

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Petition for Redetermination
Under the Insurance Tax Law of:

ReliaStar Insurance Company
IT ET 34-000267-010
89000895720

Appearances:

For Petitioner:	Mr. Andrew G. Loeb, Attorney Ms. Lori Nuebel, Attorney
For Department of Insurance:	Mr. David K. Okumura, Sr. Insurance Examiner Mr. Robert Palumbo, Supervising Insurance Examiner Ms. Jenny Chuang Mr. John M. Fogg Mr. Tony Sangwand
For Special Taxes Department:	Mr. David Levine, Acting Assistant Chief Counsel Mr. William Kimsey, Supervising Tax Auditor II
For Appeals Section:	Ms. Susan M. Wengel, Senior Tax Counsel

MEMORANDUM OPINION

This opinion considers the merits of the petition for redetermination under the Insurance Tax Law for the years 1992, 1993 and 1994. Following the issuance of the Notice of Deficiency Assessment for all three years, petitioner paid the proposed assessment at the same time as it filed the petition for redetermination. Therefore, this matter will be treated as a claim for refund under Revenue and Taxation Code section 12978.

Petitioner is an insurance company which is subject to tax in this state based on “the amount of gross premiums, less return premiums, received in such year by such insurer upon its business done in this State.” (Rev. & Tax. Code, §12221.) In 1996, following a desk audit by the Department of Insurance (DOI), petitioner received a letter from DOI questioning the reporting of certain items for 1992, 1993 and 1994. Petitioner surmised that DOI believed additional tax was due on amounts reported as investment management administration fees and surrender charges on annuity and variable life insurance products. Petitioners calculated the additional tax that would be due if these items were included in its taxable measure, and remitted the additional tax amount

indicated. DOI accepted petitioner's calculations and directed the Board of Equalization to issue a determination for the amount remitted plus interest. Petitioner paid the balance and filed a petition for redetermination and a claim for refund.

This matter was heard by the Board on February 3, 2000, in Culver City. Three issues were presented for the Board's consideration:

- (1) Whether administrative management fees or surrender fees charged against the contract value of a variable life insurance policy constitute gross premiums subject to tax.
- (2) Whether administrative management or surrender fees charged against a premium deposit for a variable annuity contract constitute gross premiums subject to tax.
- (3) Whether the claim for refund may be increased if it is asserted more than four years after April 1 of the year following the year for which tax was allegedly overpaid.

ISSUE NO. 1
Variable Life Policy Charges

A "variable life" insurance product is one in which the cash surrender value (or "contract value") and the death benefit may vary, depending upon the performance of certain investment options. In the typical case, an insurance company receives the premium payments and establishes a separate account for the policyholder. The funds are invested as the policyholder directs, among a range of investment alternatives offered. The policyholder's eventual benefit, either upon surrender of the policy or at death, is dependent upon the performance of the investment alternatives selected.

The insurance contract generally provides that the "contract value" will be charged for certain management fees. For illustration, assume the initial premium was \$100, and there was no "front-end load." The policyholder directed a fixed income alternative yielding 7 percent. The management fee charged by the insurance company was 1 percent. At the end of a year, the policyholder's contract value would be \$106, representing the initial premium, plus \$7 in interest income, less \$1 in management fees.

Variable life insurance contracts also typically contain surrender fees, if the policyholder surrenders the policy before a certain length of time. These fees are usually on a declining scale. An example might be 50 percent if the policy is surrendered in the first year, 40 percent if surrendered in the second year, down to no surrender charge if the policy is held more than five years. A policyholder canceling a policy during the surrender charge period would receive the contract value, minus the surrender charge.

The question here is whether the management fees and surrender charges constitute additional “gross premiums” for purposes of the insurance tax.

The DOI regarded the charges made by petitioner (management fees) against accumulating funds as taxable gross premiums. DOI also considered surrender charges taxable as gross premiums. The position of DOI is that the charge is the administrative cost of terminating the policy and that, although usually deducted from the cash value of the policy prior to refunding the balance, it could be billed to the policyholder if the insurance company failed to deduct the surrender charge prior to the refund.

We conclude that neither the management fees nor surrender charges constitute additional “gross premiums” for purpose of the insurance tax.

Petitioner reported and paid gross premiums tax on the entire amount it received from its policyholders in connection with variable life policies. The management fees and surrender charges do not affect the amount of premium received. Rather they simply impact the amount of the benefit the policyholder or beneficiary will eventually receive. (See *Equitable Life Assur. Society v. Johnson* (1942) 53 Cal.App.2d 49.) They do not represent any additional out-of-pocket payment by the policyholder, and as such do not constitute additional taxable gross premiums.

