



State Tax Sourcing of Certain Guaranteed Payments Made to Individual Partners for Services

Multistate Tax Commission

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FOR DISCUSSION PURPOSES ONLY

This white paper is prepared by the staff of the Multistate Tax Commission (MTC) as part of the MTC's uniformity project on state taxation of partnerships, published as of the date shown, and may be subject to revision. This draft white paper is not intended to provide accounting or legal advice to taxpayers and cannot be cited for that purpose.

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INTRODUCTION

Scope of this White Paper

Payments by partnerships to partners can be categorized in various ways and may have very different tax effects depending on a number of factors. As a result of initial research and discussion, the scope of this white paper has been limited to the following question:

Should states source an individual partner's guaranteed payments for services as distributive share or compensation?

The white paper does not address guaranteed payments made for the use of capital, guaranteed payments made to partners that are corporations or pass-through entities, payments to indirect partners, or other payments made to partners not acting in the capacity of partners.

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.

Reason for the White Paper

The workgroup has developed a comprehensive outline of issues that should be addressed by states that tax partnership income.¹ The outline showed that, for some issues, states' rules were either lacking or inconsistent. One such issue involves the sourcing of guaranteed payments for services. The work group decided to address this issue as part of its review of state sourcing of partnership income, generally.

Approach Taken in the White Paper

This white paper contains the following sections in addition to the findings and recommendations which are summarized in the Executive Summary below and detailed in the final section of the paper:

- (I) Important Context – Provides background on terms and concepts used in the partnership tax system that are useful for understanding the sourcing of guaranteed payments generally;
- (II) Specific Federal Rules – Summarizes important federal rules to which states conform;
- (III) Amounts and Types of Guaranteed Payments – Summarizes data on guaranteed payments and provides some examples of how they are used; and
- (IV) State Sourcing Rules – Provides a survey of the rules for sourcing guaranteed payments that have been adopted by the states.

Note on Complexity

Economic arrangements between partners can take many different forms and can often be exceptionally complex in nature. Guaranteed payments are often used in such arrangements, and the basis for those payments, can vary greatly. The treatment of guaranteed payments under Internal Revenue Code, Subchapter K is, itself, somewhat complicated and varies depending on the purpose of the guaranteed payment.

The purpose of this white paper is to identify and describe the aspects of guaranteed payments for services that may affect state sourcing of those payments. It does not attempt to set out a comprehensive analysis of guaranteed payments or their treatment for tax purposes generally.

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

EXECUTIVE SUMMARY

Only about half the states have explicitly addressed the sourcing of guaranteed payments made to partners for services. The majority of those states would source these payments in the same way as distributive share. A minority would use an approach that looks to where the services are performed by the partner—which this white paper refers to as the “compensation” approach.

Using different sourcing approaches may lead to duplicative taxation. Also, state adoption of pass-through entity taxes requires consideration of whether guaranteed payments are included in the entity tax base and, if so, whether their sourcing is consistent.

Guaranteed payments for services may be distinguished from other types of partnership income/payments in both economic terms as well as for federal and state tax purposes. But these differences do not clearly point to one particular state sourcing method for these payments. Nor does it appear that there is anything that prevents states from using either of the methods in most cases. Rather, different factors (set out more fully in Section V.) may generally favor one method versus the other.

Nevertheless, this white paper can make the following recommendations:

1. States should explicitly address the sourcing of guaranteed payments in order to avoid uncertainty.
2. States should source guaranteed payments the same whether applying tax to the partner on a pass-through basis or on the entity.
3. States that provide guaranteed payments should be sourced as distributive share should also:
 - a. Address whether this applies to individuals working in foreign jurisdictions who may source the payments as compensation for federal purposes—and provide necessary adjustments to the federal tax base.
 - b. Address whether they follow federal treatment in distinguishing guaranteed payments for services from partner-partnership transactions.
 - c. Specify that this sourcing treatment does not apply to payments made to retired partners that are required to be sourced to residence under 4 U.S.C. §114.
4. States that source the payments as compensation should also:
 - a. Impose appropriate limits to ensure that the payments are genuinely similar to compensation for services performed and to avoid income shifting.
 - b. Address whether they will follow federal treatment in distinguishing guaranteed payments from distributive share/distributions.
 - c. Address whether they will follow federal treatment in distinguishing guaranteed payments for services from guaranteed payments for capital.
5. To mitigate the possibility of multiple taxation, consider provisions that might grant additional credits to residents who can show that they paid tax on more than 100% of their guaranteed payments based on different state sourcing rules.

SECTION I. IMPORTANT CONTEXT

This Section I provides background information necessary to understand the issues discussed.

I. A. Terms Used in this White Paper

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

Substantive Tax Rules – refers to the tax rules outside of IRC Subchapter K which determine calculation of tax, for example: whether income is taxable or exempt, whether expenses are deductible or capitalized and amortized, whether items are considered ordinary income (or loss) or capital gains (or losses), whether losses are subject to limitation rules, **etc.**

Sourcing or State Sourcing – methods of assigning a part of multistate income or items to a state.

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.

Partnership Item (Item) – any item of income, expense, gain, or loss that is separately recognized.

Partnership Income – The calculation of income (or loss) of the partnership under Subchapter K and using the federal form 1065.

Partner Capital Account – the accounting concept that tracks the amount of a partner's share of the partnership assets net of that partner's share of liabilities.

Outside Basis – the tax basis of a partner's interest in a partnership which is affected by allocations of income, expense, gain, or loss as well as contributions and distributions.

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, whether or not any distribution of cash or property is made 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 outside basis.

Distributions – money or property transferred by the partnership to a partner 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 of money or property to partners.

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

Guaranteed Payments – transfers of money or property from a partnership to a partner acting in the capacity of a partner either for services or for the use of capital and which are properly treated as such under Subchapter K, rather than as distributions.

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.

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.

I. B. Summary of Partnership Accounting Rules – Book & Tax

Partnerships, like all businesses, must keep records for both financial (“book”) and tax purposes. While these book and tax rules may differ somewhat (e.g., calculation of depreciation expense), they attempt to fairly reflect the partnership’s activities and the partners’ economic arrangement. But the pass-through system used for tax purposes adds significant complexity.

Pass-through taxation requires partners to recognize and pay tax on their distributive shares of partnership income, expense, gain, and loss. This means partnerships must keep detailed accounting information, including partner-specific information, and provide it to partners annually. And when a single partnership is part of a large, complex, tiered structure, neither its records nor the records of any of the partnerships will be sufficient to determine the ultimate tax effects on an indirect taxpaying partner.

The following accounting rules are the basis for the pass-through system:

- **Income is taxed on a pass-through basis.** – Rather than having the entity pay tax on its income (loss), Subchapter K exempts the entity and, instead, imposes tax on direct or indirect taxpaying partners on their distributive share of the partnership’s items or its net income (loss).
- **Income is taxed when earned, rather than when distributed.** – Partnership income, unlike income of taxable corporations, is taxed only once, when earned, whether or not partners receive actual distributions. This requires a system for tracking partnership items reported by the partners so that income is not taxed again when distributed.
- **Partnership items making up net income (loss) maintain their character.** – To prevent taxpayers from using partnerships to alter the tax treatment of items of income, expense, gain, or loss, the character of items must also be tracked as they pass through to the taxpaying partners.
- **Partners do not have to share income according to capital interests.** – Rather than allocating partnership income or items proportionally according to partners’ capital interests, partners may allocate income or items on some other basis, which will change relative capital interests over time.
- **Partners may allocate separate partnership items in different proportions.** – Items of income, expense, gain, or loss do not have to be allocated in the same proportions. Instead, partners can agree to allocate different partnership items in different proportions.
- **Distributions need not match income allocations.** – Distributions need not be made in the year partnership income or items are allocated to partners, nor must any year’s distributions be made in the same proportion as allocations.
- **Partners may receive payments unrelated to income or “guaranteed payments.”** – In addition to receiving distributions from their capital accounts (that is, from contributions or allocated income), partners may also receive “guaranteed payments” that are unrelated to the income earned and allocated to the partner, and are effectively treated as an expense of the partnership.
- **Partners and their partnerships may engage in separate transactions.** – Partners may engage in transactions with each other or with the partnership as unrelated persons and receive payments which are treated differently than distributions or guaranteed payments.
- **There are no limits on the number of partners a partnership may have.** – Unlike S corporations, there are no limits on the number of partners that partnerships may have, so that some partnerships have thousands of partners.
- **There are no limits on tiered structures.** – Partnerships can be structured in tiers so that the ultimate taxpaying partners will receive shares of income earned by lower tiers indirectly, as the distributive share of other, higher tier 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.

This white paper generally assumes that the partnership arrangements will follow an accrual basis for both tax and book purposes.

I. C. Federal Reporting of Guaranteed Payment Information

As will be discussed further in this white paper, the federal tax treatment of guaranteed payments may have some bearing on state sourcing of those payments. In particular, to the extent states choose to source guaranteed payments for services differently than distributive share income, they will need to be able to distinguish the payments to which that treatment is properly applied. This note summarizes how information on guaranteed payments is reported for federal tax purposes.

