

STATE OF NEVADA
LEGISLATIVE COUNSEL BUREAU

LEGISLATIVE BUILDING
401 S. CARSON STREET
CARSON CITY, NEVADA 89701-4747
Fax No.: (775) 684-6600



LEGISLATIVE COMMISSION (775) 684-6800
JOHN OCEGUERA, *Assemblyman, Chairman*
Lorne J. Malkiewich, *Director, Secretary*

INTERIM FINANCE COMMITTEE (775) 684-6821
BERNICE MATHEWS, *Senator, Co-Chair*
STEVEN HORSFORD, *Senator, Co-Chair*
Mark Krmpotic, *Fiscal Analyst*
Rick Combs, *Fiscal Analyst*

LORNE J. MALKIEWICH, *Director*
(775) 684-6800

BRENDA J. ERDOES, *Legislative Counsel* (775) 684-6830
PAUL V. TOWNSEND, *Legislative Auditor* (775) 684-6815
DONALD O. WILLIAMS, *Research Director* (775) 684-6825

Legislative Commission
Legislative Building
Carson City, Nevada

We have completed an audit of the Department of Taxation, Insurance Premium Tax. This audit is part of the ongoing program of the Legislative Auditor as authorized by the Legislative Commission. The purpose of legislative audits is to improve state government by providing the Legislature, state officials, and Nevada citizens with independent and reliable information about the operations of state agencies, programs, activities, and functions. The results of our audit, including findings, conclusions, recommendations, and the Department's response, are presented in this report.

We wish to express our appreciation to the management and staff of the Department of Taxation for their assistance during the audit.

Respectfully presented,

A handwritten signature in black ink, appearing to read "Paul V. Townsend".

Paul V. Townsend, CPA
Legislative Auditor

November 16, 2010
Carson City, Nevada

STATE OF NEVADA
DEPARTMENT OF TAXATION
INSURANCE PREMIUM TAX

AUDIT REPORT

Table of Contents

	<u>Page</u>
Executive Summary	1
Introduction	6
Background	6
Scope and Objective	11
Findings and Recommendations	12
Administration of the Insurance Premium Tax Continues to Challenge the Department.....	12
Review of Returns Not Sufficient.....	12
Inadequate Tax Forms and Instructions Complicate Reporting	26
Improvements to Insurance Premium Tax Administration Needed.....	28
Appendices	
A. Audit Methodology.....	33
B. Cooperative Agreement.....	35
C. Response From the Department of Taxation.....	39

EXECUTIVE SUMMARY

DEPARTMENT OF TAXATION INSURANCE PREMIUM TAX

Background

The Department of Taxation (Department), established in 1975, is responsible for the general supervision and control over the State's revenue system. The Department collects a total of 16 taxes and fees of which the insurance premium tax is the third largest.

The insurance premium tax was enacted in 1933 and is authorized by Nevada Revised Statutes section 680B. The tax is assessed on each insurer transacting insurance business in this State on net direct premiums and considerations at a rate of 3.5 percent. One component of the insurance premium tax involves annuities which are agreements whereby an individual is guaranteed to receive a series of stipulated amounts commencing either immediately or at some future date. Nevada is one of only six states in the country that tax annuity considerations.

In 2006, we completed an audit which included the Department's administration of the insurance premium tax. We found the Department's administration of the insurance premium tax was not adequate to ensure the tax was collected accurately, equitably, and in accordance with applicable laws and regulations. Pursuant to our prior audit, which included a recommendation to communicate with the Division of Insurance regarding premium tax issues, the Department and Division of Insurance entered into a cooperative agreement regarding the administration of the premium tax.

Purpose

The purpose of this audit was to determine if the administration of the insurance premium tax was performed accurately, equitably, and in accordance with all applicable

EXECUTIVE SUMMARY

DEPARTMENT OF TAXATION INSURANCE PREMIUM TAX

laws and regulations. Our audit included a review of the insurance premium tax and related activities and focused on returns submitted for calendar year 2009. In certain instances, we reviewed tax returns from years prior to 2009.

Results in Brief

Current processes and controls utilized by the Department of Taxation for the administration of the insurance premium tax do not ensure taxes are collected accurately, equitably, and in accordance with laws and applicable guidance. Due to insufficient review of returns, more than \$5 million in taxes went uncollected in tax years 2007 to 2009 because errors, inaccuracies, and unsupported deductions were not identified or corrected. Additionally, insurers who elected to pay tax when amounts annuitized deferred taxes on annuities of \$7.5 million for the 2009 reporting year alone, and rarely reported or paid tax on annuitizations for the years we reviewed. Furthermore, tax forms and instructions do not provide enough guidance to insurers for proper and consistent reporting. Finally, changes to certain functions can assist the Department in streamlining administration of the tax. Since the insurance premium tax is the third largest tax collected by the Department, proper administration of the tax and enhanced cooperation with the Division of Insurance is essential to collecting all premium taxes due.

Principal Findings

- Insurers did not always report and account for dividends properly. Fifteen of 16 insurers reporting paid-up addition dividends did not pay tax on these amounts even though the Department indicated they should. Had the Department identified these amounts as being misreported, more than \$5 million in taxes

EXECUTIVE SUMMARY

DEPARTMENT OF TAXATION INSURANCE PREMIUM TAX

could have been collected between 2007 to 2009. (page 12)

- Deductions for dividends related to untaxed premiums were allowed in 7 of 11 returns and resulted in an \$8,000 reduction in taxes due. Statutes allow for dividend deductions related to taxable premiums; therefore, dividend deductions should be limited to premiums directly subject to taxation. The Department's forms and instructions do not require companies to identify and account for dividends related to untaxed premiums. (page 14)
- Elections to defer the payment of premium taxes until annuities are applied for purchase (back-end) resulted in tax deferrals of \$7.5 million by 15 of 25 insurers in 2009. Few companies who elect this method pay any tax on annuities even though sizeable deferrals have occurred. These 15 insurers deferred over \$213 million in annuity considerations for the 2009 reporting year. Perpetual deferrals occur because the Department does not review annuity schedules, identify unreasonable reporters, or inform the Division of Insurance who can elect to perform an audit of the insurer. (page 15)
- Monitoring annuity elections continues to be problematic as the Department's annuity election log is not sufficient. In response to our prior audit, the Department developed an annuity election log; however, the log was not designed to ensure the proper reporting of elections. Additionally, the log does not necessarily reflect the approved election for each insurer as reported elections were inconsistent with Division of Insurance records in 8 of the 25 returns. Because elections dictate when taxes are due, knowing the approved election is the only way the State can be assured companies are reporting and paying tax on annuities properly. (page 19)

EXECUTIVE SUMMARY

DEPARTMENT OF TAXATION INSURANCE PREMIUM TAX

- Annuity schedules, used to document, identify, and calculate taxable annuities, were often inaccurate. We found 14 of 25 insurers improperly completed the annuity schedule. In addition, we found amounts received and detailed on National Association of Insurance Commissioners (NAIC) reports for deposit type contracts were improperly included on annuity schedules. Seven of 12 insurers reported non-taxable, deposit type contracts on the annuity schedules and 4 paid taxes totaling \$38,000 on these non-taxable products. Ensuring the accuracy of the annuity schedule is essential to ensuring proper administration of the premium tax. (page 20)
- “Other considerations” were not always reported or taxed consistently in returns because some uncertainty exists whether all, or a portion of these products meet the statutory definition of a taxable consideration. Eight insurers of the 25 reported “other considerations” totaling \$930 million in NAIC reports but did not pay tax on these considerations. Some reported “other considerations” as annuity products and others did not account for them on returns even though amounts were often a significant percentage of total premiums and considerations. Although “other considerations” may not qualify as taxable products, if subject to taxation, as much as \$32 million in additional taxes could be due for tax years 2007 to 2009. As a result, it is important to determine taxability of these products. (page 21)
- Home office credits were not always confirmed. Our review of the five largest home office credits found the Department does not routinely verify eligibility and not all deductions were calculated properly. The Department does not have adequate review procedures to ascertain the appropriateness and accuracy of the credits taken. (page 24)
- Current premium tax returns and instructions are complex, insufficient, and contributed to reporting

EXECUTIVE SUMMARY

DEPARTMENT OF TAXATION INSURANCE PREMIUM TAX

errors noted above. Varied insurance products with separate tax implications, such as annuities, require sufficient, accurate, and detailed guidance to ensure proper and consistent reporting. (page 26)

- The Department's computer system allows staff to create fictitious credits without notice, review or approval. Compensating system controls are needed to ensure data is complete and proper. When individuals have primary access to computer programs and the ability to manually modify data, compensating system controls such as exception reports or supervisory approval are necessary to ensure data is complete and proper. (page 29)

Recommendations

This report contains 11 recommendations to improve the Department's administration of the insurance premium tax. Specifically, we made recommendations to improve, develop, modify, and correct several aspects of its administration of the tax. We also made recommendations to work with the Division of Insurance to revise tax forms and instructions, monitor annuity reporting, and investigate improper reporting. (page 43)

Agency Response

The Department, in response to the audit report, accepted the 11 recommendations. (page 39)

Introduction

Background

The Department of Taxation (Department), established in 1975, is responsible for the general supervision and control over the State's revenue system. The chief administrative officer of the Department is the Executive Director, who is appointed by the Governor. The Nevada Tax Commission, established in 1913, is the head of the Department and exercises general supervision over the Department's activities.

The mission of the Department is to provide fair, efficient, and effective administration of tax programs for the State of Nevada in accordance with applicable statutes, regulations, and policies; serve the taxpayers, State and local government entities; and enable and recognize Department employees.

The Department's goals include:

- Ensure the stable administration of tax statutes.
- Improve compliance through education, information, and enforcement.
- Cooperate with other agencies and entities to better serve taxpayers.
- Provide improved and more efficient service.
- Promote the fair and equitable treatment of taxpayers.
- Enhance workforce proficiency through training and communication.
- Improve tax administration through new technology.

