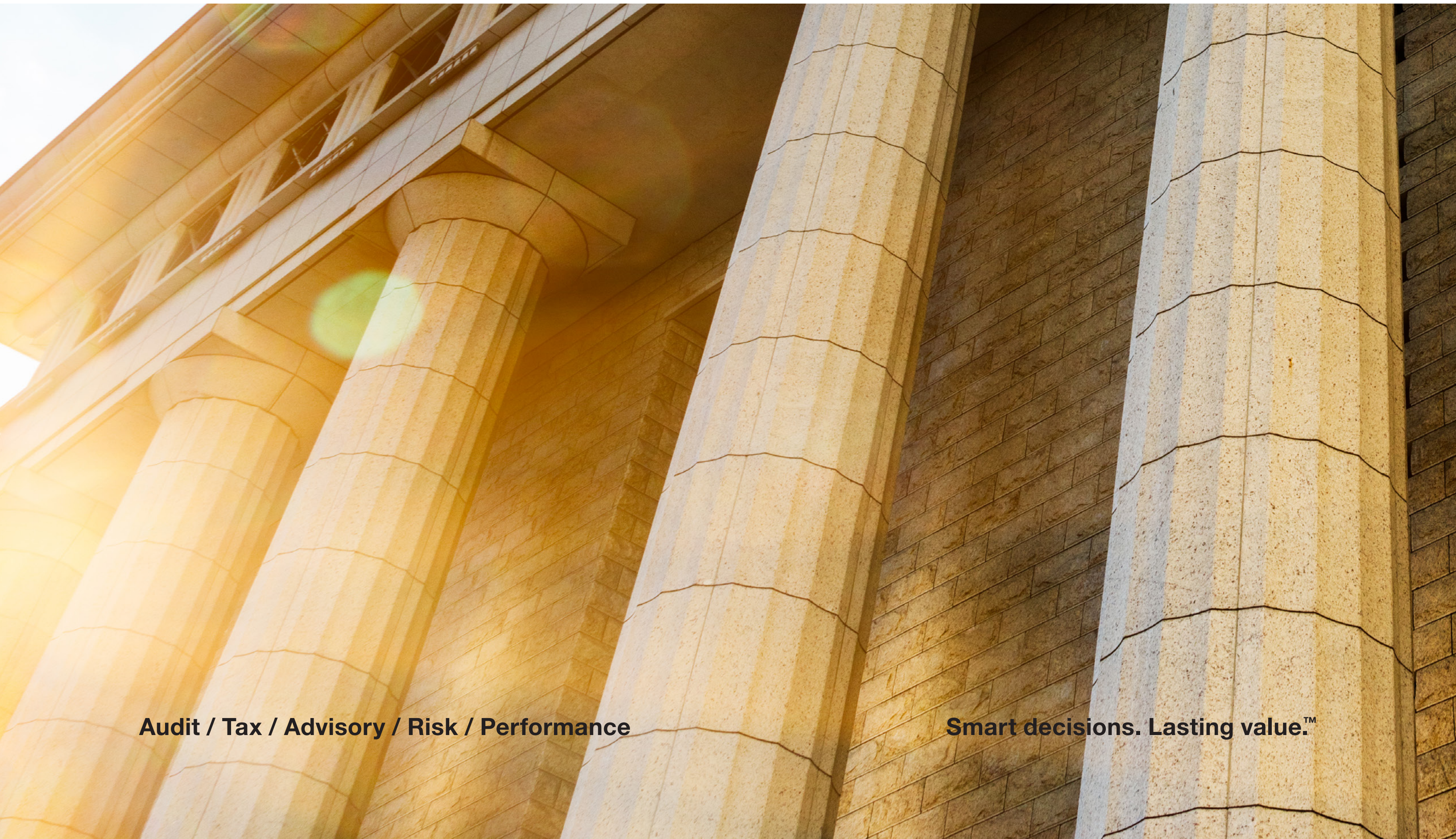
September 2018

Reinsurance and the New Tax Law

By William F. Buechler Jr., J.D., CPA, and Joseph A. Magyar, CPA



Many dealers have offset the recent downward trend in vehicle margins through increased finance and insurance (F&I) profitability.

One way dealers have maximized their F&I income is through participation in the underwriting profits on the F&I products sold. Underwriting profit essentially is the amount of profit on the product after commissions, management and administrative fees, and claims. A number of structures exist for the dealer to participate in these products – each with varying benefits. These structures also have a range of tax treatments that may affect the overall benefits and risks significantly. The tax issues were complicated further by certain provisions of tax reform under the legislation known as the *Tax Cuts and Jobs Act of 2017* (TCJA).

