



**MULTISTATE TAX COMMISSION**

*Working Together Since 1967 to Preserve Federalism and Tax Fairness*

**To: Uniformity Committee, Income and Franchise Tax Subcommittee**

**From: Sheldon H. Laskin**

**Date: July 20, 2012**

**Subject: Report from Drafting Group re Partnership or Pass-Through Entity Income  
Ultimately Realized by an Entity That is Not Subject to Income Tax**

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## Introduction

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 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 on a tax-free basis, 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 Executive Committee sent the matter to the Uniformity Committee for development. The Uniformity Committee then initiated a project at its Spring 2008 meeting, but broadened the topic 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 at various times included Michael Fatale (MA), Brenda Gilmer (MT), Phil Horowitz (CO), Carl Joseph (CA), and Frank O'Connell (GA). 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. In the Spring of 2011, the Subcommittee approved a model proposed statute that would impose income tax on a partnership or limited liability company that is more than 50% owned by a non-taxable entity and voted to recommend that the Executive Committee send the proposal to a public hearing. The Executive Committee approved the proposal for hearing and a hearing was held on May 16, 2011. A copy of that proposal, with the Hearing officer's proposed modifications following public hearing, is attached hereto as Exhibit 1. On June 6, 2011, the Executive Committee met by teleconference to consider the Hearing Officer's report and recommendations regarding this proposed model statute, and whether or not the model should be sent to a bylaw 7 survey. After significant public comment from insurance industry representatives and committee discussion, the Executive Committee voted to continue its deliberations to its July 28, 2011 meeting in Whitefish, Montana.

At the July 2011 meeting, the Executive Committee heard again from insurance industry representatives who acknowledged the issue that the model addresses, expressed their belief that there is a better approach to address the issue than the current proposed model, and expressed their willingness to assist the Uniformity Committee in developing the alternative approach. The Executive Committee then voted to request the Uniformity Committee consider additional proposal(s) from the industry and provide additional information back to the Executive Committee. The Executive Committee specifically requested the Uniformity Committee to develop a chart, or matrix, showing the significant tax issues raised when corporate income taxpayers and non-corporate income taxpayers are commonly owned, and the existing MTC models, proposed MTC models, and other options for addressing each issue.

Following the July 2011 Executive Committee meeting, the Subcommittee continued to work with industry representatives (the Trades) and insurance regulators in an effort to find common ground. The drafting group periodically met with the Trades by teleconference, during which the Trades presented their position that the MTC model was unnecessary, would likely trigger retaliatory tax and that existing anti-abuse mechanisms adequately address issues raised by insurer overcapitalization and captive insurance companies. The drafting group considered the Trades' position in its reconsideration of the MTC model. A summary of the drafting group's work as of February 2012 is provided in a staff memo to this committee dated February 24, 2012, a copy of which is attached as Exhibit 2. At the Subcommittee's March meeting, Michael Fatale gave a presentation to the group regarding the history of this issue with respect to the Insurance Industry. The Trades formally presented their proposed alternative model language with supporting material, on March 29, 2012.<sup>1</sup> The Trades stated of its submission that:

- 1) It reiterates the insurance industry's strong belief that if this project is even necessary, the potential abusive use of an insurance company to evade taxes should be its focus. From the outset of this project the industry has made it clear that we believe the tax treatment of LLCs and partnerships owned by insurance companies cannot be separated from the rationale for and truly unique nature of the premium/retaliatory tax system imposed on the insurance industry. When viewed holistically as it should be, the insurance industry reasserts there is no issue of equity.
- 2) It provides feedback on an important aspect of the Executive Committee's discussion at last July's annual meeting that focused on whether tools already exist that can be used or enacted by states to address overcapitalized insurance companies/abuses.
- 3) As requested by the Executive Committee at the annual meeting last July, it provides revised draft model language aimed at addressing the potential abusive use of an insurance company to evade taxes.

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<sup>1</sup> The Trades model language and supporting material is available on the MTC website at <http://www.mtc.gov/Uniformity.aspx?id=5619>.

4) It responds to the Uniformity Committee's February 10 request for additional analysis of potential retaliatory tax implications as a result of the project's current model language.

Email Submission From the Trades, March 29, 2012

Finally, the Executive Committee considered this project during an informational session at its meeting on May 10, 2012. Mr. Fatale again gave his presentation. Representatives of the Trades were present, submitted a supplemental statement dated May 8, 2012 and summarized their position.

Briefly, the Trades again questioned the necessity for the proposal, asserted that existing enforcement tools currently exist that are sufficient to address whatever problems there may be in respect to captive insurers and overcapitalization, and expressed concerns that the proposal could subject insurers to retaliatory tax. The Trades' position is more thoroughly discussed in the remainder of this memo. The discussion in this memo reflects the views of the drafting group expressed during the drafting group meetings.

## **I. History and Scope of The Problem**

Under current law, pass-through entities such as partnerships and limited liability companies (LLCs) are entitled to an exemption from state income tax. As income realized by those pass-through entities is passed through to the partners or members, it is subject to state tax at the ownership level. It is precisely to avoid double taxation – initially at the pass-through level and then again at the partner or member level – that the pass-through is afforded tax exempt status. It is *not* the purpose of affording pass-through entities tax-free status to permanently exempt the income itself from taxation. Rather, the income is subject to tax when received by a taxable entity or individual. However, if the ultimate recipient of the income is *itself* not subject to income tax, then the income will not be taxed at all. This was never the intent behind affording tax-free status to pass-through entities.

For example, insurance companies are generally subject to gross premiums tax in lieu of a net income tax. To the extent that insurance companies conduct non-insurance lines of business through pass-through entities, the income of those pass-through entities is currently not subject to tax at any point in time; not when earned by the pass-through and not when paid to the insurance company. This creates a tax inequity between pass-through entities that engage in precisely the same lines of non-insurance business, depending on whether the parent of those entities is an insurer or a taxable entity. Because the insurance industry has worked with us to raise specific issues, throughout this memo we will address their specific issues and continue to discuss the project using the insurance industry situation as a backdrop, even though it should be remembered that the model would apply to other industries or entities as well if those industries or entities are not corporate income tax payers.

This inequity is of relatively recent derivation. Michael Fatale has conducted an analysis of insurance industry organizational charts provided by the Trades, in order to trace the development of LLCs and other pass-through entities owned by insurance companies over the past 20 years. He has twice presented a summary of his analysis, initially during a drafting group teleconference on February 10, 2012 and then at an MTC Executive Committee meeting on May 10, 2012. Those charts show that the business structure of insurance companies over that time frame has reflected the general business trend over approximately the past 20 years, to structure lower-level entities in pass-through form.<sup>2</sup> Some examples from Mr. Fatale's research illustrate the growth of non-insurance lower-level LLCs whose assets are under management by insurance parents.

1. John Hancock Life Insurance Company. In 1999, John Hancock's SEC-filed organization group showed the John Hancock affiliated group owned no LLCs, while it did own two corporations. By 2011, the SEC-filed organization charts showed at least five non-insurance LLCs owned either directly or through one or more other LLCs by John Hancock. According to "Find the Best", the Internet listing for one of these LLCs – Management, LLC— currently manages two hundred accounts totaling an estimated \$117,290,206,047 of assets under management.
2. Hartford Life Insurance Company. In 1998, Hartford's SEC-filed organizational chart shows the Hartford group owning no LLCs. Several LLCs appeared on the chart the following year. By 2010, the number of LLCs owned by or owning other LLCs in the Hartford group had grown to at least six. One – RVR LLC – was formed on April 29, 2009 to take title to and manage real property. According to "Find the Best", Investment Services, LLC manages 55 accounts totaling an estimated \$59,397,017,574 of assets under management and HL Advisors manages 33 accounts totaling an estimated \$45,029,570,030 of assets under management.
3. Pennsylvania Mutual Life Insurance Company. Janney Montgomery, a Philadelphia-based regional retail brokerage, was acquired by Penn Mutual in 1982. It was converted to an LLC in 1999. According to "Find the Best", it currently has \$8,918,685,956 of assets under management.

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<sup>2</sup> According to a recent article in the Wall Street Journal, "the percentage of U.S. corporations organized as nontaxable businesses has grown from about 24% in 1986 to about 69% as of 2008.... The percentage of all firms is far higher when partnerships and sole proprietors are included. By some estimates, more than 60% of U.S. businesses with profits of \$1 million are structured as pass-throughs, the highest rate among developed countries...." *More Firms Enjoy Tax-Free Status*, by John D. McKinnon (WSJ, January 10, 2012).

The magnitude of the assets involved in these examples illustrate the central issue presented by use of a pass-through structure when the corporate parent is itself not subject to tax – it was never contemplated that use of a pass-through structure would result in creating a class of pass-through entities whose income would be nontaxable at any level, merely because the parent is itself not subject to tax. In the specific context of insurance, it was never contemplated that the “in lieu of” premium tax would shield income of this magnitude from taxation at the pass-through level.

