Massachusetts Tax Advisory

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Benefits of Establishing A Massachusetts Security Corporation Following A Public Offering

The Problem

Following a public offering, a corporation may have substantial proceeds that will be invested for some period of time pending use by the company for research and development, acquisitions, or other corporate purposes. A corporation doing business in Massachusetts generally will be subject to the Massachusetts corporate excise of 9.5% on the investment income (including capital gains) generated by these interim investments. Moreover, the amount of the offering proceeds may be substantial enough to cause the corporation to be classified as an intangible property corporation for Massachusetts tax purposes. An intangible property corporation will be liable for an additional Massachusetts corporate excise of 0.26% of its net worth allocable to Massachusetts. For this purpose, a corporation generally is an "intangible property corporation" if, at year end, the ratio of its tangible assets located in Massachusetts to its total assets located in Massachusetts is less than 10%.

The MSC Solution

In certain cases, placing the proceeds of a public offering in a subsidiary that qualifies as a Massachusetts security corporation (an "MSC") can alleviate these tax burdens. In particular, the use of an MSC can provide relief from both the income measure and the net worth measure of the Massachusetts corporate excise. An MSC is not subject to the normal corporate excise of 9.5% on its net income and is not subject to the normal corporate excise of 0.26% on its net worth. Instead, an MSC generally is taxed at the rate of 1.32% of its gross income (subject to a minimum tax of $456). See the chart below for a simple hypothetical example of how state taxes can be reduced through the use of a subsidiary qualified as an MSC.

MSC Requirements

The subsidiary formed to be an MSC can be either a Massachusetts or foreign (e.g., Delaware) corporation. In general, to qualify as an MSC, the subsidiary must engage exclusively in buying, selling, dealing in, or holding securities (except securities of a DISC) on its own behalf and not as a broker.

For purposes of qualifying a subsidiary as an MSC, the term "securities" has a narrower meaning than the common meaning of that term or its meaning for securities laws purposes. Securities qualifying as permissible investments generally include publicly traded securities such as publicly traded common stocks and bonds. To the extent that investments are made in other types of "securities," the corporation runs the risk of failing to qualify. For example, intercompany loans or notes received in connection with a lending business or in a disposition of a prior business are not acceptable investments, even though they may qualify as "securities" for other purposes. Moreover, it is possible that certain investments, such as private placements, will involve activities deemed by the Department of Revenue to be beyond the scope of "investment activities." All securities must be purchased for investment purposes only and must not involve the MSC in the operation of any portfolio companies. Furthermore, an MSC must act on its own behalf and should not be used as a bank account by its shareholder(s). Proper and separate accounting records should be maintained, and all transactions between the parent corporation and the MSC subsidiary should be properly documented.

In addition to the above operational requirements, in order to qualify as an MSC, a corporation must file a request with the Department of Revenue to be classified as an MSC by the end of the first year in which it wants to be taxed as an MSC. Once classified, the corporation need not file a request to be classified as an MSC for subsequent years unless its MSC status is subsequently revoked.

Delaware Holding Company Alternative

As an alternative to an MSC, some corporations seeking investment vehicles organize a Delaware subsidiary as a holding company for investments. Under Delaware law, such a holding company may qualify as a "passive investment company," which is not subject to Delaware tax. Unlike an MSC, a Delaware holding company has the advantage of being able to hold intangibles other than securities, such as patents, licenses, and copyrights. Moreover, compared to MSCs, which are frequently audited and challenged by the Massachusetts Department of Revenue, a Delaware holding company is less likely to be challenged by Delaware tax authorities.

Nevertheless, in order to avoid Massachusetts taxation of the Delaware holding company, it is essential to establish its presence in Delaware and to avoid the establishment of any presence in Massachusetts. This may be difficult if the holding company's investment activities are to be supervised or managed by personnel in Massachusetts. Moreover, Massachusetts has recently adopted an aggressive position that seeks to expand its jurisdiction to tax entities that license intangible property to Massachusetts licensees, even where such companies have no physical presence in the state. Forming a subsidiary to hold investments as an MSC may be the best means of reducing Massachusetts tax burdens resulting from investment holdings following a public offering.

Effect of MSC on Massachusetts Tax Liabilities Attributable to Investment Assets

The following chart illustrates an example of how an MSC subsidiary can reduce Massachusetts tax liabilities.

Assumptions:

1. All income and net worth is 100% allocable to Massachusetts.
2. Parent Corporation is an intangible property corporation as a result of its intangible assets.
3. The first column illustrates the Massachusetts tax liability of the parent corporation holding the investment assets, and the second column illustrates the combined Massachusetts tax liability of the parent and an MSC subsidiary that holds the investment assets.

	Parent Corporation	**Parent Corporation & MSC**

Gross Investment Income	$ 1,100,000	$ 1,100,000
Net Investment Income	$ 1,000,000	$ 1,000,000
Massachusetts Excise on Income	@ 9.5% $ 95,000	@ 1.32% $ 14,520
Net Worth *(attributable to investment assets)*	$10,000,000	$10,000,000
Tax	@ 0.26% $ 26,000	$ - 0 -
Total Tax	$ 121,000 $ (14,520)	$ 14,520
State Tax Savings Attributable to Use of an MSC	$ 106,480	

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