

## TAX UPDATE

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### ANALYSIS OF DEPARTMENT OF REVENUE ADMINISTRATION'S FINAL PROPOSAL FOR INTEREST & DIVIDENDS ADMINISTRATIVE RULES

This article is to provide our readers with an update on the status of the so-called "LLC Tax". The changes in the Interest Dividends ("I&D") statute did not create a new tax on limited liability companies. The changes effectively made distributions from all partnerships and limited liability companies taxable under the I&D tax similar to the way distributions are treated when made to New Hampshire residents by corporations. Under prior law some, but not all, of the distributions from partnerships and limited liability companies were subject to the I&D Tax.

The Department of Revenue Administration ("DRA") has filed the final proposal of the I&D Administrative Rules with the Joint Legislative Committee on Administrative Rules ("JLCAR"). The JLCAR is a committee of the New Hampshire Legislature comprised of members of the Senate and the House of Representatives. This committee has amongst its duties the responsibility of reviewing the administrative rules promulgated by the State's agencies prior to the rules becoming effective.

The rule making process requires that the JLCAR review the draft rules and during that process the committee will provide another opportunity for public input on the rules. The I&D *Final Proposal* will likely be on the JLCAR agenda for the February 19, 2010 meeting. The agendas for the committee are published on the legislative web site. The public may submit written comments in advance of the committee meeting to the JLCAR or can appear at the meeting and request the opportunity to provide oral testimony. The JLCAR can agree with the rules as filed or it can file a

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preliminary objection and ask that the DRA re-examine the rule in light of the objection and provide a response which could delay the implementation of the rule while the DRA prepares its response.

Commissioner Clougherty conducted four public hearings on the rules prior to the submission of the final proposal. The DRA made a significant effort to work with taxpayers, attorneys and accountants in drafting the rules. The comments made by the public did make a significant difference in the language of the proposed rule the DRA submitted to the JLCAR for approval. The Commissioner and his staff deserve credit for their efforts. Although the public may still not be in full agreement with the language, the final proposal is a significant improvement from the initial draft rule and does incorporate many of the comments made by the public.

### **DEBT FINANCED BY THE ENTITY**

One of the most controversial parts of the statute and the rules relate to the term “Debt Financed by the Entity” which the Legislature added within the definition of a “dividend”. See [RSA 77:1-a, II](#). The DRA modified the definition of this term in Rev 901.06 of the final proposal so that its application limits the taxability of the distribution to circumstances in which the entity making the distribution has accumulated profits (federal earnings & profits for corporations). Under the revised language, any amount distributed beyond the accumulated profits will no longer be considered a dividend subject to the I&D.

This new approach continues to be outside the initial expressed intent for the new statutory phrase, which was to address the forgiveness of shareholder loans, and the plain meaning of the words used by the Legislature – debt **financed by** the entity, but the tax result is reasonable. The DRA should consider recommending a legislative change to the term to reflect the intent of the provision.

### **ACCUMULATED PROFITS & REASONABLE COMPENSATION**

Another area of concern relates to the concept of accumulated profits for unincorporated businesses as it compares to the earnings & profits (“E&P”) of a corporation for federal income tax purposes. The final proposal has been greatly modified and expanded; however, it continues to require the calculation of the accumulated profits of unincorporated businesses at the partner or member level while the E&P of corporations is calculated at the entity level. This creates a constitutional infirmity because the tax paid on a distribution received from an unincorporated business will be different simply based on the type of entity that pays it even when the operations of the businesses are the same.

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Although the rule now includes an “S” corporation in the calculation of accumulated profits of corporations under the Internal Revenue Code of 1986, as amended (“IRC”), the calculation of E&P pursuant to the IRC does not apply to an “S” corporation. We believe that the intent of the DRA was to indicate that an “S” corporation would calculate its accumulated profits as if it were a “C” corporation for federal tax purposes.

The regulatory language now provides guidance on how a partner or member is to calculate his/her current year and accumulated profits when an entity files a partnership return. See Rev 902.08(d). A separate subparagraph addresses the calculation in instances where the limited liability company files a proprietorship return. See Rev 902.08(e). Deductions under IRC Section 179 are also addressed in this rule. The rule provides an option to take the deduction or to convert the depreciation to straight-line over the life of the asset.