The Department collects a total of 16 taxes and fees including statewide sales and use taxes, estate taxes, net proceeds of minerals tax, property tax on interstate and inter-county companies, and excise fees and taxes. Excise fees and taxes include charges on insurance premiums, liquor, cigarettes, other tobacco products, lodging, tires, government services, bank excise, business licenses, live entertainment, modified business, and real property transfers. This audit focused on the insurance premium tax.

Insurance Premium Tax

The insurance premium tax was originally enacted in 1933 and is authorized by Nevada Revised Statutes section 680B. The tax is assessed on each insurer transacting insurance business in this State on net direct premiums and considerations

at a rate of 3.5 percent.¹ Premiums and considerations include policy premiums, membership and other fees, assessments, and bail or annuity contracts received covering property or morbidity risks. Annuities are agreements whereby an individual is guaranteed to receive a series of stipulated amounts commencing either immediately or at some future date. Nevada is one of only six states in the country that tax annuity considerations. These states include California, Maine, South Dakota, West Virginia, and Wyoming. Statute allows insurers certain deductions and credits against the tax including:

- Premiums paid with funds from a pension, annuity, or profit-sharing plan exempted per Internal Revenue Service codes 401, 403, 404, 408, 457, or 501.
- Returned premiums.
- Dividends, savings, and unabsorbed premium deposits returned to policyholders in cash or credited to their accounts.
- Assessments paid to the Nevada Insurance Guaranty Association and the Nevada Life and Health Insurance Guaranty Association.
- Assessments paid to the Division of Industrial Relations by industrial insurers.
- Insurers who maintain a home or regional office in Nevada.

The National Association of Insurance Commissioners (NAIC) helps state regulators protect the interests of insurance consumers through financial and market conduct regulation. This is accomplished, in part, through its development of uniform financial reporting standards for insurers. Insurers file standardized reports to the NAIC summarizing their financial operations annually. These reports are the basis used to file annual insurance tax returns in Nevada.

The Department maintains four offices with its headquarters located in Carson City, district offices in Las Vegas and Reno, and a field office in Henderson. The Department had 316 filled full-time equivalent positions as of October 2010. Currently one position is dedicated solely to insurance premium tax administration and other staff assist in the process of recording and reviewing returns, depositing receipts, and supervising and overseeing the insurance premium tax process.

The Department has implemented a new computer system, at a cost of \$42 million, designed to facilitate tax return processing and revenue distribution. Certain

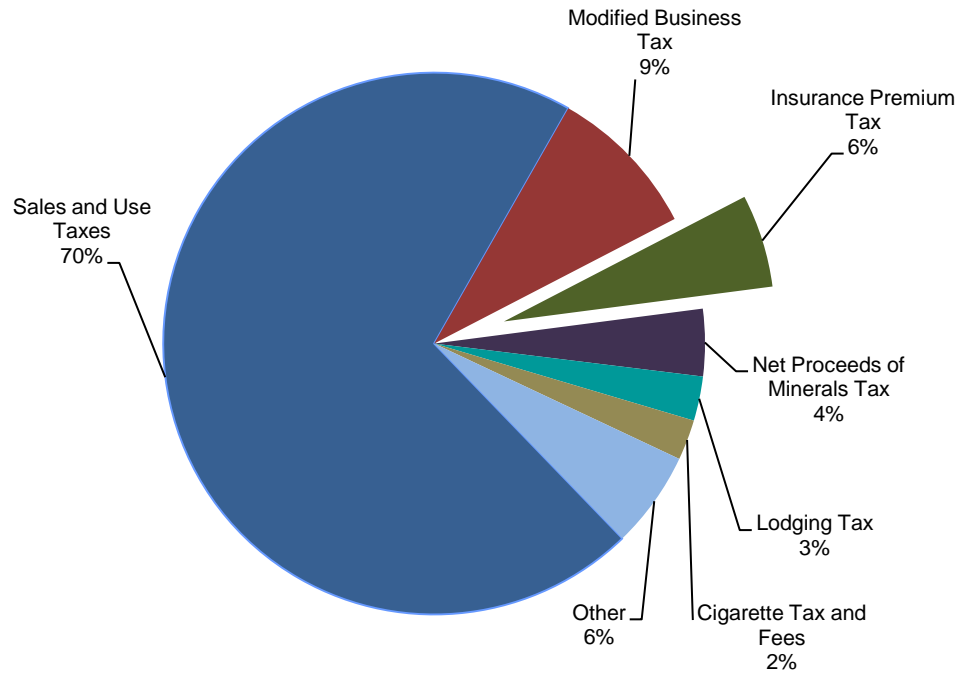
¹ Policies written by insurers classified as risk retention groups are taxed at a rate of 2% on net direct premiums.

functions related to administering the insurance premium tax were incorporated into the system. The system was first used to process insurance premium tax returns during 2009.

The Department collected and distributed about \$234 million in insurance premium taxes during fiscal year 2010. Compared to the other taxes collected by the Department, insurance premium taxes are the third largest tax collected. Exhibit 1 shows the taxes collected by type by the Department during fiscal year 2010.

Exhibit 1

**Department of Taxation
Revenue by Tax Type
Fiscal Year 2010**

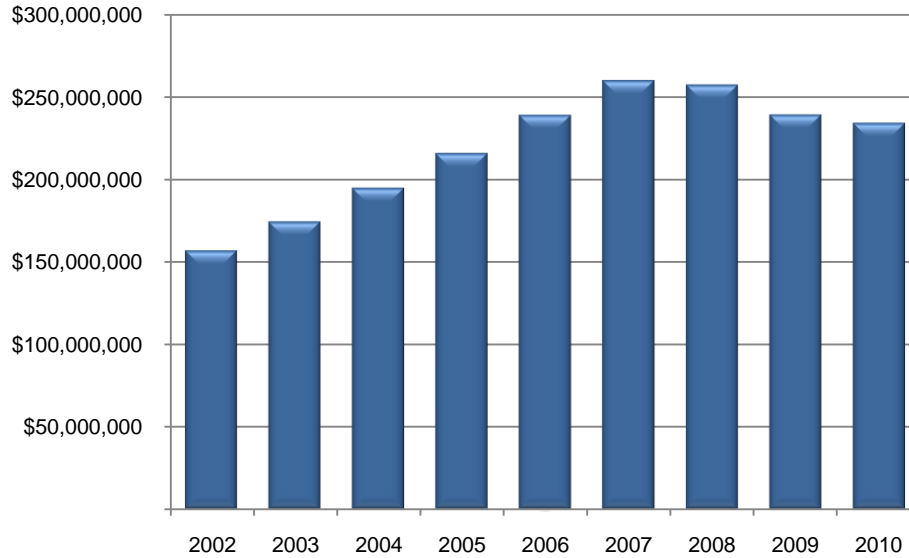


Source: Department of Taxation records for fiscal year 2010.

Note: Other tax revenue consists of liquor tax, government services fee, estate tax, business license fees, live entertainment tax, other tobacco products, bank excise tax, real property transfer tax, centrally assessed property tax, and tire tax.

Insurance premium tax revenues are deposited into the State’s General Fund. During the last three years, the collections of insurance premium taxes have decreased. Exhibit 2 shows the collection of insurance premium tax for fiscal years 2002 to 2010.

**Department of Taxation
Insurance Premium Tax Collections
Fiscal Years 2002 to 2010**

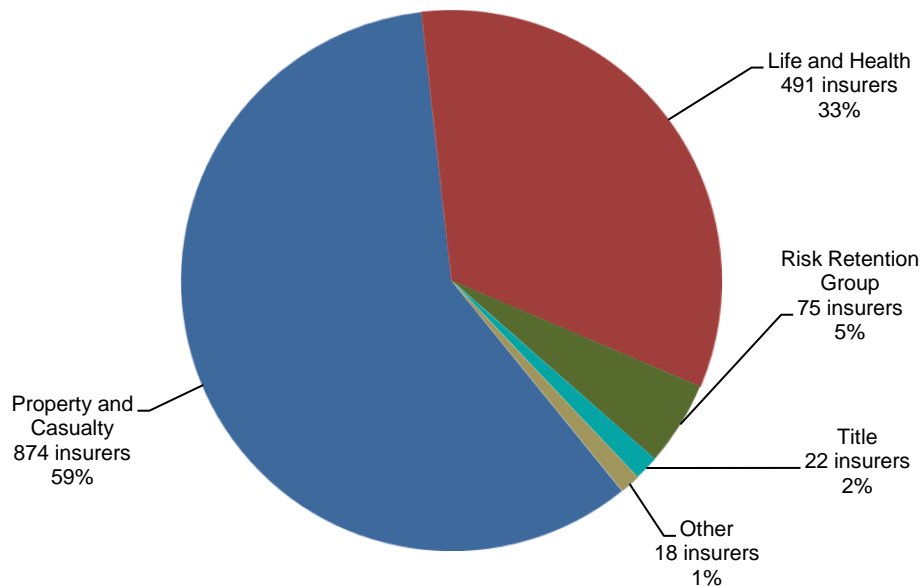


Source: State accounting system.

While premium tax revenues increased more than 65% from fiscal year 2002 to 2007, revenues have decreased about 10% from 2007 to 2010.

The Division of Insurance's records of active insurers indicate 1,480 insurance entities were subject to the insurance premium tax as of December 31, 2009. Exhibit 3 shows the number of actively licensed insurers by the license type.

**Insurers by License Type
As of December 31, 2009**



Source: Division of Insurance records.

Note: Other includes health maintenance organization and dental care licenses. Surplus lines and captive insurers are not included in this schedule as they are collected by the Division of Insurance.

In 2006, we completed an audit which included the Department's administration of the insurance premium tax. We found the Department's administration of the insurance premium tax was not adequate to ensure the tax was collected accurately, equitably, and in accordance with applicable laws and regulations. Our recommendations required the development of policies and procedures over the administration of the tax. Additionally, our recommendations included the need for improved annuity reporting documentation, modifications to forms and instructions, improved training, proper assessment of penalty and interest, timely issuance of debit and credit memos, improved communication with the Division of Insurance, and clarification on certain issues.

