



MULTISTATE TAX COMMISSION

Maximizing the synergies of multi-state tax cooperation

To: MTC Executive Committee

From: Sheldon H. Laskin, Counsel

Date: July 15, 2013

Subject: Staff Final Project Report for the Model Statute for Partnership or Pass-Through Entity Income Ultimately Realized by an Entity That Is Not Subject to Income Tax

This project was initiated in February 2008, following a request from the Massachusetts Commissioner of Revenue, Navjeet Bal, to Jan Goodwin, the then chair of the Multistate Tax Commission (MTC) and to MTC Executive Director Joe Huddleston. The Massachusetts Commissioner noted that income realized by pass-through entities that are owned and controlled by insurance companies are not subject to income tax, either at the pass-through or the parent level. In contrast, income realized by pass-through entities that ultimately flows through to a taxable entity is ultimately subject to income tax at that time. The Massachusetts Commissioner was specifically concerned that “tax equity problems [can] arise when insurance companies, which under most state statutes are taxed only on their gross premiums, own interests in partnerships and limited liability companies that generate income from non-insurance businesses.”¹ In general, this result is inconsistent with the rationale for creation of pass through entities. Pass-through entities were created in the law to allow for income realized by those entities to be subject to tax only once, at the parent level, rather than at both the entity and the parent level; and not to create a permanent exclusion from income tax for that income entirely.

The Executive Committee sent the matter to the Uniformity Committee. That Committee initiated a project at its Spring 2008 meeting, but broadened the project to address this issue with respect to pass-through entities that are owned and controlled by any entity that is not a corporate income taxpayer (i.e., the project was not limited to the situation where the parent company is an insurance company). The Income and Franchise Tax Subcommittee created a drafting group to gather and provide educational information, to identify policy issues for the Subcommittee’s consideration, and lastly to draft a proposed model statute in accordance with the Subcommittee’s policy choices for the Subcommittee’s consideration.² The drafting group and the Subcommittee both received significant

¹ A copy of Commissioner Bal’s request is attached as Exhibit 1.

² The drafting group consisted at various points of persons with the state revenue agencies of California, Colorado, Georgia, Massachusetts and Montana.

input from state insurance regulators and the insurance industry. The insurance industry was represented primarily by several trade groups (the “Trades”).³

The Subcommittee initially considered a range of options to address the pass-through issue. Those options included requiring unitary insurance companies to be included in a combined report with their non-insurance affiliates and a California statutory provision that reduces or disallows deductions for dividends received from an overcapitalized insurance company. While each of the proposals that were evaluated merit consideration for addressing various deficiencies in the states’ tax laws, the Subcommittee ultimately rejected them for this project as not being responsive to the tax equity issue created by income flowing from a pass-through entity to a parent entity that is not subject to income tax.

The Uniformity Committee considered its options and chose to work on a model statute that would impose income tax on a pass-through entity owned and controlled by a non-taxable entity (i.e., as if the pass-through entity were a separate taxable entity). The Committee approved a model proposed statute at its Spring 2011 meeting that would impose income tax on a partnership or limited liability company that is 50% or more owned by a parent entity that is not subject to income tax. The Executive Committee approved the proposal for a hearing that was held on May 16, 2011.⁴

Throughout the process leading up to the May, 2011 hearing, the Trades provided significant public comment. The Trades disagreed with the premise for the project, urging that if there is an underlying tax equity issue suggested by the ownership and control of pass through entities by an insurance company that this must be viewed in the broader context of the fact that the insurance industry bears a relatively high total effective tax rate under the current nationwide gross premiums tax system. Also, the Trades expressed concern that subjecting a pass-through entity owned by an insurance company to income tax could possibly trigger a retaliatory premium tax imposed on such an insurance company that is domiciled in a state that imposes income tax on the pass-through entity.⁵ And the Trades stated that the MTC process had not demonstrated a need for the proposal; that there would be significant new tax inequities (disfavoring insurance companies relative to state corporate income taxpayers) that would be created by the proposed model; and stated also that to the extent there is such a need, there are adequate alternative remedies for the states to employ in response to abusive tax practices undertaken by insurance companies.

Following public comment by and on behalf of the Trades and Executive Committee discussion, the Executive Committee voted on July 28, 2011 to ask the Uniformity Committee to consider additional proposals from the Trades and provide additional information back to the Executive Committee. The Executive Committee also asked the Uniformity Committee to prepare a matrix for its consideration,

³ The Trades were the American Council of Life Insurers, American Insurance Association, National Association of Mutual Insurance Companies and Property Casualty Insurers of America.

⁴ A copy of the Hearing Officer’s Report and proposed model statute is attached as Exhibit 2.

⁵ Others who spoke on behalf of the Trades also expressed this concern, including Dan Schelp, a representative from the National Association of Insurance Commissioners (NAIC), Steve Johnson, the Deputy Insurance Commissioner of Pennsylvania, and Richard Pomp, a Professor of Law at the University of Connecticut.

showing the significant tax issues that are raised when corporate income taxpayers and non-corporate income taxpayers are commonly owned, and the existing MTC models, proposed MTC models, and other options for addressing state tax issues that can manifest in the context of insurance companies and other non-corporate income taxpayers.⁶ Following the July 2011 Executive Committee meeting, the industry representatives and insurance regulators participated in meetings of both the Subcommittee and the drafting group in an effort to find common ground.

