
OPINION NO. 1701

TAXATION, PUBLIC UTILITIES;
TAX RATE, COMPUTATION OF.

The amount credited to reserve for industrial accident awards is not a proper deduction from gross income in arriving at the net income for the purpose of determining the tax rate of a public utility.

WORKMEN'S COMPENSATION; RE-
SERVE FOR AWARDS, NATURE
OF.

The setting up a reserve for industrial accident awards by a self-insured does not of itself create an expense, and such amount is not deductible in arriving at the public utility tax rate of such self-insurer.

TAXATION, PUBLIC UTILITIES;
TAX RATE; COMPUTATION OF.

Industrial accident compensation payments by a self-insurer are as much a part of the cost of doing business as is the cost of insurance.

Honorable Wm. Borthwick,
Tax Commissioner,
Territory of Hawaii,
Honolulu, T. H.

Sir:

Relative to your inquiry as to the nature of a reserve for industrial accident awards in determining the tax rate for public utilities, we understand the following to be the facts:

The Mutual Telephone Company, Ltd., instead of taking out workmens compensation insurance or obtaining guarantee insurance or depositing security with the Territorial Treasurer, has been duly authorized to act as, and has been operating as, a self-insurer under the workmen's compensation law. Section 7526, R. L. 1935. Without being required to do so, said company has set up a reserve for industrial accident awards, crediting to such reserve account an amount equal to the premium which it would be obliged to pay for an insurance policy, had it elected to be so insured under the first of the four alternative methods of furnishing security. Thus, the question to be answered is whether such an amount credited to said reserve is deductible from gross income to arrive at net income, in the determination of the company's public utility tax rate. Chapter 69, R. L. 1935.

It may be conceded at the outset that, if said company were to have paid out money in the form of premium for industrial accident insurance, the pro rata

expenditure on the insurance used up would constitute a part of its operating expense and, hence, would be deductible from gross income. The same is true in the absence of any insurance, when an industrial accident award is made and the self-insurer becomes liable. The mere setting up of a reserve for industrial accident awards, however, does not of itself create an expense. Our search has failed to reveal any cases defining the exact nature of such a reserve. Authorities on accounting, however, distinguish the various types of reserves set up in books of account, and they bring out the fact that such a reserve is to be distinguished from a reserve for taxes, which sets up an accrued liability, and from a reserve for bad debts or a reserve for depreciation of assets, which reflect valuation. 2 Kester, *Accounting, Theory & Practice*, 443-446; Graham & Katz, *Accounting in Law Practice*, (2d Ed.) 174-178.

No matter what accounting device is resorted to in an attempt to provide for the payment of subsequent industrial accident awards, no liability arises against the company until an accident occurs. In that respect the thing for which the reserve is created is obviously different from taxes which have already accrued though not then payable, from bad debt allowances which directly reduce the asset of accounts receivable, or from depreciation which has already occurred. Immediately upon the accrual of liability under the workmen's compensation act, however, a debit charge against such reserve for the amount of an award constitutes an expense deductible from gross income, for as stated by the court in *Bowen v. Hockley*, 71 F. (2d) 781, 784, "compensation payments by a self-insurer are as much a part of the cost of doing business as is the cost of insurance".

Our supreme court has interpreted the words "gross income" and "net income" as used in chapter 69, R. L. 1935, (Act 43, 2d Sp. S. L. 1932, as amended) in a case which decided that interest paid by a public utility

on its bonded indebtedness was not an item deductible from gross income in arriving at its tax rate. *Haw. Cons. Ry. Ltd. v. Borthwick*, 34 Haw. 269. Pertinent portions of the opinion follow:

" * * * As generally understood the word 'net' when used in connection with the term 'income' means the excess of or remainder from gross income after the deduction from gross income of the same period of the aggregate of all items of cost and expenses incurred and accrued in the production of gross income excluding capital expenditures. * * *"

"* * * According to its ordinarily accepted meaning we therefore conclude that the annual net income of a utility from its utility business is the excess of or the remainder existing after the deduction from gross income from its, utility business of the same period of the aggregate of all items of costs and expenses incurred and accrued in the production of the same, exclusive of contractual interest upon indebtedness for capital expenditures. * * *"

The amount charged and credited to reserve for industrial accident awards is obviously not an item of cost or expense incurred or accrued in the production of gross income, for the entry of such amount is not predicated on any corresponding liability, nor does it of itself give rise to any debt or obligation. Good accounting practice may call for the creation and maintenance of such a reserve so that the normal operations of the company's business may not be hampered by the necessity of meeting obligations that are certain to arise in the future; but the law does not require any amount, whether as a reserve or otherwise, to be set aside, nor does it require any segregation of assets, for such purpose. Whether or not the practice is advisable, or what the amount of such reserve should be is solely a matter of internal company policy. The action of the company in this respect does not in the least affect the determination of its tax rate.

For the foregoing reasons it is our opinion that the amount credited to reserve for industrial accident awards is not a proper deduction from gross income in arriving at the net income for the purpose of deter-

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mining the public utility tax rate of Mutual Telephone
Company, Ltd.

Very truly yours,

RALPH YAMAGUCHI,
Special Deputy Attorney General.

APPROVED:

J. V. HODGSON,
Attorney General.