Cooperative Agreement with Division of Insurance

During the 1993 Legislative Session, the responsibility for collecting and maintaining insurance premium tax records was moved from the Division of Insurance

to the Department of Taxation. Since that time, the Department has been responsible for a majority of the insurance premium tax duties.

Pursuant to our 2006 audit which included a recommendation to communicate with the Division of Insurance regarding premium tax issues, the Department and Division of Insurance entered into a cooperative agreement. Under the original and modified agreements, the Department's primary responsibilities continue to be collecting the tax, ensuring the tax is reported and remitted timely, and assessing applicable penalty and interest. Furthermore, the Department accounts for and distributes premium tax revenues and is responsible for refund requests. The Division of Insurance agreed to periodically examine insurers to ascertain whether taxes have been reported and paid correctly. During the 2010 Legislative Special Session, Assembly Bill 6 was passed which required the Division of Insurance to begin performing desk audits on insurance premium tax returns starting July 1, 2010.

Scope and Objective

This audit is part of the ongoing program of the Legislative Auditor as authorized by the Legislative Commission, and was made pursuant to the provision of NRS 218G.010 to 218G.350. The Legislative Auditor conducts audits as part of the Legislature's oversight responsibility for public programs. The purpose of legislative audits is to improve state government by providing the Legislature, state officials, and Nevada citizens with independent and reliable information about the operations of state agencies, programs, activities, and functions.

The scope of our audit included a review of the insurance premium tax and related activities and focused on returns submitted for calendar year 2009. In certain instances, we reviewed premium tax returns from years prior to 2009. The objective of this audit was to determine if the administration of the insurance premium tax is performed accurately, equitably, and in accordance with all applicable laws and regulations.

Findings and Recommendations

Administration of the Insurance Premium Tax Continues to Challenge the Department

Current processes and controls utilized by the Department of Taxation (Department) for the administration of the insurance premium tax do not ensure taxes are collected accurately, equitably, and in accordance with laws and applicable guidance. Due to insufficient review of returns, more than \$5 million in taxes went uncollected in tax years 2007 to 2009 because errors, inaccuracies, and unsupported deductions were not identified or corrected. Additionally, insurers who elected to pay tax when amounts annuitized deferred taxes on annuities of \$7.5 million for the 2009 reporting year alone, and rarely reported or paid tax on annuitizations for the years we reviewed. Furthermore, tax forms and instructions do not provide enough guidance to insurers for proper and consistent reporting. Finally, changes to certain functions can assist the Department in streamlining administration of the tax. Since the insurance premium tax is the third largest tax collected by the Department, proper administration of the tax and enhanced cooperation with the Division of Insurance is essential to collecting all premium taxes due.

Review of Returns Not Sufficient

Errors, misreporting, and mathematical mistakes occurred frequently on insurance premium tax returns but were not identified or corrected because the Department does not sufficiently review returns. We found dividend and annuity reporting continues to be challenging, uncertainty regarding the taxability of particular products exists, errors occurred repetitiously, and home office credit eligibility went unverified. By performing a basic review of returns for accuracy, completeness, and reasonableness, the Department can determine underpayments and assist the Division of Insurance by identifying and recommending returns for audit.

Dividend Reporting Problematic

Insurers did not always report and account for dividends properly. Our review found most insurers failed to report dividends as specified on forms and instructions. In

addition, insurers rarely adjusted dividend totals for amounts related to untaxed products. Finally, insurers used varying methods of accounting for “other” dividends.

The NAIC classifies dividends into the following categories:

- Paid in cash or left on deposit.
- Applied to pay renewal premiums.
- Applied to provide paid-up additions or shorten the endowment or premium-paying period.
- Other.

NRS 680B.030 allows dividends, savings, and unabsorbed premium deposits returned to policyholders in cash or credited to their accounts to be deducted from taxable premiums. Several Attorney General Opinions have indicated dividends applied to provide paid-up additions should be taxed because they are considerations and therefore included in gross premiums.

The Department failed to identify insurers who misreported paid-up addition dividends. A paid-up addition dividend is used to purchase additional insurance that increases an insurer’s benefit. Our analysis of returns found 15 of 16 insurers reporting paid-up addition dividends on NAIC schedules did not pay tax on these amounts even though the Department and Attorney General indicated tax should be assessed. Had the Department identified these amounts, more than \$5 million in taxes could have been collected for the 2007, 2008, and 2009 tax years.

Forms require insurers to increase gross premiums for paid-up addition dividends. Amounts are added to gross premiums because the tender of the dividend back to the insurer to purchase additional insurance must be classified as a consideration and taxed accordingly. Current Department interpretation does not allow paid-up addition amounts included in gross premiums to also be deducted. Yet, the insurers we reviewed accounting for paid-up addition dividends on returns included amounts in total dividend deductions as well. Our review also found some insurers failed to account for paid-up addition dividends altogether. Either of these methods is contrary to how the Department portrayed amounts should be reported. Exhibit 4 details insurers reporting paid-up addition dividends, taxes due related to paid-up addition dividends, and taxes paid.

**Paid-Up Addition Dividend Reporting
Tax Years 2007, 2008, 2009**

Company	2007 Paid-Up Additions	2008 Paid-Up Additions	2009 Paid-Up Additions	Total Paid-Up Additions	Tax at 3.5%	Tax Paid
A	\$ 4,441,963	\$ 4,579,283	\$ 4,418,383	\$ 13,439,629	\$ 470,387	\$ -
B	2,366,897	2,390,866	2,178,307	6,936,070	242,762	-
C	13,305,725	13,950,472	11,851,614	39,107,811	1,368,773	-
D	31,154	37,845	46,325	115,324	4,036	-
E	12,569,624	13,859,741	12,080,434	38,509,799	1,347,843	-
F	4,047,784	4,495,623	5,397,017	13,940,424	487,915	-
G	6,304,230	6,943,435	5,713,162	18,960,827	663,629	-
H	207,828	217,336	216,751	641,915	22,467	22,467
I	1,422,757	1,530,955	1,631,573	4,585,285	160,485	-
J*	-	-	66,419	66,419	2,325	-
K*	-	-	59,886	59,886	2,096	-
L	187,210	198,963	224,129	610,302	21,361	-
M	14,788	13,013	6,430	34,231	1,198	-
N*	-	-	215,117	215,117	7,529	-
O	4,240,167	4,938,219	4,506,893	13,685,279	478,985	-
P*	-	-	24,377	24,377	853	-
Totals	\$49,140,127	\$53,155,751	\$48,636,817	\$150,932,695	\$5,282,644	\$22,467

Source: Annual insurance premium tax returns for the stated year obtained from the Department of Taxation.

* We did not review prior year returns for these companies. It is likely amounts are similar to the 2009 reporting year.

In our prior audit, we found companies reported paid-up addition dividends similarly. At that time, we suggested the Department request guidance regarding whether paid-up addition dividends should be allowed as a deduction. In August 2007, the Department requested clarification regarding this issue; however, the response reaffirmed the taxability of paid-up addition dividends and did not directly address whether amounts also qualified as a deduction under NRS 680B.030. Because some uncertainty remains the Department should revisit this issue, in collaboration with entities such as the Division of Insurance and the Office of Attorney General, and seek further clarification.

The Department also allowed insurers to deduct dividends related to premiums that had not been taxed. Eleven of the 25 life and health insurers in our sample deducted dividends, of which 7 deducted all dividend amounts, equaling about \$8,000 in taxable assessments, even though taxable premiums were reduced for qualified and

deferred amounts. In certain instances, insurers were allowed to deduct annuity dividends even though the insurer had elected to defer taxes based on a “back-end” tax payment method. Under this method, few if any current year considerations were included in taxable gross premiums. Statutes allow for dividend deductions related to taxable premiums only; therefore, dividend deductions should only be allowed for those amounts directly related to premiums subject to taxation. Forms and instructions do not account for, allow, or address this issue; however, we found some companies adjusted for dividends related to qualified premiums without being directed to. The Department should incorporate changes to forms and instructions to require companies to modify dividend totals related to untaxed premiums and account for them accordingly.

Finally, insurers reported “other” dividends differently. Even though few insurers reported “other” dividends and most excluded these amounts from dividend totals, some insurers deducted them. During our review of 2009 returns, we found 8 of 25 insurers reported “other” dividends, of which 3 deducted “other” dividends of approximately \$50,000 while remaining insurers excluded these amounts from deductions. Discussions with staff and NAIC personnel did not provide sufficient clarification regarding whether “other” dividends are deductible. The Department, in conjunction with the Division of Insurance should determine whether “other” dividends should be allowed as a deduction to gross premiums.

Dividend reporting continues to be problematic for the Department because returns are not sufficiently reviewed for accuracy or reasonableness. Had the Department performed a review of returns, many of these issues could have been identified, clarified, and corrected. Insurance premium taxes are significant to the State warranting further effort to ensure all appropriate taxes are collected.

Annuity Deferral Results in Low Taxes

Elections to defer the payment of insurance premium taxes until annuities are applied for purchase (back-end) typically results in significant tax savings for life and health insurers. Fifteen companies saved about \$7.5 million in taxes by deferring recognition of annuity considerations until amounts have been applied for purchase. Similar to our prior audit issued in 2006, we found few companies reported annuitizations even though sizeable deferrals of annuities have steadily occurred over

many years. Companies perpetually defer amounts because the Department does not have adequate procedures to identify unreasonable reporting and communicate those insurers to the Division of Insurance for follow-up.

