



# State Tax Treatment of Guaranteed Payments and Related Issues

Multistate Tax Commission

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FOR DISCUSSION PURPOSES ONLY

*This white paper is a draft prepared by the staff of the Multistate Tax Commission (MTC) as part of its uniformity project on state taxation of partnerships, and is subject to revision. This DRAFT version of the white paper is current as of April 16, 2023.*

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# IMPORTANT NOTE: TERMINOLOGY & PARTNERSHIP ACCOUNTING

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*To assist readers of this white paper, we note the way certain terms will be used as well as the importance of partnership accounting, which is more complex than accounting for corporations.*

## **Note on Terms Used in this White Paper**

As used in this white paper, the following terms will have the meaning noted below:

**Partnership** – any entity properly taxed under IRC Subchapter K.

**Partner** – any person (including an individual, corporation, other partnership, trust, charitable organization, etc.) that holds an interest in a partnership.

**Pass-Through Entity** – any entity subject to federal tax on a pass-through basis including a partnership or S corporation.

**Partner Capital Accounts** – the amount of a partner’s share of the partnership assets.

**Outside Basis** – the tax basis of a partner’s interest in a partnership.

**Allocation** – the dividing up of the economic or tax results of a partnership between the partners and assigning shares of income or items to partners.

**Distributive Share** – the share of partnership income (loss) or items of partnership income, expense, gain, or loss allocated to partners according to the rules of Subchapter K. Allocation of income and gains will increase partners’ capital accounts and their outside basis, whereas allocation of expenses and losses will decrease capital accounts and outside basis. Allocation of distributive share may or may not be accompanied by a distribution of cash or property to the partners.

**Contributions** – money, property, or services transferred by a partner to a partnership which are properly treated as contributions to the partner’s capital account (in the case of services—with the recognition of ordinary income to the partner) and which increase the partner’s basis in the partnership interest, or “outside basis.”

**Distributions** – money or property transferred by the partnership to a partner which are properly treated as reductions from the partner’s capital account and which decrease the partner’s outside basis.

**Draws** – annual or other regular periodic distributions.

**Distributive Share/Distributions** – distributive share and distributions, collectively.

**Partner-Partnership Transactions** – transfers of money, property, or services between partners and partnerships in an exchange that would properly be treated as a transaction between unrelated parties for tax purposes—rather than as a contribution/distribution or a guaranteed payment.

**Guaranteed Payments** – money or property transferred by the partnership to a partner for services by the partner in the capacity as a partner or for the use of capital and which are properly treated as such under Subchapter K.

**Sourcing or State Sourcing** – determining the state that will subject multistate income or items to tax.

**Substantive Tax Rules** – refers to the tax rules other than pass-through system created by Subchapter K and may include whether income is taxable or exempt, whether expenses are deductible or are capitalized and amortized, whether items are considered ordinary income (loss) or capital gains or losses, and whether any rules or limitations apply based on the character of the item, such as loss-limitation rules.

Unless otherwise noted, other terms used in this white paper will generally have meanings that are consistent with their use, if any, under IRC Subchapter K or federal income tax rules.

## Note on Partnership Accounting

Like all businesses, partnerships must keep records for both financial (“book”) and tax purposes. While the rules for book and tax accounting may differ somewhat (e.g., the treatment of depreciation expense), the goals are the same—to fairly reflect the partnership’s activities and the partner’s economic arrangement. The book and tax accounting rules needed to do this can be much more complicated than those needed for corporations and shareholders for a number of related reasons, including:

- **Income is taxed on a pass-through basis.** – Rather than requiring the entity to pay tax on its income (loss), Subchapter K imposes tax on each direct or indirect taxpaying partner on their distributive share of the income (loss).
- **Income is taxed when earned, rather than when distributed.** – Unlike corporations, where shareholders are only taxed on their distributions of income, partnership income is taxed once when earned. Not only is taxing distributions simpler and more certain, taxing income once, when earned, requires the tracking of tax paid by the partners so that income is not taxed a second time when distributed.
- **Items making up net income (loss) maintain their character.** – To ensure that partnerships cannot be used to alter the tax treatment of items of income, expense, gain, or loss, this character of items must also be tracked as the items pass through to the partners to be taxed.
- **Partners have flexibility in dividing not just income but separate items.** – Rather than simply dividing net partnership income (loss), partners can agree to divide specific partnership items of income, expense, gain, or loss in different ways.
- **Partners have flexibility in sharing items other than according to capital interests.** – Rather than dividing partnership items proportionally, according to the partners’ current capital interests, partners may agree to divide items in other ways, which may change their capital interests over time.
- **Annual distributions may not match income allocations.** – Distributions need not be made in the year partnership income or items are earned and allocated to partners, and may be made in amounts that are lesser than or greater than the partner’s share of the income or items in the particular year.
- **Partners may receive payments unrelated to income.** – Partners may also receive “guaranteed payments” which are partnership payments that are unrelated to the income of the partnership.
- **Partners may engage in transactions.** – Partners may also engage in transactions with each other or with the partnership as separate persons.
- **There are no limits on the number of partners.** – Unlike S corporations, there are no limits on the number of partners that partnerships may have, so that some partnerships have thousands of partners.
- **Tiered structures are permitted.** – Partnerships can be structured in tiers so that the ultimate tax-paying partners may receive shares of income, indirectly, through other pass-through entities.
- **Partnership agreements may change over time.** – Partners may change their economic arrangements over time as circumstances change or as partners join or leave the partnership.

To accomplish the necessary tracking of and accounting for partnership income, expense, gain, and loss in this system, partnerships must keep detailed information, including partner-specific information, and provide that information to partners annually. The fact that partnerships can exist in large, complex, tiered structures also means that any one partnership’s records may be insufficient to determine the tax effects on a particular tax-paying partner.

Unless otherwise noted, this white paper assumes that the partnership arrangements described have economic substance and are properly accounted for and reported by partnerships and partners. The white paper also generally assumes partnerships described will follow an accrual basis for both tax and book purposes.

# EXECUTIVE SUMMARY

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*This draft white paper is not intended to provide accounting or legal advice to taxpayers and cannot be cited for that purpose. This draft was prepared by the staff of the MTC—Helen Hecht, Chris Barber, and Jennifer Stosberg. Those with questions on the white paper can contact Helen Hecht, at [hhecht@mtc.gov](mailto:hhecht@mtc.gov).*

## **The MTC Partnership Work Group**

This white paper was prepared by the staff of the Multistate Tax Commission with the advice and assistance of a work group of member states established by the MTC uniformity committee. The work group was created to study how states tax the multistate income of partnerships and to recommend how they might do so in a more effective, compatible, and uniform manner—consistent with established state tax policies and the shared principles for dividing multistate income.

## **The Reason for the White Paper**

The workgroup initially developed a comprehensive outline of issues for states taxing partnership income.<sup>1</sup> The outline showed that, for some issues, states rules were lacking or inconsistent. One such issue involves the treatment of what the Internal Revenue Code (IRC) Subchapter K refers to as “guaranteed payments” and how these payments are distinguished from both distributive share/distributions and partner-partnership transactions. The workgroup decided to address the issue of guaranteed payments as part of its review of state sourcing of partnership income.

## **Approach Taken in the White Paper**

Because most states conform to the federal tax treatment of partnerships found in Subchapter K, this white paper contains a general overview of the rules that are most relevant to distinguishing guaranteed payments and their treatment for federal purposes. The paper surveys some of the more common forms of guaranteed payments and how the federal rules distinguish them from distributive share/ distributions and from partner-partnership transactions. Then the paper summarizes the specific rules for the sourcing of guaranteed payments that have been adopted by certain states. Finally, the paper considers the implications of the different state treatment of guaranteed payments and related issues.

## **Summary of Findings and Implications**

States may source income from partnerships in one of three ways—based on the partnership’s activities, the partners’ activities, or the residence or domicile of the partners. In addition, states typically tax 100% of the income of resident individuals and provide a credit for taxes paid on the same income to other states, with certain limitations. Roughly half of the states do not have tax rules that specifically address the sourcing of guaranteed payments. The states that do have such rules are split in how they source those payments.

States that have sourcing rules that distinguish guaranteed payments for purposes of sourcing appear to rely on the characterization of these payments under Subchapter K. But the federal treatment of guaranteed payments has evolved over time and there are still uncertainties in federal rules, especially distinguishing guaranteed payments from the two other categories of transfers between partnerships and partners—distributive share/distributions and partner-partnership transactions. Also, Subchapter K has anti-abuse rules to prevent the use of artificial structures and transactions from changing the intended tax result—which may not be useful in addressing income shifting at the state level.

States may also assume that all guaranteed payments are alike. But partners have flexibility in structuring and organizing their economic agreement—and different partnerships often operate very differently. This has also led to the development of complicated partnership arrangements where the proper application of the rules may not be clear.

And while states are not bound to follow federal sourcing treatment, they must tax foreign partners and partnerships doing business in their states consistently with the dormant foreign commerce clause.

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<sup>1</sup> Available on the project web page, here: <https://www.mtc.gov/Uniformity/Project-Teams/Partnership-Tax>.

# INTRODUCTION & IMPORTANT CONTEXT

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*The issue addressed in this white paper is the state sourcing of guaranteed payments and what states should consider in developing rules for sourcing these payments. This introduction provides important context for this issue.*

## **The Issue – How Should States Source Guaranteed Payments?**

All states source multistate business income (loss) applying formulary apportionment, while using specific rules of assignment for certain items of income. These sourcing rules, in turn, use information about the activities that gave rise to the income. Most states that tax partnership income also follow the federal pass-through system of Subchapter K. When applying formulary apportionment or rules of assignment to partnership-related income, states may look to:

- Activities of the partnership that recognized or incurred the income (loss),
- Activities of the partner, or
- Activities of both the partnership and partner.

In addition, states typically impose tax on 100% of the income of individual resident partners and provide a credit for taxes paid on the same income sourced to and taxed by other states, with certain limitations.

As will be discussed further in this Introduction, states sourcing rules, like the federal tax rules generally, recognize the fundamental difference between activities undertaken by partners through the partnership, which result in distributive share and distributions, versus activities where the partner and partnership may engage in separate transactions as unrelated parties, which result in other income (loss). But guaranteed payments do not clearly fall into either of these two distinct categories. So unless states specifically address guaranteed payments, it may not be clear how those payments should be sourced.

But developing state sourcing rules for guaranteed payments is complicated by the fact that the federal categories are sometimes unclear in both in their design and in application to common partnership arrangements. And, as will be discussed in Section III of this paper, states that have specifically addressed the sourcing of guaranteed payments have developed diverse sourcing rules. All this creates the potential for uncertainty and risk for both states and taxpayers.

## **How Guaranteed Payments Fit into the Federal Tax Framework**

This section considers the conceptual differences between these different categories of partnership-related allocations or transfers and how the pass-through system treats these different categories. It contains an overview of the aggregate and entity theories of partnership taxation and how those theories attempt to mirror the economic substance of the partners' economic arrangement.

### **NOTE – Reference to “Distributive Share/Distributions”**

The federal tax treatment of guaranteed payments is often compared to that of other partnership-related concepts—distributive share, distributions, and partner-partnership transactions. (See how these terms will be used in Note on Terms Used above.) But distributive share and distributions are also closely related and their treatment is more complex, which can cause confusion.

Under Subchapter K, if income (loss) is recognized by the partnership in a particular tax year, the partners will also recognize their share as distributive share in that same year, regardless of whether they also receive any distributions. And because partnership income is taxed once, partners generally do not pay tax on distributions. But partnerships can also make other types of payments to partners that are not properly treated as distributions. In that case, the partners would pay tax when those payments are received. Because the treatment of distributive share and the treatment of distributions are closely related, this white paper will sometimes use the term “distributive share/distributions.”

