The California Commission on Health and Safety and Workers' Compensation

Issue Paper on Tax Status of Self-Insured Groups (SIGs)

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Commission on Health and Safety and Workers' Compensation

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Introduction

On March 23, 2006, Senator Abel Maldonado requested the Commission on Health and Safety and Workers' Compensation (CHSWC) to evaluate issues of contributions, reserves, taxation, and the possible need for tax exemption for Self-Insured Groups formed under Labor Code Section 3700 et seq.

Background

All employers except the State are required to secure the payment of workers' compensation by either insurance or self-insurance, according to Labor Code Section 3700. Prior to 1993, private companies and public entities were allowed to self-insure. Private companies could only self-insure if they met the qualifications individually. Public entities could self-insure either individually or under pooling arrangements known as Joint Powers Authorities (JPAs).

In 1993, the Legislature authorized the establishment of private-industry Self-Insured Groups (SIGs) for workers' compensation. The amendment was part of a Chapter 121 of Statutes of 1993, which was one piece of a major workers' compensation reform package passed by the Legislature in that year. "Open rating" – the repeal of the minimum rate law – was another significant component of the package intended to reduce employers' costs for workers' compensation.

According to the Department of Industrial Relations, Office of Self-Insurance Plans, "During 2001, group self insurers began forming in the private sector for the first time. The first such application was approved for new-car dealers, effective January 1, 2002."[1] As of November 3, 2005, there were 22 self-insured groups listed on the roster of the Office of Self-Insurance Plans.[2] SIGs are an established and increasingly available alternative for employers to comply with the obligation to secure the payment of compensation.

As SIGs have begun to proliferate, an unexpected tax consequence is becoming evident. To understand the tax consequences and the potential effects of a change in tax status, one must first understand a little bit about the finances of SIGs.

Terminology and Finances of SIGs

A SIG must have multiple layers of financial capacity to meet its liabilities for payment of compensation on behalf of its member companies. The primary source of funds for payment of

[1] http://sip.dir.ca.gov/Generalinfo.htm, accessed March 28, 2006.
[2] http://sip.dir.ca.gov/GroupRoster.pdff

claims is income to the SIG from **contributions** paid by its members. Contributions are comparable to the insurance premiums paid by insured employers to insurance companies. **Reserves** are set aside to pay benefits that will be required in future years as a result of injuries occurring in the current year. If a SIG has too little money available to meet its obligations, it must raise additional money by an **assessment** on its members. This requires that the members be financially capable of complying with a call for assessments. Certain exposures may be covered by **excess insurance**. If the SIG fails to pay its claims, the Director of the Department of Industrial Relations may draw on the SIG's **security** to pay the claims.

The Department of Industrial Relations (DIR) adopted regulations to establish these layers of financial capacity for SIGs. According to regulations, SIGs must:

- [3]Maintain a consolidated net worth of the group members of at least $5,000,000.
- Maintain a consolidated annual net income of the group members of $500,000
- Have sufficient income to fund
  - The group self-insurer's actuarially projected claim liabilities at the 80% confidence level,
  - To pay expected administrative expenses to operate the group self-insurer's business operations, and
  - To post the security deposit required.
- Carry specific excess insurance with a maximum self-insured retention of $500,000 per occurrence.

The first two of those points are concerned with the ability of the SIG to collect contributions and assessments if needed. The "income" point refers to income to the SIG in the form of member contributions which are the expected source of funds. The requirement of funding claims at an 80 percent confidence level plus expenses helps to assure that there will be adequate funds on hand to meet all compensation obligations. A 50 percent confidence level would be the probable amount of future liabilities, but for any given year it would have an equal chance of being either too little to pay claims or more than required to pay all claims incurred. A higher confidence level will increase the likelihood that claims can be satisfied from the funds in reserve. The result is that the SIG will be overfunded for most years, and the excess can be used to offset the years when it is underfunded. Eventually, the excess which is not needed to backfill the underfunded years may be refunded to members in the form of **dividends**.

The SIG itself is a legal entity separate from its members. By regulation, it is required to be a nonprofit mutual benefit corporation. The tax consequences arise primarily from the fact that a large part of the SIG's income received in a given year must be put into reserves for future payment of incurred claims, so income will usually exceed the amount paid for liabilities and operating expenses.

