MULTISTATE TAX COMMISSION

Working Together Since 1967 to Preserve Federalism and Tax Fairness

To: MTC Executive Committee

From: MTC Uniformity Committee

Date: December 6, 2012

Subject: MTC Project Regarding Partnership or Pass-Through Entity Income That Is Ultimately Realized By An Entity That is Not Subject to Income Tax

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Attached hereto for this committee's consideration is the revised proposed model statute regarding partnership or pass-through entity income that is ultimately realized by an entity that is not subject to income tax. This committee may take a range of actions, which include approving the proposal for a bylaw 7 survey, sending the proposal back to the uniformity committee for additional work, or ending the project.

This project was initiated in February 2008, following a request from the Massachusetts Commissioner of Revenue to Jan Goodwin, the then chair of the Multistate Tax Commission and to MTC Executive Director Joe Huddleston. The Commissioner expressed concerns that income realized by pass-through entities that are owned by insurance companies are not subject to income tax, either at the pass-through or the parent level. In contrast, income realized by pass-through entities that ultimately flows through to a corporation or other taxable entity is ultimately subject to income tax at that time. The Commissioner was concerned that this creates an inequity in the tax treatment of income realized by pass-through entities depending on whether the owner of the pass-through entity is itself subject to income tax. Furthermore, pass-through entities were designed to assure that the income realized by those entities would be subject to tax once, at the parent level, and not to create a permanent exclusion from income tax for that income entirely. The Executive Committee sent the matter to the Uniformity Committee which initiated a project at its Spring 2008 meeting, but broadened the project to address this issue with respect to pass-through entities that are owned by any entity that is not a corporate income tax payer, not just to the insurance industry. The Income and Franchise Tax subcommittee created a drafting group to gather and provide educational information, to identify policy issues for the subcommittee's consideration, and lastly to draft a proposed model statute in accordance with the subcommittee's policy choices for the subcommittee's consideration. The drafting group and the Subcommittee both received significant input from state insurance regulators and the insurance industry. After the drafting group completed its work, the Uniformity Committee approved a model proposed statute at its Spring 2011 meeting. The proposed model statute would impose income tax on a partnership or limited liability company that is more than 50% owned by a non-corporate income tax entity. The Executive Committee approved the proposal for hearing which was held on May 16, 2011.

Following significant public comment by and on behalf of the insurance industry and Executive Committee discussion, the Executive Committee voted on July 28, 2011 to ask the Uniformity

Committee to consider additional proposals from the industry and provide additional information back to the Executive Committee. The Executive Committee also asked the Uniformity Committee to prepare a matrix for its consideration, showing the significant tax issues that are 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 the issues. The matrix was developed and is attached. Following the July 2011 Executive Committee meeting, the subcommittee and the drafting group both met with industry representatives and insurance regulators in an effort to find common ground. Ultimately, the industry (the Trades) presented its proposed alternative model language on March 29, 2012.[1]

Following the Trades submission of its alternate proposal, the drafting group prepared a detailed analysis of industry's proposal, which was submitted to the Income and Franchise Tax Subcommittee on July 20, 2012.[2] It was clear from the Trades' alternate proposal that the industry does not agree that there is a tax equity issue that warrants imposing income tax on the income of a pass-through entity if that income is passed through to a non-taxable entity. Instead, industry proposed various alternatives, some of which the states currently employ, to address abusive tax structures (overcapitalization and captive insurance companies) that are not responsive to the equity issue identified by the subcommittee.

On July 20, 2012, the subcommittee received the drafting group's report. Following discussion, the subcommittee voted to accept the proposed model statue and recommend it to the uniformity committee with amendments. The amendments remove the hearing officer's proposed revision to disallow a REIT the dividend paid deduction under certain circumstances. The subcommittee agreed it could continue to work on treatment of REITs and mutual funds separately if necessary. The proposal was then accepted by the full Uniformity Committee.[3] The Uniformity Committee then voted to resubmit the revised proposal to the executive committee.[4]

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[1] The industry's proposal is available on the Commission's website, at http://www.mtc.gov/Uniformity.aspx?id=5619.

[2] A copy of the July 20, 2012 drafting group report is included with this memo. The Report provides a more detailed history of the project than is included here. The matrix requested by this committee is Exhibit 3 to the Report.

[3] Initially, the Uniformity Committee mistakenly believed that the drafting group wanted the proposal to be returned to the drafting group and directed that it be so returned. At the time of the initial vote, no representative of the drafting group was present in the room. Following the vote, a member of the drafting group, Phil Horwitz, came back into the room. He then explained that the drafting group was of the view that the proposal could go to this committee for consideration for a Bylaw 7 survey and, if necessary, the drafting group could continue its work on other issues. Following a motion to reconsider, the Uniformity Committee voted to send the proposal on to this committee. .

[4] Also attached are two additional documents. First is a memo dated November 7, 2012 from representatives of the insurance industry (the Trades), that is a response to the drafting group memo of July 20, 2012. The points raised in the November 7 memo are addressed in this memo or have previously been addressed in the July 20, 2012 memo. Contrary to the assertion in the November 7 memo, the Commission has always been open to NAIC's offer to survey its membership to provide some empirical basis for the Trades' assertion that the model statute would subject insurers to the risk of retaliatory taxation. No such survey has been submitted to MTC staff or to the drafting group.