United States Court of Appeals for the Third Circuit

GULF OIL CORPORATION,

Appellant in No. 89-2049

v.

COMMISSIONER OF INTERNAL REVENUE

COMMISSIONER OF INTERNAL REVENUE,

Appellant in No. 89-2050

v.

GULF OIL CORPORATION

Docket No. 89-2049

Date of Decision: September 11, 1990

Judge: Mansmann, opinion

90-2 USTC Para. 50,496, 914 F2d 396, 73 AFTR2d Par. 94-581

Principal Code Reference: Section 901

Filed September 11, 1990

No. 89-2050

APPEAL FROM THE UNITED STATES TAX COURT

Tax Court No. 22499-82

Argued June 28, 1990

Before: Sloviter and Mansmann, Circuit Judges, and Thompson, District Judge. *

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OPINION OF THE COURT

MANSMAN, CIRCUIT JUDGE.

Gulf Oil Corporation and the Commissioner of Internal Revenue cross-appeal several decisions of the U.S. Tax Court involving Gulf's corporate tax liability for tax years 1974 and 1975.

Gulf, both directly and through its foreign subsidiaries and affiliates, explores, develops, produces, purchases and transports crude oil and natural gas world-wide, and manufactures, transports and markets petroleum products. Gulf is an accrual method taxpayer using the calendar year as its tax year. During 1974 and 1975, Gulf was a Pennsylvania corporation with its principal office in Pittsburgh, /1/ filing federal corporate income tax returns with the Internal Revenue Service in Philadelphia, Pennsylvania. During 1974 and 1975, Gulf and certain of its subsidiaries constituted an "affiliated group" as that term is defined in I.R.C. section 1504. /2/ As the common parent, Gulf timely filed consolidated federal income tax returns for these tax years on behalf of itself and certain of its subsidiaries. We refer to this affiliated group variously as "Gulf" or as "the taxpayer."

The Commissioner determined federal income tax deficiencies of $80,813,428 and $166,316,320 for Gulf's tax years 1974 and 1975, respectively. Gulf challenged these deficiencies in the U.S. Tax Court, alleging numerous erroneous rulings by the Commissioner. Due to their complex and diverse nature, certain issues were severed and tried at a special trial session, resulting in seven Tax Court opinions, four of which are involved in this appeal.

The first issue, referred to by the parties as the "Worthless Properties" issue, involves the question of whether Gulf could take abandonment loss deductions pursuant to I.R.C. section 165 on geological strata which were found to be devoid of mineral deposits and, hence, were deemed worthless by the taxpayer, even though the entire lease was not abandoned. Gulf appeals from the Tax Courts determination that there was no abandonment.

The second dispute, referred to as the "Kuwait Nationalization" issue, presents several questions, the foremost of which is whether the value of the price discount under a five year crude oil supply agreement is ordinary income to the taxpayer or whether it was compensation by Kuwait for its nationalization of the taxpayer's interests and, hence, a capital gain. Gulf appeals from the Tax Court's determination that the price discount was not compensation for nationalization. The Commissioner appeals from the Tax Court's determination that the taxpayer could accrue and deduct, in tax year 1975, Kuwait income taxes related to the prospective five year crude oil supply agreement.

The third problem, referred to as the "Captive Insurance" issue, presents cross-appeals by Gulf and by the Commissioner concerning the Tax Court's determination that the premiums paid by the taxpayer to its subsidiary insurance company were not deductible expenses and that the payments on losses by the subsidiary insurance company to other subsidiaries owned by Gulf were not constructive dividends to the parent corporation.

Finally, in the section referred to as the "Iran Agreement," upon the Commissioner's appeal, we must determine whether the Tax Court erred by concluding that Gulf possessed an economic interest in minerals in place pursuant to a 1973 Agreement. The Tax Court determined that the taxpayer possessed an economic interest and, therefore, was permitted to take a depletion allowance deduction for tax year 1974 and was further permitted to have a foreign tax credit for taxes paid to Iran.

We will address these issues seriatim, keeping in mind our scope of review. We exercise plenary review of the Tax Court's construction and application of the Internal Revenue Code. Pleasant Summit Land Corp. v. Comm'r, 863 F.2d 263, 268 (3d Cir. 1988). With respect to disputes of fact, we may reverse the Tax Court's decision only if the findings are clearly erroneous. A finding is clearly erroneous when "there is evidence to support it, [but] the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed." Anderson v. City of Bessemer City, N.C., 470 U.S. 564, 573 (1985); Double H Plastics, Inc. v. Sonoco Prods. Co., 732 F.2d 351, 354 (3d Cir. 1984). We are quite aware that we cannot reverse findings of fact simply because we would have decided the case differently. Anderson v. Bessemer City, 470 U.S. at 573. Our jurisdiction rests on 26 U.S.C. section 7482(a): United States Courts of Appeals have exclusive jurisdiction to review Tax Court decisions.

Under the appropriate standard of review for each issue, we are affirming in part and reversing in part the decisions of the U.S. Tax Court. Our reversing in part requires recomputation of Gulf's tax liability for these tax years. Thus, we will remand for a recomputation of Gulf Oil Corporation's 1974 and 1975 tax liability consistent with this opinion.

I. WORTHLESS PROPERTIES

On this first issue relating to Gulf's offshore oil and gas leases, Gulf presents two questions: (1) whether Gulf had "abandoned," as a matter of law, particular offshore leases in tax years 1974 and 1975, which would entitle it to an I.R.C. section 165 loss deduction; and (2) if the deduction were permitted, the appropriate calculation of the amount of Gulf's basis in each lease which would properly be allocated to the worthless operating minerals interests. We will affirm the Tax Court's decision, reported at Gulf Oil Corp. v. Comm'r, 87 T.C. 135 (1986), that Gulf failed to prove abandonment of the leases involved.

A. Facts

During tax years 1974 and 1975, Gulf held undivided interests in twenty-three offshore oil and gas leases in the Gulf of Mexico, covering blocks located in the offshore areas of Louisiana and Mississippi, Alabama, and Florida (MAFLA). /3/ The lessor for one lease, in offshore Louisiana, was the State of Louisiana (the Louisiana lease). The U.S. Department of Interior /4/ was the lessor for the other twenty-two leases (the Department leases). Gulf based its bids for these leases on its perception of the value of the underlying minerals. The bids reflected basic geologic evaluations which were used to estimate the amount of oil and gas present in each block of land to be leased. /5/ These were balanced against the potential costs of placing the lease into production. From this, Gulf would calculate a geological assessment of risk, the most important factor in determining how much to bid.

Successful lease bidders were required to pay the lessor an upfront cash bonus for each lease. For the leases at issue, Gulf and its co-lessees paid cash bonuses ranging from $1.127 to $61.166 million per lease ($15 million average). /6/ In addition, lessees were also required to pay a yearly delay rental on each lease to ensure lease retention throughout the primary term, permitting lessees to complete exploration. Delay rentals on the Department leases were $3.00 per acre; /7/ thus, to retain rights in twenty-two of the leases, Gulf and its co-lessees would be required to pay approximately $20,000 per lease per year. Delay rentals on the Louisiana lease were one-half of the cash bonus payment for each lease. Since the total cash bonus payment on this lease was $7.713 million, Gulf and its co-lessees would be required to pay approximately $3,856,600 per year to retain rights in this lease.

Lessees could relinquish rights to the Department leases in three ways. First, since the primary term of each lease was five years from the effective date of the lease, each lease would expire automatically by operation of law at the end of its five-year primary term, unless the lease was extended by either production in paying quantities or continuation of drilling. Second, the lessee could elect not to pay the required annual delay rental on the lease. Third, the U.S. Department of Interior, pursuant to its regulations, would accept a release or relinquishment of either an entire offshore lease or an "officially designated subdivision" thereof. However, per regulations in effect since 1954, the Department would not accept relinquishment of horizontal intervals, strata, or sands in an offshore lease. Once the lessee relinquished rights in a lease, the lease became available for bid at a subsequent lease sale.

Gulf acquired undivided interests in these twenty-three offshore oil and gas leases from 1972 through 1974. Shortly after acquiring these interests, Gulf personnel determined how many geological strata, i.e., horizontal layers, underlying each lease might contain gas or oil deposits. Determinations were based upon the known geology of other nearby parcels. Gulf personnel determined that each of the ten offshore Louisiana leases potentially contained between six and thirty-nine deposits, and that each of the thirteen offshore MAFLA leases potentially contained between three and eight deposits. Gulf then allocated its total basis in each lease, consisting of the initial cash bonus payment plus any geological and geophysical costs, among the strata believed to contain oil and gas deposits. /8/ Pursuant to I.R.C. section 614(b)(2), Gulf made an election to treat each potential mineral deposit (horizontal strata) in each lease as a separate property. /9/ Gulf's tax department initiated the process establishing its separate property procedures in the Gulf of Mexico. For a valid I.R.C. section 614(b)(2) election, more than one operating mineral interest must exist in a single tract or parcel of land.

During or prior to the tax years in issue, wells were drilled on the leases in question. As a consequence of unsuccessful drilling operations, Gulf determined that some of the potentially productive strata underlying each lease did not contain any oil or gas deposits or commercial quantities of oil and gas. Therefore, Gulf viewed these strata as worthless. Nonetheless, Gulf continued to retain all its rights to the leases and continued to pay the yearly delay rentals on the Department leases to protect its interests in the strata not deemed worthless. Also, Gulf farmed out limited rights in two of the leases, retaining its interest in the depth intervals farmed out and paying a portion of the development costs of subsequently discovered mineral deposits in farmed-out strata. Gulf even claimed production from a deposit in one strata it earlier asserted that it abandoned.

Presuming its I.R.C. section 614(b)(2) election was enforceable, Gulf claimed section 165 abandonment loss deductions on its 1974 and 1975 consolidated federal corporate income tax returns of $35,561,455 and $108,108,366, respectively. These loss deductions were based on "abandonments and extraordinary retirements" of the potential mineral deposits within certain of the offshore leases which Gulf had elected to treat as separate properties and which it now considered worthless. The Commissioner fully disallowed the deductions, determining that Gulf had not established the worthlessness of the mineral interests. The Tax Court agreed with the Commissioner, holding that Gulf failed to prove any act evidencing its present declaration that these properties were worthless and abandoned in tax years 1974 and 1975, whether the property is defined as each of the potential mineral deposits or as the lease itself. Thus, the Tax Court found it unnecessary to decide whether each potentially productive stratum could properly be treated as a separate property under I.R.C. section 614(b)(2). Gulf appeals from this decision.

B. Abandonment

Gulf contends that the Tax Court committed three legal errors: (1) denying the deduction without deciding whether Gulf's potential mineral deposits in each lease qualified as operating mineral interests eligible to be treated as separate properties by way of an election under I.R.C. section 614(b)(2); (2) implicitly concluding that the property at issue is the lease itself and not the prospective mineral deposits; and (3) determining the availability of a loss deduction under I.R.C. section 165 solely on the basis of whether Gulf disposed of legal title to its allegedly worthless operating mineral interests during the tax years in issue.

Gulf argues that the legal question of whether an I.R.C. section 165 deduction is available cannot be addressed unless the scope of the property in question is defined. Gulf asserts that the property in question is the potential mineral deposits or each horizontal stratum within the leases, and not the entire lease itself, because the potential mineral deposits within each lease are operating mineral interests and, therefore, separate properties as a result of Gulf's I.R.C. section 614(b)(2) election. Hence, Gulf contends, each potential mineral deposit in each lease is a separate property which could be abandoned for purposes of a loss deduction pursuant to I.R.C. section 165.

The Commissioner counters that the Tax Court was not required to decide whether the taxpayer was entitled to treat the potentially productive strata underlying the leases as separate properties since, in any event, the taxpayer failed to show abandonment. The Commissioner also argues that, even if the Tax Court should have determined the nature of the property in question, the taxpayer was not entitled to treat the horizontal strata as separate properties.

Under I.R.C. section 165, a taxpayer may take a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise. I.R.C. section 165(a). A loss deduction is permitted under I.R.C. section 165 only for a taxable year in which the loss is sustained, as evidenced by closed and completed transactions and as fixed by identifiable events occurring in such taxable year. Treas. Reg. section 1.165-1(d)(1). Similarly, a loss deduction is allowed for obsolescence of nondepreciable property, such as an oil lease, where a loss is incurred arising from the sudden termination of the property's usefulness in that business or transaction. The termination can occur, for example, when the business or transaction is discontinued, or when property is permanently discarded from use. Treas. Reg. section 1.165-2(a). For this purpose, the taxable year in which the loss is sustained is not necessarily the taxable year in which the overt act of abandonment, or the loss of title to the property, occurs. Id.

I.R.C. section 165 losses have been referred to as abandonment losses to reflect that some act is required which evidences an intent to permanently discard or discontinue use. A. J. Industries, Inc. v. United States, 503 F.2d 660 (9th Cir. 1974). "[I]n order for a loss of an intangible asset to be sustained and to be deductible, there must be (1) an intention on the part of the owner to abandon the asset, and (2) an affirmative act of abandonment." 503 F.2d at 670. Moreover, "mere intention alone to abandon is not, nor is non-use alone, sufficient to accomplish abandonment." Id., citing Beus v. Comm'r, 261 F.2d 176, 180 (9th Cir. 1958).

Gulf failed to establish that it had taken any affirmative act manifesting its abandonment of the Department property, and, indeed, conceded (see Gulf Oil, 86 T.C. at 163), that none of the leases themselves had been abandoned during the tax years at issue. Gulf can demonstrate no act, such as relinquishment of the lease or nonpayment of delay rentals, /10/ which would support its claim of abandonment. Indeed it preserves the right to drill, explore and produce from these strata. Merely abandoning the strata or leases on paper because they are deemed worthless is insufficient to demonstrate abandonment for purposes of an I.R.C. section 165 loss deduction. See Beus, 261 F.2d at 180.

The absence of any act manifesting Gulf's intention to abandon is a finding of fact. We have examined the record and conclude that the Tax Court's finding was not clearly erroneous. Thus no error of law in applying section 165 to these facts occurred.

No deductions for abandonment loss may be taken with respect to the leases, again a mixed question of law and fact based upon the absence of an affirmative act of Gulf's intention to abandon.

Just as the Tax Court did not feel compelled to reach the question of whether individual strata could be treated as separate properties under section 614(b)(2), we, too, do not comment on it. We leave that difficult question for future resolution when the facts more closely depict abandonment.

C. Conclusion

We hold that the Tax Court properly concluded that Gulf had failed to prove abandonment, whether the property is understood as separate strata or as the entire lease, and hence was not entitled to the deductions under I.R.C. section 165. We will therefore affirm the Tax Court's decision.

II. KUWAIT NATIONALIZATION

The issues presented in these cross-appeals arise from events occurring during the 1975 nationalization of the Kuwait Government's oil resources. Specifically, Gulf challenges the Commissioner's finding and the Tax Court's decision that the value of a price discount given to Gulf by Kuwait in a five-year crude oil supply agreement is properly categorized as ordinary income rather than as additional compensation for the Kuwait Concession nationalization, which would qualify the transaction for preferred capital gains tax treatment under I.R.C. section 1231. The Commissioner appeals the Tax Court's determinations that the present value of this price discount is properly accrued and reported in tax year 1975 under I.R.C. section 451 rather than reported in each of the five years of the agreement, and that the Kuwaiti income taxes on this price discount are properly accrued and deducted in tax year 1975.

We will affirm that part of the Tax Court's decision holding that the price discount is not compensation for the Kuwait Concession nationalization since this finding of fact is not clearly erroneous. Therefore, the Kuwaiti income taxes related to the price discount constitute a deduction under I.R.C. section 164 rather than a foreign tax credit under I.R.C. section 901. We will reverse the Tax Court's decision that the present value of the price discount is properly accrued and reported in tax year 1975 because the record demonstrates that all of the events fixing the right to receive the income had not occurred. Consequently, the income taxes related to the price discount cannot be accrued and deducted in tax year 1975.

A. Facts

We begin with the facts, not generally in dispute, as set forth by the Tax Court in its opinion, Gulf Oil Corp. v. Comm'r, 86 T.C. 937 (1986). The Middle Eastern country of Kuwait first granted operational rights to Gulf Oil Corporation in 1934. In 1951, however, Gulf's interest was redefined in a document known as the 1951 Concession Agreement. /11/ In this agreement, Gulf was granted rights to one-half of the Kuwait Concession while BP Kuwait Ltd., a subsidiary of the British Petroleum Co. Ltd., obtained rights to the other half. Gulf's stake in the Kuwait Concession was one of its most valuable holdings in the Middle East oil area from the time of the grant until completion of the 1975 nationalization. During this time, Gulf established its customer base and built production facilities dependent on Kuwaiti crude oil.

In 1972, oil prices increased dramatically as a result of disruptions in the flow of Middle East oil. /12/ During this unstable period, oil producing governments began nationalizing in order to exert pressure to increase their participation in the oil concessions. OPEC's stated policy concerning compensation, by which all members were to comply, was that members should pay the oil companies only the book value for physical assets. Nothing should be paid for the value of the minerals in place since oil in place was deemed to be owned by each member's government.

Through the 1973 General Agreement, /13/ an imposed non- negotiated agreement, Kuwait acquired 25 percent interest in the Kuwait Concession and related assets in Kuwait with the option to obtain up to 50 percent of the Kuwait Concession and related assets by 1982. /14/ However, through the 1974 Concession Agreement, /15/ Kuwait increased its Concession ownership to 60 percent by formation of Kuwait Oil Co., a Kuwaiti corporation, owned 60 percent by Kuwait, 20 percent by BP Kuwait and 20 percent by Gulf Kuwait. The agreement also stated that the affiliation between Kuwait, Gulf Kuwait and BP Kuwait should be reevaluated prior to 1979. As consideration for each of the 1973 and 1974 agreements, Kuwait complied with OPEC policy, paying only the book value of the appropriate proportionate share of the physical assets related to the Concession.

On March 5, 1975, the Kuwaiti Minister of Oil /16/ announced Kuwait's intent to nationalize the remaining 40 percent of the Concession. /17/ In response, Gulf began to negotiate with the Kuwaiti Government to obtain as good an overall package as possible for relinquishing its entire interest in the Kuwait Concession. At a March 29, 1975 meeting, the Kuwaiti Prime Minister assured Gulf that the government did not intend to force the oil companies out of Kuwait, stating that Kuwait needed the oil companies and respected their past contributions to the country. Gulf "attributed great significance to the Prime Minister's words since they indicated that a negotiated settlement between the Kuwaiti Government and the [oil] companies was possible." Gulf Oil Corp., 86 T.C. at 943. After the initial meetings in late March, Gulf and BP continued to negotiate with the Kuwaiti Government, attempting to conclude a settlement acceptable to all parties. Kuwait's initial and final position was that the only compensation to be paid to Gulf and BP for the nationalization was $25,250,000 each, representing the net book value of the physical assets, in accord with the OPEC formula. Gulf countered that it had to be reimbursed on the basis of an overall package furnishing not only cash payment for its physical holdings, but also a sufficient economic benefit representing the loss of expected profits from its Kuwait Concession interest. Gulf was reluctant to surrender its rights in the Kuwait Concession for payment based exclusively on the OPEC formula.

Nonetheless, the final 1975 Nationalization Agreement specified that Gulf Kuwait and BP Kuwait would each be paid $25,250,000. The parties executed the agreement on December 1, 1975; the agreement was ratified by the Kuwaiti National Assembly on March 18, 1976. Additional agreements not subject to ratification (including the Crude Oil Supply Agreement at issue in this case) were effected contemporaneously with the Nationalization Agreement on December 1, 1975. None of the executed documents included any manifestation that Kuwait intended the additional commercial arrangements to be compensation for the Kuwait Concession nationalization.

The primary additional agreement was the Crude Oil Supply Agreement, /19/ which covered six items. The first and most detailed item covered Gulf's agreement "to purchase 650,000 barrels per day of Kuwaiti crude oil from April 1 through December 31, 1975, and 500,000 barrels per day" from January 1, 1976 through March 31, 1980. /20/ 86 T.C. at 945. The price per barrel was the price initiated by the Kuwaiti Government for sale to usual purchasers, less "a sum which after the deduction of Kuwaiti Income Tax payable with respect thereto shall be 15 U.S. cents per barrel." Id. Gulf was required to market the acquired oil in Kuwait at the pre-discounted price. The Crude Oil Supply Agreement contemplated that a binding contract with more definite terms would be executed shortly, indicating that the foregoing "terms would be treated as a binding contract until the formal contract was executed." Id.

