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Affinity Group Administrators

Self-Insureds Tackle Taxation Issue

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Self-insured group administrators are sponsoring legislation in California that would allow them to avoid paying taxes of up to 8.8 percent on the some of their workers' comp reserves.

The bill, SB 420, authored by Gloria Negrete McLeod (D-Montclair) will free the maturing industry of an unexpected consequence that results in the state collecting taxes on a portion of the reserves, which are collected as contributions from employers that join together to form self-insured groups. All of the administrators for the 28 self-insured groups operating in California are backing the legislation, according to Clay A. Jackson, vice president and chief legal officer for Affinity Group Administrators.

The industry had hoped to float legislation last year for a 2007 implementation, but time ran out, forcing them to abandon the push. Jackson says the legislation is essential because the taxes are cutting into funds that are supposed to be used to pay injured workers' claims.

"The money is being collected to pay claims of injured workers," Jackson says. "If you tax off 10 percent off the top of that every year, you have 10 percent less to pay to the injured workers."

Regulations that created SIGs made them nonprofit, mutual-benefit corporations and the intent was that they would not be subject to taxes. But nonprofits aren't necessarily tax exempt, a fact overlooked by the Office of Self-Insured Plans (OSIP) when drafting the enabling legislation in 1994.

SIGs as group self-insured administrators operate similarly to insurance companies. 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.

Regs require SIGs to maintain an 80 percent confidence level as 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. What's not spent of the contributions taken in each year is being taxed.

AB 420 would authorize workers' compensation self-insured groups to take a deduction for all member contributions or assessments accrued for purposes of paying subsequent years of its members' workers' compensation liabilities or contributions.

"The real crux of this is that it was the intent of regulators when putting [SIGs] together, they weren't thinking it was going to be a taxable event," says Rick Brush, director of private groups for Bickmore Risk Services, another group administrator. "By taxing them you're depleting that amount from reserves used to pay for workers' comp claims."

When the problem was first broached, the Office of Self-Insurance Plans asked the Commission on Health and Safety and Workers' Compensation to study the problem. The commission found that SIGs "pay a higher proportion of their gross receipts in state taxes than workers' compensation insurance companies pay."

The 8.84 percent they pay on taxable income compares to the 2.35 percent gross premium tax insurers pay instead of state franchise taxes, according to the study.

If nothing is done to change the taxation of SIGs, according to CHSWC's issue paper, several consequences could arise, including:

- The uncertainties concerning the taxation of SIGs under existing law, which results in an increased risk of failure for this fledgling industry.
- Current tax law encourages maintaining only the minimum required reserves and SIGs should be encouraged to retain surplus to assure capacity to meet all of their obligations "even under more extreme conditions."
- The taxation of money going into reserves creates pressure to lower the required amount of reserves, which would weaken their ability to pay claims during high claims years.
- Risk of insolvency of a SIG is increased when its ability to raise funds "by assessing its members is thwarted by the taxation of those funds."

Mark Johnson, manager of OSIP, says that as long as the legislation doesn't attempt to change the 80 percent confidence factor for reserves, the office may support the legislation. As of last week it had not weighed in with support.

"At first blush, if anything [the bill] would make them stronger because they wouldn't have to use a lot of that money to pay taxes," Johnson says.

Jackson says he has received word from labor that it will take a neutral stand on the legislation, which is all a group of employers can ask for when trying to avoid opposition from them.

During review of the language at a CHSWC meeting on the matter last year, Angie Wei, legislative director for California Labor Federation, sympathized with 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."