

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

March 9, 2011

Dear Chairman Cordi:

The above trade associations (“the Trades”), representing the majority of the life and property and casualty insurance industry, urge you to not to adopt the Uniformity Committee’s recommendation to advance to a public hearing its “Proposal on Taxation of Pass-Through Entities Owned by Affiliates Not Subject to Corporate Income Tax” (“Proposal”). In two prior formal submissions (attached), testimony, and multiple communications with MTC staff, the Trades have urged that the Proposal has not been subject to sufficient outside input and rests on questionable and unproven assumptions. This remains no less the case today.

This project began over three years ago with a letter to MTC officials, dated February 12, 2008, from Massachusetts Revenue Commissioner Bal. The MTC’s development of the Proposal since that time has regrettably been characterized, not by insufficient time, but by insufficient study.

The MTC has repeatedly emphasized the importance of understanding the retaliatory tax effects of the Proposal. The record reflects that it was largely uncertainty about these effects that prompted Massachusetts to refrain from adopting a similar proposal and then to refer this project to the MTC in the first instance. Nevertheless, to the best of our knowledge, no such study has been undertaken by the MTC. Instead, the Proposal rests on the MTC staff’s unsubstantiated statement that “Members of the subcommittee have expressed a belief that this [risk of retaliatory taxation] is unlikely, because insurance income would not be subject to tax under the model.” (MTC staff memo dated November 19, 2010).

Having recognized the centrality of the retaliatory tax issue, has the MTC done a legal analysis of retaliatory tax statutes and practices in 50 jurisdictions to support the foregoing belief? Has the MTC surveyed regulators about relevant retaliatory tax practices or developed any empirical evidence whatsoever to support this belief? Has the MTC consulted with state insurance regulators? Has the MTC considered the question (raised by the Trades last February) why a state applying its retaliatory tax would respect the indispensable fiction created by the Proposal -- that a pass-through entity is not a pass-through entity if it is owned by an investor that is an insurance company -- when this fiction would be created by the insurer’s home state solely for the express purpose of *avoiding* retaliatory taxes (a substantial source of revenue for lower-tax states) in other states? This is not a situation where we don’t like the answers. Rather, this is a situation where the MTC’s process to date has yielded no credible answers at all.

Nor are retaliatory tax effects and their potential implications for the current insurance tax system the only areas where needed groundwork has not been done:

- The MTC repeatedly affirms that the Proposal is driven solely by tax equity (and not tax avoidance) concerns. Yet we have seen no response by the MTC to the many new tax inequities, detailed in the Trades' filing on July 22, 2010, that would be *created by* this Proposal (*e.g.*, utilization of losses in the pass-through entity, utilization of losses in the insurance company, direct versus indirect insurer investment, double income taxation in states that impose income-based taxes on insurers).
- We have seen no response by the MTC to the relationship of the MTC's perceived "tax equity" issue to overarching questions of tax equity created by grafting a new insurance tax burden from the state income tax system when economists and academics agree (and the MTC has not disagreed) that under the nationwide premium tax system, insurers already bear an effective tax rate and tax burden far greater than virtually any other industry.
- As discussed in the Trades' July 1010 filing, the MTC itself has recognized the need to sharpen the issues through additional education (*e.g.*, relating to the use of captives by non-insurance companies, the use of LLCs and partnerships by insurance companies, and insurer investment practices and restrictions). Here again, we have seen no evidence that this research has been done.

The MTC apparently has received little or no input from state insurance regulators about retaliatory tax implications, jeopardy to the current state insurance tax system, the relevant insurance regulatory framework, or the need for the Proposal in light of state restrictions governing insurer investments. MTC staff states simply that insurance commissioners have ignored or declined *staff's* invitations to participate. We have seen no response to the Trades' suggestion that invitations from MTC *members* to their insurance regulator counterparts would greatly enhance the prospects of positive responses.

The *only* input from outside of the MTC itself we are aware of in the development of this Proposal has come from the Trades and Professor Richard Pomp (statement attached), both of whom cautioned about the uniqueness of the insurance tax system, the risks of retaliatory taxation, the unintended adverse consequences of adopting this Proposal, and the flawed process that has characterized the MTC's development of the Proposal to date.

The MTC's Uniformity Recommendation Development Process provides that, prior to any formal public hearing under Step 6: "With regard to uniformity matters drawing broad public interest (as partially determined from the comments received...) the Uniformity Committee will, at the completion of its work, generally recommend to the Executive Committee the development of a broad-based public participation process to review the then current version of the proposal." (Step Three); and "...a public participation working group is formed that represents the interest of the states, affected commerce, and the public at large, possibly including academics..." (Step Four).

For substantive reasons stated in our prior submissions, the Trades urge the Executive Committee to terminate this project. At a minimum, however, essential elements of the Proposal

rest on a flawed process and unsubstantiated speculation. The Proposal is not ready to advance to a formal public hearing (much less to the states) and, if not terminated, should be referred back to the Uniformity Committee for further study and/or to develop “public participation working group drafts or recommendations” (per Step Four of the Recommendation Development Process).

