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New Hampshire Changes its Taxation of LLCs (and Partnerships) and Their Members (and Partners)

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Recent New Hampshire legislation has changed the way a limited liability company (“LLC”) and its members are taxed in the State. The change has been widely publicized, but not well understood. (The new law, and this discussion, apply not just to LLCs and their members, but also to partnerships and their partners). Unfortunately, because the changes were introduced so late in the legislative process, there was insufficient time for proper vetting of the provision, and as a result, there is a lot of misinformation floating around. We’d like to clarify as much of that as we can at this early point, although much of the confusion and uncertainty will not likely be resolved definitively until the Department of Revenue Administration (“DRA”) issues guidance with respect to the new law through the rulemaking process and possibly in a more timely Tax Information Release.

(1) Effect on LLCs as separate entities. The new law has little direct effect on LLCs themselves. In the past, LLCs were subject to the Interest and Dividends Tax (the “I&D Tax”) only if they did business in New Hampshire, had at least one New Hampshire resident as a member, and had “nontransferable interests.” Under the new law, LLCs are not subject to the I&D Tax under any circumstances. That is the good news; however, the bad news is that the law will have an indirect effect on LLCs by likely increasing the number of “deemed compensation” audits for them with a potentially corresponding increase in their Business Profits Tax (“BPT”) liability—more on deemed compensation below.

(2) Significant impact on members of LLCs. The direct effect of the new law is on members (owners) of LLCs (and partners of partnerships) who are residents of New Hampshire. In the past, when a member of an LLC received a distribution attributable to interest and dividend income of the LLC, the member had to pay I&D tax on the distribution only if the interest and dividend income had not been subject to the I&D Tax at the LLC level. Under the new law, no

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LLC will be subject to the I&D tax. As a result, all LLC members who are residents of New Hampshire will be subject to I&D tax on distributions from LLCs. A distribution from an LLC will generally be treated as a dividend for I&D Tax purposes, regardless of the source of the income at the LLC level, but only to the extent the distribution is (i) from current or accumulated earnings and profits, (ii) is not a liquidating distribution and (iii) exceeds the amount of any deemed compensation deduction allowed for BPT purposes—again, more on deemed compensation below.

(3) Two levels of tax (“double tax”). If we step back and take a look at the overall effect of the new law, the real impact is in the fact that the new I&D Tax treatment of members is in addition to the BPT that the LLC already pays on its income. As a result, the “double tax” treatment that has always applied to corporations doing business in New Hampshire and their New Hampshire shareholders (BPT at the corporate level and I&D Tax at the shareholder level) will apply to LLCs and their members.

(4) Application of the law - how much of a distribution will be taxable? While the legislative language itself is not especially clear, the Commissioner of the DRA has stated in a letter to the Business & Industry Association that, in general, distributions from LLCs will be subject to the same rules that apply to dividends paid by corporations. Thus, a distribution received from an LLC should only be subject to the I&D Tax to the extent the LLC has the equivalent of earnings and profits as determined under federal tax law. In practice, this should mean that the taxable portion of a distribution received from an LLC will be determined in two steps: First, the distributions to members that could be subject to the I&D Tax will be reduced by the deemed compensation deduction available to the LLC and perhaps other items to be identified as the new law and its application is clarified, the “Adjusted Distribution,” and then, the LLC’s earnings and profits will be reduced by that same amount, the “Adjusted E&P.” Then the Adjusted Distribution will be treated as a dividend for I&D Tax purposes but only to the extent of the Adjusted E&P for the tax year.

