MULTISTATE TAX COMMISSION

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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.[1] 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.
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> 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.
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> 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.

[1] 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.[2] 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.

[2] 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.[3]

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.[4] 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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[3] 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.

[4] 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.[5]

Staff has analyzed the memo entitled Retaliatory Tax Risks Under the MTC Model, supplied by the Trades.[6] 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.[7] 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.[8] 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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[5] 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.

[6] 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

[7] Code of Alabama, §27-3-29, cited in the Trades' memo.

[8] 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.[9]

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.[10] Furthermore, the District of Columbia currently imposes income tax on pass-through entities themselves.[11] 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

[9] 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.

[10] 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.

[11] 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.[12]

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

[12] 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.[13] 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

[13] 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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> …
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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
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> 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.
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> 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."[14]

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.[15] Such a tax would include income received from pass through entities.

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

[15] 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.