An annuity is an arrangement whereby an individual (annuitant) is guaranteed to receive a series of stipulated amounts commencing either immediately or at some future date. Premiums accepted for life and annuity contracts funded from pension, annuity, or profit-sharing plans that are exempt per certain Internal Revenue Codes are not taxable and are known as “qualified premiums”. Other funds accepted by a life and health insurer for the accumulation and eventual purchase of an annuity may be taxed by one of two alternatives. Companies may elect to pay tax on annuity premiums on a “front-end” or “back-end” basis. For “front-end” taxpayers, premiums are reported and taxed at the time premiums are paid by the annuitant for the purchase of an annuity. “Back-end” taxpayers defer taxes on the premiums until the policy is annuitized and the policyholder begins to receive benefits. If this method is elected, taxes are due on the premiums paid by the annuitant and any interest or dividends credited to their account. Life and health companies signified their election on the return filed in 1971 or the first calendar year they transacted business in the state, whichever came later. Changes to the original reporting election must be approved by the consent of the Insurance Commissioner.

Of the 25 life and health insurers reviewed, 15 elected to defer taxes on annuities until the time of annuitization. Only 6 of the 15 reported some amount of annuitization during the year, either from immediate annuities, or amounts from prior periods. An immediate annuity is purchased with a lump sum and payments to the policyholder begin immediately. Exhibit 5 shows the 15 “back-end” reporters reviewed and the amounts reported related to annuity contracts.

Exhibit 5

**Life & Health Insurers Electing “Back-End” Annuity Payment Method
Reported Amounts
Annual Returns for Calendar Year 2009**

Company	Annuity Considerations Per NAIC Report	Qualified Annuity Considerations	Total Deferred	Annuitizations Reported	Tax Paid
1	\$ 10,696	\$ -	\$ 10,696	\$ -	\$ -
2	2,895,886	2,845,077	50,809	-	-
3	16,626,730	16,512,993	113,737	-	-
4	16,507,524	15,337,414	903,529	266,581	9,330
5	1,310,784	97,407	1,213,377	-	-
6	6,251,584	4,636,860	1,492,679	122,045	4,272
7	2,752,409	-	2,660,335	-	-
8	4,023,221	200,000	3,274,202	683,440	23,920
9	7,808,211	3,116,199	4,692,012	-	-
10	25,452,920	15,215,503	10,237,417	-	-
11	54,186,577	24,947,083	22,135,348	7,134,048	249,692
12	24,827,491	1,789,823	23,037,668	932,272	32,630
13	38,085,104	-	38,032,193	52,910	1,852
14	57,563,227	12,287,718	45,275,509	-	-
15	72,220,982	12,304,805	59,916,177	-	-
Totals	\$330,523,346	\$109,290,882	\$213,045,688	\$9,191,296	\$321,696

Source: Calendar year 2009 insurance premium tax annual returns obtained from the Department of Taxation.

Few insurers reported a reasonable amount of annuity considerations as being annuitized during the year. Some of these insurers have elected to tax annuities on a “back-end” basis for decades, which has resulted in the deferral of significant sums. Consequently, annuitizations should be occurring each year as annuitants are entitled to payments. One company indicated it has elected to defer annuities since 1976 but reported few annuitizations or sale of immediate annuities during tax years 2007, 2008, and 2009. Exhibit 6 shows the annuity reporting of this company, including considerations, deferrals, and annuitizations for the 2007 to 2009 reporting years.

Exhibit 6

**Annuity Products
Company 15
Annual Returns 2007 to 2009**

Year	Annuity Considerations Per NAIC Report	Qualified Annuities Reported	Amounts Deferred Under “Back-End” Election	Immediate Annuitizations	Prior Year Annuitizations	% of Annuities Qualified & Deferred
2007	\$ 93,341,268	\$ 49,277,913	\$ 43,934,815	\$128,540	\$ -	99.9%
2008	82,969,504	48,025,264	34,197,763	746,477	-	99.1%
2009	72,220,982	12,304,805	59,916,177	-	-	100.0%
Total	\$248,531,754	\$109,607,982	\$138,048,755	\$875,017	\$ -	99.6%

Source: NAIC reports and insurance premium tax annual returns obtained from the Department.

Standard insurance reports indicate benefits related to annuities are being paid. Annuity benefits generally conform to a series of payments of set size and frequency and are based on the life expectancy of the policyholder. Annuity benefit payments on NAIC reports indicate annuitizations have occurred, because insurers are reporting annuity benefits as being paid during the year. For 2009, the 15 companies in Exhibit 5 reported over \$163 million in benefits being paid to annuitants. Rationally, if companies continue to pay benefits, annuitizations should continue to transpire as policies commence payment and others cease.

Companies would report fewer annuitizations if the insurer has a high rate of annuity surrenders. Annuity surrenders occur when an annuitant cancels an annuity contract and the insurer returns considerations collected less applicable fees. Surrenders of annuity policies affect the amount of annuitizations that a company may report. Our review of 10 “front-end” taxpayers found only 1 of them reported surrenders related to taxable annuities from current or prior periods. In this instance, the insurer accounted for surrenders equaling nearly 7% of taxable annuity considerations reported for the year. While “front-end” insurers in our sample wrote fewer annuity contracts, the low surrender rate indicates more annuitizations should be reported by “back-end” taxpayers than currently are.

Current forms and schedules related to annuity reporting are confusing and do not provide for a precise accounting of annuity activities based on election method. Other states require insurers to complete separate, detailed schedules which request specific information based on annuity election method. Additionally, the Department does not review insurance premium tax returns for accuracy or reasonableness. With current knowledge, the Department can identify insurers who continually report unreasonable annuity amounts and recommend the insurers for audit to the Division of Insurance.

Actual Error Not Determinable

In order to verify amounts reported by insurers on sampled returns, we intended to solicit supporting documentation regarding annuity totals for the 2007 to 2009 reporting years. We discussed this approach with the Division of Insurance and requested assistance in obtaining documentation. The Division of Insurance provided

contact information for sample insurers and reviewed our letter requesting documentation. However, prior to letters being issued, the Office of the Governor intervened and refused to allow the Division of Insurance to assist us. As a result, we were unable to ascertain actual amounts of under-reported annuitizations for insurers in our sample.

Monitoring of Annuities Continues to be Difficult

Monitoring and accounting for annuity products continues to be challenging for insurers and the Department. Annuity reporting election logs continue to be inadequate to ensure proper reporting. Furthermore, more than half of insurers failed to correctly complete schedules dedicated to annuity reporting. Since annuities can be substantial and complex, accurate accounting and monitoring of reporting is essential to ensuring all appropriate taxes are collected.

In our prior audit issued in 2006, we recommended the Department develop and maintain a reference regarding each company's method for reporting and paying tax on annuities. Pursuant to that recommendation, the Department began tracking the election noted on annual returns for life and health insurers. While the Department is compiling information regarding each company's reported annuity election, it is not maintaining this reference in a manner which facilitates its intended purpose of identifying insurers who report annuities inconsistent with their approved election. For instance, the Department's log is compiled anew each year from company notations on annual returns. Additionally, we found the 2009 annuity log to be unreliable for 4 of the 25 insurers sampled as the log indicated no election for 3 insurers when an election was apparent and did not reflect the correct election for the remaining exception.

Furthermore, the Department's election log does not necessarily reflect insurers' approved election of record. Statute indicates original elections were made on each company's first annual insurance premium tax return filing, or the return filed in 1971, whichever occurred later. Changes in official elections must be approved by the Insurance Commissioner. We compared Department election information or actual reporting methods with information from the Division of Insurance and found inconsistencies in 8 of 25 insurers. While none of the eight resulted in underpaid taxes, the inconsistencies demonstrate the need to definitively determine an official election for

each insurer. Four insurers paid tax on annuities as front-end reporters in 2009; yet, Division of Insurance records indicated the insurers elected the back-end method. The Division of Insurance did not provide documentation indicating any of these insurers had been approved for a change in method. Front-end reporters pay tax each year so the risk of underpaid taxes due to a change in method from back-end is minimal.

Without a valid, reliable, consistent election log, the Department will be unable to identify insurers reporting annuities improperly. Therefore, the Department needs to collaborate with the Division of Insurance to determine the approved election of record for each insurer and compare the log to actual methods used in annual returns.

Annuity Schedules Inaccurate

Annuity schedules used to document, identify, and calculate taxable and deferred annuity considerations were often inaccurate and incorrect. We found 14 of 25 insurers improperly completed the annuity worksheet. Misreporting and errors consisted of inclusion of non-taxable products, unsupported figures, mathematical errors, and misuse of the schedule. Considering amounts noted on annuity worksheets directly affect other schedules where tax liabilities are calculated, ensuring the accuracy of annuity schedules is crucial to collecting all amounts due the State.

Amounts received and detailed on NAIC reports for deposit type contracts were improperly included on annuity schedules. In an opinion, rendered to the Department because of a recommendation from our prior audit, the Attorney General indicated deposit type contracts were not subject to taxation. However, 7 of the 12 insurers in our sample, who classified amounts received as deposit type contract funds on their NAIC reports, included them on annuity schedules. Four of the seven paid tax amounting to \$38,000 on \$1.1 million in deposit type contract funds. Even though the Department requested clarification regarding the taxability of deposit type contracts after our last audit, it failed to use that information when administering the insurance premium tax program. As a result, the State could be liable for refunds related to amounts improperly taxed.

Annuity schedules were not always properly used and figures reported were inadequately supported. Seven of the 25 insurers in our sample made mathematical errors or misused the annuity schedule to report taxable annuities. For example, one

insurer reported its tax deferred annuities where taxable premiums should be reported. Although the insurer's tax liability was properly calculated on other schedules, the Department did not correct the error. Additionally, four insurers reported amounts on annuity schedules that were not adequately supported. When figures reported are complex, confusing, or are inconsistent with amounts reported in other schedules, additional supporting documentation is needed to ensure that the taxes paid are accurate.

Errors and misreporting occurred because forms and instructions do not mention how to account for annuity considerations and deposit type contract funds. Additionally, the Department does not perform a review of annuity schedules to identify reporting issues. Ensuring the accuracy of the annuity schedule is essential to ensuring administration of the insurance premium tax is proper.

