Thursday, August 21, 2025 Mark Richardson

What lasting impact will the CFM 831(b) case have on the captive industry?

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It's the 831(b) tax court case that has been hailed as the first sign of hope that a micro-captive owner could in future prove they operated a legitimate insurance arrangement, but just how much could the CFM Insurance, Inc. v. Commissioner change things for the sector?

The US Tax Court's recent decision in *CFM Insurance, Inc. v. Commissioner* has been described as both a setback and a breakthrough for micro-captive owners.

While the taxpayer ultimately lost for the 11th consecutive time to the IRS, the court made unprecedented findings in favour of the micro-captive, affirming risk distribution and actuarially determined premiums.

Industry experts spoke to *Captive Review* about the hope the court's opinion generated, offering a more nuanced judicial view than expected, particularly by recognising risk distribution was present in the 831(b)-electing micro-captive.

Bailey Roese, a partner at Dentons, said that the IRS often appears to act as if no captive electing 831(b) is valid, but that the judge's opinion in this case demonstrates that each case is case specific.

"The court found risk distribution to be present, and it appears that the court found the issue of whether the arrangement was insurance in its commonly accepted sense to be a very close call," she said. "In that way, this case was very different from some others that came before."

Nevertheless, with the taxpayer still losing, Rob Walling, principal and consulting actuary at Pinnacle Actuarial Resources, argued the case represents the size of the challenge facing other captive owners with their own court cases.

"Honestly, the takeaway is that while there appears to be some daylight on the ability to win the battles over premium pricing and risk distribution, the burden of proof on the taxpayer is still quite high," he said.

"The captive owner needs to demonstrate not only actuarially determined premium and sufficient risk distribution, but also risk transfer, insurable risk, and operations consistent with an insurance company of the appropriate scale and complexity. Also, while there is some hope for proving risk distribution through statistically independent risk units, reinsurance pools still prove challenging."

New and current 831(b) programmes

As a result, Walling said that the biggest change within the industry to come out of this case would be in how new 831(b) micro-captives are set up and structured.

“Many existing 831(b) micro-captives provide insurance to operating companies with sufficient statistically independent exposure units to satisfy internal risk distribution,” he said. “I can see one outcome of this ruling being that some of these captives may choose to opt out of the risk pools that they are participating in and satisfy risk distribution via risk units.”

And Eryn Brasovan, partner at Womble Bond Dickinson, agreed that takeaways from the *CFM* case are most instructive for captive owners in the process of setting up and currently operating captive insurance companies, especially those that may be eligible to make an 831(b) election.

“The court’s lengthy analysis of determining risk distribution by reviewing independent risk exposure units demonstrates the level of detail that captive insurance owners should address at the time of formation and continuing through utilisation of the captive,” she said.

“Of particular note is the court’s focus on whether asserted risk exposures were supported by documentation of such risks, whether as schedules to the policies or business records that substantiated the existence and claimed number of risk exposures.”

Learnings

As a learning for captive owners from the case, Brasovan said they must ensure that the risks covered by policies are evidenced by specific written records that are maintained and updated throughout the life of the captive insurance company.

“Creating a written record of risk exposure units after a captive insurance owner is already subject to IRS audit and/or any tax court litigation may not be accepted as evidence of risk distribution at the time the policies were underwritten and issued,” she added.

In addition, Allan Autry, partner at Johnson Lambert, highlighted a learning for captive owners to take around the criteria of common notions of insurance – for which CFM was ultimately found to fail.

He said that for years this aspect had been overlooked compared to the other criteria of insurable risk, risk shifting and risk distribution. But in this case he said there had been continued evaluation of the criteria.

“This case further solidifies the importance of meeting the common notions of insurance hurdle,” he said. “This provides further clarity on the importance of continuing to act like an insurance company and do the right things: pay premiums on time, submit valid claims, have binding policies, actuarially driven premium, and have board members that know the role they are playing in the captive operations.”

Risk distribution assessment

Assessing the judge’s interpretation of what made this case different to past cases, by affirming risk distribution, is also a valuable study that could have implications for future cases.

Autry reflected on what 831(b) owners facing their own court battle with the IRS could take from this interpretation,

as well as those that had preceded it, and said this case had provided some clarification on what the courts could be looking for.

"We know that a few hundred exposure units is not enough but thousands to millions is enough when having just a few regarded entities in the structure," he said. "Also, we have the introduction of exposure units not needing to be independent of the individual policies but a mixture of exposures from multiple different policies being offered by a captive."

He feels the judges remarks discussing risk distribution will play into setting a new precedent.

