

LINDA LINGLE
GOVERNOR
JAMES R. AIONA, JR.
LT. GOVERNOR

STATE OF HAWAII
OFFICE OF THE DIRECTOR
DEPARTMENT OF COMMERCE AND CONSUMER AFFAIRS
335 MERCHANT STREET, ROOM 310
P.O. Box 541
HONOLULU, HAWAII 96809
Phone Number: (808) 586-2850
Fax Number: (808) 586-2856
www.hawaii.gov/dcca

LAWRENCE M. REIFURTH
DIRECTOR
RONALD BOYER
DEPUTY DIRECTOR

TO THE HOUSE COMMITTEE ON FINANCE

TWENTY-FOURTH LEGISLATURE
Regular Session of 2008

Thursday, March 27, 2008
4:00 p.m.

**TESTIMONY ON SENATE BILL NO. 2315, S.D. 2, H.D. 1 – RELATING TO
INSURANCE.**

TO THE HONORABLE MARCUS OSHIRO, CHAIR, AND MEMBERS OF THE
COMMITTEE:

My name is J. P. Schmidt, State Insurance Commissioner (“Commissioner”),
testifying on behalf of the Department of Commerce and Consumer Affairs
(“Department”).

The Department supports this measure.

The purpose of this version of the bill is to amend: (1) the definitions of “insurer”
and “reciprocal insurer” in the Insurance Code, Hawaii Revised Statutes (“HRS”)
chapter 431; and (2) HRS § 431:7-204 by adding a definition of “attorney-in-fact” and
clarifying that the attorney-in-fact of a reciprocal insurer is exempt from taxes on income
derived from its principal business as attorney-in-fact. This version of the bill has a
defective effective date of July 1, 2020.

In *Director of Taxation v. Medical Underwriters of California*, 115 Haw. 180
(2007), the Hawaii Supreme Court ruled that Medical Underwriters of California (“MUC”)
was not an insurance company exempt from payment of the Hawaii general excise tax
(“GET”). MUC is the attorney-in-fact of Medical Insurance Exchange of California
(“MIEC”), a reciprocal insurance exchange, and the managing agent for Claremont

Liability Insurance Company ("CLIC"). Based on its understanding that it was an "insurance company" exempted from the GET, MUC did not file GET returns and did not pay GET on funds received in exchange for its services rendered to MIEC and CLIC.

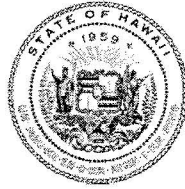
Under current law, the reciprocal insurer is required to appoint an attorney-in-fact through which the reciprocal insurer operates. The reciprocal insurer is entitled to the GET exemption. But if its attorney-in-fact is taxed anyway, that contradicts the exemption statute.

The intent of this measure is to ensure that: (1) the reciprocal insurer and its attorney-in-fact are treated as a single entity for tax purposes; (2) the GET exemption applies to "insurers", rather than to "insurance companies"; and (3) the GET exemption applies only to the income or gross receipts derived from its principal business as the attorney-in-fact.

We thank this Committee for the opportunity to present testimony on this matter and request your favorable consideration.

LINDA LINGLE
GOVERNOR

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LT. GOVERNOR



KURT KAWAFUCHI
DIRECTOR OF TAXATION

SANDRA L. YAHIRO
DEPUTY DIRECTOR

STATE OF HAWAII
DEPARTMENT OF TAXATION
P.O. BOX 259
HONOLULU, HAWAII 96809

PHONE NO: (808) 587-1510
FAX NO: (808) 587-1560

HOUSE COMMITTEE ON FINANCE

TESTIMONY REGARDING SB 2315 SD 2 HD 1 RELATING TO INSURANCE

TESTIFIER: KURT KAWAFUCHI, DIRECTOR OF TAXATION (OR DESIGNEE)

DATE: MARCH 27, 2008

TIME: 4:00PM

ROOM: 308

This legislation redefines the definition of insurance companies that qualify for the general excise tax exemption for insurers. This legislation also makes various amendments to the insurance laws.

The Department of Taxation (Department) **supports the intent** of this legislation.

If this bill were to be effective in FY2009, there will be an estimated revenue loss of approximately \$202,546 in FY2009 and annually thereafter. The Department had the opportunity to review additional information since its prior revenue estimates were provided on this measure.

