AMERICAN COUNCIL OF LIFE INSURERS
AMERICAN INSURANCE ASSOCIATION
PROPERTY CASUALTY INSURERS ASSOCIATION OF AMERICA

February 19, 2010

Dear Chairman Miller:

The above trade associations ("the Trades"), representing the majority of the life and property and casualty insurance industry, urge you not to adopt the "Draft Statute to Address Income Earned By Entities Not Subject to Income Tax Derived from Ownership Interest in Passthrough Entity," released on November 20, 2009.1 The Trades believe that the Draft Statute has been subject to insufficient outside input and rests on questionable and unproven assumptions. In several respects, these assumptions can be evaluated only with input from state insurance regulators.

The Trades would welcome the opportunity to comment on the Draft Statute and the Staff Analysis on which it is based, but it is not the purpose of this letter to provide such comment. Rather, our intent here is simply to state why we believe that the Draft Statute is not ready to receive the imprimatur of your Subcommittee (much less the MTC or the states).

The Uniformity Subcommittee has not had an opportunity to hear from the insurance industry or its regulators about the specific implications of the Draft Statute. It is true that insurance industry representatives met with the Subcommittee in Santa Fe on July 28, 2008 (and informally prior to this meeting). But at that time, the Subcommittee was in the early stages of considering eight diffuse options to address three distinct issues. At the time the industry was heard, there was no clear definition of the perceived problem, much less the suggested remedy. It was not until the Subcommittee met in July of last year that it focused attention on the present issue and it was not until November that the Draft Statute was released. To the best of our knowledge, there has been no consultation on the Draft Statute with stakeholders (e.g., the insurance industry, state insurance regulators, small business investment interests, and other affected industries) or independent experts (e.g., Professor Richard Pomp, a frequent advisor to the MTC, who has studied the state corporate income tax and insurance tax systems). The Trades have offered to organize a panel to provide the Subcommittee with outside, expert input, including state insurance regulators and Professor Pomp.2

This process has resulted in a Draft Statute that rests on two stated assumptions (as applied to the insurance industry): first, that there are "serious tax equity issues" which must be addressed by taxing certain insurer investment income; and second, that the Draft Statute can be adopted without impairing the states' longstanding choice for taxing insurance companies (i.e., the nationwide premium and retaliatory tax system). To date, however, there has been no showing that either of these assumptions is sound.

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1 The Draft Statute is appended to a staff and working group memorandum to the Uniformity Committee, Income and Franchise Tax Subcommittee, dated November 20, 2009. This memorandum was the latest in a series of staff memoranda relating to this issue (and other issues) spanning roughly one year (the others are dated September 30, 2009, March 6, 2009 and November 7, 2008). These memoranda, prepared by MTC staff in coordination with a small working group, are referred to herein, individually and collectively, as the "Staff Analysis."
2 As we reported to MTC staff, this proved impossible for the upcoming March MTC meeting owing to prior commitments of several invitees.
“Serious Tax Equity Issues”

Premium tax, imposed on a base of gross underwriting receipts, together with retaliatory tax, is the chosen tax system for the privilege of conducting the insurance business in virtually all jurisdictions. The Staff Analysis (in considering one of eight options for taxing insurer income) references economic studies proving that this system consistently yields far more revenue than an income-based tax, but then dismisses the importance of this factor, as follows:

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.

In fact, economic studies (done over decades by and for the states and industry) generally do take account of what the Staff Analysis refers to as “tax avoidance”; i.e., the fact that insurer investment income is not taxed under the gross premium tax system (to an insurer or pass-through investment entity). These studies, many of which rely on the calculation and comparison of effective income tax rates on the insurance industry and income tax-paying industries, consistently show that the insurance tax burden (and resulting state revenues) is far greater than it would be under a corporate income tax system. The Staff Analysis, which focuses on slices of investment income that are outside the gross premium tax base, fails to explain how the perceived “equity issues” leave the states (or any other parties) aggrieved, or to fairly evaluate the most urgent and obvious equity issues for the insurance industry (and policyholders) in this broader context.

