



MULTISTATE TAX COMMISSION

Working Together Since 1967 to Preserve Federalism and Tax Fairness

To: MTC Executive Committee

From: Sheldon H. Laskin

Date: March 7, 2011

Subject: MTC Non-Corporate Income Tax Payer Project

The purpose of this memo is to present the attached draft model statute for consideration by this Committee for submission to public hearing pursuant to Article VII of the Multistate Tax Compact.

I
Background

This project was initiated following a request dated February 12, 2008 from the Massachusetts Commissioner of Revenue, Navjeet Bal, to Jan Goodwin, the then-Chair of the Multistate Tax Commission and to MTC Executive Director Joe Huddleston. Commissioner Bal expressed concerns about tax equity issues raised by current state tax laws as applied to insurance companies. In most states, insurance companies are taxed only on their gross insurance premiums and are not subject to income tax. As a result, insurance companies with ownership interests in pass-through entities such as partnerships and limited liability companies receive income that flows through those entities and avoid income tax on that income, either when received by the flow through entity or when ultimately received by the insurance company. In contrast, corporations that are subject to income or franchise tax would pay tax upon receipt of income from an affiliated flow-through entity. The disparity in tax treatment presents serious tax equity issues as insurance companies are free to invest in non-insurance businesses that are identical to the business investments of taxable corporations and/or, in the case of a diversified business that includes an insurance company, may restructure the enterprise such that the insurance company comes to own a controlling interest in a non-insurance business that is structured as a flow-through entity. The Uniformity Committee initiated a project at its Spring 2008 meeting to address this issue with respect to pass-through entities owned by any entity that is a non-corporate income taxpayer.

The Income and Franchise Tax Subcommittee formed a drafting group to gather and provide educational information and identify policy issues for the Subcommittee to work through, and then to draft a proposed model statute in accordance with the Subcommittee's policy choices for

the Subcommittee's consideration. The drafting group consisted of Michael Fatale, Brenda Gilmer, Phil Horowitz, and Carl Joseph. The drafting group met regularly by teleconference. The subcommittee regularly directed the drafting group to prepare modified drafts for the subcommittee's consideration, following discussion of each proposed draft during the subcommittee's regularly scheduled meetings.

II Education

The subcommittee began by initiating an educational effort to familiarize itself with issues associated with this project, both historically and at the present. Because the tax treatment of insurance companies is unique and particularly technical, much of the educational effort focused on that industry.

The drafting group was responsible for organizing four educational presentations to the Subcommittee. The first was a presentation by insurance industry representatives explaining the industry's perspective on the retaliatory tax issue in general and as implicated by the Massachusetts legislative proposal. Briefly, industry is of the view that subjecting the income of non-insurance affiliates of insurance companies to income tax could raise retaliatory tax issues in at least some states, because the economic incidence of any tax would flow through to the insurance company. Industry also raised concerns that the adoption of a model statute similar to that in the attached drafts could have unintended and adverse consequences as a result of subjecting the non-insurance income of insurance companies to income taxation at the pass-through level. The second presentation was given by Gary Johnson who is with the Texas Comptroller of Public Accounts and provided an overview of state regulation and taxation of insurance companies in general. The third presentation was given by Brenda Gilmer, and explored the federal tax treatment of insurance companies, particularly overcapitalization issues. Finally, the fourth presentation, by a representative of the New York Department of Taxation and Finance described New York's experience in imposing an income tax on life insurers. In New York, the income of life insurance companies is subject to income tax, but only if the tax would fall within a very narrow range based on a percentage above and below what the gross premium tax is. As such, New York's experience is unlikely to be typical of a tax without such a narrow triggering mechanism. The New York presentation also described that state's recent legislative attempt to address issues that relate to "captive" insurance companies.

In addition, MTC staff informed state insurance commissioners of the project on a number of occasions and, although they did not do so, the commissioners were invited to participate in the project at any stage and in any way so as to inform the subcommittee of the regulators view of the issues raised by the project.

III Summary of Proposal

The attached draft proposal was adopted by the Income and Franchise Tax Subcommittee in October, 2010.

The draft would impose tax not on the ownership entity but at the pass-through level. The draft is designed to address concerns that the tax equity issues raised by the ability of non-taxable entities to engage in business activities through pass-through entities may well apply to businesses other than insurance.¹ Therefore, the draft is written to apply more broadly than to pass-through entities owned by insurance companies alone. Tax would be imposed on certain listed partnerships or disregarded entities that are at least 50% owned by an ownership entity including an insurance company, but excluding a non-profit entity, that is not subject to certain specified state taxes. The draft allows each state to specifically list the ownership entities that would be appropriately within the scope of the draft and lists “an insurance company” as an example of such an entity.

At its meeting on December 8, 2010, the full Uniformity Committee voted to send the draft to this Committee for its consideration for submission to public hearing.

¹ It should be noted that the purpose of the draft proposal is not primarily to address tax avoidance concerns. Rather, the primary concern that the proposal is designed to address is a tax equity issue raised by the historical tax treatment of insurance companies in combination with the modern proliferation of non-taxable pass-through entities. The theory behind the non-taxability of pass through entities is that the income is eventually subject to tax at the ownership level. The justification for not taxing the income of pass through entities disappears if the ownership entity is itself not subject to tax.

**MTC proposed statute regarding partnership or pass-through entity income
that is ultimately realized by an entity that is not subject to income tax
As Approved by the Income & Franchise Tax Uniformity Subcommittee
October 19, 2010**

When 50 per cent or more of the capital interests or profits interest in an entity for which deductions would be allowed under section 162 of the Internal Revenue Code, 26 U.S.C. 162 and that would otherwise be treated as a partnership or disregarded entity for purposes of *[insert applicable state tax or taxes]* is owned, directly or indirectly, by *[identify each entity type that is not subject to income tax and that state wants to cover under this provision, such as “an insurance company,” with a citation to the state tax statute applicable to each such entity type]*, the net income *[or alternative tax base]* that passes through to such *[name each entity type identified above, e.g. “insurance company.”]* shall be taxed to the partnership or disregarded entity as if the partnership or disregarded entity were a corporation subject to tax under chapter *[insert state statute]* To the extent applicable, income that is taxable to the partnership or disregarded entity pursuant to this section, and any related tax attributes and activities, shall be included and taken into account in a combined report filed under *[insert state statute]*. As used herein, the term “partnership or disregarded entity” shall include a real estate investment trust (REIT) within the meaning of Section 856 of the Internal Revenue Code of 1986, as amended.