Essentials of DOWCs

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Edvie Castro is COO and General Counsel of the DOWC family of companies. She combines sharp business savvy with in-depth legal knowledge and an intuitive approach to change leadership that she applies enthusiastically and effectively within our organization and the automotive industry.

Edvie has successfully made it her mission to shape the industry one agent and dealer at a time, with direct conversation and customized guidance and education to increase growth opportunities. She prioritizes the effort to break through the information barrier that has grown stale in the industry, preventing agents and dealers from clearly understanding how they can control their own wealth while remaining compliant.

Edvie's contributions to the industry include her relentless drive for positive change, her ability to operationalize her organization's vision, and her intense focus on supporting dealers' financial growth and overall success through the broadest possible array of participation and structure options and carefully managed, state-by-state regulatory compliance. She can be contacted at edvie.castro@dowc.com.

Andrew Weill is a principal in the San Francisco law firm Weill & Mazer, which focuses on complex commercial, estate and tax litigation. He is a Certified Tax Law Specialist and a leading authority on litigation and tax controversies involving structures taxed as insurance and reinsurance, including tax audits and other compliance issues. He was the counsel for the taxpayers that resulted in the issuance of the published rulings validating reinsurance structures for auto dealers and the revocation of IRS Notice 2002-70.

Mr. Weill is the past President of the Board of Directors of the National Association of Dealer Counsel and the past President of the San Francisco Tax Club. His clients include car dealers and dealerships, domestic and foreign companies, and individuals and entities involved in aftermarket financial products for the automotive and other industries. For the past 18 years, he has been a regular presenter at the annual Risk Transfer and Taxation Conference and has made presentations for AICPA, CCIA and numerous other organizations. He has been invited to present before the National Office of the Internal Revenue Service on tax issues of relevance to car dealers. He can be contacted at weill@weillmazer.com.

Understanding F&I Participation: An Opportunity for Counsel

- Mitigate risk to dealership entities
- Shift from a legal expense to a strategic business partner
- Comprehensive approach to structure selection
- Provide guidance throughout the lifecycle of a structure

Evolution of Participation

Dealer profit via product markup → Inclusion of incentives for owners, managers, & F&I personnel → Guaranteed Retro

Profit Share → Reinsurance → Dealer Obligor → DOWC

Determining the “Best” Participation Structure

- Direct and/or Contingent Liability
- 831(a) vs. 831(b) election and disclosure requirements
- Contractual Obligations
- Financial Requirements
- State Prior Approvals
- Ownership structure
- Corporate Structure
- Favorable Considerations
- Cost of insurance policies & other expenses
- Form & Rate Filing
- Attribution Rules
- Access to capital

DEEP DIVE:

DOWC

What is a DOWC?

- A DOWC is a domestic C corporation.
- The DOWC serves as the provider/obligor/warrantor for the F&I products and is responsible for payment of consumer claims.
- The DOWC takes on risk and is considered an insurance company for federal tax purposes, but not regulatory purposes. It files an 1120PC return.
- The DOWC must satisfy all state and lender requirements.
- The DOWC utilizes a third-party administrator for numerous services, including the adjudication of claims.

Formation & Management

- Domicile determination and nexus review
- Ownership review and tax considerations
- Formation of corporation
- Secretary of State filings
- Licensure applications
- Insurance policies (if applicable)
- Product determinations and development
- Form development
- State form and rate filings (if applicable)
- Lender form filings (if applicable)
- Cession and experience reporting
- Financial reporting and tax filing

Typical Documentation

- Corporate formation and governance documentation
- Management agreement
- Administration agreement with a third-party administrator
- Warehouse agreement
- Producer agreement with dealers
- Contractual liability insurance policy and related agreements

Financial Considerations

- Bank accounts and cash flow/remittance type
- Collateral and trust accounts, account access
- Files an 1120PC federal return
- State taxation varies, most start with federal and adjust

Accounting Considerations

- DOWCs utilize an accepted method of accounting that results in NOLs that can be used to offset income in growth years.
- At the time NOLs run out, structure changes may be necessary in which the dealer counsel should have input.