Respectfully submitted,

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

Attachments

cc:

Wood Miller, Chairman, Uniformity Committee  
Joe Huddleston, Executive Director  
Shirley Sicilian, General Counsel  
Sheldon Laskin, Counsel

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

July 22, 2010

Dear Chairman Miller:

The undersigned trade associations (“the Trades”) together represent the great majority of the life insurance and property and casualty insurance industries. We appreciate the opportunity to provide additional comments concerning the Project Regarding Income Earned by Non-Corporate Income Taxpayers Derived from Ownership Interest in a Partnership or LLC (the “Project”).<sup>1</sup> We appreciate also the opportunity to speak at the upcoming meeting of the Income and Franchise Tax Uniformity Subcommittee (the “Subcommittee”) of the Uniformity Committee of the MTC on July 25.

These comments were originally prepared in response to a Draft Statute posted to the MTC’s website in February 2010 (the “Draft Statute”). However, on July 15, two new and revised versions of the Draft Statute (the “Revised Draft Statute”) were posted to the MTC’s website and will, we assume, be presented to the Subcommittee for the first time at the July 25 meeting. Although we have attempted to react as quickly as possible and have included our initial thoughts with respect to the Revised Draft Statute below, we have not yet had time to undertake a thoughtful discussion regarding the full extent of the Revised Draft Statute. Should the Subcommittee remain committed to the Revised Draft Statute following its initial consideration at the July 25 meeting, we would request a further opportunity to address the Subcommittee regarding this matter.

**Summary of Comments.** We urge the Subcommittee to reject both the Revised Draft Statute and the Draft Statute (collectively, the “Draft Statutes”) for at least the following reasons:

1. The Revised Draft Statute represents a **fundamental expansion** of the Project that would have **dramatic and unfair consequences** for insurance companies and their policyholders nationwide.
2. The Draft Statutes are based on a faulty premise. **Insurance company taxpayers pay higher taxes than non-insurance corporate income taxpayers.**
3. The Draft Statutes **discriminate** against pass-through entities depending on what type of entity owns the majority interest, creating **new inequities, inconsistencies, and controversies.**
4. Any concern among Subcommittee members regarding “abusive” transactions is ill-founded. **Insurance companies are subject to extensive state regulation that creates strong incentives for investment decisions to be driven by nontax business considerations.** States already possess ample tools to combat transactions perceived as abusive.
5. Although the Subcommittee has itself identified several areas requiring further study, to the best of the Trades’ knowledge such research has not been conducted.

---

<sup>1</sup> These comments are intended to supplement our submissions dated February 19, 2010 and March 23, 2010. Our prior comments were based on previous drafts of the Draft Statute, including a draft dated February 19, 2010.

## **Background**

The Draft Statute.<sup>2</sup> Under the Draft Statute, whenever an insurance company owns at least a 50% ownership interest in a “pass-through entity” engaged in a trade or business other than an insurance trade or business, the pass-through entity becomes subject to tax on the investment income passed-through to the insurance company. Although the Subcommittee’s discussions to date have focused on what were described as abusive transactions, a recent memo authored in support of the Draft Statute states that the “lack of a tax avoidance motive is immaterial to the general purpose” of the Draft Statute, because the purpose of the Draft Statute is “to address an inequity in the income tax treatment of pass-through income generated by separate business entities that is entirely the result of the fact that some companies are not subject to state income tax.”<sup>3</sup>

The Revised Draft Statute. The Revised Draft Statute would impose tax on a pass-through entity if 50% or more of the interests in the entity are owned by an insurance company or any other entity not subject to income tax except an organization exempt under Section 501 of the Internal Revenue Code. The application of the Revised Draft Statute is not limited to pass-through entities engaged in a trade or business.

## **Detailed Analysis**

### **1. The Revised Draft Statute represents a fundamental expansion of the Project that would have dramatic and unfair consequences for insurance companies and their policyholders nationwide.**

In addition to the concerns expressed in the remainder of these comments with respect to both Draft Statutes, the Revised Draft Statute suffers from three fatal flaws, detailed below.

First, the Revised Draft Statute is not limited in its application to pass-through entities engaged in a trade or business. Thus, the Revised Draft Statute would impose tax on passive investments such as investment funds held by insurance companies in support of their obligations to pay policyholder claims. Imposing tax on the investment income of insurance companies would represent a fundamental shift in the long-standing nationwide system of state insurance taxes, which rests on the foundation of premium taxation, retaliatory taxation and constitutional and statutory “in lieu” protections, and has been the states’ chosen system for taxing the privilege of conducting the insurance business nationwide.<sup>4</sup>

The underwriting and investment aspects of the insurance business are inextricably interrelated. As stated by the U.S. Supreme Court (in describing a life insurer’s underwriting and investment receipts):

An insurance company obtains most of its funds from premium paid to it by policyholders in exchange for the company’s promise to pay future death claims and other benefits. The company is also obligated to maintain reserves, which, if they are to be adequate to pay future claims, must grow at a sufficient rate each year. The receipt of premiums necessarily entails the

---

<sup>2</sup> See Alternative Draft 1, Memo from Sheldon Laskin to the Subcommittee, dated February 19, 2010.

