DEPARTMENT OF REVENUE

NOTICE OF PROPOSED AMENDMENT

1) Heading of the Part: Income Tax

2) Code Citation: 86 Ill. Adm. Code 100

3)

Section Number:	Proposed Action:
100.2850	New Section

4) Statutory Authority: 35 ILCS 5/203(d)(2)(H)

5) A Complete Description of the Subjects and Issues Involved: This rulemaking provides guidance for determining the amount of the subtraction allowed to partnerships under IITA Section 203(d)(2)(H) for personal service income or for a reasonable allowance for compensation for services rendered by partners.

6) Published studies or reports, and sources of underlying data, used to compose this rulemaking: None

7) Will this rulemaking replace any emergency rulemaking currently in effect? No.

8) Does this rulemaking contain an automatic repeal date? No.

9) Does this rulemaking contain incorporations by reference? No.

10) Are there any other proposed rulemakings pending on this Part? Yes

Section Numbers	Proposed Actions	*Illinois Register* Citation
100.2175	New Section	41 Ill. Reg. 14166; November 27, 2017
100.7300	Amendment	41 Ill. Reg. _____; December 15, 2017

11) Statement of Statewide Policy Objective: This rulemaking does not create a State mandate, nor does it modify any existing State mandates.

12) Time, Place and Manner in which interested persons may comment on this proposed rulemaking: Persons who wish to submit comments on this proposed rulemaking may submit them in writing by no later than 45 days after publication of this Notice to:

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Legal Services Office
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13) Initial Regulatory Flexibility Analysis:

A) Types of small businesses, small municipalities and not for profit corporations affected: This rulemaking provides guidance needed by partnerships to determine their income subject to Personal Property Tax Replacement Income Tax.

B) Reporting, bookkeeping or other procedures required for compliance: None.

C) Types of professional skills necessary for compliance: None.

14) Regulatory Agenda on which this rulemaking was summarized: July 2017.

The full text of the Proposed Amendment begins on the next page:

SUBPART I: BASE INCOME OF PARTNERSHIPS

Section 100.2850 Subtraction Modification for Personal Service Income or Reasonable Allowance for Compensation to Partners (IITA Section 203(d)(2)(H))

a) In General. A partnership is allowed to subtract from taxable income *any income of the partnership which constitutes personal service income as defined in 26 USC 1348(b)(1) (as in effect December 31, 1981) or a reasonable allowance for compensation paid or accrued for services rendered by partners to the partnership, whichever is greater*. (IITA Section 203(d)(2)(H))

1) Purpose. Under the IRC and federal income tax law, a partner is not an employee of the partnership. Consequently, a partnership generally may not deduct in computing the taxable income of the partnership amounts paid to a partner for services rendered to the partnership. (Estate of Tilton, 8 BTA 914 (1927)) Instead, such amounts are considered distributive shares of partnership income (Revenue Ruling 55-30, 1955-1 C.B. 430). In contrast, a shareholder of a corporation may also be employed by the corporation. Amounts paid by the corporation to the shareholder that constitute compensation for services rendered as an employee may be deducted by the corporation in computing its taxable income under 26 U.S.C. 162(a)(1). The purpose of the subtraction modification under IITA Section 203(d)(2)(H) and this Section is to allow partnerships, for purposes of computing their liability for the tax imposed under IITA Sections 201(c) and (d) (replacement tax), a deduction for compensation paid to partners for services rendered to the partnership similar to the deduction allowed to a corporation for compensation paid a shareholder-employee for services rendered to the corporation.

2) Amounts that Qualify for Subtraction. The United States Supreme Court defines a partnership as: “[a] partnership is … an organization for the production of income to which each partner contributes one or both of the ingredients of income – capital or services.” (Commissioner v. Culbertson, 337 U.S. 733, 736, 69 S.Ct. 1210, 1211 (1949)) The subtraction modification allowed under this Section generally represents the income of the partnership that may be considered a reasonable allowance for the services actually rendered by the partners in their capacity as such. Under 26 USC 707(c), to the extent