Taxable Income Calculation

	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5	YEAR 6	YEAR 7	YEAR 8	YEAR 9	YEAR 10
Earned Premium	$200	$200	$200	$200	$200	$200	$200	$200	$200	$200
Expenses	($1400)	$0	$0	$0	$0	$0	$0	$0	$0	$0
Net Profit / Loss	($1200)	$200	$200	$200	$200	$200	$200	$200	$200	$200
Taxable Income	($1200)	($1000)	($800)	($600)	($400)	($200)	$0	$200	$200	$200

PROFIT IN YEAR 8

- Gross premium is utilized as a starting point. In the example above, $2,000.
- Expenses to the company include but are not limited to dealer profit, incentives, administration fees, and insurance fees. Expenses are recognized in the first year. In the example above, $1,400 in the aggregate.
- Premiums are earned prorated over the term of the contract. In the above example, $200 per year over a ten-year period.

- The resulting net operating loss (NOL) is carried forward.
- Claims and other expenses as well as investment income are captured within the calculation, potentially affecting the NOL.
- Note that there are book-to-tax differences. Adjustments are made from GAAP to STAT and TAX.

Financial Benefits of a DOWC

- Opportunity for substantial growth with extended deferral of federal tax as a result of NOL carried forward and potential preferred shareholder taxation
- Domestic entity with reasonable costs of formation and management as well as capitalization requirements
- Not immediately making the 831(b) election
    - Not subject to the premium cap
    - Not subject to 8886
- Insurance policy not per se required, resulting in broad investment opportunities and greater returns
- No tax on investment income
- Increased access to capital and control of product mix, reserves, investments
- Control over reserves and coverage
- Ability to leverage all portfolios for growth

Legal Benefits of a DOWC

- Minimize liability of dealership entities as to F&I products
  - Reduce contingent claims liability
  - Reduce contingent cancellation liability
  - Control over reserves and process
  - Ability to ensure statutory compliance
  - Insulate against reputational harm

- Broad ownership options with continuous control over corporate structure
  - Estate planning purposes
  - No control group concerns (subject to prior structures)
  - No additional disclosures
  - Portability

Legal Benefits of a DOWC

- Greater control over statutory compliance and product development
  - Options for satisfying financial security requirements
  - Options for functionality of and coverage under products
  - Ability to ensure statutory compliance

- Control over use of insurance policies, rates, and filings
  - Subject only to statutory and lender requirements

- Greater control over contractual obligations and rights as to investments
  - Letters of credit, leveraged asset accounts, and other options

- Greater control over runoff configuration

Proforma Assumptions (Inputs)

How many **years of new production** do you want to Proforma? *	20
What is the expected Return on Investments **(ROI)** on cash deposits? *	4.00%
What is the **Annual Management Fee**? *	$10,000
What is the estimated **Annual Audit Fee**?	$
What is the **Annual Renewal and Compliance Fees**?	$
What is the total of any other **General & Administrative Expenses**?	$
What percentage of **UPR** should be **restricted**? *	102%
What percentage would you like to quota share? *	50%

Section 3 - Provide the Year over Year (YoY) growth rates per year *

Production Year 01	NA	Production Year 11	3%
Production Year 02	3%	Production Year 12	3%
Production Year 03	3%	Production Year 13	3%
Production Year 04	3%	Production Year 14	3%
Production Year 05	3%	Production Year 15	3%
Production Year 06	3%	Production Year 16	3%
Production Year 07	3%	Production Year 17	3%
Production Year 08	3%	Production Year 18	3%
Production Year 09	3%	Production Year 19	3%
Production Year 10	3%	Production Year 20	3%

Proforma Assumptions (Inputs)

