IRC §1252
- Oil, Gas & Geothermal Property & Designed to use more air than necessary for complete combustion of fuel- IRC §617(f) & IRC §1254

Unrealized Receivables

Recapture Items

- Mining Property – IRC §617(d)
- Franchises, Trademarks & Trade Names – IRC §1253(a)
- Market Discount Bonds – IRC §1276(a) & IRC §1278
- Short-Term Obligations – IRC §1271(a) & IRC §1283
- DISC Stock – IRC §995(c)
- Stock of Controlled Foreign Corporation – IRC §1248(a)

Unrealized Receivables Recapture Items

Recapture potential of an asset is:

- Computed by assuming that the partnership sold the recapture property.
- Adjusted for any special basis adjustment in effect under IRC §743(b) & IRC § 732(d).
- Treated as separate asset with a basis of zero.

Example

- Tom owns a one-third interest in ABC partnership.
- The partnership holds items of IRC §1245 property.
- The aggregate FMV of the IRC §1245 property is less than the aggregate bases of the property

Example (cont'd)

§ 1245 Asset	Cost	Accumulated Depreciation	Adjusted Basis	FMV	Potential Gain/(Loss)
A	\$200,000	\$75,000	\$125,000	\$100,000	(\$25,000)
B	\$80,000	\$10,000	\$70,000	\$65,000	(\$5,000)
C	\$300,000	\$45,000	\$255,000	\$270,000	\$15,000
Total	\$580,000	\$130,000	\$450,000	\$435,000	(\$15,000)

Inventory Items

IRC § 751(a) – Sale or exchange of Partnership Interest

Includes all inventory items regardless their value.

(Planning opportunity to recognize a “hot asset” loss if inventory items are not appreciated.)

Inventory Items

IRC Section 751(b) – Redemption

Substantially Appreciated Inventory Items

(FMV >120% of Adjusted Basis)

Four types of Inventory Items

- 1) Stock in trade & property held for sale to customers in the ordinary course of business - IRC § 1221(I).
- 2) Property if sold by the partnership, would not be a capital asset or IRC § 1231 property.
- 3) Stock of a foreign investment company subject to recapture under IRC § 1246.
- 4) Property which would be classified as inventory if held by the selling partner rather than the partnership.

Inventory Items

If inventory is pre-sold, the value of the sales contract converts to and “unrealized receivable” regardless of the appreciation.

Sale or Exchange of Partnership Interest

In accordance with IRC § 741

In the case of a sale or exchange of an interest in a partnership, gain or loss... shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in IRC § 751

Sale or Exchange of Partnership Interest

In accordance with IRC § 751(a)

The amount of any money, or the fair market value of any property, received by a partner is exchanged for all or a part of his interest in the partnership attributable to (1) unrealized receivable of the partnership or (2) inventory items of the partnership, shall be considered as an amount realized from the sale or exchange of property other than a capital asset.

Sale or Exchange of Partnership Interest

- 1) Allocate to the selling partner the amount of income or loss that would have been allocated to him if the partnership were to conceptually sell all of its IRC § 751 assets in a fully taxable transaction.

Sale or Exchange of Partnership Interest

-
- 2) The selling partner's capital gain or loss is the difference between the income or loss that the transferor partner would have recognized without the existence of IRC § 751, adjusted by the income or loss calculated in (1) above.

Sale or Exchange of Partnership Interest

By fragmenting the sale into separate sales of IRC §751 assets, and non- IRC § 751 assets could result in ordinary income in excess of the partner's overall gain, and an offsetting capital loss that possibly can't be utilized.

Redemption of Partnership Interest

In a complete redemption, the payment made by the partnership with respect to redeeming the partner's share of cash-basis accounts receivable is treated as a guaranteed payment or a share of partnership income (IRC §736(a)).

Sale Versus Redemption

Recognition of ordinary income by a partner differs depending on whether the disposition is a sale or redemption.

Sale Versus Redemption

T owns a 1/3 interest in TKM Partnership that has the following assets. T's outside basis is \$60,000 and T will receive \$200,000 for her interest.