Reporting of Guaranteed Payments Starts with the Partnership Return

Form 1065		U.S. Return of Partnership Income		OMB No. 1545-0123
Department of the Treasury Internal Revenue Service		For calendar year 2022, or tax year beginning _____, 2022, ending _____, 20_____		2022
Go to www.irs.gov/Form1065 for instructions and the latest information.				
A Principal business activity	Name of partnership			D Employer identification number
B Principal product or service	Type or Print	Number, street, and room or suite no. If a P.O. box, see instructions.		E Date business started
C Business code number		City or town, state or province, country, and ZIP or foreign postal code		F Total assets (see instructions)
\$ _____				
G Check applicable boxes: (1) <input type="checkbox"/> Initial return (2) <input type="checkbox"/> Final return (3) <input type="checkbox"/> Name change (4) <input type="checkbox"/> Address change (5) <input type="checkbox"/> Amended return				
H Check accounting method: (1) <input type="checkbox"/> Cash (2) <input type="checkbox"/> Accrual (3) <input type="checkbox"/> Other (specify): _____				
I Number of Schedules K-1. Attach one for each person who was a partner at any time during the tax year: _____				
J Check if Schedules C and M-3 are attached <input type="checkbox"/>				
K Check if partnership: (1) <input type="checkbox"/> Aggregated activities for section 465 at-risk purposes (2) <input type="checkbox"/> Grouped activities for section 469 passive activity purposes				
Caution: Include only trade or business income and expenses on lines 1a through 22 below. See instructions for more information.				
Income	1a Gross receipts or sales	1a		
	b Returns and allowances	1b		
	c Balance. Subtract line 1b from line 1a			1c
	2 Cost of goods sold (attach Form 1125-A)			2
	3 Gross profit. Subtract line 2 from line 1c			3
	4 Ordinary income (loss) from other partnerships, estates, and trusts (attach statement)			4
	5 Net farm profit (loss) (attach Schedule F (Form 1040))			5
	6 Net gain (loss) from Form 4797, Part II, line 17 (attach Form 4797)			6
7 Other income (loss) (attach statement)			7	
8 Total income (loss). Combine lines 3 through 7			8	
Deductions (see instructions for limitations)	9 Salaries and wages (other than to partners) (less employment credits)			9
	10 Guaranteed payments to partners			10
	11 Repairs and maintenance			11
	12 Bad debts			12
	13 Rent			13
	14 Taxes and licenses			14
	15 Interest (see instructions)			15
	16a Depreciation (if required, attach Form 4562)	16a		
	b Less depreciation reported on Form 1125-A and elsewhere on return	16b		16c
	17 Depletion (Do not deduct oil and gas depletion.)			17
	18 Retirement plans, etc.			18
19 Employee benefit programs			19	
20 Other deductions (attach statement)			20	
21 Total deductions. Add the amounts shown in the far right column for lines 9 through 20			21	
22 Ordinary business income (loss). Subtract line 21 from line 8			22	
Tax and Payment	23 Interest due under the look-back method—completed long-term contracts (attach Form 8697)			23
	24 Interest due under the look-back method—income forecast method (attach Form 8866)			24
	25 BBA AAR imputed underpayment (see instructions)			25
	26 Other taxes (see instructions)			26
	27 Total balance due. Add lines 23 through 26			27
	28 Payment (see instructions)			28
	29 Amount owed. If line 28 is smaller than line 27, enter amount owed			29
	30 Overpayment. If line 28 is larger than line 27, enter overpayment			30

Guaranteed payments—whether for services or for the use of capital are reported as an expense on the federal partnership return. This means that the partnership income (loss) that will be allocated as distributive share to the partners is reduced. Note that here, guaranteed payments are not broken out between those for services and those for the use of capital.

Items from the Partnership Return then Flow Through on Schedule K-1s to Partners

651121
OMB No. 1545-0123

Final K-1 Amended K-1

Schedule K-1 (Form 1065) 2022
Department of the Treasury
Internal Revenue Service

For calendar year 2022, or tax year beginning / / 2022 ending / /

Partner's Share of Income, Deductions, Credits, etc. See separate instructions.

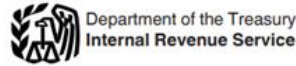
Part I Information About the Partnership		Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items	
A Partnership's employer identification number		1 Ordinary business income (loss)	14 Self-employment earnings (loss)
B Partnership's name, address, city, state, and ZIP code		2 Net rental real estate income (loss)	
C IRS center where partnership filed return:		3 Other net rental income (loss)	15 Credits
D <input type="checkbox"/> Check if this is a publicly traded partnership (PTP)		4a Guaranteed payments for services	
E Partner's SSN or TIN (Do not use TIN of a disregarded entity. See instructions.)		4b Guaranteed payments for capital	16 Schedule K-3 is attached if checked <input type="checkbox"/>
F Name, address, city, state, and ZIP code for partner entered in E. See instructions.		4c Total guaranteed payments	17 Alternative minimum tax (AMT) items
G <input type="checkbox"/> General partner or LLC member-manager <input type="checkbox"/> Limited partner or other LLC member		5 Interest income	
H1 <input type="checkbox"/> Domestic partner <input type="checkbox"/> Foreign partner		6a Ordinary dividends	
H2 <input type="checkbox"/> If the partner is a disregarded entity (DE), enter the partner's TIN _____ Name _____		6b Qualified dividends	18 Tax-exempt income and nondeductible expenses
I1 What type of entity is this partner?		6c Dividend equivalents	
I2 If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here <input type="checkbox"/>		7 Royalties	
J Partner's share of profit, loss, and capital (see instructions):		8 Net short-term capital gain (loss)	19 Distributions
Beginning Ending		9a Net long-term capital gain (loss)	
Profit _____ % _____ %		9b Collectibles (28%) gain (loss)	
Loss _____ % _____ %		9c Unrecaptured section 1250 gain	20 Other information
Capital _____ % _____ %		10 Net section 1231 gain (loss)	
Check if decrease is due to sale or exchange of partnership interest <input type="checkbox"/>		11 Other income (loss)	
K Partner's share of liabilities:		12 Section 179 deduction	21 Foreign taxes paid or accrued
Beginning Ending		13 Other deductions	
Nonrecourse . . . \$ _____ \$ _____		22 <input type="checkbox"/> More than one activity for at-risk purposes*	
Qualified nonrecourse financing . . . \$ _____ \$ _____		23 <input type="checkbox"/> More than one activity for passive activity purposes*	
Recourse . . . \$ _____ \$ _____		*See attached statement for additional information.	
Check this box if item K includes liability amounts from lower-tier partnerships <input type="checkbox"/>		For IRS Use Only	
L Partner's Capital Account Analysis			
Beginning capital account . . . \$ _____			
Capital contributed during the year . . . \$ _____			
Current year net income (loss) . . . \$ _____			
Other increase (decrease) (attach explanation) \$ _____			
Withdrawals and distributions . . . \$ (_____)			
Ending capital account . . . \$ _____			
M Did the partner contribute property with a built-in gain (loss)?			
<input type="checkbox"/> Yes <input type="checkbox"/> No If "Yes," attach statement. See instructions.			
N Partner's Share of Net Unrecognized Section 704(c) Gain or (Loss)			
Beginning . . . \$ _____			
Ending . . . \$ _____			

For Paperwork Reduction Act Notice, see the Instructions for Form 1065. www.irs.gov/Form1065 Cat. No. 11394R Schedule K-1 (Form 1065) 2022

The federal Schedule K-1 now breaks out the guaranteed payments from the 1065 that are paid to each partner between those payments that are made for services and those that are made for capital. This may be the only place in the federal filing where this distinction is made.

The Partners Then Report Information from their Schedule K-1

2022



Partner's Instructions for Schedule K-1 (Form 1065)

Partner's Share of Income, Deductions, Credits, etc.
(For Partner's Use Only)

Note. Although the partnership is reporting the beginning and ending balances on an aggregate net basis, it is generally required to keep records of this information on a property-by-property basis.

an asterisk (*) in the left column and enter "STMT" in the dollar amount entry space to indicate the information is provided on an attached statement.

Part III. Partner's Share of Current Year Income, Deductions, Credits, and Other Items

The amounts shown in boxes 1 through 21 reflect your share of income, loss, deductions, credits, and other items from partnership business or rental activities without reference to limitations on losses or adjustments that may be required of you because of:

1. The adjusted basis of your partnership interest,
2. The amount for which you are at risk, and
3. The passive activity limitations.

Income (Loss)

Box 1. Ordinary Business Income (Loss)

The amount reported in box 1 is your share of the ordinary income (loss) from trade or business activities of the partnership. Generally, where you report this amount on Form 1040 or 1040-SR depends on whether the amount is from an activity that is a passive activity to you. If you are an individual partner filing a 2022 Form 1040 or 1040-SR, find your situation below and report your box 1 income (loss) as instructed, after applying the basis and at-risk limitations on losses. If the partnership had more than one trade or business activity, it will attach a statement identifying the income or loss from each activity.

-8-

Partner's Inst. for Sch. K-1 (Form 1065) (2022)

IRS Instructions for Partners direct them to report their guaranteed payments from their Schedule K-1s on the 1040 Schedule E, Line 28, which then is then reported on the Form 1040, Schedule 1, Line 5—which is the place where the partner's distributive share of the partnership's ordinary business income is generally reported. Schedule E may or may not break out distributive share from guaranteed payments, or payments for services from payments for the use of capital.

1. Report box 1 income (loss) from partnership trade or business activities in which you materially participated on Schedule E (Form 1040), line 28, column (i) or (k).

2. Report box 1 income (loss) from partnership trade or business activities in which you didn't materially participate, as follows.

a. If income is reported in box 1, report the income on Schedule E (Form 1040), line 28, column (h). However, if the box in item D is checked, report the income following the rules for *Publicly traded partnerships*, earlier.

b. If a loss is reported in box 1, follow the Instructions for Form 8582 to figure how much of the loss can be reported on Schedule E (Form 1040), line 28, column (g). However, if the box in item D is checked, report the loss following the rules for *Publicly traded partnerships*, earlier.

