CliftonLarsonAllen

CliftonLarsonAllen LLP
600 Washington Avenue, Suite 1800
St. Louis, MO 63101-1312
314-925-4300 | fax 314-925-4350
CLAconnect.com

CURRENT IRS ISSUES WITH REINSURANCE AND CAPTIVE INSURANCE

As many dealers know, the importance of F&I products and the use of small insurance companies have become significantly important to dealers trying to transfer various warranty risks, thereby, improving collectability of note portfolios due to mechanical breakdowns, and generate underwriting profits. One effective approach, many dealers are using to provide these services, involves reinsurance program strategies.

These risk transfer transactions involve a dealer setting up a reinsurance company that receives premiums to insure against mechanical or other losses that can arise on vehicles purchased from them. In addition to mechanical loss there are other products such as, collateral protection insurance (CPI) or guaranteed asset protection (GAP); a product that insures customers against the risk of financial loss when there is a difference between the outstanding loan amount and the actual cash value of a vehicle, involved in an accident, if it is declared a total loss.

Many such insurance companies are referred to as a PORC (Producer Owned Reinsurance Company) or a PARC (Producer Affiliated Reinsurance Company). These are companies that dealers form to insure the risk of administrators or other 3rd party insurance companies (Direct Underwriters). In other words, a dealership will sell a product (for example a service contract) to a customer that is insured with a Direct Underwriter, which will then reinsure its risk with the customer to the PARC established by the dealer.

The customer then has a contract with the Direct Underwriter, who has a contract with the dealer's affiliated reinsurance company. The dealer does this so that he can assure customized, credible and convenient insurance is available to his customers. In addition, the dealer may benefit from underwriting profit generated when premium income exceeds the ultimate claims experience.

Generally these PARCs are set up in foreign domiciles. While this sounds exotic and seems complex, the primary reason such entities are formed in foreign domiciles is to avoid the economically prohibitive capital requirements, and equally onerous regulations that historically accompanied formation in a U.S. domicile. There is no tax benefit to being formed as foreign company. In fact, virtually all of these foreign domiciled small reinsurance companies make a 953(d) election to be taxed as a U.S. taxpayer.

These reinsurance companies also file Code Sec. 831(b) elections, with their initial income tax filings, to be treated as small property and casualty insurance companies. This allows these companies to avoid paying tax on underwriting profits. However, it should be noted that tax is paid on investment earnings from premium income net of claims and related expenses.

This tax treatment is provided to encourage small insurance companies to retain their risk and use the related premiums to pay claims without being burdened by the complexity of regulations and tax rules applicable to large insurance companies. Ultimately, owners of these type entities pay income tax on underwriting profits earned inside the reinsurance companies when such funds are distributed to them as stockholders.

This favorable tax benefit, derived by excluding underwriting profit from taxation, is what has attracted the attention of the IRS, motivating them to determine whether or not potential abuses exist. In addition, the IRS seems concerned about the owners' ability to use reinsurance companies to shift value between family members.

PATH Act Changes

The PATH Act (Protecting Americans from Tax Hikes), passed in December 2015, made a couple of changes with regard to small insurance companies. First, it increased the annual premium limit for these small insurance companies from $1,200,000 to $2,200,000 per year (adjusted annually for inflation). Second, it implemented two diversification tests which potentially restrict the use of these companies and disallow their treatment as insurance companies eligible for the favorable tax treatment.

The first "risk diversification test" provides that net premiums, or gross written premiums (if greater), from one insured cannot exceed 20 percent of total premiums for the year. If they do, then the company can still be treated as a small property and casualty insurance company if, it meets the second test, the "relatedness test". This test essentially requires that the operating company (a dealership or related financing company) remitting over 20 percent of the premiums must have virtually identical ownership to that of the reinsurance company.

The apparent objective of these requisites is to require ownership of captive insurance companies to be virtually the same as the dealership, if more than 20 percent of premiums come from the dealership. In other words, it appears the IRS is concerned that these reinsurance companies were being structured to transfer ownership of income and assets from the dealer to his children or others to avoid the estate taxes.

While this Act was signed in December, 2015, there are many unanswered questions that taxpayers and their advisors want answered to understand how to completely comply with these regulations; unfortunately, it appears unlikely any such information will be received before 2017 returns have to be filed.

