The purpose of this memo is to propose a course of action to be taken by the Non-Income Taxpayer Working Group.

I. Background

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

In 2007, Massachusetts Governor Deval Patrick proposed legislation to address certain tax loopholes in Massachusetts, including the tax equity issues described above. The bill
included a proposal to impose tax on an insurance company on its non-insurance income as derived from a more than 50% ownership interested in a partnership or flow-through LLC.

The bill was submitted to a three-person subcommittee of a fifteen member Study Commission of Corporate Taxation appointed by the Governor, the Speaker of the Massachusetts House and the President of the Massachusetts Senate. During the subcommittee’s consideration of the non-insurance income proposal, concerns were raised as to whether adopting the flow-through recommendation would have “retaliatory premium tax” implications for Massachusetts-based insurers. That in turn caused the subcommittee to be concerned that the proposal could put Massachusetts-based insurance companies at a competitive disadvantage in relation to insurers that are based in other states, and whose non-insurance flow-through income is not subject to tax. In light of these concerns, the proposal was revised to subject a partnership or LLC to income tax to the extent that the income would otherwise flow through to an owner — such as an insurance company — that is not subject to income tax. As in the case of the prior proposal, the provision would only apply where the owner possessed a more than 50% ownership interest in the flow-through entity. The subcommittee voted 2 – 1 to recommend adoption of the revised proposal, with the dissenting member continuing to express concerns about the proposal’s retaliatory tax implications.

When the full Commission considered the revised proposal, it was recommended for further study, particularly because of the retaliatory tax issue. The Department of Revenue then requested the MTC to undertake a Uniformity Committee project to study issues that arise from the receipt of otherwise taxable income by an entity that is not subject to income tax. The Department specifically requested that the project include a study of the retaliatory tax issue. The Uniformity Committee initiated the project at its Spring 2008 meeting.

II. Summary of the Work Group’s Efforts to Date

The work group consists of Michael Fatale, Brenda Gilmer, Phil Horowitz and Carl Joseph. The work group has met by teleconference on a regular basis. Initially, the work group arranged educational presentations to familiarize the Subcommittee in general with how the states tax insurance companies and their non-insurance affiliates, to identify the issues raised by the relationship between a taxable and a non-taxable entity and to receive industry input on the retaliatory tax issue. The work group also more generally considered state tax issues that arise in connection with insurance companies, with an eye towards considering whether such other tax issues should also be addressed.

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

The work group considered each of the following options for further possible development.

1. Focus on specific abusive transactions that tend to isolate income in a non-taxable affiliate.
2. Subject non-taxable affiliates to an unrelated business income tax, a corporate income tax with a credit for gross premium tax paid or adopt Minnesota’s former approach of imposing the higher of a gross premium or corporate income tax.¹
3. Subject the non-taxpayer investment income from affiliated entities to a gross income tax.
4. Subject capital contributions to the gross premium tax.
5. In combined reporting states, include the non-taxable company in the combined group.
6. Adopt the California approach (pertaining to overcapitalized insurers, though in a very specific context).
7. Adopt the Massachusetts approach.
8. Enact expense add back provisions for payments to a non-taxable affiliate.²

III.
Recommendations

The work group recommends that the Subcommittee direct the work group to provide:

1. A draft model statute for Subcommittee discussion and consideration based on the Massachusetts proposal to subject a partnership or LLC to income tax to the extent that the income would otherwise flow through to an owner that is not subject to income tax.

¹ Minnesota repealed the income tax on insurance companies because the gross premium tax consistently yielded more revenue.
² These options are described in more detail in a memo to the committee dated March 6, 2009, a copy of which is attached hereto.
2. A draft proposal concerning the tax treatment of over-capitalized insurers, provided that the Subcommittee can agree in broad principle as to how to set forth in a statute or rule of general applicability when an insurance company is overcapitalized for tax purposes.

It should be noted that the proposed Massachusetts rule would adequately address the flow through issue, but would not address other income shifting issues or any issues that arise from the generation of expenses as a result of payments to a non-taxable entity. Nevertheless, the Massachusetts proposal appears to be an effective and easily administrable solution to the tax equity issue that lies at the heart of a flow-through relationship between a taxable and a non-taxable entity. Further, unlike many of the other listed issues, the flow through issue is one that the states are apparently powerless to address in the absence of some specific statutory fix and, as such, the issue is of particular importance. Moreover, apart from any potential retaliatory tax issue, which the work group thinks would be unlikely, this particular fix seems to be the easiest to implement.  