<sup>3</sup> Memo from Sheldon Laskin to the Subcommittee, dated June 11, 2010, fn 4.

<sup>4</sup> Oregon is the only state that taxes insurers under a net income-based “excise” tax, but not a premium tax.

creation of reserves and additions to reserves from investment income. Thus the insurance company is not only permitted to invest, but it *must* invest; and it *must* return to the reserve a large portion of its investment income...

*U.S. v. Atlas Life Insurance Co.*, 381 U.S. 233, 247 (1965). Although the premium tax component of the insurance tax system is based on gross underwriting receipts, this is a *comprehensive tax system on the privilege of engaging in an insurance business*, in all of its aspects, in the states. Thus, states have heretofore deemed the insurance tax system sufficient to tax the entire insurance business, i.e., its underwriting income (premiums) and its investment income.<sup>5</sup>

The inappropriateness of superimposing on this system a new tax on investment income is best illustrated by a simple example comparing a non-insurance corporate income taxpayer with an insurance company taxpayer. To make the example as objective as possible, it is based on the highly unlikely assumption that both taxpayers have the same amount of investment income. In reality, however, as a general rule, investment income would make up a much higher portion of the overall income of an insurance company than a non-insurance company, such that the proposal would result in a significantly higher tax burden on the insurance company than the non-insurance company.

	<b>Non-Insurance Co.</b>	<b>Insurance Co. current law</b>	<b>Insurance Co. after Revised Draft Statute</b>
Gross Receipts/Premiums	\$1,000	\$1,000	\$1,000
Less: expenses	(\$950)	(\$950)	(\$950)
Investment income from pass-throughs <sup>6</sup>	\$100	\$100	\$100
<b>Net income before taxes</b>	<b>\$150</b>	<b>\$150</b>	<b>\$150</b>
Less: Taxes			
Income tax (7%)	\$10.50	\$0	\$0
Income tax on pass-through entity (7%)	\$0	\$0	\$7
Premium tax on gross premiums (2%)	\$0	\$20	\$20
<b>Total tax paid</b>	<b>\$10.50</b>	<b>\$20</b>	<b>\$27</b>

In this simple example, under existing law, an insurance company subject to 2% premium tax pays nearly 200% the amount of tax that a non-insurance company taxpayer subject to a 7% income tax with the exact same receipts and expenses would pay (\$20 vs. \$10.50). Subjecting the insurance company to the income tax on its investment income heightens the disparity, increasing the burden on the insurance company to nearly 260% (\$27 vs. \$10.50).

It is no solution to suggest that insurance companies could merely hold investment assets directly, rather than in partnership or limited liability company form, in order to avoid the application of this onerous and inequitable rule. Insurance companies hold investment assets in a variety of legal forms for legitimate and important business reasons. For example, an insurance company might choose to create a medium-term corporate bond fund to purchase corporate debt. The insurance company might hold 99.9% of the interest in the fund, using the remaining interest to provide incentive compensation to personnel responsible for managing the company's medium-term corporate bonds. Imposing income tax on the income earned by the insurance

<sup>5</sup> Although some states supplement the premium tax with an income tax, insurers are generally permitted cross-tax credits or caps.

<sup>6</sup> Example is for purposes of illustration and does not necessarily reflect the proportion of investment income that might be earned by an insurance company from a investment held in pass-through entities.

company from the fund could impair the company's ability to meet its obligations to pay policyholder claims,<sup>7</sup>

Finally, the Revised Draft Statute could result in additional tax burdens being imposed on the some of the nation's most vital non-insurance regulated industries, including financial institutions, telecommunications companies, and public utilities. These stakeholders have not had the opportunity to address the Subcommittee, and it would be imprudent for the Subcommittee to act with respect to the Revised Draft Statute without considering the effect of adopting a new tax on these industries.

**2. The Draft Statutes are based on a faulty premise. Insurance companies bear a significantly higher burden of state business taxes than non-insurance businesses.**

Both of the Draft Statutes purport to be based on the notion that the current system results in an inequity, such that exempting insurance companies from the income tax somehow results in insurance companies bearing a lower tax burden than non-insurance corporate taxpayers. As stated above, the purported purpose of the Draft Statutes is "to address an inequity in the income tax treatment of pass-through income generated by separate business entities that is entirely the result of the fact that some companies [*i.e.*, insurance companies] are not subject to state income tax."<sup>8</sup> The notion that the current system results in "inequity" that favors insurance companies is demonstrably incorrect, as illustrated by the example discussed above. The results of that example are confirmed by multiple studies conducted by states and economists over decades. It is universally accepted in the academic and economic communities – and recognized by the MTC itself<sup>9</sup> -- that the insurance tax system imposes a tax burden that is many multiples of the tax burden imposed on non-insurance corporate taxpayers, or that would be imposed on the insurance industry if it were subject to income taxation in lieu of the current insurance tax system.<sup>10</sup>

