Reinsurance Strategies

October 26, 2022

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Reinsurance Strategies - Agenda

- F&I Products
- Over-Rides / Over-Remits
- Types of Programs
  - Third Party Programs
  - Retro Programs
  - Reinsurance Programs
    - Controlled Foreign Corporations (CFC)
      - Micro Captives
    - Non-Controlled Foreign Corporation (NCFC)
  - Dealer Owned Warranty Company (DOWC)

F&I Products

- Vehicle Service Contracts (VSC)
- Vehicle Limited Warranty Contracts
- Guaranteed Asset Protection (GAP)
- Collateral Protection Insurance (CPI)
- Credit life
- Others – Tires for Life, Oil Changes for Life

Over-Rides / Over-Remits

- What are they?
  - Additional cost added on to an F&I Product
  - Typically paid to the Dealer at their direction

- Why?
  - Reduces gross profit to dealership and related pay for managers and F&I personnel
  - Provides working owner income apart from non-working owner
  - Can specially allocate income to certain employees or to other family members
  - Such income is taxable as ordinary income
  - Dealers like to get cash personally
  - Qualified Business Income “QBI” Eligibility? Grouping Elections?

Over-Rides / Over-Remits

- Why Not?
  - Separate the fruit (income) from the tree (producer) doctrine
  - S corporation shareholder pro-rata allocation requirements
  - Self employment tax for individual recipients
  - C corporation deemed dividend
  - Can not be added to Micro Captive or NCFC; “Over stuffing”
  - Not fair to all owners – *be careful!*

Third Party Programs

Pros:

- Very simple to understand – Dealership has a cost for each product & the amount charged in excess of cost is gross profit to the dealership
- No tax risk
- No tail exists for liability exposure
- No insurance risk

Cons:

- No additional profit to dealership from underwriting or investment income
- No favorable tax rates

Retro Programs

Pros:

- Dealer shares in underwriting and investment income (to some extent)
- Often paid to individuals, not the dealership (beware of tax issues)
- No risk of loss – amount funded to insurance company will be the maximum loss. No tail liability.

Cons:

- Program is not transparent – *"trust us"*
- All income is taxed as ordinary income
- No control of assets or earnings
- Amounts paid to dealers individually are subject to SE tax

Micro Captives

Generally:

- Organized and formed in foreign country (Turks & Caicos, Nevis Island, Bahamas, etc.)
- Everything else is conducted in United States
- Small Property & Casualty under IRC Sec. 831(b)
  - Tax is based on investment income
- IRC Sec. 953(d) election is typically filed to be treated as a U.S. Taxpayer

Micro Captives

Pros:

- Typical reinsurance found at one or two point dealerships
- Very transparent – you can look at exact cash in-flows and out-flows
- Lowest cost administratively
- Dealer earns all underwriting and investment income
- Identified by IRS in 2016 as "Transaction of Interest"; Has generally withstood scrutiny in the dealership environment
- Dividends are taxed at capital gain rates
- Liquidation is taxed at capital gain rates
- Investment income taxed each year in U.S. at <u>corporate</u> tax rates
- No state taxes

Micro Captives

Cons:

- ***Premium can not exceed $2,450,000 per year (2022 indexed amount)***
  - Generally premium is the amount paid by the dealership as cost on contracts submitted; not the gross premium paid by the customer
- Assets are typically held in trust, but with Letter of Credit, a strong dealer can generally get access to all funds
- Dealer Obligor programs may be subject to SWIM tax (**most programs for new car dealerships are now Admin Obligor (don't require SWIM)**)
- Have a liability tail that continues once dealer quits funding with new contracts

Non-Controlled Foreign Corporations (NCFC)

Pros:

- No limit on premiums that may funded
- ***Often used by large dealer groups because no premium cap***
- Liquidations are treated as capital gains

Non-Controlled Foreign Corporations (NCFC)

Cons:

- Admin expenses are generally higher than Micro Captive per contract
- No transparency of cash inflows and outflows
- Dividends are treated as ordinary income
- Often loans are taken until liquidation
- Very complex vehicles and not well understood
- Incurs premium taxes
- Generally require filing of Form 5471 (Information Return of U.S. Persons With Respect to Certain Foreign Corporations) in year of setup
- Hard to get out of
- No Control of Assets

Dealer Owned Warranty Company (DOWC)

- Trending as the replacement for NCFC
- DOWC is obligor on all included products
- Typically organized as a **C Corporation** in same state of producing Dealership; state rules vary on licensing requirements
- Taxed as a Property & Casualty Insurance Company

Dealer Owned Warranty Company (DOWC)

Pros:

- Typically formed and managed by a third-party administrator (TPA)
- Large upfront tax losses in the corporate insurance company can defer income taxes for 5 to 7 years (depending on loss ratios and premium volume)
- Control of coverage, rates, branding, and investment decisions

Cons:

- Cost/Capitalization requirements (vary by state)
- Complexity combined with State Registration and State Regulation Requirements
- Annual Financial Reporting Requirements

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