Current version — Nov 2, 2026. Update history: https://riskcoveragehub.com/captive-insurance/
Informational Field Card • Program Design Series

Change of Machinery, Not a Discount: A captive is an insurance company formed and capitalized to insure its owner. Instead of renting an insurer's balance sheet, a business builds a small one of its own and keeps only the risks it is prepared to own. Risks the business is not prepared to own still get transferred — captives commonly buy reinsurance above the retained layer, and many commercial coverages stay in the commercial market entirely.

1. WHAT A CAPTIVE IS & HOW IT WORKS

Mechanics: A business (or group) forms a licensed insurer in a captive domicile. The insurer issues policies to the parent and takes on specified pieces of risk.

- **Premium Flow:** Premiums flow from operating company into captive as dedicated underwriting capital.
- **Claims Payment:** Covered losses within the retained layer are paid out of the captive under disciplined governance.
- **Surplus Retention:** Money not paid out in claims remains the owner's — held as reserves and surplus rather than forfeited to a commercial insurer.
- **Defined Slices:** Captives take a defined slice: a deductible layer, a specific line, or risks commercial markets misprice or decline.

2. THE 3 LEGITIMATE MOTIVATIONS

What unites every sound captive is scale and predictability — keeping the financial benefit of both:

Driver	What It Delivers in Practice
Control	Owner crafts custom policy wording, directs claims handling discipline, and selects exactly which exposures to underwrite.
Economics	Underwriting profits stay in-house when loss experience beats market manual pricing; unlocks access to wholesale reinsurance.
Unwritten Risks	Fills commercial voids — writes narrow, well-understood operational risks that commercial markets decline or price exorbitantly.

3. THE HONEST OWNER PROFILE

A business should only consider a single-parent captive if it checks all three requirements:

REQUIREMENT 1 **Material Recurring Cost:** Insurance spend is substantial, steady, and an unavoidable operational reality every single year.
REQUIREMENT 2 **Stable Loss History:** Historical loss record is mature, documented, and credible enough to price with actuarial confidence.
REQUIREMENT 3 **Governance Discipline:** Real willingness and organizational capacity to operate a regulated insurance company with fiduciary rigor.

4. SLICING ARCHITECTURE: THE LOGISTICS SCENARIO

Choosing the correct risk slice determines whether a captive succeeds or fails:

The Sound Slice (Frequency)	The Unsound Slice (Severity)
Composited Scenario: A regional logistics fleet with frequent, predictable auto liability claims (running trucks daily). **Structure:** Captive retains the frequent first-dollar deductible layer; loss history is steadier than commercial pricing. Buys commercial excess / reinsurance above layer. **Result:** Underwriting profits retained in good years; retail purchase converted into managed cost.	**The Contrast:** Captiving rare, catastrophic severity (e.g., the 1-in-a-decade catastrophic blow). **The Trap:** A single catastrophic loss hits a thinly capitalized captive owned by the business that suffered the loss. **Result:** Both the parent balance sheet and the captive balance sheet take the blow simultaneously, destroying capital.

Governing Rule: Predictable frequency is what captives digest well; catastrophic severity belongs with third-party commercial capital.

5. THE HONEST SCALE THRESHOLD

Not a Small-Shop Product: A small business that forms a captive to insure risks it cannot afford to lose has not transferred risk — it has concentrated it, at additional expense, in a company it owns.

Exhaust Ordinary Market Instruments First:

- **Higher Deductibles:** Take on larger retentions within commercial policies to reduce retail premium spend.
- **Better Loss Control:** Invest directly in fleet telematics, facility safety, and operational risk mitigation.
- **Cleaner Risk Presentation:** Package granular underwriting data to secure favorable commercial terms.

A captive enters the conversation only after these commercial tools are fully exhausted and premium volume is large enough to support an insurer.

6. THE STANDING COST STACK (THE OPERATIONAL METER)

Formation is the cheap part; operation is the meter. Fixed costs do not shrink for smaller premium bases:

Stack Item	Operational Function & Cost Character
Formation & Domicile	Initial legal incorporation, regulatory licensing, and annual domicile maintenance fees.
Captive Manager	Required third-party administrator managing day-to-day operations, books, and compliance.
Annual CPA Audit	Mandatory independent statutory financial audit conducted annually.
Actuarial Opinion	Credentialed actuary must issue formal annual statement on loss reserves and IBNR.
Filings & Premium Taxes	State and domicile regulatory filings, premium taxes, and annual licensing renewals.
Fronting Collateral / LOC	Pledged letter of credit or collateral demanded by fronting carrier issuing licensed paper.

The Liquidity Trap: Capital is committed, not liquid. Surplus is held under regulatory lock; it cannot be extracted to cushion a bad operating quarter.

7. THE TAX QUESTION: SUBSTANCE OVER COSTUME

Insurance in Substance or Nothing: Premiums are deductible only if the structure satisfies real risk shifting and risk distribution under legal and actuarial standards.

The 831(b) Micro-Captive Lesson: Small-captive elections built primarily as wealth-transfer or deduction vehicles face aggressive IRS enforcement and repeated Tax Court defeat.
• *Warning signs:* Premiums priced for deductions, circular risks, zero claims.
• *The rule:* Form the captive because the insurance economics work; let tax treatment follow substance.

8. ALTERNATIVE ON-RAMPS: GROUP & CELL CAPTIVES

Structure	Mechanics & Honest Trade-Offs
Group Captive	Jointly owned by similar businesses. Spreads fixed costs and volatility. *Trade-off:* Results are pooled; a bad year for peers means assessments or reduced returns.
Cell Captive	Rents a segregated cell inside an existing insurer; walled-off assets/liabilities. *Trade-off:* Far lower capital/formation burden, but policy forms and governance belong to house.

9. THE ONE QUESTION TO ASK YOUR BROKER

"Which of my risks are frequent and predictable enough that retaining them through a captive beats transferring them — and is my total premium volume large enough to run a regulated insurer on top of them?"

Real Conversation	Sales Costume
Broker identifies specific layers, quantifies historical loss frequency, models standing fixed costs against premium volume, and defines reinsurance attachment.	Broker dwells on tax write-offs, wealth transfer, offshore secrecy, or vague generalities without stress-testing fixed operating costs.

Informational & Educational Notice: This quick card is published strictly for educational purposes and is condensed from RiskCoverageHub.com. It does not constitute legal, tax, actuarial, or insurance formation advice. Captive feasibility requires independent analysis by licensed captive managers, credentialed actuaries, qualified CPAs, and specialized legal counsel.