	Basis	FMV
Cash	\$30,000	\$30,000
Inventory	\$45,000	\$55,000
Accounts Receivable	\$105,000	\$80,000
Goodwill	\$0	\$435,000
Total	\$180,000	\$600,000

Sale Versus Redemption

The result is that A would recognize:

**Sale or Exchange = \$ 5,000 ordinary loss
 \$145,000 capital gain**

Redemption = \$140,000 capital gain

Proposed Regulations

- Apply to IRC § 751(b) – Redemptions/Distributions
- Issued November 3, 2014
- Effective for distributions on after the date the regulations are finalized, but may be applied to transactions occurring on or after Nov. 3, 2014 if applied on all future transactions.

Proposed Regulations

- **Current regulations = gross value approach**
(Partner's gross value of partnership's assets)

- **Proposed regulations = hypothetical sale approach**

(The amount of ordinary income allocated to the partner if the partnership disposed of all of its property at FMV, including taking into account IRC §704(c) allocations.)

THANK YOU

Angelina L Milo, CPA

(216) 928-5412

amilo@meadenmoore.com



EXPERIENCE THAT COUNTS.

Sec. 754 elections in sales of partnership interests

Presented by: Alexander Morgan – Partner, Tax Services

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Sec. 754 election – quick overview

- For a sale/exchange of a partnership interest or the death of a partner, Sec. 754 permits the partnership to make an optional election to adjust the basis of its assets with respect to the transferee partner.
- Sec. 743(b) sets forth the criteria for basis adjustments required for a transferee partner's share of partnership assets.
- Sec. 754 election also used to specially adjust the basis of partnership property following a distribution of property to a partner. Sec. 734(b)
- Sec. 754 election activates both Secs. 743(b) *and* 734(b) for all transfers and distributions made during the year for which the election is made, and during all subsequent tax years until the election is revoked.

Sec. 754 election – quick overview

- The primary intent of Sec. 743(b) basis adjustments is to equalize a partner's share of inside basis in partnership assets and the partner's basis in its partnership interest.
- Basis adjustments under Sec. 743 do not affect the partnership's computation of income and are intended to affect the newly incoming partner only.
- On the other hand, adjustments under Sec. 734 affect all of the partners.

Sec. 754 election – quick overview

Let's look at example some examples with and without the election:

EXAMPLE 1 (without election)

ABC Partnership has just one asset with a basis of \$300 and a fair market value of \$600. C, whose basis for her 1/3rd partnership interest is \$100, sells her interest to D for \$200. The partnership then sells its asset for \$600 (FMV). The partnership level gain is \$300, and D's 1/3rd share of the gain is \$100.

- Consequently, the gain is taxed twice.
- Although gain recognized by D increases his basis for his partnership interest to \$300 (vs. \$200 FMV of his share)

Sec. 754 election – quick overview

EXAMPLE 1 (cont.)

So if D later sells his interest for \$200 (its FMV), he will realize a \$100 loss (albeit a capital loss which could be undesirable).

EXAMPLE 2 (with election)

Same facts as above but this time a Sec. 754 election is made by the partnership. As a result, the partnership can increase its basis in the property by \$100 which is the buyer's share of the step-up. Only the buyer will benefit from the additional depreciation deductions resulting from the step-up while the other partners will continue to depreciate their previously remaining basis.

Sec. 754 election – quick overview

Mandatory basis adjustments – required even in the absence of a 754 election

- Negative Sec. 743 adjustments are mandatory when there is a “substantial built-in loss” in the partnership immediately after the transfer
- Negative Sec. 734 basis adjustments are mandatory where there is a “substantial basis reduction.”

Built-in loss or basis reduction is substantial if greater than \$250,000.

Let's now discuss when the election may or may not make sense in a sale of partnership interests:

- Sec. 754 provides the means for a partnership to make an election applicable to basis adjustments
 - Sec. 743(b) for transfers of partnership interests; and
 - Sec. 734(b) for partnership distributions.
- Then there is also Sec. 755 which provides the rules for allocating basis adjustments under Sections 743(b) and 734(b) among partnership property.
- Under Sec. 755, basis adjustments must be allocated between capital gain property and ordinary income property.

So why is Sec. 755 relevant in the context of a sale of partnership interests and Sec. 754 election?

