



MULTISTATE TAX COMMISSION

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To: MTC Uniformity Committee, Income and Franchise Tax Subcommittee

From: Sheldon H. Laskin, Counsel

Date: November 20, 2009

Subject: Draft Statute to Address Income Earned By Entities Not Subject to Income Tax Derived from Ownership Interest in Passthrough Entity

The purpose of this memo is to provide background on this project and the draft statute which the subcommittee has requested.

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 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 Massachusetts Commission considered the revised proposal, it was recommended for further study, particularly because of the retaliatory tax issue. The Massachusetts 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. The MTC project is not focused specifically on insurance companies. Rather, the project included a broad review of issues that can arise when any entity that is not a state corporate taxpayer, including an insurance company, is affiliated with an entity that is a corporate taxpayer.¹ The Uniformity Committee created a work group to provide educational background, to identify issues and possible solutions, and ultimately to provide a draft statute in accordance with subcommittee direction. 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.

II. Educational Efforts to Date

Initially, the work group arranged educational presentations to familiarize the Subcommittee in general with issues raised by the relationship between a taxable and a non-taxable entity and to receive insurance industry input on the retaliatory tax issue.

¹ Most states exclude insurance companies from imposition of a net income tax. Some states exclude other industries too, e.g., financial institutions and telecommunications companies.

The work group either made or was responsible for organizing 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. Industry participants included the following individuals:

Sandra A. Jones, Senior Tax Manager, Genworth Financial.

James R. Williams, Senior Vice President and Associate General Counsel, Mass Mutual Financial Group.

Robert F. Montellione, Vice President, State Taxes, Prudential Financial, Inc.

Jeffrey M. Serether, Director State and Local Taxes, American International Group, Inc.

Allan J. Stein, Vice President and Associate General Counsel, American Insurance Association.

James D. Hall, Regional Vice President, State Relations, American Council of Life Insurers.

Stephen W. Broadie, Vice President, Financial Legislation and Regulation, Property Casualty Insurers Association of America.

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.

III.

Identification of Tax Issues and Possible Solutions

The work group identified state tax issues that arise in connection with companies that are not subject to income tax and possible solutions for addressing these various 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. Overcapitalization/ 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.

The work group identified each of the following options for addressing one or more of the issues.²

1. 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.³
2. Subject the non-taxpayer investment income from affiliated entities to a gross income tax.
3. Subject capital contributions to the gross premium tax.
4. In combined reporting states, include the non-taxable company in the combined group.
5. Adopt the California approach (pertaining to overcapitalized insurers, though in a very specific context).
6. Adopt the Massachusetts approach.

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.

³ Minnesota repealed the income tax on insurance companies because the gross premium tax consistently yielded more revenue.

7. Enact expense add back provisions for payments to a non-taxable affiliate.

The subcommittee considered the work group's list of issues and possible solutions at its meetings of November 2008, March 2009, and July 2009. At the July 2009 meeting, the work group recommended priority be given to developing option 7 (the MA approach to addressing the pass-through problem) and that it should continue to identify solutions for addressing the overcapitalization/asset stuffing problem. The subcommittee adopted that recommendation and directed the work group to provide a first draft of a model statute based on the Massachusetts pass-through bill. The work group has done so, and a copy is attached for consideration by the subcommittee.⁴

⁴ At its July 2009 meeting, the subcommittee also directed the workgroup to focus next on identifying solutions to the overcapitalization/ asset stuffing issue. The work group continues to explore this issue.