ADMINISTRATION OF
THE INSURANCE TAX PROGRAM IN CALIFORNIA:
A CASE FOR LIMITED REFORM

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INTRODUCTION

Insurance taxes are the fourth largest source of revenue for the state's General Fund, with an estimated $675 million to be collected in 1985-86. As with other major sources of revenue, it is important that the state maximize the yield from this tax per dollar of administrative cost. Among other things, the yield depends on the efficiency with which the tax is administered and the effectiveness of the administering agency's audit program.

As a result of questions raised by state agencies and legislative staff regarding the administration of the insurance tax, the Legislature enacted Ch 994/80. That measure requires the Legislative Analyst to review the present administrative arrangement and recommend revisions to existing law and procedures. This report was prepared in response to the requirement contained in Chapter 994.

Chapter I of the report provides the reader with a description of the insurance tax and how it is applied. Chapter II describes the mechanisms for administering the tax that are now in place. Chapter III seeks to answer the question of whether the audit program, as currently structured, maximizes insurance tax revenue collections. Chapter IV presents our recommendations for legislative action that would address the system's shortcomings.

This report was prepared by Lori Parmer under the supervision of Peter Schaafsma.

EXECUTIVE SUMMARY

Insurance tax collections represent the fourth largest source of state General Fund revenues, with an estimated $675 million to be collected in 1985-86. Under existing law, the state's insurance tax program is administered jointly by the Insurance Commissioner (Department of Insurance), the Board of Equalization, and the State Controller. The Department of Insurance is responsible for general administrative functions and auditing; the Board of Equalization issues assessments and hears appeals; and the Controller handles collections and accounting. The rather complex administrative process that has been established for this tax is illustrated in a series of charts included in Chapter I.

Chapter 994, Statutes of 1980 (AB 1579), requires the Legislative Analyst to review the present administration of the tax and recommend revisions to existing law and procedures.

FINDINGS

Our review of the insurance tax found several deficiencies in the way it is being administered. These deficiencies include the following:

1. The Department of Insurance's operations are unnecessarily fragmented, since these operations are spread among the department's offices in three cities;

2. The development and communication of tax policy is handled in an incomplete and inconsistent fashion;

3. The exchange of information among the three agencies is inadequate;

4. The responsibility for billing taxpayers for taxes due is fragmented among the agencies; and

5. The productivity of the audit program is not being maximized.

The audit function is a particularly critical element of insurance tax administration, both because it identifies additional taxes due the state and because it deters improper reporting and payment of taxes by insurers. Currently, the Department of Insurance has full responsibility for insurance tax audits, performing <u>desk audits</u> of tax returns filed with DOI's Tax Bureau, and conducting <u>field audits</u> as part of its on-site examinations of insurers' financial condition.

Our review finds that the Department of Insurance's audit activities are deficient in the following respects:

1. The automated review process, which screens all tax returns, is not used to guide the selection of audits for manual desk audit;

2. Because solvency is the primary concern of field examiners (as, indeed, it should be) the verification of taxes due may not be given sufficient emphasis in the selection and performance of field examinations;

3. The department concentrates its field examination efforts on California insurers, while the available data suggests that audits of out-of-state firms probably would be more productive; and

4. The department does not keep comprehensive records, making it difficult to track audit costs and productivity and use that information to develop an effective audit selection system.

CONCLUSIONS

Our analysis concludes that the risks of restructuring the program to consolidate all administrative functions within a single agency outweigh the potential benefits from consolidation that have been documented to date. Moreover, we find no evidence to support the Board of Equalization's claim that an alternative audit system--one that emphasizes field audits of insurers, rather than comprehensive desk audits of their returns--would be more productive than the system currently employed by the Department of Insurance.

RECOMMENDATIONS

In order to improve both administrative efficiency and audit effectiveness, we recommend that the Legislature:

- Eliminate the State Controller's collection and accounting responsibilities under the insurance tax program;
- Direct the Department of Insurance to consolidate its operations so as to reduce the geographic fragmentation that now exists;
- Shift to the Department of Insurance responsibility for billing insurers for deficiencies and delinquencies;
- Keep responsibility for insurance tax audits with the Department of Insurance;
- Direct the Department of Insurance to:
  - develop a system for ranking insurers according to their desk audit potential;

- shift audit resources from the examination of California companies to the examination of out-of-state insurers under the National Association of Insurance Examiners' auspices;
- improve the system used to track deficiency assessments so as to provide a better basis for improving the effectiveness of the audit selection system; and
- improve the recording of deficiency assessments and other adjustments of tax, penalties, and interest which result from the audit process.

CHAPTER I

ADMINISTRATION OF THE INSURANCE TAX

THE INSURANCE TAX

There are approximately 1,400 insurance companies licensed to do business in California, two-thirds of which are domiciled outside the state. In 1982, these insurers generated over $20 billion in direct premiums by writing policies covering risks in California.

The State of California taxes insurers on the basis of the "gross premiums" they receive in connection with business transacted in California, less returned premiums and reinsurance. This tax is imposed on insurers licensed to do business in California ("admitted" insurers) in lieu of all other state and local taxes except those on real property and motor vehicles. There are, however, two types of insurers which are not subject to the basic premium tax. These insurers write title insurance and ocean marine insurance, and are taxed on the basis of income and underwriting profits, respectively. (In this report, we refer to the annual insurance taxes on business, other than ocean marine, as "premium taxes".)

The state imposes several other types of insurance taxes. Out-of-state insurers doing business in California are required to pay an additional "retaliatory tax." This tax is assessed as a means of balancing the tax burdens imposed by California with those imposed by the insurer's home state. In addition, a "surplus line" broker's tax is levied on brokers who place business with insurers that are not licensed in California and are not qualified to sell policies within the state. Surplus line brokers sell policies that typically are not written by insurers licensed to do business in California. Often, these policies cover unusual risks, such as malpractice and those associated with dynamite factories, and carry large premiums. Because the state has no authority to tax insurers who are not licensed by the state, the premium tax is, instead, imposed on the brokers who sell these policies.

Table 1 summarizes the rates for the various insurance taxes levied by California, as well as the bases against which these rates apply. Table 2 shows the amount of insurance taxes assessed by the state against the four primary types of insurance companies.

Table 1

Summary of Taxes Imposed on California Insurers

Type of Insurer	Tax Rate/Tax Base
Insurance companies licensed to do business in the state:	
a. Premium tax	
• Life, fire & casualty	2.33 percent of gross premiums (direct premiums written, less returns)[a]
• Title	2.33 percent of income (excluding income from investments)[a]
• Ocean Marine	5 percent of underwriting profits (net earned premiums less losses and expenses)
b. Retaliatory tax	Imposed on out-of-state (foreign) insurers when the state in which that insurer is incorporated imposes a higher tax on California insurers doing business there than California imposes on its own (domestic) insurers. Tax equals the difference between the other state's insurance tax rate and California's.
Surplus Line Brokers	3 percent of gross premiums on insurance placed with insurers not licensed to transact business in California.

a. Chapter 327, Statutes of 1982, reduced the gross premiums tax rate from the 2.35 percent rate prescribed by the State Constitution to 2.33 percent. The lower rate will be in effect from 1982 through 1986, after which insurance premiums will again be subject to a 2.35 percent rate.

ADMINISTRATIVE ORGANIZATION AND COSTS

Article XIII, Section 28, of the California Constitution provides for the taxation of insurance companies. In addition to specifying how the tax is to be applied, the Constitution assigns to the Board of Equalization responsibility for assessing insurance taxes. In practice, however, the tax is self-assessed, and the board's duties are limited initially to "assessing" the amount reported by the taxpayer on his tax return. The board also hears appeals of tax deficiency assessments resulting from audits conducted by the Department of Insurance.

The responsibilities of the other two agencies involved in the administration of the insurance tax are set forth in the Revenue and Taxation Code (Part 7, Division 2). The Code assigns to the State Controller responsibility for insurance tax-related collections and accounting, and assigns to the Insurance Commissioner (Department of Insurance) responsibility for general administrative functions and auditing. Although each of these three agencies has a distinct role to play in administering the insurance tax, there is considerable interplay among them. These interrelationships are rather complicated.

Table 3 provides a short description of each agency's insurance tax functions and shows the staffing levels and annual costs for these functions. As can be seen in the table, the total costs associated with the insurance tax program are estimated at $306,000 for 1984-85. These amounts, however, make no allowance for the costs of tax audits conducted by the Department of Insurance as part of the on-site examinations of an insurer's financial condition. The state is reimbursed for the costs of these examinations by the insurance companies themselves.

Table 2

Insurance Tax Assessments, by Type of Company
(in thousands)

	1981-82					1982-83				
	Premium Tax		Retaliatory Tax		Total	Premium Tax		Retaliatory Tax		Total
	(a) Number	Amount	Number	Amount	Amount	(b) Number	Amount	Number	Amount	Amount
Fire/Casualty	620	$294,894	76	$1,591	$296,485	647	$300,106	84	$2,496	$302,602
Life	537	167,932	81	1,593	169,525	565	181,816	81	1,103	182,919
Title	21	6,493	2	20	6,514	21	6,103	2	25	6,128
Ocean Marine	46	225	--	--	225	48	184	--	--	184
Total Initial Assessment	1,224	$469,544	159	$3,204	$472,749	1,281	$488,209	167	$3,624	$491,833
Net Adjustments (Deficiency Assessments, Refunds, and Cancellations)					182					-31,429
Total assessments					$472,930					$460,404

Source: Board of Equalization.
a. Includes 119 returns with zero tax liability.
b. Includes 137 returns with zero tax liability.

