MULTISTATE TAX COMMISSION

State Taxation of Partnerships – Report to the Work Group

MARCH 15, 2023

LAST CALL

- Reviewed the general sourcing principles and possible “exceptions”—that is—items that need their own specific sourcing rules.
- Began review of the issue of guaranteed payments, their treatment under Subchapter K, and their sourcing.
- NOTE – In this area, even compared to other partnership related matters, the federal rules are often less than perfectly clear and have evolved (and regressed) over time.

(If nothing else – this should make states feel better about their “underdeveloped” partnership rules.)

GUARANTEED PAYMENTS – SOME OF WHAT WE "KNOW."

- Under IRC § 707(c) –
  - "Determined without regard to income"
  - May be for services or the use of capital
- Unlike distributive share—guaranteed payments
  - Are actually paid or accrued.
  - Have no effect on a partner's capital accounts or outside basis.
  - Are always treated as ordinary income to the partner.
  - Are a business expense of the partnership or may be required to be capitalized.
- Also –
  - Any partner, including limited partners, can receive guaranteed payments.
  - Guaranteed payments may be subject to federal self-employment tax.

GUARANTEED PAYMENTS – IMPORTANT DISTINCTIONS

- Guaranteed payments versus regular distributive share (IRC § 704)
- Guaranteed payments to a partner versus payments made to a partner not acting as a partner.
- Guaranteed payments for services versus guaranteed payments for capital.

DISTINCTION - GUARANTEED PAYMENTS VERSUS REGULAR DISTRIBUTIVE SHARE (IRC § 704)

- Not always clear.
- Partners can perform services and contribute capital and receive only distributive share.
- Nor does it always look like "compensation."
- Even the distinction that it is "determined without regard to income" isn't always clear.
- Example –
  - A and B form Partnership AB. A contributes $100,000 cash and B contributes property worth $50,000.
  - A and B generally agree that A and B will split the income of the partnership 50/50, but A will receive a minimum of $2,000 each year.
  - In Year 1, AB has net income of $3,000. Is any or all of the $2,000 paid to Partner A a guaranteed payment? (Answer – IRS regulations have gone both ways - See Reg. § 1.707-1(c) and proposed regs.)

WHY DOES IT MATTER FOR FEDERAL TAX PURPOSES?

- Guaranteed payments give partnerships even more flexibility than IRC § 704(b) in dividing up the economic and tax results of the partnership.
- Example –
  - Partners A and B form Partnership AB.
  - In Year 1, AB has income of $100,000.
  - Unless they agree to special allocations, A and B will each be allocated some amount of income.
  - What if A and B agree A will receive a guaranteed payment of $200,000 per year and then they will split the remaining income?
  - Partner A will report $200,000 in guaranteed payments and a $50,000 loss, and B will report a $50,000 loss.
- NOTE: As an ordinary expense of the partnership, the partnership expense of the guaranteed payments must generally be allocated consistent with IRC § 704(b) (and substantial economic effect rules).

WHY DOES IT MATTER FOR FEDERAL TAX PURPOSES (PART II)?

- Guaranteed payments should not change the character of distributive share items.
- Example –
  - Partner X in the XY partnership is to receive a payment of $10,000 for services, plus 30% of the taxable income or loss of the partnership.
  - The partnership has $30,000 in capital gains and no other items of income or deduction except the $10,000 paid X as a guaranteed payment.
  - Under section 702(a), the partnership has a $10,000 ordinary loss and $30,000 in capital gains.
  - Partner X's 30 percent distributive shares of these amounts are $3,000 ordinary loss and $9,000 capital gain. In addition, X has received a $10,000 guaranteed payment which is ordinary income to him. (See Reg. 1.707-1.)
- It may matter for sourcing and for the qualified business income deduction under IRC § 199A.

WHY DOES IT MATTER FOR STATE TAX PURPOSES?