The Kuwaiti government alluded to all the agreements -- other than the Nationalization Agreement -- as commercial arrangements and not as recompense for the nationalization of the Kuwait Concession. Kuwait's unfailing public and private posture was that the discount had been given to Gulf because Gulf was such a large buyer of Kuwaiti crude oil. Although no other major buyer of Kuwaiti oil, other than BP, acquired a discount during 1974 and 1975, Royal Dutch Shell was benefitting from favorable credit terms. Gulf objected to the advantageous terms offered to Shell since it deflated the discount Gulf received. After the Nationalization Agreement was executed, Gulf was advised that Shell's contract was altered to eliminate the favorable credit terms.

As an accrual method taxpayer using the calendar year as its tax year, Gulf is required to report recognized accrued gains and losses each calendar year. /21/ Thus, on its 1975 consolidated federal corporate income tax return, Gulf reported a total I.R.C. section 1231 capital gain of $276,517,903 related to the Kuwait Concession nationalization, and a foreign tax credit of $315,674,245 for Kuwaiti foreign income taxes paid or accrued.

Of the reported capital gain amount, $1,117,956 represented the difference between Kuwait's stated cash payment to Gulf for physical assets in Kuwait as nationalization proceeds ($25,250,000), and Gulf's adjusted basis in those assets for tax purposes ($24,132,044). /22/ The $275,399,947 balance represented the present value of the discount Gulf was to receive over the five-year term of the Crude Oil Supply Agreement, which Gulf asserts was also part of the nationalization proceeds. The Commissioner disagreed that the nationalization proceeds included the crude oil discount. Thus, the Commissioner fully disallowed the reported I.R.C. section 1231 capital gain, allowed a loss under I.R.C. section 1231 of $133,638, and determined that Gulf realized ordinary income of $952,469 /23/ under the nationalization agreement. Before the Tax Court, the Commissioner also asserted alternatively that, if the discount were part of the nationalization proceeds, a discount on future purchases had no discernable fair market value in 1975. Thus, no gain could be accrued and reported in 1975. Although the Tax Court held that the present value of the discount was properly accrued and reported in 1975 since the amount could be ascertained with reasonable accuracy in 1975, the court determined that the value of the discount was not part of the nationalization proceeds; therefore, the accrued amount must be recognized as ordinary income and not as section 1231 capital gain.

Of the reported foreign tax credit amount, $151,469,970 related to tax accrued on the crude oil discount included as nationalization proceeds. /24/ The Commissioner disallowed this credit because (except for taxes accrued before the March 5, 1975 nationalization date and limited by I.R.C. section 907) it did not represent a creditable tax under I.R.C. section 901. Thus, the Commissioner allowed a foreign tax credit of $94,763,164 /25/ for Kuwaiti income tax accrued or paid before March 5, 1975. For the period March 5 through December 31, 1975, the Commissioner determined that the accrued Kuwaiti foreign income tax was not an allowable foreign tax credit, /26/ but allowed a $36,209,447 deduction (rather than a credit). For the period beyond December 31, 1975, the Commissioner disallowed any credit or deduction for tax allegedly accrued. Although the Tax Court agreed that the income tax related to the discount was a deduction and not a foreign tax credit, the court held that the tax was a properly accrued and reported deduction in 1975 since the amount could be calculated with reasonable accuracy by mere mathematical extrapolations from the present value of the discount.

We turn first to the threshold issue of whether or not the Crude Oil Supply Agreement's price discount is compensation for the Kuwait Concession nationalization, a question of fact from which Gulf's tax implications are twofold. If the discount is not considered as nationalization compensation, Gulf will not receive the benefit of preferred capital gains tax treatment on the income from the discount. Second, Gulf will not receive the benefit of a foreign tax credit for the Kuwaiti income taxes due related to the Crude Oil Supply Agreement; rather, those income taxes will have to be reported on its tax return as a deduction. We will then address the final issue of whether the Tax Court correctly permitted Gulf to accrue in 1975 the five-year taxes, a matter invoking our plenary review since it involves construction of the Internal Revenue Code.

B. THE NATIONALIZATION AND CRUDE OIL SUPPLY AGREEMENTS

Gulf argues that the Tax Court's holding that the discount did not constitute nationalization compensation is clearly erroneous because the "overwhelming evidence presented . . . clearly establishes that . . . the Crude Oil Supply Agreement [discount] constituted the major part of the consideration [Gulf received] for the 1975 nationalization of its remaining 20 percent interest in the Kuwait Concession." Gulf urges us to review the totality of the circumstances rather than the Kuwait Government's public declarations, chiefly, that Gulf and Kuwait engaged in lengthy negotiations throughout most of 1975, attempting to conclude a mutually satisfactory settlement for the nationalization. /27/ Gulf and BP rejected two Kuwaiti counterproposals as economically inadequate before finally accepting the official one. Gulf asserts that at all times during negotiations, it considered the discount as nationalization compensation; in fact, both parties treated the discount as compensation during the nationalization negotiations. Indeed, the Kuwait

Minister of Oil advised that Gulf and BP deserved some "special consideration" for past contributions to Kuwait, and that "some discount should be given to them to repay them for their contributions."

Gulf urges us to consider that the nationalization documents are contemporaneous and interrelated /28/ in such a way that the owners of the Kuwait Concession received a discount on crude oil while others did not. Gulf Kuwait and BP Kuwait, as owners of the Kuwait Concession, were the only large purchasers who obtained the right to purchase crude oil at a discount. Kuwait unilaterally terminated Royal Dutch Shell's favorable credit terms in direct response to Gulf's objection that any such benefit would reduce the value of Gulf's crude oil discount as compensation. Kuwait wanted to justify publicly the discount given to Gulf. The discount was not a mere commercial arrangement given to Gulf in exchange for a package of separate items, since these items involved future commercial arrangements to be negotiated at arm's length.

While the evidence presented could be viewed as supporting Gulf's argument that the discount constituted nationalization compensation, we cannot reverse the Tax Court on this issue unless the Tax Court was clearly erroneous, since the intent of the parties is a question of fact which must be determined by the factfinder. To interpret contracts with some consistency and to provide contracting parties with a legal framework with a measure of predictability, courts must bind parties by the objective manifestations of their intent rather than by ascertaining subjective intent. Mellon Bank, N.A. v. Aetna Business Credit, Inc., 619 F.2d 1001, 1009 (3d Cir. 1980). Moreover, we have said: "The subjective meaning attached by either party to a form of words is not controlling on the scope of the agreement between the parties unless one party knows or has reason to know of a particular meaning attached by the party manifesting assent." Brokers Title Co. v. St. Paul F. & M. Ins. Co., 610 F.2d 1174, 1174 (3d Cir. 1979), Citing Restatement (Second) Contracts section 226, Comment b.

Although the Tax Court agreed that Gulf intended to negotiate for as good an overall package with Kuwait as possible in connection with the Kuwait Concession relinquishment, the court found that Kuwait did not intend at any time to pay any more as nationalization compensation than the amount set under the OPEC formula. Although the two agreements were signed on the same date, the Tax Court concluded that the documents served separate purposes: the Nationalization Agreement nationalized the Kuwait Concession; the Crude Oil Supply Agreement set forth guidelines for future commercial arrangements. The Tax Court was not convinced that the two documents were sufficiently interrelated to warrant a conclusion that the discount was additional nationalization compensation. The court found that the objective facts were far more consistent with the official Kuwaiti position than with the characterization urged by Gulf. In arriving at its decision, the court stated that Gulf's position was supported by no more than the statements of Gulf's employees as to the goals that it wished to achieve in the negotiations.

After our review, we are not left with the definite and firm conviction that the Tax Court erred. Therefore, we cannot hold that the Tax Court's findings are clearly erroneous. We will affirm the Tax Court's decision that the discount from the Crude Oil Supply Agreement was not compensation for the 1975 nationalization of the Kuwait Concession.

C. KUWAIT INCOME TAXES

Section 901(a) of the Internal Revenue Code provides a credit for income taxes paid, or accrued during the taxable year, to any foreign country or United States possession. I.R.C. section 901(b)(1). Income taxes paid or accrued during the taxable year to any foreign country IN CONNECTION WITH THE PURCHASE AND SALE OF OIL AND GAS EXTRACTED IN THAT COUNTRY, however, are not considered taxes for purposes of I.R.C. section 901 if (1) the taxpayer has no economic interest in the oil or gas to which I.R.C. section 611(a) applies and (2) the purchase or sale is at a price which differs from the fair market value for the oil or gas at the time of purchase or sale. I.R.C. section 901(f). Since we affirmed the Tax Court's decision that the crude oil supply discount was not additional nationalization compensation, it follows that the Kuwaiti income taxes are subject to the section 901(f) test.

Gulf conceded before the Tax Court that it did not have an economic interest in the minerals in place in Kuwait after March 5, 1975 (the nationalization effective date). Furthermore, Gulf presented no evidence that the pre-discount price set by contract as the purchase and sales price for the oil was equal to fair market value. Since the I.R.C. section 901(f) requirements are met, the Kuwaiti income taxes do not qualify as a foreign tax credit under I.R.C. section 901; rather, these taxes qualify as a deduction under I.R.C. section 164, which allows deductions for foreign taxes paid or accrued. The Tax Court did not commit an error of law in applying section 901 and, therefore, we will affirm the Tax Court in this regard; however, we disagree that the taxes can be accrued in tax year 1975.

D. TAX YEAR 1975

With respect to the amount of the deduction to be taken in tax year 1975, the Tax Court concluded that the present value of the income from the five-year discount was properly accrued (but, as ordinary income) in 1975 because, under the terms of the Crude Oil Supply Agreement, Gulf was to purchase a specific amount (750,000 barrels per day for five years) at a constant discount ($0.15 per barrel). Therefore, computing the present value of the discount required no more than applying the contractual terms to the extrapolation from figures available in 1975. Moreover, the court found that accrual was proper in tax year 1975 because, by its terms and as manifested by the parties' actions, the 1975 Crude Oil Supply Agreement was a binding contract, not subject to ratification by Kuwaiti officials, until the actual Crude Oil Supply Contract was executed in 1976. The court also concluded that the Kuwaiti income taxes related to the discount were properly accrued since they, too, could be calculated with reasonable accuracy in 1975. Neither party disputes the fact that accrual, in 1975, of the Kuwaiti income taxes payable on the Crude Oil Supply Agreement discount depends entirely on whether or not the corresponding income from that discount can be accrued and reported in 1975.

We disagree with the Tax Court's holding that the value of the discount and the corresponding Kuwaiti taxes can be accrued in tax year 1975. For an accrual method taxpayer, income is includible in gross income when (1) all the events have occurred so that the right to receive the income is fixed; and (2) the amount of the income can be determined with reasonable accuracy. Treas. Reg. section 1.451- 1(a). Income is accruable in the year the taxpayer's right to receive that income becomes fixed and definite, even though it may not actually be received until a later year. Comm'r v. Blaine, Mackay, Lee Co., 141 F.2d 201, 203 (3d Cir. 1944); see also Freihofer Baking Co. v. Comm'r, 151 F.2d 383, 385 (3d Cir. 1945), Security Flour Mills Co. v. Comm'r, 135 F.2d 165, 167 (3d Cir. 1943), affirmed 321 U.S. 281 (1944). An expense is deductible for the tax year in which (1) all the events have occurred which determine the fact of the liability; and (2) the amount thereof can be determined with reasonable accuracy. Treas. Reg. section 1.461-1(a)(2). An expense is accruable in the year the liability becomes fixed and certain, even though it may not be paid until a later year. Blaine, Mackay, Lee Co., 141 F.2d at 203; see also Freihofer Baking Co. v. Comm'r, 151 F.2d 383, 385 (3d Cir. 1945), Security Flour Mills Co. v. Comm'r, 135 F.2d 165, 167 (10th Cir. 1945). "To satisfy the all-events test, a liability must be 'final and definite in amount,' Security Flour Mills Co. v. Comm'r, 321 U.S. 281, 287 (1944), must be 'fixed and absolute,' Brown v. Helvering, 291 U.S. 193, 201 (1934), and must be 'unconditional,' Lucas v. North Texas Lumber Co., 281 U.S. 11, 13 (1930)." United States v. Hughes Properties, Inc., 476 U.S. 593, 600 (1986).

Since we have determined that the Tax Court did not err in ascertaining that the value of the crude oil discount did not constitute nationalization compensation, we must view the Crude Oil Supply Agreement as any other executory contract. Unconditional liability under an executory contract is not created until at least one party performs. See North Texas Lumber Co., 281 U.S. at 13. Gulf's unconditional liability to pay for the crude oil under the contract does not arise until Kuwait performs by passing title to the crude oil. It is not until Gulf is unconditionally liable to pay for the crude that its right to the income from the discount becomes fixed. During oral argument, Gulf's counsel correctly conceded that, if this discount was not found to be nationalization compensation, the income from the discount is not properly accruable in 1975. In view of the above, we find that the Tax Court erred in holding that both the income from the discount and the corresponding Kuwaiti income taxes payable were properly accrued in 1975.

E. CONCLUSION

We will affirm the Tax Court's decisions that the price discount is not additional compensation for Kuwait's nationalization of its crude oil resources and that the corresponding Kuwaiti income taxes payable do not constitute a foreign tax credit. We will reverse the Tax Court's holding that both the income from the discount and the corresponding Kuwaiti income taxes payable were properly accrued in 1975.

III. CAPTIVE INSURANCE

Both parties appeal from the Tax Court's decisions involving payments of insurance premiums by Gulf and its domestic affiliates to Gulf's wholly-owned foreign subsidiary, Insco, in tax years 1974 and 1975. Gulf deducted these insurance premiums as section 162 ordinary and necessary business expenses, but the Commissioner disallowed these deductions and instead determined that both premium payments from Gulf's foreign affiliates and claims paid by Insco to Gulf and its domestic affiliates represent constructive dividends to Gulf. The Tax Court -- in a majority opinion and numerous concurring opinions -- found that the insurance premiums paid by Gulf and its domestic affiliates that were ceded to Insco were not deductible insurance premiums. The court also held that neither the portions of the insurance premiums paid by Gulf's foreign affiliates that were ceded to Insco nor claims paid by Insco relative to the reinsurance of the risks of Gulf and its domestic affiliates were constructive dividends to Gulf. We will affirm on both issues.

A. FACTS

The parties generally stipulated to the operative facts on the issues before the Tax Court, which the court set forth at length in its opinion of Gulf Oil Corp. v. Comm'r, 89 T.C. 1010 (1987). We repeat only those most important to our resolution.

Through the late 1960's, Gulf and its affiliates were able to obtain insurance coverage at acceptable rates from commercial insurers. The general policy of Gulf and its affiliates was to self- insure risks up to $1 million. For those risks in excess of $1 million, including catastrophic risks, i.e., risks in excess of $10 million, Gulf obtained insurance coverage from primary insurance carriers and reinsurers in both the United States and world-wide markets.

Several incidents occurred in the late 1960's /29/ which caused commercial insurance carriers to increase the rates charged to the oil industry and either limit or altogether eliminate coverage for certain types of risks. Gulf decided that the higher rates for the coverages made available to it did not adequately reflect its claims history. Therefore, in late 1970, Gulf participated with several other major independent oil companies in the creation of Oil Insurance Ltd. (OIL). /30/ Gulf also created Insco, Ltd., its own subsidiary insurance company authorized to conduct general insurance business under the laws of Bermuda. /31/ Initial capitalization for Insco was authorized at $10 million. However, Insco originally issued 1,000 shares valued at $1,000 per share, of which only 12% was paid. Marsh & McLennan, Incorporated, an insurance brokerage and consulting firm, agreed to provide Insco with all underwriting and related services.

Generally, Gulf and its affiliates entered into insurance contracts with and paid premiums to third-party commercial carriers. Although Gulf and its affiliates paid premiums directly to third- party commercial carriers, a significant portion of the primary carrier's exposure was reinsured with Insco. /32/ On December 29, 1973, Gulf executed guarantees in favor of American International Group, Inc. (AIG) /33/ and of Oil Industry Association that obligated Gulf to indemnify these insurers should Insco be unable to meet its obligations with regard to its reinsured risks. These guarantees were in effect during the tax years at issue.

In 1975, Gulf shifted ownership of Insco to Transocean Gulf Oil Co., a wholly owned Gulf holding company incorporated in Delaware. Insco collected its shares of non-paid-up stock, while Transocean contributed $880,000 in capital. Simultaneously, Insco distributed 9,000 new shares at $1,000 par, which Transocean purchased as fully paid. This increased Insco's paid-in capital to $10 million. Gulf and its affiliates then began to place catastrophic risk coverage directly with Insco which, in turn, reinsured those risks. Gulf also commenced withdrawal from OIL over the minimum five-year period required. Also in 1975, Insco first began insuring risks of unrelated parties. Over subsequent years, Insco increased underwriting risks for unrelated parties and continued to underwrite additional risks of Gulf and its affiliates.

In tax years 1974 and 1975, Gulf reported ordinary and necessary business expense deductions pursuant to I.R.C. section 162 for insurance premiums, which the Commissioner challenged. The Commissioner disallowed $10,285,330 and $10,900,081, respectively, representing the amounts of insurance premium payments made by Gulf and its domestic affiliates to primary insurers that the insurers subsequently ceded to Insco. In addition, the Commissioner recharacterized, as constructive dividends, the amounts of insurance premium payments ($4,029,646 and $4,662,192, respectively) made by Gulf's foreign affiliates that were subsequently ceded to Insco. Finally, the Commissioner treated claims paid by Insco in these tax years (1,001,441 and $3,059,194, respectively), relative to the reinsurance of the risks of Gulf and its domestic affiliates, as constructive dividends directly to Gulf or to Gulf through Transocean. However, the Commissioner also determined that Gulf and its domestic affiliates sustained deductible uninsured losses under I.R.C. section 165 for the same amounts, $1,001,441 and $3,059,194, respectively.

The Tax Court held that the portions of the insurance premiums paid by Gulf and its domestic affiliates that were ceded to Insco were not deductible insurance premiums. Gulf appeals, claiming the Tax Court committed legal error because the court allegedly based the decision on a "substance over form" analysis that ignores the separate existence of Gulf and its affiliates, including Insco.

The Tax Court rejected the Commissioner's position and found that insurance premiums paid by the foreign affiliates could not be considered constructive dividends under the test in Sammons v. Comm'r, 472 F.2d 449 (5th Cir. 1972), since those payments were for the affiliates' benefit, i.e., providing risk coverage, rather than for a shareholder purpose. In addition, the claims paid by Insco to Gulf and its domestic affiliates were not constructive dividends since the claims were paid in consideration for the premiums paid.

The Commissioner appeals, contending that, under Helvering v. Le Gierse, 312 U.S. 531 (1941), the transaction at issue does not constitute "insurance" for federal tax purposes and must be considered as constructive dividends to Gulf.

B. DEDUCTIBILITY OF INSURANCE PREMIUMS PAID TO INSURANCE SUBSIDIARY

Under I.R.C. section 162(a), insurance premiums are deductible as ordinary and necessary business expenses. The premium is the means by which two unrelated parties measure the cost of the risk-shifting. Whereas insurance premiums are deductible expenses, amounts entered into self-insurance funds are not. Clougherty Packing Co. v. Comm'r, 811 F.2d 1297, 1300 (9th Cir. 1987). As the Supreme Court stated in Le Gierse, both "[h]istorically and commonly insurance involves risk- shifting and risk-distributing." Le Gierse, 312 U.S. at 539. Thus, to be permitted to take an insurance deduction, the relationship between the parties must actually result in a shift of risk. Id. at 540-41.

Gulf asserts that it meets this standard because it created a separate legal identity in Insco for risk shifting and, in fact, Insco insured the risks of unrelated parties, evidence of risk distributing. (In tax year 1975, 2 percent of Insco's premium income came from unrelated parties.)

The threshhold question we must address is whether Insco's insurance coverage to Gulf and its affiliates satisfies both the element of risk transfer and that of risk distribution, regardless of whether Insco insured risks of unrelated parties, if Gulf and its affiliates, both domestic and foreign, are each viewed as separate entities. "Where separate agreements are interdependent, they must be considered together so that their overall economic effect can be assessed." Clougherty Packing Co., 811 F.2d at 1301.