The rule also requires the addition of any gain that is not recognized for federal income tax purposes on the distribution of property to a partner or member if the gain would have been recognized by the entity if it were considered a “C” corporation. This will create additional recordkeeping for purposes of the I&D not currently required for the business taxes. The purpose of this provision is to equalize the treatment of such distributions for unincorporated and incorporated businesses.

The partner or member accumulated profits calculation allows a reduction for the compensation of the member or partner in the year the compensation would be deductible. The amount must be reduced by any payments for services received as guaranteed payments. The provision also states, “A payment of unpaid compensation from a prior year shall not decrease accumulated profits.” The intent of this language is not clear. We believe the intent is to treat the compensation deduction in a manner similar with its treatment under the Business Profits Tax as to timing but to restrict the effect of the deduction compared to how compensation deductions impact the calculation of E&P for federal income tax purposes. This treatment may also create potential issues where operating losses become a factor for unincorporated businesses.

One of our acquaintances, Larry Bournival CPA of Howe, Riley & Howe PLLC identified differences with the definitions section and the examples in the final proposal of the rules when he compared it with an earlier version in his possession. After discussing the matter with him we agreed that there was a potential issue. The final proposal has changed the definition of an organization for purposes of the I&D Tax and the related Administrative Rules. This change impacts the concept of accumulated profits and the undistributed



revenues of unincorporated businesses. The pertinent portion of the definition of accumulated profits under proposed Rev 901.01 (b) provides "... the total undistributed revenues of the entity from whatever source derived." The term total undistributed revenues appears to be limited to an organization that is "... required to file a federal partnership return or a limited liability company required to file as a proprietorship". It goes on to indicate that the term reflects "...the excess income received and retained by an organization after the payment of its expenses from the current year or from prior years." (Emphasis Added) See proposed Rev 901.20.

Proposed Rev 901.15 as released on November 12, 2009 defined "Organization" in part as "... (h) limited liability company; or (i) **any other legal or commercial entity.**" (Emphasis Added) The proposed rule also stated "Entity" means, as used in RSA 77:1-a, II (c), organization, as defined in Rev 901.15." This document also contained an Example 4 under the total undistributed revenue entitled "Distribution From a Sole Proprietorship that Are Not Taxable". The example discusses the use of some of the business funds as personal expenses and concludes that the personal expenses are not taxable under I&D since "...a proprietorship (other than a single member limited liability company) is not considered an 'organization' under Rev 901.12 for purposes of determining the sources of taxable dividends under RSA 77:1-a, II." The reference to Rev 901.12 should have been to Rev 901.15.

The final proposal changes the definition of subparagraph (i) so that it now reads "Any other legal or commercial-~~entity form of~~ **business**" (Emphasis Added). This document also does not contain the Example 4 referred to above. It is unclear why these changes were made. It is possible that the prior use of the word entity as a defined term referring to organization and then having the term organization refer back to the word entity was creating a problem. If the change was merely to eliminate the circular reference then the necessity to remove the Example 4 seems questionable. Is the change removing **entity** and adding **form of business** intended to change the conclusion reached in Example 4 of the Initial Proposal of November 12, 2009?

A recent lawsuit filed in Hillsborough County Superior Court discusses a potential constitutional issue about the different treatment under the amended I&D tax where an LLC owning rental real estate would pay the BPT and the distributions to its New Hampshire resident member would be subject to the I&D while an owner operating as a proprietor of rental real estate would only be required to pay the BPT and would not be subject to the I&D. The claim being made in the suit is that the similarly situated individuals would be taxed differently. See Wennin, LLC v. State of New Hampshire Department of Revenue Administration (Hillsborough



Cty. Super. Ct. No. 10-E-11) (Petitioner's Petition for Declaratory Judgment Concerning Constitutionality of Amendments to RSA 77 and Petition for Permanent Injunction filed January 12, 2009).