Typical types of F&I products available for dealer participation include extended vehicle service contracts, guaranteed auto protection (GAP) waivers, and road hazard tire coverage, among others. The profit participation programs typically include guaranteed retrospective (retro) agreements, participating retro agreements, and insurance and reinsurance programs, including dealer owned warranty company (DOWC), controlled foreign corporation (CFC), and noncontrolled foreign corporation (NCFC). Each of these programs has both pluses and minuses from a federal income tax and business risk perspective.

Retrospective agreements

A typical guaranteed retro agreement provides for an annual payment that is not based on the performance of the products but is instead based on the contract count netted with the cancellations. For example, the payment may be based on the number of active policies. Payment directly to the dealer will be taxed at the dealer's federal and state (if applicable) individual income tax rate, with the top federal marginal rate at 37 percent. If payment is to the dealership and the dealership is an S corporation, a partnership, or a limited liability company taxed as a partnership, the TCJA may permit a deduction of up to 20 percent, resulting in a net top federal effective income tax rate of 29.6 percent. Because the retro payment is not based on the performance of the contracts, little business risk is attached to the structure; however, typically, there is also a lower potential profit. Likewise, no additional administrative costs or significant federal income tax risks are associated with the structure of these contractual arrangements.

A participating retro agreement also is a contractual arrangement that provides for a payment if the contracts under such arrangement meet specific performance levels for the given period. For example, the payment may be based on the claims experience on the active policies. Generally, the participant faces no risk of loss, but, again, less potential exists for profit shared – although typically more potential than under the guaranteed retro agreement because there may be no additional payments if the performance parameters of the contract are not met. The federal tax consequences generally match those of a guaranteed retro agreement.

Essentially, each of these retro arrangements represents an additional commission after the sale of the product based on meeting contractual goals.

Dealer owned warranty company

Beyond the retro agreements, dealers may consider setting up a captive insurance company to participate directly in underwriting profits. These structures typically require an outlay of costs – including initial capitalization – to set up and an annual administrative expense to maintain. The most direct type of such captive structure is a DOWC. These types of companies often insure more than just service contracts; however, they cannot cover GAP waivers, limited warranties, and other dealer obligor products. A DOWC normally is the direct writer of the contract sold in the dealership's F&I office. This type of arrangement allows the dealer to participate in both the underwriting profits and investment income from the premium dollars invested to pay future claims.

A DOWC typically is formed as a separate legal entity domestically under state law, and state regulations vary from little oversight to extensive guidelines, reporting, and required initial capitalization. DOWC taxation occurs under one of two methods of insurance company federal income taxation.

Regular insurance companies are taxed on their underwriting and investment income as C corporations at a flat 21 percent rate. Special rules for insurance companies may allow for significant deferral of the underwriting income. It is not uncommon for these companies to generate taxable losses for several years at inception and during periods of premium growth.

If the annual premiums are below $2.3 million (amount indexed for inflation) measured by the retail cost of the product to the consumer, the DOWC may be able to elect as a small insurance company to be taxed only on investment income. Current tax law would subject this income to the 21 percent corporate federal income tax rate.

Dividends and liquidating distributions of both regular and small insurance companies are taxed at capital gain rates for federal income tax purposes. The federal tax rate on these amounts typically is 23.8 percent.

While it is possible to convert from a regular to small insurance company under the right circumstances, that might present a number of potential pitfalls and should be done only after consultation with a tax adviser. A particular concern would be the formation of a regular insurance company with an intent to insure amounts above the $2.3 million small insurance company limit and later reduce premiums and make the small insurance company election when the entity becomes taxable or in anticipation of winding down the entity combined with establishing a similar new entity to issue such contracts. The IRS likely would find such a plan abusive and may be able to attack under a variety of arguments. Any upfront plan that involves reincorporating with slightly different ownership also should be approached with caution. Dealers should be very careful regarding such approaches.

Controlled foreign corporation

While most DOWCs are domestic direct writers of F&I products, another common structure is a CFC. Typically, the cost to establish and run a domestic captive insurance company exceeds the costs of a CFC. Some foreign jurisdictions have significant expertise in F&I captive companies and favorable statutes for such companies.

In order to take advantage of a number of favorable federal income tax provisions for insurance companies, dealer CFCs make an election to be taxed as a domestic corporation for federal income tax purposes.

To the extent the domestic election is valid, the federal tax consequences are the same for a CFC versus a U.S. domiciled insurance company.

The CFC usually is not the direct writer of the F&I products; rather, a third-party administrator with a U.S. domiciled insurance company is the direct writer of the contract. This fronting company then reinsures the contracts to the dealer's CFC, which may be taxed as a regular insurance company or elect to be a small insurance company if eligible. Most CFCs are taxed as small insurance companies and may benefit from the reinsurance arrangement to ultimately insure more policies than a DOWC because the reinsurance premiums are measured by the net reserves, which do not include the dealership commissions and administrative fees when measuring the $2.3 million limitation.

