NEIL ABERCROMBIE
GOVERNOR

BRIAN SCHATZ
LT. GOVERNOR

FREDERICK D. PABLO
INTERIM DIRECTOR OF TAXATION

RANDOLF L. M. BALDEMOR
DEPUTY DIRECTOR

STATE OF HAWAII
DEPARTMENT OF TAXATION
P.O. BOX 259
HONOLULU, HAWAII 96809
PHONE NO: (808) 587-1530
FAX NO: (808) 587-1584

HOUSE COMMITTEE ON CONSUMER PROTECTION & COMMERCE

TESTIMONY OF THE DEPARTMENT OF TAXATION REGARDING HB 798 RELATING TO TAXATION

TESTIFIER:	**FREDERICK D. PABLO, INTERIM DIRECTOR OF TAXATION (OR DESIGNEE)**
COMMITTEE:	**CPC**
DATE:	**JANUARY 31, 2011**
TIME:	**2PM**
POSITION:	**SUPPORT**

This measure assesses the general excise tax (GET) on certain life insurance proceeds paid to corporations, banks, and others that are not related to the insured.

The Department of Taxation (Department) **supports** this measure.

SUPPORT FOR TAXING CORPORATE INSURANCE PAYOUTS—The Department supports this measure because it taxes business receipts that should be taxable under a gross receipts tax. Under a gross receipts system of taxation, all receipts are taxed uniformly. Exemptions should be limited. Currently, corporate insurance payouts are exempt from the GET, which erodes the GET tax base. Taxing corporate life insurance amounts for GET purposes is sound tax policy because these amounts are, after all, business receipts.

The Department finds no basis for these amounts to be exempt. Thus, the Department supports amending the GET law to tax corporate life insurance.

TECHNICAL SUGGESTION—The Department suggests eliminating the definitions of "bank owned life insurance policy" and "corporate owned life insurance policy" contained within the bill. The Department suggests utilizing the definition of "employer-owned life insurance contract" contained at Section 101(j)(3) of the Internal Revenue Code.

MODIFY THE CURRENT "GRANDFATHERING" PROVISION—The Department also suggests modifying the July 1, 2011 effective date by adding the proviso "unless there is a material change in the policy," and defining "material change" similar to those terms in Section 101, IRC. This provision will ensure that a person with a contract issued before the bill's effective date doesn't obtain a windfall after the effective date by substantially modifying the contract in their favor.

REVENUE GAIN—This measure will result in revenue gain as follows:

- FY2012, $45,000;
- FY2013, $90,000;
- FY2014, $135,000,
- FY2015, $180,000; and
- FY2016, $225,000.

The Chamber of Commerce of Hawaii
The Voice of Business in Hawaii

Testimony to the House Committee on Consumer Protection & Commerce
January, 31, 2011 at 2:00 p.m.
Conference Room 325, State Capitol

RE: HOUSE BILL NO. 798 RELATING TO TAXATION

Chair Herkes, Vice Chair Yamane, and Members of the Committee:

My name is Jim Tollefson and I am the President and CEO of The Chamber of Commerce of Hawaii ("The Chamber"). The Chamber opposes House Bill 798 relating to Taxation.

The Chamber is the largest business organization in Hawaii, representing more than 1,100 businesses. Approximately 80% of our members are small businesses with less than 20 employees. As the "Voice of Business" in Hawaii, the organization works on behalf of its members, which employ more than 200,000 individuals, to improve the state's economic climate and to foster positive action on issues of common concern.

This measure imposes the general excise tax on the gross income derived from a life settlement, bank-owned life, or corporate-owned life insurance policy issued after 6/30/2011. States expressly that the tax shall not be imposed on any compensation received by an insured for the transfer of the policy or designation of a beneficiary or any death benefit received by a person related to the insured.

The purpose of a corporate-owned life insurance policy is to hedge against the financial cost of losing a key employee to unexpected death, the risk of replacing the employee or to fund corporate obligations to redeem stock upon the death of an owner. Businesses rely on this type of policy knowing that they can continue operations without major disruption in the event of the loss of that key employee.

Many small businesses purchase this type of insurance. The tax increase provided in the bill will impact businesses that try to plan ahead and protect themselves against unpredictable events.

We respectfully ask that the committee holds this measure. Thank you for the opportunity to submit comments.

Hawaii Bankers Association

TEL:
808-524-5161
FAX:
808-521-4120
ADDRESS:
1000 Bishop Street, Suite 301B
Honolulu, HI 96813-4203

Presentation to the House Committee on Protection & Commerce
Monday, January 31, 2011, at 2:00 pm

Testimony on House Bill 798 Relating to Taxation

TO: The Honorable Robert N. Herkes, Chair
The Honorable Ryan I. Yamane, Vice Chair
Members of the House Committee on Protection & Commerce

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 policy will be diminished by a 4% tax, then the amount of the keyman's life policy 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 under federal law because it is a life insurance proceed. In a very real sense, BOLI proceeds are 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. That should not be done.

Imposing this tax and increasing the cost of key man's life will reduce a bank's income and a borrower's borrowing capacity at a time of fragility in our economic system. Accordingly, HBA opposes this bill and respectfully requests that it be held.

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

The Hawaii Business League
Century Square 1188 Bishop St., Ste 1003 Honolulu, HI 96813-3304
Phone: (808) 533-6819 ◈ Facsimile: (808) 533-2739

January 31, 2011

Testimony To: House Committee on Consumer Protection & Commerce
Representative Robert N. Herkes, Chair

Presented By: Tim Lyons
President

Subject: H.B. 798 – Relating to Taxation

Chair Herkes and Members of the Committee:

I am Tim Lyons, President of the Hawaii Business League, a small business service organization. We are opposed to this bill.