Box 2. Net Rental Real Estate Income (Loss)

Generally, the income (loss) reported in box 2 is a passive activity amount for all partners. However, the income (loss) in box 2 isn't from a passive activity if you were a real estate professional (defined earlier) and you materially participated in the activity. If the partnership had more than one rental real estate activity, it will attach a statement identifying the income or loss from each activity.

If you are filing a 2022 Form 1040 or 1040-SR, use the following instructions to determine where to report a box 2 amount.

1. If you have a loss from a passive activity in box 2 and you meet all the following conditions, report the loss on Schedule E (Form 1040), line 28, column (g).

a. You actively participated in the partnership rental real estate activities. See [Special allowance for a rental real estate activity](#), earlier.

b. Rental real estate activities with active participation were

1. If box 3 is a loss, follow the Instructions for Form 8582 to figure how much of the loss can be reported on Schedule E (Form 1040), line 28, column (g). However, if the box in item D is checked, report the loss following the rules for *Publicly traded partnerships*, earlier.

2. If income is reported in box 3, report the income on Schedule E (Form 1040), line 28, column (h). However, if the box in item D is checked, report the income following the rules for *Publicly traded partnerships*, earlier.

Box 4a. Guaranteed Payments for Services

Guaranteed payments are payments made by a partnership to a partner that are determined without regard to the partnership's income. Generally, amounts on this line are not passive income, and you should report them on Schedule E (Form 1040), line 28, column (k) (for example, guaranteed payments for personal services).

Box 4b. Guaranteed Payments for Capital

These are guaranteed payments other than for services, such as for the use of capital or attributable to section 736(a)(2) payments for unrealized receivables or goodwill. Amounts on this line should be reported on Schedule E (Form 1040), line 28, column (k) (for example, guaranteed payments for capital).

Box 4c. Total Guaranteed Payments

Amounts on this line include total guaranteed payments paid to you by the partnership.

Portfolio Income

Portfolio income or loss (shown in boxes 5 through 9b and in box 11, code A) isn't subject to the passive activity limitations. Portfolio income includes income (not derived in the ordinary course of a trade or business) from interest, ordinary dividends, annuities or royalties, and gain or loss on the sale of property that produces such

An Individual Partner may Exclude Guaranteed Payments For Services Performed Overseas

Form 2555 (2022) Page **2**

Part III Taxpayers Qualifying Under Physical Presence Test
Note: U.S. citizens and all resident aliens can use this test. See instructions.

16 The physical presence test is based on the 12-month period from _____ through _____

17 Enter your principal country of employment during your tax year. _____

18 If you traveled abroad during the 12-month period entered on line 16, complete columns (a)–(f) below. Exclude travel between foreign countries that didn't involve travel on or over international waters, or in or over the United States, for 24 hours or more. If you have no travel to report during the period, enter "Physically present in a foreign country or countries for the entire 12-month period." **Don't** include the income from column (f) below in Part IV, but report it on Form 1040 or 1040-SR.

(a) Name of country (including U.S.)	(b) Date arrived	(c) Date left	(d) Full days present in country	(e) Number of days in U.S. on business	(f) Income earned in U.S. on business (attach computation)

Part IV All Taxpayers

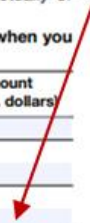
Note: Enter on lines 19 through 23 all income, including noncash income, you earned and actually or constructively received during your 2022 tax year for services you performed in a foreign country. If any of the foreign earned income received this tax year was earned in a prior tax year, or will be earned in a later tax year (such as a bonus), see the instructions. **Don't** include income from line 14, column (d), or line 18, column (f). Report amounts in U.S. dollars, using the exchange rates in effect when you actually or constructively received the income.

If you are a cash basis taxpayer, report on Form 1040 or 1040-SR all income you received in 2022, no matter when you performed the service.

2022 Foreign Earned Income	Amount (in U.S. dollars)
19 Total wages, salaries, bonuses, commissions, etc.	19
20 Allowable share of income for personal services performed (see instructions):	
a In a business (including farming) or profession	20a
b In a partnership. List partnership's name and address and type of income. _____	20b
21 Noncash income (market value of property or facilities furnished by employer—attach statement showing how it was determined):	
a Home (lodging)	21a
b Meals	21b
c Car	21c
d Other property or facilities. List type and amount. _____	21d
22 Allowances, reimbursements, or expenses paid on your behalf for services you performed:	
a Cost of living and overseas differential	22a
b Family	22b
c Education	22c
d Home leave	22d
e Quarters	22e
f For any other purpose. List type and amount. _____	22f
g Add lines 22a through 22f	22g
23 Other foreign earned income. List type and amount. _____	23
24 Add lines 19 through 21d, line 22g, and line 23	24
25 Total amount of meals and lodging included on line 24 that is excludable (see instructions)	25
26 Subtract line 25 from line 24. Enter the result here and on line 27 on page 3. This is your 2022 foreign earned income	26

Form **2555** (2022)

Guaranteed payments for services performed in a foreign jurisdiction are reportable on Form 2555 here as foreign earned income and on the Form 1040, Schedule 1, Line 8d, as an exclusion from other income.



Amounts from Schedule 1 are then Reported on the Form 1040

SCHEDULE 1 (Form 1040) **Additional Income and Adjustments to Income** OMB No. 1545-0074
 Department of the Treasury Internal Revenue Service **2022** Attachment Sequence No. 01
 Go to www.irs.gov/Form1040 for instructions and the latest information.
 Name(s) shown on Form 1040, 1040-SR, or 1040-NR Your social security number

Part I Additional Income

1	Taxable refunds, credits, or offsets of state and local income taxes	1
2a	Alimony received	2a
b	Date of original divorce or separation agreement (see instructions):	
3	Business income or (loss). Attach Schedule C	3
4	Other gains or (losses). Attach Form 4797	4
5	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	5
6	Farm income or (loss). Attach Schedule F	6
7	Unemployment compensation	7
8	Other income:	
a	Net operating loss	8a
b	Gambling	8b
c	Cancellation of debt	8c
d	Foreign earned income exclusion from Form 2555	8d
e	Income from Form 8853	8e
f	Income from Form 8889	8f
g	Alaska Permanent Fund dividends	8g
h	Jury duty pay	8h
i	Prizes and awards	8i
j	Activity not engaged in for profit income	8j
k	Stock options	8k
l	Income from the rental of personal property if you engaged in the rental for profit but were not in the business of renting such property	8l
m	Olympic and Paralympic medals and USOC prize money (see instructions)	8m
n	Section 951(a) inclusion (see instructions)	8n
o	Section 951A(a) inclusion (see instructions)	8o
p	Section 461(l) excess business loss adjustment	8p
q	Taxable distributions from an ABL account (see instructions)	8q
r	Scholarship and fellowship grants not reported on Form W-2	8r
s	Nontaxable amount of Medicaid waiver payments included on Form 1040, line 1a or 1d	8s
t	Pension or annuity from a nonqualified deferred compensation plan or a nongovernmental section 457 plan	8t
u	Wages earned while incarcerated	8u
z	Other income. List type and amount:	8z
9	Total other income. Add lines 8a through 8z	9
10	Combine lines 1 through 7 and 9. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 8	10

This amount includes guaranteed payments and distributive share from Schedule E.

This is the amount excluded for guaranteed payments earned overseas.

Ultimately, guaranteed payments that are not excluded as foreign-sourced are reported on the Form 1040, Line 8, Other Income, along with any other income from Schedule 1, and these net amounts then go into the calculation of federal adjusted gross income on which most states begin their calculation of state taxable income.

1040 Department of the Treasury—Internal Revenue Service **2022** U.S. Individual Income Tax Return OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

Filing Status Single Married filing jointly Married filing separately (MFS) Head of household (HOH) Qualifying surviving spouse (QSS)
 Check only one box. If you checked the MFS box, enter the name of your spouse. If you checked the HOH or QSS box, enter the child's name if the qualifying person is a child but not your dependent.

Your first name and middle initial Last name Your social security number
 If joint return, spouse's first name and middle initial Last name Spouse's social security number

Home address (number and street), if you have a P.O. box, see instructions. Apt. no. Presidential Election Campaign
 Check here if you, or your spouse if filing jointly, want \$3 to go to this fund. Checking a box below will not change your tax or refund.

City, town, or post office. If you have a foreign address, also complete spaces below. State ZIP code
 Foreign country name Foreign province/state/county Foreign postal code You Spouse

Digital Assets At any time during 2022, did you: (a) receive (as a reward, award, or payment for property or services); or (b) sell, exchange, gift, or otherwise dispose of a digital asset (or a financial interest in a digital asset)? (See instructions.) Yes No

Standard Deduction Someone can claim: You as a dependent Your spouse as a dependent Spouse itemizes on a separate return or you were a dual-status alien

Age/Blindness You: Were born before January 2, 1958 Are blind **Spouse:** Was born before January 2, 1958 Is blind

Dependents (see instructions): (1) First name Last name (2) Social security number (3) Relationship to you (4) Check the box if qualifies for (see instructions): Child tax credit Credit for other dependents

Income Attach Form(s) W-2 here. Also attach Forms 1099-INT and 1099-DIV if you did not get a Form W-2; see instructions.