[3] 8 Cal. Code Regs. Sections 15203.2(f) and 14478(a).

Federal and State Tax Provisions on SIGs

PLEASE NOTE

The Commission on Health and Safety and Workers' Compensation does not give tax advice or interpret tax law. This paper should not be cited as authority on tax law. Descriptions of tax law in this paper are based on information received from others and may differ from the actual rights and liabilities of taxpayers. The purpose of this issue paper is to inform legislative deliberations affecting workers' compensation issues, not to interpret tax law.

A SIG is required by regulations[4] to be a private, nonprofit mutual benefit corporation.[5] "Nonprofit," however, does not necessarily mean tax-exempt. This fact was not considered when the regulations were written for SIGs.[6]

From a member's point of view, a contribution to the SIG will ordinarily be an expense that is deducted from that member's taxable income for the year in which it is paid or incurred. Excess contributions which are not required for reserves can be returned to the members. A refund of excess contribution will ordinarily be recognized as income for the year in which it is received or accrued.

From the SIG's point of view, contributions are included in gross income, and payments of claims are deductible expenses. The contributions are usually received in excess of the payments each year for a number of reasons, including the requirement of reserving to an 80 percent confidence level.

According to an opinion by Ted Hall, a CPA advising SIG representatives:

> Section 461 of the Internal Revenue Code sets forth the general rules for deductibility of trade or business expenses. Sec. 461(h) provides that certain liabilities cannot be deducted until "economic performance" occurs. Sec. 461(h)(2)(C) provides that in the case of workers compensation liabilities, economic performance occurs when payment is made to the injured party. Ergo, no federal deduction for reserves for accrued but unpaid claims. California conforms to IRC Sec. 461(h).
>
> Subchapter L of the IRC provides special rules for the taxation of insurance companies. In my opinion there is significant authority to tax self-insured groups as insurance companies under Subchapter L of the IRC.
>
> Sec. 832 of the IRC is the general provision regarding the computation of taxable income for insurance companies. Sec 832(b)(5) allows a deduction for losses incurred. Losses incurred

[4] 8 Cal. Code Regs. Sections 15201(s), 15470(a).

[5] Defined by Corp. Code Section 5059.

[6] Letter February 21, 2006 from Mark Ashcraft, former Manager of Office of Self Insurance Plans, to Mark Johnson, current Manager of Office of Self Insurance Plans. See attachment.

> includes paid and unpaid losses. Unpaid losses (or reserves) are subject to a discount as provided in Sec. 846. The first year discount on unpaid workers compensation claims is about 12.5% of gross reserves. Gross reserves are generally determined for tax purposes based on actuarial studies.
>
> Sec. 461(h) is not operable if a company is taxed under Subchapter L of the IRC.
>
> California R&T C does not have conforming legislation to federal Subchapter L. This is because insurance companies are not subject to the California Franchise or Income Tax under Article 13, Sec. 28 of the California Constitution. That section of the Calif. Constitution taxes "insurers" on gross premiums. The premium tax rate is 2.35% of premiums collected in the state. The premium tax is "in lieu" of the California income or franchise tax on corporations.
>
> Since self-insured groups are not subject to the California premium tax, the "in lieu" exemption does not apply to them. Since there is no equivalent of Subchapter L accounting under the Calif. R&TC, self-insured workers compensation groups are potentially subject to taxation on the difference between contributions received less operating expenses and paid losses.

CHSWC defers to Mr. Hall's interpretation of California tax law in the absence of evidence to the contrary. For state purposes, it is correct that SIGs are not insurance companies. Insurance companies are subject to a 2.35 percent premium tax in lieu of other income taxes,[7] but this rate does not apply to SIGs. Instead, they are probably subject to the 8.84 percent franchise tax (income tax) which is applicable to other corporations.[8] SIGs receive gross income to the extent of contributions received from members, and SIGs can offset expenditures for operating expenses and for claims paid. As Mr. Hall advises, existing state law probably does not allow a deduction under existing law for the money placed into reserves for incurred losses.