Notice 2016-66 Disclosure

Besides changes required by the PATH Act, in November 2016, the IRS issued Notice 2016-66. This notice is troublesome in that it requires taxpayers and their preparers to include certain disclosures, related to various insurance transactions, in the returns of the reinsurance company, the dealership and those of the shareholders as well as, potentially, other parties. Therefore, one reinsurance company could potentially require the filing of 5 or more disclosure statements by various related parties.

Notice 2016-66 outlines insurance situations it is seeking information on which it has identified as "Transactions of Interest". The transactions described in this notice are not those of most dealership reinsurance companies.

In general, the Notice seeks information on captives that insure "business enterprise risk"; i.e. those insurance companies providing insurance to the operating business for risks such as: general liability, data breach, catastrophe, terrorism, etc. These are generally risks inherent in the operating business; as opposed to those risks that are reinsured by PARCs which insure customer related risks directly related to mechanical breakdowns, vehicle collision or other similar risks of the dealerships' customers.

Unfortunately, even though the Notice outlines, albeit vaguely, those risks it is interested in when identifying transactions to which disclosures are required, it does not exclude reinsurance transactions for which a dealership assumes responsibility, as the contractual obligor, and acts as a "dealer obligor (DO)". These DO products are not uncommon in dealer insurance transactions; whereby, a dealership insures a customer's risk which is then subsequently transferred to the PORC. Even though the actual risk is with the Direct Writer, it still appears to meet the requisites for reporting under the Notice.

This Notice has bewildered the dealerships, insurance administrators, shareholders and tax advisors trying to figure out how to respond. The penalties for failure to file are significant at $50,000 per non-disclosure, per entity required to disclose, per year. Thus one reinsurance company's failure to disclose could cost the related companies $50,000 per entity. So if 5 disclosures were required, potential penalties could be $250,000 per year. For this reason many preparers and their clients feel that disclosing may be the only alternative.

Disclosing could possibly result in scrutiny of the dealership, or other disclosing parties, as the IRS determines how it is going to use the information included in the admission. Obviously, many parties would rather not disclose, hoping to avoid the unpleasantry typically associated with a potential examination.

The disclosure for years prior to 2016 (2013 – 2015) was initially required to be completed by January 30, 2017. Fortunately the IRS issued Notice 2017-08, which delayed the requirement until May 1, 2017.

While industry groups in the legal, tax and other professions are working to persuade the IRS to revise its Notice and exclude traditional dealer reinsurance companies from the disclosure's requirements, it is unclear if the IRS will do so. This, therefore, leaves taxpayers and their preparers in a dilemma with regard to 2016 tax return filings. Most such calendar year taxpayers are required to file their returns on either March 15, 2017 or April 18, 2017. To file such returns timely will require disclosure; if such returns are extended until after their original due dates, it is possible these returns may not require disclosure. Particularly, if the groups mentioned are successful in getting the IRS to eliminate PORCs or PARCs from its reporting requirements.

It is worth noting that in the early 2000's, the PARC industry was subjected to this scrutiny. The resulting examinations and IRS guidance ultimately resulted in such transactions being eliminated from IRS scrutiny.

At this time, no one can predict what will ultimately happen with any certainty. The decision to file timely or extend will be left to each taxpayer.

In Summary

In summary, since Congress expanded the premium cap from $1,200,000 to $2,200,000, it is clear Congress feels that such entities, and the related tax provisions, are valid and should be maintained. However, with the additional diversification requirements of the PATH Act and the "Transaction of Interest" disclosures required by Notice 2016-66, it is clear the IRS is concerned about abuse in this area and is trying to just allow transactions it feels are within the intent of the law. In the meantime, it leaves taxpayers with decisions to make in an environment that is not clear. We can only hope the IRS will issue more guidance; if not, important decisions will have to be made by taxpayers and their preparers without full guidance.

Dave Wiggins, CPA is a principal with Clifton Larson Allen's dealership group team. He has extensive knowledge of the inner workings of heavy, new, use and BHPH dealerships, including new developments regarding tax and regulatory compliance issues. Dave specializes in federal and state taxation with the unique perspective of those specific strategies that apply to dealerships, finance companies and their owners. He can be reached at david.wiggins@CLAconnect.com *or 314-925-4300.*