Professor Martin F. Grace concisely begins his study of the relative burden imposed by the state life insurance tax system (*Excessive State Taxation of the Life Insurance Industry: The Case for Reform* (December 23, 2003)) with the simple finding that "[t]he insurance industry is overtaxed."<sup>11</sup> Others who have compared the insurance and corporate income tax systems for states and/or industry agree. The following illustrative excerpts from various studies represent only a handful of examples of the relevant research (examples confined to member states of the Subcommittee in the interest of brevity, emphasis supplied):

- **California (2008).** "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..." *Investment Income and the Insurance Gross Premiums Tax* (California Legislative Analyst's Office at page 4).

---

<sup>7</sup> Indeed, the burden of such tax could fall directly on policyholders where an insurance company holds investment funds in a separate account supporting such things as variable life insurance contracts.

<sup>8</sup> Memo from Sheldon Laskin to the Subcommittee, dated June 11, 2010, fn 4.

<sup>9</sup> The March 6, 2009 and November 20, 2009 memos to the Subcommittee recognize that Minnesota repealed its income tax on insurers because the premium tax "consistently yielded much higher revenue."

<sup>10</sup> It also is well accepted that the insurance tax system generates a reliable, generally growing source of revenue for the states, far in excess of the revenue that would be generated by taxing insurer income, and that remains steady during periods of economic stress and reduced corporate profitability.

<sup>11</sup> It should be noted that Professor Grace is considered a credible source by MTC staff. See Memo from Sheldon Laskin to the Subcommittee, dated February 19, 2010.

- **California (2003).** “All of the available evidence shows that California’s tax laws currently impose a **much heavier burden on insurance companies** than on companies in other industries.” *The Taxation of Insurance in California* (Hamm, Fortenbaugh, Schmidt, Johanson at LECG Economics and Finance at page iii).
- **California (1991).** “The income-based tax burden on these property/casualty insurers [companies writing between 42.3% and 50.1% of the total California market between 1984-1989] ranged from a low of 16.9% in 1987 to a high of 53.9% in 1985 and **exceeded the tax rates imposed on other industries in every year.**” *California Taxation of the Property/Casualty Insurance Industry* (Hofflander, Nye, Charlesworth, Brydon at Stanford Consulting Group at page i).
- **California (1990).** “These figures illustrate that the **tax burden imposed on the life insurance industry** by the State of California **greatly exceeds that imposed on other California industries.**” *Taxation of the California Life Insurance Industry* (Hofflander, Nye and Charlesworth at page 5).
- **Florida (2006).** “The insurance premium tax has grown in importance as a source of tax revenue in recent years as annual intangibles tax and estate tax revenues have been reduced to zero. **Because of its growing importance as a revenue source, proposals to change this tax warrant careful scrutiny.**” *An Overview of Florida’s Insurance Premium Tax, Report No. 2007-122* (Prepared by Committee on Finance and Tax for Florida Senate at page 17).
- **Florida (1991).** “The P&C industry was subject to an **effective tax rate of 33.5** percent in Florida over the five-year period from 1985 to 1989 (using the statutory income measure which is applied for the purpose of insurance regulation). The effective tax rates for the comparison industries in the manufacturing, retail trade and banking sectors ranged from 5.6 to 9.9 percent over the same period.” *Comparative Analysis of the Taxation of the P&C Insurance Industry in Florida* (Price Waterhouse at page i).
- **Florida (1990).** “There is a wide acceptance and a statistical basis for determining that each one percent of the insurance premium tax (a gross receipts tax) is equivalent to a 20.4% net income tax.” *Report of the Florida Insurance Premium Tax Task Force to the Florida Legislature* (at page 4).
- **Massachusetts (1997).** “Taxes as a percentage of profits are **higher in the insurance industry than in any other industry** in the state and greater than on other financial services.” *The Effect of State Tax Policy on the Insurance Industry In Massachusetts* (Prof. Craig L. Moore, University of Massachusetts at page 7).
- **Missouri (2003).** “Banking and other credit institutions paid an average of only \$8000 in 2002. Insurance companies, in comparison, paid an average of about \$86,400 per company, **approximately 20 times the average liability of the non-financial corporations** and nearly eleven times the average liability of other financial institutions.” *2003 Taxation of the Insurance Industry in Missouri* (Dr. Edward H. Robb at page 2).
- **Missouri (1992).** “As can be seen from the data...the insurance industry bears a vastly disproportionate tax burden. Nonfinancial corporations with positive net income paid net Missouri income taxes of \$206.5 million in fiscal year 1991. This amounts to an average liability of approximately \$7,100 per return. These corporations also paid \$57.5 million in franchise taxes, an average of about \$2,100 per corporation – a total of less than \$10,000 from both taxes. Insurance companies, in comparison, paid \$124.4 million, an

average of about \$74,000 per company, approximately **8 times the average liability of the nonfinancial corporations.**" *Taxation of the Insurance Industry in Missouri* (Dr. Edward H. Robb at page 2).