In Moline Properties v. Comm'r, 319 U.S. 436, 439 (1943), the Court held that a corporation must be recognized as a separate taxable entity if that corporation's purpose is the equivalent of a business activity or is followed by the carrying on of a business. The Court of Appeals for the Sixth Circuit relied on this proposition in Humana Inc. v. Comm'r, 881 F.2d 247, 252 (6th Cir. 1989), when it held that fellow subsidiaries of a captive insurer, i.e. in a brother-sister relationship, could properly deduct insurance premium payments to that insurer.

In Humana, the Tax Court had expressly recognized the legal, financial and economic substance of insurance provided by a wholly owned insurance subsidiary to its brother-sister affiliates. Nonetheless, the court of appeals suggested that a parent's insured loss paid by the insurance subsidiary would have a dollar-for-dollar impact on the parent's net worth. Although many of the facts in Humana are similar to those in this case, critical distinguishing facts exist. In contrast to the facts here, (1) the captive insurer in Humana was fully capitalized initially; (2) no agreement ever existed under which Humana, Inc. or any Humana subsidiary would contribute additional capital to the insurer; and (3) Humana, Inc. and the hospital subsidiaries never contributed additional amounts to the insurer nor took any steps to insure the insurer's performance. In contrast, Insco began as an undercapitalized subsidiary and Gulf executed guarantees in effect during the tax years at issue to protect its primary insurers, AIG and OIA, should Insco fail to meet its obligations as reinsurer. It is thus difficult to see that Gulf truly transferred the risk to Insco during the years in question.

We conclude that the Tax Court did not err in finding that the risk was not here appropriately shifted to the insurance subsidiary during 1974 and 1975. Gulf's arguments that it actually paid premiums to Insco, that Insco was required to establish and maintain appropriate reserves and to satisfy other regulatory requirements imposed by Bermuda law, that each insured had rights against Insco under insurance contracts, and that the source for payment of their claims included premiums paid by others and Insco's capital, do not address the crucial question of whether there was transfer of financial risk. Le Gierse, 312 U.S. at 540, Clougherty Packing Co., 811 F.2d at 1300.

Our decision is consistent with previous opinions of the Tax Court. The Tax Court has held that payments to a captive subsidiary, designated as premiums, whether from the parent corporation or from other subsidiaries, did not represent payments for insurance. See Carnation Co. v. Comm'r, 71 T.C. 400 (1978), aff'd, 640 F.2d 1010 (9th Cir. 1981); Clougherty Packing Co., 84 T.C. 948; Humana v. Comm'r, 88 T.C. 197 (1987), aff'd in part, rev'd in part, 881 F.2d 247 (6th Cir. 1989) (disallowing insurance premium deductions on the parent-subsidiary relationship, allowing brother-sister subsidiary to deduct the insurance premiums). Thus, the Tax Court has plainly held that where the captive was wholly owned by its parent, and the captive insured risks only within the affiliated group, the risk is not truly distributed.

We recognize that with regard to the tax year 1975, the majority of the Tax Court held that the 2% net premiums from unrelated parties was de minimis and did not demonstrate the existence of a true transfer of risk. One concurring judge of the Tax Court warns that the court's opinion will create a problem because at some point the majority's analysis will require a line to be drawn as to when third party premiums are no longer de minimis. He argued that, as far as risk transfer is concerned, there can be no true risk transfer when a captive insurance company is involved. In response, another concurring judge rejected that analysis as not invoking insurance law principles but relying, rather, on economic theory. The lone dissenter would have adopted the concurring "economic" theory, but disagreed with the majority's "overreaching" opinion.

We need not reach the issue which divided the judges of the Tax Court -- whether the addition of unrelated insurance premiums into the insurance pool for tax year 1975 establishes risk transfer and justifies the deduction of insurance premiums paid by the unrelated party to the insurance pool. It is clear to us that, because of the guarantee to the primary insurers, Gulf and Insco did not truly transfer the risk, nor was there a de facto risk distribution to third parties, elements crucial to the allowance of a premium deduction.

C. CONSTRUCTIVE DIVIDENDS

We turn now to the insurance premiums paid by Gulf's foreign affiliates to Insco and to the claims paid by Insco to Gulf and its domestic affiliates, which the Commissioner argues constitute constructive dividends to Gulf. His theory is that "where funds are transferred from one such sibling corporation to another, . . . the funds pass from the transferor to the common stockholder as a dividend and then to the transferee as a capital contribution." Sammons, 472 F.2d at 453.

In Sammons, the Court of Appeals for the Fifth Circuit formulated a two-part test to determine whether a transfer of property from one corporation to another corporation constitutes a constructive dividend to a common shareholder in both corporations. The first prong of the test is objective and requires a determination that there was a distribution of funds.

A transfer of funds by a corporation to another corporation which the former owns directly or indirectly can be a constructive dividend to the individual controlling stockholder only if (1) the funds are diverted from the parent-subsidiary corporate structure and come within the control of the stockholder, and (2) no adequate consideration for the diversion passes from the stockholder to the corporation, i.e., there must be a net distribution.

Sammons, 472 F.2d at 453-54. The second prong of the Sammons test is a subjective determination. Thus, a constructive dividend will be found where, in addition to the determination of distribution, "the business justifications [for the transfer] put forward are not of sufficient substance to disturb a conclusion that the distribution was PRIMARILY for shareholder benefit." Sammons, 472 F.2d at 452 (emphasis in original).

The Tax Court found that the second prong was not met since the insurance premium payments in question were for the benefit of the affiliates, i.e., the affiliates were provided risk coverage. In other words, there was an adequate business reason for the payment of funds, here risk insurance, by the affiliates to Insco. The benefit to Gulf was tangential, the same "benefit" it would have received if an outside third-party insurer were to insure the losses of Gulf's affiliates.

The Commissioner provides no strong reason, support or authority to compel us to overturn either the Tax Court's factual determination of an adequate business reason for the transfer or the legal conclusion that the payments in question do not constitute constructive dividends to Gulf.

D. CONCLUSION

The Tax Court did not err in denying a section 162 business expense deduction for insurance premiums paid to Gulf's captive insurance subsidiary (Insco) by Gulf and its domestic affiliates or in refusing to categorize the insurance premiums paid by Gulf's foreign affiliates to Insco and claims paid by Insco to Gulf's domestic affiliates as constructive dividends.

We will thus affirm the Tax Court's decision on these cross- appeals.

IV. IRAN AGREEMENT

This final appeal presents the question of whether Gulf, as one of a particular group of oil companies, continued to hold an economic interest in Iranian oil and gas under a 1973 Agreement with Iran and the National Iranian Oil Co. (NIOC). Resolution of this question will determine whether, in tax year 1974, /34/ Gulf can take a percentage depletion deduction under I.R.C. section 611 on proceeds from Iranian oil sales, and whether, in tax year 1975, /35/ Gulf can claim a foreign tax credit under I.R.C. section 901 (rather than a deduction under I.R.C. section 164) for Iranian income taxes paid during 1975. /36/ The Commissioner appeals the Tax Court's decision reported in Gulf Oil Corp. v. Comm'r, 86 T.C. 115 (1986), that Gulf did possess an economic interest under the 1973 Agreement.

Whether Gulf possesses an economic interest under the 1973 Agreement is a question of law involving statutory construction and interpretation over which we exercise plenary review. We find that Gulf possessed an economic interest, as a matter of law, under the 1973 Agreement and we will thus affirm the Tax Court's decision. Consequently, the percentage depletion deduction under I.R.C. section 611 in tax year 1974 and the foreign tax credit for Iranian income taxes paid under I.R.C. section 901 in tax year 1975 are proper.

A. FACTS

Iran became the sole owner of all its minerals and refineries when the Iranian oil industry was nationalized in 1951. National Iranian Oil Co. (NIOC) was organized at the time of nationalization to operate oil fields and refineries formerly run by Anglo-Iranian Oil Co., Ltd. (now known as the British Petroleum Co., Inc.). All NIOC shares were held by the Iranian government. Subsequently, Iran began negotiating with various oil company representatives to formulate a plan for resumption of the development and operations of the Abadan Refinery and the south Iranian oil fields. During this time, Iran mandated that all petroleum products produced in, or exported from, Iran were to be purchased from NIOC at the wellhead. Purchasers could then resell those products to affiliated and third- party customers.

A group of oil companies (the Consortium), including Gulf, entered into an agreement with Iran and NIOC on October 29, 1954 (the 1954 Agreement). The agreement consisted of two parts: Part I related to the Consortium's exploration, production, purchase and sale of Iranian crude oil, natural gas, and refined petroleum products; Part II comprised a final settlement between Iran and Anglo-Iranian Oil Co., Ltd. relating to outstanding claims between them resulting from the 1951 nationalization. Part I's stated objective was to provide for the effective marketing of these Iranian products, to be achieved through use of the capital, management and technical skills of the Consortium. The term of the agreement was twenty-five years, with the right to renew for three additional five-year periods. /37/

Pursuant to the 1954 Agreement, the Consortium formed two Dutch operating companies to function in a defined area of southern Iran known as the agreement area. One company was to explore and produce the crude oil, natural gas, and petroleum products; the other to refine those products. The products were produced for Iran, the holder of legal title to the minerals in place since the 1951 nationalization. Although the operating companies had the right to explore, produce and refine, Iran and NIOC retained several rights, such as the right to audit the accounts of the operating companies, to obtain technical data and other information pertaining to operations under the agreement, and to inspect the operating companies' technical activities.

The 1954 Agreement permitted each Consortium member to designate one of its subsidiaries as a trading company (registered in Iran) which was required to purchase from NIOC and to resell in Iran for export. /38/ With respect to crude oil, the trading companies were required to purchase all that the exploration and production company produced, other than that used in the company's operations and the amount required by NIOC to meet Iran's internal consumption. The amount of crude oil and natural gas to be produced by the operating companies, after an operational loss allowance, was that required by NIOC for Iranian internal consumption plus NIOC's optional crude oil amount as in-kind payment from the trading companies, /39/ and that required by the trading companies for resale. Title to crude oil and natural gas purchased passed from Iran to the trading companies at the wellhead, as it had since the 1951 nationalization. The trading companies paid NIOC a fixed percentage /40/ of the 1954 Agreement's posted prices for the crude oil and natural gas, then resold in Iran at prices which were also regulated by the agreement. In addition to these stated payments to NIOC by the trading companies, NIOC received a sufficient amount of crude oil and gas to satisfy Iranian internal consumption. The trading companies were required to pay Iranian income tax on their profits from resale in Iran, although deductions were permitted for operating costs, the purchase price paid to NIOC, and a discount.

Acting through NIOC, Iran retained ownership of all the assets, while the operating companies had the right to use all fixed assets and facilities within the agreement area. Nonetheless, the operating companies were obligated, over the term of the 1954 Agreement, to replace these assets at their own expense, and the trading companies provided the financing for any new or additional assets or facilities. In recognition of the commitment to replace these assets, a fixed assets charge was included in the operating costs for the first ten years of the agreement. When a new or additional asset or facility was built or purchased for NIOC's benefit, cost or book value amount reimbursement, through an additional inclusion in operating costs, was permitted over ten years. The trading companies were also required to pay the operating companies' exploration, development and working capital costs, service fees, and maintenance of the assets and facilities used for operations. NIOC was obligated to pay that portion of the operating costs attributable to production required for Iranian internal consumption.

On September 17, 1954, in response to a request by Gulf's trading company, the Internal Revenue Service issued a ruling (the 1954 Ruling) on the 1954 Agreement, stating that the arrangement had "all the essential characteristics of a lease," 86 T.C. at 122, thereby creating an economic interest which would allow percentage depletion, and which would qualify the Iranian income taxes as creditable foreign income taxes. Prior to 1973 (when another sale and purchase agreement was entered into), parties to the 1954 Agreement amended that agreement four times; /41/ however, the Consortium continued to operate using the same basic structure of the 1954 Agreement until 1973.

On July 19, 1973, /42/ the Consortium entered into another sale and purchase agreement with Iran and NIOC (the 1973 Agreement). /43/ The stated objective, taken from the preamble, was to develop and exploit Iran's hydrocarbon resources optimally, ensuring that Iran's crude oil and other products were accessible to consumers worldwide. The agreement stated Iran's determination that NIOC would exercise full and complete ownership, operation and control of the petroleum industry's mineral reserves, assets and administration. "WHEREAS with a view to the full realization of the[se] objectives . . ., the Parties . . . agree that the general relationship of Iran/NIOC and the above mentioned oil companies shall be revised and adjusted as set forth in this Agreement;. . . ." 86 T.C. at 123-124. The term of this agreement was twenty years. /44/ As occurred under the 1951 nationalization, NIOC retained exclusive ownership of assets, facilities and reserves, and title to the crude oil and other petroleum products passed to each trading company at the wellhead. Consistent with the terms of the 1954 Agreement, the 1973 Agreement also required that each trading company pay Iranian income tax on its resale profits.

The trading company concept was continued under the 1973 Agreement, and the trading companies were still required to purchase from NIOC and to resell in Iran for export. The two operating companies, however, were dissolved. /45/ Pursuant to the 1973 Agreement, the Consortium formed a new joint stock company which, under a five-year renewable service contract, was to explore, drill and produce in accordance with NIOC's directives. NIOC funded the new joint stock company, including all required operations capital; however, the trading companies were required to advance, annually, 40 percent of NIOC's annual budgeted capital expenditures for operations as a prepayment for crude oil purchases. Each annual prepayment was to be amortized over ten years, and then set off against crude oil payments due to NIOC. The 1973 Agreement also permitted a payment set off for the amount the operating companies had not yet recovered by prior operating cost adjustments for the cost or book value of assets used or under construction as of March 20, 1973. The trading companies recouped the prepayments and the balance of the operating companies' reimbursements through production purchases.

Under the 1973 Agreement, NIOC was entitled to an annual amount of crude oil to satisfy Iran's internal consumption requirements plus an amount for export. /46/ By September 1 of each year, after allowing for NIOC's quantity entitlements, NIOC was to notify the trading companies of the amount of crude oil that would be available to them in the following year; and, by October 1, the trading companies set forth their requirements. If, after all the trading companies' nominations were in, any excess crude oil remained for the following year, that excess became available to NIOC for export. However, if NIOC had no need, the trading companies could then purchase the excess. Therefore, each year, NIOC was committed to produce a quantity of crude oil and other petroleum products that would satisfy its own entitlement plus the Consortium's final nominations. After actual production, if NIOC had underestimated the total amount available, the trading companies could revise their nominations up to the increased level of the actual production. If NIOC either had overestimated the total amount available or, by force majeure, could not produce the amount required for export, NIOC and the trading companies ratably reduced their available quantities. If the ratable reduction was insufficient, only the trading companies' available quantities were to be reduced.

The trading companies' crude oil purchase pricing under the 1973 Agreement was composed of four parts: crude oil operating costs, limited to NIOC'S costs for extracting the crude oil; 12.5 percent of the applicable posted crude oil price (the stated payment); a balancing margin; /47/ and, interest. The trading companies' crude oil resale pricing regulations corresponded with those under the 1954 Agreement. Natural gas purchases were handled differently under the 1973 Agreement. Trading companies were now obligated to purchase all natural gas NIOC did not require for internal consumption. None of the trading companies' required annual prepayments (40 percent of NIOC's annual budgeted capital expenditures for operations) was allocated to a natural gas prepayment.

Gulf did not request a new Internal Revenue Service ruling concerning its economic interest status under the 1973 Agreement. However, the Internal Revenue Service did issue a ruling (the 1980 Ruling on the 1973 Agreement on May 15, 1980, pursuant to another Consortium member's request. The 1980 Ruling indicated that the oil companies possessed nothing more than an economic advantage under the agreement; they did not hold an economic interest. Therefore, percentage depletion deductions and foreign tax credits would no longer be available.

In tax year 1974, Gulf reported a percentage depletion deduction under I.R.C. section 611 of $121,641,999 for depletion of hydrocarbons in Iran; in tax year 1975, Gulf reported an Iranian foreign income tax credit under I.R.C. section 901(f) of $320,691,083. /48/ The Commissioner fully disallowed both entries, contending that Gulf no longer held an economic interest in Iranian gas and oil in place under the new 1973 Agreement. However, of the foreign tax credit amount reported, the Commissioner did allow a deduction of $289,760,918, /49/ rather than a tax credit./50/ Finally, the Commissioner added a $2,801,811 capital gain under I.R.C. section 1231, determined to be realized and reportable (pursuant to I.R.C. sections 451 and 1231) in tax year 1975 as a result of credits Iran gave to Consortium members for fixed assets under Article 10 of the 1973 Agreement. /51/ The Tax Court disagreed with the Commissioner, finding that Gulf had demonstrated "that it had made and was continuing to make investments in the production of the minerals, which investments could be recovered solely by means of production of those minerals." 86 T.C. at 136. Therefore, Gulf continued to possess an economic interest, not merely an economic advantage, in the Iranian minerals in place after execution of the 1973 Agreement. The Commissioner appeals from this decision.

We turn to the dispositive legal question of whether Gulf possesses an economic interest under the 1973 Agreement. Only the owner of an economic interest in a depletable resource may take annual depletion deductions. Treas. Reg. section 1.611-1(b). With respect to foreign tax credits, a United States citizen or corporation is allowed a credit under I.R.C. section 901(a) for income taxes paid or accrued during the taxable year to any foreign country or United States possession. I.R.C. section 901(b)(1). Nonetheless, income taxes paid or accrued during the taxable year to any foreign country in connection with the purchase and sale of oil and gas extracted in that country are not to be considered as tax for purposes of I.R.C. section 901 if (1) the taxpayer has no economic interest in the oil or gas to which I.R.C. section 611(a) applies, and (2) either the purchase or sale is at a price which differs from the fair market value for such oil or gas at the time of such purchase or sale. /52/ I.R.C. section 901(f).

Thus, if Gulf does not possess an economic interest under the 1973 Agreement, its tax implications are twofold. First, Gulf will not receive the benefit of a percentage depletion deduction for tax year 1974 under I.R.C. section 611. Second, Gulf will not receive the benefit of a foreign tax credit under I.R.C. section 901 for the Iranian income taxes paid in 1975; rather, those income taxes will have to be reported as a deduction under I.R.C. section 164.

B. Economic Interest Under the 1973 Agreement

The test for the recognition of an "economic interest" was stated by the U.S. Supreme Court in Palmer v. Bender, 287 U.S. 551 (1933): an economic interest exists where a taxpayer "has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital." Id. at 557; see also Treas. Reg. section 1.611-1(b). The Commissioner contends that under the 1973 agreement, Gulf's interest fails both prongs of the Palmer test.

The first prong has proven difficult for the courts to apply. As the Tax Court here recognized, the meaning of "economic interest" is vague. Many courts have found it difficult to single out one recurring factor that clearly indicates such ownership. Tidewater Oil Co. v. United States, 339 F.2d 633, 637 (Ct. Cl. 1964). There is clearly no requirement that a holder of an economic interest must possess legal title, for an economic interest and a legal interest are two separate entities. "Economic interest does not mean title to the oil in place but the possibility of profit from that economic interest dependent solely upon the extraction and sale of the oil." Kirby Petroleum Co. v. Comm'r, 326 U.S. 599, 604 (1946).

In Palmer v. Bender, the Supreme Court stated that

the lessor's right to a depletion allowance does not depend upon his retention of ownership or any other particular form of LEGAL INTEREST in the mineral content of the land. It is enough, by virtue of the leasing transaction, he has retained a right to share in the oil produced.

287 U.S. at 557 (emphasis added); see also Thomas v. Perkins, 301 U.S. 655, 661 (1937). Therefore, the fact that Iran holds legal title, as it has since the 1951 nationalization, is not determinative of whether Gulf possesses an economic interest under the 1973 Agreement. See Comm'r v. Southwest Exploration Co., 350 U.S. 308 (1956) ("tax law deals in economic realities, not legal abstractions").

The Supreme Court has proposed several factors to consider in determining whether an economic interest in minerals in place exists. Paragon Jewel Coal Co. v. Comm'r, 380 U.S. 624, 633-634 (1965); Parsons v. Smith, 359 U.S. 215, 225 (1959). See also Costantino v. Comm'r, 445 F.2d 405, 409 (3d Cir. 1971). More recently, in Freede v. Comm'r, 864 F.2d 671, 674 (10th Cir. 1988), Cert. denied, 110 S. Ct. 52 (1989), the Court of Appeals for the Tenth Circuit discussed five different factors to be considered. /53/ See also Tidewater Oil Co., 339 F.2d at 637. All of the factors enumerated by the courts are simply considerations that we may examine in determining the existence of an economic interest in the particular case before us. Indeed, the Supreme Court has recognized the problems that arise in applying these stated principles to the peculiar circumstances of each case. Paragon Jewel Coal Co., 380 U.S. at 627.

