10(d)-11(d)

L E G I S L A T I V E

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

BILL NUMBER: SB 2315, SD-1

2/12 EDT

INTRODUCED BY: Senate Committee on Commerce, Consumer Protection and Affordable Housing

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 corporate or other attorney-in-fact of a reciprocal insurer shall be subject to all taxes imposed on corporations of 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, 2008

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

SB 2315, SD-1 - Continued

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 exempted 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 corporate insurer or 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.

Digested 2/11/08

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SENATE COMMITTEE ON WAYS & MEANS
TESTIMONY REGARDING SB 2315 SD 1
RELATING TO INSURANCE

TESTIFIER: KURT KAWAFUCHI, DIRECTOR OF TAXATION (OR DESIGNEE)
DATE: FEBRUARY 22, 2008
TIME: 11:00AM
ROOM: 211

This legislation redefines the definition of insurance companies that qualify for the general excise tax exemption for insurers.

The Department of Taxation (Department) has **no comments** on this legislation at this time.

This legislation will result in a revenue loss of approximately $3.3 million per year. Using data provided by DCCA, the Department obtained premium tax collections paid in 2006. To obtain the tax base associated with these tax collections, a premium tax rate of 2.75% was assumed. The 4% general excise tax rate on the insurance tax base was assessed to approximate the taxes paid by attorneys-in-fact.

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TO THE SENATE COMMITTEE ON WAYS AND MEANS

TWENTY-FOURTH LEGISLATURE
Regular Session of 2008

Friday, February 22, 2008
11:00 a.m.

WRITTEN TESTIMONY ONLY

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

TO THE HONORABLE ROSALYN BAKER, 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.

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; and (2) the GET exemption applies to "insurers", rather than to "insurance companies".

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

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

SENATE COMMITTEE ON WAYS AND MEANS
Sen. Rosalyn H. Baker, Chair
Sen. Shan S. Tsutsui, Vice Chair

Friday, February 22, 2008, 11:00 a.m.
State Capitol, Conference Room 211

WRITTEN TESTIMONY ONLY

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 strongly supports this bill.

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:

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