- **Texas (2004).** "The premium tax and other state and local taxes impose a **significantly higher tax burden** on property/casualty insurers that the tax they would pay if taxed as general corporations. This study estimates the property/casualty insurers paid \$334 million more in taxes in FY 2003 than they would have if they were taxed as general corporations." *Tax Burden Imposed on Property/Casualty Insurers in Texas* (Ernst & Young at page 1).
- **Texas (2004).** "Because the premium tax applies to a tax base much larger than the base for the franchise tax, the premium tax combined with other state and local taxes, imposes a **significantly higher tax on life/health insurers** than the tax they would pay if they were taxed as general corporations...[W]hile general corporations are subject to a maximum rate of 4.5 percent of net taxable earned surplus (net income), the premium taxes paid by life/health insurers are equivalent to 17.1 percent of net taxable earned surplus." *The Excess Taxation of Life/Health Insurers in Texas* (Ernst & Young at pages 1-2)
- **Texas (1998).** "Price Waterhouse studies prepared in 1991 and 1997 found that the effective tax rate imposed on the P&C industry in Texas was, on average, **4 to 8 times higher than for five other representative industry groups** in Texas over the 1985-1989 and 1992-1993 periods." *Taxation of the Texas Property and Casualty Insurance Industry* (Price Waterhouse at page E-1).

The academic and economic literature is compelling: the current system imposes a higher tax burden on insurance company taxpayers than non-insurance company taxpayers. This burden is imposed on the privilege of engaging in the insurance business – including both underwriting and investing – in a state. The premise of the Draft Statutes, therefore, is false. There is no "inequity" in the current insurance tax scheme that favors insurance companies.

### **3. The Draft Statutes discriminate, creating new inequities.**

However, enactment of either of the Draft Statutes would create substantial inequities where none currently exist, because the Draft Statutes discriminate against pass-through entities owned by entities that are not subject to an income tax (e.g. insurance companies) in favor of pass-through entities owned by companies that are subject to an income tax.<sup>12</sup> The inequities that would be created by the Draft Statutes have not been included within the written analysis prepared to date, have not been considered by the Subcommittee, and are fundamentally unfair. Specifically:

First, the Draft Statute discriminates against insurance companies in favor of non-insurance corporate income taxpayers because non-insurance corporate income taxpayers are permitted to use losses in pass-through entities to offset their income or income earned by other pass-through entities in computing the amount of income tax due. Under the Draft Statute, if a pass-through entity has income, the income would be taxed at the pass-through level to the extent the entity is owned by an insurance company, regardless of whether the insurance company also owns other pass-through entities that have experienced losses. A non-insurance

---

<sup>12</sup> Note that for purposes of this letter, only the effect of the Draft Statutes on insurance companies will be discussed. As noted previously the Revised Draft Statute applies to more industries than insurance companies and the Subcommittee should solicit their comments as well.

corporate income taxpayer, on the other hand, would be able to offset the pass-through entity's income using either losses earned by other pass-through entities or using its own losses.

Second, the Draft Statute discriminates against insurance companies because any losses in an insurance company could not be used to offset income earned by the pass-through. A non-insurance corporate income taxpayer, on the other hand, would be able to offset its losses against the pass-through entity's income. Thus, an otherwise unprofitable insurance company would in essence face two different state tax liabilities (i.e., premium and retaliatory tax and a reduction in the pass-through entity's income because of the income tax at the pass-through entity level under the Draft Statutes) and an unprofitable non-insurance corporate income taxpayer would not owe tax at all. The example below illustrates this point using a non-insurance corporate taxpayer with \$1,000 of gross receipts, \$1,100 of expenses, and \$100 of investment income earned through a pass-through entity. The non-insurance corporate taxpayer uses the investment income to offset operating losses, and pays \$0 of overall tax. An insurance company with the exact same items, on the other hand, pays \$27 of total tax.

Because the pass-through entity's income cannot be offset by an insurer's losses (whether investment or underwriting), even an unprofitable insurance company would bear the economic burden of gross receipts taxes on its premiums (under the existing premium tax statute) and a new tax imposed on the gross amount of its investment income (under the Draft Statute). The non-insurance corporate income taxpayer, however, is only subject tax on net profits, and if profits are \$0, the amount of tax imposed is \$0.

