LEGAL EXPERTISE

Maurice P. Gilbert
Devine Millimet

DEVINE MILLIMET
ATTORNEYS AT LAW

111 Amherst Street
Manchester, NH 03101
603-695-8612
devinemillimet.com

Legislature changes the New Hampshire reasonable compensation burden of proof

By Maurice P. Gilbert

On June 25, 2011, Senate Bill 125 (Chapter 207, Laws of 2011) was enacted into law without Governor Lynch's signature. It makes several significant changes to the standards governing the compensation deduction under the Business Profits Tax for proprietorships, partnerships and limited liability companies. These changes build upon significant changes made to the statute governing the compensation deduction in 2010. The changes apply to taxable periods beginning on or after January 1, 2011. Tax practitioners now have the task of dealing with different statutory requirements for three taxable periods: the pre-2010 years, the 2010 year, and the post-2010 years.

Chapter 207 and its impact on post-2010 taxable periods

The new law retains the following concepts that are in the current (2010) statutory provisions:

(1) The $50,000 recordkeeping safe-harbor;

(2) The requirement that compensation may only be provided to natural persons for the services they render to their business organizations; and

(3) The level of compensation provided must be fair and reasonable using the standards found under Internal Revenue Code (the "IRC") Section 162(a)(1), the United States Department of the Treasury Regulations, Internal Revenue Service (the "IRS") pronouncements and any judicial cases relating to reasonable compensation under the IRC.

We do not discuss these provisions because they are consistent with the 2010 statutory language. Some of the new provisions are very beneficial to taxpayers while others have negative impacts compared to the current law.

Provisions contained in Chapter 207 - Favorable to taxpayers

(1) The language included in RSA 77-A:4, III(g) provides the burden of proof required for the taxpayer, the presumption created when the taxpayer meets its burden of proof and finally the burden of proof that the DRA must meet in order to make an adjustment to the compensation claimed by the taxpayer. The taxpayer's burden is that the business organization must prove that all individuals for whom a compensation deduction was claimed have performed personal services for the business organization at any time during the taxable period. Once the taxpayer satisfies that burden, then the amount claimed as a compensation deduction for the taxable period is presumed to be reasonable unless the DRA proves by a preponderance of the evidence that the amount claimed is clearly unreasonable.

(2) Section 3 of the bill adds a new paragraph in RSA 21-J providing that the burden of proof on any changes made to compensation deductions must be borne by the DRA. Presumably, this language will cover instances in which the adjustment to compensation relates to a corporate entity (rather than a proprietorship, partnership or limited liability company) in which case the provisions of RSA 77-A:4, III do not apply. The language in Section 3 does not provide the same detail about what the business organization must prove, nor does it create a presumption of reasonableness or reference the clearly unreasonable requirement.

(3) Section 4 of the bill amends the Interest & Dividends Tax by creating a new subparagraph under RSA 77:4 indicating that any excess compensation determined by a DRA audit "…shall not be considered a dividend under this chapter unless such determination is accepted by the Internal Revenue Service." It is doubtful that the IRS would consider such an adjustment to be a dividend in the case of a proprietorship, partnership or limited liability company. It is also unclear how a New Hampshire compensation deduction adjustment for a corporation taxed federally as a Subchapter S corporation would be impacted.

Provisions contained in Chapter 207 - Unfavorable to taxpayers

(1) The law recreates a limitation on the compensation deduction of unincorporated business organizations similar to the 2009 maximum compensation provision. The limitation is equal to the sum of the "earned income", net rental income and the 15 percent commission on the sale of business assets. Earned income is the amount reported as such on the federal income tax returns of the proprietor, partners or members of the business organization. Incorporated business organizations do not have such a limitation for the officers of the business.

(2) An unincorporated business organization will no longer be able to create or increase a net operating loss for a taxable period even when the compensation is actually paid to the proprietor, partner or member. The current statutory language allows such an increase in the operating loss deduction for 2010. The limitation now creates a potential constitutional problem between the treatment of incorporated and unincorporated business organizations.

(3) The legislation, in two sections, requires that the business organization must maintain records that demonstrate the reasonableness of the compensation using the federal standards under IRC Section 162(a)(1). Unfortunately, the language does not provide any guidance on what kinds of records the Legislature contemplates so this issue which has haunted many small businesses continues.

(4) The bill does not define what is meant by "clearly unreasonable". Based on the testimony provided during the Legislative hearings on HB 557, it would appear to be less than the standard of "grossly excessive" that was used prior to 1991 and the current law that provides no stated standard for the DRA to meet.

(5) The provisions of the bill do not apply to all years that remain open under the Statute of Limitations and subject to challenge by the DRA.

With uncertainty lingering, our recommendation continues to be the same. Compensation planning remains imperative, at least until it is clear how the DRA will adjust its approach under Chapter 207. By establishing employment agreements, implementing compensation arrangements, and payment strategies, taxpayers will be in a better position to respond to the DRA under the new standards and will reduce the risk of facing a costly audit and increase the likelihood of prevailing when challenged.

Maurice P. Gilbert is Devine Millimet's director of State Taxation. He brings an extensive knowledge of federal multi-state tax planning, enforcement, and compliance procedures to the firm's clients, assisting them with federal and state tax planning opportunities, evaluating the tax implications of proposed business transactions, and providing analysis on proposed state and federal tax legislation and regulatory changes.