State Issues and Developments 2019 Updates

F&I Reinsurance and Product Conference
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October 29, 2019

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What States Care About

- Consumer protection
- Insurance compliance
- Taxes

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Consumer Protection

- Often prescribes mandatory provisions of contracts
- Highly variable according to product and state
- In some cases, licensing may be required
- State compliance can be raised by IRS in assessing tax liability

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Insurance Issues

State Insurance Departments care about:

- Risk to consumers and therefore to state guaranty fund. Usually addressed by bonds, CLIP, other security
- Possible classification as insurance product requiring some level of licensing

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Insurance Issues, Part 2

- It's not just the state insurance department to consider
- Consumer lawyers will look for statutory deficiencies to justify litigation
- Characterization as insurance can open door to recovery of attorney's fees
- Never forget: **Lawyers are greedy!** If you need a reminder, I can help!

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Polling Question

In which state are the majority of your F&I contracts generated?

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State Tax Issues

- Procurement taxes
- DOWCs need to comply with state tax filing requirements
  - Variability according to state
  - Some states may not agree with IRS treatment as insurance company
- ARCs and NCFCs typically aren't resident in a state but, next slide please…

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California Franchise Tax Board

- 2014 FTB posted article entitled "Is Your Offshore Affiliated Risk Company Required to File a California Tax Return?"
- This article describes the result of a field audit only
  - Not a judicial decision
  - Not a ruling at any level higher than the field
  - Ultimate outcome of this matter remains in doubt because subject to administrative protest, internal appeal rights and judicial review

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FTB Rationale to Claim Arcs Are Taxable

- ARCs conduct no corporate activity, have no assets, offices, personnel, or business presence in their offshore legal domicile.
- Legal domicile is only a paper domicile with virtually no other connection to the offshore location.
- ARCs are actively managed, directed and controlled in California.
- ARCs do not sell any insurance policies, do not perform any insurance functions, do not file a California tax return and are not registered as an insurance company with the California Department of Insurance.

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What does this mean?

- Of all these factors, only one arguably gives rise to California nexus: “actively managed, directed, and controlled in California”
- Earlier in article: “The ARC agrees to hold and invest the funds derived from Dealer’s sale of VWSC. The funds are held in trust/custodial accounts with domestic financial institutions. The trust/custodial accounts are for the benefit of the ARC. ARC earns investment income as a result of this activity.”

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FTB – Key Issues to Consider

- From what article says, it appears that the “management and control” is that California owners/directors may be involved in investment decisions
  - Who really has control over investment decisions?
  - Is this enough for commercial domicile?
- Article footnote 4 states: “[The ARC’s] business is limited to receipt of funds, investment of these funds, and the eventual distribution of these receipts to its shareholders and/or affiliated company, Dealer.”
  - This appears to be a plain misstatement because it disregards all insurance activities of the ARC.

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FTB Current Status

- In 2014, I reported “FTB is conducting independent administrative review and it is impossible to predict whether it will persist in field position, modify it, or reject it in whole or part.”
- Current progress: “Molasses on a cold day in January waiting in line at the DMV.”

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Polling Question

Which participation program needs to file a state tax return?

A. Non-Controlled Foreign Corporation (NCFC)
B. Dealer Owned Warranty Company (DOWC)
C. Controlled Foreign Corporation (CFC) with 953(d) election
D. None of the above

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Wayfair – U.S. Supreme Court Decision

- June 2018 Decision – Allows states to base sales tax collection obligation on REMOTE SELLERS with no PHYSICAL PRESENCE in the state
- Why does F&I care?
  - Services may be subject to sales tax in some states
  - Resale certificates may be needed to exempt transactions from sales tax on services
  - Implications for income tax nexus, in addition to sales tax nexus

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Wayfair – Overview of Activity

- Many states and local jurisdictions have enacted laws or regulations, in response to the Wayfair decision
  - Sales tax
  - Gross receipts tax
  - Net income tax
- Initial observation
  - In auto dealer and auto F&I arena, there may be more of a COMPLIANCE BURDEN
  - However, new announcements are coming out monthly, if not weekly

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Wayfair – CA Sales and Use Tax

- Administrative burden on out-of-state auto dealers
- California Department of Tax and Fee Administration (CDTFA) stated:
  - If the remote dealer's sales into CA exceed the $500,000 threshold, the remote dealer must register with CDTFA and file sales and use tax returns, even though the remote dealer may not have to remit any use tax and is not required or authorized to collect use tax from a California vehicle purchaser

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CA Wayfair – Continued

- Vehicle Parts - In addition, remote vehicle dealers should determine whether any vehicle parts are being sold to California purchasers. CDTFA confirmed that the remote dealer must aggregate their parts sales with the vehicle sales, in calculating whether sales exceed the $500,000 threshold
- Burden - Since many remote dealers may not end up remitting any tax, due to the special CA vehicle use tax rules, the CDTFA registration and tax return requirements may feel more like an administrative burden, without significant revenue for CA

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Texas Wayfair Proposed Regulation Gross Receipts Tax

- Under draft proposed amendments to regulation, a foreign (non-Texas) entity with taxable gross receipts from business done in Texas of $500K or more has Texas nexus, even if no physical presence
- Under proposal, new economic nexus standard would apply with reports due on or after January 1, 2020

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Pennsylvania Wayfair – Income Tax

- Starting with tax year 2020, a corporation with at least $500K in annual sales but no physical presence in Pennsylvania will have to file a corporate net income tax return
- Tax is expected to hit companies that have licensing arrangements, including franchise agreements and software
- Before change, if no physical presence, no return was required

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Questions

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