In the past, we have utilized the Paragon Jewel Coal factors in determining whether an economic interest exists, noting that perhaps the most important factor to consider is whether, under the contract, the taxpayer has the right to exhaust the mineral deposit to completion or whether, through a contract provision which empowers the owner to terminate the contract at will, the taxpayer is subject to the owner's will. Whitmer v. Comm'r, 443 F.2d 170, 173 (3d Cir. 1971); see also Costantino, 445 F.2d at 409.

In determining that certain miners did not possess an economic interest in coal in place, the Court in Paragon Jewel noted that (1) the miners' investments were in movable equipment rather than in the coal in place; (2) their equipment investments could be recovered through depreciation rather than by depletion; (3) the contracts between the miners and the landowners were completely terminable without cause on short notice; (4) the landowners retained all the capital interest in the coal in place, rather than surrendering any portion to the miners; (5) the landowners owned the coal at all times, even after it was mined, precluding the miners from selling or keeping any of it; (6) the landowners retained all proceeds from the sale of the coal; and, (7) the miners could look only to the landowners for all sums due under their contracts. Paragon Jewel Coal Co. v. Comm'r, 380 U.S. at 633-34, Citing Parsons v. Smith, 359 U.S. at 225.

Applying the Paragon Jewel Coal factors to the circumstances of this case, we conclude that Gulf has an economic interest in the Iranian hydrocarbons under the 1973 Agreement. The Consortium members invested substantial capital, under the 1954 Agreement, in Iranian plant assets and facilities which, at the time of the 1973 Agreement, the members had not fully recovered. Some of these assets (e.g., buildings) were obviously not movable. Because Iran held legal title to all assets since the 1951 nationalization, Gulf could not have depreciated any of those assets to recoup the invested capital. /54/ Also, other than Iran and NIOC, the Consortium held the exclusive right, through the trading companies, to sell the minerals, thereby demonstrating that it clearly retained a right to share in the oil produced. See Palmer, 287 U.S. at 557. Finally, with regard to the contract being terminable at will, the 1973 Agreement was a long term contract (with a term of twenty years), rather than one terminable at will by Iran or NIOC without cause on short notice.

We are unpersuaded by the Commissioner's assertion that Gulf possesses merely an economic advantage under Helvering v. Bankline Oil Co., 303 U.S. 362, 367-368 (1938). We agree that where a taxpayer merely processes the mineral and is not engaged in production, that taxpayer may have an "economic advantage" from production, but has no economic interest in the mineral in place. Bankline Oil Co., 303 U.S. at 367-368. As well, where a taxpayer has no capital investment in the mineral deposit, a mere economic advantage derived from production through a contractual relation to the owner does not constitute an economic interest. Bankline Oil Co., 393 U.S. at 367; see also Treas. Reg. section 1.611-1(b)(1). Here, however, Gulf and the other members of the Consortium have, in fact, made capital investments in Iranian plant assets and facilities that were still not recovered. Moreover, the Tax Court found that Gulf had made, and was continuing to make, investments in the production of the minerals. 86 T.C. at 136.

The second prong of the Palmer test, that the return on the investment must be realized solely from the extraction of minerals, "has been interpreted to mean that the taxpayer must look SOLELY to the extraction of oil or gas for a return of his capital." Southwest Exploration Co., 350 U.S. at 314. In allowing depletion deductions, for which possession of an economic interest is a requisite, Congress was trying to encourage mineral discovery and development. Tidewater Oil Co., 339 F.2d at 637. Depletion allowances are "based on the theory that the extraction of minerals gradually exhausts the capital investment in the mineral deposit. . . . [The allowance] is designed to permit a recoupment of the owner's capital investment in the minerals so that when the minerals are exhausted, the owner's capital is not impaired. . . ." Southwest Exploration Co., 350 U.S. at 312. "The test for the right to depletion is whether the taxpayer has a capital investment in the oil in place which is necessarily reduced as the oil is extracted." Kirby Petroleum Co., 326 U.S. at 603. The "investment" test requires only an economic commitment to look to production of the mineral for income. Southwest Exploration Co., 350 U.S. at 316.

We begin our analysis of the second prong with the specific term of the 1954 Agreement, under which Consortium members were operators or producers, which the 1954 Internal Revenue Ruling characterized as the equivalent of a lease. The Commissioner claims that under the 1973 Agreement the Consortium's role was changed substantially and they became merely purchasers. The Commissioner asserts that Gulf's profits were derived from the purchase (at the wellhead) and resale of the oil, rather than from the extraction and sale of the oil. We note, however, that the 1973 Agreement provided for recoupment of capital investments by set off, over time, in the trading companies' purchase prices from NIOC. Thus, there was capital invested prior to the 1973 Agreement which had not been recovered and could only be recovered through the profits made by way of purchase at the wellhead, which depended on extraction of the oil. Clearly, Gulf had an economic commitment to look to the production of oil for a return on its investment. See Southwest Exploration Co., 350 U.S. at 316.

Further, the Commissioner argues that it was by no means clear that production, followed by the trading companies' purchases and subsequent resales of oil, was the only means by which the Consortium members could recover their "investment." Yet the Tax Court found that the 1973 Agreement established no other method for the Consortium members to recover their investments, 86 T.C. at 136, and we reach the same conclusion.

Finally, we turn to the Commissioner's challenge of the Tax Court's finding that the 1973 Agreement merely revised and adjusted the 1954 Agreement. We have reached our conclusion that Gulf held an economic interest in the Iranian gas and oil deposits under the 1973 Agreement independent of this finding. Thus, we need not review the Commissioner's contention that the Tax Court erred by determining that Gulf possessed an economic interest because the 1973 Agreement was a modification and extension of the 1954 Agreement.

C. Conclusion

We conclude that Gulf possesses an economic interest in Iranian oil and gas deposits under the 1973 Agreement. Gulf is therefore entitled to a depletion deduction for tax year 1974 and a foreign tax credit for tax year 1975.

V. CONCLUSION

Gulf Oil Corporation has filed a motion for a remand for recomputation under Rule 55 to calculate the 1977 and 1978 net operating loss carryback for Gulf's tax years 1974 and 1975. As a result of our decisions in these appeals, a remand is necessitated for both tax years. Therefore, the matters raised in the motion can properly be presented to the Tax Court on remand.

We will remand these appeals to the Tax Court for recalculation consistent with this opinion.

A True Copy:

Teste:

Clerk of the United States Court of Appeals for the Third Circuit

FOOTNOTES

* Honorable Anne E. Thompson of the United States District Court for the District of New Jersey, sitting by designation.

/1/ Gulf Oil Corporation is now known as Chevron U.S.A. Inc.

/2/ Except as noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.) as amended and in effect during tax years 1974 and 1975.

/3/ Gulf acquired interests ranging from 33-1/3% to 70% in ten offshore Louisiana leases in 1972-74, and from 33-1/3% to 100% in thirteen offshore MAFLA leases in 1974.

/4/ The Minerals Management Service administers the grant, development, operation, and surrender of oil and gas leases by the United States.

/5/ By 1972, petroleum companies, such as Gulf, had extensively explored, discovered and developed the offshore Louisiana area. Thus, bidders on new leases had production history and geologic control data available to them in determining the amount they would bid. However, immediately prior to the taxable years in issue, offshore MAFLA was not a developed area. Hence, no production or geologic control data was available.

/6/ Gulf's share of each cash bonus payment was based on its undivided percentage interest in each lease.

/7/ Each lease (including the lease from the State of Louisiana) covered an area of between 5,000 and 5,760 acres.

/8/ For the offshore Louisiana leases, Gulf allocated its basis equally among the strata believed to contain oil and gas. For the offshore MAFLA leases, Gulf allocated its basis among the potential mineral-containing strata in proportion to each stratum's estimated value relative to the other strata in that lease.

/9/ The facts are unclear as to which year Gulf made this separate property election. We note only that the parties stipulated that Gulf made the election and the Tax Court ruled that the election was timely made.

/10/ We note that Gulf alleges that it did not pay the delay rental on the Louisiana lease for 1975; however, relinquishment of the lease was not executed until June 21, 1976.

/11/ This agreement, confirmed by later agreements, established that the Kuwait Concession was to run to the year 2026.

/12/ These disruptions resulted from factors such as the formation of OPEC, the Yom Kippur War, and the Arab Boycott.

/13/ The parties to this agreement were Kuwait, BP, BP Kuwait, Gulf, and Gulf Kuwait.

/14/ The Agreement anticipated an increase by 5 percent increments in Kuwait's ownership of the Kuwait Concession until it achieved the 50% interest.

/15/ Parties to this agreement were Kuwait, BP Kuwait and Gulf Kuwait.

/16/ Until January, 1975, control over oil policy had previously been vested in the Minister of Finance.

/17/ Since Gulf and BP (through Gulf Kuwait and BP Kuwait) were the only Concession holders for the onshore Kuwait area, no other oil companies were involved in the 1975 nationalization.

/18/ The Tax Court found that Gulf would have preferred either that the items in these agreements be "included in a single comprehensive document subject to approval by the National Assembly, or that the Nationalization Agreement and additional agreement explicitly cross-reference each other." 86 T.C. at 945. Kuwait, however, was reluctant to accede to either suggestion.

/19/ This agreement was executed on December 1, 1975. The formal supply contract anticipated by this agreement was executed on March 24, 1976. The contract terms were in accord with those specified in the agreement.

/20/ The remaining five items in the Crude Oil Supply Agreement were as follows: (1) Gulf and Kuwait were to discuss commercial petroleum products sales; (2) Gulf agreed to purchase a set amount of bunker fuel during the term of the supply agreement; (3) Gulf was to charter three Kuwaiti tanker vessels for so long as the supply contract and succeeding agreement were in effect; (4) Gulf was to furnish appropriate experienced personnel to support Kuwait Oil Co.'s operations and any other Kuwaiti government entity engaged in oil operations; and (5) Gulf and Kuwait assented to pursue shared commercial investment ventures. These five points were outlined in approximately one paragraph, with arrangement for the execution of business terms and formal contracts to occur at a later date.

/21/ An accrual method taxpayer recognizes a realized gain or loss in the tax year when (1) all events have occurred that fix the right to receive payment from the sale or other disposition of property, and (2) the amount can be determined with reasonable accuracy. Treas. Reg. section 1.451-1(a). A realized gain or loss is generally defined as the difference between the amount the taxpayer realizes on the sale or other disposition of property and the adjusted basis of that property. I.R.C. sections 1001(a), (c). Adjusted basis is defined as basis adjusted as provided under I.R.C. section 1016 [e.g., expenditures chargeable to capital account, exhaustion, obsolescence, amortization]. I.R.C. section 1011(a). A taxpayer's realized amount is the sum of any money received plus the fair market value of any property (other than money) received. I.R.C. section 1001(b).

/22/ Both parties agree that Gulf realized compensation of $25,250,000 under the 1975 Nationalization Agreement, representing Kuwait's stated cash payment for the physical assets, resulting in a realized gain of $1,117,956. Since this agreement was executed on December 1, 1975, this realized gain is also recognized in tax year 1975. During the tax years involved in this case, capital gains were given preferential tax treatment under the Internal Revenue Code. A "section 1231 capital gain" is any recognized gain (1) from the sale or exchange of property used in the trade or business, and (2) from the compulsory or involuntary conversion into other property or money of (a) property used in the trade or business, or (b) any capital asset held for more than six months in connection with a trade or business or a transaction entered into for profit. I.R.C. section 1231(a)(3)(A). For purposes of I.R.C. section 1231, "property used in the trade or business" means real property or property of a character subject to I.R.C. section 167 depreciation allowance, used in the trade or business, and held for more than six months. I.R.C.

section 1231(b)(1). Neither party disputes that the $1,117,956 realized, recognized gain is a capital gain under I.R.C. section 1231 which qualifies for preferential tax treatment.

/23/ The Commissioner gave no explanation for this ordinary income determination.

/24/ This figure, computed by multiplying the present value of the discount ($275,399,947) by the Kuwait tax rate, 55 percent, represents the Kuwaiti income tax Gulf would be required to pay over the five-year term or the oil supply contract.

/25/ Actual accrued Kuwaiti income taxes for January 1 through March 4, 1975 was $142,748,973. This amount was reduced by an adjustment under I.R.C. section 907(a) of $47,985,809, resulting in the allowable $94,763,164 credit.

/26/ After adjustments under I.R.C. section 907(a), this determination resulted in a net foreign tax credit disallowance of $220,911,081.

/27/ Gulf asserts that the 1975 negotiations differed significantly from those surrounding the 1973 and 1974 partial nationalizations, both of which were concluded with minimal negotiations and with little resistance from Gulf since it continued to retain an interest in the concession.

/28/ Under Article 4 of the Nationalization Agreement, it was agreed that the parties would enter into arrangements concerning the commercial supply of crude oil to Gulf and BP.

The Government and the Companies agree to enter into arrangements concerning the commercial supply to the Companies of Kuwait Crude oil and matters related thereto.

The preamble to the Crude Oil Supply Agreement refers specifically to Article 4 of the Nationalization Agreement.

This Agreement made in Kuwait the 24th day of March, 1976, by and between the Ministry of Oil of the Government of Kuwait, represented by the Minister of Oil (herein referred to as "SELLERS") and Gulf Kuwait Company (herein referred to as "BUYERS"). This Agreement refers to the agreement dated December 1, 1975, made between said Government on the first part and BP (Kuwait) Limited and BUYERS on the second part and its associated agreements of same date.

/29/ These incidents included a refinery explosion in Louisiana and an oil spill off Santa Barbara, California.

/30/ OIL was formed as a petroleum industry mutual insurance company in 1971 for the purpose of providing catastrophic risk insurance coverage for its member-shareholders.

/31/ Insco was incorporated on November 3, 1971. Gulf's management agreed that Insco would initially insure only certain foreign risks of domestic subsidiaries. Later, Insco was to provide further insurance, including coverage for Gulf's marine fleet and United States situs risks. Gulf contemplated that Insco would eventually offer insurance coverage to unrelated third parties.

/32/ The primary carriers retained a commission for acting as a fronting or ceding company for Insco.

Insco's assumed risks were limited to $10 million, but did not include the first $1 million of loss, which Gulf and its affiliates self-insured. Insco ceded the portion of the premiums it received attributable to catastrophic risks either to third-party reinsurers or to OIL.

/33/ Primary insurers for a substantial amount of the risks reinsured with Insco.

/34/ Gulf could not take depletion deductions in tax year 1975 since effective January 1, 1975, percentage depletion deductions were no longer available (with a few exceptions) for oil and gas wells, per I.R.C. section 613(d).

/35/ Gulf could not claim a foreign tax credit in tax year 1974 since I.R.C. section 901(f) foreign tax credits relating to oil and gas only became effective for taxable years after December 31, 1974.

/36/ The Tax Court was presented with the additional question of whether the 1973 Agreement was a nationalization of depreciable assets and, if so, whether I.R.C. section 1231 gain or loss should be recognized in tax year 1975. All events with respect to the alleged sale or exchange occurred in tax year 1973, a tax year not before the court. The Tax Court ruled that it had no jurisdiction to determine tax liability for a tax year where no deficiency was determined unless necessary for determining tax liability for tax years that were before the court. Neither party has appealed this ruling.

/37/ The agreement would be extended until 1984 if the first right to renew were exercised, until 1989 if the second were exercised, and until 1994 if the third were exercised.

/38/ Gulf International Co., a wholly owned domestic subsidiary, was Gulf's trading company. Virtually all of its purchases were repurchased by Gulf Iran Co., another wholly owned domestic subsidiary, for resale to affiliated and third-party customers.

/39/ See infra, note 8.

/40/ For crude oil purchases, the payment was 12.5 percent of the posted price (or, at NIOC's option, delivery of crude oil in kind equal to the posted price). For natural gas, the payment was 5 percent of the posted price for each 1,000 cubic meters.

/41/ The dates and purposes of the amendments were: to make technical pricing changes (January 11, 1965); to specify Iranian's crude oil requirements to be delivered by Iran to certain other countries in exchange for goods (December 11, 1966); to set forth the trading companies' accounting and taxation concerning sales of natural gas liquid products (December 23, 1966); and, to provide for increases in posted prices and stabilization of tax rates through December 31, 1975 (the Tehran agreement) (February 14, 1971).

/42/ The effective date of the agreement was retroactively set as March 21, 1973.

/43/ This agreement was entered into even though the 1954 Agreement had not yet expired.

/44/ We note that the expiration dates of both the 1973 and 1954 Agreements would be about the same: the 1973 Agreement would expire in 1993; the 1954 Agreement (if the right to renew was exercised three times) would expire in 1994.

/45/ Effective July 19, 1973, both operating companies' rights and activities were terminated.

/46/ Although the facts do not make this clear, it appears this condition was simply incorporating the December 11, 1966 amendment to the 1954 Agreement. NIOC's stated quantity for export "was to be phased in over a nine year period and thereafter was subject to a ceiling." 86 T.C. 125.

/47/ The balancing margin, taken together with all other financial and fiscal benefits accruing to Iran and NIOC, was to ensure that the total financial benefits to Iran and NIOC would be no less favorable than those applicable to other Persian Gulf countries. The 1973 Agreement estimated the balancing margin at $0.065 per barrel for the period March 21, 1973 through December 31, 1975. 86 T.C. at 126-27.

/48/ The parties subsequently stipulated that, during 1975, Gulf paid $243,795,264 in income taxes to Iran.

/49/ This figure consists of $243,795,264 in income taxes (found to be substantiated, but not creditable) plus $45,965,654 in noncreditable extra payments (not an income tax).

/50/ The $30,930,165 balance was disallowed both as a deduction and a credit.

/51/ Since the Tax Court ruled it had no jurisdiction to consider whether the 1973 Agreement was a nationalization of depreciable assets, adding a capital gain under I.R.C. section 1231 for tax year 1975 is obviously being disallowed.

/52/ The Tax Court found that the oil purchases at issue were not at their fair market value.

/53/ The five factors enumerated were (1) the degree of legal interest in the minerals, (2) whether there is significant control over the mineral deposits, (3) the extent of the contribution to the development or operation of the mineral extraction, (4) the risk of loss, and (5) whether the interest is necessarily depleted as the mineral is extracted. Freede, 864 F.2d at 674.

/54/ Compare this factual situation with the one involving the Kuwait nationalization after which Gulf was compensated for its lost capital pursuant to OPEC standards of paying for the book value of the assets in place.

TAX COURT CASE

United States Tax Court

GULF OIL CORPORATION,

Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

89 T.C. No. 70

Docket No. 22499-82

Date of Decision: November 24, 1987

Judge: Whitaker, opinion

Filed November 24, 1987.

In 1971 Gulf incorporated Insco, a wholly owned foreign subsidiary, to conduct a general insurance business. During 1974 and 1975 Gulf and its affiliates insured risks with unrelated insurance carriers who, by prearrangement, reinsured with Insco and ceded premiums on such reinsurance to Insco. Insco paid claims on the reinsured risks. In 1975 Insco began insuring risks of unrelated parties. Net premium income from unrelated parties represented 2 percent of its total net premium income in 1975.

The Commissioner determined that premium payments made by Gulf and its domestic affiliates were not deductible to the extent those payments were ceded to Insco. He also recharacterized as constructive dividends to Gulf the premiums paid by the foreign affiliates which were ceded to Insco. In addition, he recharacterised as constructive dividends to Gulf the payments of claims by Insco to Gulf and its domestic affiliates. HELD, the sums paid to Insco are not deductible as ordinary and necessary business expenses. Humana v. Commissioner, 88 T.C. 197 (1987); Clougherty Packing Co. v. Commissioner, 84 T.C. 948 (1985), affd. 811 F.2d 1297 (9th Cir. 1987); and Carnation Co. v. Commissioner, 71 T.C. 400 (1978), affd. 640 F.2d 1010 (9th Cir. 1981), followed. HELD FURTHER, the premiums paid by the foreign affiliates to Insco and the claims paid by Insco do not constitute constructive dividends to Gulf. See Mobil Oil Corp. v. United States, 8 Cl. Ct. 555 (1985).

