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## Letter Ruling 87-9: Corporate Trust Alternative Apportionment

September 18, 1987

You request a ruling on behalf of the ("Trust") and ("Trustee") with respect to the classification of the Trust as a "corporate trust" for Massachusetts income tax purposes, and the exemption of the Trust from the tax imposed by G.L. c. 62, § 8(a). You state that the Trust is entitled to an exemption from the Massachusetts personal income tax because its apportionment percentage for apportioning the Trust's Massachusetts adjusted gross income is less than 10 percent. See G.L. c. 62, § 8(b)(iii).

For the reasons stated below, we rule that:

1. The Trust is a "corporate trust" for Massachusetts income tax purposes; and
  2. The Trust is exempt from the tax imposed under Chapter 62 pursuant to G.L. c. 62, § 8(b)(iii).
- Facts

The Trustee represents that the relevant facts are as follows. This ruling is conditioned on the continued existence and accuracy of all facts which the Trustee represents.

The Trust will be created under a Declaration of Trust before the transfer of assets described below and will be governed by Massachusetts law. The Trust is a trust the beneficial interest in which is divided into transferable certificates of participation or shares within the meaning of G.L. c. 182, § 1. The Trustee's principal place of business is located in Boston, Massachusetts. The principal office of the Trust will be located at the principal office of the Trustee. The Trust will apply for an Employer Identification Number. The Trust will maintain its books and records on a calendar year basis and adopt an accrual method of accounting.

The beneficial interest in the Trust will be divided into two classes, one of which will enjoy priority as to payment. The classes will be evidenced by separate certificates of beneficial interest (collectively referred to herein as "Certificates of Beneficial Interest" or "Certificates"). The Certificates entitle holders to their pro-rata shares of the cash flow of the Trust after the payment of expenses, the funding of certain accounts and funds, and payment of amounts due on the Trust's Securities. There are ' no restrictions on the transferability of the Certificates, except those stated under applicable securities law and those stated in the Trust's declaration of trust.

The Trust will acquire from the "Agency" ("Agcy") approximately 6,442 loans to 4,128 borrowers ("Loans") Agcy is an agency of the United States "Government". The Loans are currently held as assets of the Insurance Fund, which is administered by Agcy. The Loans are fixed-rate loans to public bodies and to not-for-profit organizations in rural areas in connection with financings of water and waste disposal facilities and community facilities. Approximately 70 percent of the Loans by principal amount were made directly to local government units, and the interest on these is tax-exempt; the remaining approximately 30 percent were made to Section 501(c)(3) organizations or other not-for-profit organizations, such as hospitals, nursing homes, and cultural and educational facilities.

The Trust is being formed to acquire certain Loans from the Agcy. In 1986, federal legislation was passed which required the Agcy to sell certain of its Loans by September 30, 1987. The Loans will

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be selected at random from a pool consisting of the Loans that meet certain criteria, e.g., loans that are not in default. It is expected that initially less than 1 percent of the selected Loans will be sourced in Massachusetts that is, loans secured by Massachusetts property or loans to Massachusetts borrowers (hereinafter "Massachusetts Loans"). The Trust states that additional Massachusetts Loans acquired in substitution for other loans cannot cause the interest income on the Massachusetts Loans to exceed 7 percent of the interest income from all Loans of the Trust.

The Loans will be acquired by the Trust in exchange for (1) issuance to Agcy of all of the Trust's Certificates, (2) cash representing the proceeds of the sale of the Trust's Class A Bonds ("Senior Securities") in a public offering, and (3) either the Trust's Class B Bonds ("Junior Securities"), or the proceeds from the sale of the Class B Bonds in a private placement. The Senior Securities are expected to have an initial value approximately equal to 93% of the Loans, and the Junior Securities are expected to have an initial value approximately equal to 7% of the Loans. For Federal income tax purposes, no gain or loss will be recognized upon the transfer of the Loans from Agcy to the Trust by virtue of Section 351 of the Internal Revenue Code.