This is admittedly not so easy to follow, so here is an example that may help. Assume that an LLC (i) has earnings and profits of \$100,000 before taking any deemed compensation deduction into account, (ii) qualifies for a deemed compensation deduction of \$65,000, and (iii) distributes \$80,000 to the member whose services provide the basis for the deemed compensation deduction. In this case, only \$15,000 of the distribution should be subject to I&D Tax. Of the \$80,000 distribution, \$65,000 is deemed compensation, so the Adjusted Distribution is \$15,000 (\$80,000 - \$65,000). The \$100,000 of earnings and profits reduced by the deemed compensation leaves Adjusted E&P of \$35,000 (\$100,000 - \$65,000). Because the Adjusted E&P (\$35,000) exceeds the Adjusted Distribution (\$15,000) the entire Adjusted Distribution is subject to I&D Tax. As of the end of the year, the earnings and profits of the LLC would stand at \$20,000 (\$35,000 - \$15,000) to be carried forward into the next year.

(5) Deemed compensation; more aggressive audits. And finally—deemed compensation. For many years, the DRA has had in place a program to identify and audit so-called “deemed compensation” deductions taken by LLCs (and partnerships) to reduce their BPT liability. The deemed compensation deduction was introduced into the BPT to attempt to equalize the treatment of corporations and LLCs and thereby comply with the New Hampshire Constitution’s requirement that all taxpayers (in this case, corporations and LLCs) be taxed the same. Because corporations pay BPT on the portion of their gross income left after deductions for compensation paid to owner/employees, LLCs must be afforded that same treatment. But because LLCs usually do not pay compensation to their members (rather the members share in the distribution of profits, often referred to as their “draw” if paid during the course of the year), the value of the members’ services, as determined under the BPT regulations, is treated as a deduction against the LLC’s gross business profits, thereby reducing the portion of the LLC’s income subject to the BPT, and hopefully equalizing the BPT treatment of LLC’s and corporations. The determination of deemed compensation requires a review of what compensation would be reasonable under all the facts and circumstances, requiring not only proof of the nature, quality and frequency of the services provided to the LLC by its members, but also the value of those services.

The new law increases the impact of the proper determination of deemed compensation on the State’s treasury by nearly 60% because every dollar treated as a dividend instead of deemed compensation now will not only increase the BPT liability of the LLC (as has always been the case), but will also increase the I&D Tax owed by the recipient member. One hundred dollars of disallowed deemed compensation that used to yield an additional \$8.50 to the DRA will now yield that amount plus \$5.00 of I&D Tax, for a total of \$13.50. So it is inevitable that the DRA will increase the number of deemed compensation audits and argue more aggressively for lower standards for reasonable compensation.

(6) Distributions of debt financed by the LLC. The least understood and most uncertain aspect of the new law has to do with the treatment of a distribution of “debt financed through the entity.” This would typically refer to the financing of appreciated property owned by an LLC to effectively monetize and distribute the appreciation in the property, a common practice in real estate ventures. The Commissioner has said that such distributions will only be taxed to the extent that they are also out of earnings and profits, but the statute does not read that way and there are other complications to managing such treatment that even the DRA admits exist. For example, it is unclear whether the dividend treatment would be suspended to the extent it exceeded earnings and profits in the year of the distribution and treated as a dividend in later years in which there are earnings and profits? If so, it is also unclear how the suspension would be tracked? Specifically, would it apply forever or for a limited period of time? We hope that the DRA will provide guidance in this area soon enough for members and managers of LLCs and their advisors to plan appropriately.

(7) Retroactive effect. One of the most troublesome aspects of the new law is that it applies to all taxable periods ending on or after December 31, 2009. A taxable period ending on December 31, 2009 includes a taxable period that begins as early as January 1, 2009, so the tax is retroactive, making planning for the full year dependent in part upon events that have already occurred.

Planning for this new double tax on LLCs and their members will be an “adventure” for all of us. In particular, if the DRA does not quickly explain more fully how it intends to treat distributions funded by proceeds from entity financings, planning for such distributions in 2009 will be fraught with uncertainty. Also, planning for appropriate deemed compensation deductions in light of both the DRA’s interpretation of the law and other reasonable interpretations will become increasingly important. The DRA intends to issue rules to clarify the new law, but whether those rules will be available in time to help with 2009 tax planning remains to be seen.