Due to the small insurance company benefits, dealers with more than $2.3 million in annual premiums may wish to form multiple insurance companies. The $2.3 million must be aggregated among related entities. It may be possible under certain facts and circumstances to form multiple insurance companies for a large dealership or group of dealerships generating more than the $2.3 million in premium, but it would be necessary to avoid related-party attribution among the owners of these multiple insurance companies.

For example, stocks owned by a dealer and his or her adult children generally are not attributed to each other. Thus, the dealer and an adult child each might form a separate insurance company and each insure up to $2.3 million of annual premiums. This process involves two important tax considerations. First, the ownership structure must break ownership attribution under complex IRS rules, which is primarily a mathematical exercise. Second, and of equal importance, the companies must document a nonfederal tax purpose to form the multiple insurance companies.

Both DOWC and CFC structures may be subject to certain tax risks.

The exclusion of the premium income by electing small insurance companies represents a significant benefit; however, the IRS has targeted "abusive" small insurance companies, which means additional scrutiny of all such companies. Currently, if the small insurance company has reinsured certain F&I products, such as GAP waivers or dealer obligor products, it may be subject to additional tax information reporting, which can draw IRS attention and add an administrative expense to owning and operating the small insurance company.

Recent audits indicate that related-party loans from insurance companies may lead to an extensive, time-consuming, and expensive examination of the captive. Document requests for electing small insurance companies also indicate that illiquid investments, such as real estate, are red flags to the IRS. The underwriting income and insurance company tax benefits, however, remain significant enough for many dealers to accept the insurance and tax risks. While captive insurance structures are appropriate and provided for under current tax law, dealers would be wise to avoid areas of uncertainty and perceived abuse that may encourage the IRS to challenge the details of a particular arrangement.

Noncontrolled foreign corporation

Prior to the recent TCJA, an NCFC structure was available and preferred by large dealers and groups to reinsure F&I products and defer the income taxation until it was repatriated (taken as a dividend or liquidating distribution from the NCFC). Earnings repatriated upon liquidation typically were taxed as capital gains at 23.8 percent. Such an outcome is similar to a CFC with the small insurance company election but without the $2.3 million cap on annual premiums.

Accordingly, this structure was attractive to large dealer groups, but they might struggle to find a comparable structure going forward. The TCJA made several changes to the tax code to limit this option for most dealers. Although some of these structures still may be available post TCJA, their use is far more restrictive under the new rules, and the taxation may have changed. Dealers with existing NCFC arrangements should gather as much information as possible from the NCFC, captive management, and third-party administrator and then consult with their tax advisers.

Each dealer may have a specific set of facts and circumstances that make a particular structure most beneficial. In addition to the tax consequences, dealers should consider other factors that may vary depending on the structure, including cash flow, management involvement and incentives, plans for growth or acquisitions, administrative costs or complexity, and estate or succession planning. A combination of a quality third-party administrator and dealership tax adviser should be involved to assist dealers in evaluating all these details in the wake of tax reform.

Learn more

Bill Buechler
Managing Director
+1 615 360 5530
bill.buechler@crowe.com

Joe Magyar
Partner
+1 813 209 2435
joe.magyar@crowe.com

As seen in F&I and Showroom.

crowe.com

"Crowe" is the brand name under which the member firms of Crowe Global operate and provide professional services, and those firms together form the Crowe Global network of independent audit, tax, and consulting firms. "Crowe" may be used to refer to individual firms, to several such firms, or to all firms within the Crowe Global network. The Crowe Horwath Global Risk Consulting entities, Crowe Healthcare Risk Consulting LLC, and our affiliate in Grand Cayman are subsidiaries of Crowe LLP. Crowe LLP is an Indiana limited liability partnership and the U.S. member firm of Crowe Global. Services to clients are provided by the individual member firms of Crowe Global, but Crowe Global itself is a Swiss entity that does not provide services to clients. Each member firm is a separate legal entity responsible only for its own acts and omissions and not those of any other Crowe Global network firm or other party. Visit www.crowe.com/disclosure for more information about Crowe LLP, its subsidiaries, and Crowe Global.

The information in this document is not – and is not intended to be – audit, tax, accounting, advisory, risk, performance, consulting, business, financial, investment, legal, or other professional advice. Some firm services may not be available to attest clients. The information is general in nature, based on existing authorities, and is subject to change. The information is not a substitute for professional advice or services, and you should consult a qualified professional adviser before taking any action based on the information. Crowe is not responsible for any loss incurred by any person who relies on the information discussed in this document. © 2018 Crowe LLP.

RD-19003-008B