Table 3

Costs Associated with
California's Insurance Tax Program

Agency Functions	Personnel-Years			Expenditures (in thousands)		
	Actual 1982-83	Estimated 1983-84	Estimated 1984-85	Actual 1982-83	Estimated 1983-84	Estimated 1984-85
State Board of Equalization:						
Renders annual insurance tax assessments, hears taxpayer appeals and makes decisions on petitions for redetermination and claims for refund.	1.6	1.6	1.6	$67	$76	$80
Department of Insurance:						
Collects and deposits insurance premium taxes, audits tax forms filed by insurers.	3.0	5.0	5.0	90	137	148
State Controller:						
Maintains accounts and collects delinquencies for taxes on insurance companies.	1.5	1.5	1.5	62	74	78
Totals	6.1	8.1	8.1	$219	$287	$306

THE ADMINISTRATIVE PROCESS

The system used to administer the insurance tax has three main elements: assessment and collections, audits, and appeals. The assessment and collection element includes activities such as mailing prepayment coupons and tax returns, recording payments, and assessing tax liabilities. These activities take place at different times during the year and are performed by different agencies. The audit and appeals elements encompass activities that take place on an ongoing basis. These activities also involve the participation of more than one agency. Charts I, II and III provide an illustration of the roles played by each of the three agencies in the administration of the premiums tax.

Assessments and Collections

The Department of Insurance (DOI), the Board of Equalization (BOE), and the State Controller's office (SCO) are all involved in the assessment and collection function. The duties of each agency, as well as the specific activities that each performs are different for the premium tax and the retaliatory tax.

In the case of premium taxes, the Department of Insurance sends prepayment coupons to insurers each February (see Chart I). Insurers must send to the DOI prepayments for current-year taxes by the 15th of May, June, August, and November. Throughout the year, the Controller's office records receipts and issues delinquency notices. In February of the following year, the Department of Insurance sends insurers tax forms for use in making their final payments (see Chart II). Insurers must file

CHART 1

INSURANCE TAX PREPAYMENTS

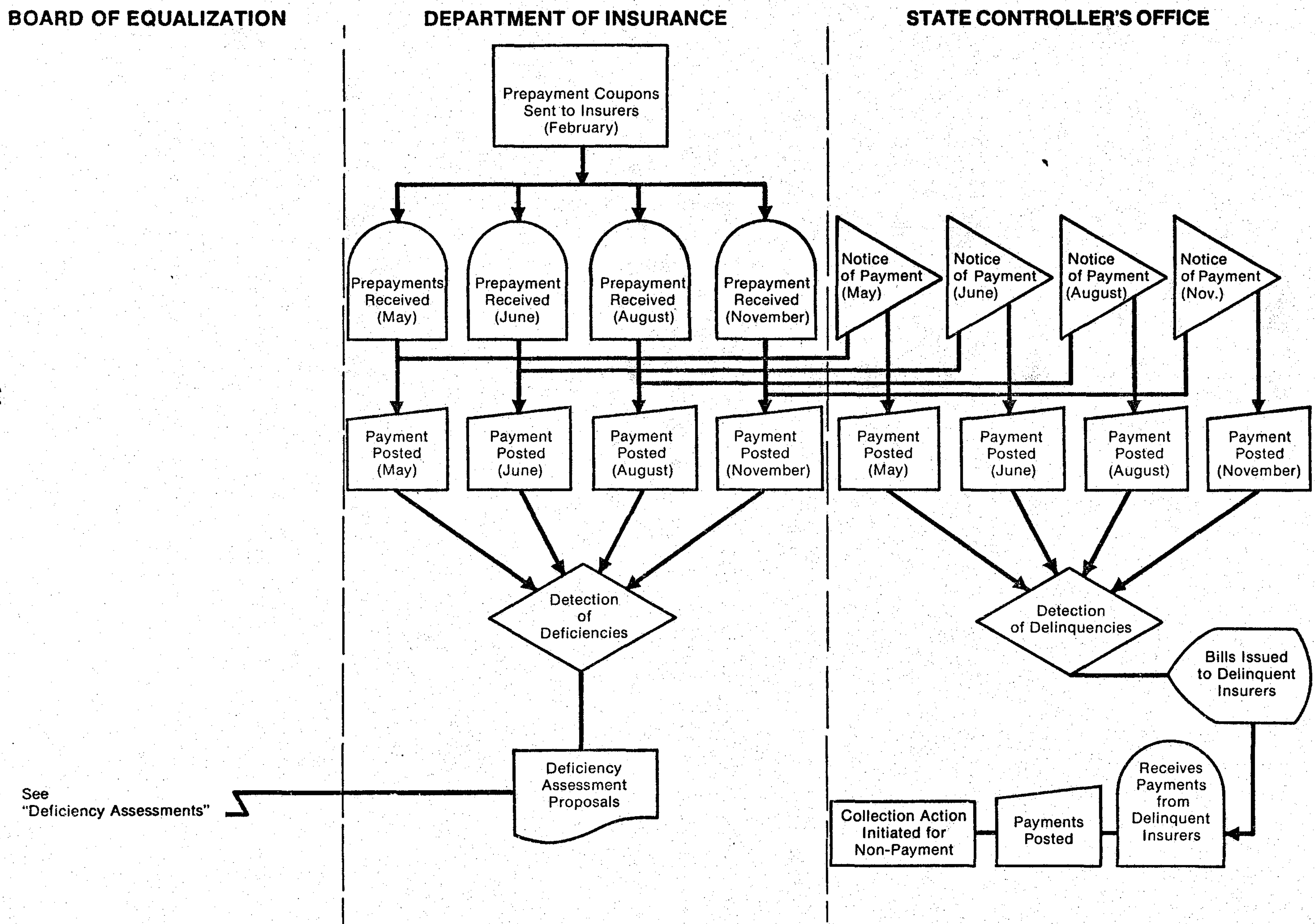
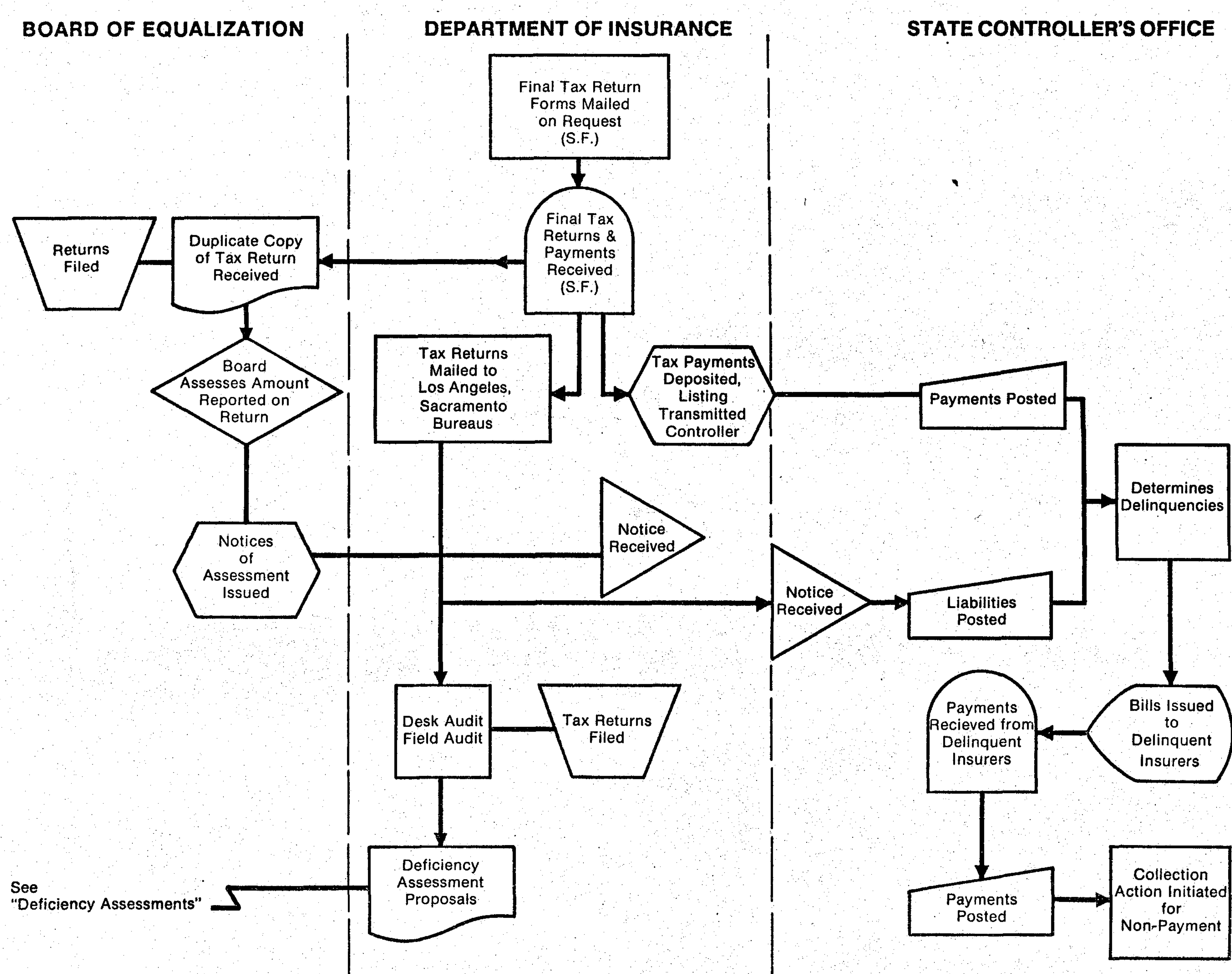


CHART 2

INSURANCE TAX FINAL PAYMENTS



these returns together with their final remittances (made payable to the State Controller), by April. The Department of Insurance's San Francisco office then deposits the payments, transmits notices of such deposits to the SCO, and forwards the returns to both its Tax Bureau in Los Angeles and its Electronic Data Processing Bureau in Sacramento. The DOI also forwards duplicate copies of the returns to BOE for review. The board "assesses" the insurance companies for the amount of tax reported on these returns, and sends notices of initial assessments to DOI and SCO. The SCO then records the receipts submitted with the returns, posts the assessments, and issues delinquency notices for amounts not received, including penalties and interest.

