

# **JOHN CUNNINGHAM'S LLC NEWSLETTER FOR TAX AND FINANCIAL PROFESSIONALS**

ISSUE NO. 17 (March 2, 2005)

## **RESTRUCTURING YOUR CLIENTS' BUSINESSES TO AVOID THE BUSINESS PROFITS TAX**

Under Section 6,I of the New Hampshire Business Profits Tax Act, RSA 77-A:6,I:

Every business organization having gross business income in excess of \$50,000 during the taxable period shall . . . make a return to the commissioner [of the Department of Revenue Administration].

The rule contained in this BPT section (which I'll call the "\$50,000 Rule") is well known to those of us who hold ourselves out as New Hampshire tax professionals.

However, not all of us are as alert as we should be to the tax-saving possibilities inherent in the \$50,000 Rule. To illustrate these possibilities:

Jane Roe is the owner of a single-member LLC called "Jane's Place." Jane reports the income of her company on Schedule C. Her company owns a parcel of New Hampshire land and the buildings located on it, consisting of a service station and a convenience store. The land and buildings are worth \$300,000. Jane's Place also owns service station and convenience store tools, equipment, vehicles and inventory (including, for example, food and gasoline) worth about \$150,000. Jane usually keeps about \$50,000 in cash in the bank account of her company as operating capital. (In keeping with the usual legal practice, I'll refer to the non-real property business assets of Jane's Place as its "personal property.") Jane's Place uses its real and personal property to conduct a highly profitable service station and convenience store business.

However, Jane is semi-retired and works for Jane's Place for only about 10 hours a week. Thus, her accountant has advised her that for BPT purposes, she can't safely deduct more than \$20,000 a year as compensation for her services to Jane's Place. The result of this and other factors is that every year, Jane's Place has taxable business profits of about \$100,000 and an annual BPT tab of about \$8,500.

What should Jane do if she wants to reduce or eliminate her BPT liability?

Here's what she should do:

She should transform Jane's Place from an operating business into a real estate holding company.

She should distribute the name “Jane’s Place” and all of the other personal property owned by her real estate holding company to herself. (Because, from a federal income tax viewpoint, Jane’s Place is a sole proprietorship, she can make these distributions on a tax-deferred basis.)

She should form a new LLC to serve as her personal property holding company, and she should contribute all of her personal property to this company. To avoid Social Security tax on its rental income, Jane’s personal property holding company should make an S election when it is formed.

She should form a new single-member LLC to operate her business. To protect Jane from Social Security tax, this LLC, too, should make an S election.

She should lease her real property from her real property holding company to her operating company under a written real estate lease agreement.

She should lease, license and lend her personal property from her personal property holding company to her operating company under a written lease agreement, license agreement and promissory note.

All of the above intercompany agreements should contain arm’s-length terms.

If Jane does these things, her real estate holding company can probably charge her operating company annual real estate rentals amounting to \$50,000; her personal property holding company can charge her operating company annual rents, royalties and interest totaling another \$50,000; and the entire \$100,000 will not only be deductible by her operating company but also exempt from BPT in the hands of her holding companies. In addition, her real estate holding company rentals will be exempt from the Self-employment Tax under Internal Revenue Code Section 1402(a)(1), and, as indicated, her personal property rental income will be exempt from FICA.

To summarize: If any of your clients own businesses with significant real estate or personal property assets (including their business names), ask yourself whether, through the adoption of holding company/operating company structures, your clients can avoid significant BPT and perhaps also significant Social Security taxes.

If the answer is yes, the accounting and legal fees to restructure your client’s business may amount to a couple of thousand dollars in Year 1. However, thanks to the \$50,000 Rule and the other tax rules cited above, the tax savings even in that year will probably cover these costs; and everything thereafter will be gravy. And above and beyond these tax savings, the client will gain a whole new dimension of business asset protection.