L E G I S L A T I V E

# TAXBILLSERVICE

126 Queen Street, Suite 304 TAX FOUNDATION OF HAWAII Honolulu, Hawaii 96813 Tel. 536-4587

SUBJECT: GENERAL EXCISE, Taxation of certain insurance death benefits

BILL NUMBER: HB 798, Proposed HD-1

INTRODUCED BY: House Committee on Finance

BRIEF SUMMARY: Adds a new section to HRS chapter 237 to provide for the imposition of the general excise tax on the gross income derived from a life settlement insurance policy by a person unrelated to the insured. The tax shall not be imposed on: (1) any compensation received by the insured of a life insurance policy for the transfer of the policy to another person or designation of a beneficiary; or (2) any death benefit paid under a life insurance policy upon the death of the insured to a person related to the insured.

Defines "gross income derived from a life settlement insurance policy" as: (1) the value of the death or other benefit paid upon the passing of the insured to a person unrelated to the insured under a life settlement insurance policy; and (2) any compensation received by a person, other than the insured, from the transfer of a life settlement insurance policy to another person. Defines "life settlement insurance policy" as a life insurance policy between an insurer and an insured under which: (1) a third party unrelated to the insured purchases, pays for, or finances the purchase of the policy for the insured, and the third party is designated as the beneficiary; (2) the insured purchases the policy with the insured's own funds, but designates an unrelated third party as the beneficiary in return for compensation from the third party; or (3) the insured transfers the policy to an unrelated third party in return for compensation from the third party. Also defines "transfer" for purposes of the measure.

Makes conforming amendments to HRS section 237-24.

EFFECTIVE DATE: July 1, 2011

STAFF COMMENTS: Under the current law, death benefits are not subject to the 4% general excise tax. While this measure would subject the death benefits or other gross income derived by a provider of a life settlement contract to the 4% general excise tax, it appears that this measure is merely proposed to generate funds to address the dire financial condition of the state at the expense of selected taxpayers.

This measure seems to focus on insurance benefits paid on a life settlement to a person unrelated to the insured as opposed to insurance death benefits paid to a next of kin. It should be remembered that the general excise tax is imposed on the gross income of a taxpayer for the privilege of doing business in the state. One then has to ask what privilege of doing business does an insurance death benefit represent? Were goods or services sold to produce the death benefit? If anything, the service that was sold was the promise to pay a death benefit represented by the insurance premium. While insurance premiums are not subject to the state general excise tax, they are subject to the in-lieu insurance premiums tax. So while this measure may be aimed at taxing insurance benefits that result from insurance policies that insure an employee or corporate officer, the proposal misses the point that the product or service proposed to be taxed has already been taxed when the premium was paid.

Finally, one has to understand the types of policies being targeted here. Companies or businesses take out such insurance in order to cover the unfortunate circumstance when a key employee is lost to death or in some cases disability. These persons may be crucial to the continued operation of the company and can range anywhere from the chief executive to the comptroller or treasurer or even the chief accountant. In order to cover the costs of insuring the smooth transition to another person, the business may have to hire temporary help or utilize resources such as the death benefit payment to conduct a search for a replacement. These are costs that would not otherwise have been budgeted for in the annual operating budget. Thus, these death benefits step in to cover those extraordinary and unforeseen costs. Thus, imposing the general excise tax merely exacerbates what is already a traumatic and difficult time for a company operation. It makes little sense to merely add to the cost of healing this wound in the company's operation, an event that could substantially disrupt the ebb and flow of the businesses life cycle.

If this measure is enacted, it would result in the taxation of life settlements to an unrelated third party in the case of a bequest of an insured who has designated a charitable organization as a recipient of the life settlement who will be subject to the general excise tax on such proceeds. As proposed, it is questionable whether this is the intent of the proposed measure. Apparently lawmakers avoided trying to levy the general excise tax on benefits that go to a relative of the deceased but overlooked the situation where such proceeds are intended to benefit a charity. This underscores the need to exercise care in attempting to turn another stone to find additional revenues without exploring the consequences of such an action.

Thus, this measure should be seen for what it truly is, nothing more than another grab for money to bail the state out of its financial woes at the expense of taxpayers and the economy.

Digested 2/24/11

TESTIMONY OF THE AMERICAN COUNCIL OF LIFE INSURERS
IN OPPOSITION TO HOUSE BILL 798, RELATING TO TAXATION

February 25, 2011

Via e mail: fintestimony@capitol.hawaii.gov

Honorable Marcus R. Oshiro, Chair
Committee on Finance
House of Representatives
Hawaii State Capital, Conference Room 308
415 South Beretania Street
Honolulu, Hawaii 96813

Dear Chair Oshiro and Committee Members:

Thank you for the opportunity to testify in opposition to House Bill 798, relating to Taxation.

