First, let us start at the very beginning. You might be asking yourself, "How can a company insure itself?" Good question. You have been trained to understand insurance as a contract that transfers risk to another entity—an insurance company. Well, the definition of insurance has not been rendered moot; for captives to be considered real insurers, there must be some degree of risk transfer. Captives that do not satisfy the risk transfer tests are nevertheless captives, but not for tax and accounting purposes. More on this later.

Most captives cover casualty lines such as workers compensation and general liability and are fully or partially funded to cover "expected losses" for each line of coverage. An actuary determines expected losses based on a company's historical loss amounts and payout characteristics. Captives usually only cover losses within a specific deductible or retention amount; $250,000 per occurrence is a typical captive limit. This means that the actuary's expected losses only include losses falling at $250,000 and under.

For example, let us assume that your company's historical general liability losses are, as we say, all over the board. You have got many small losses, of course, but you also have several large losses exceeding $250,000. Your actuary will only use the losses falling under $250,000 to calculate expected losses, assuming that all future losses over $250,000 will be transferred into the commercial insurance markets.

The strict definition of a captive is an insurance vehicle that is owned by its policyholder(s). Many of the world's captives do not satisfy the IRS definitions but remain captives because of the role they fulfill for their parent companies.

Captives must be formed in a special U.S. state or foreign country, known as a captive domicile, that has special enabling legislation. Bermuda is the most well-known offshore domicile, and the largest, and Vermont is the preeminent onshore domicile.