January 17, 2018

To Deduct or Not Deduct: The Illinois Personal Service Income Conundrum

by David A. Hughes , Samantha K. Breslow

This article was previously published in Bloomberg Tax Reports.

Partnerships and limited liability companies ("LLCs") currently subject to the Illinois "replacement" tax received a gift this holiday season: proposed regulations addressing the deduction for reasonable compensation or personal services income. On December 11, 2017, the Illinois Department of Revenue ("Department") issued proposed regulations that seek to clarify the scope of the deduction by setting forth specific rules and hypothetical examples. Nevertheless, even with the proposed regulations, the deduction is beset by ambiguities that will continue to create confusion for taxpayers currently under audit or who intend to claim the deduction in future years.

Purpose of the Deduction

Under the Internal Revenue Code and federal income tax law, a partnership typically may not deduct amounts paid to a partner for services rendered to the partnership in computing its taxable income because a partner is usually not considered an employee of the partnership. *Estate of Tilton*, 8 BTA 914 (1927). A partnership itself is not subject to net income tax so the lack of a deduction for payments to partners for personal services rendered to the partnership is not meaningful. By contrast, partnerships and LLCs are subject to the Illinois "replacement tax," an entity level net income tax. 35 ILCS 5/201(c). For this reason, the Illinois Income Tax Act ("Act") allows a partnership or LLC to deduct from its base income any income of the partnership which constitutes personal service income, as defined in Section 1348(b)(1) of the Internal Revenue Code, or a reasonable allowance for compensation paid or accrued for services rendered by the partners to the partnership, whichever is greater. 35 ILCS 5/203(d)(2)(H).

The purpose of the deduction is to put partnerships and LLCs on equal footing with corporations, which can deduct compensation paid to a shareholder-employee for services rendered to the corporation under 26 USCS ? 162(a)(1). Relying on the Act's deduction, taxpayers such as real estate partnerships, engineering firms, and law firms have for many years "zeroed out" their income by claiming a deduction for the full amount of distributions made to partners.

Proposed Regulations Provide Some Clarification

The challenge for Illinois taxpayers is that subsequent to the enactment of the deduction, neither the General Assembly nor courts have clarified the breadth of the deduction or the meaning of the terms "personal service income" or "services rendered by partners". Moreover, the Department has recently audited a significant number of taxpayers claiming the deduction and subsequently denied the deduction. With the burden on the taxpayer to support the availability of the deduction, how does a taxpayer prove that amounts paid to partners were "personal service income" or a "reasonable allowance" for services rendered?

The proposed regulations provide that in determining whether an amount claimed as a subtraction for services rendered exceeds a reasonable allowance, the rules under 26 USCS ? 162(a)(1) apply. These rules are not overly helpful in this context as they merely allow taxpayers to deduct a reasonable allowance for salaries or other compensation for personal services actually rendered. The proposed regulations also apply the 7th Circuit's determination in *Exacto Spring Corp. v. Commissioner*, 196 F. 3d 833 (7th Cir. 1999), where the court held that an amount claimed as compensation for services rendered must satisfy the "independent investor test" whereby income allocated to partners results in a satisfactory return on partnership capital. Thus, if the partnership's payments to partners results in sufficient funds available for a return on partnership capital, there is a rebuttable presumption that the payments made to the partners are a reasonable allowance and therefore deductible.

The proposed regulations provide little practical guidance for applying the "personal service income" aspect of the deduction. The regulations instead repackage and reiterate the definitions of "personal service income" and "earned income" provided by 25 USCS ? 401(c)(2)(C) or 26 USCS ? 911(b), as in effect on December 31, 1981. The proposed regulations do clarify that the deduction may only consist of that portion of the taxable income of the partnership that constitutes earned income from a trade or business. Thus, passive income on investments cannot be deducted as personal services income. Although this guidance is useful for taxpayers with passive income or substantial capital, for businesses that strictly generate income from professional services, such as law and accounting firms, there is still little clarification regarding whether they can deduct the full amount of their taxable income as personal service income.

Handling Current and Future Audits

Takeaways for Taxpayers Under Audit

Taxpayers faced with an audit should not fret, but instead should prepare to produce support for the deduction. A common misperception among taxpayers is that the Department is required to support the disallowance of the deduction and they accordingly starve the auditor of information. The Department is only required to perform a reasonable investigation and the burden is instead on the taxpayer to support the deduction. As a result, taxpayers under audit should generally cooperate by producing any supporting documentation substantiating the services provided by the partners, including calendars, time logs, itineraries, or emails. Although the auditor may ask for additional documentation or ultimately grant only a partial allowance of the deduction, cooperating with the auditor's requests can result in a more efficient and taxpayer-friendly outcome.

In order to defend the reasonableness of compensation paid to the partners, a taxpayer can alternatively present the salary or compensation of a person in a comparable position at an unrelated business. For example, how much would the business be willing to pay a third party to perform the same services? In this regard, audit

discrepancies can arise if an auditor utilizes inaccurate or outdated market data as a comparison. Additionally, although this strategy may be effective for businesses that have access to accurate and favorable competitor data, it may not be feasible for professionals in unique positions that lack a market comparable.

Planning for Future Audits

The key step in preparing for a future audit is to maintain clear records supporting the specific activities performed by the partners and the responsibilities required of their positions. While it may be too costly or burdensome for certain taxpayers, partnerships claiming the deduction should consider requiring its partners complete daily time reports to substantiate the specific activities performed. Although there is no smoking gun in terms of supporting documentation, the objective is to document, to the extent possible, the nature of the activities performed by the partners and the degree of their contribution to the value of the partnership.

For example, a significant issue in construing the scope of the deduction is the amount of income that represents a return of capital. Specifically, the Department typically claims in audits that payments representing a return of capital cannot be considered compensation for services rendered by the partners. This approach has made its way into the proposed regulations, which provide that payments made to a partner for the return of capital are not compensation for services rendered by the partner. This restriction likely comes to a surprise to many taxpayers who have been freely claiming the deduction over the course of decades without any guidance from the Department regarding a return of capital. As such, for future audit defense purposes, businesses that have capital assets should keep sufficient books and records that document how much income represents a return of capital.

By contrast, taxpayers should, at minimum, be able to deduct any guaranteed payments or self-employment income reported to the partners on Lines 4 and 14, respectively, of the Federal Schedule K-1. However, not only do certain partnerships or LLCs not make guaranteed payments to their partners, but the amounts distributed may also be artificially low or an inaccurate measure of the value of the services rendered by the partners. As such, many Illinois partnerships and LLCs may be dissatisfied with the extent of the deduction if the Department ultimately limits its scope to these amounts on a prospective basis.