

**BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO**

In the Matter of the Protest of	)	
	)	DOCKET NO. 24192
[Redacted],	)	
	)	
Petitioner.	)	DECISION
_____	)	

**BACKGROUND**

On May 12, 2011, the Idaho State Tax Commission (Commission) issued a Notice of Deficiency Determination (NODD) to [Redacted], (Taxpayer) assessing additions to tax and interest for taxable year 2008 in the amount of \$6,762.

Taxpayer filed an Idaho Partnership Income Tax Return for taxable year 2008 and elected, pursuant to Idaho Code § 63-3022L, to report and pay the taxable income on behalf of its partners. During a review of the partnership return filed with the Commission, the staff of the Income Tax Audit Bureau found that Taxpayer failed to include guaranteed payments as income subject to the Idaho apportionment factor for taxable year 2008.

On July 13, 2011, Taxpayer, through its manager [Redacted], submitted a letter timely protesting the NODD. In its letter, Taxpayer stated that the guaranteed payments were attributable to stock options exercised upon the sale of the company. The guaranteed payments were not made to the partners in connection with services performed for the company. For those reasons, Taxpayer believed the guaranteed payments were properly excluded from income subject to the Idaho apportionment factor.

Taxpayer, through its representative [Redacted], requested a telephonic informal conference before the Commission. In this request, Mr. [Redacted] affirmed Taxpayer's position that the guaranteed payments were not includable in calculating Idaho taxes because they were

attributable to stock options exercised upon the sale of the company. A telephonic informal conference was held on December 19, 2011. Mr. [Redacted] appeared on behalf of Taxpayer.

After review of all relevant information contained in this file, the Commission is advised of its contents and now issues its decision. For the reasons set forth below, the Commission affirms the NODD issued on May 12, 2011.

### **LAW AND ANALYSIS**

#### **A. Under the Internal Revenue Code and Treasury Regulations, Guaranteed Payments are Treated as a Partner's Distributive Share of Partnership Ordinary Income.**

Partnerships are flow-through entities.<sup>1</sup> In general, each partner accounts for his distributive share of the partnership's gains and losses, charitable contributions, taxes, and income or loss.<sup>2</sup>

If, while acting in his capacity as a partner, a partner receives a fixed payment for services or for the use of capital, and the payment is determined without regard to the partnership income, then that fixed payment is classified as a guaranteed payment.<sup>3</sup> For purposes of Internal Revenue Code (IRC) §§ 61, 162, and 263 only, the transaction will be viewed as made between the partnership and a non-partner.<sup>4</sup> Guaranteed payments are characterized as ordinary income to the partner and must be included in the partner's gross income under IRC § 61(a).<sup>5</sup> The partnership may receive a deduction under IRC § 162 which allows non-receiving partners an equalizing adjustment to account for the guaranteed payment.<sup>6</sup> For all other purposes, the IRC treats guaranteed payments as if the transaction occurred between the partner in his capacity as a

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<sup>1</sup> I.R.C. § 701

<sup>2</sup> I.R.C. § 702

<sup>3</sup> I.R.C. § 707(c)

<sup>4</sup> I.R.C. § 707(c)

<sup>5</sup> Treas. Reg. 1.707-1(c)

<sup>6</sup> The deduction must still meet the requirements set forth under IRC § 162, specifically, the deduction must meet the requirement for an ordinary and necessary expense in relation to a trade or business.

partner and the partnership. Treasury Regulation § 1.707-1(c) specifically provides:

Guaranteed payments are considered as made to one who is not a member of the partnership only for the purposes of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses)... For the purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner's distributive share of ordinary income... (Emphasis added).

In other words, the IRC and the corresponding regulations view and characterize guaranteed payments as a partner's distributive share of the partnership's ordinary income for any other purpose outside of IRC § 61, 162, and 263.<sup>7</sup>

B. Idaho Law Appropriately Includes Guaranteed Payments in a Partner's Idaho Income Subject to Apportionment Because These Payments Represent the Partner's Distributive Share of Ordinary Income.

Idaho Code § 63-3030(a)(9) states every partnership which conducts business in Idaho shall submit returns with respect to taxes measured by income of the partnership. Income Tax Administrative Rule 280 (IDAPA 35.01.01.280) states that partnerships operating both within and without Idaho shall apply the principles of allocation and apportionment of income set forth in Idaho Code § 63-3027. These principles generate an apportionment factor which measures the percentage of business activity conducted in Idaho. A partnership's Idaho tax is calculated by applying the apportionment factor against the Idaho taxable income.