The Trades do not dispute that the current structure of the insurance industry allows otherwise taxable income to escape state income tax entirely, either at the pass-through or at the insurance company level. Rather, they respond in a number of ways. First, they question the need for the proposal at all, noting that non-insurance lines of business conducted from within the insurance company *itself* have never been subject to state income tax. Second, they point out that the gross premium tax results in more state revenue than would a net income tax. Next, they assert that the MTC’s proposal would create tax equity issues of its own. They further argue that the adoption of the proposal could have adverse retaliatory tax consequences. In general, they urge the states to be aware of the risk of unintended consequences in making any changes to the current tax treatment of pass-throughs owned by insurance companies.

## **II. Non-insurance lines of business conducted within insurance companies**

The Trades note that historically insurance companies conducted non-insurance lines of business from within insurance companies themselves. Current state insurance regulations regarding capitalization and claim reserves make it very difficult for non-insurance income to come out of the insurance company without regulatory approval. Therefore, there are non-tax reasons for insurance companies to put non-insurance lines of business into a non-insurance pass-through. As there is no loss of income tax revenue in doing so – the income was not previously subject to tax – the Trades question the need for the current proposal.

As Mr. Fatale’s presentation makes clear, the problem that the proposal seeks to address is that non-insurance lines of business that were formerly conducted by non-insurance corporate subsidiaries of the insurer on a taxable basis are now being conducted in pass-through form and therefore escape taxation at any level. And, as Mr. Fatale’s presentation also makes clear, this is a relatively new phenomenon. That insurers may formerly have conducted non-insurance lines of business from within the insurance company itself is not germane to this concern. Again, the focus of this proposal is on non-insurance lines of business that were formerly subject to state income tax as a corporate subsidiary of an insurer but are no longer because they are currently held in pass-through form. Having said that, the MTC remains open to considering any language the Trades might wish to submit that would create an exception to the proposal for non-insurance

lines of business that were formerly conducted on a tax-free basis from within the insurer itself and are now conducted in pass-through form.<sup>3</sup>

### III. Tax Equities

The Trades maintain that it would be inequitable to impose state income tax on an LLC owned by an insurance company, because doing so would preclude an insurer from being able to offset its losses against LLC taxable income as insurers are generally not subject to state income tax.

The Trades' position inverts the basis upon which *taxpayers* are allowed to offset losses against income *received* by the taxpayer. If the model is adopted, it would be the LLC and not the insurer that would be the taxpayer.<sup>4</sup> But the Trades hypothetical presupposes that the LLC did not sustain a loss; if it had, there would be no tax. Instead, the Trades objection is based on the fact that the LLC would not be allowed to offset *its* taxable income with a loss incurred by the nontaxable insurance company. This type of "loss offset" on income earned by the taxpayer that subsequently flows up to a nontaxpayer does not exist in state income tax law.

Having said that, there are loss scenarios under which the insurance company and its LLCs would benefit from losses under the proposal.

First, in years in which the LLC realizes a tax loss and the insurer realizes income, the LLC would pay no tax and the state could not offset the insurer's income against the LLC loss, because the insurer is not ordinarily subject to state income tax.

Second, to the extent the LLC's allowable losses in any one year are subject to a cap, ordinarily the LLC itself would be able to carry its unused losses forward to subsequent years in which it realizes income. In this situation, there is an offset against income, entirely at the LLC level.

Third, if imposition of income tax at the LLC level would be at all relevant to the calculation of retaliatory tax, any year in which the LLC realizes a loss would reduce retaliatory tax below what it would be under current law. Under the current tax regime, those losses are unavailable to the insurer at all, because the LLC isn't subject to income tax.

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<sup>3</sup> At the May 10, 2102 MTC Executive Committee meeting, Bruce Johnson, a member of the MTC Executive Committee, expressed a willingness to consider a "rebuttable presumption" that would allow a pass-through, in an appropriate case, to demonstrate that the proposal ought not apply to it and invited industry to submit suggested language. To date, the Trades have not responded.

<sup>4</sup> The Trades have consistently opposed imposing tax on the flow-through income received by the insurer. If the tax were imposed on the insurer, the insurance company would be able to offset its losses against the income received.

#### IV. Retaliatory Tax

The Trades have consistently maintained that imposing state income tax on LLCs owned by insurers could subject insurance companies to additional retaliatory tax in states that do not adopt the MTC proposal. The regulators who have participated in the project express uncertainty regarding whether the retaliatory tax would apply or not.

In taxation, as in life, one should always be cautious about unintended consequences. It is certainly not the intent of this project to subject insurers to additional retaliatory tax in any state. Where retaliatory tax is concerned, caution is particularly advisable because the states are free to impose retaliatory tax free of the restrictions ordinarily imposed on state taxation by the Commerce Clause. While other provisions of constitutional law – such as the due process and equal protection clauses – do provide some limits on state discretion to impose retaliatory tax, for the most part the only limitations on a state’s ability to impose retaliatory tax are those contained in state law. This makes prediction of the likely consequences of imposing income tax on an LLC owned by an insurer particularly difficult. The best that can be done is to make a reasonable assessment of the likelihood of this occurring, and weigh that determination in the balance of all the other reasons for and against the proposal.<sup>5</sup>

Staff has analyzed the memo entitled Retaliatory Tax Risks Under the MTC Model, supplied by the Trades.<sup>6</sup> It appears from the memo that retaliatory tax can be imposed on insurance companies and their agents and representatives, if the insurer’s home state imposes taxes, licenses or fees on foreign insurers that exceed those imposed by that foreign state.<sup>7</sup> In filing its annual premium and retaliatory tax return, an insurer is required to state other taxes and fees to which it is subject so as to calculate any applicable retaliatory tax.<sup>8</sup> It is extremely difficult to see how an LLC would be considered an agent or representative of an insurer -- and hence subject to retaliatory tax --, merely because the insurer has an ownership interest in the LLC. Nothing in these materials suggests that an affiliate of an insurance company that is not itself an insurance company, agent or representative is subject to the gross premium or the retaliatory tax. Therefore, it does not appear that state income tax imposed on a non-insurance

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<sup>5</sup> One factor in making this determination is the likelihood that imposition of retaliatory tax by one state is likely to have a snowball effect in inducing other states to, as the name of the tax explicitly says, retaliate against insurers based in that state. The Commerce Clause would preclude this from occurring in regards to any other tax. But the whole purpose behind the retaliatory tax is to allow a state to protect its domestic insurers from adverse taxation in other states by allowing the state to retaliate against foreign insurers if those states impose a tax burden on the domestic insurer that its home state does not.

<sup>6</sup> NAIC and the Trades have submitted extensive materials regarding state retaliatory tax, for which staff is very grateful. Again, these materials are available on the MTC website at <http://www.mtc.gov/Uniformity.aspx?id=5619>

<sup>7</sup> Code of Alabama, §27-3-29, cited in the Trades’ memo.

<sup>8</sup> The Trades provided three blank state gross premium and retaliatory tax returns, copies of which are available on the MTC website at <http://www.mtc.gov/Uniformity.aspx?id=5619>

affiliate of an insurance company would figure into the retaliatory tax calculation. Indeed, the Trades acknowledge that states currently impose income tax on non-insurance corporate affiliates in which insurers have an ownership interest, apparently without triggering additional retaliatory tax on the insurers. It is therefore unclear why imposing the same tax, on the same terms, on LLCs in which insurers have an interest would produce a different result. The Trades suggest that such a tax could lead to retaliatory tax, because imposing such a tax would merely create a “legal fiction” to allow the states to impose tax on the investment income of insurance companies.<sup>9</sup>

All businesses, in whatever form conducted, are legal fictions. This is true of a corporation as much as it is of an LLC. These entities are created by state law, and subject to the terms and conditions of that law. That Congress has chosen to provide a tax exemption for LLCs and other pass-through entities at the federal level in no way limits the state’s power to limit the pass-through exemption where it is overbroad, in order to plug a loophole or for any lawful reason. See, for example, *Commonwealth of Pennsylvania v. N.I., Inc.*, 375 A. 2d 898 (PA Cmwith Ct 1977) (State is free to impose capital stock tax and corporate net income tax on Subchapter S corporation, notwithstanding contrary federal tax treatment). This loophole does not exist at the federal level – where the federal corporate income tax IS imposed on insurance companies. The situation is unique to state taxation. States frequently impose tax on LLCs and other pass-through entities to address particular problems unique to state taxation. For example, nexus considerations have led a number of states to require LLCs and partnerships to either withhold income tax from non-resident members or partners or to pay the tax themselves, even though there is no need for such a requirement at the federal level.<sup>10</sup> Furthermore, the District of Columbia currently imposes income tax on pass-through entities themselves.<sup>11</sup> There is every reason to believe that the DC law **currently** applies to non-insurance LLCs in which an insurance company has less than 100% ownership. Apparently, there have been no adverse

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<sup>9</sup> It is worth noting again that the MTC proposal is not limited to insurance companies. Other entities that are not subject to state income tax, such as non-insurance financial institutions or telecommunication companies, would also be covered by the proposal. A claim that insurers are being discriminated against would not appear to be viable for retaliatory tax purposes merely because the tax may also fall on LLCs that are owned by insurers.

