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

May 16, 2011

Ms. Loretta King
Multistate Tax Commission
444 N. Capitol Street, N.W., Suite 425
Washington, DC 20001-1538

Re: Comments on MTC's Proposed Statute Regarding Partnership or Pass-Through Entity Income That Is Ultimately Realized By An Entity That Is Not Subject To Income Tax

Dear Ms. King:

The undersigned trade associations ("the Trades") thank you for the opportunity to submit comments on the Multistate Tax Commission's ("MTC's") draft Proposed Statute Regarding Partnership or Pass-Through Entity Income That Is Ultimately Realized By An Entity That Is Not Subject To Income Tax (formerly known as the "Project Regarding Partnership or Pass-through Entity Income on Income Earned by Non-Corporate Income Taxpayers Derived from Ownership Interest in a Partnership or LLC"). We also thank you for the opportunity to have commented on this project as it has been considered by the Income and Franchise Tax Subcommittee (the "Subcommittee) of the Uniformity Committee over the past two years.[1] We represent the great majority of the life insurance and property and casualty insurance industries and the MTC's draft proposed statute is of great concern to us.

Summary Conclusion

For the reasons discussed in detail below, we respectfully submit that the draft proposed statute has not been subject to sufficient investigation and could have serious repercussions if adopted by any state. We therefore recommend that the draft proposed statute not be recommended for adoption by the Commission and instead be returned to the Subcommittee for further study on the matters specified below.

The comment letters previously submitted by the undersigned trades include a detailed discussion of most of the trades' comments. Although we have submitted substantial comments at each stage of this project, with all due respect the undersigned trades do not feel that their comments have been adequately reviewed or evaluated. We therefore would respectfully request that the Hearing Officer consider and respond specifically to each of the comments set forth below.

Description of the Draft Proposed Statute

The Draft.[2] Under the draft proposed statute, when an insurance company owns at least a 50% ownership interest in a pass-through or partnership entity for which deductions would be allowed under Section 162 of the Internal Revenue Code, a portion of the net income of the entity equal to the insurance company's share would be subject to state income tax at the entity level

[1] These comments are intended to supplement our submissions dated February 19, 2010, March 23, 2010 and July 22, 2010. Our prior comments were based on previous drafts of the Draft Statute, including drafts dated February 19, 2010 and July 15, 2010.

[2] *See* Alternative Draft 1, Memo from Sheldon Laskin to the Subcommittee, dated February 19, 2010.

"as if the entity were a corporation." The draft proposed statute indicates that "to the extent applicable," income attributable to the entity and related tax attributes and activities shall be included in a combined report.

Detailed Comments

1. The Subcommittee Has Not Fully Investigated The Proposal

Since the inception of this project, the Subcommittee has recognized that several aspects of the proposal require further study. The proposal was first presented during the March 2008 meeting of the Subcommittee, when Michael Fatale presented a letter from the Commissioner of the Massachusetts Department of Revenue requesting that the MTC 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."[3] 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."[4]

As discussed in more detail below, no comprehensive review of the retaliatory tax system was conducted. Nonetheless, the project progressed. In early 2008, members of the MTC staff met with industry representatives, who echoed the concern regarding retaliatory taxation and raised additional concerns.

The project was again discussed at the July 2008 meeting of the Subcommittee, at which the undersigned trades presented their concerns in detail. A representative of the Texas Comptroller's office also made a presentation. 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.[5] 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.[6]

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 impact of retaliatory taxation, 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.

[3] Letter from Navjeet K. Bal to Jan Goodwin and Joe Huddleston, dated February 12, 2008.

[4] Minutes of the March 12, 2008 meeting of the Uniformity Committee, Income and Franchise Tax Subcommittee.

[5] Minutes of the July 2008 meeting of the Uniformity Committee, Income and Franchise Tax Subcommittee.

[6] Personal notes of Trade Association representatives.

The Subcommittee did not arrange to meet with state insurance regulators.[7] Nonetheless, the project progressed. The Subcommittee again discussed the project at the July 2009 annual meeting, and in November 2009, a new draft of the model statute was released. In a letter dated February 19, 2010 (attached as Exhibit A), the undersigned trades submitted comments repeating their concerns that the Subcommittee had not yet conducted the analysis necessary to proceed. The undersigned trades later submitted an analysis by Professor Richard D. Pomp, describing "issues of process" in the Subcommittee's development of the draft statute (attached as Exhibit B). The Pomp analysis recommended that the Subcommittee engage in a "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," and cautioned against "any rush to judgment" on the project.

The analysis recommended by Professor Pomp was not conducted. Nonetheless, the project progressed. In July 2010, two new and revised versions of the draft statute were posted to the MTC's website and presented to the Subcommittee at the July 2010 annual meeting. The undersigned trades again submitted written comments (attached as Exhibit C) articulating numerous concerns about the draft statutes and made a presentation to members at the Subcommittee meeting. At the conclusion of the meeting, the Subcommittee decided to solicit input on particular topics before proceeding.

