

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

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**DO NEW HAMPSHIRE MEMBERS OF SINGLE-MEMBER
LLCs OWE THE I&D TAX ON DISTRIBUTIONS FROM
THEIR LLCs?**

EXECUTIVE SUMMARY. The DRA has indicated informally that in its view, New Hampshire members of single-member LLCs owe the Interest and Dividends Tax (the "I&D Tax") on distributions to them from their LLCs. Apparently, the DRA is not presently enforcing this position, but, needless to say, this could change at any time.

However, in my view, a careful reading of the relevant DRA regulation—namely, Rev. 901.17—makes clear that the above DRA position is flatly wrong.

DISCUSSION. For many New Hampshire residents that are members of single-member LLCs, the question in the title of this newsletter is an important one. These New Hampshire residents include, for example, individuals who conduct their businesses as single-member LLCs and who, because of Business Profits Tax reasonable compensation rules or otherwise, cannot lawfully "comp out"—i.e., cannot pay all of the net income of their LLCs to themselves in a given taxable year as compensation for their services to or for their LLCs.

EXAMPLE: Mary Roe, a New Hampshire resident, owns and manages a single-member LLC that conducts a highly profitable construction business. Before paying Mary any compensation, the LLC has calendar year 2005 taxable net income of \$1.5 million. Mary's accountant advises her that if the LLC pays compensation to her for 2005 of more than \$300,000, she may face a difficult audit by the DRA.

What is the answer to the above question, and how does this answer apply to Mary Roe?

The relevant tax analysis is complex, but it can be briefly summarized in the following points:

- (1) RSA 77:4,III. RSA 77:4,III provides, in effect, that the I&D Tax does not apply to New Hampshire residents that receive distributions from LLCs with nontransferable membership rights (the LLC statutory equivalent of shares).
- (2) Rev. 901.17. Rev. 901.17 defines the membership rights of a New Hampshire LLC as being transferable for purposes of RSA 77:4,III only if, under the governing LLC act or the LLC's LLC agreement, these rights meet both parts of a two-part test:

- (a) First, a member must be able to transfer the membership rights in question without the approval of another member (the “approval” test).
 - (b) Second, the transfer of these rights must not trigger the dissolution of the LLC (the “dissolution” test).
- (3) Nontransferability under Rev. 901.17. It is obvious that under the above Rev. 901.17 two-part test, the membership rights of an LLC will be *nontransferable* if, under the governing act or the relevant LLC agreement, the LLC in question fails *either one* of the above tests.
- (4) Single-member LLCs and the “approval” test. By definition, a single-member LLC has only one member. Thus, arguably, the member of a single-member LLC will always be able to transfer the member’s membership rights without the approval of “another member” and thus cannot ever fail the above Rev. 901.17 “approval” test.
- (5) RSA 304-C:50. Furthermore, under the default rules of the New Hampshire Limited Liability Company Act and most other U.S. LLC acts governing LLC dissolutions, a member’s transfer of the member’s membership rights will not dissolve the LLC. *See, e.g.,* RSA 304-C:50 (rules setting forth events triggering LLC dissolutions).
- (6) Providing for transfers of membership rights as events of dissolution in the LLC agreements of single-member LLCs. However, under the New Hampshire Limited Liability Company Act and most or all other U.S. LLC acts, the member of a single-member LLC is free to enter into an LLC agreement with the LLC that will provide contractually that the member’s transfer of all or any of the member’s membership rights by sale or otherwise *will* trigger the LLC’s dissolution. *See, e.g.,* RSA 304-C:1,VI (definition of LLC agreement as applicable to single-member LLCs); RSA 304-C:50,I (contractual freedom of LLC members to determine events that will trigger their LLC’s dissolution). If the LLC’s LLC agreement so provides, then the membership rights issued by the LLC will be *nontransferable* under the Rev. 901.17 “dissolution” test, and, as a result, under RSA 77:4,III, the LLC’s member will not be liable for the I&D Tax on distributions from the LLC.
- (7) LLC contractual flexibility concerning determination of dissolution events. Furthermore, the dissolution of the LLC that will occur under the LLC’s LLC agreement when the member transfers the member’s membership rights can be validly cancelled after that transfer by act of the member or the transferee. This is so because, among other considerations, (a) there is no provision in the New Hampshire Limited Liability Company Act nor in most other U.S. LLC acts to the contrary; and (b) the statutory hallmark of the New Hampshire Limited Liability Company Act and other U.S. LLC acts is contractual freedom—which clearly includes the right to undo the LLC’s dissolution. *See* RSA 304-C:78,II (LLC contractual freedom and enforceability).

- (8) Contractual freedom of LLC members to reinstate LLC as going concern after dissolution. It should be understood that in traditional partnership and LLC statutory business organization law, a dissolution is not the termination of an entity's existence; rather, it is a mere change of the entity's purpose from that of a going concern to that of an entity in the process of winding up. *See* RSA 304-A:30 (definition of dissolution under New Hampshire Uniform Partnership Act). However, both partnerships and LLCs are contractual entities, and under both partnership and LLC business organization law, the owner or owners of the entity (i.e., in the case of a single-member LLC, the member) are free to agree contractually to reinstate the partnership or LLC as a going concern after its dissolution. *See*, e.g., RSA 304-A:41, I. *See* Revised Uniform Partnership Act, Section 802(b) and official comments thereunder. *See* Rev. Proc. 95-10, 1995-1 C.B. 501, Section 5.01 (right of members of multi-member LLCs to vote to continue their LLCs after the dissolution of these LLCs by reason of member dissociations).

The importance of the above analysis for Mary Roe is obvious: The analysis makes clear that if her LLC distributes to her the above \$1,200,000 of net profits, Mary will not have to pay the I&D Tax on this distribution. (Moreover, if Mary's single-member LLC has an S election in effect for 2005, the above \$1,200,000 will not be subject to FICA.)

I am grateful to Bill Steele of William Steele & Associates, P.C., for key ideas in the above analysis. However, I alone am responsible for any error in the analysis.

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