- *If guaranteed payments are sourced differently than distributive share.*

GUARANTEED PAYMENTS VERSUS PAYMENTS MADE TO A PARTNER NOT ACTING AS A PARTNER

- Not always clear.
- Example –
  - Partnership is engaged in real estate leasing. Partner A also has a separate construction business. Are the following guaranteed payments or payments to A not acting as a partner?
    - Partner A receives a set amount in exchange for overseeing work done by others on the Partnership's property.
    - Partner A receives a set amount in exchange for doing certain work on the Partnership's rental properties.
    - Partner A receives a variable amount depending on the time A spends overseeing the work of others.
    - Partner A receives a variable amount depending on time and materials needed for A to do work.
    - Partner A has a separate contract with Partnership to do construction work.

WHY DOES IT MATTER FOR FEDERAL TAX PURPOSES?

- Some payments to a partner not as a partner would have to be capitalized rather than expensed.
- This creates a timing difference, requiring the partnership to recognize the expense over time and, in the meantime, allocate additional income to the partners generally.

WHY DOES IT MATTER FOR STATE TAX PURPOSES?

- *If guaranteed payments are sourced the same as distributive share.*

GUARANTEED PAYMENTS FOR SERVICES VERSUS PAYMENTS FOR CAPITAL

- It's not always clear.
- Example –
  - A, B, and C form a partnership in which they contribute equally and in which they are all active.
  - In Year 5, the partnership needs additional cash and A contributes an additional $10,000.
  - Which of the following represents a guaranteed payment for the use of capital, versus services?
    - Partner A receives a guaranteed payment equal to the amount received by the other participating partners.
    - Partner A receives a guaranteed payment in excess of the other participating partners, but that payment is not calculated based on or dependent on the additional contribution.
    - Partner A receives a guaranteed payment in excess of the other participating partners and the dollar amount of the excess is equal to 5% of the additional contributed capital.

WHY DOES IT MATTER FOR FEDERAL TAX PURPOSES?

- The payment might be characterized as interest expense of the partnership and would be limited by IRC § 163(j).
- If so, the receiving partner must also be allocated the excess amount as income under IRS proposed regulations.

WHY DOES IT MATTER FOR STATE TAX PURPOSES?

- *If guaranteed payments are sourced differently than distributive share only when paid for services.*

OTHER FEDERAL (AND POSSIBLY STATE) TAX ISSUES

- Self-employment issues.
- How are payments made for the partners personal benefit—e.g., healthcare or other benefits—treated? See Rev. Rul. 91-26.
- Disguised sales – which is an issue to which federal anti-abuse rules may apply.
- Federal sourcing – when the payment is for services done outside of the U.S.
- Guaranteed payments made to a partner as retirement benefits may only be taxed by the partner's state of residence. 4 U.S. Code § 114

Summary

- We researched whether there has been state tax litigation over the sourcing of guaranteed payments. The cases we found are listed in the next slide.
- We also researched to see if any states have specific pass-through entity ("PTE") tax provisions on the sourcing of guaranteed payments. For the states that specifically address guaranteed payments in their PTE tax provisions, they generally do so in the context of indicating whether guaranteed payments are included in the base. However, not all states have addressed guaranteed payments in their PTE tax provisions.
- If we have missed anything in our research, please contact Jenn Stosberg at jstosberg@mtc.gov

**Our research should not be relied on as tax advice. For specific questions, please contact your state department of revenue and/or tax advisor.*

CASES

1. **Alabama**: *Tanner & Guin v. Alabama Dep't of Revenue* (Ala. Tax Tribunal May 4, 2015) – guaranteed payments paid to Mississippi attorneys were a part of the distributive share for purposes of composite returns.

2. **New Mexico**: N.M. Public Decision No. 12-12 (April 9, 2012) – resident taxpayer received guaranteed payments for his duties as a CEO member of an LLC. The taxpayer's allocation of the guaranteed payment to New Mexico as compensation was upheld.

3. **New York**: *In re Tosti,* No. 822915 (N.Y. Tax App. Trib. May 12, 2011) – treated guaranteed payments as distributive share citing prior New York decisions on the issue.