Our firm represents the American Council of Life Insurers ("ACLI"), a national trade association, who represents more than three hundred (300) legal reserve life insurer and fraternal benefit society member companies operating in the United States. These member companies account for 90% of the assets and premiums of the United States Life and annuity industry. ACLI member company assets account for 91% of legal reserve company total assets. Two hundred thirty-nine (239) ACLI member companies currently do business in the State of Hawaii; and they represent 93% of the life insurance premiums and 95% of the annuity considerations in this State.

As currently worded, ACLI must respectfully oppose this bill.

HB 798 would impose Hawaii's general excise tax on the proceeds payable under a COLI and BOLI policy.

Taxing these proceeds is unprecedented. No state in the union taxes life insurance proceeds. COLI is insurance that employers purchase to help them weather the financial loss resulting from the death of a key employee. Without it, businesses might not have the capital necessary to keep operations afloat and to provide continuing employment to its employees after the loss of a key employee.

COLI also provides a guaranteed method for employers to finance benefits for their employees and retired employees, such as heath care, disability, survivor and supplemental retirement benefits. When the insured employee dies, the insurance benefits are used by the employer to offset the costs of these employee benefits.

**Small Businesses Rely on COLI**

Smaller businesses often purchase life insurance to protect against financial loss from the deaths of key employees and to facilitate business continuation after the death of a business owner. Without COLI, many of these businesses would not have the resources necessary to keep operations running.

**Bank Regulators Recognize the Value of COLI**

COLI is utilized widely by banks and other financial institutions of all sizes under guidance from their regulators and is a particularly important financial asset to banks during the current fiscal crisis. The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision, have identified life insurance as an appropriate means for banks to finance employee benefit plans. Joint interagency guidelines note, "Like other businesses, institutions often use life insurance as a financing or cost recovery vehicle for pre and post retirement employee benefits."[1] The guidelines add, "In these arrangements, an institution insures the lives of directors or employees in whom it has an insurable interest to reimburse the corporation for the cost of employee benefits."

Subjecting COLI and BOLI to Hawaii's general excise tax would leave businesses, particularly small employers, with fewer funds available to continue operations following the death of a key employee; and to fund the cost of employee health and retirement benefits. Imposing the tax would, therefore, make it more difficult for employers to preserve their businesses and the jobs and benefits of their workers. If employers are unable to retain their employees or provide them with health, retirement and other important benefits the State of Hawaii will need to spend its scarce resources for these purposes.

The tax treatment of COLI is already heavily regulated by the U.S. Tax Code. Unlike all other forms of insurance purchased by businesses, COLI premiums are not tax deductible. COLI policy loan interest is generally not deductible. Congress and all state legislatures have recognized the important role played by COLI and, accordingly, they do not subject COLI benefits to direct corporate income tax. At the federal level, when applicable COLI is only subject to an alternative minimum tax.

Nevertheless, HB 798 would impose yet another tax when the insurance is paid. Subjecting the State's 4% general excise tax on businesses punishes those who take responsible steps to plan for and protect their own financial future and the financial security of their families and others who are dependent upon them for their financial support and well being. Life insurance provide businesses with this protection.

At a time when businesses are struggling financially HB 798 would only make an already bad situation worse for employers. When increasing jobs and providing health coverage is a top priority in this country, HB 798 may result in reducing jobs and diminishing health benefits for Hawaii's people. In the current economy it would be particularly bad public policy to do

[1] OCC Bulletin 2004-56.

damage to one of the few reliable methods that businesses have for funding employee and retiree benefits.

For the foregoing reasons ACLI respectfully requests that as currently drafted this Committee defer passage of HB 798.

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Presentation to the House Committee on Finance

Friday, February 25, 2011 at 6:00 p.m.

Testimony on House Bill 798 Relating to Taxation

TO: The Honorable Marcus Oshiro, Chair
The Honorable Marilyn B. Lee, Vice Chair
Members of the House Committee on Finance

My name is Neal Okabayashi for the Hawaii Bankers Association. We oppose HB 798.

The passage of HB 798 will have a deleterious effect on the cost of loans for businesses, as well as harmful to banks, and thus will harm Hawaii's economy.

HB 798 would impose a 4% general excise tax (GET) on the proceeds of a BOLI (bank owned life insurance policy) and key man's insurance policy issued after July 1, 2011. While HBA recognizes the need for revenue enhancement during this economic downturn, we also recognize that without an expansion of loans, the economic downturn may not advance as rapidly or as far as we desire.