J. Waddy Bullion, Emily A. Parker, Sean T. Crimmins, Buford P. Berry, J. Y. Robb III, and Margaret S. Alford, for the petitioner.

Joel V. Williamson and Joseph R. Goeke, for the respondent.

WHITAKER, JUDGE:* The Commissioner determined deficiencies in petitioner's Federal income tax for the taxable year 1974 in the amount of $80,813,428 and for the taxable year 1975 in the amount of $166,316,320. Petitioner, respondent, and the Court agreed that certain issues would be severed and tried at a special trial session. /1/ One of the issues tried was designated as the "Insco issue." It involves the following two questions:

1. Whether petitioner may deduct as ordinary and necessary business expenses amounts paid as insurance premiums by Gulf Oil Corporation and its domestic affiliates to the extent that those payments were ceded to its wholly owned captive insurance company, Insco, Ltd.; and

2. Whether the payments designated as premiums made by the foreign affiliates of Gulf Oil Corporation which were ceded to Insco, Ltd., and the claims paid by Insco, Ltd., to Gulf Oil Corporation and its domestic affiliates represent constructive dividends to Gulf Oil Corporation.

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts and accompanying exhibits are so found and incorporated by this reference.

Gulf Oil Corporation (hereinafter referred to as petitioner or Gulf) is a corporation organised under the laws of the Commonwealth of Pennsylvania with its principal office in Pittsburgh, Pennsylvania. During the taxable years a issue, Gulf and certain of its subsidiary corporations constituted an "affiliated group" as that term is defined in section 1504. /2/ Petitioner, directly and through its foreign subsidiaries and affiliates, is engaged in world-wide exploration, development, production, purchase, transportation, and marketing of petroleum products. Petitioner maintained its books of account for the taxable years in issue on the accrual method of accounting using the calendar year as its taxable year. Gulf, as the common parent of an affiliated group of corporations, timely filed consolidated Federal income tax returns for its taxable years 1974 and 1975 on behalf of itself, and certain of its subsidiary corporations, with the Office of the Internal Revenue Service at Pittsburgh, Pennsylvania.

By virtue of their world-wide operations, Gulf and its foreign and domestic subsidiaries and affiliates were exposed to various risks. These risks fall into three general categories.: (i) those associated with domestic and foreign on- and off-shore properties, marine hull and machinery, and marine cargo which include, but are not limited to: fire, windstorm, flood, earthquake, spills, pollution, seepage, contamination, shipwreck, collision, seizure, explosion, hurricane, typhoon, cyclone, hail, lightning and liability to third parties incident thereto; (ii) those associated with general casualty which include, but are not limited to, workmen's compensation, automobiles and other vehicles, and products liability; and (iii) those associated with disability, life and accident of employees.

Until the late 1960's commercial coverage for the risks of Gulf and its affiliates was available at acceptable rates and adequate coverages. Up until this time the general policy of Gulf and its affiliates was to self-insure risks up to an amount of $1 million. Insurance coverage for risks in excess of $1 million, including catastrophic risks, which were generally considered to be those risks in excess of $10 million, was obtained from third-party primary insurance carriers and reinsurers in the United States and world-wide markets. However, in the late 1960's several incidents occurred in the oil industry that caused commercial insurance carriers to increase rates and provide more limited coverage or to altogether eliminate coverage for certain risks. Some of these incidents included a refinery explosion at Lake Charles, Louisiana, an oil spill off the coast of Santa Barbara, California, and Hurricanes Betsy and Camille. Subsequently, Gulf decided that its excellent loss history was not being adequately reflected in the higher rates in the coverages that remained available in the primary and reinsurance markets. In response, Gulf participated in the creation of Oil Insurance Limited (OIL) with several other major and independent oil companies and also created its own insurance company subsidiary, Insco, Ltd.

OIL was formed in late 1970 as a petroleum industry mutual insurance company for the purpose of providing insurance coverage of catastrophic risks of its member-shareholders in excess of $10 million. OIL originally included Gulf and seven other shareholder companies. In 1971 OIL was restructured because of concern over the deductibility of premium payments. As part of the restructuring, shareholders could only withdraw from OIL over a 5-year period. The method of calculating premiums was also changed so that they were based upon both the loss experience over the previous 5 years and the gross assets of each shareholder. Gulf was dissatisfied with the new premium formula because it resulted in the subsidy of smaller, independent shareholders by larger shareholders, such as Gulf. Nevertheless, Gulf agreed to participate in OIL as restructured.

In further response to the changes in the third-party primary insurance and reinsurance markets, Gulf contemplated the formation of a captive insurance subsidiary to provide coverage for Gulf and its subsidiaries and affiliates. In 1968 Gulf conducted a feasibility study in concert with Marsh & McLennan, Inc., an insurance brokerage and consulting firm, with regard to the advisability of establishing an affiliated insurance company outside of the United States. This study, which updated a 1964 study, included consideration of the potential tax and financial benefits to be obtained through the operation of such an insurance affiliate. On June 10, 1971, the management of Gulf approved a plan to establish an affiliated insurance company in Bermuda. Under this plan, the insurance affiliate would initially insure only certain foreign risks of domestic subsidiaries. Later, the insurance affiliate was to provide further insurance, including coverage for Gulf's marine fleet and U.S. situs risks. Gulf also contemplated eventually offering insurance coverage to unrelated third parties.

On November 3, 1971, Gulf incorporated Insco, Ltd. (Insco), as a foreign wholly owned subsidiary authorized to conduct general insurance business under the laws of Bermuda. Although an initial capitalization of $10 million was authorized, Insco initially issued 1,000 shares with a value of $1,000 per share of which only 12 percent was paid up. Insco established its office in Hamilton, Bermuda, with a staff of two, consisting of A.W. Gregg, president, and a secretarial assistant. Gregg was a Gulf employee who had been in the insurance division of Gulf's treasury department. In addition, David B. Vaughn of Marsh & McLennan Management, Ltd., a Bermuda subsidiary of Marsh & McLennan, Inc., served as vice-president and R.S.L. Pearman of Conyers, Dill & Pearman, solicitors for Insco, served as assistant secretary. W.H. Burkhiser and J.C. Kelly, both employees of Gulf, served as treasurer and secretary of Insco, respectively. Pursuant to an agreement dated November 10, 1971, Marsh & McLennan Management, Ltd., agreed to provide Insco with all underwriting, premium rating, claims, reinsurance, record keeping, banking, and check disbursement services relative to its operations.

Generally, but not uniformly, the following depicts the relationship between Gulf, its affiliates, primary commercial carriers, Insco Ltd., OIL and reinsurers of catastrophic risks. Gulf and its affiliates entered into insurance contracts with third-party commercial carriers relative to their respective risks. By prearrangement with these insurance carriers, a significant portion of the primary carrier's exposure was reinsured with Insco Ltd. Gulf and its affiliates paid premiums directly to the primary commercial carriers. To the extent the primary carriers reinsured the risks of Gulf and its affiliates with Insco. Ltd., premiums paid them by Gulf and its affiliates were ceded to Insco Ltd. The primary carriers retained a commission for acting as a fronting or ceding company for Insco Ltd. The risks assumed by Insco Ltd. from primary carriers relative to Gulf and its affiliates were limited to $10 million but did not include the first $1 million of loss. This latter amount was self-insured by Gulf and its affiliates. It was the practice of primary carriers and Insco Ltd. to reinsure catastrophic risks, i.e., those exceeding $10 million, with third party reinsurers on the worldwide reinsurance market or place them in OIL. A portion of the premiums received by Insco Ltd. attributable to its insurance of a portion of the risks of Gulf and its affiliates was ceded to reinsurers who accepted the catastrophic risks of Gulf and its affiliates exceeding $10 million.

Relative to the risks of Gulf and its affiliates associated with on-shore properties, such as refineries and chemical plants, it was the general practice to self-insure such properties up to a $1 million deductible level. Risk exposures in excess of $1 million up to a $40 million level were placed with a primary carrier such as Oil Insurance Association, a third party commercial insurance concern. By prearrangement the first $10 million of coverage, exclusive of the $1 million deductible, was reinsured with Insco Ltd. Risk exposures between $10 million and $40 million were retained by the primary carrier. Risk exposures exceeding $40 million, up to a level of $150 million, were placed with OIL. Upon Gulf's phased withdrawal from OIL, risk exposures exceeding the $40 million limit were reinsured in the worldwide commercial reinsurance market.

Relative to risks associated with off-shore properties such as drilling rigs and production equipment, the practice of Gulf and its affiliates was to self-insure up to a level of a $1 million deductible. Risk exposures in excess of $1 million were insured by a primary carrier who was frequently a member of the American International Group. The limit of coverage in the case of off-shore properties was determined by the value of the properties involved. By prearrangement, generally 50 percent of the primary carrier's coverage limit, up to a $10 million level, was reinsured with Insco Ltd. The primary carrier retained coverage in excess of $10 million and often reinsured a portion of this coverage in the worldwide reinsurance market or with OIL.

Relative to the risks of Gulf and its affiliates associated with marine hull, i.e., oil tankers and other vessels, it was the practice of Gulf and its affiliates to self-insure up to a $1 million deductible level. Risk exposures in excess of the $1 million deductible were placed with a primary carrier such as Lloyd's of London, American International Group, or Argonau Mid-West Insurance Company. The limits of the liability of the primary carrier depended upon the value of the particular hull being insured. By prearrangement with the primary carrier, 50 percent of the primary carrier's coverage up to a $10 million level was reinsured with Insco Ltd. The primary carrier retained coverage in excess of $10 million and often reinsured a portion of this coverage in the worldwide reinsurance market, generally through the London reinsurance market. OIL did not assume any catastrophic coverage relative to the marine hull risk exposures of Gulf and its affiliates.

Relative to the risks of Gulf and its affiliates associated with marine cargo, it was the practice to self-insure up to a $1 million deductible level. Risk exposures in excess of the $1 million deductible level were placed with a primary carrier such as the Insurance Company of North America. The amount of coverage held by the primary carrier was dependent upon the limit of the policy of insurance. By prearrangement with the primary carrier, the latter's coverage was reinsured with Insco Ltd. up to a level of $10 million. The primary carrier retained coverage in excess of $10 million and often reinsured a portion of this coverage in the worldwide reinsurance market or with OIL.

Gulf made available to its employees a group life insurance benefit plan in which employees could participate. This plan was written through a policy issued by Connecticut General. The benefit plan included a provision which continued life insurance for employees who were disabled, with Gulf paying a premium for such life insurance while they were so disabled. By pre-arrangement, 100 percent of Connecticut General's exposure was reinsured with Insco Ltd. while the employee was disabled. The premium for this exposure was ceded to Insco Ltd. Connecticut General received a fee for administrative services provided to Insco Ltd.

Insco's premium income received from Gulf, Gulf's affiliates, and third parties consisted of earned and unearned premiums. Earned premiums relate to amounts paid i a particular year for coverage in that year while unearned premiums relate to amounts paid in a particular year for coverage in a subsequent year.

Set forth below is the gross premiums written and the net premium income reported by Insco on its financial statements for the years 1972 through 1983:

Year	Gross Premiums Written	Net Premium Income
1972	$ 1,064,000	$ 569,000
1973	8,118,000	2,505,000
1974	12,344,000	11,816,000
1975	21,300,000	16,177,000
1976	31,770,000	30,079,000
1977	40,269,000	41,238,000
1978	85,017,000	73,926,000
1979	112,630,000	75,812,000
1980	153,670,000	87,621,000
1981	154,022,000	94,758,000
1982	140,454,000	98,158,000
1983	114,090,000	82,264,000

Net premium income is gross premiums written, less the increase or decrease in unearned premiums relative to the prior year, minus commissions, expenses, and premium taxes.

Set forth below is a schedule of Insco's yearly and cumulative investment income (primarily consisting of interest income) for the years 1972 through 1980.

Year	Yearly Investment Income	Cumulative Investment Income
1972	$ 8,197	$ 8,197
1973	85,433	93,630
1974*	1,151,290	1,244,920
1975*	2,439,525	3,684,445
1976*	4,102,747	7,787,192

1977 6,886,287 14,673,479

1978 9,260,000 23,933,479

1979 14,188,000 38,121,479

1980 21,285,000 59,406,479

(Amounts are computed on a consolidated basis where appropriate. Years with asterisks end 11/30; all other years end 12/31.)

For the years 1972 through 1983, the amounts that Insco had available to meet insurance loss claims (that is, the value of Insco's assets minus its liabilities (other than estimated unpaid losses and loss expenses /3/)) were as follows:

Year	Amount
1972	$ 0.7 million
1973	3.0 million
1974*	11.5 million
1975*	34.3 million
1976*	61.2 million
1977	79.7 million
1978	124.7 million
1979	171.6 million
1980	223.9 million
1981	260.1 million
1982	285.4 million
1983	305.4 million

(Amounts are computed on a consolidated basis, where appropriate. Years with asterisks are years ending 11/30. All other years end 12/31.)

Set forth below is a schedule of Gulf and its foreign and domestic affiliates whose risks were reinsured with Insco during the taxable years 1974 and 1975 along with their respective country of incorporation:

Name	Country of Incorporation
Gulf Oil Corp.	U.S.

Mene Grande Oil Co. U.S.

Ecuadorian Gulf Oil Co. U.S.

Zaire Gulf Oil Co. U.S.

Key International Drilling Co., Ltd. Bermuda

Britama Tankers, Ltd. England

Belgulf Tankers, NV Belgium

Nedgulf Tankers, NV Belgium

Fuel Transport Co., Ltd. Liberia

Compannia Maritima Rio Gulf Co., SA Spain

Gulf Oil Company (Nigeria), Ltd. Nigeria

Afran Transport Co. Liberia

Gulftankers, Inc. Liberia

Insco paid claims to primary carriers relative to all risks it reinsured totaling $1,001,444 and $3,107,212 for the years 1974 and 1975, respectively. No part of the claims paid in 1974 and only $48,018 of the claims paid in 1975 related to the risks of unrelated third parties.

Members of the American International Group, Inc. (AIG), served as primary insurers for a substantial amount of the risks of Gulf and its affiliates that were reinsured with Insco. On December 20, 1973, Gulf executed a guaranty in favor of AIG that obligated Gulf to indemnify AIG in the event Insco could not meet its obligations regarding the risks it reinsured. The AIG guaranty remained in effect throughout the relevant years. On December 20, 1973, Gulf also executed a similar guaranty relative to the risks reinsured by Oil Industry Association. The latter guaranty, or a substituted version thereof, was in effect throughout the relevant years. Gulf was never required to indemnify any primary insurers under these guaranties.

In 1975 several changes in the operation and structure of Insco were made. Among these changes, Gulf transferred ownership of Insco to Transocean Gulf Oil Company (Transocean), a wholly owned Gulf holding company. At this time Insco called its issued but non-paid-up shares and Transocean contributed capital of $880,000. Concurrently, Insco issued 9,000 new shares at a value of $1,000 per share. These shares were fully paid-up by Transocean thereby increasing the paid- in capital of Insco to $10 million. Gulf and its affiliates no longer directly placed catastrophic coverage with OIL or other third-party reinsurers, but rather placed those risks with Insco, which, in turn, reinsured those risks.

In 1975 Insco first began insuring risks of unrelated parties. Net premium income from the insurance of non-Gulf risks represented 2 percent of the total net premium income of Insco for the taxable year 1975. Gulf also determined that it should withdraw from OIL and commenced doing so over the minimum 5-year period. In October 1975, J.M. Turnbull of Gulf's financial department replaced A.W. Gregg as president of Insco.

In a statutory notice of deficiency mailed to petitioner, the Commissioner determined that payments made by Gulf and its domestic affiliates to primary insurers were not deductible insurance premiums to the extent those payments were ceded to Insco. As a result, the Commissioner disallowed insurance expense deductions claimed by Gulf and its domestic affiliates as follows:

Insurance Expense Disallowed

	1974	1975
Gulf Oil Corp.	$ 8,970,653	$ 9,426,308
Mene Grande Oil Co.	1,059,306	1,168,453
Ecuadorian Gulf Oil Co.	214,398	185,414
Total	$10,244,357	$10,780,175

With the consent of petitioner, the Commissioner amended his pleadings to disallow additional deductions claimed for insurance premiums ceded to Insco in the amounts of $40,973 and $119,906 for the taxable years 1974 and 1975, respectively.

The Commissioner also recharacterised the insurance premium payments made by foreign affiliates of Gulf as constructive dividends to Gulf to the extent those premiums were ceded to Insco. In the statutory notice of deficiency, the Commissioner determined that Gulf received dividend income in the amounts of $2,659,410 and $4,662,192 /4/ for the taxable years 1974 and 1975, respectively. In addition, with the consent of petitioner, the Commissioner amended his pleadings to reflect that Gulf had additional taxable income from constructive dividends arising from the payment of insurance premiums to Insco by foreign affiliates of Gulf in the amounts of $1,369,236 for the taxable year 1974. The parties agree that for the taxable year 1974 each of the Gulf foreign affiliates who paid premiums to Insco, through third-party primary insurers, had sufficient current or accumulated earnings and profits equal in amount to the constructive dividends determined by respondent. The parties agree that with the exception of Belgulf Tankers, NV, Britama Tankers, Ltd., Gulftankers, Inc., and Gulf Oil (Great Britain) Ltd., each of the Gulf foreign affiliates who paid premiums to Insco in 1975, through third-party primary insurers, had sufficient current or accumulated earnings and profits equal in amount to the constructive dividends determined by respondent.

In the statutory notice of deficiency the Commissioner also treated claims paid by Insco in the taxable years 1974 and 1975 relative to the reinsurance of the risks of Gulf and its domestic affiliates as constructive dividends directly to Gulf or to Gulf through Transocean. These payments of claims, which were treated as constructive dividends, totaled $1,001,441 and $3,059,194 for the taxable years 1974 and 1975, respectively. However, the Commissioner determined that Gulf and its domestic affiliates sustained deductible uninsured losses under section 165 for the taxable years 1974 and 1975 totaling $1,001,444 and $3,059,194, respectively.

From 1976 to the present Insco increased its underwriting of third-party risks and continued to underwrite additional risks of Gulf and its affiliates. In April 1977 Insco hired Leslie Dew to guide the expansion of Insco's underwriting efforts. He was named vice-president and chief operating officer for underwriting and was appointed to Insco's executive committee and board of directors. Dew is well respected in the insurance industry. He has an extensive background as a non-marine insurance underwriter at Lloyd's of London with one of the major underwriting syndicates. He served as deputy chairman of Lloyd's of London immediately prior to commencing work with Insco.

In 1978 Insco terminated its service agreement with Harsh & McLennan Management, Ltd. Subsequently, Insco systematically assembled the necessary staff to perform all the services previously performed by Harsh & McLennan Management, Ltd. Based upon the recommendation of Dew, Insco formed Britamco, Ltd., as a wholly owned Bermuda subsidiary. Britamco, Ltd.'s business activity was to act as an agent for Insco and other insurance companies in writing third- party insurance and reinsurance business. In order to underwrite third-party reinsurance risks in the United States, Insco entered into a trust agreement with Citibank, New York, New York, pursuant to which Insco set aside $10 million in liquid assets as security for its U.S. insureds and reinsureds relative to claims payable in U.S. currency. By establishing the $10 million trust fund, Insco was able to qualify as a non-admitted surplus line insurer in various states throughout the United States.

Set forth below is a schedule of the net premium income earned by Insco from reinsuring the risks of Gulf and its associates and third parties, as well as the amount of net premium income earned from reinsuring third-party risks as a percentage of total net premium income for the years 1976 through 1983:

Year	Gulf Related Risks	Third-Party Risks	Percentage of Third-Party Risks
1976	$29,049,000	$ 2,235,000	7 percent
1977	32,295,000	6,008,000	1 percent
1978	32,615,000	33,902,000	5 percent
1979	30,871,000	36,214,000	5 percent
1980	36,202,000	40,881,000	5 percent
1981	39,312,000	46,544,000	5 percent
1982	46,497,000	42,381,000	4 percent
1983	29,011,000	46,520,000	6 percent

It was the practice of Insco Ltd. to limit its individual loss occurrence exposure relative to third-party risk to $500,000 or less. Reinsurance was placed with unrelated reinsurers at appropriate terms and conditions to accomplish this.