Section 4 - Provide the F&I Product information *

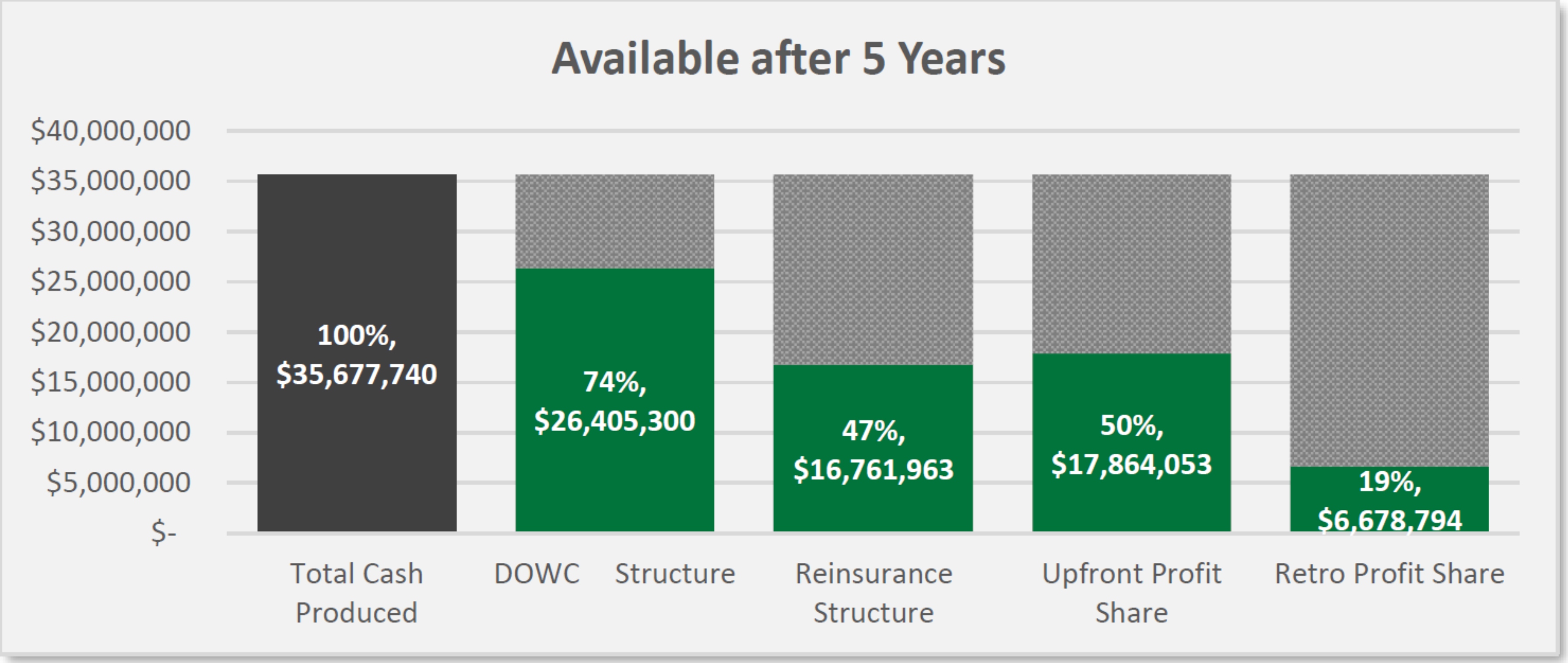
Product	Product Category	Term (years)	Monthly Count	Cancel Rate	Loss Ratio	Avg Reserves	Avg Retail
VSC	Service Contracts	3	604	15%	40%	$558	$2,650
Dent & Ding	Ancillary Service Contracts	4	118	4%	10%	$100	$750
GAP	Financial Protection	6	366	20%	40%	$113	$900
Tire & Wheel - Incl Cosmetic	Ancillary Service Contracts	4	423	5%	68%	$250	$1,300
Key Replacement	Ancillary Service Contracts	3	30	4%	50%	$100	$300
Lease Wear Care	Service Contracts	3	15	2%	20%	$100	$765
Maintenance	Maintenance Plans	3	232	4%	40%	$200	$700
Paint & Fabric	Ancillary Service Contracts	5	748	4%	30%	$176	$1,000
Paint & Fabric Upgrade	Ancillary Service Contracts	5	219	4%	30%	$176	$1,000
Roadside Assistance	Ancillary Service Contracts	3	49	4%	1%	$40	$500
Total / Wtd Avg		**4**	**2804**	**10%**	**41%**	**$256**	**$1,335**

