

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

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## ***CONVERTING CORPORATIONS TO LLCs TO AVOID THE NEW HAMPSHIRE INTEREST & DIVIDENDS TAX***

Dear colleagues:

As you no doubt know, for New Hampshire corporations and their shareholders, the combined impact of the 8.5% Business Profits Tax and the 5% Interest and Dividends Tax makes New Hampshire one of the harshest tax environments in the United States. A 13.5% combined state tax on businesses and their owners is a cruel fiscal burden.

However, I've recently come to realize that there is a partial but important solution to the problem of New Hampshire corporate taxation. In brief summary:

- As you probably know, RSA 77:4, III, provides that members of LLCs that have nontransferable shares are not liable for the I&D Tax.
- Furthermore, New Hampshire statutory business organization law makes it relatively easy to convert a corporation to an LLC through what is called a "statutory conversion."
- Finally, under the Check-the-Box Regulations, an entity that, for state-law purposes, is a corporation can convert to an LLC while still being taxable under IRC Subchapters C or S, and the conversion will not result in a deemed corporate dissolution or in corporate "death taxes."

Thus, if a New Hampshire corporation properly converts to an LLC, its shareholders who are New Hampshire residents will no longer have to pay the I&D Tax on their corporate dividends.

EXAMPLE: XYZ, Inc., an S corporation, is a New Hampshire business corporation that pays its shareholders annual dividends totaling \$200,000. All of these shareholders are New Hampshire residents. The shareholders, in turn, pay substantial annual I&D Tax. On January 1, 2004, XYZ converts to an LLC and files the appropriate IRS forms to preserve its S election. XYZ's LLC agreement prohibits each of its members from selling or otherwise transferring his or her LLC membership except with the consent of at least one other member.

The result of all this: XYZ, while it is still an S corporation for federal tax

purpose, is now an LLC for law purposes, and its owners are thus no longer liable for the I&D Tax.

There is always, of course, a possibility that the New Hampshire Department of Revenue Administration will obtain an amendment to the I&D Tax that will eliminate the above tax avoidance opportunity. However, the amendment will necessarily create a “new tax.” I question whether Craig Benson and the Legislature will impose such a tax, especially since it will hurt small businesses and raise serious New Hampshire constitutional issues.

Planning point: Many New Hampshire corporations are now avoiding the BPT and the I&D Tax by “comping out.” However, if they convert to LLCs with nontransferable shares and if they then significantly reduce compensation to shareholder-employees, the resulting FICA avoidance may yield substantial net tax savings for these shareholders.

The statutory conversions I’ve described above can be complex and tricky and may require significant legal and accounting expertise. Thus, they can be expensive. However, for some corporations, the recurring annual I&D Tax savings from conversions will far outweigh the one-time costs. In addition, the conversion can yield major nontax benefits, such as statutory asset protection, that LLCs provide but corporations don’t.

On December 28, 2003, the Concord Monitor published an article of mine about the above subject. In case you’re interested, I’m attaching a copy of the article.

If you have any questions or comments about the above statutory conversion technique for avoiding the I&D Tax, please feel free to call me at (603) 228-0125; or send me an e-mail.