
Massachusetts DOR Issues Final Directive on Restrictions on Pledges of Security Corporation Stock

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The Massachusetts Department of Revenue has issued the final version of its Directive that covers restrictions on the pledging of security corporation stock. Directive 12-2 follows the proposed Directive issued on April 6, 2012, in providing that a shareholder's pledge of its security corporation shares for a loan to the shareholder will not, in and of itself, preclude or revoke security corporation status. In addition, the Directive confirms that restrictive covenants or similar provisions that directly or indirectly accompany such a pledge will not preclude or revoke security corporation status as long as the negative covenants limit the security corporation to investment activities that are permissible for a security corporation under Massachusetts law. For example, a covenant that limits a security corporation to investments in a certain class of securities or assets would not result in revocation of security corporation status. The Directive provides the following examples of restrictive covenants that would result in denial or revocation of security corporation status:

- a covenant which provides that a stock pledgee could, in the event of a financial deterioration of the borrower (but prior to an actual event of default), become (i) a direct creditor of the security corporation or (ii) a pledge of assets of the security corporation;
- a covenant which requires the shareholder/pledgor to withdraw securities from the security corporation through a direct or indirect distribution and to provide a pledge of (or other form of security in) those securities to the lender; and
- a covenant which directs the investments of the security corporation in any manner to the securities of the shareholder or the pledgee or any affiliate of either the shareholder or the pledgee, or of any other party in whom the shareholder or the pledgee or an affiliate has a material business interest, such as customers or business partners.

A second part of the Directive discusses when it is permissible for a security corporation to acquire appreciated securities from an affiliate and subsequently sell those securities. In general, such acquisitions will not adversely affect security corporation status if such securities were initially acquired by the affiliate through a public exchange or other arms-length

secondary market and the security corporation can demonstrate that its acquisition (i) is for investment purposes, (ii) is consistent with all other requirements for security corporation classification, and (iii) is not part of a plan for disposition of an asset to minimize tax on any built-in gain.

Authors

Richard W. Giuliani

RETIRED PARTNER

☎ +1 617 526 6000



Julie Hogan Rodgers

PARTNER

Vice Chair, Tax Practice

✉ julie.rodgers@wilmerhale.com

☎ +1 617 526 6543