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Directive 09-6: Declaration and Reporting of Tax-Free Earnings and Profits of Corporate Trusts

Issue

When must tax-free earnings and profits of entities that were treated as a “corporate trust” for Massachusetts income tax purposes under the former G.L. c. 62, § 8 be reported as income by corporate trust owners, and what are the consequences of failing to properly report this income?

Directive

In meeting the tax reporting requirements under the new “check-the-box” entity classification rules detailed in Regulation 830 CMR 63.30.3, entities that were treated as a corporate trust for Massachusetts income tax purposes under the now-repealed G.L. c. 62, § 8 are required to do a final accounting of tax-free earnings and profits, and report all information necessary for their owners (that is, members, partners, or shareholders) to complete their returns. The tax-free earnings and profits are generally taxable to owners as income in the owner’s tax year that coincides with, or otherwise includes the close of, the entity’s final tax year for which it is treated as a corporate trust for Massachusetts income tax purposes under G.L. c. 62, § 8. 830 CMR 63.30.3(3)(d)3. Where the corporate trust’s tax year was a calendar year, the entity’s final year for which it was treated as a corporate trust will be calendar year 2008 (unless terminated earlier by a liquidation or other transaction), and an owner whose tax year is also a calendar year is therefore required to include the tax-free earnings and profits of the former corporate trust that are attributable to such owner on the owner’s 2008 income tax return. See 830 CMR 63.30.3(3)(d)3 (including example in penultimate sentence thereof).^[1] Where the entity’s last tax year as a corporate trust was a fiscal year ending during 2009, an owner whose tax year is a calendar year is generally required to include the tax-free earnings and profits of the former corporate trust that are attributable to such owner on the owner’s 2009 income tax return.

However, as indicated in numbered clause (ii) in 830 CMR 63.30.3(3)(d)3, if the classification of an entity as a corporate trust for Massachusetts income tax purposes changed or terminated as a result of a reclassification, reorganization, or disposition by any transaction or deemed transaction occurring on or after July 3, 2008 and before such classification would otherwise terminate by operation of law at the close of the entity’s last taxable year as a corporate trust for Massachusetts tax purposes, then the tax-free earnings and profits of the corporate trust attributable to an owner must be reported on the owner’s first income tax return that is (i) due after such reclassification, reorganization, or disposition and (ii) for the owner’s tax period that encompasses the time of such reclassification, reorganization, or disposition. For example, where the entity’s last tax year as a corporate trust would normally be a fiscal year ending during 2009 but its classification changed or terminated as a result of a reclassification, reorganization, or disposition by a transaction or deemed transaction occurring on or after July 3, 2008 and on or before December 31, 2008, then an owner whose tax year is a calendar year would be required to include the tax-free earnings and profits of the former corporate trust that are attributable to such owner on the owner’s 2008 income tax return rather than the owner’s 2009 return.

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Failure of the entity formerly taxable under G.L. c. 62, § 8 to provide the requisite information such that the tax-free earnings and profits may be properly and timely reported, failure of an owner to properly and timely report this income, failure of preparers to properly file returns for owners, or attempts by promoters to circumvent these requirements, will subject parties to all applicable penalties under G.L. c. 62C.

Discussion

Chapter 173 of the Acts of 2008 (the "Act"), has changed the way unincorporated businesses are classified and treated for purposes of the Massachusetts corporate excise and personal income tax, resulting in general conformity with federal entity classification and filing rules. Pursuant to the Act, the classification of an entity for Massachusetts corporate excise and income tax purposes follows the classification under the federal "check-the-box" rules, which permit unincorporated businesses generally to elect how they will be classified for federal income tax purposes. See generally 830 CMR 63.30.3. Among the significant changes under the Act is the elimination of G.L. c. 62, § 8, the separate taxation provisions that applied to entities that were treated as "corporate trusts" for Massachusetts income tax purposes. All entities that formerly were treated as corporate trusts under G.L. c. 62, § 8 are classified for corporate excise and income tax purposes as partnerships, corporations, or entities disregarded as separate from their owners, for all tax years beginning on or after January 1, 2009. A question has been raised about the proper timing for the reporting and taxation of tax-free earnings and profits held by entities that were taxable as corporate trusts under the former G.L. c. 62, § 8.

As part of the effort of closing the books on the entity as it changes taxable status from a corporate trust to its successor form, the Act and Regulation 830 CMR 63.30.3 generally require that tax-free earnings and profits that accumulated in the entity under G.L. c. 62, § 8 be accounted for and subject to tax at the time of change in entity classification. As a general rule, the change in entity classification results in a deemed distribution to all members of any tax-free earnings and profits of such corporate trust or any successor thereto, taxable to the members as dividend income. See 830 CMR 63.30.3(3)(d)3. The Act authorizes the Commissioner to adopt rules to prescribe methods by which such earnings and profits shall be taxed to the entities or their successors or to their direct or indirect owners, partners, or beneficiaries. See St. 2008, c. 173, §§ 96, 102. See also St. 2008, c. 173, § 46, adding G.L. c. 63, § 31M (last sentence providing for basis adjustment in shares of business corporation that was treated as corporate trust under prior law). 830 CMR 63.30.3(3)(d)[\[2\]](#).

