

S corporations take notice of DRA ruling

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A recent declaratory ruling by the New Hampshire Department of Revenue Administration has left many S corporation owners considering whether they should convert to a limited liability company in order to save money on their New Hampshire taxes.

In the spring, on behalf of an S corporation business client, we asked the DRA to rule on whether a New Hampshire S corporation can convert to an LLC without incurring additional business and real estate transfer taxes and whether distributions from the converted LLC to its New Hampshire resident owners would continue to be subject to the interest and dividends tax, as with distributions from S corporations.

The DRA's favorable ruling presents a significant planning opportunity for any S corporation owner receiving distributions which are currently subject to the I&D tax.

The I&D tax is applicable to distributions from S corporations to its New Hampshire resident shareholders. This tax affects all New Hampshire resident shareholders, but is particularly onerous for shareholders who depend on distributions from S corporations for income, such as non-employee shareholders and shareholders of real estate-holding entities.

Through a statutory conversion of the S corporation to an LLC and careful drafting of the LLC's governing documents, distributions from the same entity will no longer be subject to the I&D Tax subsequent to the conversion.

Conversion of the S corporation is accomplished by a filing with the New Hampshire secretary of state, but obtaining the favor-

able tax characteristics we achieved in the DRA's ruling involves careful compliance with a blend of state and federal legal requirements.

The starting point for the successful conversion is the federal tax code, which permits qualifying corporate reorganizations to

There's potential for significant long-term tax savings by converting to an LLC

be accomplished tax-free, provided certain technical requirements are met and a valid business purpose exists for executing the conversion aside from its tax benefits.

The Internal Revenue Service has determined that if the requirements are met and the proper timing and mechanics of the conversion are observed, then the converted LLC will not recognize any gain or loss federally on the deemed exchange of assets from the S corporation to the LLC, and the shareholders will not recognize any gain or loss federally on the exchange of their shares in the S corporation for membership interests in the LLC.

The DRA's ruling

The DRA's ruling offers S corporation owners the potential for significant long-term tax savings with minimal disruption to the business and how it files and pays its taxes.

Because the ruling is conditioned upon the conversion being recognized federally as

a tax-free reorganization, it is important to carefully review, plan, document and execute the conversion transaction. This requires a team effort from your accountant and your business attorney, who will prepare a plan of conversion and the formation documents for the converted LLC.

Don't forget, the DRA's ruling cannot be relied upon definitively by any other taxpayer, so in order to ensure your conversion will be treated similarly, close adherence to the DRA's ruling and relevant IRS rulings is strongly recommended.

If each of the state and federal legal requirements is met, then:

- The conversion will not trigger any additional tax liabilities pursuant to New Hampshire's business profits tax, business enterprise tax or real estate transfer tax
- Distributions from the converted LLC to its New Hampshire resident owners will no longer be subject to the I&D Tax (if the LLC's governance documents include the necessary provisions)
- The converted LLC will be able to continue filing and paying New Hampshire taxes in the same manner it did prior to the conversion without interruption or additional filings
- Any state tax credits of the converting S corporation will continue to be available to the converted LLC subsequent to the conversion.

The ruling became effective July 26 and has been made available on the DRA's website at <http://www.revenue.nh.gov/laws/dcrs.htm>

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