

I&D TAX PLANNING TIPS FOR DISTRIBUTIONS FROM LIMITED LIABILITY COMPANIES & PARTNERSHIPS

By: Jason E. Cole, Esq., CPA
Email: jcole@devinemillimet.com
Phone: 603.695.8566

MARCH 21, 2011

During the last two years, the New Hampshire Interest and Dividends Tax (the “I&D Tax”) was splashed all over the news when the Legislature passed the so-called LLC Tax and then repealed it for 2010 and subsequent years. Although referred to as the LLC Tax, the provisions also applied to partnerships. The I&D Tax statute has been restored to the pre-2009 law with a few small tweaks. By returning the I&D Tax to the way it was, LLC operating agreements and partnership agreements have again become a critical aspect of tax planning.

Under the new law – or the old law, depending on your perspective - a distribution received by a taxpayer from a partnership or LLC may be subject to the I&D Tax if the entity has freely transferable equity interests. Freely transferrable equity interests make the actual distribution from the organization subject to the I&D Tax as a dividend to the extent of current year or accumulated profits. [RSA 77:4, III](#) and [Rev 901.07](#). Conversely, distributions from a partnership or an LLC that has non-transferable interests are not subject to the I&D Tax as a dividend to the member or partner. The statute defines the term “transferable” as the ability “to dispose of, by any means, all rights incidental to [the member’s or partner’s] interest without a required approval of the disposition by another member and *without dissolution of the organization itself.*” (Emphasis added) [Rev. 901.18](#). Thus, the best tax planning advice that tax practitioners can pass onto their clients in order to make sure that distributions from an LLC or partnership are not taxable under the I&D Tax is to recommend that their clients consider restricting the transferability of their equity interests.

In the case of an LLC, restricting the transferability of a member’s equity interest is done by having a carefully drafted operating agreement. Like a partnership, the operating agreement is a

Tax Practice Group Federal, State & Local

Jon Sparkman, Esq., CPA,
Chair
603.695.8507
jsparkman@devinemillimet.com

Steven Cohen, Esq., CPA, LLM
603.695.8504
scohen@devinemillimet.com

Alexander J. Walker, Esq.
603.695.8553
awalker@devinemillimet.com

Maurice P. Gilbert, CPA, MST
Director of State Taxation
603.695.8612
mgilbert@devinemillimet.com

Anu R. Mullikin, Esq., LLM
603.695.8536
amullikin@devinemillimet.com

Daniel Will, Esq.
603.695.8554
dwill@devinemillimet.com

Nicholas Forgione, Esq., LLM
978.475.9100
nforgione@devinemillimet.com

Patricia M. McGrath, Esq., LLM
603.695.8537
pmcgrath@devinemillimet.com

Jason E. Cole, Esq., CPA
603.695.8566
jcole@devinemillimet.com

Harper R. Marshall, Esq.
603.695.8645
hmarshall@devinemillimet.com

Justin T. Vartanian, Esq.
603.695.8635
jvartanian@devinemillimet.com

DEVINEMILLIMET.COM

TAXENEWS@DEVINEMILLIMET.COM

written agreement of the members which governs the affairs of an LLC and sets forth how business is to be conducted. [RSA 304-C:1](#), VI. Members of LLCs can avoid the I&D Tax on their distributions by having an operating agreement that provides that no member may transfer his or her interests in the LLC without the consent of another member. Because in the case of a closely-held business, most people who are in a partnership or LLC with another person naturally presume that neither they nor their partner would sell his or her interest without such consent of the current partners, however, without having this restriction in the actual operating agreement, the taxpayer is facing the DRA without a crucial piece of evidence to support their claim. Partnership and operating agreements are generally one of the items requested during the course of an audit. As a precaution, practitioners should review the agreements to determine that the restrictions in the document are adequate to require the approval of another member.

Avoiding the I&D Tax for single-member LLCs has become more difficult – at least in terms of how the New Hampshire Department of Revenue Administration (the “[DRA](#)”) has signaled how it intends to treat distributions from single-member LLCs. The interests of single-member LLCs have always been difficult to restrict because with only one member, there are no other members to consent to a transfer. In the past, many practitioners looked to the definition of the phrase “beneficial interest in which is not represented by transferable shares” in Rev 901.02 that indicated a member approval **or** dissolution of the entity was required. Thus, a provision in the operating agreement of a single-member LLC which required the automatic dissolution of the LLC triggered by the proposed change of the sole member or a sale or exchange of the sole member’s equity interests made the single-member’s interests non-transferable. More recently, the DRA has begun to more firmly articulate a position that single-member LLCs cannot have non-transferrable shares regardless of the existence of a dissolution provision in the operating agreement. This may be based on the language in Rev 901.18 that **requires** the approval of another member **and** it does not cause the dissolution of the entity. This position seems unconstitutional because it is taxing a taxpayer differently based on the form of entity of the business, namely a single-member LLC as compared to a multi-member LLC. Until the DRA is more formally challenged on its position, however, clients should be cautioned about the potential I&D Tax implications that can result from distributions from a single member LLC. Consideration should be given to adding a second member and restricting transfer of the member interests in order to be certain that distributions from the LLC will not be I&D taxable to the member. The downside of this change, however, is that on the federal side the LLC stops being a disregarded entity and would then be taxed as a partnership.

Office Locations:

111 Amherst Street
Manchester, NH 03101
T 603.669.1000
F 603.669.8547

300 Brickstone Square
Andover, MA 01810
T 978.475.9100
F 978.470.0618

43 North Main Street
Concord, NH 03301
T 603.226.1000
F 603.226.1001

For some clients operating as a partnership or LLC, having a well-drafted partnership or operating agreement has been overlooked or put at the bottom of a long “to do” list but it is not too late to encourage clients to tackle the issue for 2011. This is particularly important in instances in which significant compensation is being paid to the members or partners since a disallowance of some of the compensation by the DRA under audit will result in an additional tax of 13.5% of the disallowed amount being assessed – 8.5% for Business Profits Tax purposes and 5% for the Interest & Dividends Tax for New Hampshire residents. For these reasons, tax practitioners and their clients are advised to review existing operating and partnership agreements carefully and consider revisions necessary to minimize New Hampshire tax effects.

The Devine, Millimet & Branch Tax Practice offers this free periodic E-Mail Alert service to provide information on recent tax developments in statutory, regulatory and case law, and decisions. If you have any questions about this e-mail, or if you know of anyone else who may be interested in receiving these alerts, please send us an e-mail at taxenews@devinemillimet.com. Previous issues of the Tax E-News, can be obtained at <http://www.dmb.com/news-and-events/newsletters.asp>.