The Top 10 Myths About Non-Controlled Foreign Corporations

Successful providers recognize that maximizing income is always a top priority for dealers. Participating in a reinsurance program, whether it is a controlled foreign corporation (CFC) or non-controlled foreign corporation (NCFC), can be an effective strategy for long-term wealth building.

In the 1990s, reinsurance was gaining a foothold in the vehicle service contract industry. CNA National wanted to offer its dealers reinsurance options that matched the high standards they had come to expect from us. We spent several years working with expert attorneys in the securities, insurance and tax fields to develop Palo Verde Insurance Co., Ltd., which launched in 1999. Over the past 16 years, it has performed exceptionally well.

Despite Palo Verde’s success, there are many pervasive myths that prevent dealers from taking advantage of the product. In order to help provide clarity, we’ve compiled and debunked the top 10 myths about NCFCs.

**Myth #1**

The term “non-controlled” means that dealers do not have any control over their money.

**FACT**

The designation “non-controlled foreign corporation” is a U.S. tax term. “Non-controlled” means that no single U.S. taxpayer holds more than 10 percent of the shares or controls more than 10 percent of the voting power, and “foreign” means that all business is conducted offshore. In the case of Palo Verde, that’s Bermuda. Palo Verde is 100 percent owned by the dealer-shareholders. Decision-making for the company is done by an elected board of directors composed primarily of dealer-shareholders. CNA National has no ownership in Palo Verde.

**Myth #2**

It is complicated and time-consuming to enter an NCFC.

**FACT**

Gaining an NCFC position is a simple process once a dealer decides it’s the right option. The whole process can be completed fairly quickly. We have even had issues of stock distributed in as little as two weeks. For Palo Verde, the subscription package is overnighted from Bermuda to the dealer, who is required to complete a personal questionnaire and provide a certified copy of his or her driver’s license. Then, CNA National prepares the required documents for signature. If the shares are to be held by a corporation, trust or partnership, slightly more documentation is required. Once the paperwork is complete, the shares can be issued. Unlike a CFC, there is no waiting for name approval, formation, etc.

Subject to program eligibility, terms, conditions and limitations. Please read contracts carefully. CNA National makes no representations as to the need for or appropriateness of producer-affiliated reinsurance companies. Reinsurance involves risk. Please consult your own legal counsel and financial representative before deciding whether to create or invest in such an entity.
NCFCs have high start-up fees and management costs.

**FACT** The “cost” of establishing a position in Palo Verde is relatively low, with an initial investment of $3,501, which is a capital contribution not an expense. Management expenses are equally distributed among all the shareholders, and the costs of operating the company have remained relatively constant. The company charter provides for up to 200 shareholders and, currently, the company has close to 60. However, adding shareholders does not increase costs. Over the last three years, Palo Verde management fees have averaged less than $3,000 per shareholder annually.

NCFCs are only an option for dealers who will exceed the $1.2 million written premium limit of a CFC.

**FACT** While it is true there is no limit on written premium in an NCFC, it’s not just for the “big guys.” In fact, the production requirements for Palo Verde are the same as for a CFC, and the cost of entry and ongoing expenses are lower. In addition, since the dealers are entering a company with a mature investment portfolio where all assets are pooled for investment, the potential returns are higher. For these reasons, our NCFC can be a good choice for any dealer considering a reinsurance structure.

There is significantly more risk with an NCFC because a dealer with high losses could severely impact the overall group.

**FACT** While we can’t speak for all NCFCs, Palo Verde protects its shareholders against excess losses through stop-loss insurance, which covers 90 percent of the excess loss. The remaining 10 percent is distributed proportionately among the shareholders. For the last three years, shareholders were individually responsible for less than $20 each to cover excess losses.

<table>
<thead>
<tr>
<th>Period</th>
<th>Excess Losses (100%)</th>
<th>Loss Recovery from CNA (90%)</th>
<th>Allocated to Shareholders (10%)</th>
<th>Avg. Expense per Shareholder</th>
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<tbody>
<tr>
<td>Year Ended 12/31/12</td>
<td>$5,357</td>
<td>$4,621</td>
<td>$536</td>
<td>$8.37</td>
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<tr>
<td>Year Ended 12/31/13</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Year Ended 12/31/14</td>
<td>$1,175</td>
<td>$1,058</td>
<td>$118</td>
<td>$1.99</td>
</tr>
</tbody>
</table>

*Based on actual results from the last three years.

The rate of return is lower in NCFCs.

**FACT** Since it is an established structure, Palo Verde has more flexibility in investment options. With an investment portfolio of over $150 million (as of June 2014), it has delivered an annual return of more than five percent since its inception in 1999—impressive results when factoring in two severe market downturns during that time span.
**Myth #7**

It’s difficult to exit from an NCFC.

**FACT**

One of the great advantages of Palo Verde is the defined exit strategy. The shareholder’s ability to cash out has been safeguarded contractually from the beginning via redemption of shares by the company. The shares are redeemed and valued at the December 31 book value. The following August 1, 75 percent of the adjusted book value is paid. Then, annually, as the remainder of the book earns out, 75 percent of the book value as of the prior year-end is paid on August 1, until the amount is fully paid.

**Myth #8**

NCFCs are heavily regulated.

**FACT**

Palo Verde is domiciled in Bermuda, which has a stable government with regulations that add a layer of protection for the investor. In terms of taxes, there are certain information disclosures required by the IRS but, since a qualifying NCFC does not pay U.S. taxes, there should not be any U.S. income tax levied on shareholders until a dividend is issued or shares are redeemed. When shares are redeemed, the gain should be treated as a long-term capital gain, which, under current U.S. tax law, receives preferential rates. Qualifying NCFCs are not currently subject to U.S. income taxes, and shareholders are not subject to U.S. tax until they either receive a dividend or redeem their shares.

**Myth #9**

NCFCs don’t have any unique tax benefits.

**FACT**

Bermuda has no income tax. While ordinary dividends paid are subject to U.S. ordinary income tax rates, many shareholders redeem their shares before a dividend is declared and choose to establish a new position. This allows the retained earnings to grow tax-deferred and then be taxed at preferential, long-term capital gains rates when shares are redeemed under current U.S. tax law.

**Myth #10**

IRS rules make owning shares in an NCFC problematic.

**FACT**

A Palo Verde shareholder does not own or control a foreign bank account. Palo Verde’s structure and business operations do not fall within the current guidelines of a passive foreign investment company, nor is it a protected cell company. The technical term for the company is non-financial foreign entity (NFFE), which is the best designation for a foreign corporation of this kind. To date, the Palo Verde structure has remained exempt from U.S. taxes imposed on certain foreign corporations, including excess profits and branch taxes as well as withholding taxes.