The assessment and collection process used for retaliatory taxes is entirely different. Out-of-state insurers file retaliatory tax information with DOI's San Francisco office by May 1. The Tax Bureau in Los Angeles makes retaliatory tax recommendations to BOE by August 15, and by September 15, the board issues assessments to insurers and transmits copies of notices to DOI and SCO. Retaliatory tax payments to SCO must be made by December 1.

In the case of both premium and retaliatory taxes, the Controller transmits to the Commissioner of Insurance each year a report identifying all delinquent insurers.

Audits

The Department of Insurance is the only agency with authority to perform insurance tax audits for both the premium tax and retaliatory tax components. After the tax returns are received in April, the department's San Francisco office forwards the documents to the Tax Bureau in Los Angeles for automated review and desk audits. State insurance examiners conduct field audits on a three-year cycle, reviewing tax liabilities of insurers as part of financial condition examinations. Based on the findings from both desk and field audits, DOI proposes deficiency assessments to the board.

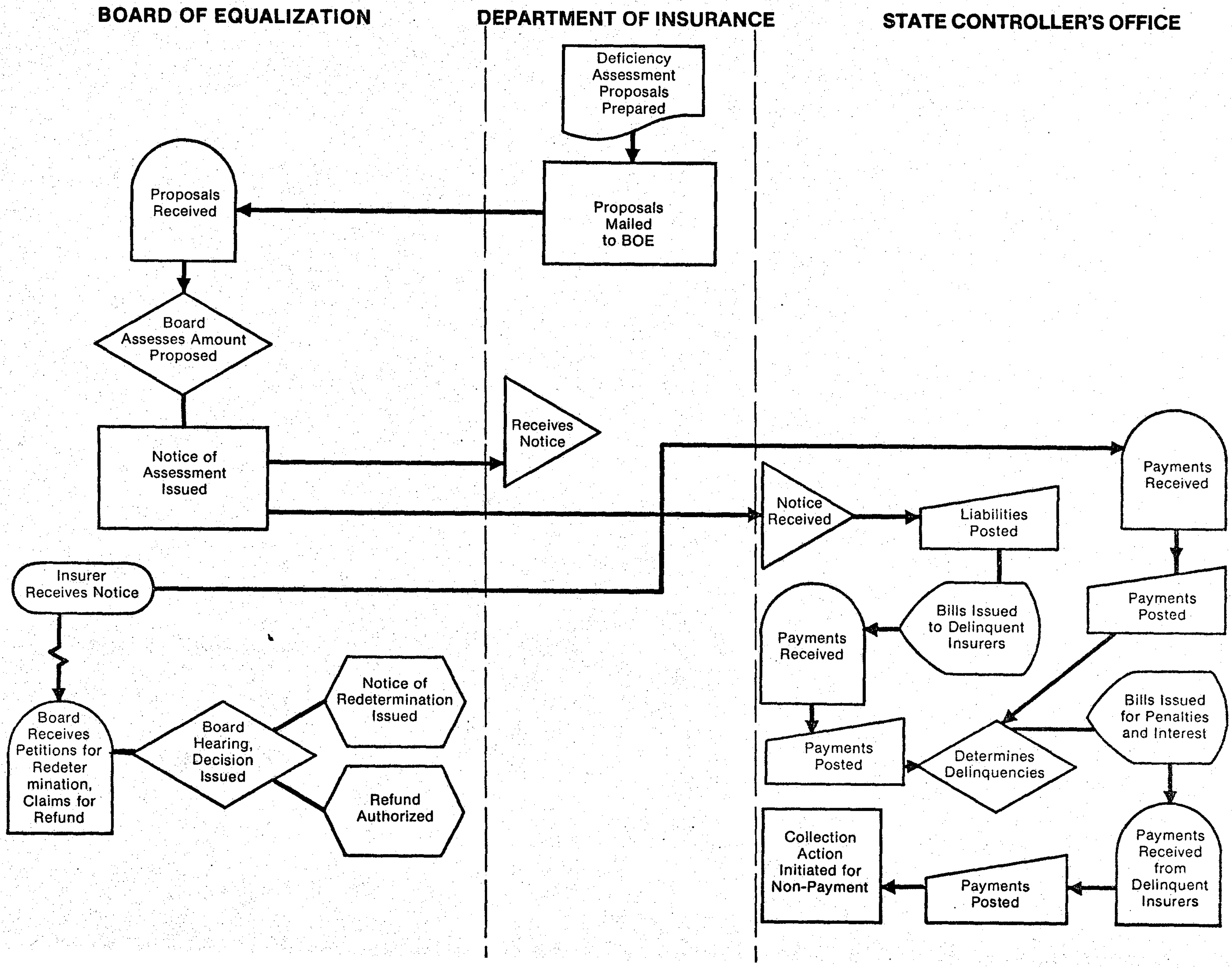
Appeals

Because the premium tax is self-assessed, virtually all appeals filed by insurers are submitted in response to deficiency notices (see Chart III). Deficiency assessments are issued by the board, based on the department's recommendation, and are subject to a four-year statute of limitations. Copies of each assessment are sent to the department and to the Controller. When a taxpayer receives a deficiency assessment notice, it has 30 days to file a protest. The insurer may file with the board either a redetermination petition indicating its refusal to pay additional assessments, or a claim for refund of an assessment already paid. The department receives a copy of the petition or claim, and provides information to the BOE to assist it in its deliberations. The BOE then conducts one or more hearings and makes its decision. After appeal of an adverse decision, the petitioner may seek relief by bringing a civil suit against the board.

In the case of retaliatory taxes, which are not self-assessed, assessments may be appealed and adjusted between the date of the official

CHART 3

DEFICIENCY ASSESSMENTS



assessment (September 15) and the date on which final payments are due (December 1). Insurers may file appeals with the BOE within 30 days of the assessment date, and the BOE then has 30 days to consider whether to revise its assessment.

The surplus line brokers tax is administered entirely by the Department of Insurance. The Board of Equalization is not involved with the assessment, collection, or auditing functions associated with this tax. Similarly, the Controller's office plays no significant role in accounting for the surplus line brokers tax, other than keeping track of total receipts reported by the department (as it does for all other state taxes).

CHAPTER II

ANALYSIS OF THE PRESENT TRIPARTITE SYSTEM FOR ADMINISTERING THE INSURANCE TAX PROGRAM

The Board of Equalization has proposed that administration of the insurance tax program be consolidated under a revenue agency. When the board first made this proposal it was highly critical of the Department of Insurance and its role in identifying and collecting revenues in excess of self-assessments owed to the state. The board cited a series of problems it had encountered in trying to issue deficiency assessments and adjudicate appeals, as it is required to do. These problems included what the board considered to be long delays in processing, transmission of erroneous information, inadequate documentation of proposals, inconsistent treatment of tax issues, inadequate recordkeeping, and generally poor communications with the other two agencies involved in administering the program. As a means of avoiding these problems, BOE sought authority to verify taxpayers' liability by conducting its own audits.

In 1983, we asked the board for information supporting its position, and the board's staff provided us with numerous examples of errors and delays in the handling of deficiency cases that it attributed to the Department of Insurance. Our review indicates, however, that each of the specific problems cited by the board occurred between 1975 and 1979. Thus, it would appear that most of the BOE's case for reassigning responsibility for the insurance tax program is built on complaints about the department's performance that date back 5 to 10 years.

It appears that few of the major problems cited by the board remain today, and that the procedures used by the department in proposing and issuing deficiency assessments have improved significantly. Both sides acknowledge that the level of trust and cooperation between the two agencies has increased significantly since 1979, and that the BOE rarely fails to follow the department's recommendations.

The BOE, however, continues to maintain that the department is not taking the steps necessary to protect the insurance tax base, because its audit program is not sufficiently vigorous. This issue will be discussed in detail in Chapter III.

ORGANIZATIONAL SHORTCOMINGS

The Board of Equalization in the past has criticized the system of divided administrative responsibility for the insurance tax program, claiming that it is inherently inefficient. It also has placed with the Department of Insurance much of the blame for the mistakes that have occurred under the program.

Partly in response to the BOE's complaints, the department automated many of its processes in mid-1979, in order to streamline operations, eliminate the primary sources of error, and minimize delays. The department claims that, as a result, its operations have improved steadily and that its error rate has declined significantly. The board acknowledges the success of the department's efforts, indicating that at the present time it is encountering few problems in getting information and assistance from department personnel. The Controller's Tax Collection Unit asserts that all three offices work well together, and it has praised the Insurance Department for its cooperative attitude.

Automation, however, cannot fully compensate for the organizational shortcomings that are almost unavoidable when three separate agencies share responsibility for a single program. Without a single agency managing operations, guiding policy formulation, and directing information flow, a great deal of written and telephone communication is necessary to assure that the activities of the various functional and organizational units scattered throughout the state are adequately coordinated.

Our review of the existing system used to administer the insurance tax indicates that the system has four major shortcomings:

1. Tax Policy is Incomplete and Inconsistent. Each of the three administrative agencies maintains its own set of operating procedures and relies on its own interpretation of California's insurance and tax codes. It is difficult to tell how consistent those policies are because, for the most part, they are not clearly set forth in policy manuals. In addition, there is some question about how well the three agencies' policies are communicated to those involved with insurance taxation, especially the insurance companies themselves.

For example, many policy decisions regarding the insurance tax are made by the Tax Bureau of the Insurance Department. In the past, the Board of Equalization has asserted that the department has not established regulations which provide an adequate interpretation of the codes, leaving the taxpayers without a source to which they can turn for uniform guidance on how the law is interpreted by the state in specific instances. In fact, the BOE has claimed that the state often has not had a formal position on an issue which is the subject of a taxpayer's appeal.