1a	Total amount from Form(s) W-2, box 1 (see instructions)	1a
b	Household employee wages not reported on Form(s) W-2	1b
c	Tip income not reported on line 1a (see instructions)	1c
d	Medicaid waiver payments not reported on Form(s) W-2 (see instructions)	1d
e	Taxable dependent care benefits from Form 2441, line 26	1e
f	Employer-provided adoption benefits from Form 8839, line 29	1f
g	Wages from Form 8919, line 6	1g
h	Other earned income (see instructions)	1h
i	Nontaxable combat pay election (see instructions)	1i
z	Add lines 1a through 1h	1z
2a	Tax-exempt interest	2a
2b	Taxable interest	2b
3a	Qualified dividends	3a
3b	Ordinary dividends	3b
4a	IRA distributions	4a
4b	Taxable amount	4b
5a	Pensions and annuities	5a
5b	Taxable amount	5b
6a	Social security benefits	6a
6b	Taxable amount	6b
7	Capital gain or (loss). Attach Schedule D if required. If not required, check here	7
8	Other income from Schedule 1, line 10	8
9	Add lines 1z, 2b, 3b, 4b, 5b, 6b, 7, and 8. This is your total income	9
10	Adjustments to income from Schedule 1, line 26	10
11	Subtract line 10 from line 9. This is your adjusted gross income	11
12	Standard deduction or itemized deductions (from Schedule A)	12
13	Qualified business income deduction from Form 8995 or Form 8995-A	13
14	Add lines 12 and 13	14
15	Subtract line 14 from line 11. If zero or less, enter -0-. This is your taxable income	15

Standard Deduction for—
 • Single or Married filing separately, \$12,950
 • Married filing jointly or Qualifying surviving spouse, \$25,900
 • Head of household, \$19,400
 • If you checked any box under Standard Deduction, see instructions.



I. D. General State Sourcing Methods

States do not use the same approach as the federal government when sourcing domestic income. This section provides a general description of state methods and their application.

Two General Sourcing Methods

States generally use two sourcing methods applied to two different categories of income:

- **Formulary apportionment** – Uses an in-state ratio, often based on amount of receipts derived from the state, to divide total net income from business activities.
- **Specific rules of assignment** – Assign items of income, expense, gain, or loss based on the nature of the item or activity (similar to federal rules used to source domestic income).

General Application to Resident and Nonresident Individuals

- **Residents** –
 - Tax is imposed on 100% of the individual's income.
 - A credit is given for tax paid to other states on the same income, but the credit is generally limited to:
 - The rate of tax the resident state would have imposed, and
 - The base the resident state would have taxed applying that state's own sourcing rules.
- **Nonresidents** –
 - Tax is imposed only on state-sourced income.
 - Formulary apportionment applies to business income earned directly by the individual (e.g., income of a sole proprietorship).
 - Specific rules of assignment apply to nonbusiness income including:
 - Investment income – which may be sourced to the location of the property or activity, if in the state, but may also be taxed when the individual is resident in the state.
 - Compensation – which has traditionally been sourced to the location of the performance of the services. There are, however, a handful of states that assign compensation to the location of the employer or the office of the employer to which the individual presumably reports.

General Application to Partnership Related Income

These sourcing methods are generally applied to partnership income as follows:

- **Distributive share – based on partnership activities** – States generally source distributive share by applying formulary apportionment or specific rules of assignment, based on the activities of the partnership or the business in which it is a part. An exception is investment partnerships where the income is sourced as if the partners earned that income directly.
- **Separate transactions between partners and partnerships** – States generally source transactions between partners and partnerships that are conducted as though they are between unrelated parties (see IRC §707(a)), by treating each as having its own separate items of income, expense, gain, or loss, that are then sourced by applying the state's general rules.
- **Guaranteed payments for services** – Unless states specifically address the sourcing of these payments, it may be unclear whether states use the sourcing approach used for distributive share income or the approach used for partner-partnership transactions. And, as will be discussed in Section III of this paper, states that have addressed the sourcing of guaranteed payments for services have adopted different rules.

I. E. Aggregate and Entity Theories as Applied to Partnership Payments

The legal and tax treatment of partnerships has been based on two competing theories—aggregate and entity. The treatment of payments by partnerships to partners will differ fundamentally depending on the theory applied. Subchapter K recognizes three general categories of partnership payments: distributive share/distributions, partner-partnership transactions, and guaranteed payments. This subsection considers how the aggregate and entity theories have been applied to these categories. The next subsection considers whether the aggregate or entity treatment of these payments may affect sourcing.

Partnership Payments

The categories of partnership payments generally recognized under Subchapter K are:

Regular Distributive Share/Distributions

Partners are allocated a share of a partnership’s income—called “distributive share”—on which they pay tax, regardless of whether they receive a distribution. This distributive share of partnership income increases a partner’s basis in their partnership interest (“outside basis”). Then, any payments properly characterized as distributions will reduce outside basis and are non-taxable to the extent of that basis. So partnership income is taxed only once.

Partner-Partnership Transactions

Partners and partnerships can engage in transactions that are similar to those between unrelated persons. When they do, the character, value, timing, etc. are determined under the normal substantive tax rules, as if the partner was not a partner. For example, if a partner sells property to a partnership, the partnership will have an expense or capitalized expenditure, and the partner will have income, gain, or loss.

Guaranteed Payments Made to Partners Acting as Partners

Guaranteed payments are a third category of transfers recognized by Subchapter K, which are similar to transactions between unrelated persons but are made when the partner is acting in the capacity of a partner. 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.

Each of these categories may be treated differently under both Subchapter K and the federal substantive tax rules—so that similar circumstances may lead to a different tax result.

Aggregate and Entity Theories

Two different theories of partnerships inform both state law and federal tax law governing partnerships:

- **Aggregate Theory**: Partnerships are nothing more than collections of persons acting together. The partnership is not considered separate from the partners. Instead, the partners are treated as if they acted directly.
- **Entity Theory**: Partnerships are persons separate from the partners. The partnership can, therefore, engage in actions separate from the partners, and even in some dealings with the partners.

For example—assume two individuals form a partnership by contributing cash. The partnership uses this cash to purchase property, which is later sold for a profit. Under the aggregate theory, the partners would be seen as having acquired the property together, using their separate funds, owning the property jointly, and then selling their shares of the property and recognizing profit directly from that sale. Under the entity theory, they would be treated as having acquired an interest in the partnership rather than the property, and the partnership would be seen as buying and selling property as a separate person. Profit would be divided by the partners according to their agreement.

Application of these theories varies, and aspects of both may apply, depending on the circumstances.

Distributive Share/Distributions – Aggregate Theory

Traditionally, the aggregate theory was the dominant theory of partnerships, so that partners were often deemed to engage in the partnership's activities collectively. In the late 20th Century, this began to change and state law now treats partnerships as entities for some purposes.² But the aggregate theory, which still applies to certain aspects of the general economic relationship between partners, is reflected in the pass-through system created by Subchapter K for taxing partnership income generally.

Rules that are employed to carry out this aggregate approach can be summarized in very general terms:

- **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).
- **Payments 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 partner's 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.

In light of these general rules, federal tax treatment of distributive share/distributions most closely tracks the aggregate theory of partnerships. Tax is not imposed on the entity. Instead, partnership items of income, expense, gain, and loss are attributed to the partners according to their agreement and are taxed to the partners. And distributions are not taxed to the extent they represent a return of either contributions or income that has already been reported for tax purposes.

² This is reflected in the Uniform Partnership Act as well as state laws generally. 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>.

Partner-Partnership Transactions – Entity Theory

Partnerships may sometimes act as separate entities with respect to the partners. When any transfer between a partnership and a partner is, in substance, a transaction similar to an exchange between unrelated parties, Subchapter K applies the entity theory so that both the partner and partnership separately recognize an exchange.

The following general rules would apply whenever a “partner engages in a transaction with a partnership other than in his capacity as a member of such partnership” (see IRC § 707(a)):

- **Transfers of Property or Services from Partner to Partnership - Recognition:**
 - The transfer will be treated as an exchange between separate persons (IRC § 707(a));
 - The transferring partner 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 by the payment.
- **Transfers of Money or Property from Partnership to Partner – Recognition as Partnership Item:**
 - The transfer is treated as an exchange between separate persons (IRC § 707(a));
 - The 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).
 - The effect of this partnership expense on the allocation of distributive share to the partner engaged in the transaction is a complicated matter involving the requirement that this allocation have substantial economic effect. (See IRC § 704(b) and related regulations.)
- **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 partnership payments will necessarily fall within either the aggregate or entity approaches described above for distributive share/distributions or partner-partnership transactions. But partners can also act in the capacity of a partner and receive payments “without regard to the income of the partnership,” (IRC § 707(c)) meaning the payments are neither distributive share/distributions nor partner-partnership transactions, at least as those categories are defined and treated under Subchapter K.

For example, partners are not considered employees of the partnership, as discussed further in Section II below. (See. Rev. Rul. 69-184.) But it has always been common for partners in professional services firms to receive payments not dependent upon partnership income for the professional services they perform. The ability of partners to receive payments not dependent upon income allows the partners who perform the business activities of the partnership to be compensated for those activities even if the partnership reports a loss for the year. But it raises questions about whether the aggregate or entity theory should be applied.

As will be discussed further in this white paper, it is not always clear when a payment is made “without regard to the income of the partnership,” given that some types of guaranteed payments are tied closely to financial results other than the amount of taxable net income or may vary over time depending upon other circumstances. But for those payments that are clearly guaranteed payments for services, the question is whether the entity or aggregate approach is more appropriate.

Example – Comparing the Economic Result to Entity and Aggregate Tax Results

The simple example here demonstrates how a typical guaranteed payment for services might be treated under either the entity or the aggregate approach.

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 (tracking capital accounts):

- X, Y, and Z have beginning capital balances of \$10,000.
- X has guaranteed payment income of \$12,000 which does not affect X's capital account.
- After subtracting the \$12,000, the partnership has a loss of \$3,000 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—equal to their capital accounts.