	<b>Non-Insurance Co.</b>	<b>Insurance Co. after Revised Draft Statute</b>
Gross Receipts/Premiums	\$1,000	\$1,000
Less: expenses	(\$1,100)	(\$1,100)
Investment income from pass-throughs	\$100	\$100
<b>Net income before taxes</b>	<b>(\$0)</b>	<b>(\$0)</b>
Less: Taxes		
Income tax (7%)	\$0	\$0
Income tax on pass-through entity (7%)	\$0	\$7
Premium tax on gross premiums (2%)	\$0	\$20
<b>Total tax paid</b>	<b>\$0</b>	<b>\$27</b>

Third, the Draft Statutes discriminate among insurance companies based on the manner in which they choose to hold investments. Under current law, an insurance company is taxed by most states in the same manner regardless whether it owns an investment directly or indirectly (i.e., through an ownership interest in a pass-through entity). As described below in Section 4, decisions regarding how investments of insurance companies should be held are highly sensitive to state regulation of financial investments, and state regulatory laws create incentives to encourage outcomes in the interest of protecting policyholders. State income tax law should not drive business decisions regarding the form of an investment. The Draft Statutes, however, would discriminate against insurers holding investment in pass-through or limited liability form, creating an incentive, for example, for an insurance company to invest in less than a controlling share of any pass-through entity. The Subcommittee might be well advised to coordinate the creation of any incentives relating to the investments of insurance companies with the NAIC.

Fourth, it appears to be intended that the Revised Draft Statute would not be adopted by a state that subjects insurance companies to income taxation. However, this does not appear to be the case with the Draft Statute. Adoption of the Draft Statute by a state that imposes an income tax directly on insurance companies would impose two income taxes on the same

investment income, once when earned by the pass-through entity and once when passed through to the insurance company. A non-insurance corporate income taxpayer would not be subject to multiple layers of tax on the same income. Moreover, it is not at all clear how the Draft Statute would be applied in states that (a) only subject certain insurers (e.g., domestic companies) to income tax (e.g., Arkansas, Indiana, Wisconsin), (b) apply reciprocal income tax non-retaliation (e.g., Illinois, Nebraska), (c) provide that income tax is creditable (in whole or part) against premium tax (e.g., Florida, Illinois, Mississippi, Nebraska), (d) provide that premium tax is creditable (in whole or part) against income tax (e.g., Louisiana, New Hampshire), (e) apply caps to combined income and premium tax liability (e.g., Illinois, Nebraska, New York), or (f) impose income tax on bases that are, in whole or part, gross (e.g., Indiana, New Hampshire). Depending on how these issues are addressed, the existing inequities identified above could be aggravated.

**4. Any concern among Subcommittee members regarding “abusive” transactions is ill-founded. Insurance companies are subject to extensive state regulation that requires investment decisions to be driven by nontax business considerations. States already possess ample tools to combat transactions perceived as abusive.**

The primary goal of state regulation of insurance companies is the protection of policyholders. To ensure that an insurance company will have sufficient funds to cover policyholder claims, states exercise stringent financial oversight of insurance companies. Although the purpose of this system of regulation is to protect policyholders, the system operates to prevent insurance companies from engaging in the type of abusive, tax-motivated transactions about which members of the Subcommittee have previously expressed concern in at least the three ways described below.

First, state insurance regulators review the financial aspects of insurance companies on a regular basis, at least quarterly. The rules for financial regulation of insurance companies are promulgated by the National Association of Insurance Commissioners. States must use these rules to maintain their accredited status.

Second, states regulate the investments of insurance companies by applying an investment law with a variety of restrictions (either the NAIC Defined Limits Version or the Defined Standards Version. Under the Defined Limits Version An insurance company may invest only in those investments permitted by statute and only in limited percentages. Under the Defined Standards Version, the capital and surplus of an insurance company and a certain percentage of reserve liabilities must be invested in very conservative investments, and the state applies a “prudent person” approach to investments in excess of a certain threshold. States commonly regulate the investments of insurers in affiliates other companies and subsidiaries, limiting the amount an insurance company may invest in subsidiaries to 10% of the amount of the company’s “admitted assets” (i.e., assets that are counted in determining the solvency of the company). Insurance commissioners may enjoin companies from making investments that would violate these restrictions, and insurance companies that violate the restrictions are subject to various penalties, including fines. Thus, because an investment in a controlled affiliate is subject to limits driven by state insurance regulation, it is generally true that the decision whether to make such an investment is driven by nontax, business considerations. .

Third, insurance companies are subject to both fixed minimum capital requirements and so-called “risk-based capital” or “RBC” requirements that operate to discourage companies from holding assets in affiliated entities. RBC requirements are determined through the application of formulas developed by the NAIC that apply various modeling, correlation and discount factors to compare the value of the actual capital held by an insurance company (called “total adjusted capital” or “TAC”) to its RBC. When the ratio of TAC to RBC reaches a certain threshold level, state regulatory law permits the insurance regulatory agency to take action ranging from permissive intervention to assuming control of the company. RBC ratios are also relied on extensively by market participants (investors, lenders, rating agencies) as a measure of the financial strength of an insurance company.

In computing an insurance company's RBC ratio, different assets held by the insurance company are included at anywhere from 100% to 30% of their value. For example, debt rated A/a or better is subject to a 0.4% haircut, whereas debt rated B/B is subject to a 10% haircut. These discounts create a strong disincentive for insurance companies to invest in any assets other than highly-rated debt instruments, because of the high discount associated with such investments in the RBC calculation. Because investments other than highly-rated marketable debt are disfavored by the state insurance regulatory scheme, it is generally true that the decision whether to make such an investment is driven by nontax, business considerations.

