

Converting to an LLC to Minimize New Hampshire Taxes

by James Usseglio

Reprinted from *State Tax Notes*, January 8, 2018, p. 195

Converting to an LLC to Minimize New Hampshire Taxes

by James Usseglio



James Usseglio

James Usseglio is a tax principal at Baker Newman Noyes in the Manchester, New Hampshire, office. Usseglio focuses on federal and state tax matters for closely held businesses and their owners, with particular emphasis on partnership, real estate, and New Hampshire tax law.

In this article, Usseglio discusses the application of New Hampshire's interest and dividends tax as it relates to corporations and limited liability companies.

The information contained herein is of a general nature. It does not constitute tax or legal advice, nor is it intended to convey a thorough treatment of the subject matter.

The definition of limited liability company for New Hampshire interest and dividends tax (I&D tax) purposes¹ provides a significant opportunity for New Hampshire resident shareholders to minimize their I&D tax liabilities by converting their state law corporations to LLCs taxed as corporations. This article briefly discusses the application of the I&D tax law as it relates to corporations and LLCs, including the primary federal and New Hampshire tax authorities and consequences relevant to the statutory conversions of state law corporations to LLCs taxable as corporations.²

¹N.H. Rev. Stat. Ann. section 77:3-a.

²This article focuses primarily on the federal and New Hampshire tax considerations of statutorily converting corporations to multi-member LLCs. It does not address other aspects of such conversions, for example, possible effects on insurance policy documents, loan agreements, and other business or legal arrangements.

New Hampshire's Interest and Dividends Tax

Introduction

New Hampshire generally imposes a 5 percent tax on the gross interest and dividends received by individual inhabitants or residents of New Hampshire. The tax is also imposed on partnerships, associations, and LLCs in which the beneficial interests are not represented by transferable shares, and that have a usual place of business in New Hampshire.³

Terms and phrases such as "limited liability company," "corporation," "dividend," "beneficial interest in which is not represented by transferable shares," "beneficial interest in which is represented by transferable shares," and "usual place of business" are referenced throughout the I&D tax statute N.H. Rev. Stat. Ann. section 77 and administrative rules Rev. 900. The definitions of these terms and phrases are critically important in determining the proper application of the I&D tax regarding LLCs and corporations.

The I&D tax is distinct from New Hampshire's business profits tax (BPT) and business enterprise tax (BET). The BPT statute N.H. Rev. Stat. Ann. section 77-A and administrative rules Rev. 300, and the BET statute N.H. Rev. Stat. Ann. section 77-E and administrative rules Rev. 2400, each provides its own definitions applicable to its taxes. Of particular interest for this article is that for BPT and BET purposes, state law LLCs that elect to be taxed as corporations for federal income tax purposes are treated as corporations,⁴ whereas for

³N.H. Rev. Stat. Ann. section 77:3; N.H. Rev. Stat. Ann. section 77:4; N.H. Rev. Stat. Ann. section 77:14-a; N.H. Code Admin. R. Ann. 901.03; N.H. Code Admin. R. Ann. 901.21; and N.H. Code Admin. R. Ann. 902.07(a)(1).

⁴N.H. Code Admin. R. Ann. 307.01(f); and N.H. Code Admin. R. Ann. 2407.02(c).

I&D tax purposes they are treated as LLCs (to be discussed further below).

Key Definitions

As noted, several terms and phrases used throughout the I&D tax statute and administrative rules are key to understanding how converting a state law corporation to an LLC taxable as a corporation can reduce the amount of income subject to the I&D tax. First, while corporations, partnerships, and LLCs in which the beneficial interest is represented by transferable shares are excluded from the “Who Taxable” section of the I&D tax law,⁵ distributions from these entities (including S corporations and single-member LLCs) are defined as “dividends” under I&D tax law and thus subject to tax.⁶

The term “corporation” means an artificial person or legal entity created under the laws of incorporation of any state or foreign country without recognizing the distinctions between types of corporations such as those drawn in the Internal Revenue Code between S corporations and other corporations.⁷ The phrase “beneficial interest in which is represented by transferable shares,” as used in the “What Taxable” section of the I&D tax law,⁸ generally means an interest in an organization where the interests are freely transferable without the necessity of securing prior member approval or causing a dissolution of the organization.⁹

Perhaps most importantly, the term “limited liability company” for purposes of I&D tax law means an LLC formed under N.H. Rev. Stat. Ann. section 304-C (New Hampshire Revised Limited Liability Company Act) or a foreign LLC as defined in N.H. Rev. Stat. Ann. section 304-C:9.¹⁰ Thus, LLCs formed under the laws of New

Hampshire or any other state, *regardless of how they are taxed for federal income tax purposes*, are LLCs for purposes of the I&D tax. Accordingly, if the LLC is not represented by transferable shares¹¹ and has a usual place of business¹² within New Hampshire, the I&D tax is imposed on the amount of interest and dividends received by the entity.¹³ If instead the LLC is represented by transferable shares, then distributions paid from such entity will generally be treated as dividends for I&D tax purposes.¹⁴

LLCs Taxed as Corporations

State law LLCs (whether single- or multi-member) that have elected to be classified as an association taxable as a corporation under the so-called check-the-box regulations¹⁵ are subject to the I&D tax provisions applicable to LLCs.

