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MTC: Pass through entity taxation proposal to move to public hearing

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In 2008, the MTC initiated a project to analyze the perceived tax discrepancy between pass-through entities owned by insurance companies and those owned by non-insurance businesses. A drafting group was formed by the Income and Franchise Tax Subcommittee to gather and provide educational information, identify policy issues and draft a model statute in an attempt to address the perceived disparity in tax treatment.

In October 2010, a proposed draft statute was adopted by the subcommittee that would impose the corporate income tax on a pass-through entity in those cases where the pass-through entity or LLC is at least 50% owned by a business entity that is not subject to state corporate income tax, such as an insurance company. While the original project only targeted pass-through entities owned by insurance companies, the model statute has since been expanded to include pass-through entities owned by any entities exempt from corporate income tax. The MTC has not provided any additional examples of other entities not subject to the corporate income tax to date, although the committee notes did identify that the provision will not apply to pass-through entities owned by non-profit entities.

The MTC Executive Committee voted on March 10, 2011, to advance the proposal to public hearings, which is the next step in finalizing the draft statute that states could then adopt via the legislative process. The MTC must give thirty days notice before any public hearing(s). If the proposal is deemed worthy to proceed through the hearing process, a recommendation of action will be drafted and circulated to the member states by the Executive Director to determine in an additional thirty day window, whether or not the members will consider adoption. If the majority of members agree to consider adoption, consideration of the item will be directed at the next regular meeting of the MTC. If a majority of the affected members does not agree based on the survey, the recommendation will be referred back to the Executive Committee for further consideration.

In the majority of states, insurance companies are generally only subject to the insurance premium tax, a flat rate gross receipts tax. This tax methodology is utilized for all revenue streams of an insurance company, to include both their underwriting and investment operations. It is a common industry practice to hold certain investments and underwriting activities in subsidiary business entities structured as flow-through entities for purposes of limiting liability and the administrative ease of accounting separation. Examples of this type of business structure and revenue streams include: 1) ownership of a hotel for investment purposes which is held by a partnership and 2) an insurance agency formed as a LLC which is used to conduct the sales activity for the insurance company. As a result of the state tax structure on insurance companies and the predominant use of flow-through entities by the industry, income received from a pass-through entity is not subjected to state income tax on that revenue in most states.

The MTC's process and proposal itself has been met with much scrutiny from the insurance industry which believes that the MTC proposal has not been subject to sufficient outside input and is based on questionable and unproven assumptions. Among the industry's concerns are 1) the industry is already taxed at a higher burden than most other industries, 2) impact on retaliatory computation for purposes of determining premium tax due, 3) new tax inequalities the draft statute would create on insurance companies, and 4) the lack of evidence that satisfactory research has been performed to address the inherent issues with the draft statute. The insurance industry is urging the MTC Executive Committee to terminate the project or at a minimum, to forgo advancement of the proposal to a public hearing but instead refer it back to the Uniformity Committee for further research and consideration.

PwC commentary

The draft model statute represents a significant change in the tax methodology for pass-through entities. If this statute passes and is adopted by states, impacted taxpayers will need to evaluate the additional burden the new tax will create and the effect it will have on market competitiveness and organizational structure.

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