Finally, members of the Subcommittee have previously expressed concern that certain businesses previously subject to income tax were "restructured" to "shift income" from a corporate income taxpayer into an insurance company exempt from corporate income tax. This concern is ill-founded, again because the state insurance regulatory system creates a strong disincentive to hold assets in an insurance company other than those needed to cover policyholder liabilities. Specifically, state insurance regulatory laws impose restrictions on the ability of an insurance company to pay dividends. Dividends are permitted only up to a certain percentage of surplus, and are only permitted with regulatory approval. Because of this restriction, the decision whether to hold an investment in an insurance company or an affiliate is driven by nontax business considerations.

For all of these reasons, members of the Subcommittee should not be concerned that existing rules permit "abusive" transactions. To the extent that members remain concerned about "stuffing" transactions, state income tax laws already include adequate tools to permit the State to deny companies the tax advantage sought in connection with such transactions.

## **5. Further research is required.**

The Draft Statutes should be rejected because the Subcommittee has not yet investigated several areas of study that the Subcommittee itself identified as necessary research. As members are aware, during the March 2008 meeting of the Subcommittee, Michael Fatale presented a letter from the Commissioner of the Massachusetts Department of Revenue requesting that the Uniformity Committee consider undertaking a project relating to the ownership by insurance companies of "non-insurance businesses" in pass-through entities, due to concern that "the structure is being used for tax avoidance."<sup>13</sup> Mr. Fatale raised the example of an insurance company owning a parking garage. The Commissioner's letter indicated that a proposal relating to this issue had been made in Massachusetts, but that members of the 15-member Study Commission assigned to consider the proposal recommended that the proposal be slated for further study, as they believed the threat of retaliatory taxation "warranted more comprehensive review."<sup>14</sup> Subsequent memos by MTC staff have also suggested a need to conduct a survey of state retaliatory tax practices.

To the best of the Trades' knowledge, the Subcommittee has not conducted a comprehensive review of the threat of retaliatory taxation. As we have previously commented, the Trades have serious concerns that the threat of retaliatory taxation is very real. The Draft Statutes rely on a fiction for the purpose of avoiding insurance retaliatory taxes. This fiction -- that a pass-through entity is a taxable entity -- applies only when the pass-through entity is owned by limited, defined entities, including insurance companies. By singling-out insurance companies, the Draft Statutes invite retaliation by the states. Unless the Draft Statute (or Revised Draft Statute) is simultaneously and uniformly enacted in all states (which would be unprecedented), insurance companies domiciled in an adopting state face the likely imposition of retaliatory taxes

---

<sup>13</sup> Letter from Navjeet K. Bal to Jan Goodwin and Joe Huddleston, dated February 12, 2008.

<sup>14</sup> Minutes of the March 12, 2008 meeting of the Uniformity Committee, Income and Franchise Tax Subcommittee.

in non-adopting states, placing them at a serious disadvantage relative to other insurers domiciled in non-adopting states and competing in the same market. A non-insurance corporate income taxpayer, of course, would not face these tax or competitive disadvantages, because a non-insurance corporate taxpayer is not subject to retaliatory tax at all.

In addition, further research is needed regarding the insurance regulatory framework. At the July 2008 meeting of the Subcommittee, members expressed concern regarding the use of “restructurings” involving pass-through entities to “shift income” out of a unitary group, and “stuffing” of insurance companies.<sup>15</sup> Concern was also expressed regarding insurance companies moving from “passive” investments into “active” investments. Chairman Spangler noted that from the perspective of an insurance regulator, some of the transactions perceived as abusive might not be abusive, and that it would be helpful to narrow the focus of the Subcommittee to those transactions that were truly abusive.<sup>16</sup>

At the conclusion of the discussion, members agreed that more education was needed, and that several issues needed to be more well-defined, including the use of captives by non-insurance companies, the use of LLCs and partnerships by insurers, and issues relating to various types of insurer investments (so-called “good” investments versus “bad” investments). It was also suggested by members that it might be helpful to hear from state insurance regulators. Although we understand that the Subcommittee did meet with a representative from New York State, it does not appear that insurance regulatory topics were discussed.

## **Conclusion**

The Trades urge the Subcommittee to reject both the Revised Draft Statute and the Draft Statute. We look forward to discussing these comments and our earlier comments with you directly at your upcoming meeting.

Respectfully submitted,

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

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

---

<sup>15</sup> Minutes of the July 2008 meeting of the Uniformity Committee, Income and Franchise Tax Subcommittee.

<sup>16</sup> Personal notes of Trade Association representatives.

**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.<sup>1</sup> 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.<sup>2</sup>

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.

---

<sup>1</sup> 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.”

