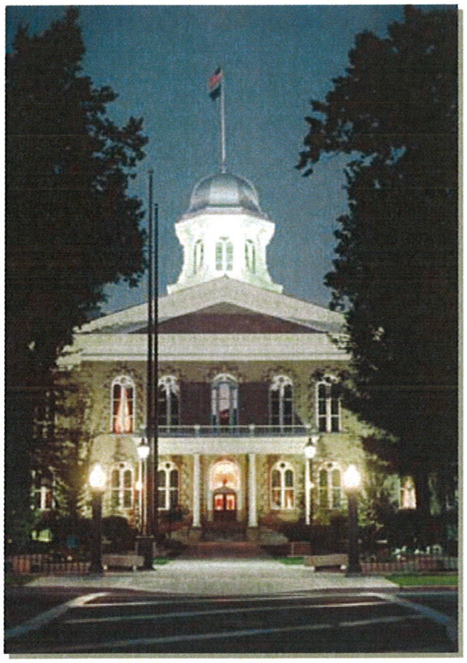

State of Nevada
Department of Administration
Division of Internal Audits

Audit Report

Department of Business & Industry
Division of Insurance
Insurance Premium Tax

Report No. 10-03
September 2009

EXECUTIVE SUMMARY
Insurance Premium Tax

Objective 1: Can the Division Increase Insurance Premium Tax Revenues?

The Division can increase insurance premium tax (IPT) revenues by implementing desk audits of insurance tax returns. We estimate these audits would resolve an estimated variance of $93 million to $163 million. Additionally, desk audits could generate a net of $481,000 per auditor annually based on our survey of revenues realized by other states as a result of these audits.

We surveyed 35 states and noted they performed desk audits on all IPT returns annually. Staff from these states stated that desk audits also increase compliance. These audits will ensure that appropriate taxes are being paid to the State.

Objective 2: Can the Division Enhance Annuity Reporting?

The Division can enhance annuity reporting by coordinating with the Department to ensure the Commissioner's consent is obtained for any change in elections. This will ensure proper reporting of tax revenues.

We reviewed all the annuity elections submitted to the Department for the years 2006 and 2007. We noted 13 changes in elections that did not receive the commissioner's consent as required by statutes. Proper reporting of annuity elections ensures compliance with Nevada statutes. Additionally, this ensures the insurers are paying to the State the proper amount of taxes when due.

INTRODUCTION

At the direction of the Executive Branch Audit Committee, we conducted an audit of the insurance premium tax (IPT) to improve revenue collection.

Division's Role and Public Purpose

Nevada collects IPT from insurance companies doing business in the State. Premiums are payments for insurance policies such as property and casualty, life, and health. Additionally, a premium tax is collected on annuities.

Nevada's IPT is collected by:

- Division of Insurance (Division) – The Division is responsible for regulating and ensuring the financial solvency of the insurance industry as well as protecting Nevada consumers in dealing with the industry. The Division also collects a very small percentage of the IPT mainly from captive insurance companies.
- Department of Taxation (Department) – The Department is primarily responsible for collecting State taxes including most of the IPT.

For fiscal year 2007, the State collected approximately $260 million in IPT revenues.

Scope and Objectives

We performed an analysis of the IPT revenues to determine if Nevada has collected the tax revenues due.

We began the audit work in December 2008. In the course of our audit, we interviewed officials from both the Division and Department, and analyzed reports from the Legislative Counsel Bureau and the National Association of Insurance Commissioners (NAIC).[1] We also reviewed the Nevada Revised Statutes. Additionally, as part of our field work, we performed state surveys to gain an understanding of their IPT. We concluded field work and testing in April 2009.

[1] NAIC is an organization of insurance regulators whose primary mission is to assist state insurance regulators. NAIC provides an avenue for the development of uniform insurance policies. They also gather statistical data from insurance companies, including information on total premiums, and taxes by state.

Our audit focused on the following objectives:

- ✓ Can the Division increase insurance premium tax revenues?
- ✓ Can the Division enhance annuity reporting?

The Division of Internal Audits expresses appreciation to the Division of Insurance and the Department of Taxation management and staff for their cooperation and assistance throughout the audit.

Contributors to this report included:

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Division of Insurance
Response and Implementation Plan

We provided draft copies of this report to Division officials for review and comment. The comments have been considered in the preparation of this report and are included in Appendix B. In its response, the Division accepted each of the recommendations we made. Appendix C includes a timetable to implement our recommendations.

NRS 353A.090 specifies that within six months after the Executive Branch Audit Committee releases the final audit report, the Chief of the Division of Internal Audits shall evaluate the steps the Division of Insurance has taken to implement the recommendations and shall determine whether the steps are achieving the desired results. The Chief shall report the six-month follow-up results to the Committee and Division officials.

The following report contains our findings, conclusions, and recommendations.

Can the Division Increase Insurance Premium Tax Revenues?

