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Home > Businesses > Help & Resources > Legal Library > Directives > Directives - By Decade > (2000-2009) Directives >

Directive 09-7: Effects on Shareholders of a Federal Tax-Free F Reorganization of a Former Corporate Trust That Has Been Reclassified as a Corporation for Massachusetts Tax Purposes

Issue

Are shareholders of an entity that was formerly treated as a corporate trust under G.L. c. 62, § 8, and that has become taxable as a corporation under G.L. c. 63 as a result of the change in Massachusetts entity classification rules, required to immediately recognize tax-free earnings and profits as income solely because the entity undergoes a federal tax-free F reorganization^[1] after the reclassification as a corporation for Massachusetts tax purposes?

Directive

Shareholders of an entity that was formerly treated as a corporate trust under G.L. c. 62, § 8, and that has become taxable as a corporation as a result of the change in entity classification rules, are not required to immediately recognize tax-free earnings and profits as income solely as a result of a valid federal tax-free F reorganization of the entity that takes place after the reclassification. Any adjustment to basis of shares of such an entity that took place at the time of the change in classification from a corporate trust to a corporation and before the F reorganization, as provided under G.L. c. 63, § 31M and 830 CMR 63.30.3(3)(d)4, is also unaffected solely on account of a valid tax-free federal F reorganization.

Discussion

Massachusetts has adopted rules conforming state entity classification to federal classification for state income tax and corporate excise purposes. See St. 2008, c. 173. See also 830 CMR 63.30.3. As a result of this conformity, for periods after these new rules are effective, Massachusetts no longer provides special tax treatment of corporate trusts, and such entities are reclassified and required to file returns in Massachusetts under the same classification they have for federal purposes. *Id.* As part of this transition, and at the time of reclassification, the legislation requires the recognition of tax-free earnings and profits that were often accumulated by the entities. See St. 2008, c. 173, § 96. As a general rule, such tax-free earnings and profits are taxable as dividends to the owners (that is, the members or shareholders) 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. See also DD 09-06. An exception to this general rule exists for corporate trusts that become reclassified for Massachusetts tax purposes as corporations. In such cases the shareholders are not required to immediately recognize all tax-free earnings and profits as income; instead, at the time of change in classification from a corporate trust to a corporation, shareholders are allowed^[2] to reduce their basis in shares of the entity by the amount of tax-free earnings and profits of the former corporate

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trust that are attributable to such shareholders, in effect deferring recognition of the income to the extent of such basis reduction.^[3] See G.L. c. 63, § 31M, 830 CMR 63.30.3(3)(d)4.

The entity classification regulation further requires that all shareholders of former corporate trusts that are subject to the special basis adjustment rules at G.L. c. 63, § 31M and 830 CMR 63.30.3(3)(d)4 must recognize taxable dividend income, to the extent of any tax-free earnings and profits corresponding to the prior basis adjustment, upon the disposition in any manner (direct or indirect, whether otherwise taxable or tax-free) on or after July 3, 2008 of any shares of the corporate successor to the former corporate trust. See 830 CMR 63.30.3(3)(d)6. Such dispositions include all dispositions, whether by sale, exchange, liquidation, gift, bequest, or other transfer. *Id.*

The Department will recognize an exception to these income recognition provisions at 830 CMR 63.30.3(3)(d)6 in the case of shareholders of an entity formerly treated as a corporate trust that undergoes, after the entity's Massachusetts tax classification has changed from that of a corporate trust to that of a corporation, a valid tax-free F reorganization. For this exception to apply, the reorganization must meet all requirements to be recognized federally as an F reorganization, and have undergone "a mere change in identity, form or place of organization of one corporation, however effected . . ." See *generally* Treas. Reg. §§ 1.368-1 – 1.368-3. In addition, such exception will apply only to the extent that a shareholder does not receive boot or recognize income for federal or Massachusetts tax purposes in connection with the F reorganization and such shareholder retains shares in the reorganized entity having a basis reflecting a continuation of the shareholder's basis in shares of the entity prior to the F reorganization. In applying these principles, where an entity has changed its classification from that of an entity taxable as a corporate trust under the former G.L. c. 62, § 8 to that of a corporation, and its shareholders have made the adjustment to basis provided under G.L. c. 63, § 31M and 830 CMR 63.30.3(3)(d)4, and where the entity subsequent to the reclassification undergoes a valid federal tax-free F reorganization, the Massachusetts basis of stock of a shareholder of such an entity will continue to reflect the Massachusetts basis as adjusted under G.L. c. 63, § 31M and 830 CMR 63.30.3(3)(d)4. A shareholder will not be required to recognize income attributable to the tax-free earnings and profits solely as a result of the mere change in identity, form, or place of organization of the entity accomplished pursuant to a federal F reorganization.

The rules in 830 CMR 63.30.3(3)(d)4 providing for tax-free earnings and profits of a former corporate trust to be reflected in a reduction in shareholder basis of an entity treated as a corporation may apply not only in cases where a former corporate trust is reclassified as a corporation for Massachusetts tax purposes by operation of law; these rules may also apply in cases where a former corporate trust was reorganized, on or after July 3, 2008 and prior to a reclassification that would otherwise have occurred by operation of law, into a successor entity treated as a corporation. See 830 CMR 63.30.3(3)(d)4. The Department will similarly recognize the F reorganization exception described in this Directive (subject to the same limitations thereon) in situations where a former corporate trust was reorganized as described in the preceding sentence, and its corporate successor subsequently undergoes an F reorganization.

The F reorganization exception recognized in this Directive is limited to shareholders of an entity that has been subject to an F reorganization to the extent that they maintain their share ownership in such entity as described above, and does not apply to any other type of corporate reorganization or transaction, including those described under federal tax rules as tax-free reorganizations.

In situations where the F reorganization exception recognized in this Directive has applied, the rules described in 830 CMR 63.30.3(3)(d)6 -- regarding recognition of income by shareholders upon disposition in any manner of shares of a corporate successor to a former corporate trust -- will, of course, apply with respect to any subsequent dispositions of shares of the entity that has undergone the F reorganization qualifying for the treatment described herein.

/s/Navjeet K. Bal

Navjeet K. Bal
Commissioner of Revenue

NKB:MTF:dt

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DD 09-7

[1] An “F reorganization” is a “mere change in identity, form, or place of organization of one corporation, however effected.” Internal Revenue Code (“IRC”) § 368(a)(1)(F).

[2] The applicable regulations provide a shareholder election to be taxed on an immediate deemed distribution of the shareholder’s proportionate share of tax-free earnings and profits in lieu of reducing basis in shares. See 830 CMR 63.30.3(3)(d)5.

[3] 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.