Following the July 2010 meeting, the undersigned trades corresponded with MTC staff assigned to the project regarding the Subcommittee's desire to hear from state insurance regulators (correspondence attached as Exhibit D). The trades advised MTC staff that the optimal approach would be for a representative or representatives of a member state (rather than MTC staff) to approach insurance regulator(s) directly and offered to work with MTC staff to identify any potential candidates and to support the MTC's invitation. To the best of our knowledge, such invitations were never extended.

Rather, in October 2010, MTC staff produced another memo regarding the project, which contained factually incorrect statements regarding the business of insurance and the investments of insurers. Most notably, the memo concluded (without citing to any authority) that "the nature of the insurance business has changed dramatically over the past twenty-five years. Until relatively recently, insurance companies could not own a controlling interest in a pass-through entity that was actively engaged in a trade or business." The undersigned trades corresponded with MTC staff (correspondence attached as Exhibit E), questioning whether any evidence existed to support the contentions in the memo and urging the Subcommittee to refrain from acting on the basis of inaccurate information, conclusory statements, and minimal outside input. Despite these concerns, the Subcommittee voted to approve the draft statute at its December 2010 meeting.

In March 2011, the draft statute was presented to the Executive Committee, and the undersigned trades once again urged that the proposal had not been fully investigated, and that the proposal should not be approved until the research and analysis identified over the course of the project as necessary had been conducted. Members of the Executive Committee questioned whether such research could be conducted as part of the public hearing process. In response, Executive Director Joe Huddleston assured members that the public hearing process would include the input of state insurance regulators. The undersigned trades are very appreciative of Director Huddleston's support in this regard.

The undersigned trades believe that before the draft proposed statute may be advanced, the Subcommittee must investigate and consider the matters discussed above, each of which has

[7] We note that the Subcommittee heard a presentation by Gary Johnson from the Texas Comptroller of Public Accounts and met with a representative of the New York Department of Taxation and Finance. Neither agency regulates the insurance industry.

been identified as necessary by the Subcommittee at various times but none of which has been given due consideration to date. For example, although the Study Commission recommended a comprehensive review of the retaliatory tax issue, no review was conducted despite repeated requests by the insurance industry. Rather, this issue has been summarily dismissed at each juncture with limited inquiry into or understanding of how the draft proposed statute would be applied under each states' individual retaliatory tax law. The Subcommittee has instead offered summary conclusions that retaliatory tax is not an issue by asserting that the tax is imposed at the pass-through entity level and not on the insurer and that there is no case law supporting the imposition of retaliatory tax in situations contemplated by the draft proposed statute. These summary conclusions are flawed. For example, the theory that imposing the tax upon the pass-through entity as opposed to the insurer prevents the imposition of the retaliatory tax is premised upon the supposition that each state will accept at face value that insurers are not subject to tax under the draft proposed statute without any analysis of the legal or economic incidence of the tax under each states' laws. In addition, no inquiry has been made concerning whether a state could take the view that the "burden" of the tax (an important concept in many states' retaliatory tax statutes) was imposed on an insurer under the draft proposed statute for purposes of applying that state's retaliatory tax. Lastly, the absence of a comprehensive review is apparent in the Subcommittee's failure to provide direct responses to questions/testimony offered by the industry as well as by Professor Pomp. The undersigned trades therefore respectfully request that the draft statute be sent back to the Subcommittee for further study, including in particular a comprehensive review of the retaliatory tax issue.

2. The Subcommittee Has Not Considered the Administrative Problems Created By The Proposed Draft Statute

As described above, the draft proposed statute would impose an entity-level tax on certain partnerships and pass-through entities. The draft does not, however, contemplate the administrative and equitable difficulties that are created for the state or for non-insurance company owners of such an entity. For example, imagine that an insurance company owns 90% of the interests of a partnership that acts as an insurance claims administrator for both the insurance company and unrelated third parties. The remaining 10% of the partnership is owned by individual officers and employees that manage the administrator (the "Managers"). Under the draft proposed statute, if the partnership earns $1000 of income, $900 of that income will be subject to tax at the partnership level. The draft proposed statute does not indicate, however, how the tax is to be administered. Many partnership agreements include pro rata allocations of all items, meaning that the Managers' shares could be reduced to account for the tax due at the entity level. Moreover, the draft proposed statute does not indicate whether, where the tax is not paid by the partnership itself, the tax will be collected solely from the insurance company partner or also from the Managers. Finally, it is not clear whether states have systems in place to administer entity-level taxes on an allocable share of income from partnership and pass-through entities. For example, if the draft proposed statute were enacted, it would be expected that the partnership entity would make estimated tax payments relating to the share of income allocable to an insurance company owner (because the tax is imposed at the entity level). However, the draft proposed statute provides that where applicable, income attributable to the insurance company owner and related tax attributes and activities are to be included in a combined report. This suggests that estimated tax payments made by the partnership entity would later be claimed by the non-insurance group affiliated with the insurance company in connection with the group's filing of a combined report, as a payment against the income tax liability of the non-insurance combined group. It is not at all clear that states have the capacity to administer this arrangement. If adopted, the draft proposed statute would require significant development of new administrative capacity in most states.