determined without regard to the income of the partnership, payments to a partner for services or the use of capital are considered as made to a person who is not a partner, but only for the purposes of 26 USC 61(a) (relating to gross income) and, subject to 26 USC 263, for purposes of IRC section 162(a) (relating to trade or business expenses). 26 CFR 1.707-1(c), states that for the other purposes of the IRC, a guaranteed payment is regarded as a distributive share of the ordinary income of the partnership. Under IITA Section 203(d)(2)(C), a partnership is required to make an addition modification in the calculation of its base income for the amount of deduction allowed to the partnership pursuant to 26 USC 707(c). Accordingly, to the extent a guaranteed payment represents a payment to the partner for services (rather than capital), such amount may be included in the subtraction modification allowed under this Section. Under 26 USC 702 and 704, a partner must take into account his or her distributive share of the items of income, gain, loss and deduction of the partnership. To the extent a partner's distributive share of the net income and gain of the partnership may be regarded as income or payment to a partner in exchange for services rendered to the partnership, that amount may be included in the subtraction modification allowed under this Section. (See Rogers v. C.I.R., 281 F.2d 233 (4th Cir. 1960) ("partnership salaries are not deductible expenses in computing partnership distributable net income, but are treated as a device for reallocating distributable net income among the partners."))

3) Amounts that do not Qualify for Subtraction. Under 26 USC 707(a), if a partner engages in a transaction with the partnership other than in his or her capacity as a partner, the transaction is generally considered as occurring between the partnership and one who is not a partner. Where a partnership pays or accrues an amount to a non-partner for services rendered, the partnership is allowed a deduction in the computation of its taxable income (see, e.g. 26 USC 162). Therefore, a payment to a partner subject to 26 USC 707(a) may not also be subtracted under this Section (see IITA Section 203(g) and subparagraph (5) of this subsection). A distribution by the partnership subject to 26 USC 731 is treated as a return of capital and/or gain from the sale or exchange of the partnership interest of the distributee partner, and, therefore, in no event may a distribution be considered compensation for services rendered by the partner. However, an allocation of partnership income to a partner may be considered compensation for services for purposes of this Section, whether or not accompanied by a corresponding distribution under 26 USC 731.

4) Reasonable Allowance. In determining whether or not an amount claimed as a subtraction for compensation under this Section exceeds a reasonable allowance, the rules for deduction under 26 USC 162(a)(1) (relating to a reasonable allowance for salaries or other compensation for personal services actually rendered) shall apply. In Exacto Spring Corp. v. Commissioner, 196 F.3d 833 (7th Cir. 1999), the court held that where an amount claimed as compensation for services rendered satisfies the "independent investor test," there arises a rebuttable presumption that such compensation is reasonable and therefore deductible under 26 USC 162(a)(1). Accordingly, where income of the partnership is allocated to partners in such amounts as to result in a satisfactory return on partnership capital, a rebuttable presumption shall arise that any remaining amount of income allocated to partners for services actually provided to the partnership is a reasonable allowance and therefore deductible under this

Section. (See also, Menard, Inc. v. Commissioner, 560 F.3d 620 (7th Cir. 2009); Mulcahy, Pauritsch, Salvador & Co., Ltd. v C.I.R, 680 F.3d 867 (7th Cir. 2012) ("[W]hen a thriving firm that has nontrivial capital reports no … [taxable] income, it is apparent that the firm is understating its tax liability"); and Brinks Gilson & Lione a Professional Corporation v. C.I.R., T.C. Memo. 2016-20 (U.S.T.C. 2016) ("The principle applied in *Mulcahy* is well established in the law and grounded in basic economics: The owners of an enterprise with significant capital are entitled to a return on their investments. Thus, a corporation's consistent payment of salaries to shareholder employees in amounts that leave insufficient funds available to provide an adequate return to the shareholders on their invested capital indicates that a portion of the amounts paid as salaries is actually distributions of earnings."))

5) Double Deductions Prohibited. IITA Section 203(g) states that *nothing in such section shall permit the same item to be deducted more than once*.

A) Under IITA Section 203(d)(2)(I), a subtraction modification is allowed to the partnership for income distributable to an entity subject to replacement tax or to organizations exempt from federal income tax by reason of IRC section 501(a). Therefore, neither a guaranteed payment nor a distributive share of net income or gain of a partner subject to replacement tax or exempt from federal income tax under IRC section 501(a) may be included in the subtraction modification allowed under this Section.

B) In addition, where a partnership pays or accrues an amount to a non-partner for services rendered, the partnership is allowed a deduction in the computation of its taxable income. Therefore, a payment to a partner subject to 26 USC 707(a) because the partner is not acting in his or her capacity as a partner, whether or not the payment is currently deducted by the partnership or capitalized, may not be subtracted under this Section.

b) Personal Service Income. Where the personal service income of the partnership, as defined in this subsection, is greater than a reasonable allowance for compensation paid or accrued for services rendered by partners, the subtraction modification under this Section shall be equal to the personal service income of the partnership.

1) Definitions.