For those entities formed as state law corporations, some practitioners for years have discussed the idea of converting them tax-free to state law multi-member LLCs¹⁶ represented by nontransferable shares through what is called “statutory conversion,” while still being taxable under IRC subchapter C or S, so that any distributions paid by the entity would not be treated as “dividends” under the I&D tax. Until a few years ago, there was no New Hampshire tax authority directly on point that would confirm the expected I&D tax treatment and confirm that there would be no adverse BPT, BET, or real estate transfer tax consequences upon such conversion. However, that lack of guidance ended when the New Hampshire Department of Revenue Administration (DRA) issued Declaratory Ruling 10391 on July 26, 2013 (to be discussed further below).

⁵ N.H. Rev. Stat. Ann. section 77:3.

⁶ N.H. Rev. Stat. Ann. section 77:4, II and III; and N.H. Code Admin. R. Ann. 901.09. Distributions from partnerships and LLCs represented by nontransferable shares, and that do not have a usual place of business within New Hampshire, are taxed at the resident owner level on the portion of the distribution that represents interest or dividends received by the entity under N.H. Rev. Stat. Ann. section 77:14-c and N.H. Code Admin. R. Ann. 902.07(b)(3).

⁷ N.H. Code Admin. R. Ann. 901.06.

⁸ N.H. Rev. Stat. Ann. section 77-4: III.

⁹ N.H. Code Admin. R. Ann. 901.04.

¹⁰ N.H. Rev. Stat. Ann. section 77:3-a.

¹¹ N.H. Code Admin. R. Ann. 901.03 (generally meaning when the interests are not transferable without obtaining prior member approval or causing a dissolution of the organization).

¹² N.H. Code Admin. R. Ann. 901.21 (means the primary place of business or a regularly used place of business of an organization).

¹³ N.H. Rev. Stat. Ann. section 77:14-a; and N.H. Code Admin. R. Ann. 902.07(b)(1) and (2).

¹⁴ N.H. Rev. Stat. Ann. section 77:4, III; and N.H. Code Admin. R. Ann. 901.09.

¹⁵ Treas. reg. section 301.7701-3.

¹⁶ Many believe that single-member LLCs can have only transferable shares, and so distributions paid by the entity post-conversion would continue to be taxed as dividends.

Overview

There are a number of ways to convert a state law corporation to an LLC, the most common methods being statutory merger, statutory conversion, or nonstatutory conversion. For most corporations, the simplest and least expensive way is through a statutory (or formless) conversion, whereby the converting corporation, by state law, remains the same business entity after the conversion as before, changing only its business organization form. Many states, including New Hampshire,¹⁷ permit statutory conversions of corporations to LLCs. To effect such a conversion, states generally require various corporate documents to be prepared and filings made with the secretary of state, including, but not limited to, a plan of conversion, certificate of conversion, and certificate of formation.¹⁸

Federal Tax Consequences

A corporation (whether C or S) converting to an LLC taxed as a partnership for federal tax purposes is rare because of potentially adverse tax consequences, regardless of the method used to effect the conversion. In general, converting a corporation to an LLC taxed as a partnership is treated as a taxable liquidation or deemed sale of assets by the corporation to its shareholders, and the corporation would recognize gain or loss on its final tax return.¹⁹ The corporation's shareholders would also recognize gain or loss on the difference between the fair market value of the property distributed in liquidation of the corporation less the adjusted basis in their stock.²⁰

A corporation, however, can convert tax-free to an LLC taxed as a corporation if it elects to be taxed as a corporation immediately after the conversion and the conversion qualifies as a tax-free reorganization under IRC section 368(a)(1). Assuming a statutory conversion is the method used to effect such conversion, the following is a summary of the key federal tax consequences and related authority in such conversions:

