

YEAR-END NEW HAMPSHIRE TAX PLANNING RECOMMENDATIONS

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Our last issue of Tax E-News discussed changes to the Business Profits Tax statute which requires business owners to keep records that substantiate compensation for purposes of reporting a reasonable compensation deduction. RSA 77-A:4, III(b). The cautionary note from that article was that a failure to maintain compensation records which support the compensation reported could result in a complete disallowance of a client's compensation deduction rather than a disagreement about its reasonableness. With year-end fast approaching and the beginning of 2012 around the corner, we recommend that your clients consider the following records to minimize the risk of having a compensated deduction disallowed:

- Document Performance-based Compensation Methodology.
 - o Before granting bonuses next month, document the methodology for how the bonus was calculated and ensure that the bonus relates to services provided rather than mere profitability of the business.
 - o Follow the same methodology next year but make sure to document the performance goals for 2012 in January. Performance goals can be based on one or more business criteria such as stock price, market share, sales volumes, earnings per share, return on equity, cost reductions, or profitability.
- Provide for Compensation in Operating or Partnership Agreements.
 - o Review these agreements annually (or at least confirm with your client that no amendments or restatements have occurred since your last review). Some operating or partnership agreements establish the compensation to be paid to business owners. The operating or partnership agreement can include

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- provisions stating who is responsible for establishing the compensation, establish a vote requirement for approving the compensation, and outline the services expected to be provided in exchange for such compensation.
- o Consider interest and dividends tax issues as well. A recent court decision takes a position that may require changes to operating agreements to ensure that interests remain non-transferable to avoid a partner or member level interest and dividends tax on distributions. Additionally, the DRA continues to hold their position that a single-member limited liability company (SMLLC) cannot have non-transferable interests regardless of the terms of the operating agreement so a member of an SMLLC ought to weigh the costs and benefits of admitting a second member to prevent their distributions from being subject to tax.
- Provide for Guaranteed Payments.
 - o A partner or member can receive compensation from a partnership or LLC if the payments are considered “guaranteed payments” pursuant to Section 707(c) of the Internal Revenue Code and is computed without regard to the income and profits of the entity.
 - Execute an Employment Agreement.
 - o An employment agreement should address the services and compensation of the business owner. The business owner may be compensated through wages, salary, commissions, or incentive-based compensation. In addition to monetary compensation, the employment agreement often specifies a fringe benefit package, including retirement plan, employee stock options, holiday entitlement, and health insurance benefits.
 - Document an Independent Investor Rate of Return and Consider Declaring a Dividend.
 - o Establish the rate of return that an independent investor might expect. Under the independent investor rule, if the rate of return can occur at the current compensation levels, then presumably the compensation is reasonable. Comparative data can be a good resource for determining an independent investor rate of return.
 - o After providing for a rate of return, consider declaring a dividend. Documenting the dividend is relatively straightforward: implement a dividend policy; and document the appropriate corporate action for declaring the dividend either through Board minutes, consent resolutions or partner or member meetings.

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- Compare Expected Compensation with Comparative Data.
 - o Perform industry research and document your findings. If you cannot find good data, then try the Almanac of Business and Industrial Financial Ratios published by CCH Incorporated, the Annual Statement Studies published by the Risk Management Association or see if there is an applicable professional or industry association that has market data.
- Consider Records Already in Existence to Memorialize Compensation and Services Informally and Contemporaneously. For example:
 - o Retain contemporaneous notes from meetings with partners, members and board members where compensation, services, performance goals and expectations were discussed.
 - o Review and consider retaining personal calendars, appointment notes, comments entered into business owners PDA devices.
 - o Draft a memorandum for the file detailing the services that were provided for the year focusing on the high-value services of the business owner. This establishes a record and can be helpful in providing a proactive response to an audit. If testimony is ultimately necessary, then the memorandum will serve as an excellent reference that will ensure that the testimony is complete and accurate.

December is the last opportunity that clients will have to substantiate their 2011 compensation and January is the best time to implement these strategies for 2012. By assessing and enhancing compensation records, your clients will be in a stronger position to overcome a challenge from the DRA or the IRS.

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