During the last several years, the bureau has revised its tax return forms to increase the volume of instructions available to taxpayers. It has also improved its system for reviewing taxpayer returns through both computerized processing and manual desk audits. In the course of making these changes, examiners in the Tax Bureau, together with their legal advisors, have developed standard policies and procedures on various tax issues. Currently, the bureau keeps a record of decisions rendered by the Attorney General and the courts, as well as the positions taken by attorneys both for the department and board. In addition, Tax Bureau examiners rely on a manual containing DOI positions on various issues. To assist taxpayers, the Tax Bureau provides instructions in packets and, when necessary, sends notifications of changes in tax law or department policy directly to insurers.

Given its responsibility for issuing deficiency assessments and hearing appeals, the Board of Equalization also plays a role in setting insurance tax policy. Although they generally follow the Insurance Department's recommendations when reviewing returns and supporting facts, board personnel also receive advice from the board's own legal staff. This, at times, has led to conflicts between the position taken by the board and the position taken by the department.

It would seem that the possibility of conflicts between the two agencies is almost unavoidable, given the divided responsibility for the insurance tax program that exists under the existing system. The only way to assure that taxpayers do not receive conflicting advice on tax questions is to assign responsibility for policy development and enforcement to a single agency.

2. Exchange of Information Among Agencies is Inadequate. One very evident shortcoming of the current system is the lack of a single, comprehensive data base available to the agencies sharing responsibility for administering the program. Each agency keeps records covering those parts of the tax collection and audit process for which it is responsible, as well as information about the activities of the other two administrative bodies. As a result, the department and the board maintain essentially duplicate tax files on insurers.

Even so, each participant's knowledge of the other's responsibilities and activities is remarkably limited. The collection, storage and retrieval of data covering various aspects of the program's administration are poorly coordinated. With no central coordination of program data, it is difficult to conduct evaluation of and planning for the insurance tax program.

Table 4 identifies each agency's responsibilities with respect to the various insurance tax functions and the information maintained by that agency. While most of the information ultimately is shared with the other agencies, the sources and locations of data may be fragmented at any point in time.

Table 4

Allocation of Responsibility for Collecting/Maintaining Information Under the Insurance Tax Program

Function	Department	Board	Controller
1. Premium Tax			
Assessments and Collections	Maintains prepayment and final return records	Maintains data on amounts of final tax assessments	Maintains data on amount of prepayment and final payments received (by company)
Deficiency Assessments	Maintains documentation supporting proposed deficiency assessments	Issues deficiency assessments	Records tax deficiency payments
Refunds	Maintains documentation supporting recommendations to BOE on refund petitions	Authorizes refunds	Writes refund warrants, tracks refund payments
Redetermination Petitions	Maintains documentation supporting recommendations to BOE	Approves redetermination petitions	--
Delinquent Accounts	--	--	Monitors delinquency status, sends delinquency notices, monitors collections
2. Retaliatory Tax	Maintains documentation supporting proposed retaliatory tax assessments	Issues retaliatory tax assessments	Receives retaliatory tax payments, monitors collections
3. Surplus Line Brokers Tax	Maintains all information on tax assessments and collections	--	--

Because each agency stores its own data and not all types of data are available centrally, any effort to utilize program data in a comprehensive fashion results in additional costs. Ongoing costs also are incurred simply to maintain in separate locations what are essentially duplicate records.

Under existing law, the Controller plays the central role in the information system for the California tax on insurers. The Controller has statutory responsibility for collecting and maintaining accounts for the Insurance Tax Fund. The Controller's Tax Collection and Refund Unit receives reports from both the department and the board so that it can record assessments and post revenue collections. Because the Controller is both collector and accountant for the insurance tax, in theory, he is the only one who has the full picture of assessments and receipts. The Controller, however, keeps data primarily for state revenue purposes and not for the purpose of analyzing how effectively the program is administered. For example, although the Controller's office may receive reports of proposed deficiency assessments from the Department of Insurance, it does not enter that information into its recordkeeping system. As a result, until deficiencies are officially issued by the Board of Equalization, the Controller lacks a complete tally of deficiencies in the pipeline.

Although the Controller has the broadest picture of insurance tax revenues, the data on revenues are not compiled and summarized in such a way as to be very useful for <u>planning and evaluation</u> purposes. The

Controller prepares monthly reports of collections for the five insurance subtaxes (premium taxes on admitted and nonadmitted insurers, retaliatory taxes, ocean marine taxes, and surplus line taxes), but the information is not summarized in annual figures. Similarly, although monthly records are kept of deficiency determinations and cancellations, it is impossible to get a detailed picture of total transactions over the course of a year.

3. Responsibility for Billings is Fragmented. Under existing law, insurers remit self-assessed premium tax payments to the Department of Insurance, along with their tax returns. They send all other payments directly to the Controller, after receiving an assessment notice or bill. The payments remitted to the Controller include penalties and interest for delinquent accounts, deficiency assessments, and retaliatory taxes.

In all cases, the amounts due are based on proposals submitted by the Department of Insurance, yet the billing is handled by the board (notifying insurers of additional tax assessments) or the Controller (billing them for penalties and interest). This administrative overlap is costly and adds unnecessary complexity to the tax collection system.

4. Operations are Geographically Fragmented. Within the Insurance Department, administrative responsibilities for the tax program are divided between the Tax Bureau in Los Angeles and the department's San Francisco office. The Tax Bureau handles most of the administrative functions, including the development of forms, the dissemination of tax information to staff and insurers and the review of returns (desk audits). However, all prepayments are received by the department's San Francisco office, where the annual returns and final payments are also filed.

At those times during the year when tax payments are due, part of the San Francisco office's staff is used to perform processing and cashiering functions. As soon as prepayments are deposited in the Controller's account at a San Francisco bank, the Tax Bureau in Los Angeles and the EDP Bureau in Sacramento are notified of the transmittals. When the last payments are received in April, returns are logged in, batched and forwarded to Los Angeles for further processing. The department could offer no justification for this fragmented procedure.

Additional geographical fragmentation characterizes the process. For example, the Field Examination Division performs financial examinations out of both Los Angeles and San Francisco, while the department's EDP Bureau, which is responsible for various data processing functions, is located in Sacramento. (The EDP Bureau is located near the Teale Data Center; it is this proximity to the center that justifies the bureau's Sacramento location.)

This geographic fragmentation of the department's operations appears to result in two separate problems. First, information reported on taxpayer returns may not always be accessible to those within the department. For example, the Tax Bureau in Los Angeles may be called upon to respond to an insurer's questions while the return is still in San Francisco. In addition, there is the added expense and risk that always comes with having to move large volumes of paper between the separate offices.

CHAPTER III

EVALUATION OF THE INSURANCE TAX AUDIT PROGRAM

Currently, the Department of Insurance has full responsibility for conducting audits of insurance tax returns. Within the department this function is assigned to two units: the Tax Bureau, which used two auditors and one tax supervisor to review annual tax returns of the 1,400 insurance companies doing business in California, and the Field Examination Division, which uses 66 examiners to audit insurance companies for tax compliance as part of their field duties.

In administering the insurance tax program, the state relies primarily on the taxpayer's own self-assessment to produce tax revenues. In order to maximize revenues, however, the state must identify as many insurers who have miscalculated or misrepresented their tax liability as possible. The audit function involves two critical tasks. First, it discovers additional tax liabilities due the state. Second, it deters the improper reporting and payment of insurance taxes.

AUDIT PRODUCTIVITY AND EFFECTIVENESS

Audit effectiveness generally is measured in terms of productivity. In a recent report on the allocation of audit resources by state tax agencies (Report No. 81-3), our office recommended the use of a single audit effectiveness criterion--net assessments per dollar of audit costs--in evaluating audit productivity. Specifically, we recommended that each of the state's tax audit systems be designed in order to maximize net assessments per dollar of audit costs.

There are two major factors affecting the productivity of an audit program: (1) the specific accounts which are chosen for scrutiny (audit selection, or allocation of resources to audits) and (2) the means by which those accounts are actually reviewed (audit process).

1. Audit Selection. Selecting audits which, at the margin, are potentially the most productive should be the primary objective of an audit selection system. Marginal productivity considerations should influence both the selection of accounts for audit attention and the allocation of audit resources among the accounts chosen for review.

2. Audit Process. The way in which an insurance tax audit is conducted also affects audit productivity. Moreover, in order to maximize audit productivity, the state must be able to capture information on the results of audits quickly.

A field audit, for example, may yield a more comprehensive verification of tax liability and may result in a larger deficiency assessment than a desk audit. The higher cost of field audits, however, may more than offset the added revenues. In an effective audit system, both desk and field procedures should be clearly defined and appropriate, and both costs and results should be easily measured and reported, so that the information can be used to refine the system over time.

A rigorous evaluation of audit effectiveness should include an analysis of statistics on audit coverage and frequency (who has been audited? how often? by what means?), as well as data on the costs and outcomes of those audit efforts (productivity, as measured by net assessments per amount of audit costs). For the insurance tax, such data are not readily available. Nonetheless, we have attempted to use the information that does exist in order to analyze the effectiveness of the insurance tax's audit program.

DESCRIPTION AND ANALYSIS OF THE TAX AUDIT PROGRAM

The audit program conducted by the Department of Insurance has two main components: (1) a two-step review of tax returns, consisting of a computerized screening of all tax forms filed with the department (EDP review) and a more in-depth manual audit of selected returns (desk audit), and (2) an on-site audit of insurers that seeks to verify the reported premium tax liability and payment (field audit). On-site audits are performed as part of a regular, state-mandated examination of each insurer's financial condition.