Certain of the Loans (representing approximately 18.93% of the principal amount of the Loans) are secured by real or personal property of the borrowers pursuant to mortgages, deeds of trust, and other security agreements. Most of the remaining Loans are either general obligation bonds or revenue bonds. Loans to Massachusetts borrowers are expected to represent less than 1% of the principal amount of the Loans.

The sale of the Loans by Agcy to the Trust is the first of a series of several Federal agency loan sales required by the omnibus Budget Reconciliation Act of 1986 ("OBRA"). OBRA requires that this loan transfer occur during the Federal government's 1987 fiscal year, which ends on September 30, 1987. In connection with this and other Federal loan sales, a Federal Credit Policy Working Group has been formed, with representatives of the Department of the Treasury, the office of Management and Budget, and each agency selling loans. This group has established guidelines for the loan sales. One of these guidelines requires that loans be sold only if future interest payments on the loans are subject to Federal income tax in the hands of the ultimate investors. Since a substantial portion of the Loans consist of loans to public bodies (the interest on which is tax-exempt), this sale is structured with the Trust purchasing the Loans and financing its purchase by the issuance to investors of the Senior Securities, the interest on which will not be exempt from Federal income tax. A business trust rather than a corporation was chosen to acquire the Loans because the General Counsel of Agcy has advised that the Agcy is not authorized to own a corporate subsidiary. OBRA provides that prior to selling any loans Agcy must require persons offering to purchase such loans to demonstrate (1) an ability to provide servicing as Agcy deems necessary to assure the continued performance on the loans and (2) the ability to generate capital to provide the borrowers additional credit as may be necessary and proper servicing of the loans. The Trust, through its Master Servicer, will maintain the files relating to the Loans and will coordinate all servicing of the Loans. Prior to each date in which a payment is due on a loan, the Master Servicer is required to notify the borrower of the amount of the principal and interest due on the loan and the current balance of the loan. If the loan is delinquent, the Master Servicer is obligated to use its best efforts to have face-to-face or telephone contact with the borrower to establish the reason for the default and the attitude of the borrower to the Loan. It must notify the Trust of its recommendation concerning the institution of collection proceedings. It is also obligated to notify the Trust at any time that a borrower is in need of an advance necessary to protect the security interest of the Trust. The Subservicer of the Loans will provide training and technical assistance with respect to the Loans, including on-site inspections, counseling borrowers on construction techniques and new technologies, and other technological recommendations needed to maintain the Loans. All these servicing activities will be conducted outside Massachusetts, except insofar as they relate to Massachusetts Loans. The Trust is itself obligated to perform or provide these servicing activities in the event its agents fail to do so.

#### Discussion

For Massachusetts tax purposes, the Trust is a "corporate trust." Section 1(j), Chapter 62 of the General Laws provides that a "corporate trust" is any partnership, association or trust the beneficial interest of which is represented by transferable shares. The Trust was created under a declaration of trust under Chapter 182 of the General Laws. The beneficial interest in the Trust is exhibited by the Certificates of Beneficial Interest, which will be exchanged by the Trust to the Agcy for the Loans. These Certificates are freely transferable and entitle the holders to their pro-rata share of the cash flow of the Trust after the payment of expenses and funding of certain accounts. We conclude that the Trust's beneficial interest is represented by transferable shares within the meaning of G.L. c. 62, § 1(j).

A corporate trust engaged in any business, activity, or transaction within the Commonwealth, whether or not it maintains an office or place of business within the Commonwealth, is subject to the income taxes imposed under Chapter 62, unless otherwise exempted under G.L. c. 62, § 8(b). G.L. c. 62, § 8(a). We conclude that the contemplated activities of the Trustee, whose principal place of business is in Massachusetts, are sufficient to subject it to personal income tax. A corporate trust's adjusted gross income is determined as if it were a resident natural person. *Id.* However, its taxable adjusted gross income will be apportioned pursuant to G.L. c. 63, § 38, as if it were a corporation. *Id.* If a corporate trust's apportionment percentage for apportioning its Massachusetts adjusted gross income is less than ten percent, it is exempt from the tax imposed under Section 8(a). G.L. c. 62, § 8(b).