Conceptually, it may appear that there are clear differences between distributive share/distributions and the other types of partnership payments. But the complexity of some partnership agreements, or other circumstances, can make it difficult to apply these concepts in practice.

## **Three Important Federal Tax Categories of Partnership Allocations and Payments**

Guaranteed payments are not simply an invention of the federal tax system. Partners have long used such payments as part of their economic arrangements. Rather, the tax rules recognize and attempt to reflect the economic substance of those agreements. But when it comes to the tax effects, Subchapter K's rules control.

Under Subchapter K, the allocations or payments to partners may be characterized as:

### **Distributive Share/Distributions**

For federal tax purposes, the allocation of a partner's share of items of partnership income, expense, gain, or loss is called the partner's "distributive share." Partners agree as to how they will share the economic results of the partnership. Partners then pay tax on this distributive share when the items are recognized and reported by the partnership, regardless of whether the partner receives any distribution. And because partnership income is taxed only once, payments to partners that are properly treated as distributions are generally non-recognition events, with certain exceptions.

### **Partner-Partnership Transactions**

When partners and partnerships engage in transactions that are similar to those between unrelated persons, they are treated that way for tax purposes as well. Character, value, timing, etc. are determined under the normal substantive tax rules, as if the partner was not a partner. So if the partnership acquires property or services from a partner, the transaction will give rise to expense, loss, or capitalized expenditure. And for the partner, the transaction will give rise to income, gain, or loss.

### **Guaranteed Payments Made to Partners Acting as Partners**

As will be discussed further below, there is a third category of transfers recognized by Subchapter K which are similar to transactions between unrelated persons but are made when the partner is carrying out some activity as a partner—rather than as an unrelated person. These transfers are called "guaranteed payments" because they are not tied to or dependent upon the partnership's income. Subchapter K recognizes two types of guaranteed payments—payments for services and payments for the use of capital.

The federal tax treatment of each of these categories may be different under both Subchapter K and federal substantive tax rules—so that similar circumstances may lead to a different tax result. Also, the federal rules contain anti-abuse provisions to prevent the use of partnership structures or transactions that would artificially alter the tax result.

## **Employment of Aggregate and Entity Theories**

The state law that governs partnerships employs two different theories of partnerships—the aggregate theory and the entity theory. These theories, in turn, affect the design of particular economic arrangements between partners—and the particular substance of those arrangements.

- **Aggregate Theory:** Under the aggregate theory, partnerships are nothing more than collections of persons acting together. The partnership is not considered separate from the partners.
- **Entity Theory:** Under the entity theory, partnerships are persons separate from the partners. The partnership can, therefore, engage in actions separate from the partners, even in some dealings with the partners.

Because Subchapter K endeavors to match the tax results with the economic arrangement of the partners, it also employs the aggregate and entity theory as part of the pass-through system which it creates. So, to understand why the federal tax rules treat the different types of transfers between partnerships and partners differently, it helps to understand how it employs the two different theories of partnerships—the aggregate and then entity theory—to reflect the partners' economic arrangement.

Note that this application of the aggregate and entity theories will, in turn, affect how the substantive tax rules apply as well as the partners' ultimate tax. One important aspect of the application of aggregate or entity theories in the partnership tax context is the effect on the partners' capital accounts and outside basis. The application of these theories and the different outcomes under each are discussed further below.



## Application to Distributive Share and Related Contributions and Distributions

Traditionally, the rights and duties of partners under state law, toward each other and toward third parties, reflected the view that the partnership was to be treated as an aggregate—so that partners were deemed to engage in any activities collectively. This began to change in the late 20<sup>th</sup> Century, so that the law began to treat partnerships as entities for a certain purposes, and this approach is now reflected in the Uniform Partnership Act as well as state laws generally.<sup>2</sup> But the aggregate theory may still apply to certain aspects of partnerships and to the general economic relationship between partners.

The pass-through system created by Subchapter K also reflects application of the aggregate theory. Partners contributions to the partnership and the partnership's distributions to partners are generally given nonrecognition treatment, with certain exceptions. This nonrecognition treatment is consistent with the partnership as an aggregate as well as the system of taxing partners on their distributive share of the partnership income (loss). Under this approach, the partnership is simply part of an accounting mechanism to track partners' contributions, distributions, and allocations of distributive share. The substantive tax rules will also be applied to the distributive share of partnership items based on the character of those items determined at the partnership level and the partners will be treated as if they earned or incurred the items directly, from the same activities.

The rules of Subchapter K that are employed to carry out this aggregate approach are summarized in very general terms below:

- Transfers by Partners to Partnership—Nonrecognition:
  - Money, assets, or services transferred by a partner to the partnership are contributions;
  - Contributions are generally nonrecognition events, except services exchanged for a capital interest (IRC § 721); and
  - Contributions increase a partner's capital account and tax basis in her partnership interest or "outside basis" (IRC § 722).
- Partners Report and Pay Tax on Shares of Partnership Items Each Year:
  - The partners divide partnership items of income, expense, gain, and loss (IRC § 704);
  - The partners report their shares of these items on their own tax returns (IRC § 702);
  - The items retain their character under the substantive tax rules (IRC § 703), and;
  - These items also affect capital accounts and outside basis (IRC § 705).
- Transfers by Partnership to Partners—Nonrecognition:
  - Money or assets transferred from the partnership to a partner are distributions;
  - Distributions are generally non-recognition events, unless they exceed basis (gains), or are liquidating distributions less than basis (losses), or when other anti-abuse rules apply (See IRC §§ 731, 741, and 737);
  - If gain or loss is realized on distributions, it is generally treated the same as the sale of a partnership interest (IRC § 731); and
  - Distributions decrease a partner's capital account and outside basis (IRC § 733).
- Reporting:
  - The partnership will report –
    - Partnership net income (loss) each year on the IRS Form 1065;
    - Partnership items allocated to partners on Schedule K;
    - Book income and assets on Schedules L and M; and
    - Each partners distributive share and capital account balances on Schedule K-1.
  - The partners will report –
    - Distributive share income as reported to them on Schedule K-1; and
    - Gain/loss, if recognized, on distributions.

<sup>2</sup> See the Uniform Law Commission's summary of changes to the 1997 version of the Act, available here: <https://www.uniformlaws.org/viewdocument/enactment-kit-73?CommunityKey=52456941-7883-47a5-91b6-d2f086d0bb44&tab=librarydocuments>.

## Application to Partner-Partnership Transactions

Although partnerships may still act and be treated as an aggregate of persons, generally, they may also act as separate entities, even in relationship to the partners. Likewise, when a transfer between a partnership and a partner is, in substance, a transaction that is similar to an exchange between unrelated parties, Subchapter K applies the entity theory rather than the aggregate theory. Using the entity theory, the rules require the partner and partnership to separately recognize an exchange, and the following general rules would apply:

- Transfers of Property or Services from Partner to Partnership - Recognition:
  - The transfer will be treated as an exchange between separate persons (IRC § 707(a));
  - Transferring partner, as a separate person, will recognize a taxable event under federal substantive tax rules—as either income, gain, or loss;
  - The transferring partner’s capital accounts and outside basis will not be directly affected.
- Transfers of Money or Property from Partnership to Partner – Recognition as Partnership Item:
  - The transfer is also treated as an exchange between separate persons (IRC § 707(a));
  - Partnership, as a separate person, will recognize a taxable event under federal substantive tax rules—either expense, gain, loss, or capitalized expenditure; and
  - The partnership item of expense, gain, or loss recognized for tax purposes will reduce partnership income and allocations to the partners as distributive share (See IRC § 703 and 704).
- Reporting:
  - The partnership will report expense, gain or loss on the IRS 1065 or capitalized expenditures as an asset on Schedule L;
  - The transferring partner will report income, gain, or loss on the partners personal or business tax return, separate from any partnership income.

## Guaranteed Payments – Aggregate or Entity Theory?

It might seem that any transfer between partners and partnerships will necessarily fall either within either the aggregate or entity approaches described above. But partners may sometimes receive payment not dependent upon the partnership’s annual income which is for services or the use of capital and where the partner is acting in the capacity of a partner, that is—*on behalf* of the partnership—rather than as an unrelated party.

It has always been common, for example, for partners in certain professional services firms to agree that they will not only split partnership income or items, but will also receive payments, not dependent upon partnership income, for the professional services they perform. The ability of partnerships to make payments to partners not dependent upon income allows the partners who perform the business activities of the partnership to be compensated for those activities. But it raises questions about whether the aggregate or entity theories should be applied.

### Background

The federal approach to the treatment of guaranteed payments is discussed in more detail in Section I, below. What is important here is that Subchapter K recognizes these economic arrangements as a third category of transfers or allocations—separate from distributive share/distributions or partner-partnership transactions. These guaranteed payments are payments made to partners, as partners, that are determined “without regard to income of the partnership.” IRC § 707(c).

Before the adoption of IRC 707(c) in 1954, it was less clear in what way such payments would affect the tax results—whether under the aggregate or entity approaches—and whether those tax results would match the economic results, particularly in terms of timing and characterization of income. In part, this is because federal courts have long held that individuals who are partners in a partnership cannot be employees of the partnership, but may be treated as “self-employed.” See. Rev. Rul. 69-184.

Payments made to partners, therefore, would be deductible for the partnership only if the partner was engaged in a service transaction with the partnership as a separate person, and not acting on behalf of the partnership to perform activities of the partnership business. The following simple example demonstrates how a typical economic arrangement between partners involving guaranteed payments might be treated under the entity and aggregate approaches described above.

## Example – Comparing the Approaches to the Economic Result

### Simple Example – Assume That:

- Partners X, Y, and Z agree as follows:
  - Each contributes \$10,000 to form a partnership.
  - X, as the manager, receives \$12,000 per year, regardless of partnership income.
  - The partners agree to split the remaining income, or resulting loss, equally.
  - The partners' will track capital accounts according to this agreement and any liquidating distributions will be made pro rata according to those capital accounts.
- In Year 1, partnership has:
  - \$30,000 of gross receipts
  - \$9,000 of income before subtracting the payment to X
  - \$3,000 of loss after subtracting that payment
- At the beginning of Year 2, the partnership has cash and assets of \$27,000, which it liquidates.

### Economic result:

- X, Y, and Z have beginning capital balances of \$10,000.
- X has income from the partnership of \$12,000, which does not affect X's capital account.
- The partnership has a loss of \$3,000 after subtracting the \$12,000, which X, Y, and Z split.
- Each partner subtracts the \$1,000 loss from their capital balances, leaving \$9,000.
- The partners share of liquidating distributions is \$9,000 each.

### Tax result – entity approach:

- X, Y, and Z have beginning outside basis of \$10,000.
- X recognizes ordinary income of \$12,000, which does not affect X's outside basis.
- Partnership reports a loss of \$3,000 after deducting the \$12,000, which the partners split.
- The \$1,000 loss each partner recognizes reduces their outside basis to \$9,000.
- The partners' liquidating distribution of \$9,000 each is equal to outside basis—resulting in no gain or loss recognized by any of the partners.

### Tax result – aggregate approach:

- X, Y, and Z have beginning outside basis of \$10,000.
- Partnership reports \$9,000 in partnership income without deducting the \$12,000.
- X, Y, and Z each report \$3,000 of partnership income.
- X, Y, and Z have an outside basis after income allocation of \$13,000 each.
- The \$12,000 payment to X is treated as a distribution, reducing X's outside basis to \$1,000.
- The partner's liquidating distribution of \$9,000 each is greater than X's outside basis of \$1,000—resulting in a capital gain of \$ 8,000. (See IRC § 731.)
- The partners' liquidating distribution of \$9,000 each is less than Y and Z's have outside basis of \$13,000—resulting in capital losses of \$4,000. (See IRC § 741).

See the comparison of these results in the table below.

