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Employers Unable to Deduct Reserve Contributions

Self-Insured Groups Work to Eliminate Tax Burden

By: Workers' Comp Executive

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Employers participating in self-insured groups (SIGs) in the California workers' comp market are unable to deduct reserve amounts contributed to SIGs as they would standard workers' comp premiums and, worse yet, SIGs pay an 8.84 percent tax on those reserves. SIGs are working on a legislative solution that would reduce the amount of their tax burden to California, but it is likely to be 2008 before relief for employers, if it comes, takes hold.

The question in the minds of some employers is whether tax relief should come in the form of deductibility for employers or tax relief for SIGs.

SIG managers tell legislators that reducing their tax burden is essential to guaranteeing that claims obligations can be met in case of a bad accident year. SIGs and labor have agreed on a proposal that would allow a SIG to elect to take a deduction on reserve amounts accrued from either contributions or assessments. The purpose would be to pay for liabilities within certain accident years.

Although SIGs had hoped to find a legislative vehicle to gut and amend by the end of this legislative session, they acknowledge that time is running short, and they don't expect to have a bill in place until next year. Crafting language acceptable to everyone was key.

"We don't want to mess anything up by pushing something through that's not ready," says Clay A. Jackson, VP and chief legal officer for Affinity Group Administrators, a SIG administrator that's leading the effort.

Labor has bought off on the proposed language but plans to stay neutral on the issue. During review of the language, Angie Wei, legislative director for California Labor Federation, wanted to make sure it didn't lower standards for SIGs.

"We don't want SIGs to be treated differently than other workers' comp products. We want to bring some rationale and conformity to this, but we don't want to lessen the standards," Wei says. "I appreciate the hard work and their wanting to get it done. If it happens, it happens."

"I think it's a good idea. We're going to talk about it with our clients and see if they want us to pursue it," he says, adding that it's the employer that pays the contribution, so it goes right to the bottom line.

Although SIGs are not workers' compensation carriers, they act like carriers in many respects. Instead of charging premiums, they collect contributions from their members, which they use to pay claims. Like insurance companies, they also post reserves to pay out future claims. To this end, regulations require tha

SIGs maintain an 80 percent confidence level to guarantee that they'll always meet their claims obligations. In other words, a SIG has to be able to pay its claims from cash eight out of 10 years.

Individual members can claim some of their contributions as a tax deduction, as they would for premiums. But no such deduction exists for the funds placed in reserves. According to Jackson, the problem is created by a "tax gap," which requires funding at an 80 percent confidence level. Any contributions collected from members not immediately spent on claims or expenses are taxed at 8.84 percent. As a result, the amount taken in tax revenue subtracts from the 80 percent confidence level and requires an additional contribution to level out.

Jackson says Affinity Group has been working on this tax issue for its clients for two years after some SIGs moved to get the 80 percent confidence level lowered to eliminate the tax gap. Working with California's Franchise Tax Board on behalf of his clients, Jackson says he was able to float a solution that could benefit the entire industry.

According to California law, a SIG is a nonprofit, mutual-benefit corporation. But nonprofit doesn't necessarily mean tax exempt, an observation overlooked by the former head of the Office of Self-Insured Plans (OSIP).

"I didn't get that right. I got a lot of things right, but I didn't get that right," says Mark Ashcraft, former head of OSIP and now a self-insurance consultant with Bickmore Risk Services, a SIG administrator.

Statutorily, SIGs are not insurance companies and even Ashcraft was caught unaware that SIGs were being hit with this tax. A letter submitted by Ashcraft to OSIP's current head, Mark Johnson, reads in pertinent part:

"It is my position then [as head of OSIP] as now, that there was not any intent by the DIR to consider group self insurers to be workers' compensation insurance carriers or that private group self insurers would be subject to income tax liability for the contributions received from its group members," the letter reads.

Deduction Rather Than Exemption

In a paper prepared by the Commission on Health and Safety and Workers' Compensation, three options were presented to address the SIG tax issue: tax exemption, taxation equivalent to insurance companies (insurance carriers pay a 2.35 percent premium tax), and tax deductions for additions to reserves. SIGs were leaning toward an exemption, but ultimately a deduction prevailed.

"That seemed the most plausible. A tax exemption seemed more than was needed to put the SIGs on a level playing field," says Judge Lachlan Taylor, a CHSWC member.

Taylor adds that he's been providing technical assistance to avoid any unintended consequences in drafting legislation.

Focusing on a deduction is also more feasible in light of current tax law. According to Jackson, the FTB never was enthusiastic about creating another tax-exempt category, preferring to accommodate SIGs somewhere else in the tax and revenue code.

"I don't think there is any tax law that specifically addresses this issue," says Ron Maddox, a program expert in FTB's exempt unit. "Within the exempt section, we have 20 categories, and you have to fit in one. [SIGs] don't fit in one."

Maddox, who's been working with Jackson on this issue, says the legal department is looking at some oth avenues SIGs could pursue to achieve a similar goal, such as excluding membership income under a different section of the tax and revenue code. This solution is similar to what SIGs are considering legislatively.

Maddox says it's premature to comment on where FTB stands on any legislation until its legal department has looked into the matter. He says he can understand the problem SIGs face in mitigating their losses. He says he's sorry it wasn't addressed earlier.

"I'm not sure how long these pools have been around, but I'm surprised they didn't talk to us first," he says.

OSIP agrees, saying this is more of a technical fix than anything else.

"No one thought they'd be paying taxes on reserves," says Johnson. "It seems fine to us. We have no objection as long as it's okay with the Franchise Tax Board." Johnson adds that his primary concern is the 80 percent confidence level, which he insists must not be compromised by any change in the regulation.