MULTISTATE TAX COMMISSION

State Tax Sourcing of Guaranteed Payments for Services & Additional Credit for Taxes Paid to Other States Proposed Models – Discussion Draft

Prepared by MTC Staff for Discussion by the Partnership Work Group
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BACKGROUND

This summary will assist the review of the model regulation, which follows below.

General Sourcing Issue:

How should states source income received by direct, individual, nonresident partners in exchange for services when those partners reported that income as a guaranteed payment for services for federal income tax purposes?

Work Group Process to Date:

At its February 15, 2023, meeting, the Work Group began discussing the sourcing of guaranteed payments from services. The Work Group has prepared a draft White Paper that provides background on the federal treatment of guaranteed payments, summarizes guaranteed payment issues addressed by the states, categorizes the different ways states source guaranteed payments, and provides related findings and recommendations.

Additional information is available on the project website at: https://www.mtc.gov/uniformity/project-on-state-taxation-of-partnerships/.

Important General Principles:

From discussions of the issue, there appears to be consensus as to the following general principles which should be considered in addressing the issue:

1. States conform to Subchapter K's conduit approach.	States generally conform to Subchapter K which provides that partnership activities determine the character of items of income, expense, gain, or loss (e.g. whether income is ordinary or capital, etc.), and this character attaches to the partner's distributive share of these items as well and affects the calculation of the partner's taxable income.
2. States do use federal sourcing rules to source partnership items in the interstate context.	While states conform to the conduit approach (general principle No. 1), the federal sourcing of items as domestic or foreign, which is part of their federal character, does not affect the state sourcing of these items between the states.

3. States generally source partnership income at the partnership level.	A nonresident's distributive share of partnership income is sourced to the state by applying allocation and apportionment rules at the partnership level, based on the partnership's activities and assets in the state, using formulary apportionment to source all items of apportionable income, expense, gain, or loss and sourcing nonapportionable items using rules of assignment.
4. State sourcing of partnership income is attributed to the partners.	The sourcing of partnership income or items determined at the entity level will be attributed to any direct or indirect partner that receives a share of that income or items, regardless of whether the partner is active or passive, holds a majority share of partnership capital, or controls or does not control the partnership.

Application of Principles to the Issue:

Federal tax rules generally source guaranteed payments for services to the location where the partner performs the services. See IRC § 911. But, under general principle No. 2 above, states are not required to apply, and the majority of states do not apply, this federal sourcing principle to interstate sourcing. Instead, the majority of states that specifically address the sourcing guaranteed payments for services do so under general principles Nos. 3 and 4 and require partners to source the guaranteed payments in the same manner as distributive share.

Other Notes on the Draft Models:

- Sourcing -
    - This model is drafted in part as a statute and in part as a regulation with examples.
    - The model statute addresses the treatment of guaranteed payments to foreign partners and to domestic partners working abroad—de-conforming from the federal sourcing treatment (location of the performance) and sourcing those guaranteed payments in the same way as distributive share. States that wish to retain federal sourcing treatment may consider omitting this provision and might then adopt the related sourcing provisions as a regulation.
    - Under federal pension law, certain guaranteed payments to retired partners can only be sourced to their state of residence. Subsection (c) satisfies this requirement by sourcing such payments made to nonresidents outside of the state.
    - Some states that generally source guaranteed payments in the same manner as distributive share make an exception for professional services. This draft model does not create such an exception but provides a drafter's note on this issue.
    - This draft does not address more complicated arrangements that can arise when partners receive special allocations in addition to guaranteed payments.

- This draft does not address the question of when a guaranteed payment might be considered as related to nonapportionable income. See *Hunt -Wesson, Inc. v. Franchise Tax Board*, 528 US 458, (2000), in which the U.S. Supreme court held that if a state requires a reduction of nonapportionable income by some amount of expense, that expense must bear a reasonable relationship to the income. The issue of when an item of partnership income or expense, including a guaranteed payment, is nonapportionable is beyond the scope of the issue addressed here.

- Additional Credit – The additional credit recognizes that a minority of states have chosen to tax guaranteed payments for services to the location of the performance of the service. This credit is drafted as a statute to be adopted by residency states that source guaranteed payments in the same way as distributive share, and may wish to provide their residents with a credit if they would otherwise pay tax on the guaranteed payment sourced to the location of performance.

[Statute] State Taxation of Certain Guaranteed Payments

(a) General Rule

Guaranteed payments recognized under Section 707(c) of the Internal Revenue Code by a direct, nonresident individual partner for the performance of services are sourced to this state as provided in [reference to section of state law that governs the sourcing of partnership distributive share using general allocation and apportionment rules applied at the partnership level].

(b) Guaranteed Payments Made to a Retired Partner

Guaranteed payments made to a retired nonresident partner are sourced outside of this state provided the payment is "retirement income" as defined in 4 U.S.C. § 114(b)(1)(I).

(c) Guaranteed Payments Made to a Foreign Partners and Domestic Partners Performing Services Overseas

Notwithstanding any provision of federal law, including IRC § 911, guaranteed payments made to foreign partners and to domestic partners performing services in a foreign country are sourced using the general rule of subsection (a). [Note that state statutes that conform the states law to federal taxable income or adjusted gross income may also need to be amended.]

[Regulation] Sourcing of Certain Guaranteed Payments

The purpose of this regulation is to provide guidance on the imposition of state income tax on certain guaranteed payments for services and the sourcing of those payments.

