Office of Chief Counsel
Internal Revenue Service
Memorandum

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subject: Appropriate treatment of Second Injury Fund estimated future assessments

LEGEND

Taxpayer =

Insurance Company =

ISSUES

1. Whether estimates of future annual assessments by Special Fund/Second Injury Fund (the "Fund") under the U.S. Longshore and Harbor Workers' Compensation Act, 33 U.S.C. §§ 901-950 (the "Act") may be included as unpaid losses under § 832(b)(5) of the Internal Revenue Code (the "Code")?

2. If the answer to Issue 1 is "no", are the assessments themselves (as opposed to estimates of future annual assessments) considered ordinary and necessary business expenses under § 832(c)(1) as provided in § 162?

FACTS

Taxpayer is the parent of a group that files a consolidated tax return on a calendar year basis.

Insurance Company is a wholly owned subsidiary of Taxpayer. Insurance Company provides workers' compensation insurance under, among others, the Act. The Act is a federal workers' compensation act, administered by the U.S. Department of Labor ("DOL"). Section 908(f) of the Act deals with situations where an employee who has an existing permanent partial disability suffers an additional injury. This additional injury is generally described as a "second injury." Similar to state workers' compensation statutes, the Act encourages the employment of previously injured workers by limiting the liability of the employer when a previously injured worker suffers a second injury that increases the worker's disability. In such "second injury" situations, the employer or insurer may request to have the disability payments apportioned to a "special fund" established under § 944 of the Act. If the request is granted, the employer's liability for compensation payments is capped at a maximum of 104 weeks and any payments due after that period are made from the Fund.

The Fund is a mandatory pool administered by DOL. The Fund distributes risks for second injury claims among self-insured employers and insurance carriers and thereby encourages the hiring of previously injured workers. The Fund accomplishes this by assuming some of the risks associated with a second injury and thus relieving the primary insurer or the self-insured employer of the liability. In the absence of the Fund, the insurer or the self-insured employer would be fully liable for such claims. The assessment mechanism spreads the costs of this coverage among those insurance carriers and self-insured employers.

The Fund operates on a year-to-year and pay-as-you-go basis. It has no liability for claims that exceed its assets. On each calendar year, DOL makes an estimate of the probable expenses of the Fund for the year. The estimated amount is then assessed against self-insured employers and insurance carriers subject to the Act. However, if an insurance company were solely responsible for an employee's disability, it would establish a reserve at the time the employee became disabled, in the total amount of the estimated payments expected to be made over the entire period of the disability. If the insurer makes a claim against the Fund, its liability to the employee would be capped at 104 weeks. The reserve would not extend beyond a two year period.

The Fund is primarily funded by annual assessments against self- insured employers and insurance carriers subject to the Act. On each calendar year, DOL makes an estimate of the probable expenses of the Fund for the year. The estimated amount is then prorated among employers and carriers by assessment.

The assessment formula to allocate estimated expenses of the Fund to insurers and employers has two parts: The first part is the ratio of the workers' compensation payments made by the specific employer or carrier, to all payments made by all employers and carriers. The second part of the ratio is the payments made by the Fund attributable to the specific employer or carrier related to the second injury claims, to all payments made by the Special Fund with respect to all employers and carriers. The two ratios are then added, and the sum is divided by two, resulting in an average ratio for that employer or carrier.

Insurance Company has been reporting the estimated future assessments from the Fund on its annual statement approved by the National Association of Insurance Commissioners (NAIC).

In computing its taxable income under § 832, Insurance Company has been including an amount allocable to an estimated value of this assessment in unpaid losses under § 832(b)(5)(A), by multiplying its earned premiums subject to the Act by a percentage based on Insurance Company's historical experience regarding the amount of the assessments ultimately paid. The supplied facts do not indicate what portion of the estimated assessment is allocable to each part of the assessment formula.

It appears that litigation over this issue may be appealable to the United States Court of Appeals for the Seventh Circuit.

LAW AND ANALYSIS

1. *Unpaid Losses under § 832(b)(5)*

The information submitted indicates that Insurance Company is an accident and health insurance company taxable under Part II of Subchapter L of the Code. Insurance companies subject to tax under section 831 of the Code are required to determine gross income under section 832(b)(1).

Section 832(b)(1)(A) provides that one of the items taken into account in gross income is the combined gross amount earned during the taxable year from investment income and from underwriting income computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners.

The term "underwriting income" is defined in section 832(b)(3) as "the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred."

