Recent Changes to the Interest and Dividends Tax: What Every Practitioner Should Know

By Amy Kanyuk and Kathryn Michaelis

Introduction

Faced with the daunting task of balancing the state's budget, last summer New Hampshire made significant changes to its Interest and Dividends ("I&D") tax in an effort to raise additional revenue and, according to some lawmakers, "close loopholes" in the existing I&D tax structure.

The legislature approved the I&D changes with no public hearing. These changes, coupled with the lack of opportunity for public review and comment, have caused considerable confusion among taxpayers and their advisors. After a lengthy rule-making process, the Department of Revenue Administration ("DRA") issued its final draft I&D regulations on January 20th (the "final regulations"), making significant changes to prior draft versions of the rules.

This article will review the 2009 statutory amendments and final regulations for practitioners who may be grappling with how the amended I&D tax will affect their clients.

I. The History of the I&D Tax

The New Hampshire legislature first enacted the I&D tax in 1923, amending it only a few times since then. The rate of tax has increased over time to the current rate of 5 percent.

Prior to the 2009 amendments, the I&D tax was imposed on interest and dividends received by three categories of taxpayers: (1) New Hampshire residents; (2) certain partnerships, LLCs and trusts; and (3) certain fiduciaries. Sole proprietorships were never subject to the I&D tax. Corporations (regardless of their status under federal income tax law as "C" or "S" corporations) were never subject to the I&D tax at the entity level. Rather, New Hampshire resident shareholders were subject to tax on dividends they received from corporations.

A confusing and outdated set of factors determined whether the I&D tax applied to interest and dividends received by a partnership or LLC at the entity level, or to "dividend-like" distributions received by the owner of the partnership or LLC, individually, from the entity. Generally, the I&D tax applied to the entity itself if it had (1) a "usual place of business" in New Hampshire, (2) an owner who was an "inhabitant" of New Hampshire, and (3) ownership interests that were "not represented by transferable shares." If the entity itself was subject to tax, owners of the entity were not subject to tax on any distribution from the entity. If the entity had any owners who were not New Hampshire residents, the entity would pay tax only on the percentage of its I&D income equal to the profits' interest of the owners who were New Hampshire residents.

On the other hand, if the LLC had freely transferable shares, the LLC did not pay any tax at the entity level, and all distributions from the LLC to its New Hampshire resident members were subject to the I&D tax, regardless of whether the distributions included interest and dividends received by the LLC.

For business planning (not tax) reasons, LLCs and partnerships typically have had non-transferable shares. Non-transferability ensures that unanticipated changes in ownership or control do not result from events such as an owner's divorce, death or financial hardship. As a result, before 2009 the I&D tax typically applied to interest and dividends received by partnerships and LLCs at the entity level, and not to "dividend-like" distributions to owners from the entity.

II. The 2009 Legislative Amendments

In the summer of 2009, the DRA recommended to the legislature that it treat all dividend-like distributions from partnerships and LLCs the same as dividends from corporations. The legislature accepted the recommendation, and Governor Lynch signed the new I&D legislation into law on June 30, 2009. As a result, the following rules now apply to the taxation of interest and dividends:

Whom and What the Tax Is Imposed Upon

The state no longer imposes the I&D tax on partnerships and LLCs at the entity level. For I&D tax purposes, the distinction between transferable and non-transferable ownership interests is now irrelevant (except with respect to trusts). The state imposes the I&D tax on "dividend-like" distributions received by New Hampshire residents from New Hampshire or out-of-state LLCs and partnerships. The new law's definition of "dividends" is quite broad, and not limited to actual dividends received by the entity and then distributed to the entity's owners. As with prior law, the state continues to impose the I&D tax on dividends received by New Hampshire residents from corporations.

The 2009 amendments establish two new statutory definitions that are fundamental in determining whether a distribution from an entity is a taxable dividend. First, the amendment defines the term "dividend" as a distribution made to an owner, other than in liquidation of the entity, with respect to his ownership interest, from the entity's "accumulated profits." Second, the amendments define the term "accumulated profits," as discussed more fully below.

The tax treatment of trusts and qualified investment companies (QICs) remains unchanged. For QICs, the New Hampshire resident holder's proportional share of the QIC's income is treated as a taxable dividend, but no actual distribution made by a QIC to the holder is taxable.

When the Amendments Become Effective

The I&D tax amendments apply retroactively to all taxable distributions beginning on or after January 1, 2009.