Examples:

In examples 1 - 5, assume the following:

- Partnership X has a 20% apportionment factor in this state.
- Partnership X's Federal 1065 shows $150,000 of gross receipts and $50,000 of guaranteed payments and no other income or deductions.
- Smith is a nonresident partner that holds a 10% interest in Partnership X.
- Jones is a nonresident partner that holds a 90% interest in Partnership X.
- The Partnership X agreement provides that Smith will receive the $50,000 in guaranteed payments and Smith and Jones will be allocated distributive share items according to their respective interests in the partnership.
- Neither Smith nor Jones has other income in this state.

(1) **Simple Example.**

Partnership X will have $100,000 ($150,000 gross receipts - $50,000 guaranteed payment) of ordinary business income that it will pass through to Jones and Smith. As a result, Smith's distributive share of partnership ordinary business income will be $10,000, and Jones' distributive share will be $90,000. Partnership X's apportionment factors will apply to the distributive shares so Smith will have an apportioned distributive share of $2,000 in this state and Jones will have an apportioned distributive share of $18,000 in this state.

Pursuant to subsection (b), Smith will also apportion 20% of her guaranteed payment ($10,000) to this state. As a result, Smith's taxable income in this state will be $12,000.

(2) **Assume also that Smith is a retired partner, and the guaranteed payment meets the requirements of "retirement income" as defined in 4 U.S.C. § 114(b)(1)(I).**

In this scenario, subsection (c) provides that the entire guaranteed payment will be sourced outside of this state. Other items of distributive share will be sourced according to [insert reference to model statutory provisions above]. As a result, Smith and Jones will have $2,000 and $18,000, respectively, of apportioned distributive share income in this state.

(3) **Assume Smith receives the guaranteed payment for services performed outside of the United States.**

Under [reference to the model act, subsection (c)], guaranteed payments made to foreign partners are sourced the same as guaranteed payments made to domestic nonresident partners. Therefore, the result will be the same as in example 1, above.

In examples 4 and 5, assume the following:

- Partnership X has offices and activities in this state.
- Partnership X has a 20% apportionment factor in this state.
- Partnership X's Federal 1065 shows $40,000 of gross receipts and no other income.
- Partnership X's Federal 1065 shows a $50,000 guaranteed payment and no other deductions.
- Smith is a nonresident partner that holds a 10% interest in Partnership X.
- Jones is a nonresident partner that holds a 90% interest in Partnership X.
- The Partnership X agreement provides that Smith and Jones will allocate distributive share items according to their respective interests in the partnership.
- Neither Smith nor Jones has other income.

(4) **Simple Example**

Partnership X will have $10,000 of ordinary business loss ($40,000 gross receipts - $50,000 guaranteed payment). Smith and Jones will have $1,000 and $9,000, respectively of distributive share of this ordinary business loss. Partnership X's apportionment factors will apply to the distributive shares so Smith will have an apportioned distributive share loss of $200 in this state and Jones will have an apportioned distributive share loss of $1,800 in this state.

Pursuant to subsection (b), Smith will also apportion 20% of her guaranteed payment to this state. So, her apportioned guaranteed payment will be $10,000, which gives Smith total apportioned income in this state of $9,800.

(5) **Smith is a retired partner, and the guaranteed payment meets the requirements of "retirement income" as defined in 4 U.S.C. § 114(b)(1)(I).**

In this scenario, subsection (c) provides that the entire guaranteed payment will be sourced outside of this state. Other items of distributive share will be sourced according to [insert reference to state sourcing statutes and rules applicable to distributive share items]. As a result, Smith will have $200 of apportioned distributive share loss in this state and Jones will have an apportioned distributive share loss of $1,800 in this state.

[Statute] Additional Credit for Taxes Paid to Other States on Certain Guaranteed Payments

NOTE: This additional credit for taxes paid is meant to be adopted by states that source guaranteed payments for services in the same way as distributive share and would ordinarily only give a credit for taxes paid to other states to the extent the income would properly be sourced in the same way. This credit provides relief from potential double taxation in certain circumstances.]

(a) Additional Credit for Taxes Paid to Other States on Certain Guaranteed Payments

A resident in this state that receives a guaranteed payment for services under IRC § 707(c) performed for a partnership in which that resident owns a direct interest and where the services are performed in another state which imposes an income tax on the guaranteed payment based on the location of the service performed may claim an additional credit against the tax owed in this state, computed by multiplying the allowable effective tax rate times the allowable guaranteed payment.

(b) Definitions

For purposes of this credit:

(1) The allowable effective tax rate equals the lesser of:

A. The amount of the resident's tax on total net income properly reported in this state before the credit provided by this section divided by the amount of that total net income; or

B. The amount of the resident’s tax paid on total net income properly reported in the other state, including any tax paid by the partnership on the resident’s behalf, divided by the amount of that total net income.

(2) The allowable guaranteed payment equals the lesser of:

A. The amount of the partner’s guaranteed payment properly reported as taxable to the other state; or

B. The amount that results from subtracting the partner’s distributive share of any related partnership net loss from the partner’s total guaranteed payment for services [subject to other limits the state may impose], multiplied by the ratio of the number of partner working days spent in the state divided by the total partner working days in the tax year, where:

1. The partner’s distributive share of any related partnership net loss is equal to the amount of the partner’s distributive share of expense and loss in excess of the partner’s distributive share of income and gain from the partnership that is allocated to the partner and properly reported in this state;

2. Partner working days are the total days during the tax year in which the partner performed services for the partnership; and

3. Partner working days spent in the state equals total days during which the time the partner spent performing services in that state exceeds the time spent working in any other state.