<sup>10</sup> See, for example, Cal. Rev. & Tax Code §§18662, 18668(a), Reg. 18662-1, Reg. 18662 – 11, 18662 -12, 18862 – 12 (entity doing business in California must withhold and pay tax on income distributed to non-resident shareholders, partners or members. Failure to do so subjects the entity to tax); Ga. Code Ann. §48-7-129(a) (3) and (4), Ga. Comp. R. & Regs. R. 560 – 7 – 8 – 34 (entity doing business in Georgia jointly and severally liable for income tax required to be withheld from income distributed to non-resident shareholders, partners or members. Entity subject to 25% penalty for failure to withhold); Md. Code Ann. §10 – 102.1(b) and (c)(1) (entity doing business in Maryland must withhold and pay tax on income distributed to non-resident shareholders, partners or members. Tax is imposed directly on the entity and treated as if paid on behalf of non-resident). I acknowledge the excellent work of MTC legal intern Lila Disque in preparing a summary of applicable state laws on state taxation of pass-through entities.

<sup>11</sup> See, for example, D.C. ST. §47 – 1808.01 (tax on unincorporated business), §47 – 1808.06 (tax on partnerships), §47 – 1808.06a (LLC classified as partnership for unincorporated business tax unless otherwise classified for federal income tax purposes).

retaliatory tax consequences as a result, notwithstanding that the insurer's investment income would be reduced to the extent that the LLC chose to pay the member's tax directly.

In addition, the justification for requiring pass-throughs to pay income tax when owned by a non-taxable entity has nothing to do with the fact that the owner may be an insurer. The central rationale behind the non-taxation of pass through income is that the income will eventually be passed through to an entity that is subject to state income tax and therefore will be taxed then. But that rationale vanishes when the income is never realized by a taxable entity. As in the case of a partnership with non-resident partners, precedent amply supports the attempt by the states to address a tax inequity that has become compelling as non-taxable entities move increasingly towards conducting other business activity in pass-through form. The Trades position would completely hobble the states' sovereign right to adjust their tax laws in light of an ever evolving economy on the mere assertion that doing so might trigger retaliatory tax.<sup>12</sup>

In essence, the Trades are asserting that whenever a change in state tax law can reduce an insurance company's return on investment, retaliatory tax is a possibility even if the tax is not imposed on the insurance company. It is difficult to see what the outer boundary of such an interpretation would be. Changes in state tax law frequently have economic consequences for third parties such as taxpayer employees, shareholders and customers. Nevertheless, the states have the sovereign authority to make any lawful change to state tax law that appears to be warranted. It does not appear that there would be support in the retaliatory tax statutes, case law or regulations for an assertion that imposing tax on a non-insurance LLC in which an insurance company has an interest should trigger retaliatory tax.

## **V. Trade Suggested Existing Tools to Address MTC Concerns Relating to Certain Income Tax Abuses/Inequities**

The Trades have submitted a list of existing tools that some states use to address certain abusive tax situations. As a preliminary matter, it is not at all clear that the Trades are *advocating* that any or all of these tools be incorporated in the MTC model proposal. Instead, the Trades simply list these tools, all of which currently exist in various forms, without taking a position as to whether the Trades in fact support their adoption. In any event, while these tools have merit in addressing certain abuses – and the states have begun to move in fashioning similar abusive tax remedies – they are not responsive to the tax equity issue that the proposal is designed to address; the conversion of formerly taxable income to tax-free income because the pass-through is owned by a non-taxable entity.

### **1. Combined Reports for Unitary Groups**

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<sup>12</sup> Dan Schelp, Managing Counsel of NAIC has offered to have NAIC perform a state survey of whether the states would impose retaliatory tax if the MTC's proposal were to be enacted into law. Staff informs the committee of Mr. Schelp's offer for whatever action the committee wishes to take.

Combined reports would not solve the equity issue that the proposed model is designed to address. First, it is not clear that a unitary group consisting of an insurance company and even a wholly owned pass-through entity would have any responsibility to file a corporate income tax return at all – with or without combined reporting. Second, even if a corporate income taxpayer were also a member of the unitary group, non-taxable entities are not ordinarily included in the combined group.<sup>13</sup> But even if they were, combining a non-taxable entity in a unitary group with its taxable affiliates in order to properly reflect the income of all members of that group does not itself subject the non-taxable entities to tax. Therefore, the income received by those non-taxable entities from tax-exempt pass-through entities would remain non-taxable both at the pass-through and at the recipient level.

## 2. Section 2.B of MTC’s Combined Report Model

The Trades note that Section 2.B of the Commission’s combined report model statute allows for the inclusion of insurance companies in a combined report with their non-insurance company affiliates in certain instances. Section 2.B of the Commission’s combined report model statute provides, in relevant part;

**2.B. Combined reporting at Director’s discretion, when.** The Director may, by regulation, require the combined report include the income and associated apportionment factors of any persons that are not included pursuant to Section 2.A., but that are members of a unitary business, in order to reflect proper apportionment of income of entire unitary businesses. Authority to require combination by regulation under this Section 2.B. includes authority to require combination of persons that are not, or would not be if doing business in this state, subject to the [State income tax Act].

The Hearing Officer’s Report for the combined report model statute explains the purpose of Section 2.B.

Under the proposed model statute, only corporations subject to an income tax are specifically required to be combined. However, it is recognized that a single unitary business may be carried on by many types of business entities acting together, not just corporations and certainly not just corporations that are corporate income taxpayers. It is also recognized that it would be theoretically correct and, in many states, legally acceptable to statutorily require the inclusion of all such business entities in the combined group in order to properly apportion the income of the entire unitary business. In recognition of the theoretical basis for combination of all entities engaged in the unitary business, the model statute also authorizes combination of unitary non-corporate-income taxpayers to be required by regulation, provided such combination can be accomplished in a manner that will generally reflect a reasonable apportionment of income for those types of unitary entities. This theoretical consideration would not have been much of an issue until a few years ago - when the federal government began breaking down some of the barriers between different types of financial services industries. One outcome of

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<sup>13</sup> But see the discussion of Section 2.B of the Commission’s combined report model statute, immediately following this paragraph.

these changes is that industries such as banking and insurance companies, which are often not corporate income taxpayers, may now branch out and engage in a unitary business with other financial service industries that are subject to the corporate income tax.

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In addition to the theoretical basis for such inclusion, it was also recognized that including non-taxable entities in a combined group does *not* subject those entities, or their income, to a state's corporate income tax. For example, unitary entities that do not have nexus with the state, and cannot be taxed by the state, are routinely included in the combined group. Including these non-taxable entities in the combined group only includes those entities' income from the unitary business in the total pot of unitary business income from which the taxable corporations' share is apportioned. The tax is then levied only on the taxable corporations' and their share of that income. The nontaxable

corporations are not subject to the tax. Nor is any of the income from the unitary business that is attributable to those entities subject to tax.

This distinction was recognized in *State ex rel. Dept. of Revenue v. Penn Independent Corp.*, where the Oregon Tax Court found the apportionable income of a unitary group should include the income of an insurance corporation even though that corporation was not subject to Oregon's corporate income tax, but instead paid a gross premiums tax. The Tax Court noted "[i]t is important to remember that including the income of a nontaxable member of a unitary group does not subject that income to taxation by Oregon. It merely provides the base from which the taxable corporation's share is apportioned." Indeed, the appropriateness of this holding has been recognized by Walter Hellerstein: "Although the result in this case is unusual, Judge Byers's thoughtful analysis of the theoretical justification for the result is plainly correct."<sup>14</sup>

Clearly, including an insurance company in a combined report does not subject that insurance company to state income tax unless state law otherwise so provides. Therefore, a discretionary decision to combine insurance companies with non-insurance affiliates would not, in most states, result in the income received by insurers from pass-through entities to be subject to tax. The model combined report statute is designed to properly reflect the income of a unitary group that includes a non-taxable entity. But because the model combined report statute does not itself subject a non-taxable entity to tax, it is not an appropriate tool for addressing the equity issue with which the current proposed model is concerned.

### **3. Income tax with credit for income tax paid to be applied to premium tax.**

At least 7 states subject insurance companies to the corporate income tax, typically in combination with a credit against the insurer's premium tax liability in the amount of income tax paid.<sup>15</sup> Such a tax would include income received from pass through entities.

