Extended Warranty Providers
What You Need to Know
Introductions

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DHG Overview

THERE WHEN IT COUNTS

- Experienced professionals who understand your industry
- Significant partner involvement
- Ongoing communication to avoid surprises
- Focused on business risks & their impact on your entity
- Accessible, responsive, hands-on style
- Customized service vs. one-size-fits-all approach
- Big Four alternative

DHG does business in all 50 states from offices in:
Alabama | California | Florida | Georgia | Maryland | New York | North Carolina
Ohio | South Carolina | Tennessee | Texas | Virginia | West Virginia
NAVIGATING COMPLICATED MARKET TRANSACTIONS

Our professionals have solid industry knowledge plus a multi-disciplined approach to financial, accounting and operational solutions by offering coordinated comprehensive services and strategies.

**Fund**
- Fund Formation
- Tax Planning & Structuring
- Audit of Fund
- Valuation Services

**Transaction Advisory**
- Financial/Accounting
  - Due Diligence
- Tax Due Diligence
- IT Due Diligence
- Operations & Human Resources Due Diligence

**Portfolio Company**
- Annual Audit
- Tax Planning & Compliance
- IT Audits & Assessments
- Valuation Services

**Exit Strategy**
- Sell-Side Due Diligence
- Initial Public Offering
- Tax Structuring
- Carve-Out Assistance
The Insurance practice is one of DHG’s largest industry segments

- **30+** Years Serving the Insurance Industry
- **100+** Insurance Industry Clients Nationwide
- **150+** Collective Years of Leadership Team Experience

DHG has a strong insurance leadership team with decades of industry experience. We combine our industry and subject matter professionals with a wide range of services and accessibility to provide a client service approach that has a regional firm feel with a national firm reach.
Circular 230 Disclosure

To ensure compliance with requirements imposed by the IRS, we inform you that any tax advice contained in this communication is not intended or written to be used, and cannot be used, for the purpose of avoiding penalties under the Internal Revenue Code.
An Overview of
Extended Warranty Providers
WHAT DO YOU KNOW ABOUT EXTENDED WARRANTY PROVIDERS?

A. I don’t know anything about extended warranty providers

B. I’m somewhat familiar

C. I’m extremely familiar
Objectives For Today

1. Understand how different programs/contracts are structured

2. Discuss the types of entity structures used and the associated cash flows

3. Identify key federal and state tax benefits and considerations

4. Identify common audit and due diligence considerations
Types of Extended Warranty Providers

- Administrator Obligor (AO)
- Dealer Obligor (DO)
- Dealer Owned Warranty Company (DOWC)

*PEGs Investing*

Original Equipment Manufacturers (OEMs)
Types of Distribution Channels

OEM

Dealerships

Financial institutions

Direct-to-consumer

*PEGs Investing*
# Primary Types of Products

<table>
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<tr>
<th>Vehicle Service Contracts (VSC)</th>
<th>Guaranteed Asset Protection (GAP)</th>
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<td><strong>Key Considerations:</strong></td>
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**Primary Types of Products**

- **Market Entry/Expansion**
- **Relocations/Consolidation**
- **Mergers & Acquisitions**

**Dealer Obligor**

- **Federal, State, Local, Public and Private Vehicle Service Contracts (VSC)**
- **Guaranteed Asset Protection (GAP)**

**Key Considerations:**

- **The Contract**
- **The Coverage**
Common Add-On Products

- Lifetime Powertrain Warranty
- Etch/Theft Protection
- LoJack
- Prepaid Maintenance Programs
- Key Replacement
- Roadside Assistance Programs
- Tire & Wheel Protection
- Other
Administrator Obligor Program

Customer

Dealership
($650 Commission)

$1,200

$550

Administrator Obligor (AO)

CLIP Insurer

$50

Profit / Expense $150

Trust Account $350

Profit / Expense
Dealer Obligor Program

Customer

$1,200

$250 TPA Fee

Dealer Obligor (Dealership) → Administrator (TPA)

Profit / Expense

CLIP Insurer

Profit / Expense

Trust Account $350

$50
Contractual Liability Insurance Policy:

- Insurance that covers liability of the insured assumed in a contract.

- Most commonly associated with service contracts but can be used in a variety of areas.

- CLIPs can be used for a variety of reasons, but the two primary reasons are driven by regulatory requirements and economics.

- Policy issued to the VSC Company that guarantees the performance obligation of the VSC Company.
Affiliated Reinsurance with CLIP

Customer

$1,200

Dealership ($650 Commission)

$550

Administrator Obligor (AO)

Profit / Expense

$350 Reserve Premium

$50 CLIP Premium

CLIP Insurer

Profit / Expense

$350 Reserve Premium

Reinsurance Company

Profit / Expense

Dealership Owner

Custodial Trust FBO Insurer & Reinsurer
An Overview of Revenue Recognition & Why Correct Earnings Matter
Poll #2

HAVE YOU INVESTED IN OR ARE YOU CURRENTLY EXPLORING AN INVESTMENT IN AN EXTENDED WARRANTY PROVIDER?