	Economic Result & Entity Approach		Aggregate Approach	
<b>Results for Partner X</b>				
Year 1	Ordinary income	\$12,000	Partnership income	\$3,000
	Partnership loss	(\$1,000)		
	Net ordinary income	\$11,000		
Year 2 (Liquidation)	Gain/loss	\$0	Capital gain	\$8,000
<b>Results for Partners Y &amp; Z (combined)</b>				
Year 1	Partnership loss	(\$2,000)	Partnership income	\$6,000
Year 2 (Liquidation)	Gain/loss	\$0	Capital loss	(\$8,000)

## **Effect of Different Approaches on Partners' Tax Liability**

In the example above, both the entity and aggregate approaches will result in the same total amount of income recognized by the partners—\$9,000. Under the entity approach, however, it will all be ordinary income (loss) and recognized earlier (in the year of the guaranteed payment)—which is closer to the economic result. Under the aggregate approach, in contrast, X will recognize some capital gain and Y and Z will recognize capital losses, the recognition of which is partially delayed until liquidation.

Because the federal substantive tax rules would treat the ordinary income and loss differently than the capital gains and losses, the total tax result will vary further. For example, in Year 1, not only would X would pay less tax under the aggregate approach, since X would not have to report the \$12,000 payment as ordinary income, but that tax difference would not be completely made up in Year 2, since X's income in Year 2 under the aggregate method would be capital gains, which are taxed at a lower federal rate. Likewise, the tax result will be different for Y and Z. Not only will they pay more tax in Year 1 under the aggregate method, but the loss recognized in Year 2 would be a capital loss, the use of which would be subject to limitations.

What this very simple example indicates is that, when it comes to certain arrangements in which partners are paid for services performed on behalf of the partnership, the entity approach to taxation is a better match for the actual economic result than the aggregate approach. Note that federal tax rules apply a slightly different form of the entity approach depending upon whether the payment is for services or for the use of capital. When the payment is for services, it is treated similarly to the payment of compensation. When the payment is for the use of capital, it may be treated similarly to interest.

## **Complexity and Unintended Consequences**

The specific treatment of guaranteed payments under Subchapter K is the subject of Section I of this white paper. But suffice it to say, unlike the simple example above, there are many real-life situations where distinctions must commonly be made between guaranteed payments and distributive share/distributions or from partner-partnership transactions. And there are also more difficult cases where a tax result consistent with the economic result is even less clear—often because the economic deal between the partners is more complicated or because the federal categories have not been precisely defined—but also because there isn't always a clear economic distinction to be drawn in the circumstances.

### **Common Distinctions**

Examples of distinctions that must commonly be made include:

#### **Guaranteed Payments Versus Draws**

A common example of a distinction that must regularly be made is the difference between guaranteed payments and periodic distributions, sometimes called "draws." For example, assume that partners each contribute \$100,000 to a partnership. They also agree that each year, they can take a minimum distribution, or draw, of \$10,000 to the extent of their partnership capital. In a year where the partnership has a loss, the partners might still receive this minimum amount. But that would not make the draw a guaranteed payment—since it would be a distribution paid out of past partnership income or contributed capital.

#### **Guaranteed Payments Versus Special Allocations**

Another common example is the difference between guaranteed payments versus special allocations. It may be the case that the partners have agreed that the income or gains from certain property will be allocated to certain partners (or this may be required under Subchapter K). In this case, certain partners may recognize income or gains in years when the partnership has an overall net loss. But that would not make these allocations of the items of income or gains guaranteed payments.

Alternatively, the partners may agree that a partner that has made a small capital contribution, but will perform services as the manager of the partnership, will receive a larger allocation of income. In this case, that partner may eventually be able to take distributions from capital in excess of any capital that partner may have contributed. But the fact that the partner is performing services as a partner, receives a special allocation of partnership income, and is therefore able to take such distributions will not make the distributions guaranteed payments, assuming the special allocation made to the partner is based on partnership income.

## Guaranteed Payments Versus Partner-Partnership Transactions

A third common example of a distinction that must regularly be made is the difference between guaranteed payments and payments made to a partner not acting in the capacity of a partner. Assume partners in a law firm, organized as a partnership, receive payments every year for legal services they provide to clients of the firm. Those payments may be properly characterized as guaranteed payments. But what if, instead, a partnership that operates a restaurant has, as a partner, a lawyer specializing in employment law. When the restaurant is sued by an ex-employee, that partner acts to defend the restaurant and receives a fee for the service. The fact that the service is performed on behalf of the partnership does not make the payment a guaranteed payment.

### More Difficult Distinctions

Unlike these common distinctions, other economic arrangements between partners may not be as easy to distinguish. Furthermore, it is widely recognized that the federal rules are insufficient to make some of these more difficult distinctions. In part, this is because the particular circumstances may matter.

#### Example:

Assume, for example, that Smith and Jones form a partnership to lease real property. Each contributes \$10,000. Smith also contributes the real property, worth \$90,000, and Jones contributes services to that property, worth \$90,000. Jones also agrees to manage the partnership. Assume the partners generally agree to split partnership income (loss) 50/50, except with certain conditions. Which of the following conditions would be guaranteed payments, either for services or the use of capital, rather than distributive share/distributions or partner-partnership transactions?

1. Smith will receive an amount equal to 5% of his capital balance, provided partnership income is at least \$5,000.
2. Same as 1 except that for every year where the partnership income is less than \$5,000, Smith will receive an additional \$5,000 when partnership income allows.
3. Smith will receive an amount equal to 5% of his capital balance regardless of partnership income.
4. Jones will receive a minimum of either \$10,000 or the first 10% of the partnership income (before the remainder is split 50/50). Assume that in the tax year at issue, the partnership income is \$20,000.
5. Same as 3, except the partnership income is \$19,000.
6. Same as 3, except the partnership income is \$9,000.
7. For growing the business, Jones will receive 5% of partnership *gross* income (rather than net income)—and since the property is already rented out on a long-term lease, the partners expect the partnership's normal profit margin, on a book basis, will be around 20% of gross income. Assume that in the tax year at issue, the partnership gross income is \$200,000 and the partnership paid for \$200,000 of renovations that were capitalized for book purposes, but were fully deductible under tax rules.
8. Jones agrees to do repairs on the property when necessary and, in years where the value of those repairs increases the property's value by 20% or more, will receive a quarter of the value of those repairs as a minimum allocation.
9. Smith agrees to recruit new partners and will receive a payment equal to 2% of the new partner capital contributions made to the partnership.
10. After several years of operation, the partnership plans to sell certain property. The partners agree to have Smith, who is also a real estate broker, market the property and agree to pay him \$10,000 for this service.
11. Same as 10 except Smith will be paid his standard commission of 5%.

## **How the Federal Tax Approach May Affect State Sourcing**

State sourcing of guaranteed payments is discussed in detail in Section III of this white paper. What is important to note here is that while state sourcing rules are independent of federal tax rules, they are often aligned with those rules. This appears to be the result of states and federal rules having a similar aim—to fairly reflect the economic substance of the related activities and income.

### **Distributive Share**

Although it is the partnership that engages in the activities giving rise to these income (loss), under the pass-through tax system, it is the partners who pay the tax. So the timing, value, character, etc., of items of income, expense, gain, and loss are all determined at the partnership level, based on the partnership's activities, those tax attributes pass through to the partners as if the partners engaged in the same activities directly. Similarly, it is also common for states to source partnership income (loss) from multistate activities by looking to the activities of the partnership, and then effectively attributing those partnership activities, and the resulting source of income, to the partners. This is consistent with the aggregate approach to partnership taxation.

### **Partner-Partnership Transactions**

In contrast with distributive share, states will not look to the activities of the partnership when sourcing payments made to partners that are properly treated as transactions between the partners and the partnership. Rather, the activities of the partner will determine the sourcing of those payments. This is consistent with the entity approach used for federal tax purposes. So when a partner recognizes income from a transaction with a partnership that is properly characterized as a transactions between unrelated persons, states will look to the activities of the partner to determine the sourcing of that income.

### **Guaranteed Payments**

States appear to generally conform to the federal substantive tax treatment of guaranteed payments—e.g., treating payments for services as ordinary income. But as Section III discusses in further detail, many states have not specifically addressed the sourcing of guaranteed payments. The majority of those that have addressed the issue source guaranteed payments using the same approach as for distributive share. A minority source guaranteed payments for services as they would compensation for services, with or without limits.

### **Why it Matters**

To the extent distributive share, partner-partnership transactions, and guaranteed payments may be sourced differently, sourcing might be altered without substantial change in the economic relationship.

Example:

- X and Y form a partnership to provide consulting services.
- X and Y have little in the way of expenses other than their time spent and some incidental costs.
- X resides in State 1, which has no income tax. Y resides in State 2, which does have an income tax.
- Most of the partnership's clients are in State 2.
- State 2 sources distributive share on the basis of partnership receipts (sales factor)
- State 2 sources guaranteed payments on the basis of where the partner is located.
- For the first three years, partnership income grows at a rate of 5% per year, and X and Y split that income 50/50.
- Then X and Y agree that, going forward, X will receive a payment for services equal to his average distributive share for the first three years, increased at the rate of 5% per year, regardless of the future partnership income.

Assuming the payment to X, starting in year four, is a guaranteed payment, the sourcing of the income will change even though the essential economic arrangement is unchanged.



# SECTION I: FEDERAL TREATMENT OF GUARANTEED PAYMENTS

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Information in this section comes from multiple sources. In addition to sources cited, see the MTC's project page on state taxation of partnerships, here: <https://www.mtc.gov/Uniformity/Project-Teams/Partnership-Tax>

## **Purpose of this Section I**

Section I provides a summary of the federal tax treatment of guaranteed payments.

### **I. A. Federal Rules**

States generally conform to both the federal substantive tax rules found in the Internal Revenue Code (IRC) and to the federal pass-through system, found in IRC Subchapter K, used to tax partnerships.<sup>3</sup> This Section I. A. describes how the substantive rules and the pass-through system work together. Also, it summarizes particular federal rules applying to guaranteed payments.

### **Background**

As discussed above, under the aggregate theory, partnerships are treated as merely persons acting together. The partnership is not considered an entity separate from the partners. "Since a person could not be regarded as an employer and an employee at the same time under this approach, a partner's compensation for services or salary was considered only a part of his distributive share of partnership profits or losses."<sup>45</sup> If the partnership did not have sufficient profits, the amount paid to the partner in excess of partnership profits were considered as paid from each partner's capital. "To the extent a partner's compensation was considered a return of his own capital, that partner received no taxable income. However, to the extent he was considered to receive the compensation from the capital of his fellow partners, the recipient partner received taxable income and his fellow partners were allowed a deduction for ordinary and necessary business expenses to the extent of their capital depletions."<sup>6</sup> Congress found this method "unrealistic and unnecessarily complicated"<sup>7</sup> and, with the adoption of IRC § 707 as part of the Internal Revenue Code of 1954, moved to an entity theory approach for certain payments to partners.

### **Specific Federal Provisions Relating to Guaranteed Payments**

IRC § 707 provides, in relevant part:

(a) Partner not acting in capacity as partner

(1) In general

If a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this section, be considered as occurring between the partnership and one who is not a partner.

(2) Treatment of payments to partners for property or services

Under regulations prescribed by the Secretary—

(A) Treatment of certain services and transfers of property

If—

(i) a partner performs services for a partnership or transfers property to a partnership,

(ii) there is a related direct or indirect allocation and distribution to such partner, and

(iii) the performance of such services (or such transfer) and the allocation and distribution, when viewed together, are properly characterized as a transaction

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<sup>3</sup> Exceptions are the District of Columbia, New Hampshire, Connecticut, and Texas, which impose entity-level taxes.

<sup>4</sup> *Estate of Tilton v. Commissioner*, 8 B.T.A. 914 (1927).