The regulation specifies that all tax-free earnings and profits that are subject to tax are immediately taxable to the owners of the former corporate trust, generally in the owner's tax year that coincides with, or otherwise includes the close of, the last tax year of the entity for which it is treated as a corporate trust under G.L. c. 62, § 8, unless and to the extent subject to the limited exception that allows for basis reduction by the owners in the shares of an entity reclassified as a corporation. See 830 CMR 63.30.3(3)(d). As noted in 830 CMR 63.30.3(3)(d)3, subject to the above-referenced exception for basis reductions, the tax-free earnings and profits of the former corporate trust must be reported to the owners upon the change in entity classification that occurs either by operation of law or by an earlier change in classification of the corporate trust (or a successor) occurring as a result of a reclassification, reorganization, or disposition resulting from any transaction or deemed transaction occurring on or after July 3, 2008. All members (resident and non-resident) must recognize such income as dividend income as follows: (i) in the case of a reclassification occurring by operation of the Act, on the member's first return due after the close of the entity's last taxable year treated as a corporate trust ending on or after December 31, 2008, or (ii) where a corporate trust was the subject of a reclassification, reorganization, or disposition resulting from any transaction or deemed transaction occurring on or after July 3, 2008 and before a change in classification that would occur by operation of the Act, on the member's first return due after such reclassification, reorganization, or disposition. 830 CMR 63.30.3(3)(d)3. In many cases entities treated as corporate trusts filed on a calendar year basis and their owners also file calendar year returns. As noted in 830 CMR 63.30.3(3)(d)3, in such cases the deemed distributions due to untaxed earnings and profits of the corporate trust occur on December 31, 2008 (or before that in the event of a prior reclassification, reorganization, or disposition) and are recognized by shareholders on their calendar 2008 returns.

In instances where the corporate trust's final taxable year under G.L. c. 62, § 8 was a fiscal year ending during 2009, an owner whose tax year is a calendar year is generally required to include the

tax-free earnings and profits of the former corporate trust that are attributable to such owner on the owner's 2009 income tax return. However, as indicated in numbered clause (ii) in 830 CMR 63.30.3(3)(d)3, if the classification of an entity as a corporate trust for Massachusetts income tax purposes changed or terminated as a result of a reclassification, reorganization, or disposition by any transaction or deemed transaction occurring on or after July 3, 2008 and before such classification would otherwise terminate by operation of law at the close of the entity's last taxable year as a corporate trust, then the tax-free earnings and profits of the corporate trust attributable to an owner must be reported on the owner's first income tax return due after such reclassification, reorganization, or disposition. For example, where the entity's last tax year treated as a corporate trust would normally be a fiscal year ending during 2009 but its classification changed or terminated as a result of a reclassification, reorganization, or disposition by a transaction or deemed transaction occurring on or after July 3, 2008 and on or before December 31, 2008, then an owner whose tax year is a calendar year would be required to include the applicable tax-free earnings and profits of the former corporate trust on the owner's 2008 income tax return rather than the 2009 return.

Consistent with the statutory and regulatory rules, there will be no circumstances where the final tax year of an entity as a corporate trust for Massachusetts income tax purposes will end later than the close of a fiscal year ending in 2009. Thus, the latest an owner can report tax-free earnings and profits income under 830 CMR 63.30.3(3)(d) is in the tax year of the owner that includes the date at which classification of the entity as a corporate trust ends, that is, either the last day of the entity's last tax year as a corporate trust for Massachusetts tax purposes or the date of an earlier reclassification, reorganization, or disposition by any transaction or deemed transaction occurring on or after July 3, 2008 and before the end of the entity's last tax year as a corporate trust. It is the responsibility of the entity that is changing classification to report to its owners any information necessary for them to properly and timely account for and report their tax-free earnings and profits and resulting tax liabilities. 830 CMR 63.30.3(3)(d)2.a.

Failure of any party with a duty to provide information, report income, or furnish advice will subject the party to all applicable penalties under G.L. c. 62C, including without limitation those at c. 62C, §§ 33 – 35E. See TIR 06-5. Such parties may include the entity formerly taxable under G.L. c. 62, § 8 or a successor, owners taxable on tax-free earnings and profits of that entity, preparers involved in reporting on behalf of affected parties, or promoters as described in G.L. c. 62C, § 35E.

Taxpayers who have filed returns reporting income from tax-free earnings and profits in error, or have failed to properly account for and declare tax-free earnings and profits as income, should file an amended return in accordance with the instructions in Administrative Procedure 605.

/s/Navjeet K. Bal
Navjeet K. Bal
Commissioner of Revenue

NKB:MTF:dt

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[1] If the tax year of an entity treated as a corporate trust was the calendar year but the year terminated pursuant to a liquidation or other transaction on or after July 3, 2008 and prior to December 31, 2008, an owner whose tax year is the calendar year would still report the income for calendar year 2008 since the owner's return for calendar year 2008 would be the first return due after the close of the entity's last tax year as a corporate trust.

[2] To the extent that a shareholder's proportionate share of tax-free earnings and profits exceeds the shareholder's basis, the shareholder must immediately recognize the income as dividend income as provided in 830 CMR 63.30.3(3)(d)4.