Tax Result – Entity Approach (tracking outside basis):

- 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.
- After subtracting the \$12,000, the partnership has a loss of \$3,000 which X, Y, and Z 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 (tracking outside basis):

- X, Y, and Z would have beginning outside basis of \$10,000.
- Partnership would report \$9,000 in partnership income without deducting the \$12,000.
- X, Y, and Z would each report \$3,000 of partnership income.
- X, Y, and Z would have an outside basis after income allocation of \$13,000 each.
- The \$12,000 payment to X would be a distribution, reducing X's outside basis to \$1,000.
- The partner's agreed upon liquidating distribution of \$9,000 each would be greater than X's outside basis of \$1,000—resulting in a capital gain of \$ 8,000. (See IRC § 731.)
- The agreed upon liquidating distribution of \$9,000 would be less than Y and Z's 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 Results	Entity Approach	Aggregate Approach
Results for Partner X				
Year 1	Ordinary Income	\$ 12,000	\$ 12,000	
	Partnership Income (Loss)	\$ (1,000)	\$ (1,000)	\$ 3,000
	Net Ordinary Income	\$ 11,000	\$ 11,000	\$ 3,000
Year 2 (Liquidation)	Total Gain/Loss	\$ -	\$ -	\$ 8,000
Results for Partners Y & Z Combined				
Year 1	Total Partnership Income (Loss)	\$ (2,000)	\$ (2,000)	\$ 6,000
Year 2 (Liquidation)	Total Gain/Loss	\$ -	\$ -	\$ (8,000)

In this example, both entity and aggregate approaches will result in the same total amount of recognized income/gain by the three partners—\$9,000 over the two years. But under the entity approach, income will be ordinary income or loss and will be recognized when received. Under the aggregate approach, some income will be capital gain (loss), and deferred until liquidation. These differences in the character are important because the federal substantive tax rules would treat the ordinary income and loss differently than the capital gains and losses—so the tax paid will vary.

And 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 may be a better match for the actual economic result than the aggregate approach. This is also the approach Subchapter K now takes, as discussed further in Section II below.

Congress's Decision to Apply Entity Approach to Guaranteed Payments

As noted above, while the aggregate theory governed the early development of partnership law, including tax law, over time this traditional view of partnerships has changed in some ways, although not in others. For example, it is still the case that partners are not considered employees of the partnership, so payments that are similar to compensation are not treated as employee compensation.

But the general application of the aggregate theory to guaranteed payments was eventually recognized as unworkable. As one court noted, prior to 1954 and the enactment of IRC § 707 (the section which governs these payments today): “the tax treatments of partners and partnerships were confused and at times contradictory.” In that case, the question was whether a payment to a partner not covered by current year income should be considered as paid from that partner's capital, or from the capital of the other partners. If the former, then it would simply be a non-taxable distribution. If the latter, then it might be treated as a deduction by the other partners for ordinary and necessary business expenses they incurred.

As the court also noted, Congress ultimately decided that applying the aggregate approach to such payments was “unrealistic and unnecessarily complicated” and thus adopted, in general, the entity approach for tax treatment of compensation to partners for services, at least as far as sections 61(a) and 162(a) were concerned.³

³ See *Cagle v. Commissioner*, 63 T.C. 86, 94 (1974) citing H. Rept. No. 1337, supra at pp. 67-68; S. Rept. No. 1622, supra at p. 92. Also note that for other purposes, guaranteed payments are treated as distributive share.

I. F. How Do Aggregate or Entity Approaches Affect State Sourcing?

State sourcing of guaranteed payments is discussed in detail in Section IV. The question here is whether state sourcing of guaranteed payments is or should be affected by whether the aggregate or entity approach is applied to these payments under the federal pass-through system.

Comparing the Sourcing of the Categories of Payments

Distributive Share/Distributions – Sourced Using the Aggregate Approach – With One Exception



As discussed above, the federal pass-through system applies the aggregate approach to the treatment of distributive share/distributions. Under this approach, the timing, value, character, etc. of a partner's share of partnership income is determined by the partnership's activities which are then attributed to the partner, as though the partner engaged in the partnership activities directly. This is true despite the fact that a partner's active or passive role in the partnership's activities may then determine how certain partnership items are treated in computing that partner's own tax.

States also source a partner's distributive share income (loss) using an aggregate approach. The activities of the partnership giving rise to the income determine sourcing of that income (e.g. through apportionment at the entity level). The source of the income is then attributed to the partner's share of that same income. An exception to this general approach is sometimes made for investment partnerships where the activities of the investment partnership itself are ignored and the partner's income is sourced as if they held the same investment assets directly.

Partner-Partnership Transactions – Sourced Using the Entity Approach



The federal pass-through system applies the entity approach to partner-partnership transactions so that the income of partners from such transactions will be characterized as though the partners are separate from the partnership. The timing, value, character, etc. of any income from such transactions will be determined based on the separate activities of the partner, rather than the partnership.

States also source a partner's income (loss) from partner-partnership transactions based on the business or other activities conducted solely by the partner giving rise to that income—rather than the related activities of the partnership. This does not mean, however, that the payments or resulting income would necessarily be sourced to where an individual partner performs the services—although this may be the result in some cases.

Sourcing of Guaranteed Payments for Services – Sourcing Approach Varies



The federal pass-through system generally applies an entity approach to guaranteed payments (similar to the treatment of partner-partnership transactions), with some limitations. But as summarized in Section III, the majority of states that have addressed the sourcing of guaranteed payments for services specifically source them in the same way as distributive share—using an aggregate approach. A minority of states source such payments as compensation

Why Sourcing of Guaranteed Payments May Not Follow the Entity Approach

One reason why states may not follow the entity approach when sourcing guaranteed payments is that such payments are a hybrid. While they have some aspects of partner-partnership transactions, they also involve partners acting on behalf of the partnership—carrying out the partnership's business from which the partnership derives income. But there are other reasons as well. One is that partnership agreements can be changed easily, assuming partners agree, and that if the economic result is the same, partners might choose to structure the agreement to include guaranteed payments in order to affect the sourcing of their income. Also partnership agreements and other circumstances can make distinguishing guaranteed payments more difficult—adding complexity to the sourcing of that income, if treated differently.

I. F. Other Considerations – Complexity and Possible Tax Avoidance

Section II below sets out the federal rules governing guaranteed payments, including specific rules distinguishing guaranteed payments from distributive share/distributions or partner-partnership transactions. In terms of context, what is important to note is that, unlike the simple example above, complex partnership arrangements and other circumstances can make determining what is a guaranteed payment much more difficult—and can also create opportunities to alter the tax result without altering the economic result through income shifting.

Examples:

The following are common examples of differences that may complicate the determination of whether a payment is properly categorized as a distributive share/distribution, partner-partnership transaction, or guaranteed payment.

- Partners may agree that they will receive regular, periodic distributions, sometimes called “draws,” for the purpose of returning capital or profits to those partners. To the extent these distributions are made out of available capital, they would generally be treated as distributions, even in a year in which there is insufficient income to cover that year’s distribution. So while they might appear to be guaranteed payments in those years, they are not.
- Special allocations can also sometimes appear to be guaranteed payments. The term “special allocation” refers to an agreement by partners to divide partnership items of income, expense, gain, or loss other than by their respective interests in the partnership. So partners may agree that some income or some expense will be allocated in greater or lesser proportion. This, in turn, could lead certain partners to recognize and report distributive shares of 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.
- Partners may also 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 some or all of the partnership’s items of income or gains. In this case, that partner may eventually be able to take distributions from capital in excess of any net income the partnership earned. But the fact that the partner is performing services as a partner and receives a special allocation of partnership items will not make the distributions that partner receives guaranteed payments.
- Partners may agree to preferential allocations or distributions of all kinds. So, for example, partners may agree that a managing member will receive the first \$10,000 of income before the remainder is allocated and may also agree that this amount will accrue over time if the income in any one year is insufficient—or may be required to be paid by a certain time regardless of the income earned by the partnership during that period.
- It may also be difficult to distinguish guaranteed payments from partner-partnership transactions in some circumstances. For example, assume a partnership operates a restaurant and has, as a general 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 may not mean the partner is acting in the capacity of a partner or make the payment a guaranteed payment.

It is not unusual for there to be disagreement about how to characterize payments under these and other similar examples—or for federal rules to be lacking. It is also not unusual for partnership agreements to specify that payments are to be made regardless of income when it is likely that the partnership will have sufficient income to cover those payments.

In turn, this complexity can make distinguishing guaranteed payments for purposes of sourcing more difficult.

Income Shifting - Examples

Another important consideration is that, to the extent distributive share and guaranteed payments are sourced differently, it may be possible to alter the sourcing without substantially changing the underlying economic arrangement.

Examples

Assume State 2 sources distributive share using the partnership's receipts factor but sources guaranteed payments based on where the partner is located and performs services.

Example 1:

- X and Y form a partnership to own and manage rental property, contributing an equal share of capital.
- X resides and works in State 1, which has no income tax. Y resides and works in State 2, which does have an income tax.
- The rental property is located in State 2 and is currently fully rented, making on average \$100,000 per year.
- X and Y agree that X will be paid a guaranteed payment of \$30,000/year and will be allocated 28% of the partnership's net income after deducting that payment.

Example 2:

- 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 on client work and some incidental costs.
- X resides and works in State 1, which has no income tax. Y resides and works in State 2, which does have an income tax.
- Most of the partnership's clients are in State 2.
- For the first three years, partnership's average income is \$200,000, and X and Y split that income 50/50.
- In year four, X and Y agree that X will receive a guaranteed payment for services of \$80,000, and will then receive a 15% share of any net income after deducting that payment.

Assuming the payments to X are guaranteed payments, the sourcing of X's income will change even though the essential economic arrangements are unchanged.