Finally, the issue of over-capitalization has obvious consequences to the states, to the extent that the income of non-insurance affiliates is used to overcapitalize the insurance company. The importance of this issue has resulted in recent legislation in both California and New York, although as to very different and somewhat narrow concerns. The work group will continue to explore methods to address this issue.

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3 One basic problem the work group found is that, because insurance companies have not historically been subject to state income tax, the states lack detailed information as to the nature and scope of issues other than the flow-through issue. It is clearly the case, however, that income of a flow-through affiliate of a non-taxable entity will escape income tax entirely, even if it is not possible to quantify the tax revenue lost as a result. Perhaps the states’ experience with a flow-through provision would give the states the information necessary to effectively address the other issues.
The MTC Uniformity Committee Income and Franchise Tax Subcommittee has been studying the potential tax compliance issues raised by the relationship between companies that are generally not subject to state income or franchise tax and corporate affiliates that are. The relationship allows for the transfer of income and generation of deductions, as the result of transactions between the non-taxpayer and its taxpayer affiliates, with the result that formerly taxable income is converted into non-taxable income. A small working group consisting of Michael Fatale, Brenda Gilmer, Carl Joseph and Phil Horowitz met on March 2, 2009 to review the issues and to recommend possible action proposals for this Subcommittee to consider in guiding the working group as it continues to explore this subject. The working group has suggested the following approaches for consideration of the subcommittee. Some would address issues related to all non-taxable/taxable affiliate situations (numbers 1, 2, 5, 7, 8); others are more specific to insurance company situations (numbers 3, 4, 6).

1. **Focus on specific abusive transactions.**

One common potentially abusive tax planning technique is to isolate income in a non-taxable affiliate. This is similar to the common corporate income tax planning technique of isolating income in non-nexus affiliates. In the insurance context, the insurance company has nexus but is not subject to tax under state law. Examples include placing accounts receivable or income-generating intellectual property into the insurance company, as well as using a pass-through entity to pass investment income through to the insurance company.

Another potentially abusive tax planning technique would be to use the non-taxable company to create an inter-affiliate deduction, such as having the non-taxable company extend loans to in-state taxable affiliates.
A third potentially abusive tax planning technique is to structure transactions as investments in entities that are themselves non-taxpayers because they are not subject to tax at the federal level. Such entities would include (1) exempt entities under IRC 501, (2) corporate taxpayers who claim dividend paid deductions, (3) taxpayers that are eligible to claim preferential treatment under the IRC, such as publicly traded partners in natural resource exploitation or financial services, and (4) beneficiaries of various tax deferral mechanisms that delay recognition of income for periods that are so long as to amount to tax avoidance.

2. Subject non-taxable companies to an unrelated business income tax, a corporate income tax with a credit for gross premium tax paid or adopt Minnesota’s former approach of imposing the higher of a gross premium or a corporate income tax.

Subjecting non-taxable companies, or their unrelated business income, to the corporate income tax has the advantage of eliminating the underlying source of the abuse — for example, insurance companies are generally subject to a gross premiums tax in lieu of a corporate income tax, while their affiliates pay the corporate income tax.\(^1\) There are several possible approaches that would have the effect of subjecting a non-taxable company to corporate income tax, at least on its unrelated business income. The simplest, of course, would be to make the insurance company subject to the state corporate income tax and eliminate the gross premium tax. But there are several issues that need to be addressed before this option could be seriously considered.

First, what would be the fiscal effect of switching from a gross premium tax regime to the net income tax? The insurance industry claims that the gross premium tax yields substantially more revenue than would the net income tax. A recent study by the California Legislative Analyst’s office tends to support that assertion.

Economists who have examined state insurance taxes have found that a simple comparison of premiums to net income suggests that insurance premiums tax revenues are several times higher than a profits tax would produce.

This is also true in California. For corporations in the Insurance Carriers and Related Activities industry with net income in 2005, federal income subject to tax was approximately $100 billion. If California taxable income for these insurers comprised about 10 percent of federal taxable income, [the state’s corporate income and franchise taxes] would have generated a little less than $1 billion in

\(^1\) Currently, seven states (FL, IL, MS, NE, NH, NY (life insurance only), and OR) impose an income tax on insurance companies. The income tax is generally imposed on an insurer’s state-apportioned net income. Some, but not all of these states, provide a credit mechanism between the income tax and the premium taxes paid to the taxing jurisdiction. It would be useful for the Subcommittee to explore whether domestic insurers in any of these states -- particularly the ones that do not allow a credit against the premium tax -- have been assessed retaliatory premium tax in other states as a result of an income tax assessment against an out-of-state insurer. Staff will speak with employees of these states regarding this and other issues raised by the imposition of a state income tax on insurance companies.
revenues. This is much less than the amount of tax paid under the gross receipts tax.


