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The Nonadmitted and Reinsurance Reform Act's Questionable Applicability to Captive Insurance Companies

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Since Congress's enactment of the Nonadmitted and Reinsurance Reform Act (NRRA) as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act,[1] questions about the NRRA's applicability to captive insurance companies have been a hot topic within the captive insurance industry.

The fact that the NRRA's arrival coincided with an upswing in attention being paid to self-procurement taxes only increased the attention being paid to the NRRA by regulators, risk managers, captive managers, and board members of captive insurance companies across the United States.

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (July 21, 2010).

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For the past year, professionals working on captive insurance matters have been asking: "What does the NRRA mean for me?" Unfortunately, the answer is rather dissatisfying: "It depends."

It depends on who you are and what your stake is; on where you are domiciled and who your regulators are; on the fact patterns of the disputes over the NRRA that may arise regarding the application of the NRRA to captives—and the various courts that eventually will resolve those disputes. And of course, it depends on whether clarifying legislation is proposed and enacted.

Executive Summary

This article will:

- provide an overview of the NRRA;
- review the legislative history (or lack thereof) relevant to its application to captive insurance companies;
- preview the lens through which any litigation likely will be focused; and
- highlight a few of the most interesting ideas and developments regarding this quandary for captives.

Overall, the article should prepare readers for the most probable result of potential court challenges regarding the applicability of the NRRA to captives—multiple decisions by different judges that come to varying results.

The Dodd-Frank Act was a sprawling legislative reform intended to apply to a wide array of financial industry activities, into which the NRRA was inserted.

The NRRA represented the culmination of long-standing efforts by surplus lines insurance companies and brokers to streamline the way taxes are collected on surplus lines insurance.

Although there was no indication by the sponsors of the NRRA that it was supposed to apply to captive insurance companies—indeed, the term captive insurance was never spoken during any related debate on the congressional record—the NRRA's eventual wording could arguably be applied to captives and has caused significant uncertainty across the enormous captive insurance industry. The confusion impacts basic business planning for companies using or considering captive insurance arrangements.

By tacking the NRRA onto the Dodd-Frank Act, Congress unintentionally has pitted states against each other in the search for revenue and now often is viewed as having inserted itself into business judgments which are better left to corporate managers. The uncertainty that the NRRA has caused for captives could be resolved easily via clarifying federal legislation but, despite efforts by certain legislators, congressional action regarding Dodd-Frank's implications for the captive insurance industry might well take second place to dealing with the well publicized concerns expressed by prominent financial institutions about other features of the Dodd-Frank reforms.

In the meantime, interested parties, including captive owners and state insurance regulators, will no doubt try to influence the future impact of the NRRA by making their views known to Washington. Presumably, their most sought after prize will be getting legislators to specify that captives, like risk retention groups, are not a nonadmitted insurer for purposes of the NRRA.

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U.S. Code, Title 15, Section 8206(11)(B) already states that the term nonadmitted insurer "does not include a risk retention group." A pragmatic next step would be the addition of an (11)(C): "does not include captive insurance companies."

At the very least, the lobbying effort will seek clarifying federal legislation to help captive owners and regulators move forward with more certainty. Given the apparent intention of Congress to deal specifically with surplus lines matters and the confusion resulting from the broad language of the act, Congress should be amenable to adopting the necessary clarification.

If the applicability of the NRRA to captives is addressed by the courts, it is unlikely that a uniform interpretation and application of the statute will emerge as a consequence, because of the varying factors in play, including competing judicial approaches to statutory interpretation and varying fact patterns and public policy implications from one case to the next. Even on the current Supreme Court, different justices tend to take different approaches to statutory interpretation; so it is fair to expect varying results from the hundreds of jurists—from trial and appellate courts alike—that may be asked to determine whether the NRRA applies to captives.

The uncertainty created by the NRRA has prompted some captive insurance companies to take steps in response to the law, but most have adopted a "wait and see" approach. Of those that have taken reactive measures, the most common approach has been to create a new captive in the parent's "home state," so that only the home state can tax the captive insurance transactions, and do so at the low rate imposed on domestic captive insurance companies, rather than at the much higher self-procurement tax rate that applies in some states for insurance purchased directly from insurance companies licensed to sell insurance only in other states.

Of course, the best course of action for any one company depends on its particular situation and, given the complexities and uncertainties involved, analysis and guidance from experienced professionals is advisable before making any changes to an existing captive program.

Captivated by the NRRA

The NRRA sets forth a framework under which states may tax and regulate nonadmitted insurance[2] placed with nonadmitted insurers.[3] Simply put, the NRRA prohibits any state except the policyholder's home state[4] from levying a tax on premiums charged by nonadmitted insurance companies and authorizes the states to enter into a tax-revenue sharing compact to the extent that some of a policyholder's risk is located outside of its home state.