<sup>5</sup> Treas. Reg. 118, § 39.183-1(b).

<sup>6</sup> *Cagle v. Commissioner*, 63 T.C. 86, 93 (1974)

<sup>7</sup> H. Rept. No. 1337, S. Rept. No. 1622.

occurring between the partnership and a partner acting other than in his capacity as a member of the partnership,

such allocation and distribution shall be treated as a transaction described in paragraph (1).

(B) Treatment of certain property transfers

If—

(i) there is a direct or indirect transfer of money or other property by a partner to a partnership,

(ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and

(iii) the transfers described in clauses (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property,

such transfers shall be treated either as a transaction described in paragraph (1) or as a transaction between 2 or more partners acting other than in their capacity as members of the partnership.

(b) Certain sales or exchanges of property with respect to controlled partnerships

(1) Losses disallowed

...

(2) Gains treated as ordinary income

...

(c) Guaranteed payments

To the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of section 61(a) (relating to gross income) and, subject to section 263, for purposes of section 162(a) (relating to trade or business expenses).

In general, Subchapter K distinguishes guaranteed payments, as discussed below, from payments to a partner not acting as a partner as transactions in exchange for services or property, and also from distributive share. Guaranteed payments for services are also distinguished from guaranteed payments for capital. These distinctions are also important for state treatment and sourcing of guaranteed payments.

### Guaranteed Payments Distinguished from Section 707(a) Payments

Congress added section 707 to the Internal Revenue Code of 1954 to address transactions between partners and partnerships. Section 707(a) provides that when “a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this section, be considered as occurring between the partnership and one who is not a partner.” Section 707(c) provides that, to the extent payment is determined without regard to the income of the partnership, payment to a partner for services or the use of capital will be treated as made to a person who is not a partner for purposes of section 61(a) and 162(a). Under either (a) or (c), the payment will be treated as made to a person who is not a partner, but a number of Code sections treat guaranteed payments differently than 707(a) payments, so the distinction between the two can be critical.

In *Pratt v. Commissioner*, 64 T.C. 204 (1975), aff'd in part, rev'd in part, 550 F.2d 1023 (5th Cir. 1977), the Tax Court distinguished guaranteed payments from 707(a) payments. *Pratt* involved general partners in two limited partnerships that were formed to purchase, develop, and operate two shopping centers. The partnership agreement provided that the general partners receive a fixed percentage of rentals in exchange for performing managerial services. The Tax Court found that these payments were not guaranteed payments under section 707(c) because they were not determined without regard to partnership income. It also found that section 707(a) was not applicable because they “receiv[ed] the management fees for performing services within the normal scope of their duties as general partners pursuant to the partnership agreement.”<sup>8</sup>

“In response to the decision in *Pratt*, the Treasury Department and the IRS issued Rev. Rul. 81-300, 1981-2 C.B. 143 and Rev. Rul. 81-301, 1981-2 C.B. 144 to clarify the treatment of transactions under sections 707(a)

<sup>8</sup> *Pratt v. Commissioner*, 64 T.C. 203, 212 (1975).



and 707(c).<sup>9</sup> Similar to the facts in *Pratt*, Rev. Rul. 81-300 addresses whether a fee paid to partners in exchange for managerial services would be treated as a guaranteed payment when the fee is based on a percentage of gross income. In holding that the management fees are guaranteed payments under section 707(c), the Service found that “the term ‘guaranteed payment’ should not be limited to fixed amounts. A payment for services determined by reference to an item of gross income will be a guaranteed payment if, on the basis of all of the facts and circumstances, the payment is compensation rather than a share of partnership profits.”<sup>10</sup>

In Rev. Rul. 81-301 the partnership has two classes of general partner: (1) director general partners and (2) one adviser general partner. The director partners have complete and exclusive control over the management, conduct, and operation of the partnership’s activities. Subject to the supervision of the directors, the adviser is only authorized to manage the partnership’s investments. In exchange for those services, the partnership agreement provides that the adviser partner receives an allocation of 10% of the partnership’s daily gross income. The adviser partner provides similar services to others as part of its regular trade or business. Its management of the partnership’s investment activities is supervised by the directors, and should a majority of the directors choose, the adviser can be relieved of its investment management duties and right to compensation. Based on the foregoing facts, the ruling held that the adviser partner’s allocation is properly treated as paid to the adviser in its capacity other than as a partner under section 707(a).<sup>11</sup>

### Payments to Partners for Property or Certain Services

As part of the Deficit Reduction Act of 1984 (the “Act”), Congress added section 707(a)(2) to address concerns that partnerships “had been used effectively to circumvent the requirement to capitalize certain expenses, and other rules and restrictions concerning various types of expenses, by making allocations of income and corresponding distributions in place of direct payments for property or services.”<sup>12</sup> The Act provided “that under Treasury regulations, if (1) a partner performs services for, or transfers property to, a partnership, (2) there is a related direct or indirect partnership allocation and distribution to the partner, and (3) when viewed together, the performance of such services (or the transfer of such property) and the allocation/distribution are properly characterized as a transaction between the partnership and a partner acting in a non-partner capacity, the transaction is to be treated as a transaction between the partnership and a person who is not a partner.”<sup>13</sup>

#### *Disguised Payments for Services*

“Section 707(a)(2) grants the Secretary broad regulatory authority to identify transactions involving disguised payments for services under section 707(a)(2)(A).”<sup>14</sup> In 2015, the IRS issued proposed regulations that provide guidance about when an arrangement will be treated as a disguised payment for services. Section 1.07-2(b)(1) of the proposed regulations provides:

“An arrangement will be treated as a disguised payment for services if—

- (i) A person (service provider), either in a partner capacity or in anticipation of becoming a partner, performs services (directly or through its delegate) to or for the benefit of a partnership;
- (ii) There is a related direct or indirect allocation and distribution to such service provider; and
- (iii) The performance of such services and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a person acting other than in that person’s capacity as a partner.”<sup>15</sup>

According to paragraph (c), all facts and circumstances should be considered in determining whether an arrangement constitutes a payment for services, but the most important factor is whether the

<sup>9</sup> C.B. 2015-32

<sup>10</sup> Rev. Rul. 81-300.

<sup>11</sup> Congress specifically addressed the holdings in Rev. Rul. 81-300 and 81-301 as part of the Deficit Reduction Act of 1984. Congress affirmed Rev. Rul. 81-301, but it concluded that the payment in Rev. Rul. 81-300 should have been properly characterized as a section 707(a) payment. As a result, the Treasury Department obsoleted Rev. Rul. 81-300 when it issued proposed regulations under the newly enacted section 707(a)(2)(A).

<sup>12</sup> JCS-41-84

<sup>13</sup> 704, H.R. Rep. No. 432 (Pt. 2), 98th Cong., 2d Sess. 1216–21 (1984) (H.R. Rep.); S. Prt. No. 169 (Vol. 1), 98th Cong., 2d Sess. 223–32 (1984) (S. Prt.).

<sup>14</sup> C.B. 2015-32

<sup>15</sup> Proposed Treasury Regulations, IRS Proposed Regulations (REG-115452-14, July 23, 2015) on Disguised Payments for Services

arrangement has significant entrepreneurial risk. “An arrangement that has significant entrepreneurial risk will generally not constitute a payment for services unless other factors establish otherwise.”

### *Disguised Sales of Property*

According to Treas. Reg. § 1.707-3(b)(1), “A transfer of property (excluding money or an obligation to contribute money) by a partner to a partnership and a transfer of money or other consideration (including the assumption of or the taking subject to a liability) by the partnership to the partner constitute a sale of property, in whole or in part, by the partner to the partnership only if based on all the facts and circumstances-

- 1.707-3(b)(1)(i)— The transfer of money or other consideration would not have been made but for the transfer of property; and
- 1.707-3(b)(1)(ii)— In cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.”

Paragraph (b)(2) of the regulation provides nine facts and circumstances that indicate whether a transfer of property should constitute a sale, including:

- 1.707-3(b)(2)(i)— That the timing and amount of a subsequent transfere are determinable with reasonable certainty at the time of an earlier transfer;
- 1.707-3(b)(2)(ii)— That the transferor has a legally enforceable right to the subsequent transfer;
- 1.707-3(b)(2)(iii)— That the partner's right to receive the transfer of money or other consideration is secured in any manner, taking into account the period during which it is secured;
- 1.707-3(b)(2)(iv)— That any person has made or is legally obligated to make contributions to the partnership in order to permit the partnership to make the transfer of money or other consideration;
- 1.707-3(b)(2)(v)— That any person has loaned or has agreed to loan the partnership the money or other consideration required to enable the partnership to make the transfer, taking into account whether any such lending obligation is subject to contingencies related to the results of partnership operations;
- 1.707-3(b)(2)(vi)— That the partnership has incurred or is obligated to incur debt to acquire the money or other consideration necessary to permit it to make the transfer, taking into account the likelihood that the partnership will be able to incur that debt (considering such factors as whether any person has agreed to guarantee or otherwise assume personal liability for that debt);
- 1.707-3(b)(2)(vii)— That the partnership holds money or other liquid assets, beyond the reasonable needs of the business, that are expected to be available to make the transfer (taking into account the income that will be earned from those assets);
- 1.707-3(b)(2)(viii)— That partnership distributions, allocations or control of partnership operations is designed to effect an exchange of the burdens and benefits of ownership of property;
- 1.707-3(b)(2)(ix)— That the transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner's general and continuing interest in partnership profits; and
- 1.707-3(b)(2)(x)— That the partner has no obligation to return or repay the money or other consideration to the partnership, or has such an obligation but it is likely to become due at such a distant point in the future that the present value of that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner.

Sections 1.707-3(c) creates a presumption that property transferred by a partner to a partnership in exchange for money or other consideration are presumed to be a sale of the property if the transfers occur within a two-year period of each other. Conversely, section 1-707-3(d), creates a presumption that a transfer is not a sale when property is transferred to a partnership by a partner in exchange for consideration if the transfers are more than two years apart.

## Guaranteed Payments Distinguished from Regular Distributive Share

IRC § 704 generally governs distributive share and provides:

(a) Effect of partnership agreement

A partner's *distributive share of income, gain, loss, deduction, or credit* shall, except as otherwise provided in this chapter, be determined by the partnership agreement.

(b) Determination of distributive share

A partner's distributive share . . . *shall be determined in accordance with the partner's interest* in the partnership (determined by taking into account all facts and circumstances), if—

(1) the partnership agreement does not provide as to the partner's distributive share . . . , or

(2) *the allocation to a partner under the agreement . . . does not have substantial economic effect.*

### *Federal Income Sourcing*

Historically, one of the most notable differences between allocations of distributive share and treatment as guaranteed payments has been for purposes of federal income sourcing. Compensation for labor or personal services performed outside the United States is treated as foreign source income for federal purposes.<sup>16</sup> And guaranteed payments are only treated as made to a person who is not a member of the partnership for purposes of IRC § 61(a) (relating to gross income) and IRC § 162(a) (relating to trade or business expenses). “For the purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner's distributive share of ordinary income.”<sup>17</sup>

In *Miller v. Commissioner*, 52 T.C. 752 (1969), the Tax Court examined the interplay of these provisions. The taxpayer was the managing member of a partnership's Paris office. He received guaranteed payments for services that were performed outside of the United States, and he attempted to exclude those payments from U.S. source income under IRC § 911(b) as earned income received from sources outside the United States. The IRS argued that IRC § 707(c) limits the treatment of payments as made to one who is not a member of the partnership to IRC §§ 61(a) and 162(a), and as a result, the taxpayer could not exclude the payments under 911(b). Instead, the payments should be treated as distributive share income and sourced at the partnership level. In holding for the taxpayer, the Tax Court found that “treating the guaranteed payments as compensation for purposes of 911 carries out the purposes of both that section and 707(c). Since 707(c) makes such payments taxable as compensation, it seems reasonable to conclude that other provisions relating to the tax treatment of such compensation are also applicable.”<sup>18</sup>

Since *Miller*, the IRS has formulated administrative rules for when it will consider the foreign earned income exclusion of IRC § 911 applicable to guaranteed payments and when how the limits of 911(b)(2)(D), which caps the amount (at \$80,000 adjusted for inflation), will be computed and applied. The rules also provide that the individual must have a tax home in a foreign country, must meet either the bona fide residence or physical presence test, and must make a valid election.<sup>19</sup>

### *IRC §199A Qualified Business Income Deduction*

Another notable difference between allocations of distributive share and treatment as guaranteed payments is for purposes of the IRC § 199A Qualified Business Income (“QBI”) deduction. As in *Miller*, other courts have examined the “but only for” language of IRC § 707(c) with mixed results.<sup>20</sup> But with the passage of the Tax Cuts and Jobs Act (“TCJA”) Congress preempted any confusion and expressly

<sup>16</sup> IRC § 862(a)(3).

