ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Margett | Analyst: Kristina E. North | Bill Number: SB 375

Related Bills: None | Telephone: 845-6978 | Amended Date: April 21, 2003

Attorney: Patrick Kusiak | Sponsor:

SUBJECT: Employer Workers' Compensation Credit

SUMMARY

This bill would provide a credit to employers that pay for workers' compensation benefits.

SUMMARY OF AMENDMENTS

The April 21, 2003, amendments replaced language related to workers' compensation with a workers' compensation credit for employers. The workers' compensation credit is discussed below.

This is the department's first analysis of the bill.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to provide an incentive for businesses that do not have excessive worker's compensation claims to remain in this state.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately and would apply to taxable years beginning on or after January 1, 2003.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Workers' compensation laws are designed to ensure that employees who are injured or disabled on the job are provided with fixed monetary awards, eliminating the need for litigation. These laws also provide benefits for dependents of those workers who are killed because of work-related accidents or illnesses. Some laws also protect employers and fellow workers by limiting the amount an injured employee can recover from an employer and by eliminating the liability of co-workers in most accidents. State workers' compensation statutes establish this framework for most employment.

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Federal statutes are limited to federal employees or those workers employed in some significant aspect of interstate commerce.

California state law requires all employers to purchase or provide workers' compensation benefits for their California employees. Employers may finance their liability for workers' compensation benefits by one of three methods: (1) self-insurance, (2) private insurance, or (3) state insurance. Employers wishing to self-insure must first obtain consent from the Department of Industrial Relations (DIR). Only certain aspects of workers' compensation are administered by a government agency.

- Under DIR, the Division of Workers' Compensation (DWC) monitors the administration of workers' compensation claims and manages the exclusive judicial system in which the claims are resolved or adjudicated.

- Under DIR, the Office of Self Insurance Plans (SIP) authorizes qualified employers to provide their own coverage for workers' compensation liabilities. SIP is responsible for certification of public and private self-insured employers, third-party administrative agencies that oversee self-insurance programs, and individual claims adjusters. Self-insurers are required to post a security deposit, which is adjusted annually to cover liabilities incurred. Self-insurers must also submit to SIP audits.

- The Department of Insurance licenses over 300 private insurance companies transacting a workers' compensation insurance business in California. However, the individual insurance companies set the insurance rates that vary and depend on a variety of factors.

- The State Compensation Insurance Fund (SCIF) is a non-profit, public enterprise that operates like a mutual insurance carrier. Unlike other carriers, SCIF exists solely for the benefit of California employers. Workers' compensation insurance may be purchased directly from SCIF. The Workers' Compensation Insurance Rating Bureau determines SCIF's rates.

Current state and federal tax laws provide various tax credits designed to provide tax relief for taxpayers who incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake.

Current state and federal tax laws generally allow taxpayers engaged in a trade or business to deduct all expenses that are considered ordinary and necessary in conducting that trade or business. Workers' compensation insurance premiums or direct benefits (for self-insured employers) qualify to the extent they are an ordinary and necessary business expense.

Neither state nor federal laws allow a tax credit similar to the one proposed by this bill.

<u>THIS BILL</u>

This bill would create a tax credit for 50% of the amount paid by a taxpayer for workers' compensation during the taxable year. The credit would require that the taxpayer's business not experience an increase in the number of workers' compensation claims in the taxable year the credit is claimed.

The credit would be available for taxable years beginning on or after January 1, 2003, and before January 1, 2008.

This bill would allow any unused credit to be carried over until exhausted.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

- It is unclear what the author intends to include in the "amount paid by a taxpayer during the taxable year for workers' compensation." For example, it is unclear if the "amount paid" would include amounts paid for insurance premiums or benefits for employees working outside of California. Additionally, it is unclear if amounts paid in excess of insurance premiums or self-insurance deposits would be included in the credit amount. Clarification of what amounts would be properly includible in the credit base would be helpful to avoid disputes between taxpayers and the department.

- Clarification is needed on what the author means by an "increase in the number of workers' compensation claims." It is unclear if the author is referring to an increase in the claim ratio for a particular class of workers, the total number of claims filed with the employer, the total number of disputed claims, or a monetary increase in claims. Without clarification, even an agency with expertise in workers' compensation would have difficulty certifying the credit.

- The department does not possess expertise related to worker's compensation claims. Typically, credits involving areas for which the department does not possess expertise are certified by another agency or agencies that possess the relevant expertise. Certification language typically specifies the responsibilities of both the certifying agency and the taxpayer.

- It is unclear how the department would verify a taxpayer's eligibility. DIR does not maintain complete workers' compensation claims information by employer. Further, any information that is maintained is confidential and could not be released to this department without statutory change. Also, any information from the taxpayer's insurer or SCIF would likely be proprietary and not be released.

- This bill does not limit the number of years for the carryover period. The department would be required to retain the carryover on the tax forms indefinitely because an unlimited credit carryover period is allowed. Recent credits have been enacted with a carryover period limitation since experience shows credits typically are exhausted within eight years of being earned.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota,* and *New York.* These states do not offer a credit similar to the credit proposed in this bill. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

FISCAL IMPACT

The department's costs to administer this bill cannot be determined until the implementation concerns have been resolved.

ECONOMIC IMPACT

Revenue Estimate

The revenue impact of this bill would result in a revenue loss in excess of $3.5 billion annually. This revenue analysis does not take into consideration premium payments paid to individual insurance companies (premiums not paid to SCIF) or benefit payments paid by self-insured employers, as this information was not available.

SCIF receives almost $7 billion dollars annually in workers' compensation premium payments from employers. SCIF represents approximately one-half of the workers' compensation insurance market with the other half covered by over 300 independent insurance companies. With a total of over $14 billion in workers' compensation premium payments annually, a tax credit of 50% would cost $7 billion if every business qualified. It is assumed that at least half of business would qualify for the tax credit for a total cost of $3.5 billion. This tax credit would be in addition to the deduction from income that businesses currently receive for the workers' compensation payments. This revenue analysis does not take into account amounts paid for employees working outside of California.

POLICY CONCERNS

Conflicting tax policies come into play whenever a credit is provided for an item that is already deductible as a business expense for tax purposes. Providing both a credit and allowing the full amount to be deducted would have the effect of providing a double benefit for that item or cost. On the other hand, making an adjustment to deny the deduction to eliminate the double benefit creates a difference between state and federal taxable income, which is contrary to the state's general federal conformity policy.

The credit would be allowed for business expenses paid for workers' compensation for employees located outside of California. Generally, credits are intended to encourage or discourage certain activities within this state.

LEGISLATIVE STAFF CONTACT

Kristina E. North
Franchise Tax Board
845-6978
Kristina.North@ftb.ca.gov

Brian Putler
Franchise Tax Board
845-6333
Brian.Putler@ftb.ca.gov