Recalling that contributions must fund actuarially projected liabilities, we observe that contributions received by a SIG in the year of an injury will be taxed to the extent that the contributions are kept in reserves for payment of benefits that may extend into future years. It has been estimated that only 15 percent of the average cost of claims is paid out in the calendar year in which the claim occurs, leaving 85 percent of the cost of the claims to be held in reserve for subsequent payments. Accordingly, approximately 15 percent of member contributions intended for the payment of benefits and operating expenses will be paid out and 85 percent of those contributions may become net taxable income to the SIG in its first year. In subsequent years, payments from reserves for prior claims will be deductible from current income. Even in a no-growth situation, contributions received will usually exceed operating expenses and benefits paid, so the difference is exposed to taxation under current law.

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[7] California Constitution, Article XII, Section 28.

[8] Revenue & Taxation Code Section 23151 provides the general franchise tax rate of 8.84%. According to personal communication from Mr. Hall April 4, 2006, SIGs are not subject to the higher rate for financial corporations because they do not fall within the definition in 18 Cal. Code Regs. Section 23183.

SIGs Compared to Insurance and Self-Insurance

Under current state law and under normal circumstances, SIGs pay a higher proportion of their gross receipts in state taxes than workers' compensation insurance companies pay. SIGs probably pay California franchise tax of 8.84 percent on taxable income. Taxable income basically consists of gross receipts from members' contributions less operating expenses and expenditures for payment of claims, but it does not allow a deduction for funds put into reserves for future payments on incurred claims. By comparison, insurance companies pay a gross premium tax of 2.35 percent in lieu of the state franchise tax.

Under federal tax law, insurance companies are allowed to deduct from current income the amount that is added to reserves. The federal provisions for calculating the taxable income of insurance companies are in Subchapter L of the Internal Revenue Code. According to the opinion from Mr. Hall, SIGs may be treated the same as insurance companies under federal law because they have the risk sharing and risk shifting characteristics of insurance.

Stand-alone self-insured employers are not required to maintain reserves, although it is prudent to do so. They may operate on a pay-as-you-go basis.

Industry Proposal

It has been suggested on behalf of the organizers of SIGs that SIGs should be made tax-exempt under California law, and that the tax-exemption of SIGs could be established by amending Section 5005.1 of the Corporations Code. That section allows certain nonprofit organizations to form self-insurance pools for automobile and tort liability. It is for public health and human service organizations such as Meals on Wheels and Paratransit. Organizations organized under Corp. Code Section 5005.1 are exempt from state franchise tax pursuant to Rev. & Tax Code Section 23701z. Adding SIGs to Corp. Code Section 5005.1 would make them exempt from state franchise tax.

Impact

We anticipate a negligible immediate loss of tax revenue if SIGs become tax-exempt. Fewer than 30 SIGs are currently in operation and the oldest has only been in existence since 2002. They have not likely grown to become an appreciable share of the tax revenue. The long term effect would depend on the extent to which SIGs grow if employers move from conventional insurance into SIGs.

Partially offsetting the decline in direct tax revenue, there may be some growth in business spending for other purposes and some increased tax revenue from the resulting expansionary effect on the economy. These positive effects cannot readily be quantified:

- Workers' compensation costs for SIG members will decrease.

- Reduced costs will enable SIG members to invest monies and strengthen the state economy, leading to increased state tax revenues.

If nothing is done to change the taxation of SIGs, several consequences are foreseeable:

- Leaving SIGs taxable like ordinary corporations is contrary to the state's intention when the program was established.
- There are many uncertainties in the taxation of SIGs under existing law, causing increased risk of failure in this fledgling industry.
- Retention of surplus should be encouraged because retaining more than the minimum reserves would further assure the capacity of SIGs to meet all obligations even under more extreme conditions. Current tax law, however, encourages maintaining only the minimum required reserves.
- The taxation of money going into reserves creates pressure to lower the required amount of reserves. Some in the industry have already sought to persuade the regulators to lower the required confidence level. Reducing the tax would reduce the pressure to weaken the layers of financial security.
- The risk of insolvency of a SIG, however small, is increased when its ability to raise funds by assessing its members is thwarted by the taxation of those funds.

CHSWC Recommendation

CHSWC agrees that SIGs are placed at an unnecessary disadvantage by the existing tax effects. The Legislature authorized SIGs as a cost-saving alternative for employers, but the benefits of that alternative are limited by taxation at a rate higher than the rate for conventional insurance. The current tax structure creates incentives that are contrary to the safety and security of both employers and workers. CHSWC recommends relieving the disproportional tax burden on SIGs.