A) Personal Service Income. The term "personal service income" as defined in 26 USC 1348(b)(1) (as in effect December 31, 1981) means: "any income which is earned income within the meaning of 26 USC 401(c)(2)(C) or 26 USC 911(b) or which is an amount received as a pension or annuity which arises from an employer-employee relationship or from tax-deductible contributions to a retirement plan. For purposes of this subparagraph, 26 USC 911(b) shall be applied without regard to the phrase, 'not in excess of 30 percent of his share of net profits of such trade or business.' The term 'personal service income' does not include any amount to which 26 USC 72(m)(5), 402(a)(2), 402(e), 403(a)(2), 408(e)(2), 408(e)(3), 408(e)(4), 408(e)(5), 408(f) or 409(c) applies; or which is includible in gross income under 26 USC 409(b) because of the redemption of a bond which was not tendered before the close of the taxable year in which the registered owner attained age 70½."

B) Section 911(b) Earned Income. The term “earned income” as defined in 26 USC 911(b) (as in effect December 31, 1981) means: “wages, salaries, or professional fees, and other amounts received as compensation for personal services actually rendered, but does not include that part of the compensation derived by the taxpayer for personal services rendered by him to a corporation which represents a distribution of earnings or profits rather than a reasonable allowance as compensation for the personal services actually rendered. In the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income-producing factors, under regulations prescribed by the Secretary, a reasonable allowance as compensation for the personal services rendered by the taxpayer, not in excess of 30 percent of his share of the net profits of such trade or business, shall be considered as earned income.” (See, e.g. Albright v. Commissioner, T.C. Memo 1984-485 (1985); Curry v. United States, 804 F.2d 647 (Fed. Cir. 1986); Friedlander v. United States, 718 F.2d 294 (9th Cir. 1983); Hardy v. United States, 589 F.Supp. 330 (E.D. Wis. 1984); Hicks v. United States, 787 F.2d 1018 (5th Cir. 1986); Hutcheson v. United States, 540 F. Supp. 880 (M.D. Al. 1982); Kampel v. Commissioner, 634 F.2d 708 (2nd Cir. 1980); Parker v. Commissioner, 822 F2d 905 (9th Cir. 1987); Roselle v. Commissioner, T.C. Memo 1981-394 (1981); Van Kalker v. Commissioner, 804 F.2d 967 (7th Cir. 1984); United States v. Van Dyke, 696 F.2d 957 (Fed. Cir. 1982); Wilson v. Commissioner, T.C. Memo 1982-289 (1982); Zahler v. Commissioner, 684 F.2d 356 (6th Cir. 1982). See also, Rev. Rul. 60-178, 1960-C.B. 14; Rev. Rul. 64-1, 1964-1 C.B. 7; Rev. Rul. 66-56, 1966-1 C.B. 87; Rev. Rul. 66-326, 1966-2 C.B. 281; Rev. Rul. 67-158, 1967-1 C.B. 188; Rev. Rul. 74-231, 1974-1 C.B. 240; Rev. Rul. 78-306, 1978-2 C.B. 218.)

C) Section 401(c)(2)(C) Earned Income. The term “earned income” as defined in 26 USC 401(c)(2)(C) (as in effect December 31, 1981) means: “gains (other than any gain which is treated under any provision of this chapter as gain from the sale or exchange of a capital asset) and net earnings derived from the sale or other disposition of, the transfer of any interest in, or the licensing of the use of property (other than goodwill) by an individual whose personal efforts created such property.” See, e.g. Bertelli v. United States, 92-1 USTC P 50,266 (N.D. Ohio 1991).

2) Subtraction is Net of Allocable Expenses. For purposes of determining the subtraction modification under this subsection (b), the personal service income of the partnership shall be the amount of such income net of allocable deductions. In Treasury Decision 7446, Maximum Tax on Earned Income (August 13, 1976), the IRS stated that in order to achieve a logical result in applying the maximum tax provisions of Section 1348, and to prevent the conversion of passive income into earned income, that a proportional allocation of expenses to earned income is required in the case of a losing service-capital operation, but no allocation is required where the expenses of the trade or business have been taken into account in determining the net profits of the trade or business. Public Law 95-600, 92 Stat. 2763, effective for taxable years beginning after December 31, 1978, repealed the “30 percent” limitation in 26 USC 911(b) for purposes applying 26 USC 1348. The legislative history of Public Law 95-600 indicates that “an individual would not be permitted to convert into personal services income

