

Audit Highlights



Highlights of Legislative Auditor report on the Department of Taxation, Insurance Premium Tax issued on December 8, 2010. Report # LA10-22.

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 of Audit

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 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.

Audit 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.

The Department accepted the 11 recommendations.

Status of Recommendations

The Department's 60-day plan for corrective action is due on March 8, 2011. In addition, the six-month report on the status of audit recommendations is due on September 8, 2011.

Department of Taxation

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 could have been collected between 2007 to 2009.

Deductions for dividends related to untaxed premiums were allowed in 7 of 11 returns and resulted in an \$8,000 reduction in taxes due. Dividend deductions should be limited to premiums directly subject to taxation. Forms and instructions do not require companies to identify and account for dividends related to untaxed premiums.

Elections to defer the payment of premium taxes until annuities are applied for purchase (back-end) resulted in tax deferrals of \$7.5 million in 2009. Few companies who elect this method pay any tax on annuities. Fifteen 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.

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.

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.

"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. 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.

Current premium tax returns and instructions are complex, insufficient, and contributed to reporting 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.

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.