Three approaches appear to be worthy of consideration.

1. <u>Tax exemption.</u> Exemption from state income taxation would allow more of the members' contributions to be devoted to securing the payment of compensation to injured workers. This solution would provide the greatest savings to employers and the lowest risk that employers would be unable to meet assessments required to maintain the solvency of the SIG. This solution is consistent with the intention of the state in establishing the program. This solution also entails the simplest legislative language.

2. <u>Taxation equivalent to insurance companies</u>. One might argue that SIGs are acting like insurance companies and should be taxed under the same 2.35 percent premium tax as insurance companies. There are substantial differences between SIGs and insurance, however, such as insurance companies' requirements for and accounting of capital and surplus and how the industries are licensed and regulated. Furthermore, this alternative is

complex and possibly would require an amendment to the state Constitution. This does not appear to be the best choice.

3. Deductibility of additions to reserves and payment of dividends. SIGs could be allowed to calculate taxable income for the California franchise tax according to Subchapter L of the Internal Revenue Code. This solution would not have all of the advantages of tax exemption but it would relieve the worst of the problems under existing law.

Bickmore Risk Services

Leadership. Trust. Solutions.

February 21, 2006

Mark Johnson, Manager
Self Insurance Plans
2265 Watt Avenue Suite 1
Sacramento, CA 95825

Dear Mr. Johnson:

RE: Group Self Insurer Taxation

As you are aware, I preceded you as the Manager of Office of Self Insurance Plans (OSIP) in the Department of Industrial Relations (DIR), a position which I held from 1987 to 2003. As Manager, I was responsible for proposing new self insurance regulations on matters affecting workers' compensation self insurance. In 1993, a statutory change occurred in Labor Code Section 3700 that permitted the formation of private group self insurers and a subsequent group of regulatory proposals were developed by OSIP and adopted by the Director of DIR. I, as Manager, was the person that conducted the rulemaking activities on this set of group self insurance regulations on behalf of the Director.

I have been asked to clarify the regulatory intent of the DIR in 1993 with respect to whether the DIR considered group self insurers to be "insurance carriers" and as to the matter of income taxation of private group self insurers. It is my position then, 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.

Discussion:

1. Group Self Insurers as Workers' Compensation Insurance Carriers

Group self insurers are not "insurers" or "carriers" of workers' compensation liabilities. For the DIR to have considered private groups to be such, would have meant that the group self insurers would have been beyond the jurisdiction of the DIR to regulate. This was not the intent of the change made to Labor Code Section 3700 that permitted group self insurance.

Labor Code Section 3700 requires all employers to secure the payment of workers' compensation in one or more of the following ways:

> "(a) by being insured against liability to pay compensation by one or more Insurers duly authorized to write compensation insurance in this state.
> (b) By securing from the DIR a certificate of consent to self insure **either** as an individual employer **or as one employer in a group of employers**, which may be given upon furnishing proof satisfactory to the DIR of the ability to self insure and to pay any compensation that may become due to his or her employees. (**emphasis added**).
> (c) For any county, city, city and county, municipal corporation, public District, public agency, or any political subdivision of the state, including each member of a pooling arrangement under a joint powers agreement (but not the State itself), by securing from the DIR a Certificate Of Consent to Self Insure against workers' compensation claims, which certificate may be given upon furnishing proof satisfactory to the Director of the ability to administer workers' compensation claims properly and to pay workers' compensation claims that may become due to its employees ...".

Self insurance of workers' compensation is regulated by the DIR under Section 3700 of the Labor Code, while carriers or insurers are regulated by the Insurance Commissioner and the Department of Insurance under the Insurance Code. Had this amendment been made in the Insurance Code, then the intent might have been to regulate the group self insurers as a carrier with regulatory jurisdiction falling to the Insurance Commissioner and the Department of Insurance. However, the 1993 amendment to Labor Code Section 3700 was made to Section 3700(b), indicating that private group self insurers were to be regulated by the DIR. Section 3700 is one of the Labor Code Sections that authorize regulatory actions may be taken by the Director. The authority references in the 1993 rulemaking file for private group self insurance regulations were the following statutes:

1. Labor Code Section 54. Section 54 sets forth the duties and powers of the Director of Industrial Relations;

2. Labor Code Section 55. Section 55 permits the Director to administratively organize the Department to conduct the work of the Department.