<sup>2</sup> 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.<sup>3</sup> The Staff Analysis (in considering one of eight options for taxing insurer income)<sup>4</sup> 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).<sup>5</sup> 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

---

<sup>3</sup> 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.

<sup>4</sup> Staff Memorandum dated March 6, 2009 at pages 2-3.

<sup>5</sup> 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,

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

cc: Ted Spangler, Chairman, Uniformity Committee

Joe Huddleston, Executive Director  
Shirley Sicilian, General Counsel  
Sheldon Laskin, Counsel

To: American Council of Life Insurers  
American Insurance Association  
Property Casualty Insurers Association of America

From: Professor Richard D. Pomp

Date: March 3, 2010

You have asked me to address a number of issues that are being discussed by the Multistate Tax Commission (MTC) regarding the taxation of the insurance industry. I have a number of technical observations on various proposals that will be the subject of future correspondence; for now, I am much more concerned about issues of process.

The insurance industry is unlike any other, and that fact requires a different process from what typically accompanies MTC proposals. Most states use a premiums tax, although a few use an income as well. All states combine either the more common premiums tax or the less common income tax, with a retaliatory tax, and with in lieu provisions.

The workings of the retaliatory tax are not always fully appreciated outside the cognoscenti.<sup>1</sup> The retaliatory tax is unique because it applies only to foreign companies, i.e., those that are not domiciled in the taxing state. All states except Hawaii (which has no domestic insurance companies) have a retaliatory tax.

Any other tax that applied only to foreign companies would be unconstitutional under the Commerce Clause. However, the tax is immune from Commerce Clause attack under the McCarran-Ferguson

---

<sup>1</sup> Indeed, although my casebook has the leading cases on the retaliatory tax that I teach as part of my advanced courses, it was not until I argued [American Fire and Cas. Co. v. New Jersey Div. of Taxation, 912 A.2d 126 \(2006\)](#) that I fully appreciated the degree of complexity and sophistication that accompanies that tax.

Act, 15 U.S.C. Secs. 1011 et seq. and was upheld by the U.S. Supreme Court in *Western and Southern*, 451 U.S. 648 (1981).

Unless you specialize in insurance taxation, the retaliatory tax is an unfamiliar feature of state taxation. Yet understanding it is critical to evaluating any proposal to change the status quo. Many policy bromides need to be re-thought because of this unique aspect of insurance taxation. Without appreciating the interaction between the retaliatory tax and changes in the existing rules, the best of intentions may well backfire.

A large majority of states also have so-called in lieu provisions found in either statutes or in state constitutions. These provide that insurance companies are subject to a gross premiums tax in lieu of a corporate income tax or franchise tax.

The insurance industry has legitimate reliance interests that need to be addressed by any change in the way they are taxed. For over 100 years, insurance companies have been subject to the premium tax, the retaliatory tax, and in-lieu provisions. In addition, unique and uniform accounting and financial reporting rules developed by the National Association of Insurance Commissioners apply. The result has been a non-volatile and predictable revenue source, certainly more stable than an income tax. As numerous studies suggest, the current regime for taxing insurance companies probably raises more revenue than would be raised by substituting a corporate income tax for the premium tax.

The industry has structured itself and made its investment decisions around the premiums tax, the retaliatory tax, and the in lieu provisions. The industry, of course, has no constitutional right to be immunized from change. Nonetheless, it certainly has the right to expect that any change be preceded by thoughtful, careful, and sophisticated analysis, which takes into account the benefits of the current regime, the costs of change, and the law of unintended consequences.

Like any industry, tax minimization strategies may exist. As I have written elsewhere regarding Delaware holding companies, there are the good, the bad, and the ugly. Every state should be on guard against illegitimate tax minimization schemes and be given adequate tools to combat those. But a rifle is always more appropriate than a shotgun, especially given the retaliatory tax.

For example, one of the issues that the MTC is concerned about is the treatment of pass-through entities. Any proposal, however, that singles out the income taxation of pass-through entities based on whether they are owned by insurance companies raises an issue of how the retaliatory tax will be applied. To be sure, the whole issue of how to tax pass-through entities raises a serious issue of tax policy, but one that is independent of the insurance industry. I would certainly encourage the MTC in its efforts to take on that larger issue.

Another proposal discussed by the MTC is the forced combination of insurers with non-insurers. I have, in general, been a strong and longtime supporter of forced combination. Insurance companies, however, unlike the rest of corporate America, have the benefit of the in lieu provisions. Forced combination might well violate these provisions.

In short, the insurance industry raises sui generis issues of tax policy that are different from other industries. The unique features of insurance taxation, especially the retaliatory tax and the in lieu provisions, require a re-thinking of traditional approaches. As a matter of process, any changes in the law need to be fully vetted by the industry, state insurance regulators, academics, and other experts with unique insights and understanding. The sheer size of the industry, the extent of its investments and legitimate reliance interests, and the role it plays in the American economy place a premium on a robust and thorough debate, based on rigorous analysis. The law of unintended consequences should caution against any rush to judgment.