"How risk distribution is viewed, how it might be achieved and what constitutes proper risk distribution will be different," he added. "The *CFM* ruling further confirms that risk distribution must constitute more exposure units than what many in the industry previously thought if there is not third party risk present or if there are less than 12 regarded entities in the structure."

However, this view was not held by all experts.

Roese in her analysis of what precedents might be taken from the case pointed to the judge's comments that he viewed the record to be "peculiar" and "unlikely to feed precedents in the future".

"Subsequent litigants will have to demonstrate that the facts and risk distribution analysis in their respective cases support their position," she said. "Well-prepared experts who can clearly communicate and demonstrate through their reports and testimony that risk distribution is present will be crucial."

Swift comparison

The interpretation of risk distribution in favour of the micro-captive owner is in contrast to how risk distribution was interpreted in the recent case of *Swift vs Commissioner* and the subsequent interpretation in appeals court.

In that case it was determined that 199 doctors were not enough to establish proper risk distribution.

Autry reflected on how *CFM* looked into what is an exposure unit for determining risk distribution, and agreed with the ruling that patient visits are not an exposure unit.

"In *Swift* they reference using what is deemed to be an exposure unit for pricing purposes and what industry standards consider an exposure unit when evaluating risk," he said. "*CFM* goes into more discussion on what is considered an exposure unit but I don't find it to be changing an interpretation of what an exposure unit is considered."

Roese said that to the extent that there are conflicting approaches, they will be relevant to future cases, "as the judge will need to determine which approach is best, or whether they can co-exist."

Brasovan added that the court in the *CFM* case attributed the differing approach between the *CFM* decision on risk distribution and the *Swift* reasoning as dependent on the individual record in front of the court.

"Case outcomes will likely continue to be determined by the unique facts and circumstances applicable to each captive insurance company and the expert testimony submitted to the court," Brasovan added.

Expert testimony

A key theme running through the *CFM* decision was the role of expert witnesses, with the judge particularly critical of how the IRS had prepared their speakers.

The IRS has gone through a number of staffing changes this year, as well as cuts to resources, but all our experts doubted this would affect how the agency approaches its ongoing evaluation of 831(b)-electing micro-captives.

However, Roese said the case had emphasised how crucial expert preparation is, and will be in future litigation.

"The court extensively reviewed the facts and carefully considered the experts' opinions on a wide variety of topics," she said. "Litigants must thoroughly prepare all aspects. The experts were particularly important in this case, so taxpayers should be aware that a well-prepared expert may be the key to overcoming common sticking points like risk shifting and risk distribution."

Roese noted that the court did not see the taxpayer's 831(b) election as automatically disqualifying, and said it was a "good sign" the judge did not treat it as a "foregone conclusion" that the captive arrangement was not insurance solely due to the 831(b) election.

Looking back on industry history, Roese added: "In the 1980's the large captives associated with public companies lost in about the first ten opinions, until they started winning. Hopefully, the courts will determine that there are compelling cases involving small captives. This case offers some insight into what judges deciding future cases will want to see from the taxpayers."

A win for the industry?

With the taxpayer ultimately losing this case though, opinion remains split across the industry on whether this can be considered a net positive or negative for the captive industry.

Autry said while the case provides clarity to what the courts might view as proper risk distribution, it also "further solidifies that mishaps in the operations, even as small as they might seem, can be a hindrance in the IRS viewing the captive as a valid insurance company."

Walling described this case as "a crack in the wall" in terms of the court's views on actuarially determined premiums and risk distribution, and said it remains to be seen whether this is a sign of a longer term trend toward a win for a micro-captive owner over the IRS in tax court.

"Every loss in the US Tax Court is detrimental to captive owners," Walling said. "It means that the case that eventually wins will have one more to hurdle clear in terms of demonstrating their differences from all of the prior case losses."

He said there remain some misconceptions within the tax court in terms of what constitutes risk distribution, the role of claims in premium determination, circular flow of funds versus the normal functioning of a reinsurance pool and several other issues.

However, he also maintains confidence that the captive industry will eventually win an 831(b) captive insurance case in tax court.

"We continue to see progress in coming to a common understanding of insurable risks, risk transfer, risk distribution and common notions of insurance," he added.

Brasovan commented that the industry is learning in real time how the tax court analyses risk shifting, risk

distribution, and common notions of insurance, and highlighted some of the key ways micro-captive owners could look to stay compliant.

“Adoption and implementation of best practices are key to regulatory compliance; among them, documented valid non-tax business purpose related to risk management, policy forms manuscripted for the intended coverage, actuarially determined premium development and risk distribution, adherence to detailed claim review and approval processes, and ongoing corporate governance,” she said.