The DRA should address the issue associated with the changes made to the proposed rules in this area so that taxpayers and practitioners would have a clear understanding of the implication of accumulated profits and total undistributed revenues to a proprietorship that is not a single member limited liability company. The issue could be quickly clarified if the change was made to eliminate the circular reference.

### **GUARANTEED PAYMENTS FOR THE USE OF CAPITAL**

The rule provides that the receipt of a guaranteed payment for the use of the members' or partners' capital shall be treated as interest for purposes of the I&D statute. See Rev 903.07. This language raises an interesting point when compared to the treatment of guaranteed payments under the Business Profits Tax ("BPT") where the guaranteed payment is added back to the income and a compensation deduction is allowed for the services provided by the partners or members. There is no distinction in the BPT adjustment for components of the guaranteed payment.

### **RECORDKEEPING REQUIREMENTS**

The final proposal continues to keep the recordkeeping requirements at the individual partner or member level for unincorporated organizations. There will need to be significant communications between the New Hampshire member or partner and the entity itself so that adequate information will be available to the member or partner for the preparation of the I&D tax returns of New Hampshire resident individuals. The resident individual will be required to calculate the individual's current year profits, the accumulated profit, his/her share of compensation deducted by the entity, the amount paid to the individual and any carryover of unpaid compensation.

The rule addresses the support for claiming that any portion of a distribution is non-taxable. See Proposed Rev 903.11. The rule presumes that any distribution received by a New Hampshire resident is subject to the I&D Tax. The individual must then demonstrate that the distribution was:

- (1) For the personal services the individual rendered to the entity;
- (2) From a return of capital; or
- (3) A liquidating dividend.



Unfortunately, the rule does not address the definition of a liquidating dividend. RSA 77:4-c addresses the sale, exchange or transfer of interests and excludes any amount received from such a transaction regardless of whether it is "...by way of liquidation, redemption or otherwise, and irrespective of the identity of the parties to the sale exchange or transfer.". The rule, if the term liquidating dividend is taken at its face value, may be restricting the intent of the statutory provision.

The Department provided some relief in the difficult area of recordkeeping for entities taxed as partnerships and LLCs taxed as a proprietorship and now will only require a computation of accumulated profits from the **later of**:

- (1) the first year the taxpayer was an owner; or
- (2) the beginning of the tax year ending on or after December 31, 2009 (i.e. January 1, 2009 for calendar year entities).

The partnership-taxed entity can also elect to compute accumulated profits from inception of the entity. Presumably this would only be to the advantage of an entity with prior years' losses and current profits.

The DRA has sought input from practitioners and others in creating a worksheet for use in determining the accumulated profits for members and partners who are New Hampshire residents. The goal is to have a worksheet ready by the time the JLCAR meeting on the final proposal is held. It will be imperative for taxpayers or their tax advisors to maintain worksheets in some format that will track the individual's current year profit, the accumulated profit and any unpaid compensation deduction carryover. In addition, the worksheet will need supporting evidence that ties to the information at the entity level. The rules do not provide any guidance on what evidence will be acceptable and the amount of evidence that will be sufficient.

## WHAT IS NEXT

If you continue to have concerns about the final proposal for the I&D Administrative Rules, you should write to the JLCAR or appear at the meeting and express your concerns. Their web address is as follows:

[www.gencourt.state.nh.us/rules/JLCAR/default.htm](http://www.gencourt.state.nh.us/rules/JLCAR/default.htm)

We reviewed the JLCAR website and did not locate the agenda for the next meeting but we believe that the committee will likely review the matter at the February 19, 2010 meeting in Concord. The agenda for that meeting has not been posted yet on the website but the session may start about 10:00 AM.



The 2010 Session of the Legislature has a few proposed bills that are aimed at making changes to the so-called “LLC Tax”. A new Senate Bill (**SB 497**) eliminates the issues associated with the “LLC Tax”. On January 25, Devine Millimet’s Tax E-News has a summary of significant legislation and the proposed bills impacting these changes are included. If you did not receive a copy of this E-News, please go to our web site and download it or contact me and I will send it to you.

Please feel free to contact Jon Sparkman, Jason Cole or Maurice Gilbert with any questions you may have regarding these proposed rules or the statutory provisions they are interpreting.

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