Apportionment is available to the Trust only if it is taxable in other states. See *Amray, Inc. v. Commissioner of Revenue*, ATB Docket No. 119875 (April 17, 1986) (The threshold question in the application of section 38 is whether the corporation is taxable in other states). If not, all of the Trust's taxable income will be allocated to Massachusetts. G.L. c. 63, § 38(b). With respect to whether a corporation is taxable in another state, Section 38(b) states as follows:

"For purposes of this section, a corporation is taxable in another state if (1) in that state such corporation is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax, or (2) that state has jurisdiction to subject such corporation to a net income tax regardless of whether, in fact, the state does or does not."

It is immaterial that the taxpayer may not have filed a tax return in a given state so long as the taxpayer's connections with the state provide a basis upon which the state might assert its jurisdiction to assess an income tax. *Amray, Inc.*, ATB Docket No. 119875.

The Trust has not indicated that it will pay taxes in another state; however, it has demonstrated that its activities in other states is such that a basis exists upon which those states might assert jurisdiction to assess income taxes. In a number of states, the Loans will be secured by liens on real and personal property pursuant to mortgages, deeds of trust, and other security agreements. Perfection of these liens will require appropriate filings within the states. Also, under OBRA, the Trust through its agents will be obligated to service the Loans. The Trust's activities in securing and servicing the Loans appear to establish a nexus within other states sufficient so that such states may assert jurisdiction to assess income taxes. See *FLA. STAT. § 220.15(5)(b); § 214.71(b)* (1986); and *Avco Financial Services Consumer Discount Company One, Inc. v. Director, Division of Taxation*, 100 N.J. 27, 494 A.2d 788 (1985). Accordingly, the Trust is entitled to apportion its income pursuant to G.L. c. 63, § 38(c).

Under G.L. c. 63, § 38(c), a corporation taxable both within and without Massachusetts is taxed in Massachusetts on its taxable net income, apportioned to the Commonwealth by means of a three factor formula described as follows:

Property Factor + Payroll Factor + (2 x Sales Factor) / 4.

The Trust claims to have no "property," "payroll," or "sales" within Massachusetts or outside of Massachusetts as those terms are defined by statute. G.L. c. 63, § 38(d)-(f). Assuming for purposes of this ruling that this claim is true, it follows that the numerators and denominators of each factor are zero. A factor is not applicable if the denominator of the factor is less than 10 percent of one third of the taxable net income, or if it is otherwise determined to be insignificant in producing income. G.L. c. 63, § 38(g). As a result, the three-part apportionment method described in Section 38(c) does not reasonably approximate the Trust's net income derived from its business activities carried on within the Commonwealth.

The Trust offers for the Commissioner's consideration an alternative method of apportionment which it believes reasonably determines the amount of net income derived by the Trust from business activity carried on within the Commonwealth. G.L. c. 63, § 42. <sup>1</sup> The Trust proposes that its income be apportioned to Massachusetts based upon the percentage of the Trust's interest income (taxable and tax-exempt) received from Massachusetts loans.

We rule that in the special circumstances of this case an apportionment formula based upon interest from Loans to not-for-profit organizations or public bodies located in the Commonwealth reasonably approximates the Trust's net income derived from its activities carried on in the Commonwealth.

Initially, less than 1 percent of the Loans are expected to be Massachusetts Loans. Additional Massachusetts Loans acquired in substitution for other loans cannot cause the total interest income on Massachusetts Loans to exceed 7 percent of the interest income of the Trust from all Loans. Accordingly, under this alternative apportionment method, the apportionment percentage of the Trust will be less than 10%. The Trust qualifies for an exemption from the personal income tax imposed under Chapter 62 pursuant to G.L. c. 62, 8(b)(iii).

Very truly yours,  
Nicholas L. Metaxas  
for Commissioner of Revenue  
September 18, 1987  
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Footnotes:

1 The Trust will be required to apply formally to the Commissioner for alternative apportionment in accordance with the statutory provisions and the regulations of the The Trust will be required to apply formally to the Commissioner for alternative apportionment in accordance with the statutory provisions and the regulations of Department of Revenue, namely 830 CMR 63.42 (proposed), which the Department is currently in the process of promulgating.