I.G. Summary

This Section I provides general information on the federal pass-through tax system and describes how guaranteed payments for services fit within that context. Guaranteed payments have been distinguished from distributive share/distributions and from partner-partnership transactions, both in theoretical terms and in how they are treated under both the pass-through system and federal substantive tax rules.

In terms of the aggregate and entity theories, guaranteed payments are treated more like partner-partnership transactions (entity theory) rather than as distributive share/distributions (aggregate theory). A case might therefore be made that guaranteed payments for services should be sourced in the same way as payments to compensate partners for the performance of services—looking solely to the activities of the partner, rather than the activities of the partnership.

But there are two other considerations that may affect the sourcing. The first is the complexity of some types of economic arrangements between partners and the difficulty in matching those arrangements to particular categories of payments, to the extent this determines sourcing. The second is the possibility that sourcing different types of partnership-related income differently might lead to taxpayers adopting structures or arrangements in order to shift income for tax purposes.

II: SPECIFIC FEDERAL RULES FOR GUARANTEED PAYMENTS

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-on-state-taxation-of-partnerships/>

Section I provided general context for a discussion of guaranteed payments and concluded that while these payments may be distinguished from two other categories of partnership payments—distributive share/distributions and partner-partnership transactions—doing so may be complicated by similarities between the categories and the complexity of certain partnership arrangements.

This Section II sets out the federal rules that apply to guaranteed payments, including:

- Subchapter K, to which most states conform,⁴
- Substantive tax rules, including IRC §199A and self-employment tax rules,
- Federal rules for sourcing guaranteed payments for services, and
- Federal rules for the state sourcing of certain guaranteed payments made to retired partners.

II. A. Subchapter K

Relevant Provisions of Subchapter K

Any discussion of the federal tax rules for guaranteed payments begins with IRC § 707. Congress added § 707 to the Internal Revenue Code of 1954, in part, to address transactions between partners and partnerships. Section 707 recognizes a difference between payments to a partner “not acting in capacity as partner,” § 707(a), versus “guaranteed payments” made “to a partner for services or the use of capital”—presumably in the capacity as partner, § 707(c). In 1984, Congress made changes to § 707, including the disguised sale rules in subsection (a)(2), which are discussed further below.

IRC Section 707 (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 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) Certain sales or exchanges of property with respect to controlled partnerships

(1) Losses disallowed

...

⁴ Exceptions are the District of Columbia, New Hampshire, Connecticut, and Texas, which impose entity-level taxes.

(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).

Section 707(c)'s description of guaranteed payments also serves to distinguish them from regular distributive share/distributions in that the payment will be a guaranteed payment "to the extent determined without regard to the income of the partnership."

In contrast, § 704, which governs distributive share provides.

IRC Section 704 (in relevant part):

(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 of income, gain, loss, deduction, or credit (or item thereof) 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 of income, gain, loss, deduction, or credit (or item thereof), or

(2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.

Under IRC § 704, partners may agree to so-called "special allocations" where partnership income, or particular items of partnership income, expense, gain, or loss are divided as agreed to, rather than according to partners' interest in the partnership, provided they have substantial economic effect. So, for example, the partners may agree that certain items of income are allocated to one partner whereas other items are allocated to another.

Application to Different Types of Payments

While the 1954 changes to Subchapter K recognized the category of guaranteed payments as separate from the two other primary categories of partnership allocations/payments—that is, partner-partnership transactions and distributive share of partnership income, expense, gain, or loss—the exact lines separating these three categories are unclear. The two provisions of IRC § 707 that are often at issue are: (1) whether the partner is acting "in the capacity" of a partner—which distinguishes guaranteed payments from partner-partnership transactions, and (2) the extent to which the payment is "determined without regard to the income of the partnership"—which distinguishes guaranteed payments from distributive share, and special allocations in particular.⁵

One example of the difficulty involves payments based on gross rather than net income. In 1975 in *Pratt v. Commissioner*,⁶ the Tax Court ruled that such payments were not covered by either § 707(a) or § 707(c). The case involved two limited partnerships that were formed to purchase, develop, and operate two shopping centers. The general partners in the partnerships agreed to receive a fixed percentage of gross rentals in exchange for performing managerial services.

⁵ See IRC § 704(b) which allows partners to share partnership items of income, expense, gain, or loss in proportions other than by the partners' interest in the partnership.

⁶ 64 T.C. 204 (1975), aff'd in part, rev'd in part, 550 F.2d 1023 (5th Cir. 1977)

The Tax Court found that these payments were not guaranteed payments under § 707(c) because they were not determined without regard to partnership income. The court also found that § 707(a) was not applicable because the managers “receiv[ed] the management fees for performing services within the normal scope of their duties as general partners pursuant to the partnership agreement.”⁷

In response to the decision in *Pratt*, 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 §§ 707(a) and 707(c).⁸ Similar to the facts in *Pratt*, Rev. Rul. 81-300 addressed 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. But in holding that the management fees in this case were guaranteed payments under § 707(c), the IRS found: “. . . the term ‘guaranteed payment’ should not be limited to fixed amounts. Instead, 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.”⁹

In Rev. Rul. 81-301 the partnership had two classes of general partner: (1) director general partners and (2) one adviser general partner. The director partners had complete and exclusive control over the management, conduct, and operation of the partnership’s activities. Subject to the supervision of the directors, the adviser was only authorized to manage the partnership’s investments. In exchange for those services, the partners agreed that the adviser partner would receive an allocation of 10% of the partnership’s daily gross income. The adviser partner also provided similar services to others as part of its regular trade or business. Its management of the partnership’s investment activities was supervised by the directors who could also relieve the adviser of its duties and right to compensation. The ruling held that the adviser partner’s allocation was properly treated as paid to the adviser in its capacity other than as a partner under § 707(a).¹⁰

In 1984, Congress amended §707(a) to provide for the treatment of “disguised sales” and some legislative history has been cited as indicating that the type of payments described in Rev. Rul. 81-300 should have been held to be §707(a) payments to partners not acting in the capacity of partners, rather than guaranteed payments as the IRS concluded in its revenue rulings. In part this may have been due to the view that guaranteeing a payment can reduce a partner’s risk in a way that is entirely incompatible with the role of being a partner. In 2015, the IRS issued proposed regulations that appear consistent with this narrower view of guaranteed payments, but has not finalized those regulations.¹¹ (See below.)

Meanwhile, the complexity of the questions concerning when something is a guaranteed payment versus a special allocation of partnership items of income, expense, gain, or loss have grown in recent years. In part, this is due to complex financial arrangements designed to reimburse partners for capital contributions or to provide them with a guaranteed return on those contributions—which are outside the scope of this white paper. See also Section III which describes other attempts to provide alternatives to guaranteed payments.

2015 Proposed Regulations

As noted above, the IRS has issued proposed regulations, not yet finalized, that respond to Congress’s indication in 1984 that it intended to draw a different line between the three categories of partnership payments—distributive share/distributions, partner-partnership transactions, and guaranteed payments to partners acting in the capacity of a partner.

⁷ Id.

⁸ C.B. 2015-32

⁹ Rev. Rul. 81-300.

¹⁰ 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).

¹¹ REG-115452-14, 80 Fed. Reg. 43,652 (July 23, 2015).

According to supplemental information in the introduction to these proposed regulations (excerpted below), the line between the different distributive share/distributions and payments covered by § 707 is determined based on all the facts and circumstances—including entrepreneurial risk:

“Congress's emphasis on entrepreneurial risk requires changes to existing regulations under section 707(c). Specifically, Example 2 of § 1.707-1(c) provides that if a partner is entitled to an allocation of the greater of 30 percent of partnership income or a minimum guaranteed amount, and the income allocation exceeds the minimum guaranteed amount, then the entire income allocation is treated as a distributive share under section 704(b). Example 2 also provides that if the income allocation is less than the guaranteed amount, then the partner is treated as receiving a distributive share to the extent of the income allocation and a guaranteed payment to the extent that the minimum guaranteed payment exceeds the income allocation. The treatment of the arrangements in Example 2 is inconsistent with the concept that an allocation must be subject to significant entrepreneurial risk to be treated as a distributive share under section 704(b). Accordingly, the proposed regulations modify Example 2 to provide that the entire minimum amount is treated as a guaranteed payment under section 707(c) regardless of the amount of the income allocation. Rev. Rul. 66-95, 1966-1 C.B. 169, and Rev. Rul. 69-180, 1969-1 C.B. 183, are also inconsistent with these proposed regulations. The Treasury Department and the IRS intend to obsolete Rev. Rul. 66-95 and revise Rev. Rul. 69-180, when these regulations are published in final form.

“B. Secondary Factors

“Section 1.707-2(c)(2) through (6) describes additional factors of secondary importance in determining whether or not an arrangement that gives the appearance of significant entrepreneurial risk constitutes a payment for services. The weight given to each of the other factors depends on the particular case, and the absence of a particular factor is not necessarily determinative of whether an arrangement is treated as a payment for services. Four of these factors, described by Congress in the legislative history to section 707(a)(2)(A), are (i) that the service provider holds, or is expected to hold, a transitory partnership interest or a partnership interest for only a short duration, (ii) that the service provider receives an allocation and distribution in a time frame comparable to the time frame that a non-partner service provider would typically receive payment, (iii) that the service provider became a partner primarily to obtain tax benefits which would not have been available if the services were rendered to the partnership in a third party capacity, and (iv) that the value of the service provider's interest in general and continuing partnership profits is small in relation to the allocation and distribution.”