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<sup>14</sup> Report of the Hearing Officer Regarding the proposed Model Statute for Combined Reporting (April 25, 2005), 10 – 11, footnotes in original omitted.

<sup>15</sup> Those states are FL, IL, MS, NE, NH, NY (life insurance only), and OR.

It is somewhat surprising to see this option included in the Trades' list of existing tools. Throughout the history of this project – indeed, from the initial attempt by Massachusetts to impose income tax directly on insurers – the Trades have consistently maintained that doing so would subject insurers to retaliatory tax. If the retaliatory tax concern were valid it is unlikely that the premium tax credit would eliminate the possibility of retaliatory tax being triggered by the imposition of income tax on insurers. It would still be the case that insurers licensed in a state that did not impose an income tax would be treated less favorably in a foreign state that did impose tax than it would in its home state. While the premium tax credit might in some cases reduce the *amount* of retaliatory tax that would otherwise be due (because the premium tax paid by the foreign insurer to the offending state would be lower), it is by no means clear that the credit mechanism would totally eliminate the retaliatory tax issue. If there is any validity to the Trades' retaliatory tax concern, the model proposal is less likely to trigger retaliatory tax because under the model the tax is imposed on the pass-through entity, not the insurer.

In any event, it is beyond the scope of this project to recommend that tax be imposed on insurers that are not currently subject to tax, particularly in combination with a credit for premium tax paid. The charge to the Uniformity Committee was to more narrowly address an inequity in the current income tax system, not to rewrite the tax system for insurers. The model proposal seeks to address the inequity modestly; by eliminating the tax-exempt status of pass-throughs if those entities pass income to an entity that is not subject to income tax. Subjecting insurers to income tax, with a credit for premium tax paid, would fundamentally change the way insurance companies are generally taxed at the state level, and would negatively impact revenue derived from a totally different tax – the premium tax. Doing so could raise profound policy issues under a tax regime that is beyond the scope of the Multistate Tax Compact. This tool may well have merit if individual states wish to adopt it, but the Commission is simply not in the best position to make that determination.

#### **4. Discretionary Adjustments to Properly Reflect Tax**

The Trades list discretionary adjustments to properly reflect tax as an existing tool to address the MTC's concerns relating to certain income tax abuses and inequities. It is certainly the case that discretionary administrative adjustments to tax are intended and designed to address various tax avoidance strategies. See, for example, Amended Hearing Officer's Report, Recommendation Concerning Proposed Multistate Tax Commission Model Statute Requiring the Add-back of Certain Intangible and Interest Expenses, p.1 (October 10, 2005) ("Expense add-back statutes were initially developed to deal with the common tax avoidance scheme of using intangible holding companies to shift income earned in a state to another jurisdiction in which that income was not taxed"); *Syms Corp. v. Commissioner of Revenue*, 436 Mass. 505 (2002) (Massachusetts Commissioner of Revenue disallows deductions for royalty payments made by affiliate of trademark owner in order to properly reflect income, where affiliated intellectual property holding company was formed solely for tax avoidance purposes). But the problem the current proposal is intended to remedy is not based on tax avoidance; it is based on

the tax inequity that results when a non-taxable entity receives income from a tax-exempt pass-through. Tax avoidance is immaterial in this context and discretionary adjustments predicated on tax avoidance are not responsive to the problem. Furthermore, if the situation involves a pass-through and an insurance company – neither of which are corporate income taxpayers – whose corporate income tax would be adjusted?

## 5. California's Reduction or Disallowance of Deduction for Dividends Received from An Overcapitalized Insurance Company

In California, an insurer subject to the gross premium tax is not considered to be a taxpayer under the corporation income tax and cannot be included in a combined report for franchise tax purposes. As a result, dividends paid by a unitary insurance subsidiary to a member of a California combined reporting group are generally not excluded from the measure of the group's gross income under the intercompany elimination rules applicable to unitary businesses. Therefore, California allows a taxpayer to take a dividends received deduction (DRD) equal to 85% of qualified dividends received from an insurance company that is 80 percent or more owned by the taxpayer. The DRD is ratably reduced in instances where the dividend does not qualify, either in whole or in part, for the DRD due to the existence of excessive insurance company asset levels. Dividends are considered qualified if the ratio of average net written premiums to average total insurance company income over a five-year period is equal to or greater than 70 percent. If the ratio is less than 70 percent but greater than 10 percent, the percentage of qualified dividends will be phased out in proportion to the net written premiums to total income five-year average percentage. If the ratio is 10 percent or less, there are no qualified dividends and the DRD is totally eliminated. Captive insurance companies are subject to greater scrutiny and stricter overcapitalization standards than non-captive insurers.

California's treatment of dividends received by a non-insurance affiliate of a non-taxable insurer is designed to address an inequity in the tax treatment of those affiliates. A company engaged in the same business that is affiliated with a taxable entity would be allowed a dividend received deduction. There is no sound reason to generally disallow the deduction for non-insurance affiliates of insurance companies merely because the insurance company is subject to a different tax regime. However, California recognizes that allowing the deduction for dividends paid by captive insurers could lead to abuse and so has imposed strict overcapitalization standards that, if exceeded, can lead to the loss of the deduction.

This existing tool is designed to address a very different tax inequity that results in non-insurance affiliates of insurance companies to be treated *less* favorably than similar businesses affiliated with taxable entities. The current model is designed to address an inequity that results in tax exempt pass-through income received by non-taxable entities being treated *more* favorably than similar income received by taxable entities. Therefore, California's treatment of dividends received by non-insurance affiliates of insurance companies is not relevant to the current issue.

## **6. Judicially Created Tools to Address Tax Avoidance (Sham Transaction, Economic Substance or Business Purpose)**

Since the seminal case of *Gregory v. Helvering*, 293 U.S. 465 (1935), both federal and state tax administrators have had the discretion to disregard, for taxing purposes, transactions that have no business purpose other than tax avoidance. *See, for example, Syms Corp. v. Commissioner of Revenue*, 436 Mass. 505 (2002) (Commissioner of Revenue acted within his discretionary authority to disregard transfer and leaseback of trade names, trademarks and service marks when the transfer and leaseback was a sham, there was no valid business purpose justifying the payment of royalties for use of the marks, and the royalty payments were between affiliated corporations and were in excess of fair value). While these judicially crafted enforcement tools perform an essential and valuable function in reducing tax avoidance when the business structure or transactions in question lack a legitimate business purpose and are engaged in solely for purposes of tax avoidance, these tools would be of no use to address the tax equity issue that led to this project.

Current law creates an income tax exemption for pass-through entities, on the assumption that tax will be paid when income is passed through to the corporate parent. The purpose of the exemption, again, is to eliminate double taxation, not to create permanently tax-free income. This purpose fails when the income is passed through to an entity that is itself not subject to income tax. Legitimate insurance companies obviously have economic substance and business purpose and there is no basis to believe that their ownership of pass-through entities is a sham. The inequity results from the combination of two tax benefits which result in permanently tax-free income, contrary to the purpose of the pass-through exemption. These judicially-crafted tools are simply not responsive to this inequity.

## **VI. Trade Suggested Model Language**

Lastly, the Trades propose model language that would essentially limit the Commission model proposal to income earned by a partnership or disregarded entity in which a disqualified insurance company had more than a 50% ownership interest. The Trades proposal defines a disqualified insurance company as an entity that would not qualify as a life insurance company under section 816 of the Internal Revenue Code or as an insurance company under section 831(c) of the Code, or an entity where the investment in the partnership or disregarded entity is not an admitted asset on the insurance company's books as defined by the National Association of Insurance Commissioners.

The Trades proposal appears to be directed at captive insurers and other abusive situations. While this proposal may well have merit as applied to those problems, for reasons previously discussed it is not responsive to the tax equity issue which the Commission's model proposal is designed to address – tax-exempt pass-through income escaping taxation entirely if it

is paid to a non-taxable entity. The purpose of exempting pass-through income from income tax at the pass-through level was to avoid double taxation, not to create a category of permanently tax-free income.

## Conclusion

At our last drafting group meeting, the Trades and the members of the drafting group agreed on one point – that they agree to disagree on the necessity of this project. Although invited many times to propose alternative solutions to the tax equity issue raised by the ownership of pass-through entities by entities that are themselves not subject to state income tax, the Trades have instead suggested that existing tools are all that are required.

The next step is for the Subcommittee to determine how it would like to respond to the Executive Committee's request for additional information and a matrix. A draft of a possible matrix is attached as Exhibit 3.