<sup>17</sup> Treas. Reg. § 1.707-1(c).

<sup>18</sup> *Miller v. Commissioner*, 52 T.C. at 762.

<sup>19</sup> See IRS LB&I International Practice Service Process Unit – Audit, Calculating Foreign Earned Income Exclusion – Partner in a Partnership with Foreign Earned Income; available here: [https://www.irs.gov/pub/int\\_practice\\_units/ito\\_p\\_09\\_06\\_05\\_19.pdf](https://www.irs.gov/pub/int_practice_units/ito_p_09_06_05_19.pdf). This publication also provides a useful summary of the applicable laws and regulations that the IRS will use determining of the guaranteed payment is of the type that should be subject to the foreign-sourcing treatment.

<sup>20</sup> *Armstrong v. Phinney*, 394 F.2d 661; *Kampel v. Commissioner*, 72 T.C. 827 (1979).

provided that qualified business income under 199A does not include “any guaranteed payment described in 707(c) paid to a partner for services rendered with respect to the trade or business.”<sup>21</sup> Conversely, distributive share income is expressly included as qualified business income under that section.<sup>22</sup>

### **Retirement Income**

Under 4 U.S.C. § 114, no state may impose an income tax on the retirement income of a nonresident individual. Retirement income includes certain payments made to a retired partner in recognition of prior service. So, under some circumstances, states could be preempted from taxing guaranteed payments to retired nonresident partners. Section 114(b)(1)(I) provides that this rule applies if such income—

“(i) is part of a series of substantially equal periodic payments (not less frequently than annually which may include income described in subparagraphs (A) through (H)) made for—

(I) the life or life expectancy of the recipient (or the joint lives or joint life expectancies of the recipient and the designated beneficiary of the recipient), or

(II) a period of not less than 10 years, or

“(ii) is a payment received after termination of employment and under a plan, program, or arrangement (to which such employment relates) maintained solely for the purpose of providing retirement benefits for employees in excess of the limitations imposed by 1 or more of sections 401(a)(17), 401(k), 401(m), 402(g), 403(b), 408(k), or 415 of such Code or any other limitation on contributions or benefits in such Code on plans to which any of such sections apply.

“The fact that payments may be adjusted from time to time pursuant to such plan, program, or arrangement to limit total disbursements under a predetermined formula, or to provide cost of living or similar adjustments, will not cause the periodic payments provided under such plan, program, or arrangement to fail the “substantially equal periodic payments” test.”

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<sup>21</sup> IRC § 199A(c)(4)(B).

<sup>22</sup> IRC § 199A(f)(1)(A)(ii).

## SECTION II. REPORTED AMOUNTS OF GUARANTEED PAYMENTS

IRS Partnership Statistics, available here: <https://www.irs.gov/statistics/soi-tax-stats-partnership-statistics>, provide information on partnership income and guaranteed payments as of 2020. These statistic show that in that year, total guaranteed payments were \$74 Billion.

### Percentage of Total Net Income

For 2020, total partnership net income, including both business and portfolio income, adding back the amount of guaranteed payments, equals \$834 Billion. Guaranteed payments, as a percentage of this \$834 Billion of partnership net income, is 9%.

### Rankings by Industry

The simple ranking in terms of total amounts, shown here, indicates that industries with the highest guaranteed payments are:

- professional, scientific, and technical services
- finance and insurance, and
- health care and social assistance.

But ranking industries by amount does not necessarily indicate the prevalence of guaranteed payments in that industry because industries also vary by size. Rankings relative to the size of the industry are difficult, however, because some industries have a total partnership net loss or pay out guaranteed payments in excess of the net income.

So the tables on the following pages provide two different rankings. The first is based on guaranteed payments as a percentage of gross partnership business income. The second ranking is based on total partnership net income after adding back guaranteed payments—showing those industries where the industry has a net loss separately.

IRS SOI - Partnership Statistics by Industry - 2020	
Comparison of Guaranteed Payments	
By Industry	Guaranteed Payments
Professional, scientific, and technical services	\$ 25,256,022.00
Finance and insurance	\$ 16,286,777.00
Health care and social assistance	\$ 8,169,592.00
Manufacturing	\$ 3,738,354.00
Information	\$ 2,818,465.00
Construction	\$ 2,589,963.00
Real estate and rental and leasing	\$ 2,573,676.00
Wholesale trade	\$ 2,366,168.00
Retail trade	\$ 1,944,790.00
Accommodation and food services	\$ 1,423,867.00
Arts, entertainment, and recreation	\$ 1,322,307.00
Management of companies (holding companies)	\$ 1,098,344.00
Transportation and warehousing	\$ 1,059,836.00
Administrative and support and waste management and remediation services	\$ 1,050,994.00
Educational and Other services	\$ 951,711.00
Agriculture, forestry, fishing, and hunting	\$ 684,961.00
Mining	\$ 469,369.00
Utilities	\$ 239,072.00
All Industries	\$ 74,044,268.00

The rankings relative to gross business income, below, indicate, again, that professional, finance, and healthcare industry categories rank the highest. Here, for all industries, guaranteed payments vary from less than 1% to almost 4% of gross business income.

<b>IRS SOI - Partnership Statistics by Industry - 2020</b>			
<b>Comparison of Guaranteed Payments</b>	<b>(In thousands of dollars)</b>		
<b>By Industry</b>	<b>Gross Business Income</b>	<b>Guaranteed Payments</b>	<b>Percentage of Gross</b>
Professional, scientific, and technical services	\$ 646,329,822.00	\$ 25,256,022.00	3.91%
Finance and insurance	\$ 584,778,654.00	\$ 16,286,777.00	2.79%
Health care and social assistance	\$ 383,678,038.00	\$ 8,169,592.00	2.13%
Arts, entertainment, and recreation	\$ 80,146,652.00	\$ 1,322,307.00	1.65%
Management of companies (holding companies)	\$ 70,286,567.00	\$ 1,098,344.00	1.56%
Educational and other services	\$ 63,589,236.00	\$ 951,711.00	1.50%
Agriculture, forestry, fishing, and hunting	\$ 57,946,634.00	\$ 684,961.00	1.18%
Real estate and rental and leasing	\$ 274,667,476.00	\$ 2,573,676.00	0.94%
Accommodation and food services	\$ 209,507,048.00	\$ 1,423,867.00	0.68%
Information	\$ 436,328,761.00	\$ 2,818,465.00	0.65%
Administrative, support, waste management, remediation services	\$ 164,616,741.00	\$ 1,050,994.00	0.64%
Construction	\$ 466,048,521.00	\$ 2,589,963.00	0.56%
Transportation and warehousing	\$ 247,199,013.00	\$ 1,059,836.00	0.43%
Manufacturing	\$ 990,435,296.00	\$ 3,738,354.00	0.38%
Wholesale trade	\$ 761,662,112.00	\$ 2,366,168.00	0.31%
Retail trade	\$ 699,536,817.00	\$ 1,944,790.00	0.28%
Mining	\$ 181,458,905.00	\$ 469,369.00	0.26%
Utilities	\$ 224,054,956.00	\$ 239,072.00	0.11%
<b>All Industries</b>	<b>\$ 6,542,271,249.00</b>	<b>\$ 74,044,268.00</b>	<b>1.13%</b>

The rankings relative to total partnership net income (loss), below, tell a slightly different story. In four industries, either the industry has a net loss after adding back guaranteed payments, or guaranteed payments exceed net income after adding back guaranteed payments (that is, the payments create an industry loss)—accommodations and food services, arts and entertainment, transportation, and utilities. For the remaining industries, the percentage of guaranteed payments relative to this net income amount varies widely—from 1.7% to almost 50%. Using this approach, the highest ranking industry, after removing the four noted, is educational and other services – at 49.53%. The next, agricultural, is less than half that – at 23.15%. And, using this ranking, the finance industry, which is the largest industry by net income, ranks second from last in terms of guaranteed payments.

<b>Comparison of Guaranteed Payments</b>		(In thousands of dollars)			
<b>By Industry</b>	<b>Total Partnership Net Income (Loss)</b>	<b>Guaranteed Payments</b>	<b>Total Partnership Net Income (Loss) Adding Back Guaranteed Payments</b>	<b>Percentage</b>	
Accommodation and food services	\$ (29,785,115.00)	\$ 1,423,867.00	\$ (28,361,248.00)	N/A	
Arts, entertainment, and recreation	\$ (10,269,954.00)	\$ 1,322,307.00	\$ (8,947,647.00)	N/A	
Transportation and warehousing	\$ (690,286.00)	\$ 1,059,836.00	\$ 369,550.00	N/A	
Utilities	\$ (18,632,782.00)	\$ 239,072.00	\$ (18,393,710.00)	N/A	
Educational and Other services	\$ 969,718.00	\$ 951,711.00	\$ 1,921,429.00	49.53%	
Agriculture, forestry, fishing, and hunting	\$ 2,273,923.00	\$ 684,961.00	\$ 2,958,884.00	23.15%	
Manufacturing	\$ 15,514,829.00	\$ 3,738,354.00	\$ 19,253,183.00	19.42%	
Real estate and rental and leasing	\$ 13,163,255.00	\$ 2,573,676.00	\$ 15,736,931.00	16.35%	
Health care and social assistance	\$ 42,163,140.00	\$ 8,169,592.00	\$ 50,332,732.00	16.23%	
Professional, scientific, and technical services	\$ 131,913,101.00	\$ 25,256,022.00	\$ 157,169,123.00	16.07%	
Construction	\$ 17,858,816.00	\$ 2,589,963.00	\$ 20,448,779.00	12.67%	
Wholesale trade	\$ 19,242,806.00	\$ 2,366,168.00	\$ 21,608,974.00	10.95%	
Administrative and support and waste management and remediation services	\$ 10,402,216.00	\$ 1,050,994.00	\$ 11,453,210.00	9.18%	
Retail trade	\$ 20,628,040.00	\$ 1,944,790.00	\$ 22,572,830.00	8.62%	
Management of companies (holding companies)	\$ 18,529,939.00	\$ 1,098,344.00	\$ 19,628,283.00	5.60%	
Information	\$ 58,158,936.00	\$ 2,818,465.00	\$ 60,977,401.00	4.62%	
Finance and insurance	\$ 441,635,920.00	\$ 16,286,777.00	\$ 457,922,697.00	3.56%	
Mining	\$ 27,176,360.00	\$ 469,369.00	\$ 27,645,729.00	1.70%	
All Industries	\$ 760,252,862.00	\$ 74,044,268.00	\$ 834,297,130.00	8.88%	



## SECTION III. STATE SOURCING RULES

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*Information in this section comes from state statutes, regulations, cases, form instructions, and guidance. This section should not be relied on as tax advice. For specific questions, contact the applicable state department of revenue or a tax advisor.*

### **Purpose of this Section III**

Since the federal partnership rules do not address the state sourcing of guaranteed payments, state specific rules can provide clarity on how guaranteed payments should be treated at the state level. This section summarizes the rules in states that have addressed the sourcing of guaranteed payments. Roughly half the states have not yet explicitly addressed the sourcing of guaranteed payments.