It is typical that many small businesses in Hawaii will use Key Man Insurance in order to protect themselves from losses as a result of a loss of a key employee. This kind of insurance is essential and necessary particularly for small corporations who need to have some sort of influx of resources in order to recoup from the loss of a key employee.

We realize that the state is hunting for cash wherever they can find it however, we believe it is essential to recognize that insurance proceeds at the time of a loss only assists partially in trying to recover from that loss both emotionally and financially. The imposition of the general excise tax on these proceeds, we believe, is going to put the State in a position of unfavorable consideration by the parties. The fact that the State would take this opportunity to extract some money out of a settlement is in our mind, unwarranted and difficult to justify.

Based on the above, we cannot concur with this bill and do not recommend its support.

Thank you.

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

Comments

INTRODUCED BY: Say

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, bank-owned, or corporate-owned life insurance policy by a person unrelated to the insured applicable on policies issued after June 30, 2011. 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, bank-owned life, or corporate-owned life 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, bank-owned life, or corporate-owned life insurance policy; and (2) any compensation received by a person, other than the insured, from the transfer of a life settlement, bank-owned life, or corporate-owned life insurance policy to another person. Defines "bank-owned life insurance policy," "corporate-owned life insurance policy," "business entity," "life insurance policy" and "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 for policies issued after June 30, 2011, 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 of a bank or corporate owned life insurance policy as opposed to insurance death benefits paid to a person or next of kin. Thus, the measure attempts to create a dichotomy between insurance death benefits paid to a business as opposed to a person. As such, there should be no distinction as these are benefits as a result of insuring a person's life where the death benefits are paid to a person or paid to a business.

Further, 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.

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 1/28/11

The Honorable Chairman Herkes and Committee Members: OPPOSED

Prudential Financial respectfully requests that HI-H798 be amended to eliminate Bank-Owned Life Insurance (BOLI) policies and Corporate-Owned Life Insurance (COLI) policies.

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 for Hawaiians. 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 HI-H798'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 H798 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 HI-H798.

Todd Thakar
Vice President, Government Relations
Prudential Financial
1121 L Street, Suite 610
Sacramento, California 95814
916-442-3423

Committee on Consumer Protection and Commerce

Monday, January 31, 2011
2:00p.m.

HI-H798

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

January 31, 2011

Via e mail: cpctestimony@capitol.hawaii.gov

Hon. Representative Robert N. Herkes, Chair
Committee on Consumer Protection and Commerce
State House of Representatives
Hawaii State Capitol, Conference Room 325
415 South Beretania Street
Honolulu, Hawaii 96813

Dear Chair Herkes 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.

ACLI respectfully requests that corporate-owned life insurance ("COLI"), also known as key man life insurance, and bank-owned life insurance ("BOLI") be removed from the 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.

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 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 COLI and BOLI be removed from this measure.

[1] OCC Bulletin 2004-56.

Again, thank you for this opportunity to testify in opposition to House Bill 798.

CHAR, HAMILTON
CAMPBELL & YOSHIDA
Attorneys At Law, a Law Corporation

Oren T. Chikamoto
737 Bishop Street, Suite 2100
Honolulu, Hawaii 96813
Telephone: (808) 524-3800
Facsimile: (808) 523-1714

House Committee on Consumer Protection & Commerce
Representative Robert Herkes, Chair
Representative Ryan Yamane, Vice Chair

Hearing Date: January 31, 2011 – 2:00 pm – Room 325

RE: House Bill 798 – Relating to Taxation

Chair Herkes, Vice Chair Yamane, 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 will impose the State of Hawaii's 4% general excise tax under Section 237, HRS, on the 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 oppose this measure. Businesses rely on COLI policies to fund employee benefits that are necessary to attract and retain employees. This bill will punish employers who, through COLI policies, responsibly maintain and fund needed employee benefits, including retiree health benefits and repercussions from untimely deaths of key employees.

Key person life insurance policies protect a company in the case of untimely death of a top salesperson, business owner, or key employee. These top employees are critical to the long term performance of the company and losing a key person can have damaging effect on any business. Key person policies provides peace of mind to business owners and shareholders alike knowing that the business can continue operations without major disruption in the event of the loss of that key employee. When an untimely death occurs, the business may lose critical management skills, may experience falling sales and productivity. The key person insurance may be the difference between the company's demise and its success.

Additionally, many lenders require a business to take out key person insurance on people they consider important before loaning money to the business. The lender will be listed as the beneficiary so if that key person has an untimely demise, the lender can collect some portion of the capital loaned or invested.

One of the most common uses of key person insurance is to buy back shares in a company from the estate of the deceased. In the case of a founding partner or majority holder, this can be crucial in helping the business retain control over its own destiny. The proceeds could be used to hire a recruitment firm to find a suitable replacement, cover expenses while the business adjusts to the loss or to cover lost cash flow from clients who leave with the loss of the key employee.

The business typically owns the policy, pays the insurance premium and is the beneficiary. The policy could also be transferred to the departing employee upon retirement as a retirement benefit or transferred to another key employee upon the retirement of the original key employee.

Life insurance death benefits have historically not been taxable under the laws of any state, and Federal tax law specifically exempts life insurance death benefits from taxation and has done so for more than a century.

We ask that you hold this measure in committee. Mahalo for allowing us to share out views.

Cynthia Takenaka
Executive Director
Ph: 394-3451
NAIFA-Hawaii@hawaii.rr.com