



PRACTICAL U.S./DOMESTIC TAX STRATEGIES

HOW US BUSINESS MANAGES ITS TAX LIABILITY

December 2008
Volume 8, Number 12

Massachusetts Department of Revenue Releases Emergency Regulation Related to “Check-the-Box” Conformity *In Addition to Predicted Rules, the Emergency Regulation Imposes Unexpected Tax Liability and Complex Reporting Procedures*

On July 3, 2008, Governor Deval Patrick signed into law An Act Relative to Tax Fairness and Business Competitiveness (Act). Among its other provisions, the Act brought Massachusetts in line with other states by introducing “check-the-box” entity conformity. As a result, Massachusetts now follows federal rules regarding entity classification, effective for taxable years beginning on or after January 1, 2009.

On December 24, 2008, the Department of Revenue (DOR) filed Emergency Regulation 830 CMR 63.30.3, Entity Classification under St. 2008, c. 173. This emergency regulation is substantially similar in content to the working draft of TIR 08-15 released on December 5, 2008, which first explained DOR’s view of the consequences of check-the-box conformity. Many provisions are effective as of the July 3 date of enactment. Because emergency regulations expire by operation of law three months after taking effect, the release of proposed final regulations and a public hearing are expected before that expiration date.

Along with predictable and benign changes to the classification regime, the emergency regulation contains some unexpected provisions that impose both unforeseen tax liability and onerous reporting burdens, particularly in the context of untaxed earnings of corporate trusts. Some of the provisions raise questions about whether the Department has overstepped its statutory authority in implementing the new rules.

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The provisions of the emergency regulation are summarized below.

Tax Consequences of Actual or Deemed Reclassification

The new entity conformity rules treat many entities as having converted to a different form at the commencement of their first taxable year beginning on or after January 1, 2009. The federal rules governing income recognition upon such a conversion generally apply, albeit sometimes with significantly different tax basis consequences.

A conversion of a corporation to a partnership is treated as a corporate liquidation followed by a contribution of all the corporate assets and liabilities to the partnership.

A conversion of a partnership to a corporation is deemed to be a so-called assets-over incorporation in which the partnership contributes all of its assets and liabilities to the corporation in exchange for stock, and the partnership liquidates immediately thereafter. In this case, Massachusetts income recognition and basis adjustments depend upon the federal rules that would apply to such a partnership incorporation, so partners recognize gain if the partnership’s liabilities exceed the tax basis of its assets.

The conversion of a corporate trust to a corporation is treated as a tax-free reorganization as to income recognition and the corporation’s Massachusetts basis in its assets, but the shareholders’ Massachusetts basis in their shares of the successor corporation will often differ (perhaps significantly) from their federal basis. There are also detailed ordering rules that govern the treatment of distributions by the converted entity.

A conversion of a corporation to a partnership is treated as a corporate liquidation followed by a contribution of all the corporate assets and liabilities to the partnership. This generally results in recognition of gain or loss at the corporate level, which must be reported on the final Massachusetts corporate return. Shareholders are not taxed immediately, however. Instead, "to provide as much consistency in asset basis as possible between Massachusetts and federal law," transferor shareholders and the transferee partnership take a carryover basis in their interests and assets, respectively.

The conversion of a corporate trust to a partnership is generally treated as a tax-free reorganization, except that it triggers a deemed corporate trust dividend of all tax-free earnings and profits to both resident and nonresident partners. Similarly, when a corporate trust is converted to a disregarded entity, the corporate trust is deemed to liquidate for Massachusetts tax purposes. This does not entail any recognition of gain or loss at the entity level, but it does trigger a deemed dividend of all tax-free earnings and profits.

Qualified subchapter S subsidiaries (QSUBs) are now disregarded for all tax purposes, including the so-called "balance sheet tax" that they have previously borne. This change is not a taxable event and does not trigger a liquidation. As a result, neither the QSUB nor its parent recognizes gain or loss. Any net operating loss or credit amounts that would have been carried forward by the QSUB remain available to the parent corporation to the extent it is eligible.