“To these four factors, the proposed regulations add a fifth factor. The fifth factor is present if the arrangement provides for different allocations or distributions with respect to different services received, where the services are provided either by a single person or by persons that are related under sections 707(b) or 267(b), and the terms of the differing allocations or distributions are subject to levels of entrepreneurial risk that vary significantly. For example, assume that a partnership receives services from both its general partner and from a management company that is related to the general partner under section 707(b). Both the general partner and the management company receive a share in future partnership net profits in exchange for their services. The general partner is entitled to an allocation of 20 percent of net profits and undertakes an enforceable obligation to repay any amounts distributed pursuant to its interest (reduced by reasonable allowance for tax payments made on the general partner's allocable shares of partnership income and gain) that exceed 20 percent of the overall net amount of partnership profits computed over the partnership's life and it is reasonable to anticipate that the general partner can and will comply fully with this obligation. The proposed regulations refer to this type of obligation and similar obligations, as a “clawback obligation.” In contrast, the management company is entitled to a preferred amount of net income that, once paid, is not subject to a clawback obligation. Because

the general partner and the management company are service providers that are related parties under section 707(b), and because the terms of the allocations and distributions to the management company create a significantly lower level of economic risk than the terms for the general partner, the management company's arrangement might properly be treated as a disguised payment for services (depending on all other facts and circumstances, including amount of entrepreneurial risk).¹²

II. B. Substantive Tax Rules

Under federal substantive tax rules, guaranteed payments often receive less favorable treatment. In particular, the following rules apply to guaranteed payments, much in the same way they would apply to partner-partnership transactions:

Ordinary income

Guaranteed payments are treated as income under IRC § 61(a). See § 707(c). Section 61(a), in turn, lists items included in “gross” or, what is considered, “ordinary” income, as opposed to capital gains.

IRC §199A Qualified Business Income Deduction

Guaranteed payments for services are not included in “qualified business income” for purposes of the so-called “qualified business income” deduction provided under IRC § 199A.¹³ Conversely, distributive share income is expressly included as qualified business income under that section.¹⁴

Self-Employment Tax

Partners may be subject to federal self-employment tax on their partnership-related income. General partners are subject to the tax on both distributive share and guaranteed payments. A limited partner can exclude distributive share income, but not guaranteed payments for services. See IRC §1402(a)(13). The IRS has published proposed regulations that interpret the term “limited partners” to include members of an LLC, but these regulations have not been finalized and the issue is subject to ongoing litigation.

II. C. Federal Income Sourcing

Earned income from compensation for labor or personal services performed outside the U.S. is treated as foreign source income for federal purposes. See IRC § 911. In *Miller v. Commissioner*, 52 T.C. 752 (1969), the Tax Court ruled that this treatment applied to guaranteed payments for services.¹⁵ 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 the limits of 911(b)(2)(D), which caps the amount at \$80,000 adjusted for inflation (now \$112,000), 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.¹⁶

As described in Section I.C. above, this exclusion of certain guaranteed payments for services earned while working overseas effectively excludes this amount from federal adjusted gross income (AGI), to which the majority of states conform or with which they begin their computation of state taxable net income. Therefore, if states choose to source these guaranteed payments not as compensation, but based on the aggregate approach used for distributive share/distributions, they would need to make an adjustment to federal AGI to include the amounts.

¹² Id.

¹³ IRC § 199A(c)(4)(B).

¹⁴ IRC § 199A(f)(1)(A)(ii).

¹⁵ *Miller v. Commissioner*, 52 T.C. at 762.

¹⁶ 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/jto_p_09_06_05_19.pdf.

II. D. 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—

4 U.S.C. § 114(b)(1)(I)

(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.”

II. F. Summary

The take-aways from the federal tax treatment of guaranteed payments can be summarized as follows:

- Distinguishing guaranteed payments from both distributive share/distributions and from partner-partnership transactions can be complicated and the lines have changed over time.
- The line between guaranteed payments for services and guaranteed payments for the use of capital is also somewhat unclear.
- Guaranteed payments may receive tax treatment that is similar to partnership-partner transactions and somewhat less favorable than distributive share/distributions, depending on the circumstances.
- Guaranteed payments for services performed overseas may be excluded from federal adjusted gross income, to which most states conform or with which they begin their tax calculation.
- Guaranteed payments paid as retirement compensation to retired partners and subject to the rule of 4 U.S.C. § 114 cannot be taxed except by the state of the partner’s residence.

III. AMOUNTS AND TYPES OF GUARANTEED PAYMENTS

IRS Partnership Statistics of Information (SOI), available here: <https://www.irs.gov/statistics/soi-tax-stats-partnership-statistics>, provide information on partnership income and guaranteed payments. In 2020, these statistics show that total guaranteed payments were \$74 billion. In prior years, the amounts of guaranteed payments for services and the use of capital were not broken out separately in partnership returns.

Percentage of Total Net Income

For 2020, total partnership net income, including both business and portfolio income, and adding back the 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 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 report a net loss or pay out guaranteed payments in excess of the total 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 is based on total partnership net income after adding back guaranteed payments—showing those industries where the industry has a net loss separately.

(amounts here shown in thousands)

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.

IRS SOI - Partnership Statistics by Industry - 2020			
Comparison of Guaranteed Payments			
	(In thousands of dollars)		
By Industry	Gross Business Income	Guaranteed Payments	Percentage of Gross
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%
All Industries	\$ 6,542,271,249.00	\$ 74,044,268.00	1.13%

It is likely no surprise that partnerships in the professional, financial, and healthcare industry sectors rank highest in terms of total guaranteed payments and the percentage of guaranteed payments to gross income, since these sectors include professional firms whose partners often participate in their businesses. Still, the range in terms of percentages is not extraordinary—between .11% and 3.91%, with 1.13% as the average.

Industry rankings of guaranteed payments relative to total partnership net income (loss), tell a slightly different story. This ranking is complicated because industries can show a loss or net income in excess of guaranteed payments, and for industries fall into this category—accommodations and food services, arts and entertainment, transportation, and utilities. It appears this may be due to lower profit margins in those industries.

For the remaining industries, the percentage of guaranteed payments relative to this net income amount varies widely—from 1.7% to almost 50%. 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 the percentage of guaranteed payments.

Comparison of Guaranteed Payments	(In thousands of dollars)			
	By Industry	Total Partnership Net Income (Loss)	Guaranteed Payments	Total Partnership Net Income (Loss) Adding Back Guaranteed Payments
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%

Common Guaranteed Payments and Alternatives

Review of different sources of information on partnerships indicates that the common type of guaranteed payment is a fairly straight-forward agreement to pay partners a set amount annually, regardless of partnership income, with or without some fairly simple limitations. These more common types of guaranteed payments would clearly meet the test under existing standards—including the IRS proposed regulations discussed in Section II above.

Also, as noted in Section II above, guaranteed payments are sometimes treated less favorably from a tax standpoint—they are always ordinary income, they are not included in the qualified income deduction under IRC § 199A, and they are subject to self-employment taxes in many cases. Therefore, it is also common for partnerships to seek alternatives to guaranteed payments that may be treated more favorably. For example, the partnership may provide the use of property or other administrative support. The partnership may also provide non-taxable reimbursement of the partners' costs in some circumstances.

But in cases where the partnership's income is primarily from capital gains, the partnership will seek alternatives that allow partners to apply this beneficial tax rate for amounts received, while still providing partners who do services for the partnership with an additional compensation for their efforts.

Partnerships may grant "profits interests" to partners, allowing them to share in partnership income without providing capital contributions. Some arrangements also provide partners performing management services with the ability to waive some or all of a guaranteed payment for an additional amount of allocated income. These and other arrangements may also affect the tax results for other partners. And there is some uncertainty about how some of these alternatives are treated for tax purposes. One question is whether any fee waived is still constructively received. If so, this may convert that waived fee in lieu of an additional profits interest into a taxable exchange subject to §707(a).

Another alternative is to provide partners who perform management services with a priority allocation—a special allocation entitling them to the first income from particular sources before the remainder is divided. For partners that have made a capital contribution, this can take the place of a guaranteed payment for the use of capital. These priority allocations can also be made during periods when the partnership has or expects certain profits. However, special allocations during periods when the partnership has net losses may be subject to re-characterization as guaranteed payments or payments subject to §707(a). See Rev. Rul. 81-300, superseded by REG-115452-14, 80 Fed. Reg. 43,652 (July 23, 2015), and Rev. Proc. 93-27. (Discussed in Section II above.)

IV. STATE SOURCING AND RELATED RULES

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

Since the federal partnership rules do not address the state sourcing of guaranteed payments, and since it is not entirely clear which of two general methods of sourcing would be most compatible with federal rules, state specific rules provide necessary clarity. This section summarizes the rules in states that have addressed the sourcing of guaranteed payments specifically. But roughly half the states have not yet explicitly addressed the sourcing of guaranteed payments.

IV. A. Summary of Guaranteed Payment Issues Addressed by States

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

Are guaranteed payments for services generally sourced the same as distributive share?

Twenty-one (21) states have rules indicating that guaranteed payments paid to individuals for 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 for 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.

Note that while this white paper does not address the sourcing of guaranteed payments for the use of capital, it appears that, to the extent states have addressed their sourcing, Michigan and Pennsylvania them based on domicile, Colorado allocates or apportions them based on the income-generating activity, and twenty states generally source these payments the same as distributive share.¹⁷

Are there any rules limiting the sourcing for guaranteed payments for services?

As noted in Section II above, 4 U.S.C. § 114 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.” This applies to guaranteed payments made to retired partners. Four (4) states have specific sourcing rules addressing guaranteed payments made to retired partners (Idaho, Montana, New Jersey, and Pennsylvania).

¹⁷ Those states are 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.

Are guaranteed payments for services included in the payroll factor?

Traditionally, states apportioned business income using a formula that included sales, property, and payroll factors—that is—ratios of in-state sales, property, and payroll to the totals both in and outside of the state. Today, 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, for periods when they used a payroll factor, California applies a special payroll factor rule for guaranteed payments made 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 are included in pass-through entity taxes are they sourced in the same manner as if reported by partners?