The following is a schedule of claims paid by Insco during the years 1976 through 1980:

Year	Claims Paid
1976	$ 4,718,000
1977	12,698,000
1978	5,989,000
1979	15,169,000

1980 25,947,000

Set forth below is a schedule of the dividends paid by Insco to Transocean during the years 1976 through 1983:

Year	Dividends
1976	-0-
1977	$10,000,000
1978	13,000,000
1979	10,000,000
1980	10,000,000
1981	10,000,000
1982	10,000,000
1983	11,000,000

During the year 1982 Insco advanced $30 million to Transocean without providing for the payment of interest. This advance was to be repaid out of anticipated future dividends of Insco.

OPINION

In this case we must decide whether Gulf may deduct as ordinary and necessary business expenses amounts paid as insurance premiums to its wholly owned captive, Insco, in 1974 and 1975. In each of our prior opinions in which we have addressed the captive insurance issue, we concluded that payments to the captive subsidiary, designated as premiums, whether from the parent corporation or from other subsidiaries, did not represent payments for insurance. Carnation Co. v. Commissioner, 71 T.C. 400 (1978), affd. 640 F.2d 1010 (9th Cir. 1981); Clougherty Packing Co. v. Commissioner, 84 T.C. 948 (1985), affd. 811 F.2d 1297 (9th Cir. 1987); Humana v. Commissioner, 88 T.C. 197 (1987). /5/ In each of those situations the captive was wholly owned by its parent and the captive insured risks only within the affiliated group. In this case we are for the first time faced with a wholly owned captive that insures unrelated, third party risks as well as those of its affiliated group. The issue before us is whether the insurance of these risks produces a result different from our prior decisions.

Gulf argues that this case is distinguishable because Insco's intention to insure the risks of unrelated third parties has been established for years prior to the taxable years in issue, that in 1975, one of the years before the Court, Insco did in fact insure unrelated parties, and that the large amount of unrelated third party risks insured in later years demonstrates that Insco is and should be treated as an unrelated insurance company. Respondent argues that Insco's writing of third party insurance is irrelevant to the existence of risk transfer, that the economic family concept precludes deductible insurance premiums to the extent that the captive insures any risks of an affiliated corporation.

In Carnation, Clougherty and Humana, we were attempting to determine whether the arrangements between the affiliated parties were insurance as defined by the Supreme Court in Helvering v. Le Gierse, 312 U.S. 531 (1941). We concluded in each situation that they were not. /6/ Central to our holdings are two principles. First, to have insurance, risk-transfer and risk-distribution must be present. Second, payments designated as premiums for insurance, which are the equivalent of nondeductible payments to a reserve for losses, are not payments for insurance; there is no risk transference in such situations. Although technically transfer of risk may occur when a captive is involved that is a separate, viable entity, financially capable of meeting its obligations, we simply declined to recognize it as such when the arrangement was merely in substance the equivalent of a reserve for losses or self-insurance.

To have a true transfer of risk, another risk-bearer must replace the insured; to speak of a transfer of risk to a fund or reserve established by the insured is merely to describe self- insurance in the jargon of insurance. [Fn. refs. omitted. K. O'Brien & K. Tung, "Captive Offshore Insurance Corporations," 31 N.Y.U. Thirty-First Ann. Inst. on Fed. Tax 665, 678-684 [H. Sellin ed. 1973).]

Furthermore,

It is apparent that the nature of the captive-insurance device involves not only the element of insurance through "transfer" of risks, but also the notion of self-insurance since the "owners" of the risks insured therein are the "owners" of the insurer. The fortunes of the two entities are interlocked to the extent that the risks insured in the captive are not reinsured. In this sense, captive insuring can be considered a risk-retention device similar to self-insurance. In fact, if self-insurance involves the conduct of risk management "according to all the sound principles and practices employed by insurance companies" it might be argued that captive insuring is the epitome of the self-insurance device * * *. [Robert S. Goshay, "Captive Insurance Companies," Risk Management, Ch. VI, Richard D. Irwin, Inc., Homewood, Illinois, 1964, pp. 80-121, at p. 85 as referenced in Humana v. Commissioner, 88 T.C. at 211.]

In addition, we rejected the "economic family" theory espoused in Rev. Rul. 77-316, 1977-2 C.B. 53. Under that theory we could have reached the same result, but we would have foreclosed a wholly owned captive from ever being considered a separate insurance company, payments to which are deductible by its owners. /7/ Recognizing that there may in fact be such situations, we declined to adopt this theory. We specifically reserved any discussion of the tax consequences of payments to captives with unrelated owners and/or unrelated insureds. Clougherty Packing Co. v. Commissioner, 84 T.C. at 960; Humana v. Commissioner, 88 T.C. at 210.

We are now faced with one of these situations. /8/ The facts of this case are for all purposes identical to those in Carnation, Clougherty, and Humana (with respect to the parent-subsidiary relationship), except that Insco, Gulf's wholly owned subsidiary, began insuring risks of third parties in 1975, one of the years before the Court. The net premium income from the insurance of third- party risks in 1975 was only 2 percent of Insco's total net premium income. However, in the years 1978 through 1981, and 1983, net premium income from third parties exceeded 50 percent of the total. In 1975 Insco paid total claims of $3,107,212, of which $48,018 represented claims paid to third parties. The issue before us is the effect, if any, of this unrelated business, on a holding that would otherwise be controlled by our prior cases.

Under principles of the insurance industry, risk transfer and risk distribution occur only when there are sufficient unrelated risks in the pool for the law of large numbers to operate. /9/ As the number of unrelated risks is increased,

protection is improved against the chance that the severity and number of harmful events will be spread over time or in other ways in groupings disproportionate to the overall risk. THAT IS, WITH AN INCREASING NUMBER OF VENTURES IN A COMBINED POOL, THE UNUSUALLY FAVORABLE AND UNUSUALLY HARMFUL EXPERIENCES TEND TO STAY MORE NEARLY IN BALANCE * * *. Emphasis added. Fn. refs. omitted. R. Keeton, Insurance Law Basic Text, p. 6-7 (1971).]

In this instance "unrelated" risks need not be those of unrelated parties; a single insured can have sufficient unrelated risks to achieve adequate risk distribution. /10/

When the law of large numbers operates, the risk of each policyholder is divided into small units and is transferred to and distributed among the policyholders. As the Supreme Court stated in Group Life & Health Ins. Co. v. Royal Drug Co., 440 U.S. 205, 211 (1979):

It is characteristic of insurance that a number of risks are accepted, some of which involve losses, and that such losses are spread over all the risks so as to enable the insurer to accept each risk at a slight fraction of the possible liability upon it. [Citations omitted.]

Thus, risk transfer and risk distribution occur upon the issuance of each policy. /11/

The premium allocable to each insured contributes to the payment of aggregate losses whether or not that insured actually suffers any loss. The cost of future estimated losses is capable of reasonably accurate estimation; what is uncertain is the identity of the insureds (or properties) which will suffer losses. /12/ Thus:

Insurance allows the individual insured to substitute a small, definite cost (the premium) for a large but uncertain loss not to exceed the amount of the insurance) under an agreement whereby the fortunate who may escape loss will help compensate the unfortunate few who suffer loss. [R. Mehr, Fundamentals of Insurance, p. 33 (1983).]

If all of the insureds are related, the insurance is merely self-insurance because the group's premium pool is used only to cover the group's losses. By adding unrelated insureds the pool from which losses are paid no longer is made up of only the affiliated group's premiums. When a sufficient proportion of premiums paid by unrelated parties is added, the premiums of the affiliated group will no longer cover anticipated losses of all of the insureds; the members of the affiliated group must necessarily anticipate relying on the premiums of the unrelated insureds in the event that they are "the unfortunate few" and suffer more than their proportionate share of the anticipated losses. /13/

Thus, when the aggregate premiums paid by the captive's affiliated group is insufficient in a substantial amount to pay the aggregate anticipated losses of the entire group, the affiliates and unrelated entities, the premiums paid by the affiliated group should be deductible as insurance premiums and should no longer be characterized as payments to a reserve from which to pay losses. /14/ Risk distribution and risk transfer would be present, and the arrangement is no longer in substance equated with self-insurance.

With these principles in mind we turn to the facts of the present case. For the year 1974, the facts of this case are in all material respects the same as those in our prior decisions, and therefore those decisions control. The amounts paid to Insco by Gulf and its affiliates are not deductible as insurance premiums. With respect to the year 1975, we reach the same result for the same reasons, with one noted difference. We have considered Insco's unrelated business in order to determine whether it is sufficient to affect the premium pool such that risk transfer has occurred, and have concluded that we do not have enough facts to determine the same. /15/ However, even without additional evidence we have concluded that the addition of 2 percent of unrelated premiums is de minimis and would not satisfy us that risk transfer has occurred. /16/ We reserve judgment however on years other than those before the Court. /17/

The second issue is whether the payments designated as premiums made by the foreign affiliates and the payments of claims by Insco to Gulf and its domestic affiliates represent constructive dividends to Gulf.

Under section 61(a)(7), gross income includes dividends. The term "dividend" is defined in section 316(a) as a distribution of property by a corporation to its shareholders out of its earnings and profits. There is no requirement that the dividend be formally declared or even intended by the corporation. See, e.g., Sachs v. Commissioner, 277 F.2d 879 (8th Cir. 1960), affg. 32 T.C. 815 (1959). Distributions by a corporation will be treated as dividends to the shareholder if the distributions are made for the shareholder's personal benefit; the funds need not be distributed directly to the shareholder. Rushing v. Commissioner, 441 F.2d 593 (5th Cir. 1971), affg. 52 T.C. 888, 893 (1969); Rapid Electric Co. v. Commissioner, 61 T.C. 232, 239 (1973).

Because we have decided that the arrangement between Gulf and Insco does not represent insurance, respondent contends that payments of claims by Insco to Gulf represent constructive dividends to Gulf. We disagree. Our holding is limited to a finding that the arrangement between Gulf and Insco is not insurance and, therefore, the payments are not deductible for Federal income tax purposes. This does not alert the fact that a captive insurance company may be a useful and legitimate tool in risk management. Insco was organized and operated to provide Gulf with sufficient protection for certain risks of loss as well as to obtain tax benefits which we have disallowed. The payments of claims by Insco to Gulf were made in consideration for the premiums paid by Gulf and ceded to Insco.

Respondent also contends that the payments designated as premiums made by the foreign affiliates and the payments of claims by Insco to the domestic affiliates represent constructive dividends to Gulf. It is clear that a transfer of property from one corporation to another corporation can constitute a constructive dividend to their common shareholder. Sammons v. Commissioner, 472 F.2d 449 (5th Cir. 1972), affg. in part, revg. in part, and remanding a Memorandum Opinion of this Court. However, before we will characterize a transfer of property from one corporation to another as a constructive dividend to a common owner, we must first examine the transfer under a two-part test set forth in Sammons v. Commissioner, supra. See Gulf Oil Corp. v. Commissioner, 87 T.C. 548 (1986).

The first part of the test is objective, i.e., did the transfer cause funds or other property to leave the control of the transferor corporation and did it allow the stockholder to exercise control over such funds or property either directly or indirectly through some instrumentality other than the transferor corporation. The first part of the test has been satisfied. The funds were transferred from foreign affiliates to Insco in the form of insurance premiums and from Insco to the domestic affiliates as payments of claims. As is typical in these cases, the critical inquiry is whether the second part of the Sammons test has been met.

The second part of the test is subjective, whether the transfer was prompted by a business purpose of the transferor corporation or a shareholder purpose of the common owner. The transferor corporations had a business purpose for making the transfers and, therefore, we hold that the second part of the test has not been satisfied. Although payments made by the foreign affiliates to Insco are not classified as deductible insurance premiums, nevertheless, such payments were for the benefit of the affiliates because they provided coverage for their risks as separate entities. While the payments made to this captive insurance company are equivalent to additions to a reserve for losses, Insco, nevertheless, represents a useful and legitimate tool in risk management. The same rationale applies to the payments of claims by Insco to the domestic affiliates. The payments were for the primary benefit of the affiliate which received them, not for the benefit of the parent Gulf.

Accordingly, we hold that the payments designated as premiums made by the foreign affiliates and the payments of claims by Insco to Gulf and its domestic affiliates do not represent constructive dividends to Gulf. See Mobil Oil Corp. v. United States, 8 Cl. Ct. 555 (1985).

An appropriate order will be issued.

Reviewed by the Court.

NIMS, KORNER, SHIELDS, HAMBLEN, CLAPP, SWIFT, JACOBS, GERBER, WRIGHT, PARR, and WILLIAMs, JJ., agree with the majority opinion.

WELLs, J., did not participate in the consideration of this case.

FOOTNOTES TO OPINION

* This case was reassigned by Order of the Chief Judge dated November 24, 1987.

/1/ This is the final opinion on the severed issues. The other opinions are reported at: 87 T.C. 548 (1986) (Constructive Dividends and Payables); 87 T.C. 324 (1986) (Intangible Drilling and Development Costs);

87 T.C. 135 (1986) (Worthless Properties); 86 T.C. 937 (1986) (Kuwait Nationalization); 86 T.C. 115 (1986) (Iranian Foreign Tax Credit); 84 T.C. 447 (1985) (North Sea Farmout).

/2/ All section references are to the Internal Revenue Code of 1954, as amended and in effect during the taxable years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

/3/ Insco made provision for the estimated unpaid amounts of losses and loss expenses arising from incidents reported to Insco during the year, together with an allowance for losses incurred but not yet reported.

/4/ This figure includes a reduction of $5,917 in the amount actually determined in the statutory notice of deficiency resulting from the concession of respondent. Premiums in the amount of $5,917 were ceded by Insco to an unrelated third-party reinsurer.

/5/ Other courts that have confronted the captive insurance company issue have also disallowed deductions for purported premium payments to a captive insurance subsidiary, albeit on theories not necessarily adopted by us. Beech Aircraft Corp. v. United States, 797 F.2d 920 (10th Cir. 1986); Stearns-Roger Corp. v. United States, 774 F.2d 414 (10th Cir. 1985); Mobil Oil Corp. v. United States, 8 Cl. Ct. 555 (1985); contra, Crawford Fitting Co. v. United States, 606 F.Supp. 136 (M.D. Ohio 1985).

/6/ See Appendix A for discussion of our prior decisions.

/7/ The "economic family" concept is based on the theory that when a captive receives a dollar, its net worth and its parent's net worth increases by that amount, and that when the captive pays out a dollar the converse occurs. Recent articles illustrate the conflict between this and petitioner's positions: Barker, "Federal Income Taxation and Captive Insurance," 6 Virginia Tax Review 267 (1986); Bradley and Winslow, "Self-Insurance Plans and Captive Insurance Companies -- A Perspective on Recent Tax Developments," 4 American Journal of Tax Policy 217 (1986).

/8/ In Mobil Oil Corp. v. United States, 8 Cl. Ct. 555, 563 (1985), the Claims Court found that one of the captive insurance subsidiaries insured risks of unrelated third parties. In Beech Aircraft Corp. v. United States, an unreported case (D. Kan. 1984), 54 AFTR 2d 84-6173, 84-2 USTC par. 9803, affd. 797 F.2d 920 (10th Cir. 1986), the District Court indicated that the captive insurance subsidiary insured risks of unrelated third parties in the years subsequent to the year before the court. In Stearns-Roger Corp. v. United States, 577 F.Supp. 833, 834 (D. Colo. 1984), affd. 774 F.2d 414 (10th Cir. 1985), the District Court found that the captive insurance subsidiary, in addition to insuring the risks of its parent and brother sister subsidiaries, insured certain risks of the parent's customers. In holding that the premium payments from the parent to the captive insurance subsidiary were not deductible, the courts did not discuss the effect of insuring unrelated third-party risks.

/9/ As a theoretical matter, risk distribution or pooling requires:

(i) Mass -- * * *,

(ii) Homogeneity -- * * *, and

(iii) Independence -- * * *.

If these requirements are met to some minimum extent, the principles of average and large numbers operate so that the risk carried by an insurer is far less than the sum of the risks of the insured. * * * To the extent that these requirements are not satisfied, the insurer can offer security to the insured only through sheer financial power. * * * If there is neither adequate distribution of risk nor the financial power to withstand the simultaneous occurrence of all or a significant portion of the insured risks, there can be no transfer of risk, and hence no insurance. [Fn. refs. omitted. K. O'Brien & K. Tung, "Captive Offshore Insurance Corporations," 31 N.Y.U. Thirty- First Ann. Inst. on Fed. Tax 665, 678-684 (H. Sellin ed. 1973).]

/10/ See, e.g., Bradley and Winslow, "Self-Insurance Plans and Captive Insurance Companies -- A Perspective on Recent Tax Developments," supra at 233-234 n. 59, and at 255 n. 121; K. Tucker and D. Van Mieghen, Federal Taxation of Insurance Companies, 20.10, p. 2012, P-H Services (1983).

/11/ This concept has been recognized by the Internal Revenue Service. See Ltr. Rul. 8111087, which states in part:

Under insurance theory risks are distributed and shifted not through the capital structure of the company, but rather through the premiums (and resulting surplus and investment income) created by the policyholders. * * *

/12/ R. Goshay Corporate Self-Insurance and Risk Retention Plans, p. 23 (1964); R. Keeton, Insurance Law, p. 7 (1971).

/13/ See, e.g., Bradley and Winslow, "Self-Insurance Plans and Captive Insurance Companies -- A Perspective on Recent Tax Development," supra at 237 n. 69, and at 242-243 n. 87.

/14/ Without expert testimony, we decline to determine what proportion of unrelated premiums would be sufficient for the affiliated group's premiums to be considered payments for insurance. However, if at least 50 percent are unrelated, we cannot believe that sufficient risk transfer would not be present. This anticipated sharing of premiums paid by unrelated insureds is similar in concept to a mutual insurance arrangement. See, e.g., Rev. Rul. 80-120, 1980- 1 C.B. 41; Rev. Rul. 78-338, 1978-2 C.B. 107.

/15/ In order to determine whether a substantial proportion of unrelated premiums are paid to a captive, we must assume that reliable actuarial estimations of risk of loss have been used to arrive at the amount of each insured's premium payment. The parties in this case did not directly address the issue of whether premiums paid to Insco were negotiated on this basis and at arm's length. It appears that during 1974 and 1975 the premiums paid were greatly in excess of the actual losses paid. While this could be due to an extraordinarily low loss year, it could also be a result of excessive premiums. Without concluding which may have been the case here, we note that excessively large premium payments can be indicative of what is in substance a risk-retention arrangement, which would support our conclusion that risk transfer was not present in those years.

/16/ Petitioner argues on brief that the years 1974 and 1975 constituted a "startup phase" for Insco, and that payments made in these years should be treated similarly to payments made subsequent to the substantial increase in third party business for the years 1978-1983. We recognize that the startup phase of a business enterprise may not reflect the ultimate intentions and future prospects of the venture. For instance, a determination as to whether an activity constitutes a "trade or business" may require a review of activities over time, as might a determination as to whether an activity is engaged in for profit, See Allen v. Commissioner, 72 T.C. 28, 33-34 (1979); Boyer v. Commissioner, 69 T.C. 521, 537 (1977) (has been appealed); Benz v. Commissioner, 63 T.C. 375, 383 (1974). Similarly, the deduction or amortization of startup costs requires a review of expenditures incurred prior to the active conduct of a trade or business. See sec. 195; Richmond Television Corp. v. United States, 345 F.2d 901 (4th Cir. 1965), vacated and remanded on other issues 382 U.S. 68 (1965). In this instance, however, we are concerned with determining the character of payments made to Insco based upon the degree of risk shifting and risk distribution present in the years before the Court. While it may not be necessary to make this determination on an annual basis, we are confident that the 2 percent of unrelated business is not sufficient to satisfy the minimum level of risk shifting and risk distribution necessary to qualify for the deduction.

/17/ In our Findings of Fact we have set forth the extent of third-party risks for 1976 through 1983, although those years are not before the Court in this case. At trial, respondent objected to the admissibility of such evidence on the ground of relevancy. We overruled his objection but admitted the evidence for the limited purpose of demonstrating the consistency or lack of consistency of petitioner in carrying out its avowed purpose described as phase two of its captive insurance program, i.e., to solicit insurance business from third-party sources.