The Division can increase IPT revenues by implementing desk audits of all insurance tax returns. We estimate these audits would resolve an estimated variance of $93 million to $163 million.[2] This reported variance may or may not result in reportable IPT revenues. However, desk audits could generate on average, a net of $481,000 per auditor annually based on our survey of revenues realized by other states as a result of these audits.

The Division is required by statute to perform the following types of regulatory examinations of insurance companies doing business in the State:

- Market Conduct Examinations – This is an examination of insurance companies' marketing practices in relation to Nevada's statutes and regulations.
- Financial Examination – This is an examination to monitor the solvency of domestic insurance companies doing business in Nevada.

Neither the Division nor the Department performs desk audits of Nevada's IPT. Desk audits involve comparing insurance companies' revenues per NAIC to the state tax returns. Desk audits also involve reviewing submitted tax returns for inconsistencies, mathematical accuracy, and ensuring appropriate taxes have been reported.

We surveyed 35 states[3] and noted they performed desk audits on all IPT returns annually. Staff from these states stated that desk audits also increase compliance. Additionally, one or two auditors on average perform these desk audits in most states.

We compared the premiums Nevada insurance companies reported to NAIC for the years 2004 through 2007 to premiums reported by these companies to the State. Based on this comparison, we calculated an estimated average variance of $23.3 million per year (See Exhibit I). The Division has seven year statute of limitation to collect IPT on unreported taxes, penalties and fines. The Division should consider auditing prior tax returns submitted to the State to determine whether the variance of $93 million calculated in Exhibit I or $163 million assuming seven year statute of limitation is a reconciliation variance or the result of unreported revenues by insurance companies.

[2] This estimate is based on 4 to 7 years depending on the availability of documents and statute of limitation.

[3] The states surveyed were: Alabama, Alaska, Arkansas, Connecticut, Delaware, Florida, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Minnesota, Missouri, Nebraska, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, South Carolina, South Dakota, Utah, Virginia, Washington, West Virginia, Wisconsin and Wyoming.

Exhibit I

Estimated Unreported Insurance Premium Tax Revenues

Year	Nevada's Actual Premium Tax Revenues Reported (A)	Estimated Potential Premium Tax Revenues[4] (B)	Unresolved Variance (Reported Revenues less than Estimated Revenues) (B-A)
2004	$194,463,211	$213,798,228	($19,335,017)
2005	$215,743,481	$237,621,679	($21,878,199)
2006	$238,786,281	$267,031,359	($28,245,078)
2007	$259,706,597	$283,457,206	($23,750,609)
Total	$908,699,570	$1,001,908,472	$93,208,903
Average	$227,174,893	$250,477,118	($23,302,226)

Once this variance has been addressed, Nevada should consider instituting ongoing desk audits of all IPT returns. We estimate Nevada could collect an additional $581,000 per auditor per year as a result of these audits (See Appendix A). However, as the number of auditors increase, the amount collected per auditor may decrease. This would cost the Division an additional $100,000 per auditor per year. These additional resources would require appropriate State approval.

The Division should perform annual desk audits of all IPT returns. The Division is best equipped to perform the desk audits because of its expertise in regulating the insurance industry. These audits should ensure that appropriate taxes are being paid to the State. Additionally, it should lead to increased compliance by the insurance companies doing business in the State.

Recommendation

1. Perform desk audits of all IPT returns.

[4] This was calculated using written premiums reported to NAIC by Nevada insurers, adjusted for non-taxable revenues such as Medicare and Medicaid included in written premiums and multiplying by tax rates derived from total reported premium tax revenues.

Can the Division Enhance Annuity Reporting?

The Division can enhance annuity reporting by coordinating with the Department to ensure changes in annuity elections are approved by the Commissioner. This will not only enhance the reporting of annuities but would ensure proper reporting of tax revenues.

An annuity is a contract between a purchaser and an insurance company, under which a purchaser makes a lump-sum payment or series of payments. In return, the insurance company agrees to make periodic payments to the purchaser beginning immediately or at some future date.

Nevada is one of ten states that tax annuities. Nevada's tax rate on annuities is 3.5 percent. Insurance companies offering annuities must notify the State of their election to be either taxed on the front-end or back-end:

- Front-end – Insurance company pays taxes on the premiums received from the purchaser for their annuity.
- Back-end – Insurance company pays taxes on the monies paid to the purchaser in a lump-sum or series of payments.

Per NRS 680B.025, any change by an insurance company from one election to another requires the consent of the Commissioner of the Division.

On an annual basis, insurance companies report on their tax return how they are paying taxes, either front-end or back-end to the Department. We reviewed all the annuity elections submitted to the Department for the period 2006 through 2007. We noted five changes in elections that did not receive the Commissioner's consent.

Proper reporting of annuity elections ensures compliance with Nevada statutes. Additionally, this ensures the insurance companies are paying the proper amount of taxes to the State when due.

Recommendation

2. Coordinate with the Department to ensure the Commissioner consents to any changes in the insurance company's annuity election.

