



NAVJEET K. BAL
COMMISSIONER

The Commonwealth of Massachusetts

*Department of Revenue
Office of the Commissioner
P.O. Box 9550
Boston, MA 02114-9550*

May 23, 2011

Sheldon Laskin
Multistate Tax Commission
444 North Capitol Street, Suite 425
Washington, DC 20001

Dear Mr. Laskin,

I write to express my support for the “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,” for which the Multistate Tax Commission held a public hearing on May 16th. This proposal would subject a pass-through entity to state income taxation as a corporation when that pass-through entity is engaged in a trade or business and is owned, directly or indirectly, more than 50% by a corporation that is not itself subject to state corporate income tax.

It is a basic premise of income taxation that all trade or business income, unless specifically exempt from income tax, should be subject to at least a single level of tax. Pass-through entities are generally understood to serve the function of preventing income from being subject to double taxation in certain instances, but were not intended to shield business income from being taxed at all. Therefore, the MTC’s proposed statute serves the important tax equity function of ensuring that there will at least be a single level of tax applied to trade or business income that is derived by a pass-through entity within the scope of the proposal. In the absence of such a statute, an otherwise taxable corporate enterprise could be structured so as to make its trade or business income entirely free from any state’s income tax. The Massachusetts Department of Revenue’s auditors have encountered such structures through the audit process.

As an example, if an insurance company, which is itself not subject to a state’s corporate income tax, owns more than 50% of a pass-through entity which is engaged in a non-insurance trade or business, then the proposed statute would subject that pass-through entity to the state’s corporate income tax, ensuring that its taxable income did not escape state taxation all together. Because most states tax insurance companies with respect to gross premiums from insurance, and not with respect to income, the income of a pass-through entity derived by insurance companies with controlling ownership interests, including, generally, so-called “captive” insurance companies,

would not ordinarily be subject to any state income tax under current law.¹ Under the taxing statutes in these states, the gross premiums tax regime was contemplated for taxing a traditional insurance business, including not only the receipt of insurance premiums but also the investment income derived from the insurance company's investment activity with respect to the premiums. However, income derived from a controlling interest in a pass-through entity that is engaged in a non-insurance trade or business, and not itself subject to income tax, is not derived either from an insurance business or from customary investment activity, and the failure to subject such non-insurance business income to tax raises significant tax equity issues.²

My understanding is that much of the MTC's consideration of this draft proposal has focused on the question of whether, by taxing the income of an entity owned by an insurance company as a corporation – particularly where such entity would otherwise be treated as a pass-through entity for purposes of federal income tax law – a state would subject insurance companies based in that state to a retaliatory tax in other states. As a practical matter, it is difficult to see how retaliatory taxes could be a concern, as the taxation of an entity other than an insurance company cannot logically be imputed to the insurance company, even in the circumstance in which the insurance company happens to own a controlling interest therein. In addition, I understand that the MTC's three-year deliberative process revealed no cases, reported or otherwise, suggesting retaliatory tax consequences in a situation where an insurance company owns a controlling interest in either a corporation or a pass-through entity that is treated as a corporation for state tax purposes. As to the latter situation, I note that "limited liability companies," which are a relatively recent phenomenon and are popularly used as a form of pass-through entity for federal income tax purposes, have not always been accorded general pass-through treatment by the states and in some states even today are not treated as pass-through entities for various state tax purposes.³ Consequently, the question of whether the MTC proposal would result in a retaliatory tax when an insurance company owns a controlling interest in a pass-through entity that is treated as a corporation for state taxing purposes seems functionally indistinguishable from the apparent non-issue presented when an insurance company owns an "actual" corporation that itself is subject to corporate income tax.

I would also suggest that the very adoption of a model uniform statute by the Multistate Tax Commission is intended to limit the adverse tax consequences that could, in theory, otherwise arise from the actions of states individually. Obviously, the purpose of the Multistate Tax Commission in issuing such a model statute would be to correct structural deficiencies in the corporate income tax or sales tax statutes of the states as a group, rather than to provide tax advantages or disadvantages to individual companies operating in particular states, which is the consequence that retaliatory insurance tax statutes are intended to address. If the development of a uniform tax rule for pass-through entities were somehow precluded by retaliatory tax concerns whenever such rules might have some effect - no matter how indirect - on insurance companies,

¹ Using a captive insurance company to shelter income from a non-insurance business by causing it to own a non-insurance enterprise structured as a pass-through entity has been specifically recognized as a common state tax planning technique. See, e.g., Charles F. Barnwell, Jr., *Captive Structures and Other Tax Planning*, State Tax Notes (November 22, 2010).

² A fair analogy to the rule being proposed here is the taxation of "unrelated business income" in the context of a non-profit corporation.

³ See, e.g. Bruce P. Ely, Christopher R. Grissom and William T. Thistle, *State Tax Treatment of Limited Liability and Partnerships*, State Tax Notes, (May 17, 2010). I note also that the federal Government itself treats certain publicly traded partnerships as corporations for federal income tax purposes, see Internal Revenue Code sec. 7704, and currently consideration is being given to also treating as corporations for federal income tax purposes certain other entities that are currently treated as pass-through entities.

it is difficult to see how the states could ever address structural tax deficiencies relating to the tax treatment of pass-through entities.

For the reasons that I have stated, I voice my support for the MTC's proposal.

Regards,

A handwritten signature in black ink that reads "Navjeet K. Bal". The signature is written in a cursive, slightly slanted style.

Navjeet K. Bal
Commissioner of Revenue