passive income on investments or assets held or used in a trade or business. For example, a sole proprietor of a small manufacturing business cannot treat dividend and interest income received on investments held by him as personal service income. If passive income is derived from investments held by a trade or business, expenses of the trade or business must be allocated between such passive income and the income available for payment as personal service income." S. Rept. 95-1263, 95th Cong., 2d Sess. (1978), 1978-3 C.B. (Part 1) 321, 506. Consistent with these authorities and the intent of the earned income definition for purposes of computing the maximum tax provisions of 26 USC 1348, the subtraction modification for personal services income may consist only of that portion of the positive *taxable* income of the partnership that constitutes earned income from a trade or business. If the subtraction modification was applied to the *gross* income of the partnership that constitutes earned income, rather than taxable income, a partnership would be allowed to convert taxable passive income into tax-exempt earned income. Therefore, where a partnership incurs a loss from a trade or business, it does not have personal services income for purposes of the subtraction modification under this Section.

c) Reasonable Compensation for Services. Where a reasonable allowance for compensation paid or accrued for services rendered by partners is greater than the personal service income of the partnership, as defined in subsection (b) of this Section, the subtraction modification under this Section shall be equal to a reasonable allowance for compensation paid or accrued for services actually rendered by partners to the partnership. In order to qualify for the subtraction under this subsection, the amounts must either: (i) in the case of a guaranteed payment for services, be paid by the partnership to the partner or accrued by the partnership in computing its taxable income; or (ii) in the case of a distributive share of the net income of the partnership (other than a guaranteed payment), be credited to the partner's capital account or otherwise increase to that extent the recipient partner's rights to distributions from the partnership.

d) Examples. The provisions of this Section may be illustrated by the following examples.

1) EXAMPLE 1. Partnership PB consists of individual partners P and B. The partnership is engaged in a manufacturing business in which capital is a material income-producing factor. The partnership agreement provides that B shall be entitled to a guaranteed payment of $100,000 annually for his services in managing the operations of the partnership. The partners agree to share all income, gain, losses and deductions equally after taking into account B's guaranteed payment. P does not provide any services to the partnership. For the taxable year, Partnership PB's taxable income, after taking into account B's guaranteed payment, is an ordinary loss of ($40,000). Under these facts, Partnership PB is allowed a subtraction modification under this Section for reasonable compensation paid to B for services rendered to the partnership. In this case, the amount of compensation is equal to the guaranteed payment of $100,000. Therefore, PB's base income for replacement tax purposes is a loss of ($40,000) (i.e. taxable income under IITA Section 203(e)(2)(H) of a loss of ($40,000), plus an addition modification of $100,000 under IITA Section 203(d)(2)(C), less a subtraction modification under this Section of $100,000).

2) EXAMPLE 2. Assume the same facts as in Example 1, except that the partnership agreement does not provide B with a guaranteed payment, and the

partnership's taxable income remains an ordinary loss of ($40,000). Because PB incurs a loss in its trade or business, it has no personal services income. In addition, because the loss is shared by the partners, no amount has been paid or accrued to the partners for services rendered to the partnership. This result is not changed even if the partnership makes distributions to the partners during the taxable year. Partnership PB is not allowed a subtraction modification under this Section. Therefore, PB's base income for replacement tax purposes is a loss of ($40,000) (i.e. taxable income under IITA Section 203(e)(2)(H)).

3) EXAMPLE 3. Assume the same facts as in Example 1, except that the partnership's taxable income consists of an ordinary loss of ($100,000), and a $200,000 capital gain under IRC section 1231. Because Partnership PB incurs a loss in its trade or business and its only item of income is a Section 1231 gain of $200,000, it has no personal services income. However, the partnership is allowed a subtraction modification for reasonable compensation paid to B for services rendered to the partnership. The amount of the subtraction modification is $100,000, unless such amount exceeds a reasonable allowance for the services B renders to the partnership. Because P has not provided any services to the partnership, none of the income allocated to P is reasonable compensation for services.

4) EXAMPLE 4. Assume the same facts as in Example 3, except that the partnership agreement does not provide for guaranteed payments. However, B is entitled under the partnership agreement to the first $100,000 of profits, if any, for his services managing the operations of the partnership. As a result, the partnership's taxable income consists solely of a Section 1231 gain of $200,000. Because PB does not have income from its trade or business, and its only item of income is a Section 1231 gain of $200,000, it has no personal services income. However, it is allowed a subtraction modification for reasonable compensation paid to B for services rendered to the partnership. Under the partnership agreement, $100,000 of gain allocated to B is in exchange for B's services managing the partnership. Provided that amount does not exceed a reasonable allowance for those services, PB is allowed a subtraction modification under this Section of $100,000. Since P has not provided any services to the partnership, none of the gain allocated to P is reasonable compensation for services. Therefore, PB's base income for replacement tax purposes is $100,000 (i.e. taxable income under IITA Section 203(e)(2)(H) of $200,000, less a subtraction modification under this Section of $100,000).