As of August 2023, sixteen (16) states that have enacted pass-through entity taxes have addressed whether guaranteed payments are included or excluded from the entity's 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). 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. 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. But also, states typically give residents some kind of offset for their share of PTE tax against the tax that would be paid by the partners individually, so the sourcing under both the entity-level tax and under the pass-through tax, applied to the partners, should be the same.

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.

In addition to these questions, note that however guaranteed payments are sourced, many states also require that partnerships withhold tax for nonresident partners or may allow partnerships to file and pay tax on behalf of those partners in the form of a composite return. Presumably, the state will need to use the same method for sourcing income and computing the tax as part of these entity-level reports as for the reporting by the partners.

IV. B. State Rules on Guaranteed Payments

This subsection IV. 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.

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.

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.

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.

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.

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; . . .

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.

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.

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.

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.

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.

(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.

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.

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.

Mississippi

Miss. Code R. § 35.III.9.01.101.4

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.

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; . . .

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.

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.

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.

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:

(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.

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

North Carolina

N.C. Gen. Stat. § 105-154

(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.

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.

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.

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.

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.

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.

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).

Wisconsin

Wis. Stat. § 71.21

According to Wis. Stat. § 71.21(6)(b), a partnership making the election to pay tax at the entity level in Wisconsin under Wis. Stat. § 71.21(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.

V. FINDINGS – CONSIDERATIONS – RECOMMENDATIONS

This section draws on Sections I – IV above to determine the important context and other information that may affect the state sourcing of guaranteed payments for services, the implications or factors favoring the different methods of sourcing, and recommendations for the states to consider.

In addition to the research reflected in this white paper, the MTC work group on the taxation of partnerships has held a number of discussions on the issue of sourcing guaranteed payments for services. The findings here are based on those discussions as well as information in Sections I-IV of this white paper.

Based on the research and discussions, the work group has formulated the question to be addressed as follows: Should states source an individual partner’s guaranteed payments for services as distributive share or compensation?

V. A. Relevant Findings

Important Federal Tax and Related Rules:

Under federal tax law, to which most states conform:

- 1) Partnership income is taxed on a pass-through basis, using the aggregate approach, so the character of items of income, expense, gain, or loss and their tax effects are determined based on the partnership’s activities and then this information is passed through to the partners, who report their distributive share of those items, along with the related tax effects. See IRC § 704(b).
- 2) In addition to allocating to partners their distributive share of partnership income and making any related distributions, partnerships can also engage in partner-partnership transactions where the partner is not acting in the capacity of a partner and which have the respective tax effects they would have if the partner was not a partner. See IRC § 707(a).
- 3) Subchapter K also recognizes that partnerships can pay partners for services performed in the capacity of a partner and distinguishes these guaranteed payments from both distributive share/distributions and from partner-partnership payments. See IRC § 707(c). REG-115452-14, 80 Fed. Reg. 43,652 (July 23, 2015).
- 4) Guaranteed payments for services are also distinguished from guaranteed payments for the use of capital.
- 5) Under Subchapter K, guaranteed payments made to partners do not retain the character of any partnership items that gave rise to those payments, unlike a partner’s distributive share of partnership income, but are treated as ordinary income to the partners.
- 6) Guaranteed payments for services, unlike distributive share income, are not included in “qualified business income” for purposes of the deduction provided under IRC § 199A(c)(4)(B).
- 7) Under federal sourcing rules, guaranteed payments for services performed in a foreign jurisdiction are attributed to that jurisdiction, with some limitations, and are excluded from domestic income to which states often conform. See IRC § 911.
- 8) Guaranteed payments for services are not treated as wages paid to employees, rather, federal guidance on self-employment taxes indicates that general partners should pay self-employment tax on partnership related income, including distributive share and guaranteed payments, while limited partners would pay self-employment tax only on guaranteed payments for services. See IRC §1402(a)(13).
- 9) Under federal pension law, certain guaranteed payments to retired partners can only be sourced to the partner’s residence. See 4 U.S.C. § 114.

Types and Amounts of Guaranteed Payments

- 1) In 2020, total guaranteed payments for services and use of capital reported to the IRS (which include both payments for services and the use of capital) were \$74 billion, or about 9% of total partnership income (after adding back guaranteed payments).
- 2) About a third of all guaranteed payments come from the professional, scientific, and technical industry sector and another quarter is from the finance and insurance sector.
- 3) Because guaranteed payments are generally treated less favorably for tax purposes than distributive share/distributions, partnerships may seek alternatives to paying guaranteed payments.

Current Sourcing Treatment by States that have Specifically Addressed the Issue

- 1) About half of the states have specifically addressed sourcing of guaranteed payments in their official guidance, including statutes, regulations, or case law. Those states take one of two general approaches:
 - a) Sourcing the same as distributive share – The majority of the states that have specifically addressed the issue source guaranteed payments the same as distributive share, which for non-investment partnerships means sourcing based on the partnership’s activities.
 - b) Sourcing as compensation – A minority of states source guaranteed payments for services as compensation—that is to the place services are performed—with or without limitations.
- 2) Some states that provide PTE tax elections also include guaranteed payments in the PTE tax base and source them as distributive share—using apportionment or allocation at the entity-level.
- 3) While the use of different sourcing methods by states may result in multiple taxation, neither the states, taxpayers, nor practitioner groups have indicated that the different sourcing of guaranteed payments used by some states has caused significant problems. While a generous credit to residents for taxes paid to other states, regardless of the sourcing method, might alleviate such problems, our research shows that the state credit rules on this issue are not clear. This issue is also affected by states’ adoption of PTE taxes and the credits provided to residents.

V. B. Considerations – Factors Favoring Each Sourcing Approach

The two sourcing approaches used by states—distributive share and compensation—lead to different results and, most importantly, may lead to duplicative taxation if different states use different approaches. Each of the approaches has factors which favor that approach, listed below.

Factors Favoring Sourcing as Distributive Share

- 1) Because guaranteed payments are simply a matter of agreement between partners and, in some cases, can lead to the same economic result for the partners as distributive share, applying a different sourcing method than that used for distributive share might result in “elective” sourcing, or income shifting.
- 2) Sourcing guaranteed payments for services as compensation requires distinguishing these payments from distributive share/distributions (and special allocations) and from payments for the use of capital. While federal rules distinguish them for certain purposes—those purposes may have a different basis than the distinction states make for purposes of sourcing. For example, federal rules may distinguish guaranteed payments for services made to limited partners when imposing self-employment taxes, but they do not distinguish such payments when made to general partners, instead, subjecting their distributive share to the tax as well.
- 3) States that have adopted pass-through entity taxes and include guaranteed payments in the tax base to which the tax is applied will generally source that tax base using entity-level apportionment or

allocation, and should use the same approach for sourcing guaranteed payments for services when taxed on a pass-through basis.

- 4) Sourcing guaranteed payments differently than distributive share may also add administrative complexity to partnership-level reporting and withholding, especially in cases where the partners receive guaranteed payments for services performed in multiple locations.
- 5) Sourcing guaranteed payments as distributive share is the approach used by the majority of states that have specifically addressed the issue.

Factors Favoring Sourcing as Compensation

- 1) Sourcing guaranteed payments for services as compensation is more consistent with the entity approach, which is also the approach generally used by Subchapter K to account for and tax these payments, rather than the aggregate approach, which is used to account for and tax distributive share.
- 2) Sourcing guaranteed payments for services as compensation may also be more consistent with the way in which some partner-partnership transactions involving the partner's services would be sourced—treating the partner as an unrelated party. When this is the case, it will not be necessary to distinguish guaranteed payments, paid to a partner acting in the capacity of a partner, from guaranteed payments to a partner acting in a separate capacity.
- 3) The fact that guaranteed payments are generally given less favorable treatment than distributive share/distributions means that the risk that they would be used merely to alter the sourcing result is somewhat reduced.
- 4) Sourcing guaranteed payments as compensation is generally consistent with the federal sourcing of such payments when partners perform services overseas, so that states that conform to federal adjusted gross income might not have to make adjustments to that amount in order to tax the payments sourced on a different basis for state purposes.

V. C. Proposed Recommendations

There is nothing that prevents states from using either of the methods for sourcing guaranteed payments made to individuals for services—whether as distributive share or as compensation. Different factors may generally favor one method versus the other. Nevertheless, this white paper can make the following recommendations:

6. States should explicitly address the sourcing of guaranteed payments in order to avoid uncertainty.
7. States should source guaranteed payments the same whether applying tax to the partner on a pass-through basis or on the entity.
8. States that provide guaranteed payments should be sourced as distributive share should also:
 - a. Address whether this applies to individuals working in foreign jurisdictions who may source the payments as compensation for federal purposes—and provide necessary adjustments to the federal tax base.
 - b. Address whether they follow federal treatment in distinguishing guaranteed payments for services from partner-partnership transactions.
 - c. Specify that this sourcing treatment does not apply to payments made to retired partners that are required to be sourced to residence under 4 U.S.C. §114.
9. States that source the payments as compensation should also:

- a. Impose appropriate limits to ensure that the payments are genuinely similar to compensation for services performed and to avoid income shifting.
 - b. Address whether they will follow federal treatment in distinguishing guaranteed payments from distributive share/distributions.
 - c. Address whether they will follow federal treatment in distinguishing guaranteed payments for services from guaranteed payments for capital.
10. To mitigate the possibility of multiple taxation, consider provisions that might grant additional credits to residents who can show that they paid tax on more than 100% of their guaranteed payments based on different state sourcing rules.