

Recently Enacted Taxes Affecting Healthcare Providers

The 2010 – 2011 New Hampshire budget, recently signed into law by Governor Lynch, may mean increased state taxes for New Hampshire health care providers that own their medical practices or related operations through limited liability companies (including PLLCs). In addition, certain non-profit “501(c)” entities (such as hospitals) that own real estate will be subject to New Hampshire’s real estate transfer tax.

Tax Increases for Owners of LLCs (including PLLCs) and Partnerships

The budget has amended the Interest and Dividends Tax statute (RSA 77) so that owners of limited liability companies (including PLLCs) and partnerships may now be subject to New Hampshire’s 5% interest and dividends tax.

Effective for taxable periods ending on or after December 31, 2009, the receipt of distributions of current year or accumulated profits from all LLCs, PLLCs and partnerships will be treated the same as dividends from corporations, and thus will be subject to New Hampshire’s 5% interest and dividends tax. The New Hampshire Department of Revenue Administration (“DRA”) estimated this statutory change will raise approximately \$10 million each year in increased revenues. This is a significant change from prior law, which only subjected distributions of profits from LLCs, PLLCs and partnerships to tax if the entity making the distribution had “transferable shares.” Many health care providers have related business entities, such as companies organized to hold and lease real property or equipment, which were structured as LLCs in recent years, and LLC and partnership owners will be negatively impacted by this change in the law. This new law has practical implications for medical practices.

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The Healthcare Practice Group provides a wide range of regulatory, corporate and litigation support to healthcare providers and suppliers throughout New England and nationally.

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Increased Importance of “Reasonable Compensation” Deductions

This new tax will increase the DRA’s already strong focus on reasonable compensation deductions. Distributions from LLCs and partnerships will only be taxable to the extent an LLC or partnership has current year or accumulated “profits.” Often times, health care entities with employees have little to no “profit” after the payment of compensation expenses (e.g., salary and bonus payments). However, New Hampshire’s DRA has been very aggressive in its assessment of whether the compensation paid to high income earners is “reasonable.” To the extent that the DRA can successfully challenge compensation paid by an LLC, PLLC or partnership, the practice will face increased taxes. Thus, the change in the law increases the importance of reasonable compensation deductions.

Providers should carefully document the “reasonableness” of compensation paid, particularly to the owners of the entity, regardless of whether a business is organized as a professional corporation or a professional limited liability company. This includes determining whether the compensation satisfies the “independent investor” test. This test is a method increasingly adopted by courts as a means of finding objectively determinable ways to evaluate the reasonableness of compensation deductions. This test involves looking at whether the compensation paid to the owners is reasonable viewed from the perspective of a hypothetical “independent investor” not actively engaging in the business but who contributed the equity capital for the business. Physician owners should also consider including survey information in their files showing the range of compensation paid to physicians practicing in the same specialty and geographic area. And, to the extent that their own compensation is at the high end of the range, physicians would be well advised to document the justification for higher compensation.

While the DRA has also aggressively challenged the payment of wages to shareholders of ‘S’ corporations, challenges to the reasonable compensation deduction for LLCs taxed as partnerships are particularly important since New Hampshire law only provides for a “deemed” deduction, as these entities are not permitted to pay W-2 compensation to owners. To the extent that the reasonable compensation deduction is limited, medical practice income will be subject to a combined 13.5% tax rate, an 8.5% business profits tax on the entity itself, and an additional 5% tax when a practice owner receives a cash distribution.

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Implications for Real Estate and Equipment Entities

Many health care providers have, for reasons unrelated to taxes, organized separate corporate entities to hold and/or lease real property or equipment. In the past, distributions of such “profits” to the owners of LLCs, PLLCs, or partnerships have generally not been subject to tax. Now, as a result of the changes in the law described above, such distributions may be subject to the 5% interest and dividends tax.

Expansion of Real Estate Transfer Tax

New Hampshire’s real estate transfer tax law (RSA 78-B) was amended to expand the definition of “real estate holding company” to include organizations exempt from federal income tax under Section 501(c) of the Internal Revenue Code that are engaged principally in the business of owning, holding, selling, or leasing real estate and which own real estate or an interest in real estate in New Hampshire. This provision will affect far fewer organizations than the LLC tax increase.

Most affected by this change in the law will be non-profit 501(c)(3) hospitals, many of which own real estate through subsidiary entities. These organizations will be adversely impacted if instead of transferring the property itself, they seek to transfer any interest in the entity that owns the property. This change is expected to raise \$1.5 million per year for the state.