3. Labor Code Section 3702.10. Section 3702.10 grants the authority to the Director to adopt, amend, and repeal rules and regulations with respect to workers' compensation self insurance reasonably necessary to carry out the purposes of Labor Code Section 129, Article 1 (commencing with Section 3700 of the Labor Code), Article 2 (commencing with Section 3710 of the Labor Code) and Article 2.5 (commencing with Section 3740 of the Labor Code).

The private group self insurance regulations were proposed and adopted pursuant to the above referenced Labor Code statutes. There was no intent in the regulations to consider group self insurers as either "insurers" or "carriers", as to do so would have been beyond the jurisdiction of the DIR.

In addition, in the regulations adopted, the private groups self insurers were clearly required to be "self insurers" under Labor Code Section 3700(b). In the California Code of Regulations, Title 8, Section 15201, the terms, "group self insurer", "group member", and "industry" was added. In addition, the nature of the required incorporation documents is specified in the definition.

1. Section 15201(s) defines "Group self insurer" as follows:
"(s) Group Self Insurer. A private, non-profit, mutual benefit corporation pursuant to Part 3 (commencing with Section 7110) of Division 2 of Title 1, of the Corporations Code established for the sole purpose of operating a group workers' compensation self insurance fund to pool California workers' compensation liabilities for two or more private employers in the same industry under California workers' compensation statutes and regulations...

2. Section 15201(t) defines "Group Member" as follows:
"(t) Group Member. A private employer issued an Affiliate Certificate as a member in a group self insurance program that has, in turn, been issued a Certificate of Consent to Self Insure as a private group self insurer"

3. Section 15201 (x) defines "Industry" as follows:
(x) Industry. Employer classification as determined using the first 2 digits of the Standard Industrial Classification Code (SIC Code) provided by the Department of Commerce, Bureau of Management and Budget.

Under these regulatory definitions, a group self insurer is not a workers' compensation "insurer" or a "carrier", but rather is a non-profit, mutual benefit corporation organized to operate a group workers' compensation self insurance fund that pools claim liabilities of two or more employers in the same industry defined by SIC Code and both the group and each member possess the requisite Certificate of Consent to Self Insure issued by the Director of Industrial Relations.

Regulatory Intents

The 1993 group self insurance regulations set up a very tight model that all private group self insurers have to conform to. This model includes:

A. Homogeneous membership – defined by industry SIC Code (CCR, Title 8, Section 15473);
B. Minimum $5 Million group financial net worth (CCR, Title 8, Section 15472)

C. Operational control exercised by Board of Trustees –with 2/3 of Board Members from group members, and the Board shall have prepared an Annual Audited Financial Statement of Group Self Insurer (CCR, Title 8, Section 15475);
D. Advanced Premium Discounts Prohibited - a form of reduced contribution to group (CCR, Title 8, Section 15476);
E May declare surplus funds but must advise Manager of OSIP and wait 12 months prior to distribution to members- (CCR, Title 8 Section 15477);
F. Required to carry specific excess insurance protection for group members—to protect against large or catastrophic losses—(CCR, Title 8, Section 15478);
G. Actuarial analysis of historical loss analysis and projected loss development of group required at least every other year and the actuary must be Associate or Fellow of Casualty Actuary Society and /or a Member of American Academy of Actuaries (Section 15481).
I. Each member provides group with Indemnity Agreement and Power of Attorney (CCR, Title 8m Section 15480) and the group self insurer, in turn, gives Department an Assumption and Guarantee Agreement for each group member (CCR, Title 8, Section 15480).

In addition to all the above, the group self insurer must prepare an extensive "Initial Feasibility Study" that is supplied to the prospective members (CCR, Title 8, Section 15471) and adopt "By-Laws" addressing any delegated functions(CCR, Title 8, Section 15475(e)(7).

The intent of the initial, private group self insurance regulations was to first create a "new" form of self insurer of workers' compensation liabilities in California—i.e. the private group self insurer and private group member – and adopt various requirements that such group or member self insurers would need to conform to.