## EXHIBIT 1



Report of the Hearing Officer Regarding Proposed Model Statute Regarding  
Partnership or Pass-Through Entity Income That is Ultimately Realized By an Entity  
That Is Not Subject to Income Tax  
May 2011

### I. Procedural Summary

#### A. Development of the Proposal

The MTC Income and Franchise Tax Subcommittee initiated this project at its March 2008 meeting, in response to a letter from the Commissioner of the Massachusetts Department of Revenue to MTC Executive Director Joe Huddleston, dated February 12, 2008.<sup>1</sup> Commissioner Bal requested that the MTC consider undertaking a project to address tax inequities presented by a business structure that allows entities not subject to state income tax to conduct another business through a partnership or disregarded entity. Ordinarily, the income of a pass through entity would be taxed upon its receipt by an entity that is subject to state income tax. But if the recipient of the income is not subject to state income tax, no tax is imposed either on the pass through or on the non-taxable entity. This is not consistent with the purpose of pass through entities, which is not to create non-taxable income but to assure that taxable income is only taxed once and not at both levels. The subcommittee assigned the drafting of the proposal to a drafting group consisting of Michael Fatale of Massachusetts, Phil Horowitz of Colorado and Brenda Gilmer of Montana.<sup>2</sup> Throughout the history of the project, the drafting group regularly reported its suggestions to the subcommittee and revised its drafts in response to the instructions of the subcommittee, both at regularly scheduled subcommittee meetings and during public teleconferences.

On June 28, 2008 Wood Miller, then chair of the subcommittee, Shirley Sicilian, General Counsel of the MTC, Sheldon Laskin, MTC Counsel and the Hearing Officer for this proposal, and Dave Davenport of Massachusetts (participating by telephone) met with representatives of the Trades at MTC headquarters in Washington, DC. During that meeting, the Trades made an educational presentation entitled *Insurance Company Taxation* which covered the gross premium tax, retaliatory tax and the state income tax of

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<sup>1</sup> A copy of Commissioner's Bal's letter is attached to the public hearing submission of the American Council of Life Insurers, American Insurance Association and the Property Casualty Insurers Association of America (hereinafter, "the Trades"), dated May 16, 2011. A copy of the Trades' submission is attached hereto as Exhibit B.

<sup>2</sup> Carl Joseph of California initially participated in the drafting group but was unable to continue due to the press of his other responsibilities.

insurance companies (including reciprocal credits where an insurance company is subject to both gross premium tax and state income tax)<sup>3</sup>. State concerns regarding insurance companies, such as overstuffing of assets into reserves, were also discussed. The Trades were invited to make its presentation to the entire subcommittee at its meeting of July 28, 2008 and the Trades did so.

Also at the July 28, 2008 meeting, Gary Johnson of the Tax Policy Division of the Texas Comptroller of Public Accounts made an educational presentation to the subcommittee titled *State Taxation of Insurance Organizations, Insurance Premium Tax, Miscellaneous Fees, Assessments and Retaliatory Tax: State Tax Planning and Court Case Review*. The Trades actively participated in the subcommittee discussion that followed both presentations.<sup>4</sup>

At the July 2008 meeting, the subcommittee expressed concerns around a wide ranging group of issues regarding the taxation of insurance companies. Those issues included the use of captive insurance companies by non-insurers, issues unique to particular investments by insurance companies, overcapitalization of insurance companies and overstuffing of insurance company reserves. The drafting group was instructed to research all issues relating to the state taxation of insurance companies and to report its research back to the subcommittee.

The drafting group met periodically by teleconference for about a year, identifying potential issues for the subcommittee to consider and proposing tentative solutions for those issues. At its meeting of July 2009, the subcommittee directed the drafting group to recommend a prioritization of those issues and possible solutions. At its teleconference on October 7, 2009, the subcommittee directed the drafting group to prepare a proposed draft statute addressing the pass through issue, to be followed thereafter with continuing work on the overcapitalization issue. In November 2009, the drafting group presented a draft statute to the subcommittee. The subcommittee directed the drafting group to revise the draft. Two alternative drafts were presented to the subcommittee in July 2010, which issued additional drafting instructions to the drafting group. The subcommittee approved the draft statute at its meeting in October 19, 2010 and the full Uniformity Committee concurred. The Executive Committee approved a public hearing in this matter via teleconference on March 10, 2011.

## **B. Public Hearing**

Following 30 days notice to the public and interested parties, a public hearing was held on May 16, 2011.<sup>5</sup> Tracy Williams, Esquire, representing the Trades appeared at the public hearing and submitted written and verbal comments, as did Dara F. Bernstein, Senior Tax Counsel of the National Association of Real Estate Trusts (NAREIT).

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<sup>3</sup> Such credits almost always result in an insurance company being subject only to gross premium tax.

<sup>4</sup> The Hearing Officer wishes to acknowledge the active participation of the Trades throughout the history of this project and to express his appreciation for that participation. In addition to its formal presentation at the July 2008 meeting, the Trades made an additional formal presentation at the July 2010 meeting.

<sup>5</sup> A copy of the Notice of Public Hearing and proposed model regulation is attached hereto as Exhibit A.

Kathleen Courtis, Esquire, offered verbal comments on behalf of General Growth Properties. The following submitted written comments only: Selvi Stanislaus, Executive Officer of the California Franchise Tax Board and Michael Fatale, Chief, Rulings & Regulations Bureau of the Massachusetts Department of Revenue. Following the public hearing, the Hearing Officer left the record open for 10 days so that interested parties could submit additional comments. Navjeet Bal, Commissioner of Revenue of the Massachusetts Department of Revenue did so in a letter dated May 23, 2011. The Trades filed a supplemental statement on May 26, 2011, as did NAREIT. All written comments are attached hereto as Exhibits B through H:

Exhibit B: *Comments on MTC's Proposed Statute Regarding Partnership or Pass-Through Entity Income That is Ultimately Realized By an Entity That Is Not Subject to Income Tax* (May 16, 2011), submitted by the Trades.

Exhibit C: *Supplemental Comments on MTC's Proposed Statute Regarding Partnership or Pass-Through Entity Income That is Ultimately Realized By an Entity That Is Not Subject to Income Tax* (May 26, 2011), submitted by the Trades.

Exhibit D: *Comments on Multistate Tax Commission's Proposed Model Statute Regarding Partnership or Pass-Through Entity Income That is Not Subject to Income Tax* (May 12, 2011), submitted by NAREIT.

Exhibit E: *Supplemental Comments on Multistate Tax Commission's Proposed Model Statute Regarding Partnership or Pass-Through Entity Income That is Not Subject to Income Tax* (May 26, 2011), submitted by NAREIT.

Exhibit F: *Comments Re: Public Hearing Regarding Proposed Model Statute for Pass-Through Entities and Exempts* (May 16, 2011), submitted by Michael Fatale.

Exhibit G: *Comments in Support of MTC's Proposed Statute Regarding Partnership or Pass-Through Entity Income That is Ultimately Realized by an Entity That is Not Subject to Income Tax* (May 23, 2011), submitted by Massachusetts Revenue Commissioner Navjeet K. Bal.

Exhibit H: *Comments Regarding Proposed Statute Regarding Partnership or Pass-Through Entity Income That is Ultimately Realized by an Entity That is Not Subject to Income Tax* (May 13, 2011), submitted by Selvi Stanislaus, Executive Officer, California Franchise Tax Board.

### **III. Summary of Substantive Provisions**

#### **A. Purpose of Proposed Model Statute**

The proposal is designed to address tax inequities presented by a business structure that allows entities not subject to state income tax to conduct another business through a partnership or disregarded entity. Ordinarily, the income of a pass through entity would be taxed upon its receipt by an entity that is subject to state income tax. But if the

recipient of the income is not subject to state income tax, no tax is imposed either on the pass through or on the non-taxable entity. This is not consistent with the purpose of pass through entities, which is not to create non-taxable income but to assure that taxable income is only taxed once and not at both levels. In addition, this business structure allows for non-taxable entities to conduct lines of business unrelated to their non-taxable business in pass through form tax free, whereas their taxable competitors in those lines of business must pay tax on the income earned by the pass through as well as the income they earn through their direct operations.

## **B. Operation of the Model Statute**

The model statute addresses the stated tax inequities by disregarding the federal tax treatment of pass-through entities and imposing state income tax directly on those entities. This equalizes the tax treatment of pass-through entities, irrespective of whether they are owned by entities that are subject to state income tax or not.<sup>6</sup>

## **IV. Summary of Written and Oral Comments and Recommendations**

1. The Trades recommend that the proposal be sent back to the subcommittee for further study. The Trades maintain, as they have throughout the project, that the imposition of state income tax on pass through entities that are related to insurance companies could subject the insurance companies to retaliatory tax. The Trades argue that the subcommittee has not adequately investigated the ramifications of this proposal on the insurance industry and on policyholders. The Trades suggest that the states lack the administrative capacity to deal with tax administration issues peculiar to the taxation of pass through entities. The Trades further contend that the states mistakenly believe that insurance companies pay less tax than non-insurance businesses and that the proposal would discriminate against insurance companies creating new inequities in state taxation.
2. NAREIT suggests that treating a REIT as a disregarded entity could result in double taxation. First, tax would be imposed on a lower tier disregarded entity of a REIT when it passes income to the REIT. Second, the REIT would be taxed again if it passed income on to a non-taxable entity.
3. Michael Fatale asserts that merely treating a REIT as a disregarded entity will not eliminate the tax inequity the proposal is designed to address, without also explicitly denying the REIT the dividend paid deduction.
3. Executive Director Stanislaus expressed her support for the proposal, as did Brenda Gilmer of Montana.