### **III. A. Summary of Guaranteed Payment Issues Addressed by States**

State guaranteed payment rules take varying approaches. This subsection III. A. summarizes the issues states can address in guaranteed payments rules and analyzes the current status of state rules on these issues. The specific state provisions are set forth in Section III. B. below.

#### **Are Guaranteed Payments for Services Generally Sourced the Same as Distributive Share?**

Twenty-one (21) states have rules indicating that guaranteed payments for individual services are generally sourced the same as distributive share (Alabama, California, Georgia, Illinois, Maine, Maryland, Massachusetts, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, New York, North Carolina, Ohio, Oregon, Pennsylvania, Rhode Island, Utah, Vermont, and West Virginia).

#### **If Guaranteed Payments for Services are not Sourced the Same as Distributive Share, how are they Sourced?**

Six (6) states source guaranteed payments for services where the individual services are performed (Colorado, Michigan, Montana, New Mexico, South Carolina, and Virginia). Two (2) states use a hybrid approach for the sourcing of guaranteed payments for services (Idaho and North Dakota). Idaho sources the first \$250,000 of a guaranteed payment to an individual partner as compensation for services, and any amount in excess of that is sourced like distributive share based upon the Idaho apportionment factor of the partnership. The \$250,000 amount is indexed annually for inflation. North Dakota sources guaranteed payments for services as distributive share, except for professional service partnerships where guaranteed payments are sourced as compensation in an amount attributable to a reasonable salary.

#### **Are there any Rules Limiting the Sourcing for Guaranteed Payments for Services?**

Four (4) states have specific sourcing rules for guaranteed payments for services involving retired partners (Idaho, Montana, New Jersey, and Pennsylvania). 4 U.S.C. § 114 may also impact state tax sourcing and provides that “[n]o State may impose an income tax on any retirement income of an individual who is not a resident or domiciliary of such State.”

#### **Are Guaranteed Payments for Services Included in the Payroll Factor?**

Most states either do not have a payroll factor or do not have a provision specifically addressing how guaranteed payments for services should be treated for purposes of the payroll factor. However, California has a special payroll factor rule for guaranteed payments to a partner who renders professional services to a partnership engaged in the practice of a profession. Oregon also has a rule including certain guaranteed payments representing compensation for services for payroll factor purposes.

#### **If Guaranteed Payments for Services are Sourced as Compensation either Generally or for Pass-through Entity Tax Purposes—does the State also give a Credit to Residents for Tax Paid to Another State on a portion of the Guaranteed Payment Sourced to that State?**

There is not a clear answer to this question. Clear statutory language about the treatment of guaranteed payments in resident credit provisions would reduce this uncertainty. Although most states have resident credits and approximately 28 states may allow the resident credit for pass-through entity taxes paid by the entity in another state—when the credit requirements are otherwise met—these states do not generally have language about guaranteed payments in their resident credit rules. An exception is Michigan which has language allowing the resident credit for certain guaranteed



payments if the credit requirements are otherwise met. See Michigan Revenue Administrative Bulletin No. 1988-31. However, Michigan does not have a rule allowing the resident credit in the pass-through entity tax context.

### **Are Guaranteed Payments for the Use of Capital Sourced the Same as Distributive Share?**

The states that address guaranteed payments for the use of capital generally source these types of payments the same as distributive share (California, Georgia, Idaho, Illinois, Maine, Maryland, Minnesota, Mississippi, Missouri, Montana, Nebraska, New Jersey, New York, North Carolina, North Dakota, Oregon, Rhode Island, Utah, Vermont, and West Virginia).

### **If Guaranteed Payments for the Use of Capital are not Sourced the Same as Distributive Share, how are they Sourced?**

Michigan and Pennsylvania allocate guaranteed payments for the use of capital to a nonresident partner based on domicile. In Colorado, guaranteed payments for the use of capital are allocated or apportioned based on the income-generating activity. However, many states do not specifically address the sourcing of guaranteed payments for the use of capital.

### **Are Guaranteed Payments Sourced Consistently for Pass-through Entity Tax Purposes?**

In the pass-through entity tax context, sixteen (16) states have addressed whether guaranteed payments are included or excluded from the pass-through entity tax base (Alabama, California, Connecticut, Kansas, Maryland, Massachusetts, Michigan, New Jersey, New Mexico, New York, North Carolina, Oregon, Rhode Island, South Carolina, Virginia, and Wisconsin). The other states with pass-through entity taxes do not address guaranteed payments.

If the pass-through entity tax base is apportioned and the guaranteed payment is included in the base, presumably guaranteed payments would be sourced the same as distributive share. For instance, Alabama has a pass-through entity tax rule stating that taxable income includes guaranteed payments and that taxable income is apportioned.

The treatment of guaranteed payments for pass-through entity tax purposes is important to consider for ensuring consistency in sourcing. For instance, if a state taxes guaranteed payments like compensation for personal income tax purposes but as distributive share for pass-through entity tax purposes, the pass-through entity tax election could become, in effect, a sourcing election.

## **III. B. State Rules on Guaranteed Payments**

This subsection III. B. sets forth the detailed rules in states that have explicitly addressed the sourcing of guaranteed payments in statutes, regulations, cases, form instructions, or guidance.

### **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.

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.

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### **California**

Cal. Rev. & Tax. Code § 17854

For purposes of computing "taxable income of a nonresident or part-year resident" under paragraph (1) of subdivision (i) of Section 17041, in the case of a nonresident partner, guaranteed payments, as defined by Section 707(c) of the Internal Revenue Code, shall be included in that

computation as gross income from sources within this state in the same manner as if those payments were a distributive share of that partnership.

Cal. Code Regs. tit. 18, § 17951-4

(g) For taxable years beginning on or after January 1, 2013, all business income is subject to the single sales factor apportionment formula pursuant to Section 25128.7, Revenue and Taxation Code, unless subdivision (b) of Section 25128, Revenue and Taxation Code, applies. If a sole proprietorship or partnership described in subsections (c) or (d) is engaged in the practice of a profession within the meaning of subsection (h), below, the payroll factor, where applicable, of the applicable apportionment formula shall include 60% of the net income of a sole proprietorship or 60% of the distributive share of partnership income of each partner rendering professional personal services to the partnership. For purposes of the payroll factor the net income of a sole proprietorship and a partner's distributive share of partnership income shall consist only of income properly classifiable as business income. The amount so determined is deemed to be compensation paid to an employee for purposes of the payroll factor only. If a partner does not render professional services to the partnership, no part of such partner's distributive share of partnership income shall be taken into account in the payroll factor. The amount deemed to be compensation paid to an employee shall be included in the denominator of the payroll factor and in the California numerator of the payroll factor if the principal location of such partner is in this state.

Guaranteed payments to a partner who renders professional services to a partnership engaged in the practice of a profession (within the meaning of subsection (h) below) shall be treated as part of the partner's distributive share of partnership income and has a source in this state in the same manner as a distributive share properly classified as business income and shall be apportioned under subsection (d), as modified under subsection (g). In computing the payroll factor of a partner who renders professional services to such a partnership and receives a guaranteed payment, 60 percent of the sum of the partner's distributive share of partnership income properly classified as business income, and the partner's guaranteed payment, shall be deemed to be compensation paid to an employee. The amount deemed to be compensation shall be included in the denominator of the payroll factor and in the California numerator of the payroll factor if the principal location of such partner is in this state . . .

(h) The practice of law, accounting, medicine or the performance of personal services in scientific and engineering discipline and the practice of any other profession in which capital is not a material income producing factor and in which more than 80% of business gross income for the taxable year is derived from personal services actually rendered by the individual or partners shall be deemed a profession for purposes of subsection (g), above.

(i) Rules and Definitions. To give effect to the foregoing, the following rules and definitions will be applied:

(1) Other Professions Defined. For purposes of this regulation, the term "other profession" includes any occupation or vocation in which a professed knowledge of some department of science or learning, gained by a prolonged course of specialized instruction and study, is used by its practical application to the affairs of others, either advising, guiding or teaching them, and in serving their interests or welfare in the practice of an art or science founded on it. The word "profession" implies attainments in professional knowledge as distinguished from mere skill and the application of knowledge to uses for others as a vocation. The performing of services dealing with the conduct of business itself, including the promotion of sales or services of such business and consulting services, does not constitute the practice of a profession even though the services involve the application of a specialized knowledge.

(2) Capital as a Material Income Producing Factor. Whether capital is a material income producing factor in the production of the income of a profession (other than law, medicine, dentistry or architecture) is to be determined by the use to which the capital is put. Ordinarily, the use of capital in a professional activity or occupation will not be considered as a material income producing factor if it is used only to defray current operating expenses such as paying salaries of assistants, rent, traveling and other incidental expenses or for investment in furniture, machines, tools and equipment essential to the carrying on of the professional activity. Capital is a material income producing factor if a substantial portion of the gross income from the occupation is attributable to the employment of capital in the business. This is

ordinarily the case where substantial inventory or substantial investment in plant, machinery or other equipment is required.

(3) Gross Income Derived From Personal Services of an Individual or Partner. For purposes of determining whether more than 80% of the unincorporated business gross income is derived from personal services actually rendered by an individual or partner, gross income from the professional practice will be deemed derived from the personal services rendered by an individual or partner if such income is personal service income as distinguished from income attributable to the sale of property or to the use of capital and such income represents fees or charges for professional services personally rendered by the individual or partner or professional fees or charges for services which are attributable to the professional activities of the individual or partner. In cases where an individual or partner employs assistants to perform part of the professional work, fees or charges relating to the services of the assistants will be attributed to the individual or partner provided the individual or partner (A) gives personal attention to the work of the business, (B) consults with clients or patients, (C) devises the work program, outlines work methods and guides and directs the work procedure of the employees in the activity, and (D) supervises the formulation of advice, conclusions and reports to clients or patients as the person responsible for the services performed by the business or establishment; or provided that some combination of the foregoing and/or other activities shows that the services of the employees are merely incidental to the practice of the profession by the individual or partner. Where the profession is carried on by a sole proprietorship or partnership, income or fees relating to work performed by employees will be attributable to an individual or partner only if, in addition to the conditions enumerated above with respect to individuals or partners, it is shown that the clients or patients are advised by an individual or partner and look to an individual or partner as being responsible for the services performed.

For example, where an accounting partnership employs assistants to do much of the detail work of making surveys, studies, audits, or other work ordinarily and customarily performed as an incident to the practice of the profession involved, income from professional charges based on services of the assistants will be deemed to be income derived from the services of the partners if a partner accepts the engagement or employment, supervises and directs the work, confers with clients, and prepares and edits or completes and approves the reports. Where the nature and character of the service rendered by the assistants is such that the services are rendered without any substantial control by a partner, such services will not be considered attributable to the partner for the purposes of this subsection.

#### Cal. Rev. & Tax. Code § 19900(a)

(1) For taxable years beginning on or after January 1, 2021, and before January 1, 2026, a qualified entity doing business in this state, as defined in Section 23101, and that is required to file a return under Section 18633, 18633.5, or subdivision (a) of Section 18601, may elect to annually pay an elective tax according to or measured by its qualified net income, defined in paragraph (2), computed at the rate of 9.3 percent for the taxable year for which the election is made.

(2) For purposes of this section, the "qualified net income" of a qualified entity means the sum of the pro rata share or distributive share of income, and any guaranteed payments, as described by Section 707(c) of the Internal Revenue Code, relating to guaranteed payments, subject to tax under Part 10 (commencing with Section 17001) for the taxable year of each qualified taxpayer, as defined in Section 17052.10.