The first component--the EDP review and desk audit--is the responsibility of the department's Tax Bureau in Los Angeles. Responsibility for the second component--field audit--lies with the Field Examination Division in San Francisco. The Field Examination Division assigns state examiners to conduct field audits of California insurers and arranges for the examinations of out-of-state insurers. The latter generally are performed through the "zone examination system" operated by the National Association of Insurance Commissioners (NAIC). While California examines its "domestic" insurers on a three-year cycle, the NAIC audits insurers with headquarters outside of the state for tax compliance only when an association examination is called at the request of an NAIC member. California's own examiners may or may not participate in such audits. (These out-of-state insurers are responsible for two-thirds of the insurance written in California.)

Audit Selection

Currently, the department does not use a consistent set of criteria to select an insurer for a tax audit. Instead, it uses different audit selection criteria at different stages of the process.

Desk Audit Selection. Before tax forms are subjected to desk audits, the Tax Bureau processes all returns through an automated review system. Using electronic data processing (EDP) techniques, the bureau screens the returns in order to (1) verify their mathematical accuracy and (2) compare the information reported by the insurer on the tax return with the data contained in the annual report which each insurer must submit to the Insurance Department. This initial review is more complex than the math verification procedures employed by the Board of Equalization and the Franchise Tax Board. The program has been developed to facilitate detection of inconsistencies in various data reported by the insurer so as to discover underpayment of taxes.

The EDP system prints the results of each review, by state and by company, in alphabetical order. The report consists of data, such as ratios and tax histories. The Tax Bureau supervisor then scans the results and decides which returns should be selected for audits. His decisions generally are based on:

(a) The Number of "Red Flags" Showing Up in the EDP Results. An insurer with a large number of inconsistencies and abnormal test ratios (e.g., a major change in the percentage of total insurance written in California) would likely be selected for audit. In addition, insurers with a previous history of deficiency assessments are subject to careful scrutiny.

(b) The Volume of Insurance Written in California. Insurers with a large volume of business in the state usually are targeted for audit.

Typically, the tax supervisor selects 15 to 20 insurers listed on the EDP printouts for immediate manual review. The printouts are then given to the staff examiners, who attempt to determine the reasons for any apparent inconsistencies or abnormal test ratios computed by the EDP system. The examiners then review a portion of the remaining accounts (those not flagged by the tax supervisor), in alphabetical order. Ultimately, the department plans to conduct desk audits of all returns but currently it is not doing so on a timely basis and there is a backlog of several hundred returns awaiting review.

In order to complete a desk audit of every return, the department needs to have in the automated system each insurer's tax return data for the current and three preceding years. The system has now reached that point, as all returns filed since 1980 have been input to the system. When it installed the EDP system, the Tax Bureau had hoped to achieve 100 percent desk audit coverage by 1984. The progress of the audits to date, however, suggests that the bureau will not achieve this goal.

Until the department achieves its goal of 100 percent audit coverage, it will need a system for distinguishing among returns so that it can target its resources on those returns with the greatest audit potential. Our review indicates that it is possible for the department to develop an automated selection system capable of ranking tax returns according to their potential productivity. Such a selection system would compare the information collected and processed by the EDP system with certain specified criteria in order to generate a list of all insurers in suggested audit sequence.

For the last several years (since the initiation of computerized processing), the department has collected data on deficiency assessments. This data could be analyzed in conjunction with various stratifications to yield a profile of productive audits. In fact, the Tax Bureau has provided us with deficiency assessment data that segregates California companies from out-of-state firms. These data include, for each insurer, the reported premium volume and the amount of tax assessed. The data also identify 25 causes for the various deficiency determinations.

Tax Bureau staff agree that it would be feasible to develop profiles of the most productive audits, based on deficiency assessment history, past experience with insurers, and various other factors that indicate potentially productive audits. Companies could be stratified according to such features as premium volume, type of business and tax history, and these features could be linked with the likelihood of detecting, assessing, and collecting additional tax revenue.

Clearly, then, the Tax Bureau has the capability to develop a more sophisticated selection system for its desk audits, a system that potentially could be used to identify companies meriting a field audit as well.

Field Audit Selection. In conducting its audit program, the Department of Insurance places primary emphasis on desk analyses of tax returns, relying on statements filed with the department and its own previous experience with taxpayers. The department attempts to verify the reporting and payment of premium taxes by instructing its auditors in the Field Examination Division to review the basis for an insurer's self-assessment in the course of evaluating the insurer's financial condition.

The California Insurance Code requires the Insurance Commissioner to examine the business and affairs of every entity licensed to sell insurance in the state whenever he deems it necessary. Currently, it is the practice of the Field Examination Division to examine all domestic insurers on a three-year cycle, with firms having potential solvency problems receiving even greater attention. The field examiners evaluate each insurer's (1) solvency, (2) treatment of policyholders, (3) compliance with insurance laws (including proper premium tax payment), and (4) advertising, underwriting and other practices. The examinations are conducted at the expense of the insurer.

The Tax Bureau has little input into the selection of insurers for field examination. Potential tax recovery is not an important criterion for either audit selection or the allocation of auditors. The bureau may bring tax matters uncovered in the course of desk reviews to the attention of examiners once an examination is announced. In addition, the bureau may request that when a company is examined, certain tax issues be investigated. However, the potential for collecting additional taxes, by itself, generally is not considered adequate grounds for conducting field examination.

The process used to select out-of-state companies for association examinations gives even less weight to tax considerations. As noted earlier, these audits take place under NAIC's auspices. In deciding whether to participate in an NAIC audit, the department makes its decision based on the following factors:

1. Staff limitations and its policy of placing first priority on examination of California firms;
2. Potential solvency problems;
3. Volume of business done in California;
4. Unusual events (such as a takeover or merger); and
5. The time elapsed since California's last participation in an audit of that insurer.

Although California insurance examiners assert that tax recovery is an important consideration for field examiners in all states, it clearly is not given significant weight in making audit selections. The solvency of an insurer is--and should be--a far more important consideration than potential tax recoveries in selecting companies for field examinations.

Table 6 shows the number of field examinations completed during the three-year period 1981 through 1983.

Table 6

Number of Financial Condition Examinations
Conducted by the Department of Insurance
1981 Through 1983

	1981	1982	1983
Regular Insurance Lines:			
California Insurers	63	82	79
Out-of-State Insurers (Association)	20	27	28
Total Insurers	83	109	107
Miscellaneous Insurance Lines:			
Underwritten Title, Home Warranty	9	72	21
Surplus Line Brokers	111	99	25
Total, Miscellaneous Lines:	120	171	46
Total Examinations	203	280	153

Table 6 shows that, with respect to the regular insurance lines, the department expends most of its field audit efforts on California insurers. In each of the three years covered by the table, approximately three-fourths of all field examinations involved California companies.

From a tax standpoint, the emphasis on California-based companies may be inappropriate, for two reasons. First, in terms of either the number of companies or the volume of insurance written, out-of-state insurers are a far more significant factor in the California insurance market than domestic insurers. Only 15 percent of the companies that paid insurance taxes in 1982 were domiciled in California. These companies collected 33 percent of the taxable premiums, and thus were assessed approximately one-third of the premium taxes. Second, audits of out-of-state insurers may be more productive. Field examiners report that audits of companies with multistate operations are more likely to yield a tax change than audits of strictly domestic insurers because the most important factor causing tax liabilities to be misreported is an incorrect interpretation of what constitutes taxable premiums in California. It is reasonable to assume that a domestic insurer will be more familiar with California's tax laws than an out-of-state insurer.

More importantly, the location of an insurer's headquarters has little to do with solvency problems. Since California insurers do not appear more prone to solvency problems than those based out-of-state, it is not clear why the department's policy is to examine only these domestic companies on a regular basis.

Audit Process

In evaluating the department's audit process, the central issue is whether desk and field audits, as currently performed, are sufficiently extensive to ensure protection of the state's insurance tax base.

Desk Audit Procedures. In addition to the information set forth in the tax return itself, examiners at the Tax Bureau use information from a variety of other sources in their efforts to confirm the accuracy of an insurer's self-assessment. They refer to annual statements, historical data in insurers' audit files, correspondence, and reports from field examinations performed by state examiners and public accounting firms. For the most part, however, the desk audit process relies on data submitted by the company itself.

Initially, we had serious concerns about how useful it was to compare data from a return with data from an annual report, since both sets of information are provided by the taxpayer and have not been verified in the field. To properly audit sales and use taxes, for example, such verification is essential. In the case of the premium tax, however, our analysis indicates that verification from source documents is less important. Because insurance premiums are based on analyses of risk, location, loss exposure, and other factors, there is little incentive for the insurers to misallocate premiums among the various states in which they do business. Because of the way the insurance business is conducted, it is important for insurers to allocate their premiums correctly.

Currently, Tax Bureau examiners uncover important insurance tax deficiencies through their desk audit procedures without consulting source documents. To really verify the tax base and determine the appropriate allocation of premiums and payment of taxes to California, however, a much greater effort would be required. Examiners claim that not only would they have to check company records in the field, they would have to go back to individual policies and consider the original analysis of the risks. It is unlikely that such an effort would be cost-effective.

Field Audit Procedures. The Field Examination Division examines the financial condition of both admitted insurers and surplus line brokers. In conducting examinations of admitted insurers, field examiners use the NAIC's Financial Condition Examiner's Handbook as a procedural guide. This handbook includes a section on taxes, licenses, and fees which contains instructions for verifying the accuracy of due or accrued state taxes on premiums. These instructions direct examiners to:

1. Verify the premium tax base by reconciling the insurer's reported premium allocation by state with its income statement.

2. Select a sample of states and recompute the taxes due or accrued for those states, referring to state regulations in order to determine taxable premiums and rate of taxation.

3. Compare the ratio of taxes to premiums for prior years with this year's ratio.

The department claims that the tax audit is an integral part of the field investigation. It estimates that 40 percent of the time spent on an examination is devoted to premium verification. According to the department, all NAIC examiners place a high priority on the tax audit, despite the fact that it receives relatively little attention in the handbook.

