

ACTION ON DECISION

SUBJECT: Erickson Post Acquisition, Inc. v. Commissioner
Docket Number: 8218-00
T.C. Memo. 2003-218

Issue:

Whether the cash payment from the wholesaler to the retailer was a taxable advance payment or a nontaxable loan.

Discussion:

Petitioner is a gasoline station operator (retailer) that entered into an exclusive supply agreement with Amoco (wholesaler) in 1996. The agreement required that the petitioner purchase and sell only Amoco products for a 5-year period, with two 5-year renewal options. In return, Amoco paid petitioner \$175,000. Petitioner executed a promissory note providing for repayment over 10 years in annual installments of \$17,500 plus 6 percent interest. The \$175,000 "loan" was secured by a lien on petitioner's gas station property. The supply agreement provided that Amoco would forgive (deem paid) annual loan payments provided the dealer supply agreement remained in full force and effect on the due date of the installment. Neither party breached or terminated the supply agreement. Consequently, Amoco forgave the annual loan payments, and the petitioner never repaid any portion of the \$175,000, or any interest thereon.

For both book and tax purposes, the petitioner treated the \$175,000 as deferred income. The petitioner recorded the \$175,000 as a liability (Amoco/Deferred Income) prorated over ten years (120 months). Each month the petitioner reduced the deferred income account balance by 1/120th of the \$175,000, and credited that pro rata amount to income. The petitioner did not characterize the \$175,000 as a loan on its books and records, nor did petitioner take deductions for interest payments on its 1996 and 1997 returns. Administratively, the Service determined that the \$175,000 was an advance payment of income fully taxable to the petitioner in the year of receipt, 1996. In litigation, the petitioner contended that the \$175,000 was a loan that was forgiven incrementally over 10 years on the due date of each annual installment. The Tax Court held that the \$175,000 was a loan rather than an advance payment of income to the petitioner.

The Service thinks that the \$175,000 was an advance payment of income that petitioner may not defer over the 10-year term of the agreement. The evidence overwhelmingly shows that the purpose of the payment was to induce the petitioner to enter into a long-term, exclusive supply agreement. The terms of that agreement reflect the parties' intent: the petitioner would not have to repay the advance or pay interest if the petitioner used only Amoco products over

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the period covered by the agreement. Petitioner's principal officer testified that he never expected to repay the \$175,000 or pay interest on the amount. Indeed, petitioner never repaid the \$175,000 or paid interest. When the taxpayer enjoys complete dominion and control over an advance payment, the payment is income rather than a nontaxable loan or deposit. Commissioner v. Indianapolis Power & Light Co., 493 U.S. 203 (1990). "The individual who makes an advance payment retains no right to insist upon the return of the funds; so long as the recipient fulfills the terms of the bargain, the money is its to keep." Id. at 212. Petitioner had only a contingent obligation to repay. Once Amoco advanced the funds to petitioner, the petitioner could keep the funds as long as it honored its contractual obligations.

The Service thinks that the Tax Court erred in finding that the \$175,000 payment to petitioner was a loan. In form, the parties did cast the transaction as a loan: Amoco and the petitioner executed a note secured by a duly recorded mortgage. However, the evidence described above strongly suggests that the payment was not really a loan in substance. To constitute a loan, at the time an amount is transferred, the recipient must intend to repay the amount and the transferor must intend to enforce repayment. Beaver v. Commissioner, 55 T.C. 85, 91 (1970). The record establishes that neither the petitioner nor Amoco expected that the money would be repaid. Petitioner treated the advance as deferred income, not a loan, for both book and tax purposes. Petitioner characterized the advance as a loan only after the Service challenged deferral. If the advance had been a true loan, petitioner would have deducted interest and reported forgiveness of debt income once a year on its book and returns.

The Service considers the opinion in Karns Prime & Fancy Foods, Ltd. vs. Commissioner, T.C. Memo. 2005-233, the better analysis. On facts very similar to this case, the court focused on the substance of the transaction and found it an advance payment of income. Karns is consistent with the analysis in other cases addressing the loan versus advance payment issue. See Westpac Pac. Foods v. Commissioner, T.C. Memo. 2001-175, and Columbo v. Commissioner, T.C. Memo. 1975-162.

The Service disagrees with the holding in Erickson Post but did not appeal because it was essentially a factual determination. However, the Service will continue to litigate this issue in cases where taxpayers attempt to avoid tax by characterizing payments for business services as nontaxable loans.

Recommendation: Non-acquiescence, No Appeal.

Reviewers:

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