Tax Consequences

In 1993, the only group self insurers in the State were the public sector joint powers authorities (JPAs), which were used as a model for the private group self insurer. The JPAs' memberships are cities, counties, school districts, and other special districts that sell their services at cost to their membership. Each member of a JPA is generally tax exempt as they are public agencies—cities, counties, school districts, etc. The JPA contribution levels (i.e. funding) from the membership is set high enough to insure that there would be enough contribution collected from the members to pay all actuarially projected claims liabilities in most years. No specific confidence level, however, was required in the existing JPA regulations, but the confidence levels ranged generally from 70% to 90% at that time among the JPAs. (Individual public agencies, particularly, the very large ones essentially budgeted their workers' compensation liabilities at 50% confidence level—what was expected based on claim file reserves.) This variable confidence level system was not brought over to the private sector group self insurers as it would permit each private group to set or change the funding levels on their own at any time. The 80% confidence level was chosen as it would mean eight (8) out of ten (10)

years (on average) each group's actuarially projected funding of claims would be adequate to pay all claims for those eight (8) years. In the one (1) or two (2) years that there might be a shortfall in funding, it was felt that the surplus from the other eight (8) years would be adequate to fund most of any shortfall. This meant that there would rarely be any group self insurer assessments needed to collect additional funds from members for prior years that may have been under-funded.

It was anticipated with 80% confidence level funding of claims, there would be an overage of contributions in most years. This would be refunded to the membership as a "dividend" (refund of an over collection of contributions) or that members would receive the refund as a credit toward the next year's contributions to be paid to the group self insurer. The members on joining the private group self insurer would pay in their share of contributions for year one, presumably taking a charge as an "expense item" in their company books for that year in the amount of the total contribution. This would be the same regardless of whether the member was paying contribution to the private group self insurer or paying premium to an insurance carrier. The member company would presumably pay income tax on their company income for that year, as well. The same cycle would occur each year thereafter as far as the group member was concerned. Any refund of excess contributions ("dividends" as they are usually referred to) would be debited as some type of miscellaneous income when returned to the group member since the original payment presumably was deducted as an expense item in the year it was paid. The refund would be added to the other income and expenses of the group member for the year in which it was received.

As Manager of OSIP in 1993, I did not anticipate that there would be any income tax liability to the group self insurer, since they were required by the regulations to be not-for-profit mutual benefit corporations and to fund their projected claim losses at 80% confidence level, with each group selling their services at cost to their membership, and passing all savings on to the group membership. It was not until after I retired from State service that I learned that being a "not-for-profit" corporation is not the same thing as being "tax-exempt" from State and Federal taxes.

Private groups will generally show surplus funding for most program years. This is in part due to the required over collection of funds at the 80% confidence level; the fact that in order to make an actuarial projection on the claim liabilities, an amount will be added in the calculations for claims liabilities that "incurred but were not reported" and that another adjustment will be made in the calculations for claims that become worse than originally anticipated. In addition, the payout of the serious workers' compensation claims will be spread over many years, sometimes the remainder of the employee's lifetime. The result is that over time, the private group self insurers can show significant taxable income, despite their not-for-profit corporate status. If income tax is to be applied on private group self insurers on the basis of income, then a portion of the funds set aside to insure the payment of the group's workers' compensation claims would instead be diverted to pay State and Federal income tax which would mean the 80%

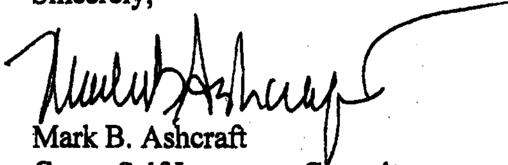
confidence level would only exist before any tax liability is considered. This is certainly not what I, as Manager of OSIP, had in mind in these private group regulations.

It should be noted that insurance companies pay a "premium tax" in lieu of all other income taxes. Group self insurers are not insurers or carriers, and therefore, not subject to premium tax.

I conclude there was no intention in 1993 on my part representing the Department of Industrial Relations to have private group self insurers to be subject to State and Federal income tax on the contributions they received from their membership.

You are aware that I have been employed since my retirement in 2003 by Bickmore Risk Services (BRS) in Sacramento. BRS provides management services to public sector and private group self insurers that operate workers' compensation, general liability, and automobile liability programs.

Sincerely,



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