Upcoming Law Changes Affecting Reinsurance Companies

By Mike Scolamiero
Harbor First Solutions

A dealership's F&I department has developed over the years into one of the most important profit centers in a store. There are several opportunities for a dealer to profit from the sale of F&I products, including the ability to participate in the revenue generated as the premiums earn out.

One of the more popular structures is a CFC (Controlled Foreign Corporation), often referred to as a reinsurance company. CFCs have been around for decades, and there are many dealers who have had terrific success with them. Congress passed their 2015 Appropriations Bill last December, which included updates to the Internal Revenue Code that will affect CFCs. For any dealer with an existing reinsurance company, it is strongly recommended that they consult with their CPA regarding these changes, and possibly change his or her participation position.

Section 831(b) of the Internal Revenue Code offers small non-life insurance companies, with annual underwriting income less than $1.2 million, the ability to elect to exclude underwriting income from taxable income, and be subject to tax only on investment income. After nearly 30 years since the $1.2 million threshold was written into law, new legislation has finally been passed. The $1.2 million ceiling is being raised to $2.2 million, and will now be indexed annually to inflation.

This is a tremendous advantage to dealers who currently own reinsurance companies, especially those that must formulate strategies to avoid going over the $1.2 million threshold. Doing so would mean losing their 831(b) status, and having to pay substantially more in taxes. Unfortunately, included in the law change are two tests designed to offset abuses of the 831(b), specifically in wealth transfer and estate planning.

The major theme behind the tests is to ensure the 831(b) isn't being used to steer a dealer's wealth to other individuals while circumventing the dealer's estate. In an effort to curb such possible tax abuse, a diversification requirement and an ownership test were added. The good news is that a dealer needs only to pass one of the two tests.

The diversification requirement states that no one policyholder can represent more than 20% of the company's net written premiums. At first glance it would seem this shouldn't present any problem, since thousands of customers contribute to the company's portfolio. However, F&I products originate as a contract between customers and the administrator, and their reserves are later reinsured into the dealer's reinsurance company.

At the moment, the general consensus is that it seems to be unclear whether the "policyholder" is the ceding company, or the underlying insured. If the IRS determines it to be the former, then just about every dealer would fail the diversification requirement. The ambiguity of this language is the result of the law being poorly written. If the law is rewritten, which is likely, then they'll change the language to better reflect the law's intention. If the word "policyholder" becomes "source", then the majority of dealers would have to move on in hopes of passing the ownership test, which will still allow them to qualify to make the 831(b) election. The ownership test requires the ownership of the 831(b) company to mirror, within 2% margins, the ownership of the company being insured. In other words, if a dealer owns 100% of their dealership, then no other individual may own more than 2% of the reinsurance company. For a dealer who has CFC's in their spouse's name, children's name, etc., it is easy to see the concern.No company will be grandfathered in with the new laws. Dealers have until 2017 to properly prepare and, if need be, restructure themselves. There are several strategies for a dealer who wants to continue participating in the earned premiums of their F&I products but has decided that it is time to move away from their CFC position. Here are three other participation structures and their advantages and disadvantages when being compared with a traditional reinsurance company (CFC):

- NCFC (non-Controlled Foreign Corporation) – Will often produce better investment income for a dealer, but they lose some control, share risk with other dealers, and pay a 1% excise tax.
- Dealer Obligor – A good structure for dealers who are looking for the quickest access to capital.The biggest downside is that the assets of the dealership are put at risk.
- DOWC (Dealer-Owned Warranty Company) – For most dealers, a DOWC is the ideal structure.It produces the strongest financial returns, creates a prolonged tax deferred period where zero taxes are paid at the corporate level, is a separate fully insured entity acting as the obligor, and offers the ability to borrow against the reserves.

Depending on each dealer's business, capital needs, tax concerns, and estate planning strategies, one of the aforementioned structures may fit their prerequisites better than the rest. It is important for a dealer to be knowledgeable of the upcoming law changes, to be aware of the different available structures, and to put themselves in the best possible position.