- The statutory conversion of a corporation to an LLC that elects to be classified as an association taxable as a corporation²¹ effective as of the date of the conversion qualifies as a tax-free F reorganization.²² The conversion must satisfy all applicable requirements under IRC section 368(a)(1)(F) and the regulations thereunder,²³ including the business purpose requirement²⁴ (such as obtaining charging order protections available under LLC statutory law²⁵).
- The letter ruling cited above concluded that an existing S corporation may convert to an LLC electing to be taxed as a corporation without losing its S status.²⁶ Of equal importance is making sure that the LLC is eligible to maintain S status by not only determining that all LLC members are eligible S corporation shareholders, but also that the LLC agreement by its terms does not create a second class of stock under subchapter S.²⁷
- An F reorganization provides that regarding the following tax attributes pre- and post-conversion, (1) the tax year does not close,²⁸ (2) any losses can be carried back to pre-reorganization years,²⁹ and (3) the corporation continues to use the same employer identification number.³⁰

New Hampshire Tax Consequences

As noted earlier, on July 26, 2013, the DRA issued Declaratory Ruling³¹ 10391 to a corporation (referred to as ABC Inc.) regarding a proposed statutory conversion. ABC Inc. was a New Hampshire business corporation that had elected

²¹ Treas. reg. section 301.7701-3.

²² LTR 200528021.

²³ Treas. reg. section 1.368-2(m).

²⁴ Treas. reg. section 1.368-1(b); and Treas. reg. section 1.368-2(g).

²⁵ See, e.g., N.H. Rev. Stat. Ann. section 304-C:126.

²⁶ LTR 200528021 citing Rev. Rul. 64-250.

²⁷ IRC section 1361(b)(1)(D); Treas. reg. section 1.1361-1(l)(1) and (2); LTR 200548021; and LTR 201624003.

²⁸ IRC section 381(b); and Treas. reg. section 1.381(b)-1(a)(2).

²⁹ *Id.*

³⁰ LTR 200528021 citing Rev. Rul. 73-526.

³¹ N.H. Code Admin. R. Ann. 209.

¹⁷ N.H. Rev. Stat. Ann. section 293-A:9.50 et seq.; and N.H. Rev. Stat. Ann. section 304-C:147 et seq.

¹⁸ See, e.g., N.H. Rev. Stat. Ann. section 304-C:149.

¹⁹ IRC section 336(a).

²⁰ IRC section 331(a).

to be treated as an S corporation for federal income tax purposes. ABC Inc.'s shareholders were seeking to convert the entity to a New Hampshire LLC (referred to as 123 LLC) via a statutory conversion, under N.H. Rev. Stat. Ann. section 304-C:147 through 149. The DRA ruled, in essence, that if ABC Inc. converted to an LLC through a statutory conversion, as described in its petition for a ruling, and elected to be classified as an association taxable as a corporation effective as of the date of the conversion, the conversion would not create any BPT, BET, or real estate transfer tax³² liabilities. Furthermore, after the conversion, 123 LLC would continue to file its required BPT and BET returns using the same business tax forms that ABC Inc. previously used; 123 LLC would file a single business tax return for the tax year that would include the periods both before and after the conversion; and any BET credits earned by ABC Inc. being carried forward at the time of the conversion would be available for use by 123 LLC based on the original carryforward periods of the credits.

The ruling also acknowledged that if 123 LLC's ownership interests were nontransferable, then distributions from the LLC to its New Hampshire resident members would not be taxable as "dividends" for purposes of the I&D tax; instead, the I&D tax would be applied at the entity level of 123 LLC.

It should be noted that only the taxpayer to which a declaratory ruling is issued may rely on it regarding the specific transaction covered in the ruling, and that the ruling may not be relied upon by any other taxpayer.³³ Having said that, a corporation contemplating a statutory conversion to an LLC structured similarly to that in Declaratory Ruling 10391 should derive substantial comfort from the ruling regarding the New Hampshire tax consequences of the reorganization.

Conclusion

Because New Hampshire taxes distributions received by residents from state law corporations

(but not from state law LLCs with nontransferable shares) as "dividends" under its I&D tax law, the LLC business organization form offers a compelling reason for resident shareholders to convert their corporations to multi-member LLCs taxed as corporations.³⁴ However, there must be a bona fide, nontax business purpose for the conversion to qualify as a tax-free reorganization. The simple desire to lower the corporate shareholders' I&D tax liability does not suffice.

In determining whether a corporation should convert, the shareholders should consult with experienced tax advisers familiar with the process. Also, nontax issues such as how existing loans, licenses, contracts, insurance policies, and other business and legal arrangements could be affected by the conversion should be considered. ■

³² See also N.H. Rev. Stat. Ann. section 78-B:2, XXI.

³³ N.H. Code Admin. R. Ann. 209.02.

³⁴ The possibility always exists that the I&D tax law may be amended to change this tax treatment.