

**JOHN CUNNINGHAM'S LLC NEWSLETTER
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**What Is “Reasonable Compensation” for Purposes of Avoiding the
New Hampshire Business Profits Tax and the New Hampshire
Interest and Dividends Tax?**

Part I: The Statutory Basics—RSA 77-A:4,III(a) and (b)

EXECUTIVE SUMMARY. A major task of New Hampshire tax advisers has always been that of advising their clients who are LLC members about how to safely maximize their reasonable compensation deduction under RSA 77-A:4,III(a) and (b) and thus to minimize their LLC’s exposure to the New Hampshire Business Profits Tax.

However, as discussed in the August 12, 2009 issue of this newsletter, the New Hampshire Legislature has recently amended the Interest and Dividends Tax statute, effective July 1, 2009, to subject New Hampshire residents who are members of LLCs to the I&D Tax on LLC distributions. This amendment has given even greater urgency to the above task, since the stakes now include exposure not only to the BPT but also to the I&D Tax.

In this newsletter issue, I will summarize the basic statutory rules for determining the reasonableness of the above deduction under RSA 77-A:4,III(a) and (b). In subsequent issues, I will summarize the New Hampshire Department of Revenue Administration administrative rules that complement these statutory rules, and I will suggest how these statutory and administrative rules should be applied to a number of hypothetical situations.

DISCUSSION

I. RSA 77-A:4,III(a) AND (b)—INTRODUCTION: THE “PROPORTIONALITY”
AND “COMPARABILITY” PRINCIPLES

The key provisions of RSA 77-A:4,III(a) are quoted below. Since these provisions are largely self-explanatory, I will not comment on them here. However, it may be useful to readers to be aware that virtually all of them and all of the provisions of Rev 303.01 rest on two fundamental principles—namely, a “proportionality” principle and a “comparability” principle.

- The proportionality principle. Under the proportionality principle, the DRA will treat the compensation paid by an LLC to a member as unreasonable if it is disproportionate to the member’s actual contribution to the profitability of the LLC for the taxable year in question. Thus, for example, assume that an LLC has one member, 10 employees and substantial business assets and that the LLC’s

member devotes only a few hours a year to actual work for it. Under these assumptions, the proportionality principle will dictate that the LLC treat only a small portion of its profits as compensation to the member and that the remainder of these profits, if transferred by the LLC to the member, be treated as non-deductible distributions, not as deductible compensation.

- The comparability principle. Under the “comparability” principle under RSA 77-A:4,III, an important consideration that the DRA “*shall*” apply in determining the reasonableness of an LLC member’s compensation is whether it is comparable to the compensation paid to owners by other companies similar to the LLC. (Italics added.)

II. RSA 77-A:4,III(a)—THE THREE-PART TEST, ETC.

- 1) The first sentence of RSA 77-A:4,III(a)—the basic three-part test. The first sentence of RSA 77-A:4,III(a) provides that in determining their taxable business profits for BPT purposes, LLCs may deduct the compensation they pay to their members only if this compensation is:¹

[i] “fair”;

[ii] “reasonable”; and

[iii] paid to the members for “time and effort” actually spent by them “in the operation of the [LLC].”

- 2) The second sentence of RSA 77-A:4,III(a)—non-deductibility of amounts paid as compensation to members but attributable to return on LLC assets or the labor of LLC employees. The second sentence of RSA 77-A:4,III(a) provides, in effect, that an LLC may not deduct as compensation “any amounts as are fairly attributable to a return on:

[i] business assets; or

[ii] the labor of non-owner employees of the business organization.”

- 3) The third sentence of RSA 77-A:4,III(a)—LLC has burden of proof. The third sentence of RSA 77-A:4,III(a) provides that “[t]he burden shall be upon the business organization filing the return to demonstrate the reasonableness of a deduction claimed under this paragraph, by a preponderance of the evidence.”
- 4) The fourth sentence of RSA 77-A:4,III(a)—the BPT “comparability” test. The fourth sentence of RSA 77-A:4,III(a) provides that “[i]n considering the reasonableness of a deduction claimed under this paragraph, the [DRA] *shall* consider the claimed deduction in light of compensation for personal services of employees (italics added):
 - a) In positions requiring similar
 - i) responsibility,
 - ii) devotion of time,

¹ In quoting the provisions of RSA 77-A:4,III(a) and (b), I have broken them up into subsections and added bracketed paragraph numbers to the extent useful to clarify their meaning.

- iii) education, and
- iv) experience;
- b) In business organizations of similar
 - i) size,
 - ii) volume and
 - iii) complexity.”
- 5) The fifth sentence of RSA 77-A:4,III(a)—factors that the DRA may take into account in determining whether LLC compensation is reasonable. The fifth sentence of RSA 77-A:4,III(a) provides that in determining the reasonableness of compensation paid by a business organization to its owners:

[T]he [DRA] shall take into account:

- [i] the value to the business organization of the labor of its non-owner employees[;]
- [ii] the use of the business assets of the business organization[;] [and]
- [iii] any other factor which may reasonably assist the commissioner in making a determination as to the reasonableness of the claimed deduction.

III. RSA 77-A:4,III(b)—RENTAL INCOME; THE “MINIMUM DEDUCTION”

RSA 77-A:4,III(b) provides as set forth below.

- (b) The amount of any deduction claimed under [RSA 77-A:4,III](a)
 - [i] shall not exceed the amount reported as earned income from the activities of the business organization as reflected on the federal income tax returns of the [LLC member] rendering such personal services;
 - [ii] but may also include an amount not to exceed:
 - [a] net rental income as compensation for operating rental property; and
 - [b] an amount not to exceed 15 percent of the gross selling price as commissions on the sale of business assets;
 - [iii] Provided, however, [that] a minimum deduction of \$6,000 shall be allowed on account of [a member] who is a natural person actually devoting time and effort in the operation of the business organization.

If you have comments on this column or wish to contact me for any other reason, please send me an e-mail at lawjmc@comcast.net or give me a call at (603) 228-0125. If you'd like to visit my website, the link is www.llcformations.com.