

**JOHN CUNNINGHAM'S LLC NEWSLETTER  
FOR TAX AND LEGAL PROFESSIONALS**

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**THE REPEAL OF THE EXEMPTION OF NEW HAMPSHIRE  
RESIDENTS FROM THE INTEREST AND DIVIDENDS TAX  
ON LLC DISTRIBUTIONS**

**Part I—Introduction**

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EXECUTIVE SUMMARY. With the enactment of a bill of the New Hampshire Legislature designated HB 2-FN-A-LOCAL (“HB 2”), New Hampshire residents who are members of LLCs with “non-transferable shares” have become subject for the first time ever to the five-percent New Hampshire Interest and Dividends Tax on distributions from their LLCs. This newsletter briefly summarizes the content of HB 2 as applicable to New Hampshire residents and comments on the legislative policy underlying it. Forthcoming issues of this newsletter will discuss techniques for lessening the adverse impact of the bill.

DISCUSSION

For many years, RSA 77:3,I(b) provided in effect that New Hampshire residents who were members of LLCs that had “non-transferable shares” would be exempt from the Interest and Dividends Tax (the “I&D Tax”) on distributions to them of LLC profits except to the extent that these distributions were of interest and dividend income of the distributing LLC on which the LLC had not paid the I&D Tax at the entity level. Under the default rules of the New Hampshire Limited Liability Company Act, multi-member LLCs automatically had non-transferable shares. Furthermore, it was relatively easy for knowledgeable New Hampshire accountants and lawyers to structure both the LLC agreements of single-member LLCs and those of multi-member LLCs that departed from these default rules to protect LLC members from the I&D Tax. The exemption constituted an important factor for New Hampshire business people in deciding whether to conduct their businesses as corporations or as LLCs.

Indeed, many New Hampshire corporations converted to LLCs with non-transferable shares in order, among other benefits, to protect their New Hampshire shareholders from the I&D Tax. I myself assisted many of these corporations in these conversions.<sup>1</sup>

However, as part of a massive effort to address severe revenue shortfalls in the current economic crisis, the New Hampshire Legislature in HB 2 effected a repeal of the above exemption (the “Repeal”), and the Repeal became effective on July 1, 2009 for

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<sup>1</sup> I should note, however, that in doing so, I always warned my clients of the possibility that the exemption from the I&D Tax for New Hampshire members of LLCs with non-transferable shares could be repealed by the Legislature at any time—although I confess that at the time, I thought such a repeal unlikely.

distributions made in taxable years beginning on or after January 1, 2009. In other words, the Repeal is retroactive.

To illustrate the retroactive effect of HB 2: Under the bill as enacted, a distribution made on September 30, 2009 to New Hampshire members by an LLC with a taxable year ending on September 30 will presumably *not* be subject to the I&D Tax in the hands of these members. Anomalously, however, a distribution made on that date by an LLC with a taxable year ending December 31, 2009 *will* be subject to the tax.

In effect, HB subjects distributions from LLCs, whether or not these LLCs have non-transferable shares, to the same I&D Tax treatment as that to which corporate distributions have always been subject. As stated in New Hampshire Department of Revenue Administration Technical Information Release TIR 2009-008, dated July 16, 2009:

Distributions from LLCs . . . will only be subject to the Interest and Dividends Tax *to the same extent that distributions to corporate shareholders are taxable as dividends.* (Emphasis added.)

HB 2 will subject to the I&D Tax New Hampshire residents receiving distributions from LLCs only to the extent that these distributions:

- Are from current or accumulated earnings and profits of the LLC;
- Are not liquidating distributions; and
- Exceed the amount of any deemed compensation deduction allowed for purposes of the New Hampshire Business Profits Tax.

On the above “deemed deduction” issue, TIR 2009-008 makes clear that the DRA will not treat LLC distributions to New Hampshire residents as subject to the Interest and Dividends Tax to the extent that these distributions function effectively as compensation to the distributees and to the extent that the distributions do not exceed DRA standards for determining the reasonableness of compensation under RSA 77-A:4,III and the regulations thereunder. The TIR states that on this and other issues, the DRA will initiate rulemaking to provide further clarification of HB 2 with respect to the I&D Tax “shortly.”

Before HB 2 was enacted, I argued strenuously against it in the New Hampshire Legislature. So did many other New Hampshire lawyers, accountants and business people. Among other things, I pointed out in a letter to state Senator Sylvia Larsen that most New Hampshire LLCs are very small business entities with only one or two members and very modest capital and income, and I pointed out in the letter that for these LLCs, distributions of LLC profits do not function as investment income. Rather, they function as compensation, even though they are not booked as such, especially by unsophisticated LLC members who are not represented by CPAs. I am concerned that with the enactment of HB 2, the DRA will often treat at least a portion of these distributions as subject to the I&D Tax; and I am concerned that unsophisticated LLC members and those who cannot afford skilled tax advice may find it hard to contest this treatment.

Finally, I pointed out in my letter to Senator Larsen that HB 2 would effectively impose a double tax on the profits of New Hampshire LLCs—first at the entity level in the form of the 8.5% Business Profits Tax; and then at the distributee level at a five-percent rate.

However, in its desperation to increase state revenues, the Legislature ignored all such arguments, and today the I&D Tax is a fact of life for many thousands of New Hampshire LLC members for whom, until July 1, 2009, it was irrelevant. So much for the “New Hampshire advantage.”

What are the practical implications of the Repeal for New Hampshire LLCs and for New Hampshire residents who are members of LLCs? For example, what are the implications of the Repeal:

- For New Hampshire businesses that have been using, or are planning to use, holding company/operating company structures consisting of two LLCs in order to avoid the Business Profits Tax and the I&D Tax; and
- For New Hampshire real estate LLCs that make distributions to New Hampshire members from the proceeds of refinancings of their real estate (a common practice of these LLCs)?

Similarly, in light of the Repeal, does it still make sense for New Hampshire corporations to consider converting to LLCs? And in the wake of the Repeal, are LLCs still preferable to corporations for New Hampshire business start-ups?

In forthcoming issues of this newsletter, I will address the above and other practical implications of the Repeal, and I will suggest techniques for mitigating its effect.

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