Keyman's life is often required in the context of a commercial loan to a small business. Its purpose is to serve as a credit enhancement (collateral) for a bank loan to insure repayment of the loan upon the death of a person integral to the profit of the business. If the proceeds of the keyman's life will be diminished by a 4% tax, then the amount of the keyman's life will have to be accordingly raised, which would increase the business' premium cost, and thus increase the cost of credit. To increase the cost of credit during these times is counterproductive.

Under applicable tax laws, BOLI proceeds are not taxed. In a very real sense, BOLI proceeds is a return of principal. To now tax BOLI proceeds is inconsistent with existing tax law. A 4% tax on BOLI proceeds impinges on a bank's fee income. To reduce bank fee income adversely impacts banks that rely on fee income to smooth out the cyclical nature of interest income which is generally impacted negatively when we are in a low interest rate margin environment, as we are now. Businesses who operate in a cyclical market environment engage in counter-cyclical measures to protect themselves, and imposing a tax on such measures is a disincentive to engaging in prudent behavior which should not be done.

We do recognize that the adverse impact of this bill is softened because it only applies to those insured after July 1, 2011 but going forward, imposing this tax and increasing the cost of key man's life will reduce a bank's income and credit quality at a time of fragility in our economic system. Accordingly, HBA opposes this bill and respectfully requests that it be held. In the alternative, if the BOLI and keyman provisions are eliminated, we would have no opposition.

I would be happy to answer any questions you may have.

STEEL FABRICATORS AND ERECTORS OF HAWAII

P.O. Box 30062 • Honolulu, Hawaii 96820-0062

February 22, 2011

Chair Oshiro and Members of the Committee:

Thank you for the opportunity to testify in opposition of HB 798, Relating to Taxation.

My name is Rupert Chun, Director of the Steel Fabricators & Erectors of Hawaii ("Steel Fabricators"), a trade association whose member companies represent 51 signatory companies to Local 803 Shopmen's and Hawaii Iron Workers Labor and Trust Fund contracts, 36 of which ar located in this State.

Steel Fabricators' signatory companies are by and large small family owned businesses. Many of these companies own key man life insurance on the lives of both related and unrelated employees.

The purpose of key man life insurance is to help business owners, particularly the owners of small businesses like our member companies, continue operating following the death of a key employee. In the case of a small business, its survival and success is often dependent upon one or a few employees.

A business uses after tax dollars to fund the cost of this insurance. Imposing the State's excise tax when the insurance is paid is in effect a double tax reducing funds which would otherwise be available to enable it to remain in business and preserve the jobs of its employees. Steel Fabricators submits that taxing these proceeds at a time when every dollar may mean the life or death of the small business is bad for Hawaii and its people.

For the foregoing reasons, Steel Fabricators requests that this Committee hold this Bill.

Sincerely yours,

STEEL FABRICATORS & ERECTORS OF HAWAII

Rupert K. Chun

Rupert Chun, Director

# S AND M WELDING CO., LTD.

1320 Kalani Street, #202 Honolulu, HI 96817-4920
Telephone: (808) 848-0090 Fax: (808) 848-0323
License No.C-2652

SUBJECT: OPPOSE HOUSE BILL 798

Chair Oshiro and Members of the Committee:

My name is Daniel P. Woo, President of S and M Welding Co., Ltd. ("S&M"). S & M has engaged in the steel construction industry in the State of Hawaii since 1964. We are a family owned business and have 21 employees.

The success of S & M's business is dependent upon its key employees. They provide the essential management skills, technical know how and business contacts and relationships that are critical to our company's operation.

S & M owns 2 life policies on the lives of 2 employees who are family members; and 1 life policy on the life of 1 employee who are not family members.

The purpose of this insurance is to help business owners, particularly the owners of small businesses like ours, continue operating following the death of a key employee.

House Bill 798 would impose Hawaii 4% general excise tax on the proceeds from a key man life insurance policy payable "to a person unrelated to the insured".

Imposing this tax on the proceeds payable to a business like ours following the death of a key employee will reduce funds that would otherwise be available to enable us to remain in business and preserve the jobs of our employees. Bear in mind that after tax dollars earned by our company are used to pay the premiums for this insurance. To impose yet another tax when the insurance is paid punishes business who provide for their own financial security and the financial security of its employees.

For the foregoing reasons, we must respectfully oppose passage of House Bill 798.

Sincerely yours,

S AND M WELDING CO., LTD.

By: Daniel P. Woo

Daniel P. Woo, President

Todd Thakar
Vice President, Government Relations
Prudential Financial
1121 L Street, Suite 610
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Committee on Finance
Hawaii State Capitol, Conference Room 308
415 Beretania Street
Honolulu, Hawaii 96813

Friday, February 25, 2011
6:00 p.m. (Agenda # 8)

HB 798

The Honorable Chair Oshiro and Committee Members:

Prudential Financial respectfully requests that HB 798 be amended to eliminate Bank-Owned Life Insurance (BOLI) policies and Corporate-Owned Life Insurance (COLI) policies, as proposed in HD1.