Taxability of Certain Products Not Known

Certain products reported on the NAIC statements were not always reported or taxed consistently in returns. "Other considerations," often a significant component amount of the total insurance business for insurers, were included in returns as annuity products by some insurers and not by others. Even though statute requires taxation of all considerations that incorporate mortality and morbidity risk, there is some uncertainty whether all, or a portion of these products meet that requirement. Since the Department does not adequately review returns, it did not identify inconsistent reporting regarding "other considerations" among insurers.

Eight of the 25 life and health insurers classified products as "other considerations" in NAIC reports. These eight insurers accounted for \$930 million in "other considerations" for the 2007, 2008 and 2009 reporting years. Five reported "other considerations" as annuity products in the *Schedule 2 Annuity Consideration Worksheet*. The remaining three insurers did not account for "other considerations" on returns. Amounts excluded were often a significant percentage of total premiums and considerations. For example, one insurer reported total premiums and considerations of \$479.2 million for 2007 to 2009, of which \$369.1 million or 77% was "other considerations". This insurer failed to account for "other considerations" on annual tax

returns; however, the Department did not inquire or investigate why “other considerations” were not reported and excluded from taxation.

“Other considerations” are defined by the NAIC as products that do not fit the standard definition of life premiums, annuity considerations, or deposit type contract funds and may incorporate mortality or morbidity risk. In our audit in 2006, the Department indicated “other considerations” should be included in the taxable measure for determining taxes due. Current discussions with Division of Insurance staff indicated “other considerations” could include taxable products, but supporting documentation would be necessary to determine if products meet the statutory requirements for taxation.

Although “other considerations” may not qualify as taxable products and may be deferred due to annuity elections, if subject to taxation, as much as \$32 million in additional taxes could be due the State for tax years 2007 to 2009. As a result, it is important to determine taxability of these products.

Insurance premium tax returns and instructions do not provide any guidance regarding “other considerations.” Since these products can be significant, more should be done to determine their taxability. Although the Department may not have the expertise to interpret the taxability of these products for different insurers, it can identify those returns with “other considerations” and recommend the return to the Division of Insurance for audit. As Division of Insurance audits progress, cooperation and corroboration between the agencies will assist both entities in reviewing returns and determining if returns are accurate and appropriate.

Other Errors Identified on Returns

Many insurance premium tax returns reviewed contained a multitude of errors. Inaccuracies included reductions on returns that were neither supported, identified, or proper, and misreporting of amounts between returns and required supporting documentation. Additionally, refunds issued were not properly calculated or reviewed. Since the Department does not adequately review insurance premium tax returns, these errors were not identified or corrected. As a result, the Department does not have assurance all taxes have been properly assessed and collected.

Reductions to gross premiums were not always adequately supported. Ten of 25 insurers deducted amounts in one schedule that exceeded the total noted in a prior schedule. Additional deductions were combined with qualified annuity considerations and could be qualified life premiums; however, amounts were not identified or supported. Total deductions exceeded those identified as qualified annuity considerations by \$4.2 million and reduced taxes due by \$146,000.

Premiums funded by pension or profit sharing plans under certain IRS codes are known as qualified premiums and are exempt from taxation. While premiums paid from these plans may be for life or annuity contracts, the majority of qualified premiums are annuity considerations. Current forms isolate qualified annuity considerations by requiring identification of this amount on two separate schedules. Additionally, instructions require qualified life premiums be reported and identified on a separate line, although only two insurers clearly identified and reported amounts in this manner.

Additionally, we found returns where other deductions were made to gross premiums that could not be verified as being proper. For example, one return reduced gross premiums by \$2 million for amounts noted as group accident and health plans. Reductions were taken on blank return lines or made on supplemental schedules submitted with returns. Although these deductions may be appropriate, there is no indication in statute, Department policy, or other guidance that these deductions are proper.

Furthermore, gross premiums and dividends reported in returns did not always agree with the information reported on the NAIC reports. Seven of 25 life and health insurers reported gross premiums and dividends in returns that did not agree to amounts reported in their NAIC schedules. Four insurers made adjustments to dividend deductions, two adjusted gross premiums amounts, and one adjusted both dividends and premiums. Although adjustments made by insurers to the NAIC schedules may be appropriate, without notation, reconciliation or adequate detail, the Department has no assurance returns are accurate and tax calculations proper.

Next, credits used to offset tax payments were transferred and used on returns of related companies without determining whether the transfer was proper. For instance, one company claimed guarantee association credits that were earned by a related

insurer. Both companies are separately licensed and conducted insurance business in the State during 2009; yet, one company did not have a sufficient tax liability to utilize the guarantee credit due them. As a result, the companies requested to transfer the \$20,000 credit to a related company where it could be used to offset taxes due. Statutes allow for companies to offset taxes due for amounts paid to guarantee companies even when operations cease, but do not address the transfer of those credits to other entities when still licensed and conducting business. Furthermore, the Department does not have policies and procedures over the use and transfer of credits. Credits directly offset tax payments and collections; therefore, establishing procedures and methods for the transfer and use of credits not directly due those using them is important.

Deductions were allowed on returns because the Department does not compare totals between schedules or investigate arbitrary adjustments. Additionally, the Department does not have adequate policies and procedures over certain aspects of the administration of insurance premiums taxes. Reductions to amounts affecting taxes due should be detailed, accurate, allowable, and should always comply with forms, instructions, and statutes.

Finally, refunds requested by insurers were not always processed properly or tracked. We found refunds issued were overstated by more than \$50,000 in three of the five returns in our sample. More was refunded than should have been because the returns contained errors related to dividends, unsupported deductions, and home office credits. Furthermore, the Department does not track unprocessed refund requests. We found refunds were tracked once processed and issued; but, requests remaining unfulfilled were not documented. Additionally, a refund balance of more than \$185,000 was transferred to another company without supervisory review or approval. Stronger controls over these functions will help in ensuring taxes refunded are proper.

Home Office Credits Not Verified or Reviewed

Home office credits, which resulted in over \$23 million in tax reductions on 2009 annual returns for the five insurers reviewed, were not always confirmed. Even though a limited number of insurers claim this credit, none of the returns we reviewed could be verified to be eligible for all or certain portions of the credit, and most calculated certain

items incorrectly. Statutes require the Department to request information from insurers to ascertain a company's entitlement to the tax reduction; however, the Department does not require sufficient documentation, nor does it adequately review and verify information received.

NRS 680B.050 and 680B.055 allow for a home office credit to be taken for insurers domiciled or having a regional home office in Nevada. The credit is equal to 50 percent of the aggregate amount of the tax due plus an amount equal to the ad valorem taxes paid by the insurer, commonly known as property taxes, during the calendar year preceding the annual insurance premium tax return. The total tax reduction from a home office credit may not exceed 80% of the total tax liability. Certain conditions must be met in order for credits to be allowed which include:

- Owning property in Nevada for the entire year for which the credit is taken.
- Occupying at least 70% of the usable space of the building owned to transact insurance business.
- Maintaining a regional home office covering at least two states and having at least 25 staff.
- Two or more insurers under common ownership may be entitled to credits if they jointly own and use, in equal interest, a home or regional office.
- An insurer may be deemed to own a building if an insurer is a partner in a limited partnership which owns a building and the insurer's interest in the building is equal to the amount of space used by the partnership or the interest in the property is 50% or more.

The Department, in accordance with NRS 680B.050(3) is responsible for requiring proof from insurance companies each year, on forms acceptable to the Executive Director, to satisfy itself that the insurer is entitled to the tax reduction.

Our review of the five largest home office credits revealed insufficient information was obtained by the Department to determine if any of the insurers adequately qualified for the credit. Specifically, the Department did not have information or documentation regarding occupancy rates or yearly ownership certifications to ensure each company qualified for the tax reduction on its 2009 return. While all five companies were domiciled in Nevada and may have qualified for the credit, without sufficient periodic verification of occupancy and property ownership, the Department cannot be assured home office credits are proper. Because qualifying for a home office credit results in a

substantial reduction in taxes, and not all companies who qualify are domiciled in Nevada, some procedures should be performed regarding home office credit eligibility.

Reductions in taxes related to ad valorem credits were not always calculated properly. Ad valorem taxes are assessed each fiscal year, July 1 to June 30, by the county assessor in which the property is situated and are commonly referred to as property taxes. Statute specifically identifies ad valorem taxes must be based on the calendar year preceding the filing of the annual return. However, three of four insurers who reduced the insurance premium tax due for ad valorem taxes calculated the deduction based on a fiscal year instead of a calendar year. In addition, reductions were not always taken based on when payments were made but were instead calculated based on when they were due.

Finally, the Department allowed insurers to take ad valorem credits on quarterly returns even though NAC 680B.230(2) indicates credits are to be taken on annual returns only. Staff indicated credits were allowed on quarterly returns in 2009 because the Department's computer program accounts for these credits quarterly and disallowing these amounts would increase staff workload. While this may be valid, regulations should be changed to reflect current Department activities.

While the Department indicated some limited procedures are performed regarding the home office credit, additional procedures to ascertain the appropriateness and accuracy of the credit is warranted. The Department's insufficient review process may allow an insurer to significantly reduce its premium tax liability when not qualified.

Inadequate Tax Forms and Instructions Complicate Reporting

Current returns and instructions used for insurance premium tax reporting are complex, insufficient, and contributed to reporting errors. Large insurers who write business in several states and prepare many premium tax forms, often made significant errors on their Nevada returns indicating forms are not clear or well designed. Furthermore, staff was often unable to clarify questions regarding proper reporting. Many of the errors, inaccuracies, and mathematical mistakes could be prevented if forms were intuitive and instructions were adequately detailed.

Insurance premium tax reporting forms are difficult to understand especially for life and health insurers. Varied insurance products with separate tax implications, and

elections for paying or deferring taxes related to annuities, complicate accurate reporting on vague and inadequate forms. Even though we identified forms and instructions as a cause of inaccurate reporting in our prior audit, few significant changes were made because the Department was developing a new computer system to account for insurance premium taxes.