This relatively small addition to the Dodd-Frank banking reform act was the product of a long-standing effort to give some order to the way in which premium taxes are levied on surplus lines insurance.[5] It caused

[2] The NRRA defines nonadmitted insurance as follows: "The term 'nonadmitted insurance' means any property and casualty insurance permitted to be placed directly or through a surplus lines broker with a nonadmitted insurer eligible to accept such insurance."

[3] The NRRA defines "nonadmitted insurer" as "with respect to a State, an insurer not licensed to engage in the business of insurance in such state."

[4] The NRRA defines "home state" as follows:

> (A) In general.—Except as provided in subparagraph (B), the term "home State" means, with respect to an insured—
> (i) the State in which an insured maintains its principal place of business or, in the case of an individual, the individual's principal residence; or
> (ii) if 100 percent of the insured risk is located out of the State referred to in clause (i), the State to which the greatest percentage of the insured's taxable premium for that insurance contract is allocated.
> (B) Affiliated groups.—
> If more than 1 insured from an affiliated group are named insureds on a single nonadmitted insurance contract, the term "home State" means the home state, as determined pursuant to subparagraph (A), of the member of the affiliated group that has the largest percentage of premium attributed to it under such insurance contract.

[5] The "home-state-only" rule of the NRRA was passed in response to lobbying efforts by surplus lines insurance companies to streamline the complicated and costly administrative process of documenting and remitting premium taxes separately in all 50 states.

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unexpected tremors across the captive insurance industry because the language of the statute was less than clear about whether it applied only to surplus lines insurance transactions or also to insurance transactions with captives domiciled outside of their parent company's home state.

Rather than using a definition that clearly limited the statute to surplus lines insurance transactions, the NRRA states that it applies to any ''nonadmitted insurer''—which is defined as ''an insurer not licensed to engage in the business of insurance'' in the policyholder's home state.[6] Thus sparked a nagging discussion within the captive world over whether Congress, in its haste to insert a minor provision aimed at surplus lines insurance into the already unwieldy Dodd-Frank Act, inadvertently upended one of the organizing principles of the captive insurance world—regulation and taxation by the captive's domicile (as opposed to the policyholder's domicile).

There are three main types of taxes that potentially come into play with captive insurance arrangements:

- premiums taxes paid by the captive;
- self-procurement taxes paid by the policyholder; and
- surplus lines taxes paid by a surplus lines broker and passed along to the policyholder.

Premium taxes are collected in connection with most captive insurance placements, and are paid to the state where the captive is domiciled. The NRRA does not directly affect the collection of these premium taxes.

Self-procurement taxes (also known as ''direct placement taxes'') are paid by policyholders that purchase insurance directly from an insurance company that has not been admitted to sell insurance in the state where the risk is located or where the policyholder is located. Self-procurement taxes are owed under the laws in approximately two-thirds of U.S. states, and historically were paid by the policyholder to the state where the risk was located. Self-procurement taxes existed before and after the enactment of the NRRA, and the only impact that the NRRA arguably has on such taxes is the place where they are collected—not the amount that is taxed.

Surplus lines taxes are owed when an insurance broker licensed in the policyholder's state places the insurance with an insurance company that is not admitted to sell insurance in the policyholder's state. The NRRA changes the way that surplus lines taxes are to be collected—from a system based on the location of the risk to a system based on the policyholder's home state. Most captive insurance placements, however, take place directly between the policyholder and the captive and, therefore, do not trigger a surplus lines tax. That said, if a broker's involvement with the placement did give rise to a surplus lines tax, then presumably the self-procurement tax would not apply.

Self-procurement and surplus lines taxes vary in magnitude from state to state but generally are between 2 percent and 6 percent of gross premiums. Captive premium tax rates are much lower. For example, New York's captive premium tax is 0.038 percent of premiums and its self-procurement tax is 3.6 percent.

After the NRRA was enacted, many captives found themselves wondering whether the benefits of being domiciled in a state other than their parent's home state exposed the company to paying more in taxes—via a self-procurement tax collected by the home state under the NRRA, plus a premium tax charged by the state where the captive is domiciled. Early on, uncertainty reigned, as captive owners, managers, and other professionals scrambled to make sense of the new law.

Some companies considered re-domesticating their captives to their home state, where they presumably would be taxed only once. Other captives came up with different strategies, as discussed in more detail below. Most seem to have opted to avoid incurring potentially wasted transaction costs by taking a ''wait and see'' approach with the hope that the new law would be clarified by Congress or the courts.

Although the NRRA was intended to change the way surplus lines taxes are collected on nonadmitted insurance sold through surplus lines brokers, there is no indication that it was intended to—or does—alter well-settled case law[7] that limits a state's ability to tax an insurance transaction in which the location of the insured risk is the only nexus to that state. This is largely because the policyholder's presence in its home state always should provide a nexus that permits that state to collect taxes on the policyholder's insurance transactions, irrespective of the potential application of the NRRA.

Legislative Intent

The Dodd-Frank Act, which spans more than 2,300 pages, has been widely criticized for a lack of debate and scrutiny in Congress and for its resulting sloppiness and unintended effects.

