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Letter Ruling 94-2: Security Corporation Sale of a Control Subsidiary

April 1, 1994

You have requested a ruling on behalf of ***** (the "Corporation") with respect to its classification as a security corporation pursuant to c. 63, § 38B. Your question is whether Corporation will lose its status as a security corporation if it sells the stock of its subsidiary, ***** (the "Subsidiary"), and takes back as part of the purchase price notes or debentures issued by the purchaser.

FACTS

Both Subsidiary and Corporation were incorporated in Massachusetts. Subsidiary was incorporated on June 16, 1976, and Corporation was incorporated on May 15, 1981. Corporation is an S corporation by reason of an S election made for the taxable year ended December 31, 1987. Subsidiary is engaged in an engineering business.

On December 23, 1991, Corporation requested classification as a security corporation for the taxable year ended December 31, 1991. This classification was granted March 12, 1992. At the time of this ruling request, substantially all of Corporation's assets consisted of slightly less than 80% of the stock of Subsidiary (the "Shares").

During 1992, prior to this ruling request, Corporation sought to sell the Shares. At one point, Corporation was close to completing a deal to sell the Shares to an unaffiliated corporation. This deal fell through. Subsequently, Corporation planned to sell the Shares to Subsidiary as part of a leveraged management buyout. Under this plan, Corporation's consideration for the Shares would be cash, and either a note or debentures. The note or debentures would be subordinated in certain respects to the junior and senior lenders of Subsidiary, who would provide substantial funds for the transaction. It is the latter transaction about which you inquire.

DISCUSSION

General Laws c. 63, § 38B provides preferential excise tax treatment for every domestic business corporation or foreign corporation that is not a DISC "which is engaged exclusively in buying, selling, dealing in or holding securities in its own behalf and not as a broker." The exclusivity requirement in this provision is to be strictly construed. See State Tax Commission v. PoGM Co., 369 Mass. 611, 613 (1976); Chatham Corporation v. State Tax Commission, 362 Mass. 216, 219 (1972).

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In applying c. 63, § 38B, the Department uses two related tests. First, it asks whether the interests the corporation acquires and holds, etc., are "securities." This test is two-pronged and evaluates both the securities in question and the related investment intent. See PoGM, 369 Mass. at 611-612; Industrial Finance Corp. v. State Tax Commission, 367 Mass. 360, 367 (1975); see also LRs 91-10, 91-8. Second, the Department asks whether the activities of the corporation are exclusively for investment. See Chatham, 362 Mass. at 219-220.

In PoGM the Supreme Judicial Court held that a security corporation could not hold a note which it had previously received for business real estate. The real estate was part of a manufacturing business, and was sold by the corporation as part of a sale of those business assets. During the year for which the corporation sought security corporation status, the income on the note constituted approximately one-third of the corporation's income. See PoGM, 369 Mass. at 612; see also PoGM Company v. State Tax Commission, ATB No. 64515 (May 12, 1975).

Letter Ruling 89-2 involved facts similar to PoGM. In that ruling, a taxpayer owned fifty percent of the stock of a corporation which sold its assets in a liquidating sale pursuant to former Internal Revenue Code § 337. As part of the assets received from the liquidation, the taxpayer received industrial development bonds ("IDBs") issued by the state of New Jersey. Five years later, immediately before the IDBs were to mature, the taxpayer organized a second corporation ("Newco") and transferred the IDBs to Newco tax-free in exchange for one-hundred percent of Newco's stock. Letter Ruling 89-2 concluded that Newco could not hold the IDBs and be classified as a security corporation, because the IDBs had been acquired in the context of a sale of a business and not for investment.

One premise behind both PoGM and LR 89-2, as your ruling request concedes, was to prevent proceeds received in connection with the sale of a business from being taxed at the preferential security corporation rate. You attempt to distinguish your situation from those situations by noting that in your situation the transferring corporation would be a security corporation before the sale of the subsidiary. However, we note that the request for classification under c. 63, § 38B predated the initiation of sale negotiations by less than one year.

We do not find the distinction that you suggest to be persuasive. Chapter 63, § 38B is intended to benefit corporations which are engaged exclusively in buying, selling, dealing in, or holding securities "for investment." Industrial Finance, 367 Mass. at 367. The transaction you describe wherein a corporation will sell an engineering business that it substantially owns does not meet this test. Security corporation classification is not intended to be a means for the owner of a non-investment business to shelter the gain realized on the sale of that business from Massachusetts tax.

Moreover, because of the relationship between Corporation and Subsidiary - and the nature of their activities - it makes no difference that Corporation intends to transfer a business by means of a transfer of a controlling interest in stock, as opposed to a transfer of assets. The inquiry under c. 63, § 38B is not a formalistic one.

CONCLUSION

Corporation will lose its status as a security corporation as of the first day of the taxable year in which it sells the stock of Subsidiary and takes back and holds notes or debentures issued by the purchaser.

Very truly yours,

/s/Mitchell Adams

Mitchell Adams
Commissioner of Revenue

MA:HMP:mtf

LR 94-2

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