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. 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.

Investment Income and the Insurance Gross Premiums Tax, California Legislative
Analyst’s Office (July 2008), at 4. A copy of the LAO report is attached.  

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.

---

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