FOR CALENDAR YEAR 2002
TAX DUE DATE APRIL 1, 2003

ATTACHMENT "B"

BACKGROUND AND PROCEDURE FOR REPORTING TAXABLE ANNUITY CONSIDERATIONS

BACKGROUND INFORMATION:

TAXABLE ANNUITY CONSIDERATIONS – Immediate vs. Deferred Annuities

IMMEDIATE ANNUITY: Funds accepted from policyholders should be reported once the annuity is purchased and benefit payments begin.

DEFFERED ANNUITY: Premiums are paid for the purchase of a deferred annuity during the accumulation period and ends when the policyholder begins to receive benefit payments. At this time, Total Annuity Considerations include both amount paid by the policyholder and the interest credited are to be reported as a tax liability for premium tax on the "back-end" basis. For "front-end" reporting, premiums are reported at the time premiums are paid for the purchase of a deferred annuity (the accumulation period). The Company may elect to remit premium tax on the "front-end" or "back-end" basis. The election change to remit premium tax on the "back-end or front-end" basis requires prior approval by the Department of Insurance.

Revenue and Taxation Code Section 12222 provides that an insurer reporting tax on a 'back-end' basis for annuity policies must report both the amount originally paid for the policy and the interest credited to the account accumulated over the years before the policy annuitized. Any amounts such as charges and/or fees collected by the Company and deducted from the policyholder's account should be added back to or reversed from the policyholder's account at the time of annuitization to account for the actual tax liability.

HYPHOTHETICAL SITUATIONS:

A. *Annuity policies on a "front-end" basis*:

Insurance Company A sells an annuity policy for $100,000 which will commence on a certain date in the future and will pay a certain amount per month for certain period. It applies the accumulated funds to the purchase of an annuity five years later. In that period, it credited $50,000 in interest to the account and made $15,000 in charges. It applies $135,000 to the purchase of the annuity.

Insurance Company B sells an annuity policy with identical terms, also for $100,000. During the five years it accumulates the funds, it credited $40,000 in interest to the account and made $5,000 in charges, applying $135,000 to the purchase of the annuity.

The fact the Company B credited less interest to its insured than did Company A, and the fact that Company B made a lower charge against the insured's funds than did Company A, does not change the fact that each company received the identical amount of premiums. Since both companies are on a front-end basis, they are required to pay tax with the return for the year in which the premium was received measured by the amount of that premium ($100,000), each company owed the identical amount of tax with respect to each respective annuity policy. The differences in earnings and charges are irrelevant.

B. *Annuity policies on a "back-end" basis*:

Insurance Company A sells an annuity policy for $100,000 which will commence on a certain date in the future and will pay a certain amount per month for a certain period. It applies the accumulated funds to the purchase of an annuity five years later. In that period, it credited $50,000 in interest to the account, and made $15,000 in charges. It applies $135,000 to the purchase of the annuity (the ending balance of the account value). **The company's tax base is $150,000.**

Insurance Company B sells an annuity policy with identical terms, also for $100,000. During the five years it accumulates the funds, it credited $40,000 in interest to the account, and made $5,000 in charges, applying $135,000 to the purchase of annuity. **The company's tax base is $140,000.**

Since these insurers are on a "back-end" basis, they owe no tax with respect to these policies for the year in which they received the premiums. Rather, they must report and pay the applicable tax with their returns for the fifth year after the commencement of the policy, which is when they applied the funds to the purchase of the annuities. The application of funds to the purchase of the annuities is relevant only to the due date of the tax, so the $135,000 each insurer paid for the annuity is not relevant to the tax it owes. As was the case of the insurers in the "front-end" hypothetical, each of these insurers had initial taxable gross premiums of $100,000. However, since these two insurers elected to pay the tax on a deferred "back-end" basis, they must each include in their respective measures of tax the amount of interest credited to their insureds' accounts. Since Company A credited $50,000 to its insured, it owes tax measured by $150,000. Since Company B credited $40,000 to its insured, it owes tax measured by $140,000.

DEFERRED ANNUITY (Group and/or Individual Policy)-
SUPPORTING DOCUMENTS REQUIRED FROM "BACK-END" ANNUITIZATIONS:

Various documents presented by a number of companies' system generated runs/reports for Annuitization Information include details by State, Policy Number, Effective Year, Gross Annuitization, Surrender Charge, Fees Charge, Interest Credited, Accumulation Value, and Qualified/Non-Qualified, etc. So far this information is sufficient to support the reported amounts in Schedule T Column 4 and deposit-type funds including "back-end" annuity considerations not yet annuitized in Schedule T, Column 6. One Company explained that its IT department extracts the annuitization information from the Company's policy administration system and converts the information from text files into excel files. This administration system is used by the Company for all policyholder information. From the random sampling of policies during our audit, the Company should provide us the detail annuitization amount including premiums paid to purchase the annuity, interest credited, surrenders, fees/charges and any other transactions that goes into and out of this policy since the information is extracted from the policy administration system.

Policyholders deserve to know how their account value was derived at the time of annuitization. This same information is needed for us to review when we sample a number of policies that annuitized. The company needs to provide us the individual policy file including a summary of itemized statement with deposits, credits, and debits (charges/fees) to arrive at the ending account value as of the date of annuitization.

For group annuity policies, the Company should have individual policyholder's deposits and the interests credited to these individual policies. Although at the time some of these individuals annuitized, their account value should not only be what should be reported as taxable annuity premiums because fees and/or charges have been collected and withdrawn from these policyholders' accounts over the accumulation years. Thus, other "out of pocket" fees paid separately in addition to premiums paid by each of these individuals plus the interest accumulated up-to-date of annuitization should be the ultimate basis on the amount of annuity considerations subject to premium tax.

FOR CALENDAR YEAR 2002
TAX DUE DATE APRIL 1, 2003

FUNDS RETURNED PRIOR TO ANNUITIZATION DATE: This applies only to deferred annuities when premium taxes are paid on the "front-end" basis. Payments made by the policyholders and reported by the Company as taxable annuity premiums can only be included as returned premiums. For example, if a policyholder purchases a ten-year period policy and pays $1,000 each year, after the fifth year decides to surrender the policy, the amount to be reported as returned premiums should only be $5,000, which is the actual premiums paid by the policyholder during the five year period prior to annuitization.

In any case, if the Company can not provide proper supporting documentation with sufficient information considering the example below to justify what was reported on the premium tax return, the amount reported as funds deposited for annuities will be considered as Taxable Annuity Considerations.

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Example:

Issue State	Policy No.	SPDA Date	Accumulation Value	Date of Annuitization (Paid-For Date)	Q/NQ Indicator
CA	A11111	11/11/88	$ $$$,$$$	XX/XX/200X	N

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Note: *Procedure for documentation and reporting is proposed based on the Revenue and Taxation Code Section 13170.*