

## NEW HAMPSHIRE SUPREME COURT DECISION ON INTEREST AND DIVIDENDS TAX PUTS LANGUAGE OF PARTNERSHIP AGREEMENTS AND LLC OPERATING AGREEMENTS IN FOCUS.

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The New Hampshire Supreme Court's recent decision in [New Hampshire Resident Limited Partners of Lyme Timber Co. v. N.H. Dep't of Revenue Admin.](#) provided a bit of clarity on some previously ambiguous provisions within the [Interest and Dividends Tax](#) ("I&D Tax") and by doing so may have provided the New Hampshire Department of Revenue Administration (the "Department") with a new avenue for pursuing tax revenue during audits of partnerships and limited liability companies. This article will provide you with a basic understanding of the facts of the case and the potential impact of its holding on your clients. The central issue facing the court was whether the language of a partnership agreement caused the partners to be individually liable under the I&D Tax instead of the tax being imposed at the entity level. The court's holding and its future implications may warrant a second look at your client's partnership agreements and operating agreements.

Lyme Timber Company ("Lyme Timber") is a limited partnership formed over thirty years ago that owns, develops and manages commercial real estate and timberland. In 2005, the Department reviewed the Business Profits Tax returns of Lyme Timber and as a result of the size of the distributions to Lyme Timber's limited partners (the "Limited Partners"), the Department also decided to take a look at the I&D returns of the business and its Limited Partners. The Department ultimately issued notices of assessment to the Limited Partners of Lyme Timber for **distributions** made by the partnership in 2002, 2003 and 2004 despite the fact that Lyme Timber reported and paid I&D Taxes on the **interest and dividend income** it had received at the entity level for those years. This resulted in significant additional tax liability because the distributions from the partnership to the partners were substantial when compared to the amount of interest and dividend income

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received at the entity level. The Limited Partners petitioned the Department for a redetermination but were denied and on appeal, a Hearings Officer upheld the Department's tax assessments.

The Department and the Limited Partners both agreed that the central issue in the dispute was who is taxable under the I&D Tax; the entity itself or the Limited Partners. The parties further agreed that the answer depended entirely on the meaning of the word "transferable" as used in the I&D Tax statute and applicable rules. Under the I&D Tax, if the beneficial interests (partnership interests if a partnership and membership units if a limited liability company) are represented by transferable shares, then the Limited Partners individually would be subject to the I&D Tax. If, however, the beneficial interests are represented by non-transferable shares, then Lyme Timber, as an entity, is subject to the I&D Tax rather than the Limited Partners.

The term "transferable" is not defined in the I&D Tax statute but it does appear in the administrative rules then in effect. Under Rev 901.02, relating to RSA 77:3, I(b) (who is taxable), beneficial interests are not considered transferrable where they cannot be transferred without obtaining prior member approval or causing a dissolution of the organization. Under Rev 901.17, relating to RSA 77:3, I(b) and RSA 77:4, III (what is taxable), beneficial interests are not transferrable unless the interest holder can dispose of, by any means, his interest without a required approval by another member and without causing dissolution. . Under Rev 901.03, relating to RSA 77:4, III (what is taxable), beneficial interests are not considered transferrable where they cannot be "freely" transferred without obtaining prior member approval or causing a dissolution of the organization. These rules prompted two main inquiries by the court. First, what precisely does "approval" mean and what type of approval is necessary in order for interests to be considered non-transferable? Second, does the phrase "by any means" stand for the proposition that the interests are transferable if there is at least *one* method of disposing of the interest without approval or must the interest holder be free to choose *any* method of disposition without approval in order for the interest to be transferable?

Before getting into the court decisions, it is important to have an understanding of the partnership agreement language being analyzed. The majority of the court's focus was on the following provision in the Lyme Timber Partnership Agreement:

11. Assignment of Partnership Units. A Limited Partner may sell or assign his Partnership Units but only on the following terms and conditions:

(a) The Limited Partner shall furnish the Partnership with an opinion of counsel satisfactory to the General Partner that the sale or assignment is in compliance with applicable securities laws and regulations.

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(b) The purchaser or assignee shall consent in writing, in form satisfactory to the General Partner, to be bound by the terms of this Agreement in the place and stead of the Limited Partner.

(c) Such assignment is to another Partner or a member of the Limited Partner's family or (1) pursuant to a bona fide written offer, (2) the Limited Partner has given the Partnership 60 days to match the offer and (3) the Partnership has not done so.

The Limited Partners appealed the Department's decision to the [New Hampshire Superior Court](#). The court held in favor of the Limited Partners on the basis that ambiguities existed within the I&D Tax statute and the rules that made it difficult or impossible to determine whether interests were "transferable" and there is a longstanding common law principle that ambiguities within a taxing statute or regulation must be construed against the government and in favor of the taxpayer. The court found that the meaning of "by any means" was ambiguous because it did not clarify whether the interest was transferable if there was a single means by which it could be transferred or whether the interest was only transferable if it could be transferred by any method the interest holder chooses. The court also found that the term "approval" was ambiguous because it was not defined by statute or rule and it was not clear whether Lyme Timber must possess the unequivocal power to block any transfer of an interest for the interests to be non-transferable or whether a more limited power would suffice. Lastly, the court noted the ambiguity created by the different language in Rev 901.02 and Rev 901.17 ("transferable") as compared to Rev 901.03 ("freely transferable") and questioned whether the addition of "freely" in Rev 901.03 implied a higher level of transferability. Although the court noted that the Department is entitled to deference with respect to the interpretation of its own rules, it found in favor of the Limited Partners because the Department's interpretations did not remove the ambiguities cited and the ambiguities must be construed against the government and in favor of the taxpayer.