Special Rules Applicable to Corporate Trust Tax-Free Earnings and Profits

The most complicated provisions in the emergency regulation concern the accounting for and taxation of corporate trust earnings and profits that have not previously been subject to Massachusetts tax. Before examining these rules, it is helpful to note four categories of tax-free earnings and profits that corporate trusts may have accumulated:

- Income apportioned outside Massachusetts by a corporate trust during any taxable year beginning on or after July 1, 2000.
- Income earned during taxable years beginning on or after July 1, 2000 and before 2003 during which the corporate trust had a Massachusetts apportionment factor of less than 10 percent.
- Post-1970 earnings and profits to the extent not subject to tax under Chapter 62 of the General Laws.
- Pre-1971 earnings and profits, where an election was made to subject the trust's distributions to tax rather than incur tax at the entity level.

The emergency regulation requires all entities that themselves were corporate trusts or whose predecessors were treated as corporate trusts on or after July 3, 2008 (each a former corporate trust) to file an accounting of all tax-free earnings that have been earned, accumulated, or distributed by the corporate trust. The emergency regulation does not specify the deadline for such accounting but provides that it must be broken down by year and show for each year the trust's tax-free earnings and profits, its Massachusetts apportionment percentage, and the category to which the tax-free earnings and profits belong. The accounting must also show for each year the beginning balance of, accruals to, distributions from, and the ending balance of tax-free earnings and profits. The former corporate trust must report to each of its members their proportionate share of tax-free earnings and profits for each taxable year.

With respect to members who were residents of Massachusetts for part of any tax year in which such earnings and profits were accrued, the report must show any income tax paid to other states with regard to such earnings and profits. With respect to nonresidents, the report must show the corporate trust's apportionment factor for each year.

All actual distributions made on or after July 3, 2008, by a former corporate trust are deemed to be paid first out of tax-free earnings and profits and are deemed to be taxable dividends to the extent thereof, whether made by a corporate trust, corporation, partnership or disregarded entity. The entity must notify the recipient that the distribution is deemed to represent taxable dividend income. Massachusetts residents are allowed a credit for tax paid to other jurisdictions. The emergency regulation takes the position that distributions to nonresidents out of all categories of tax-free earnings and profits except for the first category are subject to taxation to the extent of the apportionment factor for the year(s) in which tax-free earnings were accumulated.

Deemed distributions upon conversion are taxable in the same manner. With the exception of corporate successors to corporate trusts, a former corporate trust is deemed to make a distribution upon conversion on January 1, 2009 (or the start of the entity's fiscal year). For all entities, any reclassification or reorganization of the entity or disposition of its shares after July 3, 2008, even a disposition by gift or bequest, triggers a deemed distribution subject to tax. In the event that a shareholder of such an entity dies, the estate reduces the basis of the shares in the amount of tax-free earnings and profits, and the distribution to the heirs triggers a recognition of gain in the same amount.

With regard to corporate successors to corporate trusts, January 1, 2009 does not necessarily trigger a deemed distribution, but a shareholder's basis in its corporate

shares is reduced by its proportionate share of the former corporate trust's tax-free earnings and profits. Should the reduction exceed such basis, the shareholder is deemed to receive a dividend to that extent. If the reduction does not exceed the basis, then in the event of a reclassification or reorganization of the entity or disposition of the shares, the deemed dividend rules apply, and the basis is increased by the amount of the deemed dividend.

**Changes in Estimated Tax Payment
Responsibilities**

In order to take advantage of corporate and personal safe harbors related to the prior year's tax liability, both entities and individuals must calculate their prior-year 2008 tax liability as if the new rules had been in place at the time. For example, a corporate successor to a corporate trust must calculate the amount of tax it would have paid in 2008 had it been taxed as a corporation. Resident partners

of a partnership formerly treated as a corporate trust must take into account their proportionate share of the former trust's income for the prior year in computing their hypothetical prior year's tax, while nonresident partners relying on the safe harbor must base their estimated tax payments on the tax that would have been paid on their share of the former trust's Massachusetts-source income for the prior tax year.

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Reprinted from the December, 2008 issue of *Practical U.S./ Domestic Tax Strategies*

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