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“LLC Tax” Repealed - Opportunity to File Protective Claim for Refund

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The law that had extended the Interest and Dividends (“I&D”) Tax to distributions from limited liability companies (“LLCs”), partnerships and associations with non-transferable shares (referred to herein as the “2009 Law”) has been repealed. After a classic legislative roller coaster ride involving multiple bills, proposed amendments, threats of repeal and threats of no action, the Legislature finally passed, and Governor Lynch signed, Special Session House Bill 1, which includes the repeal of the 2009 Law.

The repeal is effective for taxable periods ending on or after December 31, 2010. For individuals, that means the 2009 Law applies for the 2009 tax year (*i.e.*, the calendar year), and the law as it existed prior to enactment of the 2009 Law applies for the 2010 tax year and thereafter. Because the repeal does not apply to 2009 taxable periods, taxpayers required to report and pay I&D Tax on distributions made taxable under the 2009 Law are not entitled to a refund based solely upon the repeal. Such taxpayers, however, may be entitled to a refund if they file a claim for refund before August 13, 2010 and the 2009 Law is held unconstitutional as a result of a pending legal challenge that was filed before the law was repealed (or pursuant to any other litigation that may be filed challenging the 2009 Law).

The Department of Revenue Administration (the “DRA”) has issued Technical Information Release (“TIR”) 2010-006, which provides guidance on how it will apply the now-repealed 2009 Law and TIR 2010-007, which provides guidance on the filing of protective claims for refund with respect to the 2009 Law.

Here is how all these changes could affect you -

Liability for I&D Tax Under the 2009 Law

Individuals

If you are a New Hampshire resident who, during any part of 2009, owned an interest in an LLC, partnership or association with non-transferable shares and you received taxable distributions from that entity during the 2009 taxable period, you are liable for I&D Tax with respect to those distributions. Additionally, if you filed under extension for the 2009 taxable period, you are still required to file the return and pay I&D Tax with respect to taxable distributions made during the 2009 taxable period.

One of the more troublesome aspects of the 2009 Law was that it was



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enacted in the middle of 2009 to be retroactive to January of that year. As a result, taxpayers were uncertain whether they would be charged underpayment of estimated tax penalties for I&D Tax for the entire 2009 taxable period. The DRA's solution to this is to allow taxpayers to file Form DP-2210/2220 (Exceptions and Penalty for the Underpayment of Estimated Tax) with an annualized statement showing when distributions were made. Based on the information provided on this form, you may qualify for an exception to the penalty. Also, if you made timely estimated payments each quarter equal to one-fourth of the prior year's tax liability, no penalty will be imposed.

The 2009 Law (both the statute and regulations) will apply for purposes of the 2009 taxable year. As a result, amounts of reasonable compensation attributable to you as an owner, partner or member that are properly deductible for Business Profits Tax purposes should be excluded from the amount of the distribution subject to I&D Tax. Any distributions to an owner who provides personal services to the entity will be charged against the compensation deduction attributable to that owner. To the extent the reasonable compensation attributable to that owner is not distributed in a given year, it may be carried forward. No I&D Tax liability will attach to distributions to a service provider until compensation attributable to that owner is exhausted. The DRA states that the intent of the 2009 Law is to identify investment income, not reasonable compensation, because return on investment is a taxable event under the I&D Tax, while payment for services is not. Accordingly, distributions are considered to come first from compensation, then from current year profits, then from accumulated profits and finally from return of capital.

For taxable periods ending on or after December 31, 2010 (*i.e.*, for individuals, beginning with the entire 2010 calendar-year), if you receive distributions as a member of an LLC, partnership or association with non-transferable shares, you will not be subject to I&D Tax with respect to those distributions.

LLCs, Partnerships or Associations with Non-Transferable Shares

LLCs, partnerships and associations with non-transferable shares that receive income from interest and dividends during taxable periods ending on or after December 31, 2010, are required to report and pay I&D Tax. To further illustrate the effective date of the repeal of the 2009 Law, the DRA provides the following two examples on the Frequently Asked Questions section of its Website:

If a limited liability company with non-transferable shares has a taxable period ending September 30, 2010 and receives dividend income during that taxable period, the limited liability company is not subject to I&D Tax. (The limited liability company's taxable period ends before December 31, 2010).

If a limited liability company with non-transferable shares has a taxable period ending December 31, 2010 and receives dividend income during that taxable period, the limited liability company is subject to I&D Tax. (The limited liability company's taxable period ends on December 31, 2010).

LLCs, partnerships and associations with non-transferable shares that are subject to I&D Tax for a taxable period ending December 31, 2010, will not be charged underpayment of estimated tax penalties for I&D Tax because they were not required to file a tax return for income received from interest and dividends during the last tax period; this would be considered their first tax period.

Filing a Protective Claim for Refund

On June 28, 2010, the DRA issued TIR 2010-007. The TIR states that a taxpayer can request a refund based on a claim of unconstitutionality related to distributions from an LLC, partnership or association that were reported on a 2009 Interest and Dividends Tax Return in either of the two following ways:

- (1) The taxpayer can file a letter with the DRA requesting a refund of the amount reported as taxable distributions from an LLC, partnership or association, indicating that the reason for the request is based on a claim that the tax is unconstitutional; or
- (2) The taxpayer can file an Amended Interest and Dividends Tax return requesting a refund with the words "Unconstitutional Claim" clearly printed on the top of the return.

The TIR instructs taxpayers to mail any such letters or amended returns to "N.H. Department of Revenue Administration, Document Processing Division, PO Box 1004, Concord, NH 03302-1004." Any such claim for refund for the 2009 Tax Year must be postmarked no later than August 13, 2010, which is the date on which the special 120-day statute of limitations for claims for refunds based on constitutional claims must be filed with respect to 2009.

In a normal case, the DRA would examine the request for refund and either issue a Notice of Refund or issue a Notice of Denial. That will happen in this case unless the taxpayer takes steps to place the action on hold. The DRA states in the TIR that because there is a constitutional challenge already pending with respect to the 2009 Law in the Hillsborough County (North) Superior Court (*Wennin, LLC v. State of New Hampshire, Dept. of Revenue Admin.* Docket No. 10-E-0048), the DRA and the taxpayer can agree, in writing, to hold action on the taxpayer's request for refund pending the outcome of the court case, and that in this case, the taxpayer can place the action on hold by notifying the DRA in its letter or amended return that it agrees to hold action on its request for refund pending the outcome of the court case. The DRA also states that agreeing to hold action on the request for refund pending the outcome of litigation does not affect a taxpayer's rights, and, at any time, a taxpayer may request that its request for refund be removed from this held status and processed according to regulations.

As a final note, it is interesting that in proposing the 2009 Law, the DRA took the position that the proposed change was necessary to eliminate unconstitutional treatment of New Hampshire taxpayers under the prior law. The argument was that holders of interests in corporations were treated for I&D Tax purposes differently from holders of interests in LLCs, partnership and associations with non-transferable shares and individuals who operated businesses as sole proprietors. The former were subject to I&D tax on distributions they received from the corporations in which they were shareholders and the latter were not subject to I&D Tax on distributions received. Accordingly, once I&D tax returns are filed for the 2010 tax year, New Hampshire residents who pay I&D tax with respect to distributions from corporations should have until August 13, 2011 to file a claim for refund based on the argument that the I&D tax as it applies to distributions they receive from their corporations is unconstitutional.

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