The Department appealed the decision to the New Hampshire Supreme Court based on the argument that Lyme Timber's Partnership Agreement did not actually require approval for a transfer to occur and thus the Lyme Timber interests were transferrable and the Limited Partners were individually subject to I&D Tax liability. The Department argued that (1) the Lyme Timber interests were transferrable because under Section 11(c) of the Lyme Timber Partnership Agreement, the Limited Partners could assign their interests to family members or other partners without any approval whatsoever, (2) the right of first refusal only provided Lyme Timber with an opportunity to match an offer, not to approve or deny the transfer and (3) Lyme Timber's practice of formally approving transfers of interests was meaningless because Lyme

Timber possessed no authority under the partnership agreement to prevent a transfer. The Department also argued that the plain meaning of the word “approval” connotes the ability to permit or prevent a transfer and therefore the word is not ambiguous. In support of its position, the Department cited federal law to the effect that a right of first refusal to match a third party’s offer to purchase does not constitute a significant impediment to the transfer of property.

The New Hampshire Supreme Court reversed the Superior Court’s holding, finding that the interests in Lyme Timber were transferable and therefore the Limited Partners were individually taxable under the I&D Tax. First, the court noted that the Limited Partners could transfer interests freely to family members or other partners under Section 11(c) of the Lyme Timber Partnership Agreement without any type of approval or right of first refusal on behalf of Lyme Timber. Second, Lyme Timber’s practice of approving each transfer as it occurred was meaningless because Lyme Timber lacked authority under the partnership agreement to prevent a transfer even if it wanted to; all Lyme Timber could do was match the offer, provided the transfer was not to a family member or another partner. Lastly, the right of first refusal provided in Section 11(c) of the Partnership Agreement merely gave Lyme Timber an option to purchase the interests to be transferred, not to actually block the transfer, and therefore it did not constitute a significant restraint on the ability of the Limited Partners to alienate their partnership interests. The court did agree that the term “by any means,” as used in defining transferability in the rules, was ambiguous but found that the ambiguity did not affect the outcome of the case because the interests were already transferable for lack of an approval requirement. The ambiguity created by the difference in language (transferable vs. freely transferable) in the rules was also disregarded by the court because Rev 901.03, containing the term “freely transferable,” by its own terms only applies to entities other than partnerships.

Because the current language on transferability of interests in the I&D Tax and Administrative Rules is essentially identical to the I&D Tax and Administrative Rules language analyzed in the Lyme Timber case, the court’s decision is of particular importance to existing partnerships and limited liability companies. While your clients’ partnership agreements and operating agreements may vary significantly from the language found in Lyme Timber’s Partnership Agreement, the court’s reasoning provides insight on how the holding may be applied to different provisions. The court explained that the clear purpose of the regulatory scheme established by the New Hampshire Legislature under the I&D Tax and the implementing rules is to hinge taxation of individual interest holders on the extent to which their interests represent individual, as opposed to collective, economic value. Because a right of first refusal does not significantly affect the marketability or value of

a limited partner's economic interest, the limited partner can still readily liquidate his or her interest for whatever price the market will bear. This arrangement causes each individual interest to have economic value independent of the other partnership interests, resulting in taxation at the individual level.

Based on the court's explanation of the intent and purpose of the I&D Tax provisions on transferability, the Department may treat anything short of a blanket approval requirement for all transfers as constituting transferable shares, resulting in I&D Tax liability for the individual partners or members. The Department may also take issue with all single member limited liability companies regardless of the strength of approval language in its operating agreement because there is no one that the single member can obtain approval from. If significant distributions to the single member are anticipated, it may be worth considering adding a second member with a minimal interest until more is known about the Department's position with respect to single member limited liability companies.

It remains to be seen how aggressively the Department is going to pursue this issue in the wake of the Lyme Timber decision but clients organized as partnerships or limited liability companies should review their current agreements to ensure their interests would not be considered transferrable under the court's holding. Agreements that carve out exceptions to approval requirements for transfers to individuals such as family members or other partners and agreements that do not explicitly require approval of transfers at all and instead just provide a right of first refusal in favor of the entity and/or the remaining partners or members should be big red flags. For less obvious transferability issues, it still may be worthwhile to amend the agreement in order to protect partners or members from the risk of individual I&D Tax assessments in the future. Finally, if a client is assessed I&D Tax on the partner or member level by the Department, file a protective claim for refund of I&D Tax paid at the business entity level within the statutory period to protect your client from being hit with the I&D Tax at both levels in the event that a challenge to the tax assessment is unsuccessful. Please feel free to contact any member of Devine Millimet's Tax Practice Group if you have questions regarding the court's holding and its implications.

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