A. Yes  

B. No
Revenue Recognition

• ASC 605-20-25- “Separately Priced Extended Warranty and Product Maintenance Contracts”

• Similar to short-duration insurance contracts

• Should be pro rata, unless evidence suggests cost are incurred in a different pattern (“Loss Emergence”)

• Also allows for deferral of certain costs, amortized on same pattern
Earnings Patterns or Curves

• Calculated actuarially and generally expressed as a cumulative earned percentage by term month

• Curves will vary based on term, coverage, initial mileage, make, etc.
Loss Ratios

- A measure by which to express losses as a percent of premiums
- Calculated as total incurred losses over premiums earned
- Incurred losses = paid losses + any loss reserves
- Can be used to estimate future losses
Assumptions:

• Total premiums written = $10 million

• Total ultimate losses = $8 million

• Ultimate loss ratio = 80%

• Currently half way through term (24/48 mo.)

• $5.9 million incurred through 24 mo.
Earnings Patterns

- PR
- Experience

Private Equity
Loss Ratios

Pro Rata
- Prem. Earned $5 million
- Losses incurred $5.9 million
- Loss ratio 118%

Loss Emergence
- Prem. Earned $7.4 million
- Losses incurred $5.9 million
- Loss ratio 80%
An Overview of Audit & Financial Due Diligence Considerations
Key Audit & FDD Issues/Considerations

1. Databases
2. Revenue Recognition
3. Working Capital
4. Other
Audit & FDD Considerations

### Databases (Internally Developed)
- Lack of proper controls
- Incorrect data input, mappings or logic
- Earnings / expense deferrals may not be accurate
- Calculated amounts may be priced incorrectly

### Revenue Recognition
- Mismatch in earnings pattern to loss emergence
- Incorrect earnings start date
- Incorrect obligor classifications
- GAAP revenue may be misstated (QofE adj.)
- GAAP unearned premium may also be misstated (working capital adj.)

### Working Capital
- Treatment of unearned revenue in working capital
  - Ensure consistency
  - Inclusion generally favorable to seller
  - Exclusion generally favorable to buyer
- Unearned revenue current vs. non-current liability
- Cash requirements for liabilities acquired

### Other
- DAC and prepaid insurance premiums
- Claims liabilities
- Revenue on a ‘written’ vs. earned basis
- Private company expenses
- Employee compensation
- Profit sharing and ‘Retro’ liabilities
- Seasonality and product trends
An Overview of Tax Treatment & Benefits for the ESC Provider
TRUE OR FALSE?

Companies issuing extended service contracts ("ESCs") qualify as insurance companies for federal tax purposes.
Qualifying as Insurance for Tax

THE 50% INSURANCE TEST

Extended Service Contract (ESC)

Administration Fee
Not Included

Insurance Premium
Included
Private Letter Rulings (PLRs)

Multiple PLRs have been issued concluding that companies issuing ESCs qualify as insurance companies for federal tax purposes:

- PLR 200042018
- PLR 200028018
- PLR 200340011
- PLR 201419007

*A sample of such PLRs*
WAYS TO ACHIEVE DESIRABLE TAX TREATMENT

Extended Service Contract Providers

Federal Taxes
Might qualify as an insurance company

State Taxes
Might be subject to state income taxes
WHY IS INSURANCE TAX TREATMENT DESIRABLE?

- A mismatch of revenue and expense in favor of the taxpayer
- Loss reserves for known incurred and IBNR can be established and deducted subject to a small discounting percentage

Extended Service Contract

<table>
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<tr>
<th>Acquisition Costs</th>
<th>Insurance Premium Revenue</th>
<th>Loss Reserves</th>
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<td>Expenses are deducted as incurred</td>
<td>80% of revenue is deferred &amp; recognized over the policy life</td>
<td>Tax reserves are generally 90% to 95% of GAAP reserves</td>
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- **ESCs can have a coverage period of 3-7 years**
- **Some ESCs aren’t effective for years after which the policy is sold**
Federal Tax Provisions

• Warranty companies file GAAP financials and most likely are not filing statutory statements

• Regulation 1.6012-2 states that insurance companies are required to file with its tax return a copy of the annual statement (or proforma annual statement)
STATE TAX SAVINGS:

- ESCs are generally subject to state income tax \textit{in lieu of} premium tax

Extended Service Contract (ESC)

State Income Tax
- Taxed on Profit
- Lower Tax Cost
- May Not Pay State Income Tax For Many Years

Premium Tax
- Taxed on Written Premium
- Higher Tax Cost
STATES DIFFER IN THEIR TREATMENT OF ESCs:

• ESCs will generally fall into 1 of 2 categories

Extended Service Contract (ESC)

Sales Tax
- Exempt any subsequent services of the contract

Use Tax
- Exempt the sale of the contract
TAX COMPLIANCE:

1. The non-filing of returns and remitting of the respective taxes is quite common

2. States are becoming aware of such underreporting and are initiating sales and use tax audits with success

3. If ESC companies have not yet been contacted by a state, they can mitigate exposure through voluntary disclosure agreements