Because of resource limitations, California examiners cannot participate in all out-of-state exams. Nevertheless, under NAIC guidelines, the state's interest is supposed to be protected by participating examiners from other states. California examiners report that they have identified additional tax revenues due other states, and that out-of-state examiners have found taxes owed to California.

Audit Costs. Table 7 displays what the Department of Insurance estimates to be its expenditures for administration of the insurance tax in the prior and current years.

Table 7

Department of Insurance
Premium Tax Program Costs
(net of reimbursed field audits)

	1983-84 Estimated	1984-85 Projected
Salaries and Wages:		
Audit (LA)	$105,211	$107,300
Collection (SF)	15,625	22,867
Cashiering (SF)	1,388	2,032
Accounting (SF)	349	509
Total, Salaries and Wages	$122,573	$132,708
Operating Expenses and Equipment	14,427	15,292
Total	$137,000	$148,000

Over two-thirds of department's total costs for administering the insurance tax program is attributable to audit activities conducted by the Los Angeles Tax Bureau. The total costs of the desk audit function, including operating expenses and equipment directly related to auditing, are estimated to be $105,211 in 1983-84 and $107,300 for 1984-85.

The data shown in Table 7 include only the cost of desk audits; they do not include costs for field audits of insurers and surplus line brokers.

These costs are fully reimbursed by the companies themselves. The state insurance examiners maintain that, because verification of premiums is an integral part of each field investigation, it is impossible to separate out the costs attributable to the tax audit portion of a financial condition examination. Furthermore, they assert that such a breakdown is unnecessary, since there is no cost to the state for field examinations.

If 40 percent of a field examination involves activities related to premium tax verification, as the Tax Bureau maintains, the costs of these activities amounts to approximately $2.1 million per year, as shown in Table 8. As noted above, these costs are fully reimbursed by the insurers.

Table 8

Field Examination Costs and Reimbursements

	Actual 1982-83	Estimated 1983-84	Estimated 1984-85
Total Costs/ Reimbursements	$3,028,986	$4,930,000	$5,226,000
Estimated Portion Attributable to Tax Audits	1,211,594	1,972,000	2,090,000

Audit Results. The cost-effectiveness of various parts of the Insurance Department's audit program is difficult to determine. Comprehensive records of audit results are not kept by the department, making it difficult to determine the number of audits performed, the deficiency assessments proposed, and the additional taxes ultimately collected as a result of audits. Moreover, neither the department nor the Board of Equalization routinely keeps records specifying whether a deficiency was identified in the course of a desk audit or field examination. Any analysis of deficiency assessment data, therefore, must begin with a manual appraisal of assessment proposals or notices in the agencies' files for each company that received a deficiency assessment.

Both agencies performed manual reviews of their records in response to our questions about audit results, and provided information about the sources of deficiency assessments. The agencies, however, could only supply data on the number of audits which led to deficiency assessments; they were not able to provide data showing what proportion of all audits performed resulted in deficiency assessments. As a result, it is impossible to evaluate the overall productivity of different types of audits.

Table 9 displays the audit data supplied by the Board of Equalization. It shows that most deficiency assessments for insurance taxes result from desk audits.

Table 9

Sources of Deficiency Assessments

Audit	1980-81 No.	1980-81 Amount	1980-81 Percent	1981-82 No.	1981-82 Amount	1981-82 Percent	1982-83 No.	1982-83 Amount	1982-83 Percent
Desk	46	$1,157,876	85.9%	64	$1,876,569	100.0%	57	$928,606	99.6%
Field	2	190,183	14.1	--	--	--	1	3,766	.4
Total	48	$1,348,059	100.0%	64	$1,876,569	100.0%	58	$932,372	100.0%

Source: Board of Equalization.

Citing the paucity of deficiency assessments arising from on-site examinations, the board has claimed that the department's field audit effort is inadequate. The board contends that the current emphasis on desk audits of insurance tax returns is inappropriate and that field investigations should be more vigorously pursued.

In support of its contention, the board points out that 90 percent of the tax deficiencies uncovered under its sales tax audit program are identified through field audits. Accordingly, the board concentrates its sales and use tax audit effort in its field examinations program.

The fact that the Department of Insurance emphasizes desk audits while the Board of Equalization stresses field audits does not mean that one approach is "better" than the other. There is a sizeable difference between the board's desk review, which simply looks at the mathematical accuracy of the figures on the return itself, and the department's desk audit, which compares information on the return with data from other sources. Nor are the field audit programs conducted by the two agencies comparable. Sales tax auditors do not review the financial position of the retail operations they visit in the field. Instead, they look exclusively for tax deficiencies, which usually result from understated taxable sales volumes. Caution should be used, therefore, in comparing the agencies' audit results and drawing conclusions about the relative productivity or potential productivity of what are very different audit approaches.

On the whole, we find that the data on deficiency assessments reported by the two agencies are not very meaningful in terms of permitting conclusions to be drawn about audit effectiveness. One of the reasons for this is that reported deficiency assessment figures do not always mean what they appear to mean, particularly with respect to the assessment of retaliatory taxes. Records kept by both the board and department show that, over the last few years, retaliatory taxes have accounted for a large portion of the "deficiency" assessments issued and reported. Most of those assessments, however, reflect late assessments rather than actual deficiencies. These assessments are issued by the board late in one year--after the cutoff date for reporting fiscal year data--and reported as deficiencies in the following year.

New York companies have accounted for most of these "deficiencies." Because of New York's extremely complicated insurance taxation system, companies domiciled in that state are unable to provide the California Insurance Department with complete retaliatory tax information until late fall, by which time it is too late to issue and report a regular retaliatory tax assessment. Consequently, these amounts are recorded as deficiency assessments in the following calendar year and include penalties for late filing.

These late assessments distort deficiency assessment figures. Since they are not issued as a result of audits, these late assessments must be backed out of the data before an evaluation of audit effectiveness can be made. Table 10 illustrates the magnitude of the problem caused by treating late assessments as deficiency assessments. During the last three years, late retaliatory tax assessments have accounted for nearly 40 percent of deficiencies assessed against out-of-state companies.

Table 10

Deficiency Assessments on
Out-of-State Insurers
1979-80 through 1982-83

	No.	Percent	Amount	Percent
Premium Taxes	130	61.6%	$3,801,845	61.0%
Retaliatory Taxes:				
-- Late assessments	63	29.9	2,262,353	36.3
-- Actual deficiencies	18	8.5	165,212	2.7
Total	211	100.0%	$6,229,410	100.0%

Source: Board of Equalization.

If these late assessments are removed from the total, out-of-state deficiency assessments drop dramatically. This is illustrated in Table 11.

Table 11

Comparison of Nominal and Actual
Insurance Tax Deficiency Assessments

	Initial Assessments[a]		Nominal Deficiency Assessments Issued[b]		Actual Deficiency Assessments[c]	
	Amount	Percent	Amount	Percent	Amount	Percent
1981-82 Premium Taxes (on 1981 Business):						
-- California	$159,835,286	33.8%	$316,690	16.9%	$316,690	31.8%
-- Other states & countries	309,708,76	65.5	659,093	35.1	659,093	66.1
Retaliatory taxes	3,204,583	0.7	900,786	48.0	20,615	2.1
Total, 1981-82	$472,748,629	100.0%	$1,876,569	100.0%	$996,398	100.0%
1982-83 Premium Taxes (on 1982 Business):						
-- California			$124,498	13.4%	$124,498	15.5%
-- Other states & countries			559,364	60.0	559,093	69.7
Retaliatory taxes			248,510	26.6	119,067	14.8
Total, 1982-83			$932,372	100.0%	$802,658	100.0%

a. Source: Department of Insurance.
b. Source: Board of Equalization.
c. Board figures less retaliatory tax adjustments due to late filings.

The board acknowledges the discrepancy between what it reports as deficiency assessments and the assessments that actually result from audits. The board has indicated that it plans to revise its reporting system to eliminate much of this distortion.

Deficiency assessments issued and reported in a given year, moreover, generally do not reflect net assessments. This is because deficiency assessments frequently are offset by refunds and cancellations, usually from previous years. Table 12 presents data supplied by the Board of Equalization which illustrate how assessment figures may be adjusted and how all of the numbers have varied tremendously from year to year.

Table 12

Net Adjustments to Insurance Tax Assessments

	1980	1981	1982
Deficiency Assessments	$1,691,753[a]	$2,017,023[b]	$1,174,427[c]
Refunds and Cancellations	209,965	1,835,339	1,305,217[d]
Net Assessments	$1,481,788	$181,684	-$130,790

Source: Board of Equalization

a. Includes 49 assessments for penalties and interest made by Controller in the amount of $343,694.
b. Includes 53 assessments for penalties and interest made by Controller in the amount of $140,454.
c. Includes 61 assessments for penalties and interest made by Controller in the amount of $243,055.
d. Court-ordered refunds of $31.3 million in 1976 taxes is considered extraordinary and is therefore excluded.

The use of deficiency assessment statistics to evaluate the effectiveness of the audit program is of dubious value for yet another reason. It is not clear whether the amount of deficiency assessments proposed, the amount issued, or the amount collected during a given fiscal year should be used to judge the effectiveness of the program and, in particular, the productivity of audit efforts. There is a great deal of difference among these three alternative measures of deficiency assessments, as shown in Table 13.

Table 13

Insurance Tax Deficiency Assessments for a Sample of 29 Insurers
July 1, 1980 - June 30, 1982

Proposed by Department of Insurance	$917,337
Issued by Board of Equalization	982,432
Collected by Controller	281,493

Most of the difference between the amounts proposed and the amounts issued can be attributed to interest charges which are assessed by the board on the date it issues a notice of deficiency. The dramatic difference between assessments and collections, on the other hand, is due largely to amounts in dispute. (Disputed assessments are also a factor in the board's adjusted assessment figures.) In the department's sample, six companies--including the three receiving the largest assessments--chose not to pay and instead filed petitions for redetermination.