As noted previously in our report, most life and health reporters submitted insurance premium tax returns with errors and inaccuracies. Our review found insurers with similar products and elections reported items differently, deductions were made but not specified, amounts that should agree between schedules did not, and annuities were not reported consistent with noted tax payment elections. These differences in reporting are compounded by inadequacies in forms which include, but are not limited to:

- Individual lines on schedules are not clearly noted as being additions to or deductions from gross premiums.
- Additions and deductions to gross premiums are allowed without specific identification. Total, and ultimately taxable, premiums cannot be reconciled to NAIC reports when adjustments are made and not appropriately detailed.
- Vague lines noted as “other” allow for undefined deductions to be taken. Common deductions, provided for in statute, should have dedicated lines on returns.
- Forms do not address reductions to dividends for premiums earned from non-taxable qualified premiums. Statute allows dividend deductions related to total premiums written, which do not include qualified premiums; therefore, dividends should be reduced for those amounts related to qualified premiums.
- Annuities are all reported on the same schedule even though informational needs differ greatly between “front-end” and “back-end” reporters to ensure annuities are properly taxed.

Compounding the ability of insurers to prepare accurate and complete insurance premium tax returns are insufficient return instructions. Inadequacies in return instructions include the failure to address how to report certain items, not clearly linking between line items on the NAIC reports and the return, and providing general definitions as instructions instead of specific guidance. For example, current instructions to complete *Schedule 2, Annuity Consideration Worksheet* are as follows:

Page 1

- **Column – Front End Annuities**
This figure should be the amount of front end annuities or annuity considerations that have annuitized.
- **Column – Total Considerations**
Line 3 (Gross Considerations) should be the total of Qualified Retirement Plans plus Front End Annuities plus Back End Annuities and should match the figures on the State (Nevada) page.

Page 2

- **Annuity Election Information** – If the insurer is reporting premium tax on annuities, they must choose the type of election either front end or back end, the date of election and date election approved by Commissioner of Insurance.
- **Column Front End Annuities** – This figure should be the amount of front end annuities or annuity considerations that have annuitized and the Premium Tax was paid when the annuity was purchased.
- **Column Back End Annuities** – This figure should be the amount of back end annuities or annuity considerations that have annuitized and premium tax is being paid at the time of maturity. Include dividends and interest in this figure.
- **Column Total Considerations** – Gross Considerations (Line 3) should be the total of Qualified Retirement Plans plus Front End Annuities plus Back End Annuities and should match the figures on the State (Nevada) page.

These instructions are general definitions of annuities, but do not provide clear guidance on how to complete lines 1 through 9 of schedule 2. Furthermore, these instructions, based on the descriptions noted above, are inaccurate because the mathematical equation noted for the *Total Considerations* column will not agree to the state (Nevada) page if annuitizations, which are typically from prior years, are included in the *Back End Annuities* column. Finally, instructions do not address how totals noted on schedule 2 affect other schedules of the tax return. Over half of life and health insurers failed to complete schedule 2 correctly indicating instructions and forms are deficient.

Department staff could not provide clarity regarding certain matters related to insurance premium tax forms and instructions during our audit and indicated a need for revisions. Statutes require the Department and the Division of Insurance to collaborate on changes. Adequate, detailed forms and instructions will assist the Department by reducing errors and mistakes making its review of returns less time consuming.

Improvements to Insurance Premium Tax Administration Needed

The Department can improve certain administrative functions regarding the insurance premium tax. Controls should be developed to prevent manual entry

overrides that impact balances due. Furthermore, revisions to the Department's computer program should be considered to reduce the number of unnecessary notices being sent to taxpayers. In addition, the Department needs to develop an organized method for safekeeping and storing insurance premium tax returns to ensure efficient retrieval.

Manual Credits Should be Properly Controlled

The Department's computer program, designed to maintain and track data regarding insurance premium taxes, allows staff to create fictitious credits without notice, review, or approval. The Department's computer program stores information regarding whether an individual insurance company is indebted to or owed money from the State. These balances are based on annual and quarterly returns, payments, and overpayments carried forward from prior periods. In addition, insurers are entitled to certain credits based on payments made to guarantee associations and oversight agencies. Due to system limitations, certain credits must be manually entered and transferred between quarters. Data changes in the program are primarily performed by the tax examiner assigned to the administration of the insurance premium tax.

Manual adjustments reducing amounts due are common and necessary, but are not identified as exceptions by the computer program. In one instance, fictitious guarantee association credits were created by Department staff and applied to a quarterly return because the system does not allow certain credit balances to be moved from one quarter to another. While the use of this fictitious credit was a valid method to properly account for the insurer's tax liability, the credits were generated without notice, review, or approval. Additionally, the amount of fictitious credits created exceeded the actual credits available to the insurer. Theoretically, Department staff could arbitrarily reduce balances owed the State without anyone knowing. When individuals have primary access to computer programs and the ability to manually modify data, compensating system controls such as exception reports or supervisory approval are necessary to ensure data is complete and proper.

Premature Notices Create Inefficiencies

Notices generated by the Department's computer program can be premature and erroneous resulting in inefficiencies and wasted resources. Billing and delinquency

notices are automatically generated and sent by the computer program; however, some notices were sent prematurely due to timing or system errors. Billing notices are initiated the day after returns are entered or changes are made in the system even though payments, credits, or other information may not be in the system. In addition, the system was not programmed to account for the different due dates related to the fourth quarter and annual returns. As a result, deficiency notices were generated to a large number of insurers who may have already submitted a return. Consequently, staff indicated time was spent correcting these errors and mailing hard-copy notices unnecessarily wastes resources. The Department began using this program for calendar year 2009 returns so some of these issues are being identified as they occur. However, the Department should consider requesting programming changes to limit the impact in the future.

Organized Method for Maintaining Returns Needed

The Department needs to revise its methods for storing and safekeeping insurance premium tax returns. Many of the returns requested could not be easily located because the Department does not have returns stored in an organized manner.

During our audit, we requested insurance premium tax returns from various companies from 2007, 2008, and 2009. Some of the returns requested could not be located for several weeks because returns submitted to the Department by insurers were stored in boxes haphazardly. In addition, certain returns relating to prior years could not be provided because the Department was scanning returns for electronic storage. While electronic storage of documents can be efficient, the Department sent the original returns off-site to a contractor without logging or maintaining a location reference and failed to ensure the scanning process was complete. As a result, during our review of an electronically stored document, we found not all pages of the return were scanned. Furthermore, without a log of original documents sent to the contractor, the Department will be unable to determine if all returns were scanned or if documents were lost or destroyed prior to the scanning process.

Secure storage of documents is critical to ensuring the insurance premium tax is administered properly. Whether returns are maintained in hard copy or electronic form,

the Department should develop a standardized method for ensuring all returns are retained and easily retrievable.

Recommendations

1. Develop policies and procedures regarding the review of annual insurance premium tax returns to identify mathematical errors, ensure amounts agree to supporting documents, and verify returns and amounts reported are consistent with revised forms and instructions.
2. Identify and communicate potential misstatements, unusual reporting circumstances, and changes in reporting annuity election methods and report them timely to the Division of Insurance for follow-up.
3. Work with the Division of Insurance to establish a log of insurers' approved annuity elections and only change the log for verified, approved election changes from the Division of Insurance.
4. Develop a process of comparing the annuity election log to returns to determine return accuracy, identify discrepancies, and communicate those to the Division of Insurance.
5. Obtain clarification regarding the taxability of "other considerations" and the deductibility of "paid-up addition" and "other" dividends.
6. Develop policies, procedures, and controls to ensure all refund requests and credit transfers are accurate and properly reviewed and tracked.
7. Develop policies and procedures to routinely validate whether insurers are eligible to take home office credits and ensure amounts taken on annual returns are accurate.
8. Work with the Division of Insurance to revise premium tax return forms and instructions to capture pertinent

information, ease confusion and complexity, and provide accurate and sufficient instruction for the proper completion of returns.

9. Develop system controls to mitigate the risk of inappropriate adjustments being made in the Unified Tax System.
10. Review current processes and implement programming changes regarding billing and delinquent notices to limit, to the extent practicable, premature or erroneous notices being sent.
11. Store insurance premium tax returns in a manner that provides for adequate safekeeping and easy retrieval.

Appendices

Appendix A Audit Methodology

To gain an understanding of the Department of Taxation, we interviewed management and staff, reviewed applicable laws, regulations, and policies and procedures significant to the financial and administrative practices of the Department. We also reviewed legislative and executive budgets, legislative committee minutes, Interim Finance Committee minutes, and Department annual reports. In addition, we identified and reviewed significant control structures relevant to the administration of the insurance premium tax by the Department. Our review included the general control environment, financial environment, and programmatic areas related to the administration of the insurance premium tax.

To determine whether the Department was properly administering the insurance premium tax, we reviewed the completeness and accuracy of the returns filed with the Department. We judgmentally selected the following samples from the largest annual returns submitted for 2009: 25 life and health insurers with annuities, 4 property and casualty insurers, 2 industrial insurers, 2 risk retention groups, 1 health maintenance organization insurer, and 1 title insurer. We reviewed each return for mathematical accuracy, consistency with premiums reported to the National Association of Insurance Commissioners, adequacy of support for credits and offsets taken, and accuracy of reported annuity premiums. For some life and health insurers, we reviewed the annual returns from calendar years 2007 and 2008 and evaluated the accuracy and consistency of returns. Further, we reviewed the refunds issued by the Department during fiscal year 2009. We selected five refunds and determined if they were accurate and proper.

To determine if the home office credits allowed by the Department to insurers were accurate, we judgmentally selected the five insurers that claimed the largest home office credits in 2009. We determined if the Department had supporting documentation on file regarding home office credit eligibility. We compared deductions taken to

supporting documentation and statutes and recalculated certain deductions to determine accuracy.

To determine if the Unified Tax System was accurately applying the correct tax rate for different insurance types and appropriately applying penalty and interest, we reviewed the computer programming code and recalculated the tax returns for the 35 insurers tested. We also traced tax payments from the state accounting system to pertinent information in the Department's database and reviewed the Department's reconciliation process.