Idaho Code § 63-3022L provides partners of a partnership with business activities in Idaho may elect to have the partnership pay Idaho taxes on behalf of the partner.<sup>8</sup> The election applies to taxes on the income of (1) wages, salary, and compensation paid to the partner on behalf of the partnership to the extent the compensation is Idaho taxable income to the individual partner and (2) the partner's share of any income, loss, deductions, or credits of the partnership

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<sup>7</sup> Id. Also, guaranteed payments are includible in the income of the recipient under the same rules of inclusion as if it were part of the partner's distributive share. I.R.C. §706(a).

<sup>8</sup> Idaho Code § 63-3022L (1)

otherwise required to be included in the partner's Idaho return.<sup>9</sup> Idaho Income Tax Administrative Rule 291 (IDAPA 35.01.01.291) further clarifies that under the election of Idaho Code § 63-3022L, the partnership must pay any taxes relating to any pass-through items of income from Idaho sources. Idaho Income Tax Administrative Rule 263 defines pass-through items of income as follows:

- a. Ordinary income or loss from trade or business activities;
- b. Net income or loss from rental real estate activities;
- c. Net income or loss from other rental activities;
- d. Interest income;
- e. Dividends;
- f. Royalties;
- g. Capital gain or loss;
- h. Other portfolio income or loss;
- i. Gain or loss recognized pursuant to Section 1231, Internal Revenue Code.<sup>10</sup>

Guaranteed payments, under the IRC, represent a distribution of a partner's distributive share of ordinary income from the partnership. Under Idaho Income Tax Administrative Rule 263(a), Idaho treats distributions of ordinary income from a partnership as pass through items taxable to the partner. Thus, for Idaho's purpose, guaranteed payments are a pass through item of partnership ordinary income and must be included in the partner's taxable income.

Taxpayer elected under Idaho Code § 63-3022L to pay Idaho taxes on behalf of its partners. It must include all pass-through items of income in calculating the Idaho taxable income. Taxpayer objected to the inclusion of guaranteed payments in this calculation. For the reasons stated above, Idaho law treats guaranteed payments as a partner's distributive share of ordinary income. Therefore, guaranteed payments are considered pass-through items of partnership ordinary income. Thus, under the election of Idaho Code § 63-3022L, Taxpayer must include the guaranteed payments in the Idaho taxable income subject to the Idaho

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<sup>9</sup> Idaho Code § 63-3022L (2)(a) and (b)

<sup>10</sup> IDAPA 35.01.01.263.

apportionment factor.

It is well settled in Idaho that an NODD issued by the Idaho State Commission is presumed to be correct. Albertson's Inc. v. State, Dept. of Revenue, 106 Idaho 810, 814 (1984); Parsons v. Idaho State Tax Commission, 110 Idaho 572, 574-575 n.2 (Ct. App. 1986). The burden is on the taxpayer to show that the tax deficiency is erroneous. Id. Taxpayer failed to show that the guaranteed payments should not be included in Idaho taxable income. It did not meet the burden of proof. Therefore, for the reasons stated, the Commission affirms the NODD issued on May 12, 2011.

THEREFORE, the NODD dated May 12, 2011, is hereby AFFIRMED, in accordance with the provisions of this decision and is APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that taxpayer pay the following tax and interest updated through March 30, 2012:

<u>YEAR</u>	<u>TAX</u>	<u>INTEREST</u>	<u>TOTAL</u>
2008	\$6,100	\$826	<u>\$6,926</u>
		TOTAL DUE	<u>\$6,926</u>

DEMAND for immediate payment of the foregoing amount is hereby made and given.

An explanation of the taxpayer's right to appeal this decision is enclosed.

DATED this \_\_\_\_\_ day of \_\_\_\_\_ 2012.

IDAHO STATE TAX COMMISSION

\_\_\_\_\_  
COMMISSIONER

\_\_\_\_\_  
COMMISSIONER

**CERTIFICATE OF SERVICE**

I hereby certify that on this \_\_\_\_\_ day of \_\_\_\_\_ 2012, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[Redacted]

Receipt No.

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