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For example, the day after President Obama signed the bill into law, the asset-backed securitization market came to a standstill because credit rating agencies refused to include their ratings in registration statements for bond offerings due to one provision in the law which imposed ''expert'' liability risks on credit rating agencies. In response, citing ''damaging policies'' within the Dodd-Frank Act, the House Financial Services Committee began the process of repealing the relevant section of the law[8] and the Securities and Exchange Commission quickly granted indefinite no-action relief.[9]

[6] 15 U.S.C. Section 8206.

[7] *State Board of Insurance v. Todd Shipyards Corp.*, 370 U.S. 451 (1962).

[8] See http://financialservices.house.gov/news/documentsingle.aspx?DocumentID=252949.

[9] Ford Motor Credit Company LLC, SEC No-Action Letter (July 22, 2010). (''Effective July 22, 2010, Section 939G of the Dodd-Frank Act provides that Rule 436(g) shall have no force or effect. As a result, disclosure of a rating in a registration statement requires inclusion of the consent by the rating agency to be named as an expert.'')

Given the lack of evidence of legislative intent for the NRRA to apply to captive insurance companies, the captive insurance industry seems to be caught in the wake of similar unintended consequences.

There are approximately 757 pages of the *Congressional Record* devoted to debate and discussion regarding the entirety of the Dodd-Frank Act. Of that legislative history, only 26 pages relate to the NRRA. Tellingly, of those pages representing the core record of the act's legislative intent, the term ''captive insurance'' is not mentioned even once. Accordingly, it seems abundantly clear that the NRRA was not designed to apply to captive insurance companies.

When the 109th Congress passed the Nonadmitted and Reinsurance Reform Act of 2006,[10] it included a ''Purpose and Summary'' section that stated that the law would ''reform and modernize two important sectors of the commercial insurance marketplace, nonadmitted insurance (also known as 'surplus lines') and reinsurance.''[11] The text of the ''Purpose and Summary'' does not mention captive insurance, but it does focus on brokers and uses a term that is not even in the statute: ''nonadmitted broker.'' This is consistent with the sponsor's interchangeable use of the terms ''nonadmitted'' and ''surplus lines.'' Rep. Dennis Moore (D-Kan.), the chief co-sponsor of the NRRA, stated in a speech before the House:

> The law [gives] sole regulatory authority over a surplus lines transaction—including the authority to collect premium taxes—to the home state of the insured . . . . The broader intent of the law is to provide a comprehensive, uniform solution to the current regulatory mess by addressing the full spectrum of surplus lines regulation: declination and reporting requirements, broker licensing requirements and electronic processing, insurer eligibility standards, and treatment of sophisticated commercial purchasers . . . . in order to truly realize the promise of the new law, the states need to take this opportunity to adopt a single set of uniform surplus lines regulatory requirements—requirements that are not just similar but the same in every state.[12]

Rep. Moore equated surplus lines and nonadmitted insurance in other instances as well. For example, during the Dec. 15, 2010 speech in the House, he explained that ''[n]onadmitted insurance, or surplus lines, is specialty insurance you cannot purchase in the traditional, admitted market.''[13]

Rep. Scott Garrett (R-N.J.), a sponsor of a 2009 version of the NRRA, also seemed to synonymize nonadmitted and surplus lines during his comments on the House floor:

> H.R. 2571, the Nonadmitted and Reinsurance Reform Act of 2009, will reform and will streamline the regulation of the nonadmitted—that's surplus lines—insurance market as well as the reinsurance market. Title I, which addresses the surplus lines market, will reduce regulatory overlap . . . .''[14].

Another sponsor, Rep. Spencer Bachus (R-Ala.), similarly stated: ''[T]oday we are seeking to advance a modest but long-overdue measure to streamline the current system for surplus lines insurance and for reinsurance . . . . Surplus lines insurance, also known as 'nonadmitted' insurance . . . .''[15]

Still other congressional representatives used surplus lines and nonadmitted interchangeably. In the Sept. 19, 2006, hearing before the House Subcommittee on Commercial and Administrative Law, Chairman Chris Cannon (R-Utah) stated: ''States allow nonlicensed insurers, known as nonadmitted or surplus line insurers, to provide insurance.''[16] Referring to the Nonadmitted and Reinsurance Reform Act of 2006, he continued:

> H.R. 5637 was written to affect a narrow area of insurance reform. It is aimed at addressing inconsistencies of State regulation in the surplus lines insurance market and streamlining its procedure. It creates a uniform system for nonadmitted insurance premium tax payments by making the taxing authority the home State of the policyholder . . . .[17]

In light of the fact that much of the congressional record treats nonadmitted insurance as synonymous with surplus lines insurance and completely fails to refer to captive insurance, it is fair to conclude that there was no legislative intent for the NRRA to apply to captive insurance.

That said, because the statute's definition of nonadmitted insurance arguably encompasses property and casualty insurance sold by a captive insurance company (so long as the captive is not licensed to sell insurance in a particular state), certain home states can be expected to argue that the NRRA applies to captives, in an attempt to collect certain taxes arising out of captive insurance transactions with policyholders headquartered in that home state.

