Herbel v. Commissioner, T. C. Memo. 1996-146

Settlement payments under take-or-pay contracts are taxable as income if they represent prepayments for future deliveries rather than loans or deposits.

Summary

In Herbel v. Commissioner, the Tax Court addressed whether a $1. 85 million payment received by Malibu Petroleum, Inc. from Arkla under a settlement agreement was taxable income. The payment settled a dispute over a take-or-pay gas purchase contract. The court held that the payment was a prepayment for gas to be delivered in the future, not a loan or deposit, and thus was taxable income in the year received. This decision was based on the terms of the settlement agreement, which did not guarantee repayment to Arkla unless certain conditions, outside of Arkla's control, were met.

Facts

Malibu Petroleum, Inc. , owned by Stephen R. and Mary K. Herbel and Jerry R. and Carolyn M. Webb, entered into a settlement agreement with Arkla over a take-or-pay gas purchase contract. The dispute arose from Arkla's alleged failure to take or pay for the minimum gas quantity required under the contract. Under the settlement, Arkla paid Malibu $1. 85 million, described as a prepayment for future gas deliveries. The agreement allowed Arkla to recoup this payment through future gas purchases, with any unrecouped balance refundable upon contract termination or well depletion. Malibu treated the payment as a loan, but the IRS determined it was taxable income.

Procedural History

The IRS issued notices of deficiency to the Herbels and Webbs, asserting that the $1. 85 million payment was taxable income for 1988. The taxpayers filed petitions in the U. S. Tax Court, seeking summary judgment that the payment was a non-taxable loan or deposit. The Tax Court denied the motion for summary judgment, holding that the payment constituted taxable income.

Issue(s)

1. Whether the $1. 85 million payment received by Malibu from Arkla under the settlement agreement was a prepayment for future gas deliveries, making it taxable income in the year received.
2. Whether the payment was instead a loan or deposit, which would not be taxable until the obligation to repay was discharged.

Holding

1. Yes, because the settlement agreement described the payment as a prepayment

for gas and allowed Arkla to recoup it through future deliveries, without a guaranteed right to repayment unless certain conditions were met.
2. No, because the payment was not subject to an unconditional obligation to repay, and the conditions for repayment were outside Arkla's control.

Court's Reasoning

The Tax Court analyzed the settlement agreement's terms, noting that it described the $1. 85 million as a prepayment for future gas deliveries. The court distinguished between loans and advance payments, citing Commissioner v. Indianapolis Power & Light Co. , which stated that the key factor is whether the recipient has a guarantee of keeping the money. In this case, Arkla had no control over the repayment conditions, which were tied to contract termination or well depletion. The court also considered that the settlement did not amend the take-or-pay provisions of the original contract, and Malibu waived claims for past non-performance through June 30, 1990. The possibility of future non-performance by Arkla did not negate the income nature of the payment, as the court noted that potential repayment does not convert income into a deposit or bailment.

Practical Implications

This decision clarifies that settlement payments under take-or-pay contracts are taxable as income if structured as prepayments for future deliveries rather than loans. Attorneys should carefully draft such agreements to specify whether payments are for past or future performance. Businesses involved in similar contracts must account for potential tax liabilities on settlement payments. The ruling may impact how companies structure settlements to achieve desired tax treatment. Subsequent cases, such as Oak Industries, Inc. v. Commissioner, have reinforced this principle, emphasizing the importance of control over repayment conditions in determining the tax treatment of payments.