III. Why So Much Controversy?

The proponents of the 2009 I&D amendments have consistently touted them as "loop-hole closing" and necessary because prior law did not treat all distributions from entities the same way. Prior law did create a bias in favor of distributions from partnerships and LLCs (which typically were not subject to tax if the entity had non-transferable shares) and against distributions from corporations that were subject to tax. However, prior law also created a bias in favor of corporations, which were never subject to tax on their dividend or interest income, and against partnerships and LLCs, which were sometimes subject to tax on their dividend or interest income.

In enacting tax laws, the legislature has broad authority to impose classifications on sources of income as long as it doesn't discriminate against taxpayers. The former I&D tax statute distinguished between types of distributions, not between types of taxpayers. In this respect, the "loop-hole closing" characterization was not well-founded, and doesn't tell the entire story, in light of how the I&D tax truly operates in practice, how the 2009 amendments impact small business owners, and how the tax interrelates to the other taxes imposed on New Hampshire businesses.

The Elephant in the Room: The Reasonable Compensation Issue

The interplay between the I&D tax and the reasonable compensation deduction under the Business Profits Tax ("BPT") remains one of the most controversial issues. Corporations, LLCs and partnerships may deduct a reasonable amount of compensation for services performed by their owners. Corporations take the deduction on their federal tax returns, and LLCs and partnerships take the deduction on their state BPT returns.

Recently, the DRA has become more aggressive in challenging the reasonable compensation deductions claimed by business entities. Business owners and their tax advisors have been navigating the issue without clear guidelines or safeguards in either the state statute or regulations. If the DRA successfully denies a compensation deduction for corporations, partnerships or LLCs, the disallowed amount not only becomes "profit" taxable under the BPT but now also becomes a taxable dividend under the I&D tax. This point is best illustrated by an example:

Ann and Fran are New Hampshire residents and each owns 50 percent of an LLC engaged in a profitable consulting business in New Hampshire. As with most LLCs, Ann and Fran's business has non-transferable shares. The LLC's income consists entirely of operating income from providing services, and it receives no interest or dividends. The LLC claims a compensation deduction for Ann and Fran in the amount of $100,000 each. The amount of taxable business profits, after taking into consideration the compensation deduction, is subject to BPT at a rate of 8.5 percent. Ann and Fran have no taxable interest or dividend income that would be subject to the I&D tax.

The DRA audits the LLC and determines that reasonable compensation for Ann and Fran is $25,000 each, not $100,000 each. As a result, the LLC must pay additional BPT on the amount of compensation that was deemed unreasonable ($150,000). At a rate of 8.5 percent, the LLC will pay additional BPT of $12,750.

Under prior law, the DRA's audit adjustments for BPT would not have created any I&D tax liability for Ann or Fran. The LLC would be subject to the I&D tax at the entity level, but would have no I&D tax liability because it received no taxable interest or dividends (all of its income came from consulting services). In addition, the DRA's denial of compensation would have no I&D tax impact on Ann or Fran because they were not I&D taxpayers under prior law.

Under the new law, Ann and Fran become the I&D taxpayers, and the I&D tax no longer applies to their LLC at the entity level. As a result, the DRA's denial of $150,000 in compensation becomes re-characterized as a taxable "dividend" to Ann and Fran for I&D tax purposes. At a rate of 5 percent, they collectively owe I&D tax of $7,500.

In summary, the DRA's disallowance of $150,000 of the compensation deduction for BPT purposes results in an increase to the LLC's BPT base by $150,000 and creates $150,000 in taxable dividends to Ann and Fran, collectively, under the I&D tax. Their small business is now subject to two levels of taxes on profit generated by the LLC at a rate of 13.5 percent.

Tax Policy Considerations

The example underscores why many business owners and their tax advisors are concerned about the detrimental effects of the 2009 amendments. These changes will have a negative impact on New Hampshire's tax policy.

First, business owners are concerned that the statutory authority to automatically convert compensation into both taxable profits (subject to the BPT) and taxable dividends (subject to the I&D tax) may encourage the DRA to engage in more aggressive compensation audits for LLCs and partnerships. As the example above illustrates, what was once a revenue stream taxed at 8.5 percent is now taxed at 13.5 percent.

Second, the 2009 amendments have, in effect, resulted in a second level of tax on operating profit generated by LLCs and partnerships, which are New Hampshire's most significant business forms for small businesses. The federal tax system promotes the use of partnerships and LLCs as a way of encouraging business growth and eliminating the double-level of tax that has traditionally been imposed only on corporate structures. New Hampshire should

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DRA Commissioner Kevin Clougherty Visits Section Meeting

On Feb. 4, the Real Property and Taxation Law Sections listen to Dept. of Revenue Administration (DRA) Commissioner Kevin Clougherty discuss the Interest & Dividends tax regulatory process. Pictured left to right Louis DeMato, Kevin Clougherty, John Washburn, Tax Section Chair, and Kathryn Michaelis.