To determine if the Department was verifying all taxable and active insurers had submitted a 2009 return, we compared the Division of Insurance listing of active insurers to the returns recorded in the Unified Tax System for 2009. We reviewed the delinquency notices sent to insurers to determine whether they were appropriate and sent timely.

Our audit work was conducted from March 2010 to September 2010. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

In accordance with NRS 218G.230, we furnished a copy of our preliminary report to the Director of the Department of Taxation. On November 4, 2010, we met with agency officials to discuss the results of the audit and requested a written response to the preliminary report. That response is contained in Appendix D which begins on page 39.

Contributors to this report included:

Daniel L. Crossman, CPA
Deputy Legislative Auditor

Shannon Ryan, CPA
Audit Supervisor

Jill Silva, CPA, CIA
Deputy Legislative Auditor

Roland Erickson
Deputy Legislative Auditor

Appendix B
Cooperative Agreement

COOPERATIVE AGREEMENT

This Cooperative Agreement (this "Agreement") is made this 28th day of May, 2010, by and between the State of Nevada, Department of Taxation (the "Department") and the State of Nevada, Department of Business & Industry, Division of Insurance (the "Division"), collectively referred to herein as the "Parties".

RECITALS

The Parties make this Agreement with respect to the following facts and objective:

A. Pursuant to NRS 680B.027, the Department has the authority to collect insurance premium tax from insurers, other than captive insurers and surplus lines insurers. Prior to 1994, this authority was vested in the Commissioner of Insurance (the "Commissioner"), as the chief officer of the Division. See Chapter 466, 1993 Nev. Stat. §§ 1266, 1270, 1271, 1272, 1273, 1367, and 1368.

B. Pursuant to NRS 680B.039 and NRS 680B.040, the Department has the authority to assess interest and penalties when an insurer, other than captive insurers or surplus lines insurers, fails to file the report or pay the tax as required by NRS 680B.025 to 680B.039.

C. The Commissioner has the authority to regulate insurers and to examine their books and records to make certain that they remain financially solvent and that they continue to satisfy all necessary qualifications to conduct the business of insurance within the State of Nevada. See NRS 679B.230 to NRS 679B.300.

D. Insurers conducting insurance business within the State of Nevada are required to collect and remit the insurance premium tax to the Department on net direct premiums and net direct considerations written. See NRS 680B.027 and NRS 680B.0353. The insurer's payment of the insurance premium tax is one of the obligations of an insurer over which the Commissioner may exercise regulatory authority to enforce compliance on the part of the insurer. See NRS 679B.227 and NRS 680B.027.

E. The Commissioner and his staff have special knowledge and expertise with respect to the accurate computation and proper reporting of the insurance premium tax. In light of this special knowledge and expertise, and given the requirement that the Department collect the insurance premium tax, the Parties wish to cooperate with one another and to define their respective responsibilities in an effort to maximize the efficiency and efficacy of the overall system by which the insurance premium tax is enforced, administered, and collected.

AGREEMENT

NOW, THEREFORE, in order to accomplish the objectives set forth above, the Parties hereby agree as follows:

1. **Collection of the Premium Tax.** The Department shall collect the insurance premium tax and shall make certain that all insurers timely report and remit the tax in the reported amounts with any applicable interest or penalties. The Department shall further ensure that all insurance premium taxes, interest, and penalties are accounted for and distributed as required by law, and that all returns, reports, schedules, and supplements filed by insurers are properly maintained as required by law.

2. **Examinations.** The Commissioner shall periodically examine insurers, pursuant to NRS 679B.230 to NRS 679B.300, inclusive, and shall include in such examination processes to ascertain that the insurers have reported and paid the correct amount of insurance premium tax required pursuant to NRS 680B.027. The examination shall include a review of premium tax reporting per reporting period and an analysis of the cause(s) of any tax deficiency. The Commissioner shall examine insurers at such intervals and according to such selection criteria and examination procedures as the Commissioner deems appropriate. The Department will participate during the examination on all issues concerning premium taxes and will have direct access to insurers and examiners to ensure that the Division and the Department work in conjunction to obtain information to resolve insurance premium tax issues in the most expeditious manner. All working papers, recorded information, documents, and copies thereof produced by, obtained by, or disclosed to the Commissioner or any other person in the course of an examination made under this chapter are confidential pursuant to NRS 679B.285.

3. **Desk Audits.** Pursuant to Section 65 of Assembly Bill 6, adopted during the 26th Special Session (2010), the Commissioner has implemented a desk audit program to audit insurance premium tax returns to ensure that insurers are complying with the provisions of NRS 680B.027. The Department will participate during the desk audit and will have direct access to insurers and desk auditors to ensure that the Division and the Department work in conjunction to obtain information to resolve insurance premium tax issues in the most expeditious manner. The Commissioner may classify, as confidential, documents received from insurers during the course of a desk audit if obtained or received from the insurer upon the express condition that they remain confidential pursuant to NRS 679B.190(5), or are confidential pursuant to NRS 679B.285.

4. **Deficiency Determinations.** Upon completing the procedures described in paragraphs 2 and 3, a report of the completed, adopted, and final uncontested examination or a report with the results of the desk audit program, shall be transmitted to the Department. If the Department determines, based upon the Department's review of the report, that the insurer in question has underpaid or failed to pay insurance premium taxes, the Department shall render a deficiency determination and issue a notice of same determination in the manner prescribed by NRS 360.300 to NRS 360.375, inclusive.

5. **Hearings.** If, after the issuance of a notice of deficiency determination as described in paragraph 3 above, an aggrieved insurer files a petition for redetermination pursuant to NRS 360.360, the Department's administrative law judge and/or the Nevada Tax Commission shall be responsible for adjudicating the matter in accordance with NRS 360.370 to NRS 360.400, inclusive. At the request of the Department or its counsel, the Commissioner shall make available such witnesses and produce such documentary evidence in his possession that is not otherwise deemed confidential including, but not limited to, NRS 689B.122 and NRS 689B.285, as may be relevant to the determination of the matter in dispute.

6. **Credits and Refunds.** The Department shall be responsible for reviewing and acting upon any request or claim for a refund of, or a credit toward, insurance premium taxes previously paid or payable in the future, as applicable, other than captive insurers or surplus lines insurers. All such requests or claims shall be submitted to and determined by the Department. At the request of the Department, the Commissioner agrees to provide reasonable assistance and advice to the Department to help resolve questions or doubts as to whether there has been an overpayment of insurance premium taxes by any insurer.

7. **Information Sharing.** The Parties agree to share and exchange such information, documents, and records as may be needed by either Party to perform that Party's obligations under this Agreement. Each Party shall fully cooperate with the other and use its best efforts to facilitate the objectives of this Agreement. At a minimum, once the Exam Report and corresponding Order are finalized and public, the Division will transmit to the Department, via e-mail, a scanned pdf copy within 72 hours of the Order's effective date. Additionally, the Division will transmit to the Department, via e-mail, a scanned pdf copy of any company responses to the Order that address premium taxes, within 72 hours of receiving such response. Finally, the Division will transmit to the Department, via e-mail, on a monthly basis, a scanned pdf copy of a spreadsheet containing the name of every examined insurer and whether premium taxes were owed pursuant to the Exam Report. Similar procedures shall apply to the Desk Audit process. All non-public information shared pursuant to this Agreement is confidential pursuant to NRS 679B.122, NRS 679B.190(5), and NRS 679B.285, where applicable.

8. **Taxpayers' Bill of Rights.** In performing its obligations under this Agreement, the Department shall adhere to the principles set forth at NRS 360.291, otherwise known as the "Taxpayers' Bill of Rights"; to which however, neither the Commissioner, his staff, nor the Division are bound.

9. **Entire Agreement.** This Agreement constitutes the entire agreement between the Parties with respect to the subject matter hereof and supersedes all prior agreements and undertakings, both written and oral, between the Parties with respect to the subject matter hereof.

10. **Severability.** If any provision hereof is unenforceable, illegal, or invalid for any reason whatsoever, such fact shall not affect the remaining provisions of this Agreement.

11. **Headings.** The headings in this Agreement have been included solely for the convenience of reference and shall not be considered in the interpretation or construction of this Agreement.

12. Obligations. The obligations set forth in this Agreement are independent of any obligations imposed by statute or regulation, and this Agreement shall not be construed to supersede or take priority over any such obligations imposed by statute or regulation.

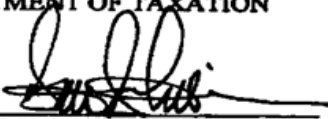
13. No Reimbursement of Costs. Neither Party shall be obligated to reimburse or pay the other Party for costs or expenses incurred in performing the obligations hereunder.

14. Termination. This Agreement may be terminated by either Party upon thirty (30) days written notice to the other Party.

IN WITNESS WHEREOF, the Parties have executed this Agreement as of the date first set forth above.

DEPARTMENT OF TAXATION

By:


DINO DICIANNO
Executive Director

DEPARTMENT OF BUSINESS &
INDUSTRY, DIVISION OF INSURANCE

By:


SCOTT J. KIPPER
Commissioner of Insurance

APPROVED AS TO FORM:


DEONNE E. CONTINE
Deputy Attorney General

APPROVED AS TO FORM:


SHANE S. CHESNEY
Senior Deputy Attorney General

Appendix C
Response From the Department of Taxation



JIM GIBBONS
Governor
ROBERT R BARENGO
Chair, Nevada Tax Commission
DINO DICIANNO
Executive Director

STATE OF NEVADA
DEPARTMENT OF TAXATION

Web Site: <http://tax.state.nv.us>

1550 College Parkway, Suite 115
Carson City, Nevada 89706-7937
Phone: (775) 684-2000 Fax: (775) 684-2020

LAS VEGAS OFFICE
Grant Sawyer Office Building, Suite 1300
555 E. Washington Avenue
Las Vegas, Nevada 89101
Phone: (702) 486-2300 Fax: (702) 486-2373

RENO OFFICE
4600 Kietzke Lane
Building L, Suite 235
Reno, Nevada 89502
Phone: (775) 688-1295
Fax: (775) 688-1303

HENDERSON OFFICE
2550 Paseo Verde Parkway, Suite 180
Henderson, Nevada 89074
Phone: (702) 486-2300
Fax: (702) 486-3377

November 15, 2010

Paul Townsend, CPA, CIA
Legislative Counsel Bureau
401 So. Carson St.
Carson City, NV 89701

Re: Legislative Counsel Bureau Audit Findings October 2010

Dear Mr. Townsend,

The Department has reviewed the audit recommendations from the audit of the Department which were provided to us on October 26, 2010. The Department is in agreement with the validity of all recommendations. However, the Department is also of the opinion that a number of these recommendations address activities that can only be accomplished by the Division of Insurance. As a result of previous audits by both the Legislative Counsel Bureau (LCB) and the Executive Branch a number of actions were taken by the Division of Insurance to determine the accuracy of premium taxes being remitted to the State of Nevada.

