

# Reinsurance: Creating Value for Your Customers and Wealth for Your Dealership

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*Reinsurance programs have been a staple of the automotive dealers' business for a long time. However, the products they offer and the business structure required to manage them have evolved significantly and there are some very important opportunities that make this an area well worth examining, whether or not your dealership currently has a reinsurance company.*

## **What Is a Reinsurance Company?**

It would make sense to start with a review of what a reinsurance company is. A Reinsurance company enables an automobile dealer to share in the underwriting profits of insurance products that would normally be realized by a third party insurance carrier. These products have become increasingly important to car buyers as the cost and complexity of vehicles has increased dramatically over recent years. These products can help your customers feel more secure with their vehicles by offering them vehicle service contracts, limited warranties and collateral protection through your own reinsurance company. Providing these policies through your own reinsurance company still gives your customers a great product and additional peace of mind, while creating the opportunity for you to collect a greater share of the revenue these programs provide.



How many vendors are in your dealership pitching finance and insurance products? There is good reason for this - there is money to be made selling these products! An in house reinsurance company is comparable to the in-house, "captive" insurance companies that have long been popular with Fortune 500 companies, as well as many small and medium size businesses to manage insurance costs. Similarly, automotive dealers have the opportunity to create their own reinsurance companies, taking on additional risk and seeking greater reward.

## **What's the Catch?**

Of course, there is no free lunch. To reap the rewards of having your own reinsurance company, you'll need to spend some time (and money) to create and manage the company. There are numerous companies in existence to assist dealers in forming captives, processing claims, developing marketing literature, handling recordkeeping and managing collected premiums.

It is important for dealers to understand that their captive insurance company is another business that must be managed and overseen. Care must be given to the administrative costs of operating the captive and regular reviews of the company's loss ratios are critical in ensuring the captive's success. The key is to maximize underwriting profits in order to maximize the cash available for investment within the reinsurance company.

There are a number of formation issues which require consideration at the outset. The IRS allows for captives to make an election to be treated as a small property and company under 831(b). In order to qualify for the 831(b) election the captive must have annual premiums under \$1.2 million. The advantage of 831(b) is that no income taxes are paid on the net income generated from the small captives insurance activities; i.e. premium income, less claims, less operating expenses equal net income from insurance activities which is not subject to income tax. However, investment income generated by the captive is subject to income tax. Additionally, dividends to the captive owners are subject to tax. If meeting the appropriate requirements, these dividends can be classified as qualified dividends and taxed at capital gains rates instead of ordinary tax rates.

Dealers often setup their captives offshore. This often concerns dealers as they fear that something underhanded is occurring. In general, most often captives are domiciled offshore because the capitalization requirements are much lower than within the United States. Dealers forming an offshore captive generally make a 953(d) election to be treated as a US corporation. The impact of this election is to effectively notify the US government that you have created a captive, domiciled in a foreign jurisdiction, but that you intend to report all activity as if you were a US corporation.

### **How to Maximize the Value of your Reinsurance Company**

While the formation of a reinsurance company will provide the dealer with additional underwriting profits, that's really only half the story. The other key ingredient is working with a financial professional who understands the reinsurance business and who can put the premiums and additional profits to work for you. This begins with a solid overall financial plan for the reinsurance company. Working with a professional who listens and understands your goals and responsibilities can add significant value here, as well as making sure that all of your fiduciary requirements are handled properly. Trying to handle the investment side on your own, or hoping it somehow takes care of itself, would be like telling your customers they should do their own transmission work!



There are a variety of investment alternatives for the premiums collected by your reinsurance company and you'll want to find a financial advisor who understands the risks and requirements for all of the various policies and time frames when you may need to utilize those premiums to pay claims. Typically, most dealerships have neglected this vital component of the business and opted for high cost, low yielding 'money market' or bond type investments that leave a very significant opportunity untapped.

Dealers should seek out an experienced financial planner who can carefully manage your risks, help you set realistic expectations and design strategies to keep your reinsurance company well positioned to handle the financial demands of your policies while working to maximize the value of your business.

In our experience, the costs for investment management in the reinsurance arena are effectively managed by utilizing a fee-based (also known as "Advisory") approach. Here, the advisor's fee is based on the amount of assets they manage for you, not on how many transactions they can generate. The advisory

relationship keeps these costs predictable and aligns the interests of the financial advisor with the reinsurance company. There is no incentive for the advisor to generate any unnecessary activity or sell any specific financial products. Their compensation is simply and directly tied to how well they do for you.

Qualified financial advisors can provide additional value if they have expertise in designing tax efficient strategies, which can make an important difference in your actual end results. A reinsurance business has its own unique tax considerations, and an advisor with experience in both tax minimization and reinsurance would be a valuable partner indeed.

### **Next Steps**

If you've already got a reinsurance business going, it is well worth your time to review your investment plan and get a second opinion to see what your options are. If you don't have a plan, it is essential to get one! If you're thinking of creating a reinsurance business, choose your providers carefully and be sure to enlist the help of a knowledgeable financial professional with reinsurance expertise to really help you get the most mileage from your new business.

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