What to Expect When The NRRA Hits the Courts

While there have been no reported cases involving disputes over the application of the NRRA to captives, with hundreds of millions of dollars in premium taxes at stake over the next several years, it is fair to expect that litigation (or rulings by tax authorities) involving various angles on the issue is likely to arise. Such litigation would address and attempt to resolve the continued uncertainty about whether the NRRA was intended to—and whether it does—apply to captive insurance.

Accordingly, no matter what a captive's current strategy is regarding the NRRA, it is advisable to understand how courts evaluate cases like these—where the legislative intent of a statute arguably does not square with the language that ends up in the statute.

There are numerous viewpoints as to how best to interpret tax statutes, any or all of which might be considered by a court asked to determine whether the NRRA applies to a captive insurance company. Among the

[10] H.R. 5637.

[11] http://www.gpo.gov/fdsys/pkg/CRPT-109hrpt649/pdf/CRPT-109hrpt649-pt1.pdf.

[12] *Congressional Record*, Extensions of Remarks Dec. 15, 2010, p. E2144 (http://www.gpo.gov/fdsys/pkg/CREC-2010-12-15/pdf/CREC-2010-12-15-pt1-PgE2144.pdf#page=1).

[13] *Congressional Record*, Extensions of Remarks, Dec. 15, 2010, p. E2144 (http://www.gpo.gov/fdsys/pkg/CREC-2010-12-15/pdf/CREC-2010-12-15-pt1-PgE2144.pdf#page=1).

[14] 155 *Cong. Rec.* H9362.

[15] 156 *Cong. Rec.* H9363

[16] Hearing before the Subcommittee on Commercial and Administrative Law of the Committee on the Judiciary, House of Representatives, 109th Congress, Second Session on H.R. 5637, Sept. 19, 2006 (http://www.gpo.gov/fdsys/pkg/CHRG-109hhrg29968/pdf/CHRG-109hhrg29968.pdf).

[17] Id.

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most widely recognized interpretive approaches are textualism, purposivism, and intentionalism.[18]

Textualism is a methodology comprised of conventions relating to the meaning people normally attribute to words they read.[19] These conventions include the plain meaning doctrine,[20] which considers the meaning people most likely would give to the text of a statute.[21] While some would say that textualists interpret a statute by examining ''the text, the whole text, and nothing but the text,''[22] others would simply say that a textualist searches for the ordinary meaning of the words used in a statute.[23]

The basis for textualist interpretation rests on a theory of separation of powers inherent in the framework of the U.S. government.[24] The legislature enacts the laws, the executive branch enforces the laws, and the courts interpret the laws.[25] Thus, the argument is that the text of a statute controls, not the unstated intent of the drafters.[26]

It would be fair to expect that litigation over the NRRA will focus largely on prior judicial and administrative constructions.

In contrast, non-textualists attempt to give effect to the legislature's intent by looking beyond the text of the statute itself to other sources for evidence of the legislators' intent.[27] The search for evidence of intent includes consideration of related statutes, appeals to grammar and syntax, and application of traditional rules of statutory interpretation.

Purposivism is a methodology that focuses on the consequences a judge believes the legislature desired to promote or avoid.[28] Legislative work papers and judicial and administrative constructions provide indicia of purpose.

Intentionalism is comprised of conventions relating to how people discern the intentions of a legislature.[29] While the legislature may intend for its text to be interpreted in a plain, ordinary manner,[30] the most often cited and heavily emphasized indicia of intent are prior judicial and administrative constructions.[31] Given the sparse indications in the *Congressional Record* of the legislative intent regarding the NRRA, it would be fair to expect that litigation over the NRRA will focus largely on prior judicial and administrative constructions as well.

Ultimately, as a result of all the differing viewpoints and methods of analysis, statutes generally are susceptible to multiple interpretations. The best evidence of this is the Supreme Court's many split decisions in cases involving statutory interpretation.[32] To understand how these differing viewpoints generally affect statutory interpretation, consider two published Supreme Court opinions more than 100 years apart:

[18] See Antonin Scalia, ''Common-Law Courts in a Civil-Law System: The Role of United States Federal Courts in Interpreting the Constitution and Laws,'' in *A Matter of Interpretation: Federal Courts and the Law*, at 23 (Amy Gutmann ed., 1997).

[19] Scalia, Role of Federal Courts, at 16-18; see also John F. Manning, ''What Divides Textualists from Purposivists?,'' 106 *Colum. L. Rev.* 70, 87-90 (2006); Jonathan T. Molot, ''The Rise and Fall of Textualism,'' 106 *Colum L. Rev.* 1, 2 (2006).