Neither the Subcommittee nor the drafting group were able to find common ground with the Trades. The states questioned whether the fact that insurance companies pay a lot of state tax in the form of gross premiums is relevant to the issue as to the appropriate income tax to be imposed on a pass-through entity that is owned and controlled by an insurance company or other non-corporate income taxpayer. The states concluded that the Trades proposal would not adequately address this issue, and that the states did not otherwise possess adequate alternative remedies to address this concern. Moreover, the states did not agree that the possibility of a retaliatory tax by reason of the application of the model proposal is a realistic concern. The proposal would impose tax on pass-through entities that are not themselves engaged in the business of insurance and would not impose tax on the insurance companies that own such entities. Currently, corporate subsidiaries of insurance companies that do not engage in the business of insurance are subject to corporate income tax, apparently without any adverse retaliatory tax consequences. Imposing the income tax on similar businesses that are instead organized as pass-through entities would have precisely the same economic effect and should therefore also result in no adverse retaliatory tax consequences. Furthermore, the states received from the Trades a compendium of the operative language of each state's retaliatory tax law. Those statutes specifically apply retaliatory tax only with respect to tax imposed on an insurance company and its "agents or representatives." The states did not agree that an entity that does not engage in the business of insurance that is owned and controlled by an insurance company would be regarded as an agent or representative of an insurance company under these statutes merely because it is owned by an insurance company.

In March 2012 and then again on May 10, 2012, Michael Fatale of the Massachusetts Department of Revenue made presentations to the Subcommittee and Executive Committee, respectively, which were intended to demonstrate the need for the proposal.⁷ These presentations discussed the historical evolution of the increasing use of LLCs and pass-through entities in general over the past 20 years. These presentations also documented several specific instances in which an insurance company transformed a large subsidiary corporation that was not engaged in an insurance business into an LLC that was subsequently owned and controlled by an insurance company. These examples each suggested an instance where the result would apparently be a significant reduction in the amount of income that would be taxable by the states.

⁶ The matrix is attached as Exhibit 3.

⁷ A copy of his presentation is attached as Exhibit 4.

Ultimately, the Trades presented their proposed alternative model language on March 29, 2012.⁸ This alternative model was similar to the states' model but applied only in the circumstances where a pass-through entity was owned and controlled by a subset of "captive" insurance companies. Following the Trades submission of its alternate proposal, the drafting group prepared a detailed analysis of industry's proposal and other comments, which was submitted to the Income and Franchise Tax Subcommittee on July 20, 2012.⁹ It was clear from the Trades' alternate proposal and comments that the Trades continued to disagree that there is a tax equity issue that warrants imposing income tax on the income of a pass-through entity if that income is passed through to an entity that is not subject to corporate net income tax.

On July 20, 2012, the Subcommittee received the drafting group's report. Following discussion, the Subcommittee voted to accept the proposed model statute as sent to public hearing on May 16, 2011 and recommend it to the Uniformity Committee with amendments. The amendments pertained to specific language in the proposal that was intended to address the ownership of a REIT. The Subcommittee agreed that it could continue to work on the treatment of REITs separately at a later date if necessary. The proposal was then accepted by the full Uniformity Committee. The Uniformity Committee then voted to resubmit the revised proposal to the Executive Committee at its December 2012 meeting.

During the Executive Committee meeting in December 2012, Michael Fatale of the Massachusetts Department of Revenue suggested two revisions to the proposed model statute that were designed to address some of the concerns expressed by the Trades and MTC Executive Committee members regarding the proposal. The Executive Committee directed that the Uniformity Committee consider those revisions for incorporation into the proposal. At its teleconference meeting of February 5, 2013, the Uniformity Committee considered the proposed revisions and after further discussion at its meeting of March 6, 2013, the Uniformity Committee approved the revisions for consideration by the Executive Committee.¹⁰

At its meeting of May 9, 2013, the Executive Committee considered a number of options in relation to the revised proposed model statute. Those options included approving the proposal for a bylaw 7 survey, sending the proposal back to the uniformity committee for additional work, sending the proposal back for an additional public hearing or ending the project. There was an extensive discussion of the revised proposal, during which the Trades submitted additional material in opposition to the proposal.¹¹

Following discussion, the Executive Committee voted to complete the project with a paper, memorializing the issues raised, research conducted, and other contributions of the committees and the

⁸ A copy of the Trades' proposed alternate proposal with supporting documentation is attached as Exhibit 5.

⁹ A copy of staff's report to the Uniformity Committee dated July 20, 2012 is attached as Exhibit 6.

¹⁰ A copy of the revised proposed model statute with Mr. Fatale's proposed revisions, is attached as Exhibit 7.

¹¹ A copy of the Trades submission to the Executive Committee on May 9, 2013, is attached as Exhibit 8. Included in this material are submissions from staff or members of NCSL and NCOIL stating a concern that the MTC model, if adopted by states, could threaten the viability of the current insurance tax system.

public that participated in this project. The Executive Committee directed that the paper be presented to the Executive Committee at its July 2013 meeting, as a report from staff requiring no further action by the Committee.¹²¹³

¹² The complete library of all documents pertaining to this project is available on the MTC website at <http://www.mtc.gov/Uniformity.aspx?id=5619>.

¹³ The Trades' response to this report is attached as Exhibit 9.