

**Illinois Department of Revenue
Regulations**

Title 86 100 Section 100.2850	Subtraction Modification for Personal Service Income or Reasonable Allowance for Compensation to Partners (IITA Section 203(d)(2)(H))
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TITLE 86: REVENUE
CHAPTER I: DEPARTMENT OF REVENUE

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 that 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)) Therefore, pursuant to this Section, a partnership is allowed a subtraction modification in an amount equal to the greater of the amount computed under subsection (b) or the amount computed under subsection (c).
- 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, these 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 USC 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 Section 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.
- A) The amounts computed under subsections (b) and (c) are comprised of the distributive shares of the partners in the income of the partnership. 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. Accordingly, a

guaranteed payment to a partner may be included in the computation of the amounts computed under subsections (b) and (c).

B) 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. When 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 be included in the amounts computed under subsections (b) and (c) (see IITA Section 203(g) and subsection (a)(5) of this Section). 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 included in the amounts computed under subsections (b) and (c). 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.

3) Double Deductions Prohibited. IITA Section 203(g) states that *nothing in that 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, when 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. Similarly, when a person receives a partnership interest for the provision of services, the partnership's deduction is determined under 26 USC 83(h). Therefore, no amount may be deducted by the partnership under this Section for the transfer of a partnership interest in connection with the performance of services.

b) Personal Service Income. When the personal service income of the partnership, as defined in this subsection (b), 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. The personal service income of the partnership is equal to the aggregate of the distributive shares of the partners in the income of the partnership that would constitute personal service income in the hands of the partners (less deductions allocable to that income as provided in subsection (b)(2)). See Rev. Rul. 74-231, 1974-1 C.B. 240.

- 1) **Definitions**

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." See also 26 CFR 1.1348-3. Under 26 USC 1348, only an individual (or trust or estate in the case of income in respect of a decedent) may receive personal service income. Therefore, only the distributive share of an individual partner (or trust or estate in the case of income in respect of a decedent) may be included in the personal service income of the partnership under this subsection (b).
- 2) **Personal Service Income 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 aggregate of the distributive shares of the partners in the income of the partnership that would constitute personal service income in the hands of the partners less deductions allocable to that income. 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, a proportional allocation of expenses to earned income is required in the case of a business in which capital is a material income-producing factor. In addition, 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. Therefore, when 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.** When a reasonable allowance for compensation paid or accrued for services actually rendered by partners is greater than the personal service income of the partnership, as defined in subsection (b), the subtraction modification under this Section is equal to that reasonable allowance. The reasonable compensation allowance of the partnership under this subsection is equal to the sum of the distributive shares of all partners who render services to or on behalf of the partnership of the income of the partnership to the extent that the distributive share would have been allowed as a deduction to the partnership under 26 USC 162 if it had been paid to the service partner for services performed in the capacity of an employee of the partnership rather than a partner. No part of the distributive share of a partner who performs no services to or on behalf of the partnership may be included in the reasonable compensation allowance of the partnership under this subsection.

- 1) **Paid or Accrued.** IITA Section 203(d)(2)(H) limits the subtraction modification for a reasonable allowance for compensation of partners to amounts "paid or accrued" to the partner for services rendered to the partnership. Therefore, the amount allowed under this subsection (c)(1) with respect to any partner may not exceed the increase, if any, in the capital account balance of the partner for the taxable year of the partnership in which the subtraction is claimed, determined under 26 CFR 1.704-1(b) without regard to contributions of money or property by the partner and without regard to distributions of money or property to the partner, but including a guaranteed payment made to the partner.
 - 2) **Reasonable Allowance.** 26 USC 162(a)(1) limits the deduction for compensation for services to a reasonable allowance. (See 26 CFR 1.162-7(b)(3).) Therefore, the amount computed under this subsection (c)(2) with respect to any service partner may not exceed what is reasonable under all the circumstances. 26 CFR 1.162-7(b)(3) states, "it is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances." In addition, in *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833 (7th Cir. 1999), the court held that "when...the investors in [the] company are obtaining a far higher return than they had any reason to expect, the owner/employee's salary is presumptively reasonable." (*Menard, Inc. v. C.I.R.*, 560 F.3d 620, 623 (7th Cir. 2009)). However, this presumption may be rebutted by other evidence showing the amount claimed as compensation exceeds a reasonable amount. (*Menard, Inc.*, 560 F.3d at 623) Accordingly, when income of the partnership is allocated to partners in amounts that would result in the partners obtaining a far higher return on partnership capital than they had any reason to expect, 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 may be included in the amount computed under this subsection (c)(2). The taxpayer shall have the burden of proving that the presumption arises.
- d) **Examples.** The provisions of this Section may be illustrated by the following examples.

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. Assume that under IRC section 1348, the amount of the income of PB reasonably attributable to B's services is \$30,000. (See *Brewster v. C.I.R.*, 607 F.2d 1369 (D.C. Cir. 1979) and IRS Technical Advice Memorandum 7932010 (1979).) In addition, assume that \$100,000 is reasonable compensation, and would be deductible to the partnership under IRC section 162(a)(1) if B rendered his management services as an employee rather than in his capacity as a partner. 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 equal to the greater of the personal service income of the partnership computed under subsection (b) or a reasonable allowance for compensation for services rendered by partners to the partnership under subsection (c). In this case, the reasonable allowance of \$100,000 exceeds the personal service income of the partnership of \$0. Therefore, the subtraction modification allowed to PB

under this Section is \$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).

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, there is no increase in B's capital account balance for the taxable year. Therefore, 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)).

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. (See 26 CFR 1.1348-3(a)(1), which states that the term "earned income" does not include gains treated as capital gains under any provision of chapter 1 of the Internal Revenue Code.) 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 the \$100,000 guaranteed payment to B. Because P has not provided any services to the partnership, none of the income allocated to P is reasonable compensation for services.

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 the \$100,000 guaranteed payment to B. 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).

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 that 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 sum of A's and B's distributive share of the \$100,000 of taxable income. Because C is not an individual, no part of C's distributive share constitutes personal services income. In addition, 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. Because the entire distributive share of A and B constitutes personal service income, and the computation of a reasonable allowance may not exceed the amount "paid or accrued" to A and B for their services, the subtraction modification is equal to the personal service 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).

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 under which, 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.

EXAMPLE 7: The facts are the same as in Example 6, 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 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)(3) of this Section, and 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 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 for services provided to it by individuals D, E, and F.

EXAMPLE 8: The facts are the same as in Example 7, 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 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)(3) of this Section, and because 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 a subtraction modification for D's distributive share of G LLC's income to the extent allowed under this Section, and allowed 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 43 Ill. Reg. 727, effective December 18, 2018)