[20] Scalia, Role of Federal Courts, at 16 (''[W]hen the text of a statute is clear, that is the end of the matter . . . . Another accepted rule of construction is that ambiguities in a newly enacted statute are to be resolved in such a fashion as to make the statute, not only internally consistent, but also compatible with previously enacted laws.''); See also, Karl N. Llewellyn, ''Remarks on the Theory of Appellate Decision and the Rules or Cannons about How Statutes are to be Construed,'' 5 *Green Bag* 297, 302 (2002).

[21] See Linda D. Jellum & David Charles Hricik, *Modern Statutory Interpretation: Problems, Theories, and Lawyering Strategies*, 35, at 37-38 (2006).

[22] See William N. Eskridge Jr., ''Textualism, the Unknown Ideal?,'' 96 *Mich. L. Rev.* 1509 at 1514 (1998).

[23] Scalia, Role of Federal Courts, at 16.

[24] Scalia, Role of Federal Courts, at 9.

[25] See U.S. Const. arts. I-III; *O'Donoghue v. United States*, 289 U.S. 516 (1933); Scalia, Role of Federal Courts, at 9.

[26] See *Chadha v. INS*, 462 U.S. 919 (1983); U.S. Const. art. I, Section 1, cls. 2-3.

[27] Scalia, Role of Federal Courts, at 16-18.

[28] See *United States v. American Trucking Associations*, 310 U.S. 534, 543-44 (1940) (''There is, of course, no more persuasive evidence of the purpose of a statute than the words by which the legislature undertook to give expression to its wishes. Often these words are sufficient in and of themselves to determine the purpose of the legislation. In such cases we have followed their plain meaning. When that meaning has led to absurd or futile results, however, this Court has looked beyond the words to the purpose of the act. Frequently, however, even when the plain meaning did not produce absurd results but merely an unreasonable one 'plainly at variance with the policy of the legislation as a whole' this Court has followed that purpose, rather than the literal words. When aid to construction of the meaning of words, as used in the statute, is available, there certainly can be no 'rule of law' which forbids its use, however clear the words may appear on 'superficial examination.' '').

[29] Jellum & Hricik, *Modern Statutory Interpretation*, at 119 (''The intention of the Legislature is first to be sought from a literal reading of the act itself, but if the meaning is still not clear the intent may be ascertained from such facts and through such rules as may, in connection with the language, legitimately reveal it.'') (citing N.Y. Stat. Law Section 92(a), (b) (McKinney 2005)).

[30] Jellum & Hricik, *Modern Statutory Interpretation*, at 118 (''The majority of states that have enacted general approach directives have enacted directives that tell courts to focus on plain meaning.'').

[31] Administrative deference doctrines, like *Chevron*, *National Muffler*, *Skidmore*, etc., exemplify the concept that administrative precedents represent the putative intent of the legislature so long as we are sure the legislature indeed delegated interpretative authority and the agency properly exercised such authority. *Chevron U.S.A. Inc. v. Natural Resources Defense Council Inc.*, 467 U.S. 837, 843 (1984).

[32] See William N. Eskridge Jr. et al., *Legislation: Statutes and the Creation of Public Policy*, 817-1098 (3d ed. 2001). See generally Charles Tiefer, ''The Reconceptualization of Legislative History in the Supreme Court,'' 2000 *Wis. L. Rev.* 205. See also, *Indianapolis Colts v. Mayor of Baltimore*, 775 F.2d 177, 181-82 (7th Cir. 1985) (finding the fact that the trial judge and the dissenting judge on the appellate panel agreed with the party's legal argument was enough to conclude that the argument did not violate Rule 11).

Church of the Holy Trinity v. United States (1892)[33] and *Gitlitz v. Commissioner* (2001).[34]

Holy Trinity offers an example of interpretive latitude.[35] There, the court considered whether a federal statute that criminalized helping an ''alien'' immigrate to the United States ''to perform labor or service of any kind''[36] applied to a person who was admitted to the United States to serve as a church ''rector and pastor.''[37] The facts were not in dispute: The Church of the Holy Trinity helped ''an alien residing in England'' immigrate to the United States to serve as the church's rector and priest.[38]

The United States argued that the statute should be interpreted broadly to include work as a ''rector or pastor,'' as the text did not limit the word ''service.''[39] Indeed, the text was expansive, extending the prohibition to ''labor or service of any kind.''[40] Further, the statute expressly exempted actors and lecturers, suggesting that all other workers were within the statute's coverage.[41]

The Supreme Court, in ''intentionalist'' mode, held that for purposes of this statute, the priest was not an ''alien'' brought to the United States to ''perform labor or service of any kind.''[42] The rationale the court proffered for departing from the literal text of the statute was that the statute was intended to reach only manual laborers, not religious ministers or ''brain-toilers.''[43] In its holding, the court stated:

> It must be conceded that the act of the [church] is within the letter of this section, for the relation of rector to his church is one of service, and implies labor on the one side with compensation on the other . . . . It is a familiar rule, that a thing may be within the letter of the statute and yet not within the statute, because not within its spirit, nor within the intention of its makers . . . .[44]