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<sup>6</sup> For reasons that are further explained below, the Hearing Officer recommends a somewhat different solution to the tax equity issue if the entity that passes the income through is a REIT. In such cases, the Hearing Officer recommends disregarding the dividend paid deduction if the REIT is owned by a non-taxable entity. In all cases the result is the same – tax would be imposed at the pass-through level.

4. Revenue Commissioner Bal outlined the purpose of and need for the proposal. She points out that corporate affiliates of insurance companies are currently subject to state income tax with apparently no resulting imposition of retaliatory tax.

## **V. Response to Witness Testimony**

### **1. Adequate Investigation**

The Trades assert that the Commission has not adequately studied the proposal, particularly by involving state regulators in the project to help in assessing the regulatory implications of the proposal. The Income and Franchise Tax Subcommittee has attempted to do so, throughout the history of the project. These efforts have met with limited success. In September 2008, the Hearing Officer invited the Maryland Insurance Commissioner to participate in the project.<sup>7</sup> The Maryland Insurance Commissioner suggested that the Hearing Officer contact the General Counsel of the National Association of Insurance Commissioners (NAIC) which the Hearing Officer did. Nevertheless, NAIC did not become involved. Similarly, MTC General Counsel Shirley Sicilian invited a NAIC representative to attend the subcommittee's meeting in March 2010. The representative expressed some interest, but did not ultimately attend.

Following the Subcommittee meeting in July 2010, the Hearing Officer spoke with Tracy Williams, Esquire, counsel for the Trades, who was attending the meeting. We discussed having an industry representative make a presentation to the subcommittee regarding how investments by insurance companies have changed since the 1980's. Subsequently, Ms. Williams indicated that the insurance trade associations she represents do not collect this information from their members and once again directed the MTC to NAIC. In an e-mail dated September 13, 2010, Ms. Williams offered to assist the subcommittee in meeting with insurance regulators. In a subsequent e-mail dated October 13, 2010, Ms. Williams instead suggested that an MTC member state, rather than MTC staff, should approach insurance regulators to solicit participation. In fact, there was one such contact in May 2010, when Gary Johnson of the Texas Comptroller's Tax Policy Division arranged a conference call between the Hearing Officer, Kevin Brady of the Texas Department of Insurance and himself, the purpose of which was to educate the Hearing Officer as to the meaning of the term "the business of insurance" as applied to an insurance company that also directly engages in a non-insurance business rather than doing so through an affiliate or pass through entity. This is the only successful contact with a regulator during the history of the project.

The initial focus of this project was quite broad. But the subcommittee greatly narrowed the current focus of the project to the partnership and disregarded entity issue at its meeting of October 7, 2009, with subsequent attention to be devoted to issues around overcapitalization. At that time, the subcommittee directed the drafting group to draft a statute to address the pass through issue. In narrowing the focus of the project, the subcommittee in effect also narrowed the regulatory implications of the project. Since

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<sup>7</sup> The Hearing Officer knows the former Maryland Insurance Commissioner, Ralph S. Tyler, as they worked together in the Maryland Attorney General's office.

October 2009 by far the most pertinent regulatory issue raised by the project has been whether subjecting the income of a pass through entity to tax would trigger retaliatory tax. While the subcommittee was unsuccessful in obtaining regulatory input on that question, as more fully explained below the Hearing Officer is satisfied, based on his own research and analysis of retaliatory tax caselaw, that it is extremely unlikely that taxing a non-insurance pass through on its own income would subject a related insurance company to retaliatory tax.

## **2. Retaliatory Tax**

The Trades suggest that imposition of state income tax on the entities subject to this proposal could expose out-of-state insurance companies to retaliatory tax to the extent that the insurer's home state adopts the proposal. In fact, Massachusetts attempted to address retaliatory tax concerns by modifying its original proposal to directly subject insurance companies to income tax to the extent those companies received income from partnerships and disregarded entities by imposing the tax instead at the partnership or disregarded entity level. The Trades objected to the modified proposal on the same grounds as they did the original.

The Hearing Officer has attempted to find any case where a state sought to impose retaliatory tax on an out-of-state insurer because the insurer's home state had imposed a tax on the income of a non-insurance affiliate of the insurance company. The Hearing Officer has been unable to find any such case, and no interested party has cited one.<sup>8</sup> As Commissioner Bal of the Massachusetts Department of Revenue points out in her letter of May 23, 2011, non-insurance corporate affiliates of insurance companies are currently subject to state income tax. Apparently, no state has ever imposed retaliatory tax on the affiliated insurance company because of that fact. The Hearing Officer finds no plausible reason why the result would be any different merely because the taxpayer is a partnership or disregarded entity for purposes of federal income tax. Presumably, the states will continue to honor the commonly accepted legal distinction between the legal incidence of a tax and the economic incidence of that tax and respect the separate business structures insurers have established to conduct their insurance and non-insurance operations.

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<sup>8</sup> During his July 2008 presentation, Gary Anderson cited the case of *First American Title Insurance Company, et al. v. Combs*, 258 S.W.3d 627 (Tex. 2008). In *First American Title Insurance*, the Texas Supreme Court held that the portion of title insurance premiums retained by title insurance agents as their fee could not be included in the computation of Texas premium tax for purposes of calculating the retaliatory tax. This had the effect of lowering the Texas premium tax attributable to foreign insurance carriers, thereby subjecting those foreign insurance carriers to Texas retaliatory tax. The Hearing Officer does not find *First American Title* to be on point as applied to the current proposal. First, the title insurance agents, unlike the disregarded entities that are the subject of the current proposal, were clearly engaged in the business of selling insurance. Second, the tax that "triggered" the imposition of retaliatory tax was the premium tax, which is the paradigmatic tax for which the retaliatory tax was created. Some portion of the premium tax would therefore always be used in the calculation of the retaliatory tax. The only question in *First American Title* was how much. The question presented in this case is whether an income tax imposed on non-premium income of a non-insurer should figure into the calculation at all, merely because the non-insurer is related to the insurer. For the reasons discussed in the text, the Hearing Officer believes it should not.

### **3. Administrative Capacity to Impose Tax on Partnerships and Disregarded Entities**

The Trades raise a number of issues in support of their contention that the states will be unable to administer a state tax imposed on partnerships and disregarded entities. But such a tax is not entirely unknown in the state tax area. For example, as Commissioner Bal notes, limited liability companies (LLCs), while afforded pass through treatment under federal law, are not always treated as pass through entities for various state tax purposes. While not without difficulty, there is no reason to believe that state tax administrators cannot devise methodologies and procedures for administering the pass through level tax that is presently being proposed.

### **4. Additional arguments raised by the Trades.**

Much of the Trades remaining arguments are predicated on a fundamental misunderstanding of the nature, purpose and effect of the proposal. Undergirding the Trades equitable arguments is the unstated assumption that the proposal is designed to tax an insurance company's investment income. This is simply not the case. As the proposal makes clear, it does not apply at all unless an insurance company owns, directly or indirectly, at least 50% of the capital or profits interest in a partnership or disregarded entity. The purpose of the 50% rule is precisely to preclude the proposal sweeping purely investment income within its scope. If an insurance company owns at least 50% of a non-insurance partnership or disregarded entity, it is more accurate to describe that business structure as allowing the insurance company to engage in two lines of business – insurance at the parent level and at least one non-insurance business at the lower tier levels.

Furthermore, the proposal imposes the tax, not on the insurance company's investment income but on the net income of the non-insurance lower tier entities.<sup>9</sup> It is the ability of insurance companies to engage in non-insurance businesses through partnerships and disregarded entities that creates an inequity in state tax treatment of such entities. If the partnership or disregarded entity is owned by a taxpayer that is subject to state income tax, state income tax is imposed on the entity to which the pass-through income flows. But if the partnership or disregarded entity is owned by an entity that is not subject to state income tax, the pass-through income is never taxed at all. The reason federal tax law allows for the creation of pass-through entities was to avoid double taxation of the same income, not to create tax-free income. This proposal is designed to address that inequity.

