# OPPORTUNITY AT RISK: REINSURANCE MEETS TAX REFORM

Learn how the Trump administration's Tax Cuts and Jobs Act affects the selection and profitability of your reinsurance program.

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The federal Tax Cuts and Jobs Act was signed into law by President Donald Trump in December 2017. The legislation was designed to reduce income tax rates for individuals and corporations, among other measures. But tax reform also affects the selection and profitability of participation programs.

The purpose of this guide is to provide a brief outline of common reinsurance models, how each is impacted by tax reform, and some insights that could help guide your selection. Six structures will be covered:

- Affiliated Reinsurance Company (ARC)
- Dealer-Owned Warranty Company (DOWC)
- Retrospective Commission Plan (Retro)
- Self-Insured Plan
- Non-Controlled Foreign Corporation (NCFC)
- Controlled Foreign Corporation (CFC)


## Affiliated Reinsurance Company (ARC)

### Who uses this model?

Affiliated reinsurance companies are ideally suited for companies with an annual ceded premium of less than $2.3 million. ARCs are currently subject to state premium taxes but not state income taxes. Multiple structures are common and typically tax-efficient while operating within the control group rules.

### How does tax reform affect ARCs?

Tax reform had no direct effect on ARCs other than establishing a flat tax rate of 21% on investment income. The result is a break-even point of $90,384:

- Annual taxable investment income below $90,384 is subject to a slight tax increase.
- Annual taxable investment income above $90,384 enjoys a slight tax decrease.

Tax reform also reduced the federal Dividends Received Deductions Provision from 70% to 50%.

## Dealer-Owned Warranty Company (DOWC)

### Who uses this model?

Dealer-owned warranty companies can be used when the annual ceded premium exceeds $2.3 million at any level. Due to insurance company statutory accounting rules, underwriting net operating loss (NOL) can be utilized to offset investment and underwriting income and improve tax efficiency. This structure is more tax-efficient in some states than others.

### How does tax reform affect DOWCs?

All C corporations are subject to the new, flat corporate tax rate of 21%. Revised NOL rules exclude property and casualty insurance companies. NOLs for DOWCs can still be carried back two years and carried forward 20 years to offset 100% of taxable income.

DOWCs typically begin to generate taxable income when their growth rate decreases and the NOL carry-overs have been fully utilized.

### Retrospective Commission Plan (Retro)

#### Who uses this model?

Retrospective commission plans are suited for "higher-risk" business, such as service contracts for high-mileage vehicles. Retros are also appropriate for companies writing "minimal" monthly contracts, typically fewer than 20 VSCs.

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#### How does tax reform affect retros?

Tax reform benefits payments made to the dealership, whatever the ownership model. Dealerships that are C corporations are taxed at the new, flat 21% corporate rate. Dealerships that are pass-through entities or sole proprietorships get a 20% deduction for qualified business income.

### Self-Insured Plan

#### Who uses this model?

Self-insured arrangements are inexpensive to administer and provide for maximum cash up-front. Relatively inefficient taxation has made self-insured plans rare in the current marketplace.

#### How does tax reform affect self-insured plans?

Tax reform benefits payments made to the dealership, whatever their business model. Dealerships that are C corporations are taxed at the new, flat 21% corporate rate. Dealerships that are pass-through entities or sole proprietorships enjoy a 20% deduction for qualified business income.


### Non-Controlled Foreign Corporation (NCFC)

#### Who uses this model?

Once a fixture among U.S. dealers, NCFCs can be potentially unfavorable in light of the changes to rules governing passive foreign investment companies (PFICs) described below.

#### How does tax reform affect NCFCs?

Tax reform added a 25% applicable insurance liabilities (AIL) test to continue to get their historical exemption from PFIC taxation. AIL has to exceed to 25% of NCFC assets, and unearned premiums are specifically excluded from this calculation. Under certain circumstances, earnings from NCFCs can now be taxed at the individual highest marginal rate.

If an NCFC becomes a PFIC, certain elections have to be made by the NCFC shareholders to preserve their capital gain tax-efficient treatment of undistributed earned surplus accumulated prior to tax reform.

### Controlled Foreign Corporation (CFC)

#### Who uses this model?

CFCs typically result from unintended consequences during the formation of an NCFC or ARC. CFC taxation remains less onerous than PFIC taxation, but the CFC model is not tax-efficient.


### How does tax reform affect CFCs?

The definition of a U.S. shareholder has changed to 10% of vote or value. Some NCFCs may become CFCs retroactive to January 1, 2018. The repatriation tax is generally not applicable to NCFCs that became CFCs after December 31, 2017.

## Fully Informed Means Fully Prepared

The Tax Cuts and Jobs Act is designed to benefit businesses and business owners, but dealers must be fully informed to take advantage and benefit from the provisions. If you have any questions about your reinsurance program — today or in the future — reach out to the experts at Portfolio Reinsurance.

Call us at **949-789-6200**, send us an email, or visit **PortfolioReinsurance.com** today!

## ABOUT PORTFOLIO

One of the nation's leading reinsurance management companies dedicated to automotive dealers, Portfolio was founded in 1989.

Portfolio pioneered reinsurance for dealers. One of our signature accomplishments was securing two IRS TAMs (Technical Advice Memoranda) that acknowledged the legitimate business purpose of dealer reinsurance managed correctly and in accordance with U.S. tax laws. These TAMs cleared the way for dealer reinsurance to be the important part the retail automotive business that it is now.

Today Portfolio manages over 1,000 reinsurance companies affiliated with over 1,800 dealerships in the automobile, RV, motorcycle, and powersport retail markets. Over 1.7 million vehicle service contracts, warranties, and ancillary products were sold by Portfolio dealers in 2017.

*Inc.* magazine rated Portfolio one of the nation's 5,000 Fastest Growing Private Companies in 2012 (under its former marketing company name, Independent Financial Systems).