There is little doubt that the ''textualist'' view would have dictated the contrary result. In his 1997 commentary on the case, Justice Antonin Scalia stated that the court was not justified in searching for meaning beyond the statute.[45] Further, according to Justice Scalia, the court's limitation of the statute to manual laborers did not make sense in light of the specific exceptions for brain-toilers, actors, artists, lecturers, and singers.[46]

In Justice Scalia's view, the priest was from England and thus met the statutory definition of an ''alien.''[47] Moreover, Scalia observed that the priest obviously performed ''labor or service of any kind'' and, thus, ''[t]he defendant's act was within the letter of the statute, and therefore within the statute: end of case.''[48]

Nevertheless, the intentionalist view prevailed and in looking to discern the intentions of a legislature, the court held that the statute was only intended to reach manual laborers and not ministers.[49] Thus, *Holy Trinity* illustrates how text and context leave taxing authorities, taxpayers, their lawyers and even judges much room to argue about the correct interpretation of a statute.

Even though the case is more than 100 years old, it is still often cited and relied upon today. For example, in *Zuni Public School District No. 89 v. Department of Education* (2007), Justice John Paul Stevens wrote a concurrence in which he invoked *Holy Trinity* and defended its strongly intentionalist methodology.[50]

In contrast to *Holy Trinity*, the court used a textualist approach in *Gitlitz*, which was a case involving an insolvent S corporation that was discharged of its debt in a proceeding under the federal bankruptcy statute.[51] Relying on Internal Revenue Code (Code) Section 108(a)(1)(B), the S corporation excluded the amount of the discharge from its gross income.[52]

Contending that debt relief to an insolvent taxpayer is nonetheless income for certain purposes, even if it is excluded from gross income, the taxpayer treated the amount relieved as an ''item of income'' and increased its basis by that amount.[53] After increasing the basis, the taxpayer was in a position to and did deduct his share of previously suspended net operating losses.[54] The deductibility of these losses was challenged by the Internal Revenue Service and became the ultimate issue to be decided by the Supreme Court.[55]

IRS argued that discharge of indebtedness was not income.[56]

[33] *Church of the Holy Trinity v. United States*, 143 U.S. 457 (1892).
[34] *Gitlitz v. Commissioner*, 531 U.S. 206 (2001).
[35] *Holy Trinity*, at 457.
[36] *Holy Trinity*, at 472.
[37] *Holy Trinity*, at 458.
[38] *Holy Trinity*, at 458.
[39] *Holy Trinity*, at 458.
[40] *Holy Trinity*, at 458.
[41] *Holy Trinity*, at 458-59.
[42] *Holy Trinity*, at 472.
[43] *Holy Trinity*, at 458.
[44] *Holy Trinity*, at 458-59.
[45] Scalia, Role of Federal Courts, at 20.
[46] Scalia, Role of Federal Courts, at 20.
[47] Scalia, Role of Federal Courts, at 20.
[48] Scalia, Role of Federal Courts, at 20.
[49] *Holy Trinity*, 143 U.S. at 458.
[50] *Zuni Public School District No. 89 v. Department of Education*, 550 U.S. 8, at 107 n.3 (2007).
[51] *Gitlitz*, at 210.
[52] *Gitlitz*, at 210; see also I.R.C. Section 108(a)(1)(B) (''Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of discharge (in whole or in part) of indebtedness of the taxpayer if . . . the discharge occurs when the taxpayer is insolvent.'').
[53] *Gitlitz*, at 210 (''Petitioners' theory was that the discharge of indebtedness was an 'item of income' subject to pass-through under § 1366(a)(1)(A).'').
[54] *Gitlitz*, at 210 (''They used their increased bases to deduct on their personal tax returns corporate losses and deductions, including losses and deductions from previous years that had been suspended under [the applicable statute].'').
[55] *Gitlitz*, at 208 (''[W]e must decide whether the Internal Revenue Code . . . permits taxpayers to increase bases in their S corporation stock by the amount of an S corporation's discharge of indebtedness excluded from gross income.'').
[56] *Gitlitz*, at 212 (''The Commissioner argues that the discharge of indebtedness of an insolvent S corporation is not an

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We should expect varying and possibly conflicting rulings as different fact patterns are presented to judges with differing interpretative (and political) inclinations.

Prior to enactment of Section 108(a)(1)(B), there was considerable diversity of opinion as to whether relief from debt caused any gain at all to an insolvent taxpayer. Several courts had decided that debt relief to an insolvent taxpayer did not produce income because an insolvent taxpayer's assets are not freed by such relief.[57] Others believed that the presence of an insolvency discharge did not matter because the failure to repay money borrowed or return property lent gives rise to income.[58]

Thus, although the text of Section 108(a)(1)(B) excluded a discharge of indebtedness from gross income, there was no clear authority as to whether the discharge constituted income in the first place.