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not discourage on the state level what the federal tax system has encouraged for years.

Third, and perhaps the most misunderstood aspect of the 2009 amendments, is that New Hampshire is putting itself at a competitive disadvantage with neighboring states. The 2009 amendments reflect a significant shift from a state that imposed one level of tax on partnerships and LLCs (BPT/BET on the entity and no I&D tax on the owners) to a state that now imposes two levels of tax on partnerships and LLCs (BPT/BET on the entity and I&D tax on the owners). No other New England state imposes two levels of tax on partnerships and LLCs. New Hampshire's "tax advantage" has diminished considerably. Ann and Fran could have a more profitable consulting business if they moved their office to Massachusetts and were subject to a 5.3 percent personal income tax, as opposed the combined BPT/I&D marginal rate of 13.5 percent in New Hampshire.

Practical Challenges

In addition to these overriding concerns, the 2009 amendments and final regulations also present several practical challenges for taxpayers.

The "Debt Financed by the Entity" Issue

The statutory definition of "dividends" now includes distributions made from "debt financed by the entity." The DRA's original interpretation of this change would have imposed the I&D tax on distributions of borrowed funds (from a bank, for example), even though borrowed funds generally aren't considered taxable income. This was contrary to generally accepted accounting principles and damaging to small business owners. Not surprisingly, the DRA's interpretation met with significant objection, and the final regulations reflect a more reasonable interpretation of the term, which is now defined as liabilities incurred by an entity that allow the entity to make a distribution to its owners, only to the extent that the distribution would be a deemed dividend. Examples of when a distribution is "deemed" to be a dividend, other than distributions in liquidation of the organization, include the following transactions: all property transfers from the entity to the owner from accumulated profits; the entity's forgiveness of an owner's debt to the extent of the entity's accumulated profits; all personal expenditures made by an entity on behalf of the owner not properly reported as compensation or loans; and automatic re-investment of property distributed from accumulated profits into additional stock.

Record-Keeping Requirements: The "Accumulated Profits" Issue

The DRA's draft regulations imposed burdensome record-keeping requirements on unincorporated entities in accounting for "accumulated profits." LLCs and partnerships typically do not keep track of earnings and profits ("E&P") or accumulated profits. The DRA's final regulations simplify the requirements and permit an owner of an unincorporated entity to compute accumulated profits by relying on the information reported on its federal income tax return. The final regulations also allow an unincorporated entity to elect to compute accumulated profits from either the later of the first year of the entity, or from 2009. While the record-keeping requirements and calculation of "accumulated profits" will likely remain an issue of contention, the final regulation has gone a long way in simplifying an onerous task.

When and How? Effective Date, Forms and Payments

Although the state enacted the I&D tax changes on July 1, 2009, the new rules apply retroactively to LLC and partnership distributions made since January 1, 2009. This raises both fairness and practical issues, with respect to tax payments and form filings. The DRA has provided informal guidance that LLCs and partnerships that made estimated I&D tax payments for the first half of 2009 must file a refund claims, while at the same time their owners who are now subject to the I&D tax are required to remit tax on distributions which, on the date they were received (i.e., before July 1, 2009), weren't taxable. Last fall, the DRA issued *Technical Information Release 2009-13*, which provides safe harbors for underpayment penalties for estimated payments. But it's unclear whether these safe harbors will protect all taxpayers. In addition, the 2009 form instructions currently don't refer to the 2009 I&D changes, provide guidance reflecting the DRA's final regulations, or provide any worksheets to help practitioners calculate the I&D tax. Unfortunately, the manner in which the 2009 amendments have been implemented and interpreted will likely catch many taxpayers unaware, creating additional liability for interest and penalties.

IV. The Final Chapter

The final chapter of this book has yet to be written. The Joint Legislative Committee on Administrative Rules (JLCAR) will hold a hearing on the DRA's final regulations on February 19. If JLCAR does not object to the regulations, they'll become final upon approval by JLCAR. The New Hampshire legislature is reviewing multiple pieces of legislation that propose to amend the reasonable compensation deduction rules and repeal or amend the 2009 amendments to the I&D tax. In addition, a taxpayer has brought suit in the Hillsborough Superior Court, challenging the I&D tax amendments and their retroactive application as unconstitutional.

New Hampshire taxpayers and business owners who must address these issues would love a fairy tale ending, but it's unlikely that that the last line will read "…and they lived happily ever after." However, at the very least, we should expect a set of rules that are clear and fair for all taxpayers, after a thoughtful and open debate about the impact that the overall tax system has on New Hampshire residents and businesses.

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