Appendix A

Estimate of Nevada's IPT Desk Audit Collection

	IPT Collections based on Desk Audits	
Survey States	**2007 IPT Collections per Auditor per Year (Column A)**	**2007 Total Revenues based on NAIC Data (Column B)**
NC	$250,000	$538,651,526
OH	$1,000,000	$498,240,660
MA	$850,000	$485,327,174
WV	$50,000	$456,090,000
MN	$247,104	$348,714,412
MD	$125,000	$307,466,025
OK	$800,000	$225,688,792
AR	$40,000	$190,376,198
KS	$400,000	$147,216,864
CT	$2,666,666	$156,695,600
IA	$266,667	$120,549,140
AK	$80,000	$56,508,721
ND	$650,000	$40,890,610
Total	$7,425,437	$3,572,415,722

Average Collection Percentage based on Total Revenues. (Total Column A/Total Column B)	0.0021	x
2007 NV Revenues:	$276,753,292	
Estimated Nevada Collection per Auditor per Year:	$581,182	

We were able to obtain annual collections per auditor per year and annual revenues recorded by the 13 states listed above. The other states surveyed refused to disclose the annual collections per auditor. In addition, we removed the states with the highest and lowest annual collections to provide a conservative estimate.

The average collection percentage calculated above was applied to Nevada's 2007 IPT revenues to determine estimated annual collection per auditor.

Appendix B

Division of Insurance
Response and Implementation Plan

JIM GIBBONS
Governor

DIANNE CORNWALL
Director

STATE OF NEVADA

SCOTT J. KIPPER
Commissioner of Insurance

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RECEIVED
AUG 12 2009
DIVISION OF INTERNAL AUDITS

August 10, 2009

Dear Administrator Chisel:

Please consider this letter as acceptance of the recommendations contained in the Executive Branch Audit of the insurance premium tax revenue collection. The recommendations will serve to assist us in better discharging our obligations to enforce the Nevada Insurance Code. I would like to note that it is my understanding of the recommendation to hire two additional staff will come as a new expense to be added in the budget and not come out of current budget allocations.

I do want to state that I cannot support or endorse the suggestion that premium taxes in Nevada for the past seven years may have been underreported or underpaid by the insurance industry by up to $163 million dollars. I believe that the rationale that was used in determining this figure is not justifiable. The basis of using other states as the foundation of the methodology in determining this figure may not be applicable.

Auditor's note: The $163 million projection was based on written premiums reported by Nevada Insurers to the NAIC. Other states were not used in determining this figure.

On behalf of the entire staff of the Division of Insurance, I want to thank you and your staff for the professional manner in which the audit was conducted. I also want to thank you for your patience and hard work in understanding this very complicated process and for working with our staff during this extremely busy legislative session.

Sincerely,

SCOTT J. KIPPER
Commissioner of Insurance

INSPO Rev 1-09

Recommendation No.1: Perform desk audits of all IPT returns.

The Division accepts this recommendation. Implementing a desk audit program for premium tax returns should enhance the accuracy and timeliness of premium tax reporting. The Division concurs with the audit report conclusion indicating variances estimated by the auditors may not result in collection of a significant amount of underpaid revenue. Variances may be the result of insufficient reconciliation and review which should be identified and improved with a desk audit program.

Implementing the recommended audit program will only be possible with additional resources. The Division will request resources to establish the program beginning in fiscal year 2012. Funding for the audit program will be included in the next biennial budget request. With approved funding, the audit program will be implemented by December 31, 2011.

Recommendation No. 2: Coordinate with the Department to ensure the Commissioner consents to any changes in the insurance company's annuity election.

The Division accepts this recommendation. The Division began receiving duplicate copies of the premium tax form filed with the Department of Taxation for the IPT due March 15, 2009 (2008 reporting year) and is in the process of finalizing procedures to ensure changes in a company's annuity election receive the Commissioner's written consent and are updated in the company's records. This recommendation will be implemented by December 31, 2009.

SCOTT J. KIPPER, COMMISSINER
788 Fairview Drive
Carson City, Nevada 89701-5790

Appendix C

Timetable for Implementing Audit Recommendations

In consultation with the Division, the Division of Internal Audits categorized the recommendations contained within this report into two separate implementation time frames (i.e., *Category 1* – less than six months; *Category 2* – more than six months). The Division should begin taking steps to implement all recommendations as soon as possible. The Division's target completion dates are incorporated from Appendix B.

Category 1: Recommendation with an anticipated implementation period of less than six months.

Recommendation	Time Frame
2. Coordinate with the Department to ensure the Commissioner consents to any changes in the insurance company's annuity election. (page 5)	Dec 2009

Category 2: Recommendation with an anticipated implementation period exceeding six months.

Recommendation	Time Frame
1. Perform desk audits of all IPT returns. (page 4)	Dec 2011

The Division of Internal Audits shall evaluate the action taken by the Division of Insurance concerning report recommendations within six months from the issuance of this report. The Division of Internal Audits must report the results of its evaluation to the Committee and the Division.