5) EXAMPLE 5. Partnership ABC is an engineering firm. The partnership's only trade or business is the provision of engineering services to clients, and capital is not a material income-producing factor. Partners A and B are individuals who provide all of the services to clients of the partnership. Partner C is a corporation which provides management services to the partnership. Under the partnership agreement, partners A and B have a 45% share of any income or loss of the partnership, and partner C has a 10% share of any income or loss. For its taxable year the partnership has taxable income from its engineering business of $100,000, plus $4,000 of portfolio interest income (net of allocable expenses). Since capital is not a material income-producing factor in the engineering services business, the partnership's personal services income is equal to the entire $100,000 of taxable income. However, because IITA Section 203(g) prohibits double deductions, the partnership's subtraction modification under this

Section may not include any part of partner C's distributive share of the partnership's income. Because C is a partner subject to replacement tax, C's distributive share of partnership income is allowed as a subtraction modification under IITA Section 203(d)(2)(I). The partnership is allowed a subtraction modification under this Section of $90,000, which is equal to partner A's and partner B's share of the personal services income of the partnership. Therefore, ABC's base income for replacement tax purposes is $3,600 (i.e. taxable income under IITA Section 203(e)(2)(H) of $104,000, less a subtraction modification under Section 203(d)(2)(I) of $10,400, less a subtraction modification under this Section of $90,000).

6) EXAMPLE 6. Partnership DEF consists of individual partners D, E and F. The partnership is engaged in a rental real estate business. DEF has entered into a management contract with G corporation, whereby in exchange for a fixed fee G corporation agrees to manage the daily rental operations of the partnership. G corporation is not a partner of DEF. The shareholders of G corporation are individuals D, E, and F, who actually perform the services required under the management contract between the partnership and G corporation. Individuals D, E, and F do not perform any other services except those set forth in the management contract. Partnership DEF is not allowed a subtraction modification under this Section, because individuals D, E and F have not rendered any services to the partnership in their capacity as partners. Rather, the services rendered by D, E, and F were provided to G corporation in their capacity as employees of G corporation.

7) EXAMPLE 7. The facts are the same as in Example 5, except that G is a limited liability company (LLC), elects to be taxed as a partnership, and is a general partner of DEF. Individuals D, E, and F are limited partners of DEF. The partnership agreement provides that G LLC shall manage the daily rental operations of the partnership. The members of G LLC are individuals D, E, and F, who actually perform the services required of G LLC under the partnership agreement. Partnership DEF is not allowed a subtraction modification under this Section because: (i) DEF is allowed to subtract G LLC's distributive share of partnership income under IITA Section 203(d)(2)(I), and therefore a subtraction under this Section is disallowed under subsection (a)(5)(A) of this Section, and (ii) individuals D, E and F have not rendered any services to the partnership in their capacity as partners. Rather, the services rendered by D, E, and F were provided to G LLC as members of G LLC. Because G LLC is taxed as a partnership, G LLC may be allowed a subtraction modification under this Section in computing its replacement tax liability.

8) EXAMPLE 8. The facts are the same as in Example 8, except that the members of G LLC are D and H LLC, which elects to be taxed as a partnership. The members of H LLC are E and F. D, E, and F perform the services required of G LLC under the partnership agreement. Partnership DEF is not allowed a subtraction modification under this Section because (i) DEF is allowed to subtract G LLC's distributive share of partnership income under IITA Section 203(d)(2)(I), and therefore subtraction under this Section is disallowed under subsection (a)(4)(A) of this Section, and (ii) individuals D, E, and F have not rendered any services to Partnership DEF in their capacity as partners. Rather, the services rendered by D were provided to G LLC as a member of G LLC and by E and F indirectly to G LLC as members of H LLC. Because G LLC is taxed as a

partnership, in computing its replacement tax liability it may be allowed (i) a subtraction modification for D's distributive share of G LLC's income to the extent allowed under this Section, and (ii) a subtraction modification under IITA Section 203(d)(2)(I) for H LLC's distributive share of G LLC's income. H LLC may be allowed a subtraction modification for E and F's distributive share of H LLC's income to the extent allowed under this Section.

(Source: Added at 42 Ill. Reg. _____, effective _____)