Table 14 presents the standard measures used to evaluate tax audit programs, based on the information available on the insurance tax program. Because of the problems discussed above, however, interpretation of the data must be done cautiously. Measures of audit productivity, such as net assessments per dollar of cost, are difficult to establish and probably not very meaningful. The meaning of year-to-year differences in the level of assessments issued is difficult to establish because of the differences in timing and definitions that we have discussed earlier. Audit costs are not easy to isolate, especially the cost of field audits, which are only partially tax-related. In addition, as noted above, the Department of Insurance asserts that field examination costs should not be treated as part of insurance tax audit costs because they are fully reimbursed by insurers.

Since we cannot establish with any certainty the cost-effectiveness of the current tax audit effort, it is not possible for us to predict the cost-effectiveness of any alternative audit program.

It is important to keep in mind that Table 14 reflects productivity only in terms of desk audit costs, even though a small portion of the deficiency assessments reflected in the table resulted from field examinations. If the estimated costs of field audits ($1.2 million in 1981-82) were included, the total cost of the department's audit program would exceed the amount recovered.

Table 14

Audit Productivity

	1980-81	1981-82	1982-83
Deficiency Assessments Issued[a]	$1,348,059	$1,876,569	$932,372
Less: Retaliatory Tax Adjustments	557,588	880,171	129,714
Actual Deficiency Assessments	$790,471	$996,398	$802,658
Cancellations Resulting from Petitions for Redeterminations	28,128	117,497	$833,839
Net Deficiency Assessments	$762,343	$878,901	-31,181
Estimated Audit Costs	$81,900[b]	$100,075[c]	$82,601[c]
Deficiencies Per Dollar Cost	$9.31	$8.78	--

a. Board of Equalization.
b. Legislative Analyst's office estimate.
c. Department of Insurance, desk audits only.

CHAPTER IV

ALTERNATIVES AND RECOMMENDATIONS

As discussed in the preceding chapters of this report, the current system--actually systems--used to administer the insurance tax are deficient in four separate ways. First, the Department of Insurance's operations are unnecessarily fragmented, since these operations are spread among the department's offices in three cities. Second, the development of tax policy is handled in an incomplete and inconsistent fashion. Third, the exchange of information among the three agencies is inadequate. Fourth, the responsibility for billing taxpayers for taxes due is fragmented among the agencies.

There is a range of approaches that the Legislature could take to improve the administration of the insurance tax, some of which are more dramatic than others. For simplicity, we can group these approaches into the following three categories:

1. Consolidate the administration of the insurance tax under one agency. One option for doing this (the option which led to this study) would be to transfer all administrative functions associated with the tax program, including the audit function, to the Board of Equalization. This would require major revisions to both the Revenue and Taxation and the Insurance codes. Alternatively, consolidation of these functions could be consolidated under the Department of Insurance, thereby eliminating the Board of Equalization's statutory and constitutional assessment

responsibilities. Appendix I contains a detailed description and analysis of the first of these two alternatives, which has been proposed by the Board of Equalization.

2. Modify the administration of the insurance tax program, without changing the basic legal framework within which the program now operates. For example, the Legislature could transfer responsibility for the accounting functions associated with the program from the Controller to the Department of Insurance or the Board of Equalization.

3. Retain the present arrangement of tripartite administration, but make procedural changes in both the administrative system and the audit program.

ANALYSIS OF THE ALTERNATIVES

At first glance, the argument for consolidating under one agency the administrative functions associated with the insurance tax seems compelling: one agency should be able to administer a tax program more economically than three can. In addition, it might seem that one agency could bring in more revenues through an audit program than could several agencies working independently. Finally, there is an appealing rationality to the idea that revenue collection should be separated from the regulation of an industry, because such a separation would eliminate the problem of reconciling the objectives of regulation and revenue collection.

Our analysis indicates that the case for consolidation under one agency, however, is not necessarily as strong as it would first appear.

Such a consolidation would, unavoidably, alter established systems for administering this important tax program. Major changes of this type, however, are risky. Changing established systems is necessarily costly, in both financial and human terms. Major revisions in existing law and systems would generate significant up-front costs, and this fact leads us to the key question: would the change generate sufficient additional revenues to more than offset these costs?

While it is possible that consolidation could increase revenues sufficiently to offset these costs, there is no hard evidence that this alternative offers a higher potential for increased revenue collections than does any other alternative. In fact, reducing the scope of desk audits (as the board proposes) might decrease deficiency assessment revenues by more than the increase produced by more intensive field audits.

It is for this reason that we believe the Legislature should not adopt the consolidation alternative at this time. Instead, we conclude that the Legislature should act to improve the administration of the insurance tax without dismantling and restructuring the present system.

RECOMMENDATIONS

Based on our review of the insurance tax program, we conclude that a number of changes in the program are warranted. These changes, which are discussed below, would improve both the administrative efficiency and the audit effectiveness of the insurance tax program.

Administrative Efficiency

In order to improve the efficiency with which the insurance tax is administered:

1. We recommend that the Legislature eliminate the State Controller's collection and accounting responsibilities under the program. This would reduce the fragmentation of responsibility that now exists by essentially reducing the number of agencies actively involved in program administrations from three to two. The Insurance Department is best equipped to take over these functions because (a) it already receives the bulk of insurance tax revenues and proposes most additional assessments, and (b) it currently keeps extensive tax files, by insurer, and appears to have the greater ability to maintain individual accounts. Further, this consolidation would enhance the department's ability to conduct the sorts of planning and analysis necessary to implement other improvements in the system.

If this recommendation were adopted, the Controller's office would continue to keep track of total insurance tax revenues reported by the department, as it does in the case of tax revenues collected by other agencies with state government.

2. We recommend that the Legislature direct the Department of Insurance to consolidate its operations so as to reduce the geographic fragmentation that now exists. The tax activities of the department logically can and should be consolidated under the Tax Bureau in Los Angeles. The collection and cashiering activities currently located in San Francisco should be transferred to Los Angeles and combined with the other administrative functions now carried out by the Los Angeles office. This would facilitate effective administration of the insurance tax program by reducing the coordination problems that now arise within the department.

3. <u>We recommend that the Legislature shift to the Department of Insurance the responsibility for billing insurers for deficiencies and delinquencies</u>. In our judgment it makes no sense for the Controller to bill insurers for penalties and interest while the board bills for additional tax. This change would further streamline the administrative system.

<u>Audit Effectiveness</u>

In order to enhance the effectiveness of the insurance tax's audit program:

1. <u>We recommend that the Legislature leave responsibility for insurance tax audits with the Department of Insurance</u>. Our analysis concludes that this responsibility should not be transferred to the Board of Equalization, for the following reasons:

- We can find no evidence to substantiate the board's claim that it could generate a higher level of deficiencies, per dollar of cost, than the department is now producing.
- If a change in audit responsibility were made at this time, promising innovations recently made in the audit program--most notably, the department's EDP system--would be lost.
- The information needed to conduct effective audits (such as annual statements) would not be as accessible to the board as it is to the department.
- Were the board to conduct field audits of insurers it would result in some duplication of effort, since the department would

still have to conduct field review of insurers to ascertain their financial soundness.

- There is no evidence that the department regards its responsibility to identify under-reported taxes any less seriously than its responsibility to ensure the financial solvency of the insurance companies.

2. We recommend that the Legislature direct the Department of Insurance to:

- Develop a system for ranking insurers according to their desk audit potential. The Department of Insurance can and should compile audit histories and build an information base capable of supporting a better audit selection process. In addition, the Tax Bureau should develop a profile of productive accounts, and use the results of its EDP screening to determine priorities for manual audits--with respect to both the order in which they are performed and the amount of time spent on each one.
- Shift audit resources from examination of California companies to the examination of out-of-state insurers (under the NAIC's auspices). The department's emphasis on regular examination of California insurers is excessive, given that two-thirds of the insurance policies now in effect within California were written by out-of-state companies. Greater participation by state examiners in association audits would provide better protection for both California policyholders and the California tax base.

- Improve the system used to track deficiency assessments, adjustments of tax, penalties, and interest so as to provide a better basis for improving the effectiveness of the audit selection system.

APPENDIX

ANALYSIS OF BOARD OF EQUALIZATION'S PROPOSAL THAT RESPONSIBILITY FOR INSURANCE TAX AUDITS BE TRANSFERRED FROM THE DEPARTMENT OF INSURANCE TO THE BOARD

The Board of Equalization maintains that the audit program administered by the Department of Insurance is inadequate. The board contends that insurance tax revenues could be increased significantly if it had the authority to conduct insurance tax audits.

In support of its position, the board cites its tax orientation and its superior audit resources. The latter include (1) trained tax auditors and field offices across the country and (2) a comprehensive audit program with established procedures, manuals, and control systems. Board officials maintain that they could improve the effectiveness of the insurance tax audit program by improving both the process used to select returns for audit and the procedures followed in conducting audits.

THE BOE'S PROPOSED AUDIT SYSTEM

Selection. The board asserts that the Department of Insurance does not place enough emphasis on field audits and fails to select returns for field audits on the basis of tax potential. If responsibility for insurance tax audits were shifted to the board, the board indicates that it would conduct these audits using a system modeled after the one used to select accounts for audit under the sales and use tax program. This system is based on classification of accounts and audit history.

Specifically, the board promises to build a vigorous field audit program and to develop comprehensive audit histories tracking tax assessments and costs, which would be used to predict potential audit productivity. The proposed selection system would segregate insurance companies into categories according to types of account (life, fire, title) and types of audits (routine, special, related), and group them by audit criteria including volume of business, annual tax liability, complexity of audit verification, and audit history.