Section 832(b)(5) provides that the term "losses incurred" means "losses incurred during the taxable year on insurance contracts" and it is generally computed as follows: (i) from losses paid during the taxable year, deduct salvage and reinsurance recovered during the taxable year, (ii) to the result so obtained, add all unpaid losses on life insurance contracts plus all discounted unpaid losses (as defined in § 846) outstanding at the end of the taxable year and deduct all unpaid losses on life insurance plus all discounted unpaid losses outstanding at the end of the preceding taxable year, and (iii) to the results so obtained, add estimated salvage and reinsurance recoverable as of the end of the preceding taxable year and deduct estimated salvage and reinsurance recoverables as of the end of the taxable year.

Section 1.832-4(b) of the Income Tax Regulations (the "Regulations") states that "[e]very insurance company to which this section applies must be prepared to establish to the satisfaction of the district director that the part of the deduction for 'losses incurred' which represents unpaid losses at the close of the taxable year comprises only actual unpaid losses."

For purposes of the NAIC annual statement, SSAP 35, *Guaranty Fund and Other Assessments*, requires the Taxpayer to charge the Fund assessment to expenses (taxes, licenses, and fees). Taxpayer accrues a liability when the assessment has been imposed or is probable; the event obligating the reporting entity to pay the imposed or probable assessment has occurred; and the amount of the estimate can be reasonably estimated. The Fund assessments are not reported as a loss incurred under the guidance of SSAP 55, *Unpaid Claims, Losses, and Loss Adjustment* Expenses.

In State Farm Mut. Auto. Ins. Co. v. Commissioner, 135 T.C. 543 (2010), *aff'd in part, rev'd in part*, 698 F.3d 357 (7th Cir. 2012), the Tax Court held that amounts allocable to extracontractual damages were not included in unpaid losses. The Seventh Circuit sustained that holding to the extent it applied to a 'punitive damages' component of unpaid losses. The appellate court instructed that § 832 is grounded on the guidance provided by the NAIC as a whole, not any auditor or regulator. State Farm, 698 F.3d at 366. As such, before the Seventh Circuit the controlling methodology is "that the NAIC-approved annual statement provides the rule for computing deductible loss reserves under § 832, at least where the NAIC has in fact provided a rule." 698 F.3d at 364. Even so, the court recognized that this deference is not absolute; that there could be a conflict between an NAIC prescription and the requirements of the Code. 698 F.3d at 366 n5.

Here, the estimated future assessments from the Fund do not represent a "fair and reasonable estimate" of "only actual unpaid losses" incurred by Insurance Company during the taxable year because these assessments do not serve to satisfy an obligation of Insurance Company to indemnify a customer for a loss suffered by that customer. Insurance Company's methodology of calculating these future assessments by multiplying the premiums earned on contracts subject to the Act by a percentage indicates the Fund assessments do not bear a direct relationship to actual losses incurred by Insurance Company. Furthermore, the applicable annual statement accounting procedures treat these items as expenses rather than claims; therefore the applicable NAIC guidance does not instruct that these assessments are to be included in loss reserves. Cf. State Farm, 698 F.3d at 364.

Accordingly, Insurance Company is not allowed to include the estimated future assessments in unpaid losses; the amount of unpaid losses reported by Insurance Company must be adjusted to reflect a fair and reasonable estimate of Insurance Company's actual unpaid losses without regard to the amount of any future assessment.[1]

2. *Ordinary and Necessary Expenses under § 162*

Under § 832(c)(1), an insurance company is allowed a deduction for all ordinary and necessary expenses incurred, as provided in § 162 (relating to trade or business expenses). See, e.g., State Farm, 135 T.C. at 556. The Service recognizes that the assessments themselves are ordinary and necessary expenses. Accordingly, when incurred under § 461, they are deductible under § 832(c)(1), as provided in § 162.

CONCLUSIONS

1. Estimates of future annual assessments by the Fund may not be included as unpaid losses under § 832(b)(5).

2. Such assessments are ordinary and necessary business expenses under § 832(c)(1), as provided in § 162.

No opinion is expressed or implied regarding any issue or argument other than the conclusions contained herein.[2] This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 317-6995 if you have any further questions.

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[1] Insurance Company argues that no adjustment to its unpaid losses is appropriate because even without regard to the portion of the unpaid losses allocable to the future assessments, the total amount of unpaid losses initially reported is a fair and reasonable estimate of Insurance Company's liability for claims that it will be required to pay in future years. That is, that the portion allocable to the future assessments is so minimal that the amount initially reported remains a fair and reasonable estimate. See, e.g., Acuity v. Commissioner, T.C. Memo. 2013-209. We offer no opinion on the appropriateness of any amount to be reported by Insurance Company as unpaid losses should Insurance Company amend its computation of taxable income to remove the portion of unpaid losses allocable to the future assessments.

[2] Insurance Company has not advanced a theory other than inclusion in unpaid losses to support the conclusion that the future assessments are properly deducted on an estimate basis.