ISSUE NO. 2

Variable Annuity Contract Charges

Front End Annuity Products

In petitioner’s variable annuity program, a policyholder deposits premiums with claimant for an annuity to begin at a point in the future. Just as in the variable life insurance product, the policyholder can direct the investment of the premium deposits until such time as the annuity payments begin. The performance of the investment impacts the amount of the eventual annuity payments. Petitioner charges administrative management fees during the period prior to the annuity payments starting, and surrender fees if the policyholder withdraws prior to annuity payments beginning.

For annuity products sold prior to 1988 (even if actual annuity payments did not begin until later), petitioner had elected to report and pay gross premiums tax upon receipt of the premium deposit. (Rev. & Tax. Code, § 12222.) If a policyholder later elected to withdraw the funds before annuity payments commenced, petitioner would treat the withdrawal as “return premiums” (See *Equitable Life v. Johnson, supra.*) and claim an offset against taxable premiums on other annuity sales in the period the premiums were returned.

Again, the question is whether the administrative management fees and surrender charges should have been reported as additional “gross premiums” by petitioner. Again, we conclude that they should not.

When petitioner elected front-end reporting, Revenue and Taxation Code section 12222 states that the measure of tax is the funds accepted by the insurer. There is no further tax due when the funds are actually applied to purchase the annuity in the future, although it is the purchase of the annuity that is the actual taxable event. The amount of tax due is not measured by the amount of funds actually applied to the purchase of the annuity (which may be more or less than the amount accepted by petitioner, depending on the performance of the investment, less charges), but it is measured by the original premium payment. If the account is surrendered prior to commencement of annuity payments, the surrender charges and administrative management fees do not affect the amount of the “return premium,” (except in the rare case that the account has declined in value below the original premium deposit amount, where they may reduce the amount of “return premium” which petitioner could deduct). They do not constitute additional gross premium received by the petitioner.

Back-End Annuity Products

In 1988, petitioner elected to begin reporting tax on its variable annuity products on a “back-end” basis, which is an alternative method permitted by Revenue and Taxation Code section 12222. When this method is elected, petitioner does not report receipt of taxable gross premium until the time the actual annuity contract is made, i.e. when the accumulated funds which have been held and invested by petitioner for a policyholder’s account are actually applied to purchase an annuity. Unlike front-end reporting, the measure of the gross premiums in this instance includes both the funds accepted by the insurer as well as the investment returns credited to the account in the period prior to actual purchase of the annuity. Petitioner properly does not reduce the taxable measure by the amount of administrative management fees previously charged, so they are included in the measure of tax at the time the annuity contract is purchased.

ISSUE NO. 3

Statute of Limitations

Petitioner has provided a recalculation of its premium tax liability based on the forms and instructions currently used by DOI, and computed without including the administrative management fees and surrender charges in taxable measure. These calculations indicate an additional claimed overpayment for 1992 of \$1,164, over and above the original claim for refund regarding the assessment issued by DOI following the audit. For 1993, the alleged additional overpayment was \$2,167, and for 1994 the alleged additional overpayment was \$2,952. However, we conclude that petitioner’s assertion of an increase in its claim for refund for those years is barred by the statute of limitations.

Revenue and Taxation Code section 12978 provides that a claim for refund must be made within four years of April 1 of the year following the year for which the overpayment was made. The claim must state the specific grounds on which it is based. (Rev. & Tax. Code, § 12979.) Petitioner may not amend its claim on grounds different from those in its initial claim after the statute has expired. (Cf. Business Taxes Law Guide, Vol. IV, Annot. 465.0100 [9/11/59].) Petitioner's assertion of an increase in its alleged overpayment was not made until its brief filed on April 9, 1999. The statute of limitations for even the most recent year (1994) under review, expired on April 1, 1999. The assertion in the April 9, 1999, brief was on a different ground (calculation error) from the original claim.

OPINION

We conclude that the management fees and surrender charges deducted from a variable life insurance policy or deducted from a premium deposit for a variable annuity contract reported on a front-end basis do not constitute gross premiums subject to tax. However, insurers reporting on a back-end basis must include management fees previously deducted from premium deposit accounts in the measure of gross premiums.

We further find that the increase recalculated by petitioner for the related claims for refund will be denied and that the tax, as computed within the statute of limitations, be refunded in the following amounts:

For 1992	\$9,934.25
For 1993	\$12,907.11
For 1994	\$21,458.07

Done at Sacramento, California, this 6th day of April, 2000.

Dean Andal _____, Chairman

Claude Parrish _____, Member

Johan Klehs _____, Member