Section 5 - Retrocession Income

UPR at Acquisition	$ -
Loss Ratio & Cancel %	50%
Number of Years Left	4

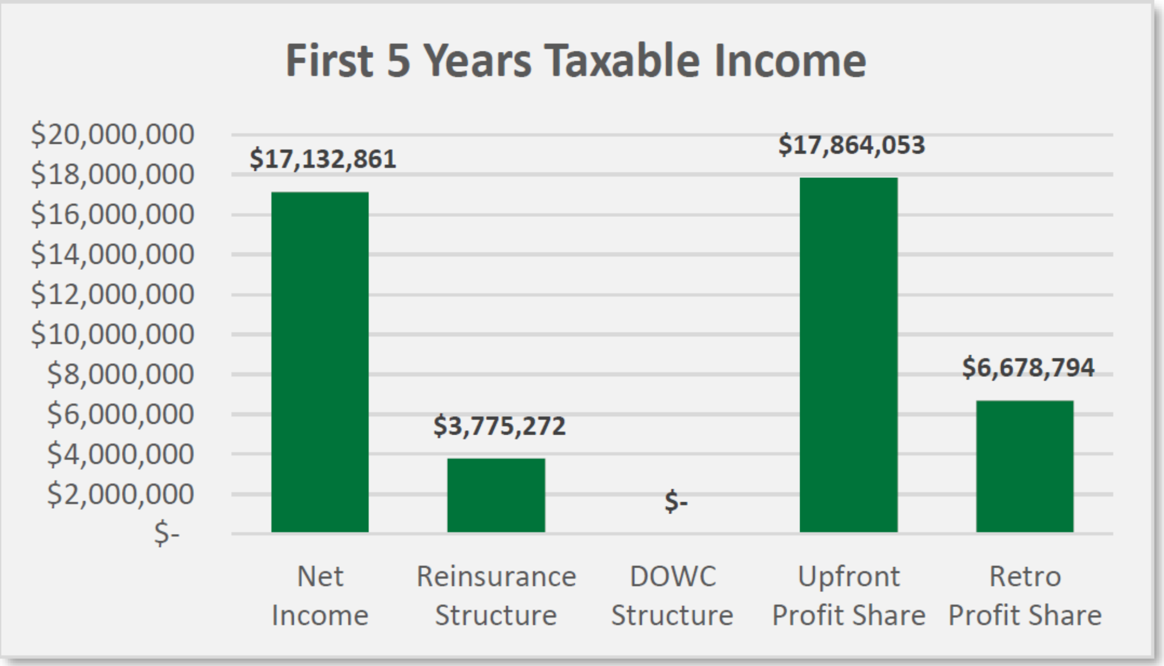
Available Cash

Section 8 - Available Cash Compared to Total Cash Produced



Taxable Income

Section 12 - Tax Comparison Highlights



What is the first year a DOWC Structure with this fact pattern would runout of the Loss Carry Forward (LCF) of their upfront Net Operating Losses (NOL)?

Year 13

Retro earn out is unaffected by the tax of year Year 13.

Common Misconceptions About DOWCs

What causes these misconceptions?

An overall misunderstanding of its functionality and benefits.

Misconception:
Reinsurance companies and DOWCs are polar opposites.

Fact:
The structures are more similar than you think! The key difference is the timing of the 831(b) election. DOWCs calculate their taxable income the same way as P&C companies and file the same tax return.

Misconception:
The accounting method for a DOWC is not well accepted.

Fact:
The accounting methods used for the DOWC structure are the same as those used by P&C insurance companies and by administrator obligors!

Misconception:
DOWCs provide only a limited tax deferral solution.

Fact:
When properly structured with a suitable product mix, the initial DOWC taxable income deferral may stretch for over 10 years!

Misconception:
All F&I products cannot be ceded to a DOWC.

Fact:
DOWCs can hold all typical F&I product risk! Even where the DOWC cannot be the provider or creditor, the risk and premium can be transferred to it.

Misconception:
DOWCs always have high capitalization requirements.

Fact:
Requirements vary by state. Not all states are the same! Some have net worth requirements or capital contribution criteria; others do not. DOWCs also have broader investment opportunities!

Practical Considerations

Candidate for a DOWC	Alternate Obligor Recommended
Large dealer groups	Smaller dealers
Premiums in excess of 831(b) cap	Premiums less than 831(b) cap
Longer term contracts	Shorter-term contracts
Appropriate mix of products	Products with low premium
Sufficient retail and acquisition costs - Products sold at retail - Dealer profit - Incentives	Lack of mark up or incentives, or many give aways
Control group concerns	Control group concerns
Preference for domestic formation	Comfort with foreign domicile
Understanding of state tax and exit strategy considerations	Understanding of required disclosures, or direct taxation
Seeking greater control and potential involvement	Less involvement, more hands-off

Recommendations

- No single obligor type or structure is a one-size-fits-all solution. Make sure to ask who, what, and where!
- Work with a reputable administrator who has the compliance, accounting, tax, and technology resources needed to ensure the proper obligor is utilized and any dealer participation is successful.
- Counsel and the administrator must work together to elevate the conversation and raise the standard of the service dealers have received previously.
- Take advantage of the educational opportunities in the industry and available through your administrator to understand the use of the appropriate obligor as a wealth-building tool for your dealers.
- Ensure you can provide solutions to your growing dealer body or someone else will!