While we understand the critical fiscal crisis in the State of Hawaii, we believe that subjecting BOLI and COLI policy death benefits to taxation may very well have the unintended consequence of reducing the tax-revenue generated by the sale of BOLI and COLI policies.

At present, when BOLI and COLI policies are sold, Hawaii premium taxes are paid in the year of the sale. Banks and Corporations purchase BOLI and COLI policies on highly compensated employees and directors after providing notice and securing the employee's written consent. At Prudential, we require a representation from the Bank or Corporation that the death benefit proceeds will be used by the Bank or the Corporation to fund employee health and welfare benefits.

Across the country, employers are struggling to continue to meet the ever-increasing cost of employee benefits. This is illustrated by the fact that in 1988, 66% of firms with 200 or more workers provided retiree health coverage and by 2008 only 31% did so. BOLI and COLI are important vehicles to help employers meet these ever increasing costs and thereby enabling them to continue to provide Hawaii employee and retiree health and welfare benefits.

We have serious concerns that subjecting BOLI and COLI products to a new tax on top of the existing premium tax will create a lose, lose, lose situation forHawaii's people. First, Hawaii's employers will simply decide that they can no longer endure the additional costs to provide certain health and welfare benefits making the Hawaii workplace less competitive; second, Hawaii's workforce and retirees will have reduced access to health and welfare benefits; and third, premium tax revenue will diminish as fewer BOLI and COLI policies are sold – given that premium taxes are realized immediately and the death benefit tax will not be paid until a future date, it is foreseeable that HB 798's taxation of BOLI and COLI policies could actually decrease tax revenue.

Again, we appreciate the significant fiscal challenges facing Hawaii. However, we believe that BOLI and COLI policies play a critical role in empowering employers to provide health and welfare benefits for their employees and retirees. We have serious concerns that the inclusion of BOLI and COLI policies in HB 798 will erode tax-revenue, and reduce employee and retiree benefits effectively shifting the responsibility from employers to the State.

For all of these reasons, we respectfully request that BOLI and COLI policies be deleted from HB 798 as contemplated by HD1.

House Committee on FINANCE
Representative Marcus Oshiro, Chair
Representative Marilyn Lee, Vice Chair

**Hearing Date: February 25, 2011 – AGENDA #8 -- 6:00 pm**

**RE: House Bill 798, Proposed HD1 – Relating to Taxation**

Chair Oshiro, Vice Chair Lee, and members of the Committee, the National Association of Insurance and Financial Advisors (NAIFA) Hawaii is made up of insurance agents throughout Hawaii, who primarily sell life insurance, annuities, long term care and disability income policies.

HB 798 would have imposed the 4% general excise tax under Section 237, HRS, on life insurance proceeds/payout or transfers from a corporate owned life insurance (COLI) policy that includes what is also known as key person insurance, a bank owned life insurance (BOLI) policy and life settlements, provided that the benefit/compensation received is not going to a family member or the insured.

We support the Proposed HD1, deleting "bank owned life insurance" (BOLI) and "corporate owned life insurance" (COLI) from HB 798. We do not have a position on the taxing of life settlement contracts.

However, <u>in the Proposed HD 1, we have serious concern regarding the definition of "life settlement insurance policy"</u> on page 1 of the bill. The American Council of Life Insurers will be submitting to this Committee, the corrective language for the definition of a life settlement contract that we support.

Mahalo for allowing us to share our views.

Cynthia Takenaka,Executive Director
Ph: 394-3451

# FINTestimony

**‾rom:** mailinglist@capitol.hawaii.gov
**ent:** Thursday, February 24, 2011 1:15 PM
**To:** FINTestimony
**Cc:** ksamuelson@moreheadgroup.com
**Subject:** Testimony for HB798 on 2/25/2011 6:00:00 PM

Testimony for FIN 2/25/2011 6:00:00 PM HB798

Conference room: 308
Testifier position: oppose
Testifier will be present: No
Submitted by: Kenneth Samuelson
Organization: Individual
Address:
Phone:
E-mail: ksamuelson@moreheadgroup.com
Submitted on: 2/24/2011

Comments:
As an agent who has witnessed the critical benefits provided by life insurance products, I urge you to vote against H.B. 1270 because it would be very harmful to individuals, families, businesses and employees and could also cost jobs, impair state revenue and increase Hawaii's exposure to the financial protection needs of its citizens. The proposed legislation would tax life insurance and disability proceeds–something that neither the federal government nor any state does because of the important benefits that these products provide.