4. **Oregon**: *Reeve v. Dep't. of Revenue*, 37 P.3d 981 (Or. 2001) – Washington resident taxpayers characterized payments from an Oregon general partnership for legal services in Washington state as guaranteed payments for services exempt from Oregon tax. The Supreme Court of Oregon determined that guaranteed payments for services made to nonresident partners are considered a distributive shares of partnership profits. See also *Pratt & Larsen Tile v. Dep't. of Revenue*, 13 OTR 270 (Or. Tax 1995).

PTE TAX PROVISIONS ON GUARANTEED PAYMENTS

- Alabama: Frequently Asked Questions on the Alabama Pass-through Entity Tax (June 30, 2022)

  Taxable income includes guaranteed payments . . . Taxable income shall be apportioned in accordance with the provisions of Chapter 27 of Title 40, Code of Alabama 1975.

- Arkansas: Frequently Asked Questions on the Arkansas Pass-through Entity Tax

  Form AR K-1 must be filed for each owner-member of an entity electing to file a PET tax return on Form AR1100PET . . . However, the items of income, deductions, etc., that normally would be included on the owner's Arkansas income tax return should be excluded with the exception of guaranteed payments to partners which are still taxable.

PTE TAX PROVISIONS ON GUARANTEED PAYMENTS

- California: https://www.ftb.ca.gov/file/business/credits/pass-through-entity-elective-tax/index.html#PTE-elective-tax-calculation

  The elective tax is 9.3% of the entity's qualified net income, which is the sum of the pro rata or distributive share and guaranteed payments of each qualified taxpayers' income subject to California personal income tax.

- Connecticut: Conn. Gen. Stat. § 12-699

  For taxable years beginning on or after January 1, 2019, guaranteed payments are included in the calculation of the Standard Base and the Alternative Base for the PTE Tax.

PTE TAX PROVISIONS ON GUARANTEED PAYMENTS

- Kansas: SALT Parity Act FAQ (December 13, 2022)

  Guaranteed payments are included in determining the electing pass-through entity owner's share of distributive income.

- Maryland: Frequently Asked Questions on the Maryland Pass-through Entity Tax (December 27, 2021)

  Equity partners' pro rata share of profits, as well as guaranteed payments to equity or non-equity partners, are included in PTE taxable income. Guaranteed payments are considered distributive income. The deduction for guaranteed payments on federal Form 1065, Line 10 is added back to federal Form 1065, Schedule, K, Line 4.

PTE TAX PROVISIONS ON GUARANTEED PAYMENTS

- Massachusetts: Massachusetts Technical Information Release No. 22-6 (March 18, 2022)

  PTE Excise is imposed on the total amount of an entity's income that passes through to qualified members and that is subject to tax under chapter 62, as reported by the entity to its members on the entity's Massachusetts Schedule K-1s, including guaranteed payments.

- Michigan: Mich. Comp. Laws § 206.815

  Deduct guaranteed payments for services rendered by a member who is an individual to the extent that those guaranteed payments were included in federal taxable income.

PTE TAX PROVISIONS ON GUARANTEED PAYMENTS

- North Carolina: Important Notice Regarding North Carolina's Recently Enacted Pass-Through Entity Tax (December 2, 2022)

  The North Carolina Administrative Code provides that "[a] nonresident individual partner is not required to file a North Carolina individual income tax return when the only income from North Carolina sources is the nonresident's share of income from a partnership doing business in North Carolina, and the manager of the partnership has reported the income of the nonresident partner, including any guaranteed payments made to the partner, and paid the tax due." This rule applies to nonresident partners of Taxed Partnerships to the extent the Taxed Partnership complies with the provisions of new N.C. Gen. Stat. § 105-154.1

- New Jersey: Notice: Gross Income Tax/Corporation Business Tax Pass-Through Business Alternative Income Tax Act (February 7, 2020)

  "Distributive proceeds" means the net income, dividends, royalties, interest, rents, guaranteed payments, and gains of a pass-through entity, derived from or connected with sources within the State.