The Supreme Court was not persuaded that discharged debt constituted income:

> [T]he statute makes clear that § 108(a)'s exclusion does not alter the character of discharge of indebtedness as an item of income. Specifically § 108(e)(1) reads: "Except as otherwise provided in this section, there shall be no insolvency exception from the general rule that gross income includes income from the discharge of indebtedness."[59]

In the opinion, written by Justice Clarence Thomas for an eight-member majority, the issue was resolved using a textualist method:

> Under a plain reading of the statute, we . . . conclude that excluded discharged debt is indeed an "item of income," which passes through to the shareholders and increases their bases in the stock of the S corporation.[60]

Thus, in *Gitlitz*, the court reached an extremely favorable result for the taxpayer, a result that sanctioned the apparently inconsistent approach whereby the taxpayer was exempted from paying taxes on the "income" that resulted from the cancelled debt, but allowing the taxpayer to increase its basis and deduct previously suspended losses based on that income. According to the court, the favorable tax treatment was justified irrespective of concerns found outside the text of the statute: "Because the Code's plain text permits the taxpayers here to receive these benefits, we need not address this policy concern."[61]

Gitlitz illustrates that under a textualist view, the consequences of a particular interpretation may not be a hindrance to such interpretation even if the consequences yield a double tax benefit.

What do these varying approaches to statutory construction mean to captive owners and managers who are trying to make sense of the NRRA? They mean that we should expect varying and possibly conflicting rulings as different fact patterns are presented to judges with differing interpretative (and political) inclinations. Different parties, lawyers and judges are apt to interpret the language and intent of the NRRA differently, and barring a clarifying amendment by Congress, it is very likely that different courts will arrive at inconsistent results in applying the statute to captives.

Developments Away From the Courthouse

Since the NRRA was enacted in July, 2010, the possibility has existed that the uncertainty for captives might be mitigated either by clarifying federal legislation or by the states, namely by adopting the premium allocation compacts envisioned under the existing law. Unfortunately, we have seen little progress over the past two years in either area.

Hoped for Legislative Clarification

Many in the captive insurance industry have been waiting for and wondering about a legislative clarification by Congress—one that comes right out and says that the NRRA does not apply to captives. Of course, such a development would neatly do away with this whole brouhaha—from Burlington to Bermuda.

U.S. Rep. Peter Welch (D-Vt.) told attendees at the 2012 Vermont Captive Insurance Association annual conference that he was working on a bill that would clarify the issue.[62] However, since the core provisions of Dodd-Frank are the subject of very hot debate in the banking industry and in Washington (e.g., application of the Volker Rule's restrictions on proprietary trading), it would be surprising if the captive insurance wrinkle became a priority for Congress.

If there is going to be a legislative clarification of the NRRA, one would expect it to occur only after more high-profile amendments or clarifications to Dodd-Frank were attended to. At that point, it would not be surprising for any clarification of the NRRA to slip into the larger amendment, much like the NRRA slipped into the Dodd-Frank Act in the first place.

States Not Good at Sharing

The NRRA authorizes the states to enter into a tax-sharing compact or agreement, but it does not mandate any uniform process for collection among states. Generally, the idea under the NRRA was that states participating in the compact would agree upon a uniform tax, and a central clearinghouse would collect the tax and apportion it among the states where the risk is located.

Most states, however, including larger states that have the most to gain from not cooperating with other states, have refused to participate in a compact, opting instead to retain 100 percent of the tax collected.

The plan to allocate taxes via a tax-sharing compact has been further undermined by the fact that the states that have been willing to share are divided between two competing compacts—the Nonadmitted Insurance Multi-State Agreement (NIMA) and the Surplus Lines

'item of income' and thus never passes through to shareholders.").

[57] See, e.g., *Astoria Marine Construction Co. v. Commissioner*, 12 T.C. 798, 801 (1949).

[58] See *Gaudiano v. Commissioner*, 216 F.3d 524, 535 (6th Cir. 2000), vacated in light of *Gitlitz*; *Witzel v. Commissioner*, 200 F.3d 496, 498 (7th Cir. 2000), vacated in light of *Gitlitz*.

[59] *Gitlitz*, at 214.

[60] *Gitlitz*, at 212.

[61] *Gitlitz*, at 220.

[62] http://www.nrra-usa.org/, Aug. 8, 2012.

Insurance Multistate Compliance Compact (SLIMPACT). To date, 44 states have taken action to implement the NRRA but only 20 states have signed NIMA or are working to implement the SLIMPACT.[63]

It was thought that the ''Kentucky proposal,'' proposed by the Kentucky Department of Insurance and recently adopted under NIMA, would have attracted sharing-averse states to that compact, since it permits a home state to retain 100 percent of the casualty insurance premiums it collects (except for taxes collected on policies that are rated on a state or location-specific basis), but defections from NIMA have cast a dark shadow over its future.

As of this writing, six of the 12 states that signed NIMA have backed out[64] and the number of SLIMPACT participants has flattened at nine—one short of the 10 states needed for its implementation.