Notably, there has been no discussion in the Subcommittee regarding the administrative difficulties that would be created by the draft proposed statute. We respectfully request that the proposal be returned to the Subcommittee for further study.

3. The Subcommittee Has Not Considered the Effect of the Proposed Draft Statute on Insurance Companies and Their Policyholders.

As discussed in detail in the trades' July 22, 2010 letter, the draft proposed statute would have dramatic and unfair consequences for insurance companies and their policyholders nationwide, and those consequences have not been investigated or understood by the Subcommittee.

First, the draft proposed statute would impose tax on investments 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.[8]

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 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.[9]

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.

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[8] Oregon is the only state that taxes insurers under a net income-based "excise" tax, but not a premium tax.

[9] Although some states supplement the premium tax with an income tax, insurers are generally permitted cross-tax credits or caps.

	Non-Insurance Co.	Insurance Co. current law	Insurance Co. after draft statute
Gross Receipts/Premiums	$1,000	$1,000	$1,000
Less: expenses	($950)	($950)	($950)
Investment income from pass-throughs[10]	$100	$100	$100
Net income before taxes	**$150**	**$150**	**$150**
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
Total tax paid	**$10.50**	**$20**	**$27**

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,[11]

Although the undersigned trades have previously presented this issue to the Subcommittee, it does not appear that the Subcommittee has adequately evaluated the industry's concerns. We respectfully request that the proposal be returned to the Subcommittee with instructions to seek the perspective of state insurance regulators on this important issue.

4. The Draft Proposed Statute Is Based On the Faulty Premise That Insurance Companies Pay Less Tax Than Non-Insurance Businesses.

The draft proposed statute purports 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. The purported purpose of the draft proposed 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 [*i.e.*, insurance companies] are not subject to state income tax."[12] 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

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[10] 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.

[11] Furthermore, the draft proposed statute does not contemplate the complexities associated with many variable insurance products that result in investments made on behalf of policyholders within Separate Accounts held by insurers. In this situation, an insurer is more properly characterized as a custodian of the investment rather than the owner. The policyholder enjoys the economic benefits of the investment made by the Separate Account and thus would suffer the cost of any tax imposed on an investment held by a Separate Account.

[12] Memo from Sheldon Laskin to the Subcommittee, dated June 11, 2010, fn 4.

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[13] -- 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.[14]

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."[15] 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).

- ***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*

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[13] 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."

[14] 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.

[15] 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.

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 proposed statute, therefore, is false. There is no "inequity" in the current insurance tax scheme that favors insurance companies.

Although the undersigned trades have previously presented this issue to the Subcommittee, it does not appear that the Subcommittee shares the industry's view regarding the inequities of imposing an additional tax on the insurance business. We respectfully request that the proposal be returned to the Subcommittee with instructions to seek the perspective of state insurance regulators on this important issue.

5. The Draft Proposed Statute Discriminates, Creating New Inequities.

Enactment of the draft proposed statute would create substantial inequities where none currently exist, because the draft proposed statute discriminates 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. The inequities that would be created by the draft proposed statute 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 proposed 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 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 statute) 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.

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

Third, the draft proposed statute discriminates 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, 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 statute, 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. In creating these incentives, the Subcommittee has not coordinated with the NAIC or state insurance regulators.

Fourth, it appears to be intended that the draft statute would not be adopted by a state that subjects all insurance companies to income taxation. However, it is not clear how the draft proposed 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.

Although the undersigned trades have previously presented these concerns to the Subcommittee, it does not appear that the Subcommittee has considered them in any detail. We respectfully request that the proposal be returned to the Subcommittee with instructions to seek the perspective of state insurance regulators and recognized tax policy experts (such as Professor Pomp) on these concerns.

6. 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. By contrast, investments in partnerships and LLCs are subject to a 19.5% 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.

Although the undersigned trades have previously presented this points to the Subcommittee, it does not appear that the Subcommittee has further investigated the nature of insurance company investments or the regulation of insurance company investments. We respectfully request that the proposal be returned to the Subcommittee with instructions to seek the input of state insurance regulators on this important issue.

Conclusion

The undersigned trades urge the MTC to return this project to the Subcommittee for further evaluation and consideration, with specific instructions to consult with state insurance regulators on the points raised in these comments. We appreciate the opportunity to present these comments and look forward to discussing them with you.

Respectfully submitted,

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

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