- The Sec. 755 Regs provide two separate methods for allocating a buyer's basis adjustment among the partnership's assets following the sale/exchange of a partnership interest.
 - Upward or downward basis adjustments under Secs. 1.755-1(b)(2)-(4) – taxpayer's overall basis adjustment will produce a positive basis adjustment with respect to the partnership's appreciated assets and a negative basis adjustment with respect to partnership assets containing unrealized losses.
 - One way basis adjustments under Sec. 1.755-1(b)(5) – taxpayer's overall positive basis adjustment can only be allocated to assets that have appreciated in value and vice versa for an overall negative basis adjustment.
- The Sec. 754 election can dictate which of the 2 above methods must be followed.

Example

Assume AB LLC, an accrual basis partnership, is made up of 2 equal members and has the following balance sheet:

	<u>Basis</u>	<u>Value</u>
Cash	30,000	30,000
Inventory	150,000	125,000
Accounts receivable	500,000	425,000
Computer equipment	100,000	100,000
Intangible assets	-	500,000
	<u>780,000</u>	<u>1,180,000</u>
Bank loan	80,000	80,000
A's Capital account	350,000	550,000
B's Capital account	350,000	550,000
	<u>780,000</u>	<u>1,180,000</u>

- B sells his 50% ownership interest to C for \$550,000 (B's share of the underlying value of the assets). C requests that the partnership agree to make a Sec. 754 election.
 - *The optimal time to make the election will depend on a couple of different scenarios to be discussed a little further on.*
- For B, the sale of his interest receives capital gain treatment, except as provided in Sec. 751 (i.e. the receivables and inventory items).

- Thus, when B sells his partnership interest he will recognize the following ordinary vs. capital gain/(loss):

Cash proceeds of sale		550,000
Relief of bank debt		40,000
Amount realized		590,000
Capital account		350,000
Share of bank debt		40,000
Basis		390,000
Net gain		200,000
Ordinary loss:		
Inventory		(12,500)
Realized receivables		(37,500)
Ordinary gain/(loss)		(50,000)
Capital gain		250,000

- From the partnership's perspective, B's sale of his 50% interest causes a technical termination of the partnership under Sec. 708.
- From a federal tax standpoint, the LLC is deemed to contribute its assets to a newly formed LLC, and then old LLC is deemed to liquidate by distributing the interests in new LLC (that the old LLC received on formation of new LLC) to the remaining and new members of the old LLC in liquidation of old LLC.

Let's circle back to C's request to make a Sec. 754 election...

- If old LLC makes a 754 election (or already had one previously in effect), the basis adjustments are made under the upward or downward basis adjustment rules of Secs. 1.755-1(b)(2)-(4) as noted above.
- The basis adjustments then carry over to the deemed newly formed LLC pursuant to Reg. §1.743-1(h)(1) regardless of whether the new partnership makes a Sec. 754 election.
- Under these (b)(2)-(b)(4) rules, this means that C would have his basis adjustments allocated as follows:

Inventory	(12,500) downward adj.
Accounts receivable	(37,500) downward adj.
Intangible assets	<u>250,000</u> upward adj.
Total	200,000 net adj.

- To recap, C's total basis adjustment is \$200,000. However, let's now discuss the 2nd method for allocating a buyer's basis adjustment under Reg. §1.755-1(b)(5) which could come into play if a 754 election is *not made* by the old partnership (or one is not already in effect).
- Under (b)(5), the “substituted basis transaction” rules will apply which allocates the basis adjustments in a different manner than under the b(2)–(4) method just described.
- A technical termination falls within the scope of the (b)(5) rules and is thus considered a substituted basis transaction.
 - Thus, without a 754 election in effect in old LLC, C's basis will be determined by reference to B's basis in the transferred interest.

- But where the (b)(2)– (b)(4) rules allow for both upward and downward adjustments to assets, the (b)(5) rules only allow for a one way adjustment.
- Overall positive adjustments can be made to capital gain assets or ordinary income assets only if that class of assets would result in net gain being allocated to the transferee from a hypothetical sale of assets.
- Likewise, within each class of assets, a basis adjustment can be made to an asset, only if the sale of that asset would produce a gain allocation on a hypothetical sale of such asset. The converse of these rules applies if the overall basis adjustment is negative.