In June of 2008, the Division of Insurance and the Department of Taxation entered into a Cooperative Agreement setting forth the responsibilities of each agency in their collaborative effort to determine the accuracy of premium taxes. Specifically, paragraph 2 of this agreement clearly states that the Commissioner of Insurance shall include in their periodic examination of insurers processes to ascertain that the insurers have reported and paid the correct amount of insurance premium tax.

On March 19, 2009, the Assembly Committee on Ways & Means and Senate Committee on Finance, Joint Subcommittee on General Government & Accountability recommended that the Division of Insurance obtain additional information pertaining to the annual premium tax reconciliation returns filed annually with the Department of Taxation. In response to that recommendation, in April of 2009, the Division of Insurance promulgated a bulletin that required that a copy of certain Annual Insurance Premium Tax forms filed with the Department of Taxation must also be provided to the Division of Insurance. Additionally, all companies are now required to file with the Department of Taxation the Schedule 2 Annuity Consideration Worksheet must now also provide a copy of this completed form to the Division of Insurance. When providing a copy of this completed form to the Division of Insurance, the company must also provide written documentation verifying the date on which the approval for either the Front End or Back End Annuity election was obtained from the Commissioner of Insurance. On May 28, 2010, the Cooperative Agreement that had been established in June of 2008 was rewritten

to include the new requirement for the Insurance Commissioner to implement a desk audit program to audit insurance premium tax returns to ensure that insurers are complying with the provisions of NRS 680B.027.

Currently, the Department of Taxation does not have the staffing or the expertise to conduct the level of "desk audits" that is addressed in a number of the findings and recommendations contained within the LCB audit report. Further, it is the opinion of the Department of Taxation that the Division of Insurance does possess the necessary level of expertise and have clearly indicated that it is their plan to ensure the accuracy of premium taxes being remitted to the State of Nevada through their periodic examinations and their desk audit program. In response to the recommendations contained with the audit report, the Department of Taxation will develop procedures to facilitate our review of returns to identify potential problems with returns. This information will be provided to the Division of Insurance to assist them in their examination and audit process.

Recommendation 1. Develop procedures regarding the review of annual insurance premium tax returns to identify mathematical errors, ensure amounts agree to supporting documents, and verify returns and amounts reported are consistent with revised forms and instructions.

Response: The Department will develop policies and procedures to conduct a basic review of all Annual Reconciliation Returns to identify mathematical errors and to identify returns with disparities between the amounts reported and the applicable supporting documentation. A report of discrepant returns will be provided to the Division of Insurance to assist them in their examination and audit process.

Recommendation 2. Identify and communicate potential misstatements, unusual reporting Circumstances, and changes in reporting annuity election methods and Report them timely to the Division of Insurance for follow-up.

Response: The Department will develop procedures to identify potential misstatements and unusual reporting circumstances. A list of any returns identified through this process will be provided to the Division of Insurance to assist them in their examination and audit process. The Department will ensure that any unauthorized changes in reporting annuity election methods are identified and reported to the Division of Insurance.

Recommendation 3. Work with the Division of Insurance to establish a log of insurers' approved annuity elections and only change the log for verified, approved election changes from the Division of Insurance.

Response: The Department had developed an annuity election log. A copy of this log has been sent to the Division of Insurance to ensure that it is and accurate and correctly reflects the annuity elections that have been approved by the Division of Insurance. Once the up-to-date log has been returned to the Department, no changes will be made to the log without the approval of the Division of Insurance.

Recommendation 4: Develop a process of comparing the annuity election log to returns to determine return accuracy, identify discrepancies, and communicate those to the Division of Insurance.

Response: The Department will develop procedures to ensure that all applicable returns will be compared to the annuity election log to identify any discrepancies with respect to the insurer's election. A list of any identified discrepancies will be provided to the Division of Insurance.

Recommendation 5: Obtain clarification regarding the taxability of "other considerations" and the deductibility of "paid-up addition" and "other" dividends.

Response: On March 4, 2008, the Nevada Office of the Attorney General issued an opinion stating that "dividends issued to policyholders and reapplied to purchase paid-up additions are subject to the insurance premium tax found in NRS 680B.027". The Department will request clarification from the Division of Insurance and The Nevada Attorney General's office regarding the taxability of "other considerations" and "other dividends".

Recommendation 6: Develop policies, procedures, and controls to ensure all refund requests and credit transfers are accurate and properly reviewed and tracked.

Response: The Department will develop procedures to ensure that all refund requests and credit transfers are approved by supervisory personnel to ensure accuracy.

Recommendation 7: Develop policies and procedures to routinely validate whether insurers are eligible to take home office credits and ensure amounts taken on annual returns are accurate.

Response: The Department did understand the requirement to validate home office credits. One of the last steps in processing the Reconciliation Returns for CY 2009 was to review the returns submitted by those insurers whose returns reflected a home office credit. In those instances where the required supporting documentation was not included with the return, the insurer was contacted and timely provided the required documentation. The Department will ensure that this procedure continues and that our written procedures clearly outline the necessary steps.

Recommendation 8: Work with the Division of Insurance to revise premium tax return forms and instructions to capture pertinent information, ease confusion and complexity, and provide accurate and sufficient instruction for the proper completion of returns.

Response: The Department has provided a copy of the Insurance Premium Tax Reconciliation return and the instruction sheet to the Division of Insurance. The Division of Insurance is in the process of reviewing these forms and will assist the Department in the creation of an improved instruction sheet.

Recommendation 9: Develop system controls to mitigate the risk of inappropriate adjustments being made in the Unified Tax System.

Response: The Department is in the process of developing the best systematic method of processing "credits" created by the receipt of negative returns from insurers. The Department will ensure that the interim use of the current "work around" to deal with these credits will require the prior approval of supervisory personnel.

Recommendation 10: Review current processes and implement programming changes regarding billing and delinquent notices to limit, to the extent practicable, premature of erroneous notices being sent.


Response: The Department has reviewed the issue and determined the best method of ensuring that erroneous billing notices are not sent. These procedures will be implemented during the next cycle of processing reconciliation returns. An examination of the circumstances surrounding the Department's sending premature delinquent notices identified that this was the result of human error. The Department will ensure that written procedures are established that include a "timeline" to prevent a reoccurrence of this problem.

Recommendation 11: Store insurance premium tax returns in a manner that provides for adequate safekeeping and easy retrieval.

Response: The Department has instituted a process ensuring that all returns that have not yet been scanned are properly stored in a numeric order that facilitates easy retrieval.

I would like to thank the Legislative Council Bureau audit staff for their professionalism and dedication in providing a valuable service to the Department.

If you have additional questions please contact me at 775-684-2060.

Sincerely

Dino DiCianno
Executive Director
Nevada Department of Taxation

**Department of Taxation
Response to Audit Recommendations**

<u>Recommendation Number</u>		<u>Accepted</u>	<u>Rejected</u>
1	Develop policies and procedures regarding the review of annual insurance premium tax returns to identify mathematical errors, ensure amounts agree to supporting documents, and verify returns and amounts reported are consistent with revised forms and instructions	<u> X </u>	<u> </u>
2	Identify and communicate potential misstatements, unusual reporting circumstances, and changes in reporting annuity election methods and report them timely to the Division of Insurance for follow-up.....	<u> X </u>	<u> </u>
3	Work with the Division of Insurance to establish a log of insurers' approved annuity elections and only change the log for verified, approved election changes from the Division of Insurance	<u> X </u>	<u> </u>
4	Develop a process of comparing the annuity election log to returns to determine return accuracy, identify discrepancies, and communicate those to the Division of Insurance.....	<u> X </u>	<u> </u>
5	Obtain clarification regarding the taxability of "other considerations" and the deductibility of "paid-up addition" and "other" dividends.....	<u> X </u>	<u> </u>
6	Develop policies, procedures, and controls to ensure all refund requests and credit transfers are accurate and properly reviewed and tracked.....	<u> X </u>	<u> </u>
7	Develop policies and procedures to routinely validate whether insurers are eligible to take home office credits and ensure amounts taken on annual returns are accurate	<u> X </u>	<u> </u>
8	Work with the Division of Insurance to revise premium tax return forms and instructions to capture pertinent information, ease confusion and complexity, and provide accurate and sufficient instruction for the proper completion of returns	<u> X </u>	<u> </u>
9	Develop system controls to mitigate the risk of inappropriate adjustments being made in the Unified Tax System	<u> X </u>	<u> </u>

Department of Taxation
Response to Audit Recommendations
 (continued)

<u>Recommendation Number</u>		<u>Accepted</u>	<u>Rejected</u>
10	Review current processes and implement programming changes regarding billing and delinquent notices to limit, to the extent practicable, premature or erroneous notices being sent	<u> X </u>	<u> </u>
11	Store insurance premium tax returns in a manner that provides for adequate safekeeping and easy retrieval	<u> X </u>	<u> </u>
	TOTALS	<u> 11 </u>	<u> 0 </u>