General Counsel Corner

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Gimme (Tax) Shelter

Recently, the United States Tax Court issued an opinion of interest to many open dealers, styled *Erickson Post Acquisition, Inc. v. Commissioner of Internal Revenue.* The court rejected the IRS' position that a loan given to a dealer to induce it to enter into a long term supply agreement constituted immediate taxable income.

In partial consideration of the dealer's agreement to enter into a five-year supply agreement with Amoco, Amoco provided what the parties characterized as a "loan" of $175,000, which was used primarily to pay for pumps and other equipment and to reduce the mortgage on one of the dealer's station sites. The money was to be repaid at 6% interest over ten years, but repayment would be forgiven so long as the dealer continued to fly the Amoco flag.

The dealer treated the $175,000 advance as non-taxable loan proceeds. Typically, loan proceeds do not constitute taxable income because the benefit to the borrower is offset by the obligation to repay.

Then the IRS darkened the picture. It sent the dealer a deficiency notice premised on the theory that the advance was not really a "loan" but a signing bonus for converting to the Amoco brand. The dealer filed a petition to the Tax Court to challenge the IRS' deficiency determination.

The Tax Court sided with the dealer after conducting a detailed analysis of the circumstances surrounding the transaction. It concluded that the advance qualified as legitimate, non-taxable loan proceeds because a true debtor-creditor relationship existed between the dealer and Amoco.

The Tax Court emphasized that the existence of a bona fide debtor-creditor relationship is a question of fact to be determined based upon the specific circumstances of a given case. In making that determination, the court considered a number of factors:

1. Was there a note or other signed obligation?
2. Was interest charged?
3. Was there a fixed schedule for repayment?
4. Was any security provided?
5. Was there a written loan agreement?
6. Had a demand for repayment ever been made?
7. Were any repayments made?
8. Did the parties' internal business records reflect that the transaction was a loan?
9. Was the borrower solvent at the time of the loan?

Applying those factors, the court concluded that there really was a loan. The parties had executed a signed promissory note that called for fixed annual payments of principal and interest to be paid over a 10-year period. The debt was secured by a mortgage and guaranteed in writing by the principal of the dealer. Amoco had recorded the mortgage, and it routinely enforced the collection of similar promissory notes if a dealer defaulted, sold the station or ran into significant financial trouble.

The IRS had argued that the entire sum should be deemed to constitute immediate taxable income because there was no repayment obligation so long as the supply agreement remained in effect. It compared the transaction to bonus arrangements under which a customer would only be required to make repayment in the form of “forfeiture penalties” if it failed to live up to its contract purchase obligations. Such arrangements are not treated as loans because there is no definite repayment obligation.

The Tax Court rejected the analogy relied upon by the IRS. It emphasized that the dealer did have an “absolute obligation” to repay the entire loan proceeds, and interest as well, if it sold the service station, and that this obligation was secured by a mortgage on the property.

The Tax Court rejected the IRS’ further argument that the advance was income because the dealer had “unfettered control” over the proceeds the moment that the payment was received. This was besides the point, the Tax Court said, because a borrower will frequently have unrestricted use of loan proceeds.

Finally, the IRS argued that the advance was not a loan because proper “formalities” had not been followed in setting it up. The mortgage given to Amoco on its face had been subordinated to an unknown and probably nonexistent debt; the dealer’s principal had signed the note individually without indicating that he was acting on its behalf; and Amoco had not made a full evaluation of the dealer’s financial condition before making the advance.

None of this impressed the Tax Court. The disparities in the loan documents could not obscure the commercial reality that an enforceable mortgage had been obtained and recorded by Amoco. Further, the service had submitted no evidence to prove its contention that Amoco had not considered the dealer’s financial condition before making the loan.

Just because the IRS lost the case does not mean that it will refrain from issuing similar deficiency notices to other dealers. If a dealer receives such a deficiency notice, he or she must file a petition with the Tax Court within 90 days. Otherwise the full tax, interest and penalty must be paid before a claim for reimbursement can filed.

The best protection is to document the transaction correctly from day one. My tax partner advises that the following steps should be taken to establish a debtor-creditor relationship for tax purpose:

1. There should be a written promissory note setting forth when, and under what conditions, repayment will occur.

2. The note should be signed by the borrower and provide for the payment of interest.

3. Collateral or security should be provided to ensure repayment.

4. Any payments due should be made on a timely basis.

5. The transaction should be treated as a loan on the company books.

The bottom line is that a supplier can agree to forgive repayment without triggering adverse tax consequences if a true debtor-creditor relationship is established. The borrower must, however, treat as income the amount of any forgiveness in the year in which it occurs.

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