Of course, in the case of insurance companies, a simple comparison of the revenue generated by the gross premium tax and a hypothetical income tax ignores the fiscal effects of tax avoidance under the current gross premium tax regime. It also ignores the equity issues raised by allowing non-insurance affiliates of insurance companies to operate tax free while taxing similar companies that are not affiliated with insurance companies.

Another issue specific to insurance companies is whether subjecting them to income tax would subject domestic insurers to retaliatory premium tax in another state as the result of an income tax assessment against an out-of-state insurer. As indicated previously, staff will explore this question with the states that impose an income tax on insurance companies.

Last, the current economic crisis suggests that, for any industry, this may not be a propitious time to replace a tax based on gross premiums with one based on net income.

A more viable approach to subjecting non-taxable companies to the corporate income tax in lieu of the gross premium tax would be to subject the unrelated business income of such companies to the income tax. This option would require detailed rules to determine when income is unrelated. Insurance companies could argue that any business income that is included in their reserves is by definition, related to the insurance business. Insurance regulators are likely to agree. Also, unless adopted in all states, a UBIT may still raise retaliatory premium tax issues outside the taxing state. Imposing the corporate income tax on non-taxable companies with a credit for gross premium tax paid would be simpler to administer than an UBIT but would still potentially raise retaliatory premium tax issues.

Finally, Minnesota formerly subjected non-taxable companies to the higher of the corporate income tax or the gross premium tax. As stated previously, Minnesota’s experience suggests that such a change may do little to address abuse, because the gross premium tax consistently yielded higher revenue than the corporate income tax.

3. To Address Insurance Company Issues Only - Subject non-taxpayer investment income from affiliated entities to a gross premium tax.

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2 Minnesota formerly imposed its corporate income tax on insurance companies. Insurers were required to pay the higher of the gross premium tax or the corporate income tax. Minnesota repealed the corporate income tax on insurance companies precisely because the gross premium tax consistently yielded much higher revenue.
This would have the advantage of eliminating the incentive for non-taxable companies to engage in abusive transactions with related entities. However, in the case of insurance companies, it is difficult to justify treating investment income as income from premiums. Also, this option raises difficult administration issues as, with limited exceptions, the gross premium tax is administered by state insurance commissioners and not by state revenue departments. Insurance commissioners have no experience in administering an income based tax. In addition, insurance commissioners would have to buy into this option for it to be viable.

4. To Address Insurance Companies Issues Only - Subject capital contributions to the gross premium tax.

This would address the asset stuffing issue, but would not address the pass-through problem. If the contribution of the asset were subject to the gross premium tax, the fact that the investment income from the contributed asset escapes income taxation may be less troublesome.

This option is similar to number 3, and raises the same theoretical and administration problems as that option.

5. In combined reporting states, include the non-taxable company in the combined group.

While this would get the non-taxable company’s income into the combined group, the only effect of doing so under current law would be to apportion that income among the affiliates that are subject to tax in the taxing state. The non-taxable company itself would remain non-taxable. This option does not address the pass-through problem.

6. Adopt the California approach.

California’s treatment of insurance companies for corporate tax purposes is explained in staff’s memo of November 7, 2008, a copy of which is attached.

While California’s approach works fairly well in limiting deductions for dividends paid by a controlled insurance subsidiary, it does not apply in many other contexts (i.e., when the insurance company is the parent, when the insurer makes loans to the non-insurance affiliates and in the pass-through context).

7. Adopt the Massachusetts approach.

Massachusetts’ proposed treatment of taxable affiliates is also explained in the attached memo of November 7, 2008.

The Massachusetts proposal focused on insurance companies, but it could be broadened to address any situation where the pass-through parent is not subject to corporate income tax. The approach imposes the Massachusetts franchise tax on the non-
insurance affiliates rather than on the insurance company. Massachusetts is of the opinion that doing so adequately addresses the retaliatory premium tax issue. It addresses the pass-through issue but not other income shifting issues or any expense-creation issues. Furthermore, the approach would require attribution rules to determine 51% ownership by an insurance company.

8. **Expense add back.**

Requiring taxable affiliates to add back payments made to a non-taxable affiliate would address the creation of inter-affiliate expenses, but would fail to address any of the income shifting strategies. As always, the effectiveness of an add back provision would depend on the scope of the statute; if drafted too narrowly the door would remain open for the creation of other inter-affiliate expenses arguably not covered by the statute.

Finally, the working group will explore what changes in federal law may have allowed regulated businesses – like insurance companies and banks - to broaden the extent of their non-insurance/non-banking lines of business.