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## Tax Law: A Step in the Right Direction: NH Reasonable Compensation Deduction

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Under the New Hampshire Business Profits Tax (the "BPT"), a proprietorship or partnership is permitted a deduction for the fair and reasonable compensation for the personal services of the business owner(s). RSA 77-A:4, III. Supporting this deduction continues to be a hot topic in New Hampshire taxation. Although little is expected to change as to how the Department of Revenue Administration (the "DRA") assesses the reasonableness of business owner compensation, this past July, the Legislature – through a collaborative effort between tax practitioners and the DRA – gave taxpayers more tools for meeting the burden for supporting this deduction by passing HB 1607, An Act Relative to the Reasonable Compensation Deduction Under the Business Profits Tax, Creating a Committee to Study Safe Harbors and Taxation of Investment Organizations, and Deleting a Provision Relative to Taxation of Certain Income Accumulated in Trust (the "Act"). See Chp. 324, N.H. 2010 Session Laws.

The Act provides for significant changes to the standards available for determining the reasonableness of the compensation deduction:

### 1. New \$50,000 Record-keeping Safe-harbor

The old law provided a minimum compensation deduction of \$6,000 per individual partner or member which would not be challenged by the DRA if the partner or member provided services. The Act repealed that provision and replaced it with a so-called "record-keeping safe-harbor" that minimizes the amount of records required to be maintained by the business and prevents the DRA from challenging the deduction. Under the new provision, a taxpayer is permitted a compensation deduction of \$50,000 per business or group of related businesses.

The safe-harbor, however, is extremely limiting for all but small businesses, because if there are multiple owners rendering services or multiple business entities involved, the \$50,000 amount must be allocated amongst the entities and individuals. Furthermore, if one of the entities is a corporation and it pays the owner a wage, the \$50,000 safe-harbor amount must be reduced by the amount of wages received by the member or partner from the related entity. It is also important to note that for 2010, neither the \$6,000 nor the \$50,000 safe-harbor amounts apply.

### 2. Ability to Pay Compensation in Excess of Profits

The Act now permits taxpayers to take a deduction for reasonable compensation which results in reducing taxable business profits below zero for any taxable period so long as the compensation is actually paid. While the possibility of a net operating loss after owner's compensation was available for corporations before the Act, it was not available to proprietorships, partnerships or LLCs. This change offers a significant planning opportunity for some taxpayers because it could result in losses for tax purposes which could be used to reduce tax liabilities in the future, so long as the compensation is reasonable and is actually paid.

### 3. Ability to Rely Upon Section 162(a)(1) of the Code

Section 162 of the Internal Revenue Code allows for a corporate deduction of reasonable compensation at the federal level. The Act makes interpretive treasury regulations and court decisions regarding Section 162 applicable to non-corporate taxpayers as well. See N.H. Admin. R. Rev. 302.15.

Determining reasonable compensation at the federal level has been a point of controversy between the IRS and corporate taxpayers which has resulted in a great deal of legal precedent. Consequently,

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the courts have developed a number of factors that must be analyzed to determine the reasonableness of a deduction. Although the factors vary across the federal circuit courts, most circuits follow a multi-factor approach that takes into account a variety of factors, while other courts have relied upon the independent investor approach. The first circuit follows a multi-factor approach with some of the most common factors being:

- role of the individual in the company;
- external comparisons;
- character and condition of the company;
- the existence of bargaining between parties making compensation decisions;
- internal consistency of compensation with employees; and
- the independent investor test.

The independent investor test is a consideration of whether an independent investor – one who hypothetically is removed from management of the business – would approve the compensation arrangement. The courts consider financial statistics such as the taxpayer's return on equity and to the extent that the taxpayer is receiving a return on equity in excess of industry averages or similarly situated businesses, they have ruled that a business-owner is entitled to a higher level of compensation.

#### 4. Accounting for Return on Investment of Capital

Regardless of whether the independent investor test is used, under the Act, it is imperative that business owners account for a return on investment when supporting compensation because the Act prohibits "the deduction of amounts that are attributable to an owner's return on investment of capital in the business organization in determining taxable business profits." This concept is not new, but it is different from the prior standard which prohibited a deduction for any amounts fairly attributable to a return on business assets or the labor of non-owner employees. The shift to a return on investment of capital approach is more consistent with the independent investor test which provides case law as guidance for taxpayers.

The Act also changes how compensation is reported on the tax return. Each unincorporated business claiming a compensation deduction is now required to include a schedule attached to its annual return which describes the total compensation deduction claimed for the tax year and allocates the deduction among each proprietor, partner or member providing services. This new reporting requirement underscores the need to engage in compensation planning for all business owners receiving compensation for services.

Finally, the Legislature established a study committee to review the concept of "safe-harbors" for compensation. The concept of safe-harbors could be expanded in future years, but if a safe-harbor results in significant revenue loss to the State, then in these tight fiscal times, it may be tough for Legislators to approve.

Differences remain in the standards for supporting compensation under the BPT, but the Act is a step in the right direction. It improves predictability and compliance for taxpayers and efficiency of tax administration for the DRA. Tax practitioners, legislators and the DRA should be credited for working collaboratively on the Act, giving hope to tax practitioners that the study committee's assessment of potential safe-harbors may prove to be just as productive.



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