Freede v. Commissioner, 89 T. C. 354 (1987)

Advance payments under 'take or pay' gas contracts may be treated as creating a production payment and thus not taxable until gas is delivered.

Summary

In Freede v. Commissioner, the Tax Court ruled that advance payments under 'take or pay' gas contracts could be treated as creating a production payment rather than immediate taxable income. The petitioners, who held working interests in a gas lease, received payments from Oklahoma Gas & Electric (OG&E) under a contract that required OG&E to pay for 80% of the gas deliverability regardless of whether they took the gas. The court held that these payments created an economic interest in the gas in place, thus classifying them as non-taxable until gas was delivered, countering the IRS's position that such payments should be immediately taxable.

Facts

H. J. Freede and Roger S. Folsom held working interests in the Endicott No. 1 lease in Oklahoma, which produced natural gas. They entered into 'take or pay' gas purchase contracts with Oklahoma Gas & Electric (OG&E), obligating OG&E to pay for 80% of the gas deliverability from the lease, whether or not they took the gas. In 1979, they received payments from OG&E, part of which was for gas actually taken, and part for gas not taken. The petitioners reported only the payments for gas taken as income and sought to defer taxation on the advance payments until the gas was delivered in future years.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the petitioners' federal income taxes for 1978 and 1979, asserting that the entire payments received under the 'take or pay' contracts should be included as income in 1979. The cases were consolidated and submitted without trial to the Tax Court, which ruled in favor of the petitioners, holding that the advance payments constituted a production payment under section 636(a) and were not taxable in 1979.

Issue(s)

1. Whether advance payments received under 'take or pay' gas contracts create a production payment under section 636(a), thus not taxable until gas is delivered.

Holding

1. Yes, because the advance payments under the 'take or pay' contracts create an economic interest in the gas in place, satisfying the requirements of a production payment under section 636(a), and thus are not taxable until gas is delivered.

Court's Reasoning

The Tax Court applied the criteria for a production payment under section 636(a), finding that the 'take or pay' contracts met all necessary conditions. OG&E had a right to a specified share of production, the economic life of the interest was shorter than the property's life, and the payments created an economic interest in the gas in place. The court rejected the IRS's argument that the payments merely conferred an economic advantage, citing that OG&E's rights and obligations under the contracts were equivalent to an economic interest. The court also noted that Revenue Ruling 80-48, which the IRS relied upon, was not binding and did not apply to the facts of this case. The decision was reviewed by the court, with a majority agreeing with the opinion.

Practical Implications

This decision allows taxpayers involved in 'take or pay' gas contracts to defer taxation on advance payments until the gas is actually delivered, affecting how such contracts are structured and reported for tax purposes. It challenges the IRS's position as expressed in Revenue Ruling 80-48 and may influence future rulings on similar contracts. Legal practitioners should consider this precedent when advising clients on the tax implications of 'take or pay' agreements, potentially leading to changes in contract drafting to align with the court's interpretation. Businesses in the energy sector might adjust their financial planning and tax strategies based on this ruling, and subsequent cases may further clarify or challenge its application.