What does this all mean for C, the newly incoming partner?

- The (b)(5) substituted basis rules may be the preferred result meaning C would rather have the 754 election made with the new partnership and not the old.
- C will have the same \$200,000 basis adjustment, regardless of whether the Sec. 754 election is made by the old LLC or the new LLC.
- But where the (b)(2)– (b)(4) rules would reduce C's share of the basis of the inventory by \$12,500 and the accounts receivable by \$37,500 and increase his share of the basis of the intangible assets by \$250,000, the (b)(5) rules would result in a \$200,000 basis adjustment to the intangible assets only (*i.e.*, the capital asset class is the only class that would produce an allocation of gain to C on a hypothetical sale of assets).

What does this all mean for C, the newly incoming partner?

- As a result, if new LLC were to dispose of the inventory and collect the A/R at the values existing at the time of the acquisition of his interest, C would recognize an ordinary loss of \$50,000; and a capital gain of \$50,000 (250,000 FMV less \$200,000 basis).
- However, on a net basis, he has achieved a \$50,000 ordinary loss/capital gain re-characterization.

In Summary

- Where there is a potential basis step-down in ordinary income assets, the (b)(5) rules can work in the buyer's favor.
- In this example, C would not want a 754 election to be made on the final return for old LLC, but would want the election made with the initial tax return of new LLC.
- But in a case where instead the ordinary income assets contained built in gain and the capital assets had a built in loss, the transferee likely would want the Code Sec. 754 election made with the final return of the old partnership.
- Thus, each fact pattern should be analyzed accordingly.

Centralized partnership audit rules under the Bipartisan Budget Act of 2015 (BBA)

- The new rules provide for the assessment and collection of tax at the partnership level.
- Adjustments are taken into account by the partnership vs. the individual partners in the in the year of adjustment (“adjustment year”) rather than the year in which the adjustment is related.
 - Thus, new partners can be on the hook for assessments relating to a prior period.
- Tax will be collected from the partnership, not the individual partners.

Centralized partnership audit rules

- Tax Matters Partner (TMP) is replaced with a partnership representative
- Partnership and all partners will be bound by actions taken by the partnership representative
- Representative must be a partner (or other person) with a substantial presence in the United States.
- Partnership representative may be an entity, but must appoint an individual to act on the entity's behalf.
- Partnership can appoint a partner or a nonpartner, including the partnership's management company, as the partnership representative, provided the person otherwise qualifies

Centralized partnership audit rules

- Partnerships required to furnish 100 or fewer Schedules K-1, and whose partners are individuals, corporations (including certain types of foreign entities), or estates can elect out of the new partnership-level audit rules.
 - Thus, election to opt out is not available to a tiered partnership
- The election to opt out must be made with a timely filed return and include a disclosure of the name and taxpayer identification number (TIN) of each partner.

Centralized partnership audit rules

- Any imputed underpayment is calculated by multiplying the total netted partnership adjustment by the highest rate of federal income tax in effect for the reviewed year (either the individual or corporate rate).
- The product of that amount is then increased or decreased by any adjustment made to the partnership's credits.
- Any resulting income tax payments under Code Sec. 6241 are not allowed as deductions.
- Decreases in taxes are not taken into account
 - Will this lead to potential double taxation?

Centralized partnership audit rules

- If preferred, a partnership can make an election within 45 days of the date of the notice of final partnership adjustment to not apply the adjustment rules at the partnership level under Code Sec. 6225 (added by the BBA), but rather at the partner level.
- Unlike under TEFRA, partnerships with 10 or fewer qualified partners must make an affirmative election to opt out of the new audit rules. Under the old rules, a small partnership was not subject to the TEFRA audit regime unless an affirmative election was made.

Cautionary note: Schedules K-1 generally may not be amended after the due date of the partnership's return except when the partnership makes an election to apply the audit adjustment rules at the partner level, and not at the partnership level.

Thank You

Alexander Morgan
Fiondella Milone & LaSaracina
Glastonbury, Conn.
amorgan@fmlcpas.com