APPENDIX A

Discussion of Prior Captive Insurance Cases

In Carnation the taxpayer corporation insured its risks with an unrelated company which in turn reinsured 90 percent of those risks with the corporation's wholly owned captive. The captive was capitalized with $120,000, the requisite legal minimum in Bermuda. Before agreeing to this insurance and reinsurance arrangement, the unrelated insurer required Carnation to agree to increase the captive's capital up to $3 million if necessary for the captive to meet its reinsurance obligations. We determined that this arrangement was not insurance, and that therefore premiums paid to the third party insurer which were ceded to the captive were not deductible. Relying on the Supreme Court decision in Helvering v. Le Gierse, 312 U.S. 531 (1941), we held that the contracts when taken together were void of risk because the agreement to increase the captive's capital bound the taxpayer to an investment risk that was directly tied to the loss experience of its captive, which was, in turn, wholly contingent on the taxpayer's losses. The Ninth Circuit affirmed our decision agreeing that as in Le Gierse, the agreements effectively neutralized risk for purposes of insurance. Carnation Co. v. Commissioner, 640 F.2d at 1013.

Le Gierse is based on the principle that an agreement may resemble insurance in form yet lack an essential ingredient to insurance. Carnation Co. v. Commissioner, 71 T.C. at 415. This principle applies regardless of whether the parent and captive are considered separate entities for tax purposes. Carnation Co. v. Commissioner, 71 T.C. at 408.

In Clougherty the operative facts were essentially the same as in Carnation although no collateral capitalization agreement was present. Clougherty Packing Co. v. Commissioner, 84 T.C. 948 (1985), affd. 811 F.2d 1297 (9th Cir. 1987). Regardless of this distinction we held that the arrangement was not insurance; the risk of loss was not shifted from the parent to its captive. We stated "to deduct insurance premiums it is essential to decide whether the relationship giving rise to the payment constitutes insurance." Clougherty Packing Co. . Commissioner, 84 T.C. at 957. We held that the payments to the captive for premiums, which were used to pay losses of the parent and its affiliates only, were not deductible; they were essentially the same as nondeductible payments to a reserve for losses. We reasoned that payments are not insurance premiums unless they are paid to shift the risk away from the taxpayer who seeks to deduct them. Clougherty Packing Co. v. Commissioner, 84 T.C. at 958. We declined to decide how the result might be affected, however, if the captive had business from unrelated customers. Clougherty Packing Co. v. Commissioner, 84 T.C. at 960.

The Ninth Circuit affirmed our result but on the theory that the risk of loss was not shifted because the losses paid by the subsidiary reduce the value of its stock and thus correspondingly reduced the value of the corporation's assets. Clougherty Packing Co. v. Commissioner, 811 F.2d 1297 (9th Cir. 1987). /18/

Humana v. Commissioner, 88 T.C. 197 (1987), presented a slightly different fact pattern, but we again reached the same result. In Humana both the parent and its affiliates paid premiums to the parent's captive, again a wholly owned subsidiary that insured only the risks of the affiliated group. We held that the tax consequences of the payments by the parent to the captive were controlled by our prior decisions in Carnation and Clougherty. Humana v. Commissioner, 88 T.C. at 207. With respect to the affiliates, the situation was no longer parent-subsidiary but instead was brother-sister. We reached the same result, however, extending the rationale of Carnation and Clougherty, and reclassifying the payments as nondeductible additions to a reserve for losses. Humana v. Commissioner, 88 T.C. at 209. We stated "If we decline to extend our holdings in Carnation and Clougherty to the brother-sister factual pattern, we would exalt form over substance and permit a taxpayer to circumvent our holdings by simple corporate structural changes." Humana v. Commissioner, 88 T.C. at 213. We thus concluded that there was not the necessary shifting of risk from the operating subsidiaries of the parent to the captive and therefore the arrangement was not insurance. Humana v. Commissioner, 88 T.C. at 214.

CONCURRENCE OF JUDGE GOFFE

GOFFE, J. concurring: In this case there are two taxable years before the Court, 1974 and 1975. The issues in each of the years is whether petitioner may deduct amounts paid as insurance premiums by Gulf and its domestic affiliates to the extent that those payments were ceded to its wholly owned captive insurance company, Insco, and whether payments designated as premiums paid by the foreign affiliates of Gulf which were ceded to Insco and the claims paid by Insco to Gulf and its domestic affiliates represent constructive dividends to Gulf. The majority holds for petitioner on the second issue and I agree with the reasoning of the majority. The majority holds for respondent on the first issue, and with respect to the taxable year 1974, bases its holding upon our prior decisions, with which I agree. However, with respect to the taxable year 1975, the majority adopts a new and novel theory, not argued, briefed, or even contemplated by the parties, with which I do not agree.

The theory of the majority can be stated as follows: "adequate" risk distribution, created by insuring the risks of independent third parties, somehow translates into risk transfer. No court has ever suggested such a theory, nor have the parties advanced such an argument. The majority holds that the addition of 2 percent of unrelated premiums is de minimis and would not satisfy the majority that the risk was transferred. However, in dicta, the majority goes on to state that if the premium income from unrelated parties is at least 50 percent, there would be sufficient risk transfer so that the arrangement would constitute insurance.

The theory of the majority is in direct conflict with all of the case law which holds that the arrangement of insurance requires a shifting of the risk AND a distribution of the risk. The novel theory of the majority blurs the distinction between the concepts of shifting of risk and distribution of risk. However, such concepts cannot be equated because they have historically been held to be separate AND distinct concepts.

In Helvering v. Le Gierse, 312 U.S. 531 (1941), the Supreme Court first stated the rule as follows:

We think the fair import of subsection (g) is that the amounts must be received as the result of a transaction which involved an actual "insurance risk" at the time the transaction was executed. Historically and commonly insurance involves risk- shifting and risk-distributing. That life insurance is desirable from an economic and social standpoint as a device to shift and distribute risk of loss from premature death is unquestionable. That these elements of risk-shifting and risk-distributing are essential to a life insurance contract is agreed by courts and commentators. See for example: Ritter v. Mutual Life Ins. Co., 169 U.S. 139; In re Walsh, 19 F. Supp. 567; Guaranty Trust Co. v. Commissioner, 16 B.T.A. 314; Ackerman v. Commissioner, 15 B.T.A. 635; Couch, Cyclopedia of Insurance, Vol. I, section 61; Vance, Insurance, sections 1-3; Cooley, Briefs on Insurance, 2d edition, Vol. I, p. 114; Huebner, Life Insurance, Ch. 1. Accordingly, it is logical to assume that when Congress used the words "receivable as insurance" in section 302(g), it contemplated amounts received pursuant to a transaction possessing these features. Commissioner v. Keller's Estate, supra; Helvering v. Tyler, supra; Old Colony Trust Co. v. Commissioner, 102 F.2d 380; Ackerman v. Commissioner, supra. [Helvering v. Le Gierse, 312 U.S. at 539-540.]

The distinction between risk shifting and risk distributing is most succinctly described in the following quotation from an early case, Commissioner v. Treganowan, 183 F.2d 288 (2d Cir. 1950), which has been uniformly followed by the Tax Court and other courts:

"Insurance" is not defined by statute, and Treasury interpretation of the term has never gone beyond a statement that section 811(g) is applicable to "insurance of every description, including death benefits paid by fraternal beneficial societies operating under the lodge system" Treas. Reg. 105, section 81.25, 26 C.F.R. 81.25. In deciding whether the $20,000 paid to decedent's widow is insurance within the statutory meaning, the Tax Court looked, rather naturally, to the test announced in the leading case of Helvering v. Le Gierse, 312 U.S. 531, 539, 61 S.Ct. 646, 649, 85 L.Ed. 996, that "historically and commonly insurance involves risk-shifting and risk-distributing." * * *

As a critical commentator on the decision below well states it: "Risk shifting emphasizes the individual aspect of insurance: the effecting of a contract between the insurer and insured each of whom gamble on the time the latter will die. Risk distribution, on the other hand, emphasizes the broader, social aspect of insurance as a method of dispelling the danger of a potential loss by spreading its cost throughout a group. By diffusing the risks through a mass of separate risk shifting contracts, the insurer casts his lot with the law of averages. The process of risk distribution, therefore, is the very essence of insurance." Note, The New York Stock Exchange Gratuity Fund: Insurance That Isn't Insurance, 59 Yale L.J. 780, 784. [Commissioner v. Treganowan, 183 F.2d at 290-291.]

The distinction between risk shifting and risk distributing was also recognized in Crawford Fitting Co. v. United States, 606 F. Supp. 136 (N.D. Ohio 1985). That is the only captive insurance case in which a court analyzed both concepts. The District Court applied the definitions contained in Commissioner v. Treganowan, supra. It held that the payments were deductible as insurance premiums because there were BOTH a shifting of risk and a distribution of risk. Some of the more pertinent quotations from that opinion are as follows:

"Insurance" is not defined under the Internal Revenue Code. The Supreme Court, however, has stated that elements of risk- shifting and risk-distributing, historically and commonly, have been considered ordinary indicia of insurance. Helvering v. Le Gierse, 312 U.S. 531, 61 S.Ct. 646, 85 L.Ed. 996 (1941).

Where elements of risk-shifting an risk-distributing are absent from an insurance contract, the fundamental aspects of an insurance agreement are lacking. See Steere Tank Lines, Inc. v. U.S., 577 F.2d 279 (5th Cir. 1978), cert. denied, 440 U.S. 946, 99 S.Ct. 1424, 59 L.Ed.2d 634 (1979). In that case, the Court stated that "a taxpayer who establishes a reserve in an effort to ensure against future losses is not entitled to a deduction at the time the reserve is established or funded. A deduction is proper when the liability becomes fixed." Id. at 282. Accordingly, the Court found that where there was no shifting or genuine pooling of risks under the insurance agreement before it, plaintiff's payment of money into a contract premium account, from which were paid all accident claims against the taxpayer, was not an insurance premium deductible as a business expense, but rather a nondeductible reserve for accident claims. See also Spring Canyon Coal Co. v. Commissioner, 43 F.2d 78 (10th Cir. 1930), cert. denied, 284 U.S. 654, 52 S.Ct. 33, 76 L.Ed. 555 (1931) (Corporation's payments into self-insurance reserve fund held not deductible as an "ordinary and necessary business expense"). A taxpayer cannot "deduct as an expense an amount which he fears he may some day be called upon to spend," such as self-insurance. See Id. at 80, citing Appeal of Pan- American Hide Co., 1 B.T.A. 1249 (1925).

The fundamental issue in the case at bar, then, is whether the payment made by the plaintiff Crawford Fitting Company to the Constance Insurance Company, characterized by the plaintiff as an insurance premium, was in fact an insurance premium deductible under section 162, or was, as the defendant contends, a reserve held by the plaintiff Crawford Fitting Company as self-insurance to cover contingent losses. [Crawford Fitting Co. v. United States, 606 F. Supp. at 140. Fn. refs. omitted.]

The Court of Appeals for the Tenth Circuit in Beech Aircraft Corp. v. United States, 797 F.2d 920 (10th Cir. 1986), described the difference between risk shifting and risk distributing as follows:

In Helvering v. Le Gierse, the Supreme Court observed that "[h]istorically and commonly insurance involves risk-shifting and risk-distributing." 312 U.S. 531, 539, 61 S.Ct. 646, 649, 85 L.Ed. 996 (1941) (citing, inter alia, Ritter v. Mutual Life Insurance Co., 169 U.S. 139, 18 S.Ct. 300, 42 L.Ed. 693 (1898)). "Risk-shifting" means one party shifts his risk of loss to another, and "risk-distributing" means that the party assuming the risk distributes his potential liability, in part, among others. An arrangement without the elements of risk-shifting and risk-distributing lacks the fundamentals inherent in a true contract of insurance. See Steere Tank Lines, Inc. v. United States, 577 F.2d 279, 280 (5th Cir. 1978), cert. denied, 440 U.S. 946, 99 S.Ct. 1424, 59 L.Ed.2d 634 (1979); Commissioner v. Treganowan, 183 F.2d 288, 291 (2d Cir.), cert. denied, 340 U.S. 853, 71 S.Ct. 82, 95 L.Ed. 625 (1950). * * * [Beech Aircraft Corp. v. United States, 797 F.2d at 922.]

The Court of Appeals for the Ninth Circuit, in affirming our opinion in Clougherty Packing Co. v. Commissioner, 84 T.C. 948 (1985), affd. 811 F.2d 1297 (9th Cir. 1987) discussed both concepts as follows:

Shifting risk entails the transfer of the impact of a potential loss from the insured to the insurer. If the insured has shifted its risk to the insurer, then a loss by or a claim against the insured does not affect it because the loss is offset by the proceeds of an insurance payment. See Beech Aircraft, 797 F.2d at 922; Treganowan, 183 F.2d at 291; O'Brien & Tung, Captive Off-Shore Insurance Corporations, 31 N.Y.U. Inst. 665, 683-84 (1973). Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as a premium and set aside for the payment of such a claim. Insuring many independent risks in return for numerous premiums serves to distribute risk. By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smoothes out losses to match more closely its receipt of premiums. See Beech Aircraft, 797 F.2d at 922; Treganowan, 183 F.2d at 291. Risk distribution incorporates the statistical phenomenon known as the law of large numbers. This law is reflected in the financial world by the diversification of investment portfolios and in the day-to-day world by the adage "Don't put all your eggs in one basket." See T. Wonnacott & R. Wonnacott, Introductory Statistics for Business & Economics 31-32, 54-55 (1972). /5/ [Clougherty Packing Co. v. Commissioner, 811 F.2d at 1300.] ____________________

/5/ While the Supreme Court in Le Gierse expressly stated that insurance must exhibit both the shifting AND the distributing of risk, the resolution of that case depended only on the absence of risk shifting. Here, too, we need not consider whether Clougherty's captive insurer arrangement exhibited risk distribution because we conclude that Clougherty did not shift its risk.

The majority in the instant case should have followed the example of the Court of Appeals for the Ninth Circuit when it affirmed this Court in Clougherty, i.e., there has been no shifting of risk; therefore, an analysis of distribution of risk is unnecessary.

The most recent discussion by the Tax Court emphasizing the distinction between risk shifting and risk distributing is Anesthesia Service Medical Group v. Commissioner, 85 T.C. 1031 (1985), affd. 825 F.2d 241 (9th Cir. 1987). We described the distinction as follows:

Expenditures are deductible as insurance expenses, however, only if a true insurance arrangement exists. Clougherty Packing Co. v. Commissioner, 84 T.C. 948 (1985); Carnation Co. v. Commissioner, 71 T.C. 400 (1978), affd. 640 F.2d 1010 (9th Cir. 1981). An insurance arrangement, in turn, necessarily involves both the shifting and the distributing of risk. Helvering v. Le Gierse, 312 U.S. 531, 539-540 (1941); Commissioner v. Treganowan, 183 F.2d 288, 290 (2d Cir. 1950); Tighe v. Commissioner, 33 T.C. 557, 564 (1959).

Risk shifting emphasizes the individual aspect of insurance: the effecting of a contract between the insurer and insured each of whom gamble on time the * * * [loss] will * * * [occur]. Risk distribution, on the other hand, emphasizes the broader, social aspect of insurance as a method of dispelling the danger of a potential loss by spreading its costs throughout a group. By diffusing the risks through a mass of separate risk shifting contracts, the insurer casts his lot with the law of averages. * * * [Commissioner v. Treganowan, 183 F.2d at 291.]

Thus, there can exist no risk distribution without risk shifting. * * * [Anesthesia Service Medical Group v. Commissioner, 85 T.C. at 1038-1039.]

The case law set forth above has uniformly held that, in order for insurance to exist, risk transfer AND risk distribution must be present. The case law has consistently treated risk transfer and risk distribution as two separate and distinct concepts. Nonetheless, the majority, citing no authority, concludes that risk distribution which includes third-party risks may be equivalent to risk transfer. Such a holding does violence to the principles of the entire line of cases emanating from Le Gierse, decided by the Supreme Court in 1941.

The majority opinion, in addition to being contrary to all of the case law, is contrary to the record made in this case. The transcript on this issue was 416 pages in length, 215 of which covered the testimony of expert witnesses whose opinions are contrary to the theory of the majority. Petitioner offered no expert witnesses. Respondent's expert witnesses were Dr. Irving Plotkin and Mr. Richard Stewart. They submitted written reports and testified at length on direct examination. There was considerable cross- examination. As the trier of fact, I found their testimony to be credible, convincing and unassailable. Furthermore, I asked numerous questions which they answered to my satisfaction. I can find nothing in the entire record to cast any doubt on their testimony. Their opinions unequivocally draw the distinction between risk distribution and risk transfer and emphasize that risk distribution cannot be equated with risk transfer.

The majority, nevertheless, states in footnote 14 on page 26:

Without expert testimony we decline to determine what proportion of unrelated premiums would be sufficient for the affiliated group's premiums to be considered payments for insurance. However, if at least 50 percent are unrelated, we cannot believe that sufficient risk transfer would not be present. This anticipated sharing of premiums paid by unrelated insureds is similar in concept to a mutual insurance arrangement. See, e.g., Rev. Rul. 80-120, 1980-1 C.B. 41; Rev. Rul. 78-338, 1978-2 C.B. 107.

I am at a loss to understand how such a statement can be made. The footnote implies that there was no expert testimony presented to me, which implication is contrary to the record in this case. Not only was expert testimony offered, but the experts who testified were Dr. Plotkin and Mr. Stewart. They are the only experts whose testimony this Court and other courts have adopted.

Dr. Plotkin is a Vice President of Arthur D. Little, Inc. and a Director of its valuation subsidiary. He holds a B.S. degree in economics from the Wharton School (University of Pennsylvania) and a Ph.D. in mathematical economics from the Massachusetts Institute of Technology, where he taught computer science and finance. He has presented numerous papers in several fields of economics and regulation before various academic societies, professional organizations, and industrial associations and has served as an editorial reviewer for the Journal of the American Statistical Association, the Journal of Industrial Economics, and the Journal of Risk and Insurance. His published papers and monographs include "Risk/Return: U.S. Industry Pattern" (Harvard Business Review); "Rates of Return in the Property and Liability Insurance Industry: A Comparative Analysis" (Journal of Risk and Insurance); The Consequences of Industrial Regulation on Profitability, Risk Taking, and Innovation, and Torrens in the United States.

Dr. Plotkin's expert report contains the following:

the concept and operation of the principles of risk distribution are independent of and unrelated to the concept of risk transfer.

* * *

To have a true transfer of risk, another risk-bearer must replace the insured. To speak of a transfer of risk to a fund or reserve established by the insured is merely to describe "self- insurance." A captive insurance subsidiary, such as Insco, represents a recognized form of funding risk retention or self- insurance. * * * there is no dispute that a captive insurance company represents a device for funding RETAINED RISKS.

* * *

* * * whether * * * insurance was provided [to unrelated parties] does not in any way affect the fact that the transactions between the parent, its subsidiaries, and the captive did not provide insurance. The fact that a captive insurance company accepts the financial consequences of the risks of persons or firms unrelated to it by ownership, does not change the relationship between it and its affiliates from formalized, funded risk retention to insurance (risk transfer). By accepting third party business, the captive and its owners do not relieve themselves of the uncertainty stemming from their retention of their own risks. Rather they accept the uncertainty inherent in the third parties' risks in addition to those inherent in their own risks.

Dr. Plotkin's expert report clearly states that the existence of third-party risks does not translate into transfers of risk from Gulf and its domestic affiliates to Insco. Simply put, a transfer of risk does not occur by reason of adequate distribution of risk created by the presence of the insured risks of independent third parties. The majority directly contradicts Dr. Plotkin's expert report and offers absolutely no explanation for its complete disregard of it.

We adopted the opinion of Dr. Plotkin in Humana v. Commissioner, 88 T.C. 197 (1987), and he likewise rendered similar opinions which were adopted in Beech Aircraft Corp. v. United States, an unreported case (D. Kan. 1984, 54 AFTR 2d 84-6173, 84-2 USTC par. 9803), affd. 797 F.2d 920 (10th Cir. 1986), Stearns-Roger Corp. v. United States, 577 F. Supp. 833 (D. Colo. 1984), affd. 774 F.2d 414 (10th Cir. 1985), and Mobil Oil Corp. v. United States, 8 Cl. Ct. 555 (1985). He testified before me that, with respect to the subject matter involved, he had spent 500 to 1,000 hours in research. The bibliography accompanying his expert report lists 22 books, 7 monographs, and 55 articles. The majority cites 1 Supreme Court case, /1/ 4 books, 4 articles, and 1 private letter ruling for various statements. However, the majority does not cite any of these as authority for its theory.

