The purpose of this memo is to summarize the issues that the Subcommittee has identified to date that may arise when a business that is not subject to income or franchise tax has affiliates that are subject to the tax. In addition, the memo summarizes possible solutions.

I. Issues

1. **Pass-through entities.** If an entity that is not subject to income tax, such as an insurance company, owns interests in a pass-through entity such as a partnership or limited liability company (LLC), the pass-through entity’s income “flows through,” untaxed, to the non-taxable company for state income and franchise tax purposes, as it would to any owner of an interest in a pass-through entity. But because the non-taxable company is not subject to income or franchise tax, the pass-through entity’s income is not subject to tax either at the pass-through level or at the owner level. By contrast, a taxable entity owning similar interests would be subject to income or franchise tax on this income. Similar issues arise when an insurance company converts a non-insurance subsidiary from a taxable C corporation to a pass-through S corporation; the formerly taxable C corporation income is no longer subject to state income or franchise tax.

2. **Asset Stuffing.** This issue arises when a corporate income taxpayer transfers income producing assets to an insurance affiliate and takes an income tax deduction for the amounts transferred, in excess of amounts reasonably required to maintain adequate reserves against claims. Again, a non-insurance company would be subject to tax on this income while the insurance company is not subject to state income or franchise tax. Corporate income taxpayers with captive insurance companies present an opportunity for sheltering otherwise taxable income through stuffing.

3. **Intellectual property.** This is basically the Delaware holding company intellectual property strategy that the states have largely succeeded in addressing in most contexts. But there is still a problem in the context of affiliates that are not corporate income taxpayers. For example, by transferring the ownership of intellectual property...
(copyrights, trademarks, patents) from an operating company to an insurance company or to a holding company wholly owned by the insurance company, the insurance company can generate intellectual property royalty payments for the use of the intellectual property by the operating company. The payments would be deductible by the operating company and not subject to tax when received by the insurance company. In the non-insurance context, the states could either assert nexus over the recipient and tax a share of the income or deny the deduction taken by the payor.

II. Possible solutions

1. **Inclusion in a combined group.** One possible solution is to require combined reporting, and to include non corporate income taxpayers in the combined group.

   There is always a potential for tax sheltering when unitary affiliates are excluded from the combined group, as intercompany transactions between members and non-members of the group have the effect of shifting income out of the combined income subject to apportionment. Combining the income of a non corporate income taxpayer with its unitary taxpayer affiliates would address the stuffing issue, as well as other transfers of income from non-income tax paying companies to their taxpayer affiliates. It would also address the intellectual property issue. It would not address the pass-through entity issue. At least two states have combined a non-income tax payer with its unitary income tax paying affiliates. In both cases, combination was sustained on appeal. *Oregon Dep’t. of Revenue v. Penn Independent Corporation*, 15 Or. Tax. 68 (1999); *Appeal of Wendy’s Int’l*, KS Board of Tax Appeals Docket No. 2006-3929-DT (January 4, 2007).

   The insurance industry has suggested that combining an insurance company with its unitary non-insurance affiliates could subject domestic insurance companies to retaliatory premium tax in their market states. This issue was not addressed in *Penn* or *Wendy’s*.

2. **The California approach.** 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 dividend due to the existence of excessive insurance company asset levels. Dividends for tax years commencing on or after January 1, 2008 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. Dividends attributable to premiums received from a member of the insurer’s affiliated group are ineligible for the DRD and captive premiums are not counted in the ratio of net premiums to total income. A similar percentage of interest expense deductions attributed to captive premiums are disallowed in proportion to the captive insurance company DRD disallowance. Finally, captive insurers have a significantly lower threshold of excess asset levels necessary to trigger imputation of income to the parent.

In addition to the DRD phase-out for overcapitalization, there are other anti-abuse provisions in the Corporation Tax Act that are designed to restrict stuffing of insurance companies with income-producing assets that would be taxable but for the fact that insurance companies are not subject to income taxation in California. Section 24425 disallows interest expense deductions for a loan from the insurance company to a non-insurer affiliate. Section 24465 prevents tax-free transfers of appreciated property to insurance subsidiaries. There are certain exceptions for transfers of property to an insurer for use in the active conduct of the insurer’s trade or business. In those cases, recognition of gain is deferred until the date the property is no longer owned by the commonly controlled group or is no longer used in the insurer’s trade or business.

Finally, section 24900 is a deemed dividend provision which empowers the FTB to include in a taxpayer’s gross income a portion of an insurer subsidiary’s current undistributed earnings and profits in a given year under certain circumstances and subject to several limitations.

This California approach addresses the stuffing issue and the intellectual property issue. It does not address the pass-through issue.

3. The Massachusetts approach.

In 2007, Massachusetts considered adopting a statute that would have imposed a tax on the non-insurance income of partnerships and limited liability companies if the income “flowed through” to an insurance company that owned, directly or indirectly, at least 50% of the interests in the flow through entity. The proposal was tabled after the insurance industry objected on the ground that such a tax could subject Massachusetts domestic insurers to retaliatory tax in some states, notwithstanding that the excise tax would not be imposed on the insurance company.

This approach would address the pass-through issue. But not the other two issues.

4. Subject non-premium income earned from transactions with affiliates to tax.

This is similar to the Massachusetts approach, although the tax would be imposed on the insurance company instead of the non-insurance affiliates. Such an approach is likely to be met with the same objection as the Massachusetts approach – the domestic insurers in any state that taxes foreign insurers are likely to be hit with retaliatory premium tax in their market states.

This approach addresses stuffing, intangible holding companies and pass-through issues.
5. Require income taxpaying affiliates to add back deductions for expenses paid to affiliated non-income tax paying companies. Given the MA experience, the insurance industry is likely to assert that addback could trigger retaliatory premium tax.

This approach addresses the stuffing and intangible holding company issue.