Significantly, the Staff Analysis seems to implicitly recognize that the underlying issue here is the states’ choice of the premium and retaliatory tax system for this industry, concluding that the current economic crisis “may not be a propitious time to replace a tax based on gross premiums with one based on net income.” Not addressed by the Staff Analysis, however, is why the current economic crisis presents the “propitious time” to impose an additional tax on this industry. Nor could the Staff Analysis credibly address this issue without hearing from state insurance regulators.

Implications for Current State Insurance Tax System

The Staff Analysis fails to consider whether the current insurance tax system can survive, as both a technical and political matter, the advancing encroachment of an income tax system (via MTC projects relating to forced combined reporting and now, the Draft Statute and multiple other options for taxing insurer income).

The Staff Analysis repeatedly references the need to survey whether domestic insurers in the roughly seven states that subject insurers to income tax are subject to retaliation against this tax

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3 Only Oregon taxes insurers under an income-based “excise tax” (but not a premium tax) and a retaliatory tax. Only Hawaii has not adopted a retaliatory tax.
4 Staff Memorandum dated March 6, 2009 at pages 2-3.
5 In Missouri, for example, studies done by Dr. Edward H. Robb (an economist who led the University of Missouri College of Business and Public Administration Research Center, and later, Edward H. Robb Consulting) disclosed that insurance companies “paid…approximately 20 times the average liability of the non-financial corporations and nearly eleven times the average liability of other financial institutions” and paid $164.4 million in premium taxes, but would have paid only $46.3 million had they been subject to the State’s income and franchise tax system instead. 2003 Taxation of the Insurance Industry in Missouri (Edward H. Robb Consulting 2003). See also Taxation of the Insurance Industry in Missouri (Dr. Edward H. Robb, January 1992).
when they do business in other states. However, the Trades have seen no discussion of the results of this survey.

While it was retaliatory tax risks that first caused Massachusetts to refer this project to the MTC, the Staff Analysis fails to take account of any empirical evidence relating to these risks (or even of diverse state retaliatory tax statutes and practices). Instead, the Draft Statute seeks to avoid these risks by creating a fiction: that a pass-through entity is not a pass-through entity if it is owned by an investor that is an insurance company. But the Staff Analysis fails to consider why other states should respect this fiction when it is created by an insurer's home state for the sole and express purpose of avoiding retaliatory taxes (a substantial source of revenue for lower-tax states) in these other states. And beyond the risks of states retaliating, the Staff Analysis fails to consider the implications for the state insurance tax system (and the states) if states do retaliate against the Draft Statute.

The Staff Analysis fails to consider how the Draft Statute can be reconciled with the letter and intent of state statutory and constitutional "in lieu" clauses. These clauses represent an implicit bargain that recognizes the disproportionately high tax burden imposed by the current state insurance tax system by providing that the taxes imposed by this system are in lieu of other taxes on insurer income and receipts. Nor does the Staff Analysis consider the impacts of the Draft Statute on investment decisions or on the extensive system of state premium tax credits, which are designed to encourage a variety of in-state insurer investments (e.g., in partnerships).

Apart from these tax-related omissions, there is a broader issue here. The Staff Analysis fails to consider whether the Draft Statute puts the current insurance tax system at risk. The relative merits of the current system and the corporate income tax system are subjects of debate within the insurance industry, with some preferring the predictability of the current system and others preferring to level the playing field among industries. Making these two tax systems progressively additive would provide economic and political impetus (and equitable underpinning) for a unified industry to advocate the choice of one system or the other. And here again, the input of state insurance departments, many of which depend on the reliable and generally-growing revenue stream provided by premium taxes, is essential.

In sum, the Trades believe that the Staff Analysis rests in large part on unfounded, internal assumptions. These assumptions have yielded a Draft Statute that could be self-defeating for the states in the long-term. If there is abuse in this area, the Trades reiterate both our belief that it is isolated and our readiness to assist the MTC in developing appropriate solutions to address it. But to adopt the Draft Statute on the record provided by the Staff Analysis to date, would be, at best, premature.

Respectfully submitted,

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cc: Ted Spangler, Chairman, Uniformity Committee
    Joe Huddleston, Executive Director
    Shirley Sicilian, General Counsel
    Sheldon Laskin, Counsel