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TAX INFORMATION RELEASE No. 92-7

RE: Application of State taxes on Inventory and Business Interruption Insurance Proceeds

The purpose of this Tax Information Release is to advise taxpayers that insurance proceeds received for inventory or business interruption losses as a result of Hurricane Iniki or other casualty are gross income subject to 4 percent general excise tax and are reportable for income tax purposes. If the taxpayer is an operator of a transient accommodation, the insurance proceeds are not subject to the 5 percent transient accommodations tax.

Section 237-2, Hawaii Revised Statutes (HRS), defines “business” as including all activities, personal, professional, or corporate, engaged in or caused to be engaged in with the object of gain or economic benefit, either direct or indirect.

Section 237-3, HRS, in part, defines gross income as the gross receipts of the taxpayer derived from trade, business, commerce, or sales, and all receipts, actual or accrued, by reason of the investment of the capital of the business engaged in, including interest, discount, rentals, royalties, fees, or other emoluments however designated.

The proceeds received for the loss or destruction of inventory, including crop losses, are amounts received for the loss of revenue resulting from the casualty to the inventory. The loss revenue that has been “made good” by the insurance settlement has the same characteristic of economic benefit to the business as in a regular sale of the inventory items. Insurance proceeds received as a result of inventory losses represent income to the business, and therefore, are subject to the general excise tax.

A similar result occurs regarding insurance payments received for business interruptions. These payments are received to cover the loss of revenue resulting from a disruption of business activities. The same economic benefit has accrued to the business as in the payment for inventory losses. Insurance proceeds for business interruptions, therefore, are subject to the general excise tax.

Section 237D-1, HRS, defines “gross rental” or “gross rental proceeds” to mean the gross receipts of the taxpayer received as compensation for the furnishing of transient accommodations. Since the taxpayer is not receiving compensation for furnishing the transient accomodation, the business interruption insurance proceeds are not considered gross rental proceeds subject to the transient accommodations tax.

For income tax purposes, business interruption or inventory loss insurance proceeds that represent the income equivalent of earnings (replacement of lost profits due to the interruption or loss) are taxable as ordinary income. Generally, business interruption or inventory loss insurance proceeds includable in gross income for federal income tax purposes are also includable as gross income for the Hawaii income tax.

The time for reporting the business interruption insurance proceeds is the year in which the loss occurred, however, where the period of business interruption overlaps two taxable years, the gross proceeds may be prorated according to the number of days the interruption occurred in each taxable year. Internal Revenue Code section 451(d), which the State adopts, provides for an election to include insurance proceeds received for the destruction or damage to farm crops in the tax year following the tax year in which the destruction or damage to the crops occurred.

The general excise and transient accommodations taxes do not apply to insurance proceeds received under a homeowners' policy for damages incurred on an individual's personal residence.

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HRS Sections Explained: Sections 235-4, 237-2, 237-3, and 237D-1