PTE TAX PROVISIONS ON GUARANTEED PAYMENTS

- New York: New York Technical Service No. TSB-M-21(1)C (August 25, 2021)

  An electing partnership's calculation of its PTE taxable income must include all items of income, gain, loss or deduction, to the extent they would flow through and be included in the taxable income of direct members or partners that are taxable under Article 22, including guaranteed payments.

- Oregon: 2021 Or. Laws, ch. 589 (2021 Or. S.B. 727)

  “Distributive proceeds” means the net income, dividends, royalties, interest, rents, guaranteed payments and gains of a pass-through entity, derived from or connected with sources within this state.

PTE TAX PROVISIONS ON GUARANTEED PAYMENTS

- Rhode Island: R.I. Gen. Laws § 44-11-2.3

  "Net income" means the net ordinary income, net rental real estate income, other net rental income, guaranteed payments, and other business income less specially allocated depreciation and deductions allowed pursuant to § 179 of the United States Revenue Code (26 U.S.C. § 179), all of which would be reported on federal tax form schedules C and E.

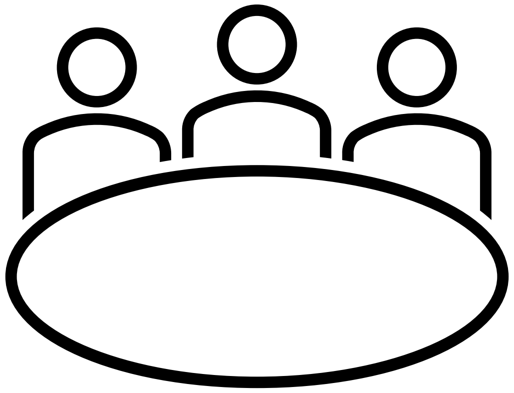
- South Carolina: S.C. Revenue Ruling #21-15; S.C. Code Ann. § 12-6-545

  Active trade or business income or loss does not include . . . payments for services referred to in Internal Revenue Code Section 707(c); amounts reasonably related to personal services. All amounts paid as compensation and all guaranteed payments for services, but not for the use of capital as defined in Internal Revenue Code Section 707(c) are deemed to be reasonably related to personal services. In addition, if an owner of a pass-through entity who performs personal services for the entity is not paid a reasonable amount for those personal services as compensation or payments referred to in Internal Revenue Code Section 707(c), all of the owner's income from the entity is presumed to be amounts reasonably related to personal services. . For purposes of this section, amounts reasonably related to personal services include amounts reasonably related to the personal services of the owner, the owner's spouse, and any person claimed as a dependent on the owner's income tax return.

PTE TAX PROVISIONS ON GUARANTEED PAYMENTS

- Virginia: DRAFT Guidelines for the Pass-through Entity Tax (October 31, 2022)

  An electing PTE's calculation of its PTE taxable income must include all items of income, gain, loss, or deduction, to the extent they would flow through and be included in the income of owners that are taxable under Va. Code §§ 58.1-320 and 58.1-360, as applicable, including guaranteed payments. However, the electing PTE can exclude income from the calculation of PTE taxable income to the extent that the PTE can establish that the amount is properly allocable to an owner who is not subject to tax on such amount under Va. Code §§ 58.1-320 and 58.1-360, as applicable. Two examples are (1) income that is not U.S. sourced and is allocable to nonresident alien partners and, therefore, not included in federal adjusted gross income under the Internal Revenue Code, and (2) retirement income of former partners that is exempt from nonresident state taxation under 4 U.S.C § 114.



INPUT FROM STATES ON THEIR RULES

POSSIBLE NEXT STEPS

- Last time we proposed:
  - Examples – demonstrating the results under different rules and the problems that the lack of uniformity may create for multistate taxpayers.
  - Exploring possible solutions – including credits for taxes paid to other states, reciprocal agreements, etc.
  - But we keep turning over rocks . . .

QUESTIONS - COMMENTS