The Trades note, correctly, that gross premium tax often results in states receiving more revenue from insurance companies than would be the case under a net income tax; that difference inheres in the difference between a tax imposed on gross receipts and a tax that is measured by net income. But again, the proposal does not subject the insurance

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<sup>9</sup> It is a basic principle of tax law that a tax legally imposed on one entity is not treated as if it were legally imposed on another merely because the second entity incurs some or all of the economic effects of the tax.

company to an additional tax; it imposes the tax on the lower-tier entities. The fact that the entire enterprise ultimately pays more total tax -- the sum of premium tax paid by the insurer and income tax paid by the disregarded entities -- under the proposal than would a non-insurance business that uses a pass-through structure to realize income is because the insurance company is engaging in at least two lines of business (insurance and at least one non-insurance business) that are subject to two different tax regimes. And further, this result is no different than if the insurance company were a 50% owner of a corporation, under current law. Similarly, the inability to utilize net operating losses across the various components of the entire business enterprise is again a function of the fact that an insurance company that engages in a non-insurance business through a pass-through is engaging in two lines of business under two distinct tax regimes. To compare such an enterprise with a non-insurance business that utilizes a pass-through to realize income, all of which is subject to one tax regime, is to compare apples and oranges. Simply put, the issue this model addresses is not about insurance companies, the premium taxes they pay, or their overall tax burden. The issue is limited to pass-through entities, and whether the policy rationale for exempting these entities' income from corporate income tax applies under circumstances where the pass-through entities' income would escape tax altogether.

The Trades also assert that the proposal would result in policyholders bearing the economic costs of tax imposed as a result of investment income realized by variable insurance portfolios that are separately established for each policyholder. The Hearing Officer has difficulty seeing why this would be so. As the Trades point out in footnote 11 of their submission, the insurance company is merely the custodian of the policyholder separate accounts. The insurance company could not be the legal owner of the accounts because, among other things, that could subject the accounts to the claims of the insurance company's creditors. The insurer makes investments not for its own account, but for that of the policyholders. Consequently, the net income of the accounts does not, as the proposal requires, pass through to the insurance company. As a result, the investment income realized by the accounts would not be subject to the proposal.

In their supplemental comments, the Trades note that Massachusetts submitted testimony and materials emphasizing the potential implications of the proposal for captive insurance companies. The Trades argue that the proposal is broader than necessary to address any state tax concerns arising out of the captive insurance business model. The Hearing Officer wishes to once again emphasize that, whatever the potential implications of the proposal for captive insurance companies, the proposal is in fact intended and designed to address a broader concern than any issues that arise out of captive insurance companies. To reiterate, the proposal is designed to address a tax equity issue that inheres in **any** case where a non-taxable entity, such as a non-captive insurance company, receives income from a related partnership or disregarded entity. Irrespective of whether the business structure includes a captive insurance company, such a structure allows income to escape state taxation either at the disregarded entity level or at the non-taxable entity level. The proposal addresses that problem; a proposal specifically tailored to captive insurance companies would not.

## **5. Treatment of a real estate investment trust (REIT) as a partnership or disregarded entity**

The National Association of Real Estate Investment Trusts (NAREIT) objects to the inclusion of a REIT within the meaning of the term “partnership or disregarded entity”. NAREIT argues that treating a non-captive REIT as a partnership or disregarded entity could have the unintended consequence of creating double taxation, by subjecting lower tier partnerships or disregarded entities to state income tax to the extent their income flows through those entities to a REIT which claims a dividends paid deduction, while also imposing tax on the REIT to the extent the REIT’s income flows through to an entity that is not subject to state income tax. NAREIT urges that the proposal be modified to make explicit that a REIT is not to be considered a partnership or disregarded entity for purposes of the proposal.<sup>10</sup>

In its supplemental comments, NAREIT has proposed an alternative draft proposal that is designed to address the tax equity issue without at the same time treating a REIT as a partnership or disregarded entity. The Hearing Officer acknowledges that NAREIT was under no obligation to propose an alternative draft to the MTC. The Hearing Officer wants to thank NAREIT for going above and beyond in this matter. The Hearing Officer will further address NAREIT’s alternative draft in his recommendations that immediately follow.

Looking at the same issue from a different perspective, Michael T. Fatale, Chief, Rulings and Regulations Bureau of the Massachusetts Department of Revenue, asserts that the proposal does not go far enough, because it does not make explicit that a REIT’s dividends paid deduction should not be recognized to the extent that the dividends are attributable to income that is passed through to an entity that is not subject to state income tax. Merely characterizing the REIT as a partnership or disregarded entity would not by itself result in disregarding the deduction.

## **VI. Hearing Officer Recommendations**

The Hearing Officer believes, somewhat paradoxically, that both NAREIT and Mr. Fatale are correct – the Hearing Officer is of the view that the proposal as currently drafted is both underinclusive as noted by Mr. Fatale and overinclusive as noted by NAREIT.

It must be kept in mind that the intent of the proposal is to impose income tax once, but only once, on flow through income to an entity that is not subject to income tax. A REIT is subject to income tax, although its income is not in fact taxed to the extent it is paid out as a dividend subject to the dividends paid deduction. If the dividend is paid to an entity

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<sup>10</sup>NAREIT also makes a passing comment that the proposal does not define an entity that is not subject to income tax. However, the proposal instructs each state to list each such entity type with a citation to the state tax statute applicable to each.

that is subject to state income tax, that tax is imposed -- once -- on the dividend payee. If the dividend is paid to an entity that is not subject to state income tax, currently no income tax would be imposed at any level. The solution to that inequity is to disallow the dividends paid deduction and tax the income -- once -- at the REIT level. But defining a REIT as a partnership or disregarded entity could well have the effect of imposing tax twice, if the dividends paid deduction is disallowed -- once on the lower tier partnership or disregarded entity and once on the REIT. That is not the intent of the proposal. Therefore, the Hearing Officer proposes modifying the proposal in two ways.

1. To make explicit that for purposes of the proposal, a REIT is **not** to be treated as a partnership or disregarded entity.
2. To disallow the dividends paid deduction to the extent the dividends are attributable to income of the REIT that flows through to an entity that is not subject to state income tax.<sup>11</sup>

The Hearing Officer seriously considered NAREIT's proposed alternative draft. While generally responsive to the concerns expressed above, NAREIT's draft may be unduly narrow. The draft is limited to situations where the non-taxable entity owns the partnership or disregarded entity through another pass-through entity. This seems to limit the draft to multiple tier business structures and not to a situation where the non-taxable entity directly owns the payor disregarded entity. The Hearing Officer believes that his proposed alternative draft will result in tax being imposed once -- but only once -- on the disregarded entity or REIT that directly passes the income to the non-taxable entity. That should satisfy NAREIT's primary concern that a REIT's lower tier entities not be subject to tax. Of course, the REIT itself will be subject to tax to the extent it passes income through to a non-taxable entity.

In all other respects, the Hearing Officer recommends that the proposal be adopted as recommended by the Uniformity Committee.

Respectfully submitted,

Sheldon H. Laskin

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<sup>11</sup> The proposed changes are set forth in the Attachment to this report.

**Attachment**  
**(Hearing Officer proposed revisions are highlighted)**

**MTC proposed statute regarding partnership, pass-through entity or real estate investment trust (REIT) income that is ultimately realized by an entity that is not subject income tax As Approved by the Income & Franchise Tax Uniformity Subcommittee As Submitted to Public Hearing March 10, 2011**

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 not include a real estate investment trust (REIT) within the meaning of Section 856 of the Internal Revenue Code of 1986, as amended.

When 50 per cent of more of the capital interests or profits interest in a real estate investment trust (REIT) as defined in section 856 of the Internal Revenue Code, 26 U.S.C. 856 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 dividends paid deduction to which the REIT is entitled under the Internal Revenue Code, to the extent attributable to dividends paid to such entity, shall not be recognized.

EXHIBIT 2



**MULTISTATE TAX COMMISSION**

*Working Together Since 1967 to Preserve Federalism and Tax Fairness*

**To: Uniformity Committee, Income and Franchise Tax Subcommittee**

**From: Sheldon H. Laskin**

**Date: February 24, 2012**

**Subject: Status Report, Project Regarding Partnership or Pass-Through Entity Income Ultimately Realized by an Entity That Is Not Subject to Income Tax**

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The purpose of this memo is to summarize project developments since the subcommittee met in Charleston in November. In November, the subcommittee was considering its proposed course of conduct following the Executive Committee's meeting in July 2011. In June 2011, the Executive Committee had considered approving the model (attached as Exhibit 1) for a bylaw 7 survey and, after receiving significant input from the insurance industry, voted to continue its discussion to its July 28, 2011 meeting. At that meeting, representatives from the insurance industry suggested again that they had concerns with the current model, had proposals that would address the committee's concerns in a less intrusive way, and that they would be willing to work with the uniformity committee to develop those alternatives. The Executive Committee voted to ask the Uniformity Committee to work with the insurance industry on developing those alternatives and then to provide a matrix summarizing the various tax problems that arise when income taxpayers and non-income taxpayers are part of the same affiliated group and the possible solutions – existing as well as proposed models – for addressing those problems. During the subcommittee's November meeting, Dan Schelp, managing counsel of the National Association of Insurance Commissioners (NAIC), appeared and outlined the basics of insurance industry taxation and regulation by state insurance commissions. The subcommittee asked Mr. Schelp a series of questions regarding retaliatory tax and its relevance, if any, to the current proposal, as well as issues of insurance company capitalization and overcapitalization. Mr. Schelp offered NAIC's technical assistance in developing rules. The subcommittee asked that the

drafting group be reconvened and that it work with industry and regulators to develop the information necessary for the subcommittee to respond to the Executive Committee.<sup>1</sup>

Since November, the drafting group has met twice with industry and regulatory representatives.<sup>2</sup> At the first meeting on January 17, 2012, industry presented an overview of state taxation of insurance and stated its view that the model is both unnecessary and not responsive to the unique tax nature of the industry. As to the first point, industry expressed the view that any concerns regarding abusive tax practices could be addressed by limiting the proposal to captive insurance companies.<sup>3</sup> In fact, the Commission has previously addressed issues of asset stuffing and income shifting to passive insurance companies by recommending that such companies be combined with non-insurance affiliates, in combined reporting states.

