IN THE MAGISTRATE DIVISION

OF THE OREGON TAX COURT

Income Tax

KENT E. AND SUSAN M. COUCH, Plaintiffs, v. DEPARTMENT OF REVENUE, STATE OF OREGON, Defendant.	)	No. 000146D **DECISION**

Plaintiffs appeal defendant's Notice of Deficiency, dated December 7, 1999, assessing plaintiffs additional income tax. A telephone trial was held on May 25, 2000. Messrs. Kent Couch, Rick Nissen (Certified Public Accountant), and Matt Zachery (Vice-President, Pioneer Energy Corporation) testified on behalf of plaintiffs. Ms. Glenda Wesley appeared on behalf of defendant.

At the conclusion of the trial, Mr. Couch suggested that he might be able to obtain additional information from Shell to support his position that Shell gave him the money to aid him in purchasing the business. With no objections from defendant, the court agreed to continue the trial on June 29, 2000.

On June 16, 2000, plaintiff submitted a letter dated June 5, 2000, from Equilon Enterprises LLC which described the Shell Oil/Pioneer Energy Rebranding Program. On June 19, 2000, the court received a copy of various checks issued to First American Title, the escrow agent for the transaction, and two vendors involved with the change in signage at the business.

On June 29, 2000, the trial was continued. Messrs. Kent Couch and Rick

Nissen appeared on behalf of plaintiff. Ms. Glenda Wesley, Auditor, appeared on behalf of defendant.

STATEMENT OF FACTS

In September 1997, plaintiff, Mr. Kent Couch, as the principal owner of Couch Investments LLC, entered into an agreement to purchase a business in Bend, Oregon. The business consisted of a gasoline station (station) with a convenience store commonly referred to as a mini-mart store. The purchase price of $750,000 was far more than Mr. Couch could manage by himself. Mr. Couch testified that in order to make the $300,000 down payment he secured a second mortgage on his home, cashed in his 401(k) pension plan and borrowed money from a neighbor. Still, Mr. Couch was short of the total down payment.

Mr. Couch contacted Mr. Matt Zachery who was employed by Lou Dobbins, Inc. dba Pioneer Energy Co. Pioneer Energy Co. is a fuel jobber who acts as a middle man for national companies such as Shell, Chevron and Tesoro. Mr. Zachery testified that he assisted Mr. Couch with his search for a business site. Mr. Zachery knew that Shell was seeking new commercial locations in Oregon because it was returning to the state. In addition, Shell was interested in securing a business presence in central Oregon. The station located on the site Mr. Couch was trying to purchase carried a BP brand. Mr. Zachery thought that Shell might pay Mr. Couch incentive money to rebrand the station.

Mr. Zachery testified that he presented the business opportunity to Shell. While a typical rebrand incentive payment (rebrand payment) is around $40,000 which is based on one cent per gallon for a three or four year period, Mr. Zachery negotiated three cents per gallon for three years based on inflated volumes. Mr. Zachery testified that Shell knew the volumes were inflated but agreed to the payment. Shell wanted to locate in

central Oregon and it was impressed with Mr. Couch's prior retail management experience. Mr. Zachery emphasized the fact that Shell's rebrand payment to Mr. Couch was three to five times more than the average rebrand payment. Mr. R. S. Valette, Areas Manager for Equilon Enterprises LLC (Shell and Texaco Working Together), on June 5, 2000, wrote that "Shell Oil wanted the station location involved in this transaction. The station was not only in a high-volume location, it was a new facility that only needed minor changes to signs and imaging." He further went on to write that "Shell Oil advanced sufficient funds toward the down payment/purchase of this location in exchange for a 10-year supply agreement." He explained that the funds from Shell transferred through its intermediary Pioneer Energy Co. were sent to the title company and were "not for Mr. Couch to use for any other purpose other than to 'close' this transaction." *Id.*

Mr. Couch testified that he entered into a Shell Jobber Acquisition Incentive Program Letter Agreement with Pioneer Energy Co. and Shell Oil Company to rebrand the gas station to a Shell branded station in exchange for financial assistance. He emphasized the fact that without Shell's money he would not have had the opportunity to buy the station in Bend. The Shell rebrand payment was almost two-thirds of the $300,000 down payment made by Mr. Couch. Mr. Couch emphasized that the copies of canceled checks submitted to the court show that Pioneer Energy paid $165,000 to First American Title Company, escrow agent, on August 15, 1997. In addition, Pioneer Energy Co. paid another $28,000 to two vendors in September 1997 to change the signs at the station from BP to Shell.

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The terms of the "Lump Sum Incentive Payment–Signs" was as follows:

"* * *Pioneer Energy Co. agrees to pay to Buyer and Buyer shall

> earn an acquisition incentive payment equivalent to the rate of **three (3)** cents for each gallon of products delivered to the Station for a period of thirty-six months from the Commencement Date (Incentive Payment). Based upon Buyer's projection that the volume of Products delivered to the Station will be **210,000** gallons per month ('Projected Volume'), Pioneer Energy Co. agrees to advance the sum of **$192,780.00** ('Advance') to be delivered to Buyer within thirty (30) days of Pioneer Energy Co.'s receipt of the Note executed by Buyer. * * * Buyer hereby waives any claim against Pioneer Energy Co. and/or Shell in the event the actual volume of Products delivered to the Station during the foregoing thirty-six (36) month (sic) exceeds the Projected Volume. However, if at the conclusion of the foregoing thirty-six (36) month period or upon the occurrence of a Termination Event, as defined in paragraph 7 the Projected Volume exceeds the actual volume of Products delivered to the Station, Buyer agrees to reimburse Pioneer Energy Co based upon the following formula:
>
> "(X-Y)($0.03/gallon)
> where X = Projected Volume; and
> Y = actual volume of Products delivered
> to Station for a period of 36 months from the Commencement Date.
>
> "(b) In addition to the foregoing, Pioneer Energy Co. shall pay to Buyer, in one installment, 50% of the delivered cost of qualifying signs that have been approved for Buyer's use at the Station by Shell's representative prior to order placement, pursuant to Shell's current sign and paint policy."[1]
> (Ptfs' Ex C - 1, 2) (emphasis in original).