Mr. Richard Stewart also testified on behalf of respondent. We likewise adopted his opinion in Humana and he has imposing credentials. Mr. Stewart was graduated from West Virginia University in 1955, where he was president of the student body and the holder of the highest academic record in the history of the institution. As a Rhodes Scholar at Queen's College, Oxford, he was president of the student body and of the law society, and received a B.A. degree in Jurisprudence, with congratulatory first class honors, in 1957. In 1959 he was graduated, cum laude, from Harvard Law School. From 1967 to 1970, he was Superintendent of Insurance of New York State, and in 1970 he was President of the National Association of Insurance Commissioners. From 1971 to 1972 he was Senior Vice President and General Counsel of First National City Bank and its parent, First National City Corp., now Citibank and Citicorp, and a member of the Policy Committee of both corporations. He was also a Director of General Reinsurance Corporation. From 1973 to 1981 he was Senior Vice President and Chief Financial Officer of the Chubb Corporation and of its subsidiaries and Senior Vice President and Director of Chubb & Son Inc. His responsibilities included personal lines underwriting, surety bonding, financial institutions underwriting, corporate finance, investments and various staff functions. From 1979 to mid- 1981 he was also a founding Governor of the New York Insurance Exchange. Since mid-1981 he has been Chairman of Stewart Economics, Inc., a consulting firm specializing in the insurance business. He is the author of Reason and Regulation (1972) and Insurance and Insurance Regulation (1980) and co-author of Automobile Insurance . . . For Whose Benefit? (1970), and Medical Malpractice (1977).

Mr. Stewart's expert report submitted to me at trial contains the following:

For there to be insurance, in both its textbook and its practical business sense, there must be transfer of risk, that is, a shifting of the financial consequences of an event, where the event or its financial consequences, or both, are uncertain at the time the insurance arrangement is made. In short, insurance involves the transfer of financial risk.

* * *

* * * what it all comes down to is whether there was transfer of financial risk. There was not. The reason is that Gulf owned Insco.

In response to questions at trial concerning an example of a parent which owned 100 percent of a captive which insured third-party risks, Mr. Stewart testified that there could be no transfer of risk from the parent to the wholly owned captive.

The only two experts who testified before me in the instant case agreed that there was no shifting of risk and that the presence of third-party risks was not relevant in determining whether there had been a shifting of risk from Gulf and its domestic affiliates to Insco. Because there was no transfer of risk, the case should be decided on that basis under the authority of our prior opinions in Humana, Clougherty, and Carnation

Co. v. Commissioner, 71 T.C. 400 (1978), affd. 640 F.2d 1010 (9th Cir. 1981). The new and novel theory of the majority reaches the same result with respect to the taxable year 1975. However, its application will lead to incorrect results when there is a higher percentage of insured risks of independent third parties. More importantly, this theory is in direct conflict with the written reports and testimony of the eminently qualified experts who testified before he and in other trials.

Furthermore, the theory of the majority, in addition to being contrary to the case law and the expert reports and testimony, is seriously flawed in its reasoning. The majority attempts to explain how risk distribution created by the presence of the insured risks of third parties is somehow transformed into risk transfer on pages 25- 26:

The premium allocable to each insured contributes to the payment of aggregate losses whether or not that insured actually suffers any loss. * * *

When a sufficient proportion of premiums paid by unrelated parties is added, the premiums of the affiliated group will no longer cover anticipated losses of all of the insureds; the members of the affiliated group must necessarily anticipate relying on the premiums of the unrelated insureds in the event that they are "the unfortunate few" and suffer more than their proportionate share of the anticipated losses.

Thus, when the aggregate premiums paid by the captive's affiliated group is insufficient in a substantial amount to pay the aggregate anticipated losses of the entire group, * * * [r]isk distribution and risk transfer would be present * * *. [Fn. refs. omitted.]

It appears that the majority equates risk transfer with the ability of the affiliated group to use the premium income of the unrelated parties to pay for its losses. If the premium allocable to each insured contributes to the payment of aggregate losses, it would seem that the logical conclusion should be that the affiliated group has shifted its risk to the extent of unrelated premiums. For example, if the unrelated parties account for 25 percent of the premium income, it would seem that the affiliated group has shifted its risk to the extent of 25 percent. However, under the majority's theory, if the aggregate premiums paid by the corporations affiliated with the captive are "sufficient" in a "substantial" amount to pay the aggregate anticipated losses of all of the insureds there is NO transfer of risk, but if the aggregate premiums paid by the corporations affiliated with the captive are "insufficient" in a "substantial" amount to pay the aggregate anticipated losses of the entire group, there is 100 PERCENT transfer of risk. I question why, under the majority's theory, some magical percentage of unrelated premium is critical to transform risk distribution into risk transfer.

Finally, the analysis of the majority is incomplete in that it fails to consider the possibility that the unrelated parties may be "the unfortunate few" and suffer more than their proportionate share of the anticipated losses. In this instance, premium income of the affiliated group may be used to cover the losses of the unrelated parties. For example, assume the affiliated group pays $50 of premiums to the captive and that the captive also receives $50 of premiums from unrelated parties. If the affiliated group incurs $60 of losses, the affiliated group will be able to use $10 of the premiums of the unrelated parties to cover its losses. On the other hand, if the unrelated parties incur $60 of losses, the unrelated parties will be able to use $10 of premiums of the affiliated group to cover its losses. This scenario illustrates the point contained in Dr. Plotkin's expert report that by accepting third-party business, the captive and its owners accept the uncertainties inherent in the third parties' risks. If we examine the whole picture and not just a portion of it, the theory of the majority does not withstand scrutiny.

I do not question the power of the Court to adopt a new theory. However, even ignoring my analysis above, I question the wisdom of adopting such a new and novel theory which heretofore has never been considered when neither party has been given an opportunity to brief the merits, if any, of the theory. Respondent has ably refuted petitioner's claim that the payments in issue constituted insurance premiums. We should not assume that he has no argument against the new and novel theory advanced by a majority of the Court. More importantly, the majority can only define and describe its theory in generalities. The theory of the majority will undoubtedly have a major impact and I question the sagacity of adopting such a theory sua sponte. Indeed, this Court should heed the admonition of the Court of Appeals for the Fifth Circuit in Brooks v. Commissioner, 424 F.2d 116 (5th Cir. 1970), revg. 50 T.C. 927 (1968), when it said:

The Tax Court based its decision on a novel theory * * * which was not raised, briefed or argued by either party. * * * In the usual circumstances we would reverse and remand so that * * * both parties may be given an opportunity to brief and argue the merits of the new theory. * * * [424 F.2d at 119.]

Chabot and Cohen, JJ., agree with this concurring opinion.

FOOTNOTE TO CONCURRENCE OF JUDGE GOFFE

/1/ The quotation is not original with the Supreme Court, but is, instead, from G. Couch, Cyclopedia of Insurance Law, sec. 1:3 (2d ed. 1959).

CONCURRENCE OF JUDGE CHABOT

CHABOT, J. CONCURRING: Both the majority and Judge Goffe agree with the result that petitioner is not entitled to any deduction for insurance premiums for the years before us in the instant case.

If, as appears to be the case, the majority are unwilling to agree with Judge Goffe's extension of prior case law as the justification for this result, then it would be the more prudent course of action to (1) note the "law of large numbers" analysis, (2) observe that that analysis would lead to the same result in the instant case but perhaps different results in other cases, and (3) indicate that the parties in other cases may wish to argue in their cases the strengths and weakness of that analysis and present the appropriate expert testimony. This approach would have preserved our opportunity to carefully evaluate a well-grounded exposition of both sides regarding the "law of large numbers" analysis. See Concord Consumers Housing Cooperative v. Commissioner, 89 T.C. 105, 106 n. 3 (1987), and the concurring opinion by Judge Korner, 89 T.C. at 125.

Instead, the majority have committed us to certain decisions in cases not before us (slip opin. at 26), decisions that might not be justified by the records made in those cases. As Judge Parker has indicated, we do a disservice to other taxpayers when we so boldly announce the result of future cases under these circumstances.

Sterrett, Goffe, and Cohen, JJ., agree with this concurring opinion.

CONCURRENCE OF JUDGE NIMS

NIMS, J., CONCURRING: I concur with the majority in both reasoning and result. However, I find it necessary to comment separately with respect to several of the concerns expressed by my colleague, Judge Goffe.

In essence, Judge Goffe would have us determine that a group of affiliated corporations can never deduct premiums paid to a wholly- owned captive insurer. The insurance of unrelated third parties, he concludes, is irrelevant because there is never shiting of risk from a parent and its affiliates to their wholly owned captive. Because there is no transfer of risk, the arrangement can never be considered insurance. Judge Goffe rests his conclusion on the expert testimony and reports of Dr. Plotkin and Mr. Stewart, both of whom relied not only upon insurance principles but also upon economic theory to arrive at their conclusion that Gulf and its affiliates did not transfer their risk to Insco.

Because the majority rejected the conclusions of Dr. Plotkin and Mr. Stewart with respect to the effect of the presence of unrelated insureds, Judge Goffe concludes, I believe incorrectly, that the majority "directly contradicts Dr. Plotkin's expert report and offers absolutely no explanation for its complete disregard of it." The majority did not completely disregard the expert reports in this case. In fact, the majority agrees with the experts with respect to their description of the necessary elements of insurancel and their conclusion that a captive insurer represents a form of risk retention or self-insurance --when the captive insures only risks of its affiliates. The majority even quotes from the same insurance text relied upon by Dr. Plotkin for the proposition that a captive is a hybrid possessing characteristics of insurance and self-insurance. The majority disagrees, however, with Dr. Plotkin and Mr. Stewart's ultimate conclusion that a wholly-owned captive is always a risk- retention device and that the addition of third party risks does not change the relationship between the captive and its affiliates from one of risk-retention to risk transfer. /2/

One is compelled to conclude that Judge Goffe, Dr. Plotkin and Mr. Stewart can only reach their conclusion by adopting the economic family theory, an approach not based on insurance principles, but rather on the principle that the capital of the affiliates remains at risk, regardless of the identity of the captive's insureds, because the affiliates and the captive are related. /3/ As the majority points out we have rejected this theory in the past and we do not, despite Judge Goffe's view to the contrary, adopt that theory here simply because the experts rely on it.

Instead, the majority relies on principles of the insurance industry to distinguish between arrangements which are in essence self-insurance and arrangements which will be recognized as insurance for tax purposes. The majority recognizes that there are circumstances under which a captive should be treated as a separate corporation providing insurance to its affiliates and premiums paid by the affiliates should be deductible.

I also disagree with Judge Goffe that the theory of the majority is "new and novel" and is in direct conflict with case law holding that insurance requires risk shifting and risk distribution.

Gulf's principal arguments throughout its briefs are that Insco should be treated as a separate corporate entity and that the agreements entered into by Gulf, Gulf's affiliates and Insco are insurance, under the definition set forth in Helvering v. Le Gierse, for which premiums paid should be deductible. /4/ Gulf argues that the agreements resulted in a transfer of risk because Insco was financially capable of meeting its obligations and that therefore Insco, rather than Gulf and its affiliates, bore the risk of loss. Gulf further argues that risk distribution was achieved both by the types of risks Insco insured and the parties who were insured. Gulf maintains that this should be true regardless of whether the captive insured unrelated parties. Alternatively it contends that the insurance of unrelated third parties is relevant because

* * * Insco's intention coupled with its carrying through on such intention support the conclusion that Insco was providing insurance in the taxable years in issue, even for the portion of such insurance which related to risks of Gulf and its affiliates.

As an example of how the insurance of unrelated third parties makes a difference, Gulf refers to 0.M. 19167, which was transmitted by G.C.M. 38136 and which was withdrawn by G.C.M. 39247:

O.M. 19167 considered the insurance of significant third party risks * * * to compel a conclusion that the transactions entered into by the insurance subsidiary should be considered "insurance" in such years even with respect to those transactions involving risks of companies which were related to the insurance affiliate. Furthermore, while O.M. 19167 expressed the opinion that there was not "insurance" in [earlier years] due to the fact that the percentage of third party risks that were insured in such years were minimal, O.M. 19167 considered that such years might be viewed by a court, not "in isolation, but as the start-up phase of what will become an insurance business in the fullest sense. . . . "

Respondent's "one economic family" theory does not take account of the fact that an insurance subsidiary may intend to insure (and may in fact insure) the risks of third parties. * * *

It is apparent from the above that one aspect of Gulf's argument is that the existence of unrelated insureds should make a difference in our determination of whether the arrangements with Insco were insurance. Gulf contends that the existence of unrelated insureds is evidence that Insco is a separate insurance company. The majority, agreeing with Gulf on this point, explains further that the existence of unrelated insureds allows the Court to distinguish between arrangements which are in substance self-insurance and arrangements which are insurance. It is with respect to this point that the majority offers its reasoning that when a substantial percentage of the captive's insureds are unrelated, risk transfer is present and will be recognized because the risks of the affiliated group are transferred to the unrelated insureds through the captive's premium pool.

Contrary to Judge Goffe's conclusion, the majority does not blur the distinction between the concepts of shifting of risk and distribution of risk. The majority requires that both be present. The majority simply recognizes that both may be present when the captive insures a substantial percentage of unrelated insureds and when the law of large numbers operates so that the premiums are reasonably calculated to cover losses. The majority's reasoning is not unlike that set forth in G.C.M. 38316, which was cited by Gulf on brief:

In short, while it is settled that for an "offshore captive to be truly an insurer it must serve to shift and distribute risks outside of the corporate group in a substantive way, we must look to both policyholders and shareholders to determine if the requisite risk shifting and distribution is present. Under insurance theory risks are shifted and distributed not through the capital structure of the company, but rather through the premiums (and resulting surplus and investment income) paid by the policyholders. Thus, we believe that, although there may be no ownership of an insurer outside of an affiliated group, we must still look to the percentage of nonaffiliated policyholders that the "captive" has, and/or the relative dollar value of premiums paid by nonaffiliated policyholders to determine the presence or absence of insurance.

With regard to the instant case, your memorandum suggests that although risk is distributed by the presence of nonaffiliated policyholders, the element of risk shifting is absent, because the parent is shifting its insurable risk to an "insurance" company for which the parent provided the basic capitalization. LOOKING TO THE CAPITAL STRUCTURE OF THE SUBSIDIARY ALONE TO DETERMINE WHETHER RISKS ARE SHIFTED FROM THE INSURED TO THE INSURER, HOWEVER, IGNORES A BASIC PREMISE OF THE INSURANCE BUSINESS, THAT IN A NORMAL INSURANCE SITUATION RISK SHIFTING AND DISTRIBUTING IS ACCOMPLISHED THROUGH THE PREMIUM- BASED UNDERWRITING OPERATION. IN OTHER WORDS, CLAIMS ARE PAID BY A SOLVENT INSURER NOT FROM PAID IN CAPITAL, BUT RATHER FROM PREMIUM INCOME, INVESTMENT INCOME, AND SURPLUS. See D. Gregg and V. Lucas, Life and Health Insurance Handbook 140 (3d ed. 1973) and S. Huebner and R. Black, Life Insurance 6 (9th ed. 1976), both of which discuss the relationship of insurance benefits and premiums in the context of life insurance; 1 W. Freedman, Richards on the Law of Insurance 2, 83 (1952). Therefore, we believe that WHEN, AS IN THE INSTANT CASE, RISKS HAVE BEEN DISTRIBUTED TO OTHER POLICY HOLDERS THEN IT NECESARILY FOLLOWS THAT THE RISK HAS ALSO BEEN SHIFTED TO THOSE OTHER POLICY HOLDERS. THUS, BECAUSE IN THIS CASE THE OTHER POLICYHOLDERS ARE NOT MEMBERS OF THE AFFILIATED GROUP, THERE HAS BEEN A SHIFTING AND DISTRIBUTING OF RISKS OUTSIDE THE GROUP, THROUGH THE MEDIUM OF THE "CAPTIVE" INSURANCE COMPANY WHICH, ALTHOUGH LARGELY OWNED BY THE PARENT, RECEIVES (AT LEAST IN THE LATTER TWO YEARS) APPROXIMATELY HALF OF THE MONEY FROM WHICH IT WILL PAY CLAIMS FROM UNRELATED PARTIES. [EMPHASIS ADDED.]

Because Gulf's primary argument was that Insco should be treated as a separate corporation providing insurance it did not go to great lengths to argue that the unrelated insureds made the difference between an arrangement that lacked risk transfer and one that did not. However, it is apparent that Gulf did present and argue, albeit as an alternative, this theory.

For the foregoing reasons I respectfully disagree with Judge Goffe's conclusions.

Whitaker, Korner, Hamblen, Swift, Jacobs, Gerber, Wright, Parr, and Williams, JJ., agree with this concurring opinion.

FOOTNOTES TO CONCURRENCE OF JUDGE CHABOT

/1/ For example, Dr. Plotkin's report provides:

The essential element of an insurance transaction from the standpoint of the insured firm, is that no matter what insured perils occur, the financial consequences are known in advance. Thus, the insured, for the price of the premium, is protected, within the limits of its policy, from such financial consequences and from having to worry about and provide for them. By reason of its contract, the insured is indemnified against loss from a defined hazard or risk. In essence, the premium represents the substitution of a small, but certain "loss," for a potentially large and uncertain loss. It provides piece of mind and the ability to devote all of one's financial resources to other concerns and objectives.

These basic principles are identical to those set forth by the majority.

/2/ Dr. Plotkin specifically concludes that by accepting third- party risks the captive and its owners accept the uncertainty inherent in the third parties' risks in addition to those inherent in their own risks.

/3/ Dr. Plotkin concluded:

So long as the firm does not transfer to another the ultimate responsibility for the financial consequences of its risks, it remains the risk bearer and faces the uncertainty of each year's actual financial losses. The attempted placing of a firm's risks, directly or indirectly, in its "insurance affiliates" does not accomplish a transference of risk, or constitute an insurance transaction as a matter of insurance theory or practice or as a matter of economic reality. We find our conclusion in complete accord with the clear theoretical and applied teachings of the economics, insurance theory, risk management, and captive self-insurance literatures and the documented practices of corporate risk managers.

Mr. Stewart concluded:

* * * what it all comes down to is whether there was transfer of financial risk. There was not. The reason is that Gulf owns Insco.

/4/ Alternatively, Gulf argued that the agreements should be treated as insurance regardless of the presence of risk transfer,

* * * When one considers the large number of risks to which Gulf and its affiliates were subject, the pooling of these diverse independent risks in a single corporate entity such as Insco achieves risk distribution which, standing alone, should result in a determination that "insurance" existed. * * *

Gulf did not pursue this argument because we held in Carnation Co. that there cannot be insurance without transfer of risk.

DISSENT OF JUDGE PARKER

PARKER, J., DISSENTING: I agree with Judge Goffe's views on the merits of the case, and normally would simply join in his concurring opinion. Here, however, I must dissent from what I perceive as the majority's unwarranted arrogation of judicial power.

I am mindful that this Court, although a trial court, functions as a collegial body. Nonetheless, such untrammeled exercise of majoritarian power as has occurred in this case could, I fear, threaten the necessary and wholesome judicial independence of the individual trial judge of this Court. Rather than serving as an instrument to assure uniform application and/or development of the tax law, the Court Conference could well become a committee of revision to try to force the individual trial judge to address some pet legal theory not presented by the case and not tried, argued, or briefed by the parties.

Judge Goffe, as the trial judge who heard this case, proposed to dispose of the case by following a well-established line of authority of this and other courts in the captive insurance area. He should have been permitted to do so. The majority does not disagree with that case law nor with the result flowing from application of that case law to the facts of this case. On the contrary, the majority reaches the same result but does so by a most unfortunate route. The majority wrested the case from the presiding trial judge, seizing it as a vehicle in which to expound a novel legal theory not presented by the pleadings, trial, arguments and briefs of the parties, and without giving the litigants an opportunity to address this theory.

In my opinion, the majority is reaching out to decide an issue that is not before it. I view such practice as particularly mischievous in this case where there may well be little practicable incentive to seek appellate review. This novel theory does not necessarily come into operation on the facts and for the years before the Court and the bottom-line result would be the same either way. A litigant may have little desire to incur the expense to appeal the basis on which he won or lost his case, where the outcome remains unchanged.