

The Effect of Recent Amendments to the New Hampshire Interest & Dividends Tax on Distributions From Your LLC.

The New Hampshire Interest and Dividends Tax, RSA 77 (the “I&D Tax”) imposes a 5% tax on interest and dividends received by New Hampshire residents.

Prior to January 1, 2009, the I&D Tax was imposed on distributions from limited liability companies (“LLCs”) only if the ownership interests in the LLC were represented by “transferable shares.” Because most closely-held LLCs impose some form of transfer restrictions on their ownership interests (e.g., a right of first refusal in favor of the LLC or other LLC members upon a proposed transfer by a member, or a right of non-transferring LLC members to approve new members), the I&D tax effectively did not apply to distributions from most LLCs.

For tax years ending on or after December 31, 2009, the “non-transferable shares” exception has been repealed, and distributions received by a New Hampshire resident from any LLC are now *potentially* subject to the 5% I&D Tax.

All is not lost, however. A member’s LLC distributions will not be subject to the 5% I&D Tax to the extent that those distributions represent the value of personal services provided by the member to the LLC (“reasonable compensation”). Regulations proposed to be issued under the amended I&D Tax statute provide that a member distribution will not be subject to the I&D Tax to the extent that the LLC is allowed a compensation deduction for purposes of the New Hampshire Business Profits Tax imposed by RSA 77-A (the “BPT Tax”). See proposed Rev 903.10.

However, on audit, the New Hampshire Department of Revenue Administration (the “DRA”) has every incentive to minimize the amount of LLC distribution characterized as reasonable compensation and re-characterize these amounts as a distribution subject to the I&D Tax. When one considers that every dollar of distribution that can be re-characterized from reasonable compensation to taxable member distribution will result in the imposition of not only the 5% I&D Tax on the receiving member, but also will result in the imposition of the 8.5% BPT Tax on the LLC, it is clear that this will be a hot audit issue for the DRA in coming years.

The question of what is “reasonable compensation” is inherently based on the facts and circumstances of each taxpayer. However, there is a large body of federal and state tax case law and guidance on the subject, which offers a roadmap to taxpayers wishing to place themselves in the best possible position to defend against DRA attempts to impose the I&D Tax on a member’s reasonable compensation. LLCs and their members can take steps to calculate and document the value of members’ compensation, but to maximize effectiveness, these compensation planning steps should be taken now, early in the tax year, and not when the issue has been identified by the DRA on audit.

In the case of LLC’s created to hold real estate or other investments, special problems may arise in determining reasonable compensation, given that a DRA auditor may, without more, conclude that the LLC engages in little activity, and thus, any compensation should be minimal.

We can provide special help and guidance if your LLC is such a company and a challenge to the compensation deduction occurs.

The tax and business lawyers at Orr & Reno, P.A. are available to help you navigate the new I&D Tax regime, including compensation planning issues. If you have any questions regarding how the revised I&D Tax will apply to distributions from your LLC, or what steps you can take now to place yourself in the strongest possible position to respond to a future DRA audit that attempts to limit the amount of LLC distributions that can be considered reasonable compensation, please contact either of the following members of our Core Business Group:

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