As to the second issue, the industry representatives noted that the “in lieu of” premium tax that insurers are subject to in every state consistently raises more revenue than would a net income tax.

Industry’s assertion is based on the experience of several states that impose a “higher of” tax regime on insurers, under which insurers are to pay the higher of the premium tax or the net income tax. It should be noted that the proposal would not impose an income tax on insurers. Instead, the proposal would impose income tax on the pass-through’s income. This income is ordinarily subject to income tax when it is passed through to taxable entities. The tax equity issue the proposal is designed to address arises from the fact that the income is never subject to tax if it is passed through to an entity that is not itself subject to tax. The purpose of providing the exclusion for pass-through entities was to assure that that income would only be subject to tax once, not that it would never be subject to tax. It is the view of the drafting group that the fact that insurance companies are subject to a different tax regime than taxable entities does not address the underlying tax equity issue – pass-through income is differentially subject to tax depending on whether or not the parent is subject to tax, contrary to the purpose of creating pass-throughs to begin with.

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<sup>1</sup> The drafting group currently consists of Michael Fatale of Massachusetts, Phil Horowitz of Colorado, Brenda Gilmer of Montana and Frank O’Connell of Georgia.

<sup>2</sup> Those representatives include Mr. Schelp, Steve Johnson from the Pennsylvania Department of Insurance, Bob Montellione of Prudential, Frank Alberts of Firemen’s Fund, Jim Hall of ACLI, Josie Lowman of AIG and Jim Williams of Mass Mutual.

<sup>3</sup> At its meeting of October 7, 2009, the subcommittee directed the drafting group to prepare a proposed draft statute addressing the tax equity issue raised by pass-through entities generating income that is passed through to non-taxable entities such as insurance companies. The current model is the result of that directive. At its October 2009 meeting, the subcommittee also directed the drafting group to continue to work on overcapitalization and captive insurance issues following the completion of the current phase of the project to address the pass-through issue.

Finally, the representatives continued to express concerns that subjecting pass-through income to tax could subject the insurers to retaliatory tax. The drafting group questioned why this would be the case, noting that corporate affiliates of insurance companies are currently subject to state income tax, apparently without resulting in any adverse retaliatory tax cases.

Following the January 17 teleconference, industry provided the drafting group with organizational charts for a number of leading insurance companies. Mr. Fatale has conducted an analysis of the charts to trace the development of LLCs and other pass-through entities owned by insurance companies over the past 20 years. He presented a summary of his analysis at the second teleconference held with industry representatives on February 10, 2012. Those charts show that the business structure of insurance companies over that time frame has reflected the general business tendency to structure its lower-level entities in pass-through form.<sup>4</sup> Some examples from Mr. Fatale's research illustrate the growth of non-insurance lower-level LLCs whose assets are under management by insurance parents.

1. John Hancock Life Insurance Company. In 1999, John Hancock's SEC-filed organization group showed the John Hancock affiliated group owned no LCS, while it did own two corporations. By 2011, the SEC-filed organization charts showed at least five non-insurance LLCs owned either directly or through one or more other LLCs by John Hancock. According to "Find the Best", the Internet listing for one of these LLCs – Management, LLC— currently manages two hundred accounts totaling an estimated \$117,290,206,047 of assets under management.<sup>5</sup>
2. Hartford Life Insurance Company. In 1998, Hartford's SEC-filed organizational chart shows the Hartford group owning no LLCs. Several LLCs appeared on the chart the following year. By 2010, the number of LLCs owned by or owning other LLCs in the Hartford group had grown to at least six. One – RVR LLC – was formed on April 29, 2009 to take title to and manage real property. According to "Find the Best", Investment Services, LLC manages 55 accounts totaling an estimated \$59,397,017,574 of assets under management and HL Advisors manages 33 accounts totaling an estimated \$45,029,570,030 of assets under management.
3. Pennsylvania Mutual Life Insurance Company. Janney Montgomery, a Philadelphia-based regional retail brokerage, was acquired by Penn Mutual in 1982. It was converted

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<sup>4</sup> According to a recent article in the Wall Street Journal, "the percentage of U.S. corporations organized as nontaxable businesses has grown from about 24% in 1986 to about 69% as of 2008.... The percentage of all firms is far higher when partnerships and sole proprietors are included. By some estimates, more than 60% of U.S. businesses with profits of \$1 million are structured as pass-throughs, the highest rate among developed countries...." *More Firms Enjoy Tax-Free Status*, by John D. McKinnon (WSJ, January 10, 2012).

<sup>5</sup> Documentation for all these examples is contained in the .pdf binder that is submitted with this memo. At this time, I am only providing a high-level summary of this material. As explained in the text, industry has requested more time to submit a position paper in support of its view that the proposal should not be adopted. That paper is to be submitted by the end of March. Following the submission of that report, I will prepare a more detailed analysis of both the states' position and that of industry.

to an LLC in 1999. According to “Find the Best”, it currently has \$8,918,685,956 of assets under management.

The magnitude of the assets involved in these examples illustrate the central question presented by use of a pass-through structure when the corporate parent is itself not subject to tax – was it ever contemplated that use of a pass-through structure would result in creating a class of pass-through entities whose income would be nontaxable at any level, merely because the parent is itself not subject to tax? In the specific context of insurance, was it ever contemplated that the “in lieu of” premium tax would shield income of this magnitude from taxation at the pass-through level?

Following the February 10<sup>th</sup> teleconference, industry offered to provide a response to the subcommittee’s request for an additional analysis of potential retaliatory tax implications of the model. In addition, industry will address why it believes that any discussion of equity must be addressed in the broader context of the unique aspects of state taxation and regulation of the insurance industry, and how the industry believes it significantly differs from all other non-insurance industries. Lastly, industry will provide model language aimed at addressing what it believes should be the focus of this project; the abusive use of an insurance company to evade taxes.<sup>6</sup> Because it is currently premium tax filing season, industry was unable to provide this information at this time and has indicated it will do so as of the end of March.

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<sup>6</sup> Industry acknowledges that the Executive Committee requested it provide proposed model language at its July 1011 meeting.

### EXHIBIT 3

## Issues Raised by Common Ownership of Corporate Income Taxpayers and Non-Corporate Income Taxpayers, and Options for Addressing Same

Issue	Suggested Options, or Existing Tools, to Address Issue	Will Option Address Tax Equity Issue That is the Focus of this Project (Y = Yes, N = No)?
Creation of permanently tax-free income as a result of income received by non-taxable entity from tax-exempt pass-through entity.	Impose income tax on pass-through.	Y
	OR Impose income tax on non-taxable entity. <sup>1</sup>	Y
Inaccurate or incomplete accounting of income of unitary group.	Include non-taxable entity in combined group.	N
Tax abusive strategies (i.e., creation of intellectual property holding company to shelter royalty income received from related affiliates).	Discretionary administrative adjustments to properly reflect income.	N
	OR Add-back statutes.	N
	OR Common law tools (i.e., sham transaction, economic substance and/or business purpose doctrines).	N

<sup>1</sup> In the case of an insurance company, the income tax may include a credit for gross premium tax paid.

### EXHIBIT 3

## Issues Raised by Common Ownership of Corporate Income Taxpayers and Non-Corporate Income Taxpayers, and Options for Addressing Same

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<b>Issue</b>	<b>Suggested Options, or Existing Tools, to Address Issue</b>	<b>Will Option Address Tax Equity Issue That is the Focus of this Project (Y = Yes, N = No)?</b>
Unavailability of dividend-received deduction when unitary dividend payer (insurance company) is not subject to income tax.	Allow dividend received deduction, with appropriate phase-outs for overcapitalized insurance companies and steeper phase outs for captive insurance companies.	N