So, while the home state rule does simplify the collection of taxes (as the surplus lines insurance lobby wanted), it does not help allocate the tax dollars to the states where the insured risks reside, as the law was expected to do. It does, however, shift the tax allocation work from the unbiased surplus lines carriers to the rather biased tax collectors.

Emerging Strategies and Captive Trends

As noted above, different captives have reacted differently to the uncertainty associated with the NRRA. It appears that very few captives have made a change in domicile based solely on the statute. That is understandable, as any development emanating from the courts or Congress might undermine an investment in a given strategy.

Of those that have made a change in response to the NRRA, the most common has been to create a captive within the parent's home state and either shift the captive business to that new entity, or to use it as a ''front'' for insurance that is then ceded to the parent's existing captive in its favored jurisdiction.

Whether a direct reaction to the NRRA is deemed necessary or not at this time, it is interesting to note that even during this period of uncertainty, interest and growth in captives has steadily increased. What follows is a brief look at these emerging trends.

Moving in With the Parents

Decisionmakers within some corporate groups who are concerned about aggressive regulators and tax collectors in their home states have decided to redomesticate their existing captives to their respective home states. That way, instead of paying the home state's self-procurement tax under the NRRA (regardless of how much risk resides out of state), the only tax owed is the state's captive premium tax, because the captive is an admitted insurance company in that state.

Of course, this approach involves a certain amount of transaction costs, as well as the opportunity costs associated with abandoning an existing captive—often in a favored regulatory environment and with an established management and administrative team. It is also unclear whether the risks associated with such a move are going to pay off, or if Congress or the courts will undermine the strategy. Indeed, there is even a lack of clarity regarding the main driver of this strategy, as many home state taxing authorities have not made it clear whether self-procurement taxes are even owed on captive insurance placements.

Moving to the Home 'Front'

Given this uncertainty, other captives inclined to react to the NRRA, but not inclined to abandon their existing captives, have taken a slightly different tack. Instead of uprooting their existing domicile and redomesticating to the parent company's home state, as described above, some policyholders have resolved to organize a new captive under the law of their home state that will act as the fronting insurer and which, then, cedes the risk to the existing foreign captive.

This strategy serves to replace the home state's self-procurement tax with its typically much lower captive premium tax, while preserving the benefits associated with the existing (and ostensibly preferred) captive domicile, which may have more robust regulatory and professional infrastructure.

Increasing Demand for Captives, Especially Onshore

One might have expected that the uncertainty surrounding the NRRA would make utilizing captives look less attractive to businesses, compared to procuring traditional insurance or simply forgoing certain kinds of insurance altogether. The market disagrees.

Insofar as Vermont is a bellwether for captive trends, the U.S. captive market continues to grow. In 2009 Vermont licensed 39 new captives, in 2010 it licensed 33, and in 2011 it licensed 41.[65] These data are particularly relevant, considering that the parent companies of the vast majority of Vermont's captives are located out of state.

What is even more interesting is that this increased demand for captives has been more focused on domiciles within the United States—compared to offshore domiciles like Bermuda—than ever before.[66] Indeed, more and more states are getting into the game, with Nevada,[67] New Jersey,[68] Florida,[69] and Connecticut[70] approving new or modernized captive insurance statutes in just the past two years.

Ultimately, this steady increase in captives should not be surprising, given the various factors that typically drive demand for captive formation:

- sophisticated risk management departments that are able to analyze the pros and cons of captive formation and are driven to realize value for their companies;
- experienced and responsive regulators in states that have been overseeing successful captives for decades;
- astute captive managers and advisers that have developed advanced and proven strategies for maximizing

[63] ''Implementing NRRA,'' *Property Casualty 360*, Feb. 27, 2012.

[64] Florida, Louisiana, Puerto Rico, South Dakota, Utah, and Wyoming are the current signatories to NIMA.

[65] State of Vermont news releases dated Jan. 8, 2010, Jan. 12, 2011, and Jan. 10, 2012.

[66] *2012 Captive Benchmarking Report*, Marsh Risk Solutions, Marsh & McLennan Companies, April 2012.

[67] Assembly Bill 74 (AB 74).

[68] P.L. 2011, C. 25

[69] House Bill 1101.

[70] Public Act No. 11-1

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value from captives that dovetail with traditional risk transfer programs or work independently of commercial insurance markets; and

■ alienating forces that push policyholders away from the commercial insurance market, namely, increasing prices on the front end and unsatisfactory claims experiences on the back end.

While a simple amendment to the NRRA that expressly excludes captives would be welcome, continued congressional inaction is to be expected, even despite efforts by Rep. Welch and others, as noted above. Meanwhile, industry participants will have to evaluate their home state's laws and posture regarding self-procurement taxes, and determine what if any strategy best advances their company's interests.

Ultimately, what the NRRA means for any particular captive depends on the facts and factors applicable to that captive, such as the domicile of its parent, the taxes imposed by the relevant taxing authorities and the approach of the applicable regulators in general. Obviously, given the complexities and uncertainties involved, analysis and guidance from experienced professionals is advisable before making any changes to an existing captive program structure.