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126 Queen Street, Suite 304

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Honolulu, Hawaii 96813 Tel. 536-4587

SUBJECT: GENERAL EXCISE, Exempt reciprocal insurer and attorneys-in-fact

BILL NUMBER: SB 2315, HD-1

INTRODUCED BY: House Committee on Consumer Protection and Commerce

BRIEF SUMMARY: Amends HRS section 237-29.7 to replace the term insurance companies with insurers.

Amends HRS section 431:7-204 to provide that each attorney-in-fact of a reciprocal insurer shall be subject to all taxes imposed on corporations or others doing business in the state, except taxes imposed on income or gross receipts derived from its principal business as an attorney-in-fact.

Defines “attorney-in-fact” for purposes of the measure and provides that a reciprocal insurer and its attorney-in-fact shall be considered a single entity.

Makes conforming amendments to HRS sections 431:1-202 and 431:3-108.

EFFECTIVE DATE: Taxable years ending after July 1, 2020

STAFF COMMENTS: This measure proposes that a reciprocal insurer and its attorney-in-fact shall be considered as a single entity to prevent the imposition of the general excise tax on the gross proceeds received by its attorney-in-fact.

Should attorneys-in-fact be treated differently from attorneys who are on contract with a taxpayer who is not exempt from general excise tax? Should the exemption for insurance companies carry over to attorneys they hire to represent them because they are considered as part of and essential to the insurance company doing business in Hawaii?

It should be remembered that the general excise tax is an imposition for the privilege of doing business in the state. While the attorney-in-fact is performing a service and receives remuneration for his services performed for the reciprocal insurance company, the question should be whether or not the attorney-in-fact is considered a part of the insurance company and should also enjoy the exemption.

It is being argued that reciprocal insurers generally do not have employees to do the business of the reciprocal insurer relying instead on the attorney-in-fact to run the business of the reciprocal insurance company. In fact, state law requires an attorney-in-fact for such insurance companies.

The question to ask is how does an attorney-in-fact for a reciprocal insurance company differ from an attorney-in-fact for another business entity? Banks are the other major entity exempt from the general excise tax. Should an attorney-in-fact for a bank, that does business in this state, be exempt from the general excise tax as well? It should be remembered that while insurance companies and reciprocal

insurance companies are exempt from the general excise tax, they do, in fact, pay state insurance premiums taxes. If, in fact, the law requires reciprocal insurance companies to operate with an attorney-in-fact, then the exemption from the general excise tax should extend only to that income that had previously been subject to the in-lieu insurance premiums tax.

Given the fact that the reciprocal insurer is an unincorporated aggregation of subscribers operating through an attorney-in-fact arrangement, it is similar to that of an unincorporated merchants association exempt under HRS section 237-243.3(9). That section exempts from the general excise tax amounts received as dues by an unincorporated merchants association from its membership for advertising media, promotional, and advertising costs for the promotion of the association for the benefit of its members as a whole and not for the benefit of an individual member or group of members less than the entire membership, whereby the attorney-in-fact would be treated similarly as the unincorporated merchants association who provides services to its members while preventing the double taxation of proceeds of the attorney-in-fact. In that way, one can be assured that the moneys paid to the attorney-in-fact by the unincorporated members of a reciprocal insurer were indeed subject to the insurance premiums tax.

The adoption of this measure would attempt to clarify that the income or gross receipts received by an attorney-in-fact/reciprocal insurer that is derived from its principal business as an attorney-in-fact for an insurer shall be exempt from the general excise tax. While this proposal may achieve that end, it takes a convoluted path to that goal by attempting to broaden the entity to say insurer instead of insurance company and amend the insurance law to spell out that the attorney-in-fact for a reciprocal insurer shall be subject to all taxes imposed on corporations other than taxes on income or gross receipts derived from its principal business as an attorney-in-fact. It would seem much clearer if a specific exemption were added to HRS 237-24.3 that would exempt amounts received by an attorney-in-fact acting on behalf of a reciprocal insurer as required by HRS 431. Thus, the exemption from the general excise tax would remain in the general excise tax law and would be limited only to that gross income received from a reciprocal insurer.

