

NEW HAMPSHIRE TAX ISSUES FOR UNINCORPORATED BUSINESS RETURNS

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As you re-focus your attention from corporate business tax returns and with April 15th just around the corner, this newsletter will highlight some new issues and potential pitfalls that tax return preparers may face this filing season and offer some hints for ensuring compliance with recent changes. Understanding that your time is a scarce commodity at this time of year, I will only review these changes briefly and suggest that you take a more in-depth look if any of the changes raise concerns for your practice.

Some Potential Consequences of the New 2011 Tax Forms

With the recent release of final tax return forms from the New Hampshire Department of Revenue Administration (the "Department"), there are a few cautionary points with respect to the forms that you should consider prior to filing. The changes to the forms from prior years are significant and do potentially involve some policy changes by the Department; therefore, as a practitioner you should begin with a detailed review of the new forms and instructions.

(1) IRC § 179 Deduction on Partnership Forms NH-1065, DP-120-P and "S" Corporation Form DP-120

The statutory language of the Business Profits Tax ("BPT") provides for the use of the IRC in effect on December 31, 2000 and this version of the Code includes an Internal Revenue Code ("IRC") § 179 deduction of up to \$20,000. The new forms do not appear to match up with the statutory language on this issue. Line 2(a) of Section 2 on Form NH-1065 asks the taxpayer to add back the amount of IRC § 179 deduction taken on the federal return in excess of \$20,000. However, it appears that Forms NH-1065 and DP-120-P calculate the NH Gross Business Profits without any IRC § 179 deduction; therefore no IRC § 179 deduction was taken and there should be no add-back. Also, because it is not designated in Form NH-1065 or the instructions, it is unclear whether the taxpayer can take the \$20,000 IRC § 179 deduction at Line 2(a), 2(f) or elsewhere. In the case of a combined return that includes a partnership, the adjustment required on the NH-1120-WE, line 10(a) relating to the IRC § 179 deduction has the same issue because the deduction was not included on the DP-120-P.

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The same issue arises with “S” corporations on Form DP-120.

(2) Proprietorship Form NH-1040 - Reporting of Business vs. Investment Income

New Hampshire’s BPT is intended to tax only the **business** income of taxpayers. However, because the NH-1040 pulls figures directly from the taxpayer’s federal return, it’s important to consider whether those figures contain any items of income unrelated to the business activities, especially if the taxpayer is a single-member limited liability company. It is possible that a portion of the income which the NH-1040 pulls from the federal return and schedules will be investment or interest income that is not taxable on the NH-1040. For example, interest earned on a bank account for the business that appears on the individual’s Federal Form 1040, Schedule B is taxable under the BPT but interest on a separate personal account is not. A similar issue may exist with the sale of assets that appear on the Federal Schedule D or similar form. Tax preparation software may not pick up on this issue so it is important to consider the sources of income taken from the federal forms before they are reported on the NH-1040.

(3) Sequencing of BET Credits

The Business Enterprise Tax (“BET”) paid by a taxpayer provides the taxpayer with a credit which can be applied against the BPT liability. BET credits which are not used can be carried forward for up to five years (effective until July 1, 2014, at which point the carry forward period increases to ten years). However, there is no statute or administrative rule dictating the order in which the BET credits must be applied. Despite the lack of any legal guidance, the 2011 forms now require application of the current year’s BET credit before any prior year credits can be applied. Practitioners who previously used the FIFO method in applying BET credits must now apply the current year’s BET credit before applying prior year BET credits, which may cause some taxpayers to lose unused credits.

(4) Estimated BPT and BET Payments

The new forms still require BPT and BET estimated payments to be determined and reported separately on the same form but allow the estimated tax payments to be combined on the annual Business Tax Summary and for purposes of determining underpayments. This gives the taxpayer more of a buffer against underpayment penalties.

