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## **Understanding Reinsurance Company IRS Audit Issues**

Producer owned reinsurance companies remain a viable and profitable option. Recent activity by the Internal Revenue Service (“IRS”) has heightened the importance of a properly structured and operated reinsurance company. After three wins in U.S. Tax Court, the IRS has significantly increased enforcement activity to find abusive reinsurance arrangements and has created 12 new examination teams.

If a reinsurance company does not operate in compliance with state and federal regulations, the tax consequences can be extremely harsh. In some cases, the total tax, penalty, and interest can be more than twice the actual premium involved. If the IRS concludes the reinsurance program is not a valid reinsurance arrangement, several tax issues could arise. The reinsurance program’s tax issues could include:

### **U.S. Tax Issues**

1. The IRS could assert that the reinsurance company is not an insurance company and ineligible to make an election to be taxed as a small insurer. As a result, previous underwriting profit would be subject to normal income tax, penalties, and interest, and the substantial underpayment penalty provisions could apply.
2. If shareholder loans are excessive, the IRS may recast these loans into dividend distributions subject to taxation by the shareholder.
3. If a program does not carefully monitor the types of products reinsured by a company (dealer-obligor v. admin-obligor products), the IRS could determine that the reinsurance company, the dealership, and the dealership shareholders failed to file appropriate disclosure (Form 8886) and assess penalties of up to \$50,000 for each. Under IRS Notice 2016-66, a Form 8886 is required for dealer-obligor products.

### **Foreign Tax Issues**

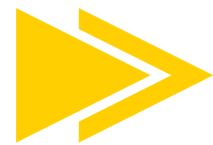
1. If the IRS asserts that a foreign reinsurer is not an insurance company, the foreign corporation will not qualify for an election to be treated as a U.S. taxpayer. As a result, foreign disclosure requirements and excise taxes would apply.
2. If the IRS denies the election for U.S. taxpayer treatment for prior years, penalties may apply for the foreign corporation’s failure to file a Form 1120-F—U.S. income tax return of a foreign corporation.

For these reasons, it makes sense to carefully review current or prospective arrangements in light of the IRS’s recent activity to ensure there are no exposures or to correct any potential exposures before an examination occurs.

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As part of any review of a reinsurance program, whether current or prospective, it is important to ask whether the organization and administration of the reinsurance company does the following:

1. Maintain compliance with all applicable state and federal licensing and insurance regulations.
2. Functions as an insurance company.
  - Collection of premium, customer data and maintain in force certificates.
  - Adjudicate claims, pay claims, and maintain claim files.
3. Reserve funds are calculated and maintained according to the reinsuring agreement and are held in a separate trust arrangement with limitations on access to the reserve funds.
4. Loans issued, are properly administered, and funded only from excess reserves.
  - Loans are documented in corporate minutes.
  - Loan interest rates are at market rates.
  - Loan documents are properly formalized and executed.
  - Loans are serviced according to the agreed terms.
5. The reinsurance company reinsures only F&I risk and not any general business or dealership risk.
6. Maintain separate books & records for the reinsurance company.
7. Separates the reinsurance company funds from the dealership funds.
8. Have valid reinsurance treaties.
9. Maintain minutes and observes other corporate formalities.
10. Comply with IRS Notice 2016-66 and file Form 8886.
11. Have a valid IRC § 953(d) election for treatment as a domestic corporation.
12. Follows the IRC § 831(b) requirements, including:
  - Premium limitation (\$2.3M for 2019);
  - Ownership diversification; and
  - Controlled group rules.
13. Maintain adequate capital and reserve levels.
14. Maintain support for the proper premium pricing of all products.

If you cannot answer yes to all the above, you may consider reaching out to the MarksNelson insurance tax group for a review of your current or prospective program.

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