Regardless of whether that suggestion is adopted or the measure moves forward in its current form, one has to question the appropriateness of the bill's title. While the issue addressed relates to reciprocal insurers, the problem that this measure attempts to resolve relates to an exemption of income received by the attorney-in-fact for the reciprocal insurer.

Digested 3/25/08



**Property Casualty Insurers
Association of America**

Shaping the Future of American Insurance

1415 L Street, Suite 670, Sacramento, CA 95814-3972

To: The Honorable Marcus R. Oshiro, Chair
Senate Committee on Finance

From: Samuel Sorich, Vice President

RE: **SB 2315 SD2 HD1 – Relating to Insurance**
PCI Position: Support

Date: Thursday, March 27, 2008
4:00 p.m.; Conference Room 308

The Property Casualty Insurers Association of America (PCI) is an association of property/casualty insurers. There are more than 100 PCI member companies doing business in Hawaii. PCI members are responsible for approximately 45 percent of the property/casualty insurance premiums written in Hawaii.

PCI supports SB 2315 SD2 HD1 because the bill provides fair treatment to reciprocal insurers and their attorneys-in-fact. The bill assures that reciprocal insurers and their policyholders are given the same exemption from the general excise tax on gross premiums that is extended to insurers that operate under other business structures.

SB 2315 SD2 HD1 is fair, reasonable and good public policy. PCI requests the committee to vote Yes on the bill.

TESTIMONY ON S.B. NO. 2315, S.D. 2, H.D. 1
RELATING TO INSURANCE

HOUSE COMMITTEE ON FINANCE

Rep. Marcus R. Oshiro, Chair
Rep. Marilyn B. Lee, Vice Chair

Thursday, March 27, 2008, 4:00 p.m.
State Capitol, Conference Room 308

My name is Gerald C. Yoshida. I am testifying on behalf of Medical Insurance Exchange of California ("MIEC") and Medical Underwriters of California ("MUC").

By way of background, MIEC was formed as a reciprocal insurer in California by doctors, for doctors, during the medical malpractice crisis during the mid to late 1970s. MIEC currently insures about 1100 private practice physicians in Hawaii, which accounts for roughly 30-35% of Hawaii's private practice physicians. MUC is MIEC's attorney-in-fact.

The purpose of this bill is to recognize a reciprocal insurer and its attorney-in-fact as a single entity that is not subject to double taxation under Hawaii law.

MIEC supports this bill, but respectfully requests the following amendments:

1. Delete the comma after the word "Reciprocal" on p. 4, line 17, so that the sentence reads as follows:

 "Reciprocal or reciprocal insurer..."
2. Amend the effective date to take effect on July 1, 2008.

Reciprocal insurers, unlike stock or mutual insurers that are incorporated entities, provide insurance through unincorporated associations of individuals, partnerships, or corporations called "subscribers." By law, subscribers of the reciprocal insurer must operate through an attorney-in-fact common to all of the subscribers. As a result, a reciprocal insurer and its attorney-in-fact are virtually indistinguishable.

Insurance companies in Hawaii are taxed in lieu of most state taxes because they are subject to the tax on insurance premiums under Hawaii Revised Statutes ("HRS") §431:7-204. HRS §237-29.7 exempts "insurance companies" from paying the general excise tax, as long as the insurance company has paid the insurance premium tax. Because the term "insurance companies" is

not defined in chapter 237, HRS, or chapter 431, HRS (the "Insurance Code"), the law has been interpreted not to apply to reciprocal insurers and their attorneys-in-fact. The problem is compounded because HRS §237-29.7 does not expressly define that the reciprocal insurer's attorney-in-fact is part of the reciprocal insurer.

The Hawaii Insurance Division has long recognized a reciprocal insurer and its attorney-in-fact as a single entity for tax purposes. Notwithstanding that our client MIEC has consistently paid its share of premium taxes under Hawaii law, MIEC and MUC have been singled out and subjected to double taxation. This ultimately affects the premium rates paid by subscribers who are private practice physicians in Hawaii.

Thank you for this opportunity to submit testimony on this bill and request your favorable consideration.

Respectfully submitted:

Gerald C. Yoshida
Char Hamilton Campbell & Yoshida
737 Bishop Street, Suite 2100
Honolulu, Hawai'i 96813
Ph: 524-3800