(5) Capital Losses: Partnership Form NH-1065 vs. Proprietorship Form NH-1040

Line 1(i) of the NH-1065 asks for the net long term capital gains of the taxpayer, but not below zero. Any excess capital losses are **required** to be carried back three years to offset prior capital gains. A tax refund for prior years’ BPT tax paid on the capital gains is allowed if the claim for refund is made within three years from the original due date of the tax, which is April 15th for calendar year unincorporated businesses. Any remaining capital loss is carried back to the second preceding year and any portion not used in the carryback period is then carried forward for five succeeding years. Based on the language in the forms and instructions, this provision appears to be mandatory.

There is not an equivalent provision for Line 1(f) of the Proprietorship Form NH-1040,

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which means that sole proprietorships and single-member limited liability companies with an individual as the member are not able to carry losses back to prior years or carry forward remaining losses unlike other business entities. In addition, there is no New Hampshire equivalent to the \$3,000 ordinary income offset for capital losses available to the taxpayer at the federal level.

(6) Use of Combined Reporting for Single-Member LLC Included in Individual's Federal Income Tax Return

As a reminder, any group of related businesses organizations conducting a unitary business both within and outside of New Hampshire must file a combined return. This is true even if, for example, the group of related entities is a series of single-member limited liability companies involved in rental real estate activities in New Hampshire and Massachusetts. Even though in those circumstances the taxpayer would report his or her business activities federally on Form 1040, Schedule E, for purposes of the BPT the taxpayer would be required to file the Combined Business Profits Tax Return, NH-1120-WE, rather than the Proprietorship Form NH-1040, combining the various activities from the Federal 1040, Schedule E.

Understanding the New Reasonable Compensation Deduction Standard

The 2011 tax year brought with it another new standard for the oft-discussed reasonable compensation deduction under the BPT. We've already covered this change in greater detail in a [previous article](#) so I will just highlight a few of the main points.

First, a taxpayer is now only required to prove that he or she actually rendered some services to the business before the deduction is presumed reasonable and the Department bears the burden of proving by a "preponderance of the evidence" that the compensation claimed was "clearly unreasonable." While this change appears to be a win for taxpayers, there is also an accompanying requirement that the taxpayer maintain "such records as may be necessary" to support the deduction taken. Many questions remain about what types of records must be maintained to meet this requirement so this is a good topic to raise with clients when looking ahead to next year. The DRA is in the process of adopting Administrative Rules that provide additional guidance in this area. You can review the [draft rules](#) on the DRA website.

Second, if a business organization was unable to take a reasonable compensation deduction in a prior year due to insufficient profits, the business organization may adjust this year's compensation deduction to reflect the under-compensation in the prior year(s). However, with the new records requirement, the business organization must maintain records sufficient to demonstrate the organization's intention to compensate an individual for services performed in the prior year(s). These records should be maintained contemporaneously with compensation decisions such as bonus calculations and salary level increases and may be considerably less valuable when created in response to a controversy with the Department.

Application of the Gambling Tax in 2011

New Hampshire's gambling tax was repealed on May 23, 2011 but only on a going-

forward basis. This means that any clients with gambling winnings in the January 1st – May 22nd time period must still file a gambling tax return, Form DP-300. As a refresher, this is a gross tax on all gambling winnings of New Hampshire residents, wherever derived, and all winnings received from a New Hampshire entity, regardless of where the taxpayer is from. Tax liability is not reduced by gambling losses or taxes paid to other states on the same gambling winnings.

There is currently a challenge to the constitutionality of the gambling tax pending in New Hampshire Superior Court in Merrimack County. If you'd like more information about the case and how it may affect clients with gambling winnings, whether from lottery tickets, casino winnings or as a professional gambler, in the current year or prior years, please feel free to give us a call or email.

Reporting of Income from Qualified Investment Companies and Mutual Funds

Last year, Senate Bill 58 (Chapter 181 of the Laws of 2011) clarified that amounts of Qualified Investment Company ("QIC") and mutual fund income reported and taxed federally as capital gains to an interest holder are not subject to the New Hampshire Interest and Dividends Tax.

Devine Millimet Can Help

If you encounter any of these issues or other related issues this filing season, feel free to give a member of our Tax Practice Group a call or an email. With one of the largest and most diverse tax practices in New Hampshire, Devine Millimet is ready to assist you and your clients with all of your tax-planning and tax controversy representation needs.

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