The board acknowledges that, without adequate audit history data, it initially would have to select companies based on criteria developed for other taxes administered by the board. The board's experience with retail store tax audits suggests that audit efforts should be focused on (1) companies with high sales (premium) volume and (2) companies headquartered out of the State of California.

Procedures. The Board of Equalization's proposed program provides for both desk and field audits, as does the current Department of Insurance's system. The desk audit component, however, would not be an "audit," but simply a check for mathematical accuracy. Comparisons with annual report information and other data would come later, in the field.

The board has provided a fairly detailed description of the design and management of the field audit program, covering control of audit assignments, audit verification procedures, discussion of results, and preparation of reports. The board also has described what the role of headquarters and district offices would be in audit management, and sketched the system it would use to process petitions for redetermination and claims for refund.

The board would undertake a vigorous audit program in the field, and asserts it could increase tax collections as a result. It bases this assertion on its experience in auditing compliance with other tax laws. Specifically, the board cites its success in identifying deficiencies through field audits as an indication of what could be expected were it given responsibility for the insurance tax audit program.

It is true that the board's field audits have yielded considerably more revenue than its desk audits, as Table 15 illustrates. Nevertheless, we believe that the board's experience under the sales and use tax program cannot be taken as an indicator of potential collections if it were given responsibility for auditing insurance tax returns.

Table 15

Sales Tax Deficiency Assessments
Issued by the Board of Equalization
(dollars in thousands)

	1981-82			1982-83		
	Number	Amount	Percent	Number	Amount	Percent
Field Audits	16,922	$184,095	97.4%	16,216	$215,425	96.5%
Return Review (Desk "Audit")	18,920	4,878	2.6	38,806	7,853	3.5

First, since the board places so much emphasis on field audit activities, it is not surprising that most of its deficiency assessments show up here. (Similarly, it would not be fair to criticize the board for failing to match the Department of Insurance's success in identifying deficiencies through desk audits--for the same reason.)

Secondly, sales tax audit results may not be indicative of audit potential in the insurance tax program because the taxes, taxpayers and audit issues are entirely different. The audit of a small retail operation, for example, differs markedly from the examination of a major--or even minor--insurance company.

Finally, the terms "desk" and "field" audit mean very different things to the two agencies. Consequently, the board's comparison clearly involves "apples and oranges."

In addition, we have two major concerns regarding the board's proposal. These concerns involve (1) coverage and potential foregone deficiency assessments and (2) the costs of implementing the plan.

Coverage. The board states that auditing for California premium taxes would require far less time than conducting a full examination of an insurer's financial condition. In conversations with our office, staff from the board's Excise Tax Unit initially indicated that their assumptions regarding staffing were as follows: Three auditors would be assigned to the insurance tax, and each auditor would spend 40 hours per audit. On this basis, each auditor could perform 50 audits per year. At this rate, 150 audits would be completed annually, covering about 10 percent of the insurers licensed to do business in California.

Cost figures provided to us by the board at a later date were based on different coverage assumptions. Specifically, board staff assumed that two auditors would perform approximately 70 audits annually, each about 40 hours long. The board states that it based the projected workload on the department's field examination activity in past years. (Our analysis shows, however, that the department actually has performed from 80 to 109 field audits annually since 1980.)

According to the Department of Insurance, the assumptions underlying both scenarios are unrealistic, and the coverage (both in number and scope of audits) would be inadequate in either case. The department agrees that on-site tax audits would be less extensive than the field examinations it now conducts. But it questions whether the premium verification could be performed in 40 hours. Insurance examiners point out that it often takes more than a week for insurance examiners just to receive information requested from a company. On the other hand, insurance specialists from the IRS have stated that, based on their experience, an audit performed strictly for California premium taxes could probably be accomplished for some companies with a 40-hour site visit.

The department points to the difficulties it has encountered in attaining adequate coverage through manual desk audits, and fears that a field audit system along the lines proposed by the board could result in a large backlog of unaudited tax returns. Even assuming that 40 percent coverage in the field could be achieved over a four-year period, the majority of insurers' returns would remain unaudited. Without a desk audit, many returns containing deficiencies would go undetected and the additional tax revenue would be foregone.

Costs. The board has prepared an estimate of the costs it would incur to take over administration of the insurance tax program, including the audit function. Table 17 lists the board's estimated costs for both one-time and continuing workload. The projected cost for a completely board-administered program--$197,000--is substantially lower than the sum of the costs now incurred by the three agencies that share program responsibilities under the existing system ($305,000). (We have not included any of the costs resulting from DOI field audits in either amount, because DOI examiners would have to continue performing field audits according to NAIC guidelines, regardless of whether the proposed tax administration changes were adopted.)

Table 16

Board of Equalization
Insurance Tax Administration Proposal
Summary of Costs

	One-Time Costs	Annual Ongoing Costs
Legal Services	--	$20,640
Registration of Insurers	$429	--
Return Processing (Includes Math Verification)	--	29,292
Auditing (Four Tax Auditors)	--	120,024
Total, Personal Services	$429	$169,956
Staff Benefits	133	52,686
Equipment	25,000	--
Programming	35,000	--
Operating Expense	700	18,300
Total	$61,262	$240,942
Projected 1983-84 Cost for Current Board Program		$95,000
Total Estimated Annual Cost for a Board-Administered Insurance Tax Program		$335,942

Given the scope of its proposal, we believe the board's estimate is too low, especially the estimate of one-time costs associated with transferring responsibility for return processing and information systems.

In addition, while we would expect some savings to result from consolidation, we question whether those savings can be realized immediately. The board has not indicated that it has any plans to draw on the experience of the Department of Insurance, which has been administering the bulk of the program for many years. This is because the board's general position is that the department's orientation is toward regulation, that it has not been properly administering the tax, and that it has not been conducting an adequate audit program. Therefore, the board proposes to reform the program on its own terms.

Conversations with board personnel indicate, however, that they are not familiar with the way the department performs many of the functions the revenue agency proposes to take over. Apparently, the board has a limited understanding of the department's current system--how tax forms have been revised and expanded over the years, what type of legal and practical information is provided to taxpayers, what is contained in the automated system developed for return review, and how audits are conducted, coordinated, and recorded by the Tax Bureau. As a result, there would be some initial reduction in productivity, as the new staff learns about the industry and refines its proposed collection assessment and audit program.

We are especially skeptical of the cost estimate provided for the board's proposed "vigorous" field audit program. The board intends to conduct its 70 annual comprehensive field investigations for $55,000 (two examiners), which is 42 percent less than the amount the department spends for its approximately 200 annual desk audits. It is questionable whether the board could accomplish what it proposes to accomplish at this level of funding. Not only does the personnel estimate seem low, but the $55,000 makes no allowance for any travel or per diem expense in support of these auditors while they are in the field.

Audit Results. There is no way to determine how effective the board's proposed audit program would be in generating additional tax revenues. The board claims it could bring in substantially more taxes; the department asserts that maximum amounts are already being collected from insurers. Neither assertion is based on sophisticated analysis; instead, they are based on personal perspectives and "25 years of experience." The Controller has taken a neutral stance on audit authority, stating that although the board's frustration at having to assess the tax (especially deficiencies) without verification authority is understandable, there is no evidence that the insurance department is doing a poor job.

ISSUES RAISED BY THE BOARD'S PROPOSAL

The BOE's proposal raises several fundamental organizational questions about audit responsibilities which have helped put the audit function at the center of the controversy over the current system used to administer the insurance tax program. These questions involve:

- Duplication of effort among the three agencies,
- Conflicts between the objectives of regulation and taxation of the insurance industry, and
- The extent to which a lack of tax experience or insurance expertise is a handicap in the performance of insurance tax audits.

Duplication. The Department of Insurance believes that giving audit responsibility to another agency would not be cost-effective because much of its current efforts would then be duplicated. Regardless of which agency has the authority to conduct insurance tax audits, state insurance examiners would continue to perform field examinations and verify premium allocation and tax liabilities. The intrusion of another set of state auditors might be considered harassment by some insurers. In addition, field audits performed solely for tax purposes would not be reimbursable.

The board claims that a focus on the tax recovery in an audit would involve much less effort than a full-blown financial condition examination and would not require reimbursement.

At the core of this issue is the definition of what constitutes an appropriate, vigorous tax audit. The department focuses on desk review while the board feels field examination is more important. As we have noted, there is, unfortunately, no analytical basis upon which to evaluate which of the two approaches is "better."

Regulation versus Taxation. There is a controversy among tax administrators and insurance commissioners across the country over whether insurance tax programs should be administered by a tax or insurance agency. Revenue departments, such as the Board of Equalization, feel that insurance commissioners tend to protect, rather than tax, insurers, and that there is an inherent conflict if the agency regulating an industry (in this case looking out for the solvency of insurers in the state) also must collect taxes from members of the industry. If the main concern is the regulation of companies for the sake of policyholders, it is conceivable that tax considerations will receive less priority and that examiners will look the other way when a company's solvency is threatened.

There is, however, no evidence that California's insurance examiners have failed to collect insurance taxes when an insurer's solvency is in jeopardy. The field examination division asserts that there is no minimum level of materiality when it comes to taxes, that all tax problems are pursued by California examiners and out-of-state examiners alike. In response to the charge of conflict of interest, the department's Tax Bureau asserts that, in fact, it has been tougher on taxpayers than the board has been in cases of deficiencies, deadlines, and other tax matters.

Expertise. Auditing for the insurance tax obviously demands an understanding of both insurance companies and taxation. It is not clear, however, which type of expertise is more important for an effective audit--a familiarity with tax codes and experience in auditing for a variety of taxes, or an understanding of the insurance industry, its rates, claims and losses, and the statutory accounting principles upon which it operates. Not surprisingly, tax auditors claim the former perspective is more essential, while insurance examiners contend the latter skills and experience are critical.