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## Colorado

### Colo. Code Regs. § 39-22-109(3)(b)(xii)

Guaranteed payments typically are in lieu of wage income and the source of such income is determined in accordance with the rules for sourcing wage income (see paragraph (4)(b)(i), above). If the guaranteed payment is not in lieu of wage income, then the guaranteed payment is allocated or apportioned based on the income-generating activity (e.g., a guaranteed

payment based on partnership income from the sale of real property located in Colorado is allocated pro rata to the Nonresident partner).

Colo. GIL-20-001 (2/28/2020)

Rule 39-22-109(3)(b)(xii) states that the source of a guaranteed payment for services is determined in accordance with the rules for sourcing wage income. Wage income is Colorado source income if it is paid for work performed in Colorado . . . guaranteed payments are not considered part of the partner's distributive share.

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## 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.

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## Georgia

Ga. Comp. R. & Regs. 560-7-3-.08(4)

Payments made to a partner for services rendered or for interest on capital contributions are not deductible in computing the net income of the partnership, such payments being held to represent a division of partner profits.

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## Idaho

Idaho Code § 63-3026A(3)(a)

Income shall be considered derived from or relating to sources within Idaho when such income is attributable to or resulting from:

(i) Any business, trade, profession or occupation conducted or carried on in this state, including the distributive share of partnership income and deductions, and the pro rata share of S corporation income and deductions. Partnership income, including guaranteed payments pursuant to section 707 of the Internal Revenue Code, is sourced to Idaho based upon the Idaho apportionment factor of the partnership; excluding:

1. Guaranteed payment to a retired partner per 4 U.S.C. section 114(b)(1)(I) that is sourced to the recipient's state of domicile;
2. Guaranteed payment to an individual partner up to two hundred fifty thousand dollars (\$250,000) in any calendar year is sourced as compensation for services. The amount of the guaranteed payment in excess of two hundred fifty thousand dollars (\$250,000) is sourced to Idaho based upon the partnership's Idaho apportionment factor. The two hundred fifty thousand dollar (\$250,000) amount will be adjusted annually by multiplying the amount by the percentage (the consumer price index for the calendar year immediately preceding the calendar year to which the adjusted amount will apply divided by the consumer price index for calendar year 2013) as defined in section 63-3024, Idaho Code; . . .

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## Illinois

Ill. Admin. Code tit. 86, § 100.3500(a)(4)

Except as provided in this subsection (a), all items of base income of a partner that are derived from the partnership shall be allocated or apportioned pursuant to this Section, including all items required to be separately stated to the partner under IRC section 703(a)(1), all guaranteed payments under IRC section 707(c), and all addition and subtraction modifications, but excluding items described in IRC section 707(a).

Illinois General Information Letter IT 22-0006 (04/15.2022)

Nonresident partners apportion guaranteed payments to Illinois based on the apportionment factor of the partnership. Resident partners include the guaranteed payments in Illinois base income.

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## 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.

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## Maine

36 M.R.S. § 5192.3

Special rules as to sources in this State. In determining the sources of a nonresident partner's income, no effect shall be given to a provision in the partnership agreement which:

A. Characterizes payments to the partner as being for services or for the use of capital, or allocated to the partner, as income or gain from sources outside this State, a greater proportion of his distributive share of partnership income or gain than the ratio of partnership income or gain from sources outside this State to partnership income or gain from all sources except as authorized in subsection 5; or

B. Allocates to the partner a greater proportion of a partnership item of loss or deduction connected with sources in this State than his proportionate share, for federal income tax purposes, of partnership loss or deduction generally, except as authorized in subsection 5.

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## 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.

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## Massachusetts

830 Mass. Code Regs. 62.5A.1

(6) Rules for Allocation or Apportionment of Income to Massachusetts for Non-resident Members of Pass-through Entities. A pass-through entity that earns or derives income from sources both within Massachusetts and elsewhere must either allocate or apportion the income to determine the amount of Massachusetts source income of its non-resident members, using the following allocation and apportionment provisions. 830 CMR 62.5A 1(6) applies to pass-through entities with non-resident members that have Massachusetts source income. Non-resident individuals use the rules at 830 CMR 62.5A.1(5). The Commissioner may by rule or other public statement create alternate allocation and apportionment methods.

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(a) General. A pass-through entity that has income that is taxable both within and outside of Massachusetts must report the member's apportioned share of income to the member. To arrive at the apportioned income figure, the pass-through entity must multiply its taxable net income by the apportionment percentage determined under M.G.L. c. 63, § 38(c) through (g) and 830 CMR 63.38.1. For Massachusetts purposes, the pass-through entity's income subject to apportionment is its entire net income derived from its related business activities, as that term is defined at 830 CMR 62.5A.1(2), and further described at 830 CMR 62.5A.1(6)(d), within and outside of Massachusetts. The entity's income subject to Massachusetts tax is its apportioned net income derived from its related business activities, plus any other income subject to the tax jurisdiction of Massachusetts. Guaranteed payments made to pass-through entity members are treated as other income of the pass-through entity is treated, and are subject to the apportionment rules in 830 CMR 62.5A.1(6)(a).

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.

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## Michigan

Michigan Revenue Administrative Bulletin 1988-31 (05/27/1988)

A guaranteed payment as defined under the Internal Revenue Code of 1986 Section 707(c) which is determined to be compensation for services rendered or for the use of capital is not considered a distributive share of the partnership's profits. The payment, to the extent included in federal adjusted gross income, is characterized as compensation or interest on the individual's return. . . A nonresident partner is taxed on a guaranteed payment to the extent the payment is includable in federal adjusted gross income and is for compensation received for personal services performed in this State. A guaranteed payment for the use of capital is allocated to the nonresident partner's state of domicile.

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.

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## Minnesota

Minn. R. 8002.0200(3)

Income received by a nonresident, which is the distributive share of partnership income from personal or professional services which are performed in Minnesota, is assignable to Minnesota in the same proportion as the partnership income is assignable to Minnesota even though the nonresident partner performed no personal or professional services in Minnesota during that year.

Form M3 Instructions for 2022

Guaranteed payments to partners (including for services and use of capital) make up a portion of the partner's distributive share of partnership income. Accordingly, to determine the Minnesota portion of each partner's share of guaranteed payments, multiply the amount reported to the partner on Schedule K-1, line 4, to Minnesota using the same apportionment percentage or assignment ratio used to allocate the income from which the guaranteed payment was deducted federally.

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## Mississippi

Miss. Code R. § 35.III.9.01.101.4

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Payments made to a partner for services rendered and for interest on capital contributions are not deductible in computing the net income of the partnership, such payments being held to represent a division of partner profits.

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## Missouri

Mo. Rev. Stat. § 143.421

2. In determining the source of a nonresident partner's adjusted gross income, no effect shall be given to a provision in the partnership agreement which:

(1) Characterizes payments to the partner as being for services or for the use of capital, or allocated to the partner, as income or gain from sources outside this state, a greater proportion of his distributive share of partnership income or gain than the ratio of partnership income or gain from sources outside this state to partnership income or gain from all sources, except as authorized in subsection 4; . . .

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## Montana

Mont. Admin. R. 42.9.303

(1) Except as provided in (2) and (3), guaranteed payments made to individual partners pursuant to section 707 of the Internal Revenue Code, 26 U.S.C. 707, are sourced to Montana based upon the Montana apportionment factor of the partnership. For example:

(a) A nonresident taxpayer's federal adjusted gross income includes three hundred thousand dollars (\$300,000) of guaranteed payments for a designated use of capital received from a partnership that has a fifty percent (50%) Montana apportionment factor. One hundred and fifty thousand dollars (\$150,000) of the guaranteed payments are included in the partner's gross income from Montana sources based on the apportionment factor of the partnership.

(2) Guaranteed payments made to a retired partner, per 4 U.S.C., section 114(b)(1)(I), are sourced to the recipient's state of domicile.

(3) Guaranteed payments made to an individual partner as compensation for services are sourced to Montana if the services provided by the individual partner are performed in the state. For example:

(a) A nonresident taxpayer's federal adjusted gross income includes five thousand dollars (\$5,000) of guaranteed payments for services performed outside of Montana received from a partnership that has a fifty percent (50%) Montana apportionment factor. None of the guaranteed payments are included in the partner's gross income from Montana sources because the services were performed outside of Montana.

(b) A nonresident taxpayer's federal adjusted gross income includes five thousand dollars (\$5,000) of guaranteed payments for services performed in Montana received from a partnership that has a fifty percent (50%) Montana apportionment factor. All of the guaranteed payments are included in the partner's gross income from Montana sources because the services were performed in Montana.

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## Nebraska

Neb. Rev. Stat. § 77-2729(2)

In determining the sources of a nonresident partner's income, no effect shall be given to a provision in the partnership agreement which:

(a) Characterizes payments to the partner as being for services or for the use of capital, or allocated to the partner, as income or gain from sources outside this state, a greater proportion of his or her distributive share of partnership income or gain than the ratio of partnership income or gain from sources outside this state to partnership income or gain from all sources, except as authorized in subsection (4) of this section; or

(b) Allocates to the partner a greater proportion of a partnership item of loss or deduction connected with sources in this state than his or her proportionate share, for federal income tax purposes, of partnership loss or deduction generally, except as authorized in subsection (4) of this section.

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## New Jersey

N.J. Admin. Code § 18:35-1.3(d)3

Guaranteed payments shall be reported as distributive share of partnership income, except guaranteed payments received by a retired partner who is receiving such payments as a result of a period of service to the partnership pursuant to a retirement agreement or pension plan. Such guaranteed payments will be treated as pension income to retired partners and shall be reported by the partner as pension income, described in 54A:5-1.j.

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.

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## New Mexico

N.M. Code R. § 3.2.1.14.R(2)

When a partner or interest holder in an entity is allocated profits or receives a guaranteed payment or other distributions for activities undertaken as a partner on behalf of the partnership such as administrative services done solely for the benefit of the partnership or for activities for third-parties transacting business with the partnership, these receipts of the partner are not gross receipts and are not subject to the gross receipts tax. When a partner engages in business separately from the partnership any transactions of that partner with the partnership, where the partner is not acting as a partner on behalf of the partnership, are gross receipts. Indicia that a partner is not acting as a partner on behalf of the partnership may include:

(a) that the partner engages in similar transactions with third parties other than the partnership;

(b) that the allocation, payment, or distribution made by the partnership is not made under the partnership agreement;

(c) that the partner's transaction(s) with the partnership involve the sale or lease of goods or the sale of services not provided by the partnership to third parties

New Mexico Public Decision No. 12-12 (April 9, 2012)

A New Mexico 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.

2023 N.M. H.B. 368 (signed by Governor April 5, 2023)

Distributed net income of a pass-through entity shall equal the amount allocated and apportioned to New Mexico pursuant to the Uniform Division of Income for Tax Purposes Act from the following:

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(1) the total income of the pass-through entity properly reported for federal income tax purposes plus, for partnerships, the amount of guaranteed payments other than premiums for health insurance paid by the partnership on behalf of a partner, less the net income or guaranteed payments properly allocated or made to:

(a) the United States, this state or a political subdivision of either;

(b) a federally recognized Indian nation, tribe or pueblo located wholly or partially in New Mexico, or any political subdivision thereof;

(c) an organization that has been granted exemption from the federal income tax by the United States commissioner of internal revenue as an organization described in Section 501(c)(3) of the Internal Revenue Code;

(d) a corporate partner that would properly include the income in the partner's New Mexico tax return as part of the partner's unitary business income; or X

(e) a pass-through entity that is an owner of the electing pass-through entity; and

(2) less the amount of net capital gains that may be deducted pursuant to Section 7-2-34 NMSA 1978 and is properly allocated to owners who are subject to tax pursuant to the Income Tax Act . .

As used in this section:

(1) "guaranteed payments" means the guaranteed payments described in Section 707(c) of the Internal Revenue Code, as that section may be amended or renumbered.

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## New York

N.Y. Tax Law § 632(b)

Special rules as to New York sources. In determining the sources of a nonresident partner's income, no effect shall be given to a provision in the partnership agreement which--

(1) characterizes payments to the partner as being for services or for the use of capital, or

(2) allocates to the partner, as income or gain from sources outside New York, a greater proportion of his distributive share of partnership income or gain than the ratio of partnership income or gain from sources outside New York to partnership income or gain from all sources, except as authorized in subsection (d), or

(3) allocates to the partner a greater proportion of a partnership item of loss or deduction connected with New York sources than his proportionate share, for federal income tax purposes, of partnership loss or deduction generally, except as authorized in subsection (d).

*In re Tosti*, No. 822915 (N.Y. Tax App. Trib. May 12, 2011)

This decision treated guaranteed payments as distributive share citing prior New York decisions on the issue.

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

(c) Information Returns of Partnerships. - A partnership doing business in this State and required to file a return under the Code shall file an information return with the Secretary. A partnership that the Secretary believes to be doing business in this State and to be required to file a return under the Code shall file an information return when requested to do so by the Secretary. The information return shall contain all information required by the Secretary. It shall state specifically the items of the partnership's gross income, the deductions allowed under the Code, each partner's distributive share of the partnership's income, and the adjustments required by this Part. A partner's distributive share of partnership net income includes any guaranteed payments made to the partner. . .

(d) Payment of Tax on Behalf of Nonresident Owner or Partner. - If a business conducted in this State is owned by a nonresident individual or by a partnership having one or more nonresident members, the business shall report information concerning the earnings of the business in this State, the distributive share of the income of each nonresident owner or partner, and any other information required by the Secretary. The distributive share of the income of each nonresident partner includes any guaranteed payments made to the partner. The business shall pay with the return the tax on each nonresident owner or partner's share of the income computed at the rate levied on individuals under G.S. 105-153.7. The business may deduct the payment for each nonresident owner or partner from the owner or partner's distributive share of the income of the business in this State. The Secretary may enforce the business's liability for the tax on each nonresident owner or partner's share of the income by sending the business a notice of proposed assessment in accordance with G.S. 105-241.9. . .

17 N.C. Admin. Code 6B.3513

(a) Although a partnership may treat guaranteed payments to a partner for services or for use of capital as if they were paid to a person who is not a partner, that treatment is only for purposes of determining the partnership's gross income and deductible business expenses. For other tax purposes, guaranteed payments are treated as a partner's distributive share of ordinary income.

(b) Deductions from adjusted gross income do not include a partner's salary, interest on a partner's capital account, partner relocation and mortgage interest differential payments, or payments to a retired partner regardless of whether they were determined without regard to current profits. The payments listed in this Paragraph shall be treated as part of the partnership income.

(c) 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. A nonresident individual partner may file an individual income tax return and claim credit for the tax paid by the manager of the partnership if the partner submits with the individual income tax return the Schedule NC K-1 or other document from the partnership verifying that the partnership paid tax on behalf of the partner.

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.

## North Dakota

### N.D. Cent. Code § 57-38-08.1.3

a. Except as otherwise provided in this subdivision, guaranteed payments paid to nonresident partners of a partnership that has business activity in this state are treated as a distributive share of partnership income for state tax purposes. In the case of a professional service partnership, the portion of a guaranteed payment paid to a nonresident partner attributable to a reasonable salary may not be treated as a distributive share. The portion of the guaranteed payment not treated as a distributive share that is for services performed in this state must be assigned as provided under subsection 1 of section 57-38-04. For purposes of this subdivision, "professional service partnership" means a partnership that engages in the practice of law, accounting, medicine, and any other profession in which neither capital nor the services of employees are a material income-producing factor.

b. In determining the sources of a nonresident partner's income, no effect shall be given to a provision in the partnership agreement which:

(1) Characterizes payments to the partners as being for services or for the use of capital or allocates to the partner, as income or gain from sources outside this state, a greater proportion of the partner's distributive share of partnership income or gain than the ratio of partnership income or gain from sources outside this state to partnership income or gain from all sources, except as authorized in subdivision d; or

2) Allocates to the partner a greater proportion of a partnership item of loss or deduction connected with sources in this state than the proportionate share of the partner, for federal income tax purposes, of partnership loss or deduction generally, except as authorized in subdivision d.

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## Ohio

### Ohio Rev. Code Ann. § 5733.40(A)(7)

For the purposes of Chapters 5733. and 5747. of the Revised Code, guaranteed payments or compensation paid to investors by a qualifying entity that is not subject to the tax imposed by section 5733.06 of the Revised Code shall be considered a distributive share of income of the qualifying entity. Division (A)(7) of this section applies only to such payments or such compensation paid to an investor who at any time during the qualifying entity's taxable year holds at least a twenty per cent direct or indirect interest in the profits or capital of the qualifying entity. For the purposes of this division, guaranteed payments and compensation shall be considered to be paid to an investor by a qualifying entity if the qualifying entity in which the investor holds at least a twenty per cent direct or indirect interest is a client employer of a professional employer organization or alternate employer organization, as those terms are defined in section 4125.01 or 4133.01 of the Revised Code, as applicable, and the guaranteed payments or compensation are paid to the investor by that professional employer organization or alternate employer organization.

## Oregon

### Or. Admin. R. 150-316-0155(1)

Guaranteed payments paid to nonresident partners of a partnership that has business activity in the state of Oregon are treated as a distributive share of partnership income for Oregon tax purposes. In order to determine the income attributable to Oregon sources, each nonresident partner's entire distributive share, including the guaranteed payments, is then subject to the allocation and apportionment provisions of ORS 314.605 to 314.675.

### Or. Admin. R. 150-314-0415

(4) The term "compensation" means wages, salaries, commissions, and any other form of remuneration paid to employees for personal services. Guaranteed payments representing compensation for services to a partnership are considered remuneration paid to employees for

personal services. Other than this exception relating to guaranteed payments, payments made to an independent contractor or any other person not properly classifiable as an employee are excluded.

(5) Guaranteed payments which represent a return of capital, interest paid on a capital account, or for any purpose other than compensation for services are excluded. Only amounts paid directly to employees are included in the payroll factor. Amounts considered paid directly include the value of board, rent, housing, lodging, and other benefits or services furnished to employees by the taxpayer in return for personal services, provided that such amounts constitute income to the recipient under the federal Internal Revenue Code. In the case of employees not subject to the federal Internal Revenue Code, e.g., those employed in foreign countries, the determination of whether such benefits or services would constitute income to the employees is made as though such employees were subject to the federal Internal Revenue Code.

*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).

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.

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## Pennsylvania

### Pennsylvania Personal Income Tax Guide, Chapter 16

For nonresidents a guaranteed payment for services rendered directly in the production of income from a business, profession or farm is allocable or apportionable to Pennsylvania to the same extent as the net profits are allocable or apportionable to Pennsylvania . . . For nonresidents a guaranteed payment for services rendered directly in the production of rental or royalty income is allocable to Pennsylvania to the same extent as the rental and royalty income is allocable to Pennsylvania . . . For nonresidents a guaranteed payment for other services or for the use of capital is allocable to their state of residence. Nonresidents are not taxed on a guaranteed payment for the use of capital for Pennsylvania personal income tax purposes.

Recent federal statutory changes prohibit states from taxing some retirement income of nonresidents. Public Law 109-264, signed Aug. 3, 2006, amends § 114 of Title 4 of the U.S. Code. The law provides that retirement payments made under a nonqualified plan maintained by a partnership and meeting specific criteria are taxable only by a state where the retired partner is a resident or where the retired partner is domiciled at the time the payments are received. To qualify for this tax treatment, the retirement payments must meet all of the following criteria:

The payments must be provided for in a written plan, program, or arrangement that was in effect before the partner’s retirement;

The payments must be in recognition of prior service performed by the partner for the partnership; and

The payments must be made over the life or life expectancy of the recipient or over a period of at least 10 years, must be paid at least annually, and must be paid in substantially equal periodic payments.

## Rhode Island

R.I. Gen. Laws § 44-30-34

(b) Special rules as to Rhode Island sources. In determining the sources of a nonresident partner's income, no effect shall be given to a provision in the partnership agreement which:

(1) Characterizes payments to the partner as being for services or for the use of capital; or

(2) Allocates to the partner, as income from sources outside Rhode Island, a greater proportion of his or her distributive share of partnership income than the ratio of partnership income from sources outside Rhode Island to partnership income from all sources, except as authorized in subsection (d) of this section; or

(3) Allocates to the partner a greater proportion of a partnership item of deduction connected with Rhode Island sources than his or her proportionate share, for federal income tax purposes, of partnership deductions generally, except as authorized in subsection (d) of this section.

R.I. Gen. Laws § 44-11-2.3(a)(2)

“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. Net income for purposes of this section does not include specially allocated investment income or any other types of deductions.

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## South Carolina

2022 Instructions for Form SC1065

Allocate personal service income, including guaranteed payments, to South Carolina if (a) the income is received by a resident individual or (b) the income is for services performed in South Carolina.

S.C. Revenue Ruling #21-15; S.C. Code Ann. § 12-6-545(A)(1)(d)

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.

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## Utah

Utah Advisory Opinion, No. 93-006 (03/22/1993)

Sources guaranteed payments the same as distributive share.

## Vermont

2022 Instructions to Schedule BI-473

Guaranteed payments are apportioned.

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## Virginia

PD 05-38 (March 16, 2005); PD 05-48 (April 7, 2005)

Guaranteed payments for services are attributed to where the services are performed.

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.

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## West Virginia

W. Va. Code § 11-21-37(b)

Special rules as to West Virginia sources. -- In determining the sources of a nonresident partner's income, no effect shall be given to a provision of the partnership agreement which:

- (1) Characterizes payments to the partner as being for services or for the use of capital; or
  - (2) Allocates to the partner, as income or gain from sources outside West Virginia, a greater proportion of his or her distributive share of partnership income or gain than the ratio of partnership income or gain from sources outside West Virginia to partnership income or gain from all sources, except as authorized in subsection (d); or
  - (3) Allocates to the partner a greater proportion of a partnership item of loss or deduction connected with West Virginia sources than his or her proportionate share, for federal income tax purposes, of partnership loss or deduction generally, except as authorized in subsection (c).
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## Wisconsin

Wis. Stat. § 71.26

According to Wis. Stat. § 71.26(6)(b), a partnership making the election to pay tax at the entity level in Wisconsin under Wis. Stat. § 71.26(6)(b), shall pay tax on items that would otherwise be taxed if the election was not made. Therefore, to the extent a partner would otherwise include the guaranteed payments in Wisconsin taxable income, the electing partnership must include the guaranteed payments in Wisconsin taxable income.

Publication 122: Tax Information for Part-Year Residents and Nonresidents of Wisconsin (March 1, 2023)

Income from Wisconsin sources includes . . . [p]rofits or losses from businesses, professions, and farm operations conducted in Wisconsin, including sole proprietorships, partnerships, limited liability companies (LLCs), and tax-option (S) corporations. This includes interest, dividend, and capital gain income attributable to Wisconsin which is passed through from a tax-option (S) corporation, as well as guaranteed payments from partnerships.

## IV. FINDINGS AND IMPLICATIONS

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### Possible considerations:

- Numbers – what do most states do.
- Idaho and federal approach – limited by amount
- Other anti-abuse rules – what might those be (if you don't use distributive share).
- Complexity versus ease of administration and compliance.
- Credits for taxes paid to other states.
- Withholding, composite, and PTE return treatment.



## V. RESOURCES

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