Mr. Couch and Mr. Zachery testified that the volume of gas over the last months have been less than the projections. Shell has not requested reimbursement from Mr. Couch and Mr. Zachery is unaware of Shell checking or auditing the station volume. Shell did inspect the station in October 1997 to ensure that it conformed to the corporate image referred to as Silverado standards.

The agreement contained the following provision for the rebrand payment reimbursement, paragraph 7:

> "Nothing herein to the contrary, if for any reason during the 10 year period commencing on the Commencement Date, (a) the station is closed or is not operated as a Shell branded facility, other than because of a

[1] The payment for costs associated with changing the canopy colors (from BP green to Shell yellow) and signage is not in dispute.

> condemnation of the station; or (b) this Agreement is terminated or not renewed for any lawful reason (collectively, "Termination Event"), Buyer shall reimburse Pioneer Energy Co. to the full Incentive Payment of **$192,780.00.*** * * The reimbursement obligation under this paragraph 6 is understood and acknowledged by the parties to be a reimbursement of the anticipated benefits to Pioneer Energy Co. to be derived from the Station that will be unrealized due to the Termination Event, and shall not be deemed to be or construed as a penalty* * *." *Id.* (Emphasis in original.)

A special condition of the agreement read: "The lump sum discounted 3 cents for 3 years amounting to **$192,780.00** will have a 10 year non-amortizing payback schedule that does not amortize annually, but in fact will amortized fully only at the end of the 120th month and not before. For example, if the Dealer debrands from Shell on the 8th year, the Dealer will owe the entire **$192,780.00**." (Ptfs' Ex C -8.)

Mr. Nissen testified that he has been a certified public accountant for 20 years. When he prepared Mr. Couch's income tax return, Mr. Nissen testified that he determined that there were substantial limitations and restrictions on the funds received from Pioneer Energy Co. and Shell. The funds were to be used by Mr. Couch to purchase the station, rebrand it to Shell, and subject to repayment if at any time during the 10 year agreement Mr. Couch changed brands. Mr. Nissen testified that he treated the funds similar to a grant and reduced the basis of the assets purchased by Mr. Couch. He testified that a grant is not income but it does reduce the recipient's basis in his assets. In the alternative, Mr. Nissen offered that the rebrand payment could be recognized as income over ten years with the assets increased by the amount of the rebrand payment and a depreciation deduction allowed based on a 15 year asset life. Mr. Nissen concluded that the payment could not be a loan because there was no regular payment terms or interest rate and repayment was not required unless Mr. Couch debranded from Shell. Mr. Nissen stated that in actuality the recipient of the rebrand payment was the

person who sold the business to Mr. Couch. In accordance with the Internal Revenue Code (IRC) standard of a "true reflection of income", Mr. Nissen concluded that it is incorrect to record the rebrand payment as income to Mr. Couch. The rebrand payment should be treated similar to other sources of financing received by Mr. Couch.

Ms. Wesley testified that based on the Internal Revenue Service Publication 3106 (5-98) generally payments received under "Image Upgrade Programs" are reported "fully in gross income in the taxable year received." (Def's Ex G-2.) In addition, Ms. Wesley concluded that the rebrand payment was prepaid income and Mr. Couch had unrestricted use of the money received. Under the claim of right doctrine, payments which give the recipient unrestricted use of the funds are taxable in the year of receipt because the cash is available for any use. Ms. Wesley concluded it is incorrect to assume that Pioneer Energy Co. and Shell gave Mr. Couch the money for the purpose of assisting him in financing his purchase of the business. She testified that Mr. Couch could have already owned the business and Shell would still have given him the rebrand payment because Shell wanted to enter the central Oregon market. Ms. Wesley relied on IRS Revenue Procedure (Rev Proc) 71-21 and Tax Court Memorandum 1994-239, *JFM, Inc. and Subsidiaries v. Commissioner* to support her treatment of the rebrand payment as income. (Def's Ex H -1 --4; K - 13 --17.) Mr. Nissen reminded the court that the Revenue Procedure also suggests that an advance payment may be reported as income "by the use of any other basis that in the opinion of the Commissioner, results in a clear reflection of income." *Id* at H-2.

The parties are in agreement that Ms. Wesley incorrectly treated the rebrand payment as self-employment income. Plaintiff is not entitled to increase its self-employment tax deduction by $10,607.

In closing, Mr. Nissen testified that the substantial understatement penalty should not apply to "this situation."

COURT'S ANALYSIS

The issue before the court is whether all or a portion of the Shell advance incentive payment received by plaintiffs in 1997 is gross income in the year received.

Section 61 of the Internal Revenue Code provides that gross income means all income from whatever source derived. Ordinarily, a taxpayer utilizing the cash-basis method of accounting is taxable in each tax year on all of the income received in that year under a claim of right and without restriction as to its use.[2] The leading case on the claim of right tax doctrine which plaintiffs allege controls the outcome of this case is *North American Oil Consolidated v. Burnet*, 286 US 417 (1932). *North American Oil* involved a dispute over the year in which income, earned on property held by a receiver during a title dispute between the taxpayer and the government, was to be taxed. The parties argued that there were three different years in which the income could be reported: 1916, the year in which the income was earned; 1917, the year in which the district court ruled in favor of the taxpayer and the money was paid to the taxpayer; or 1922, the year the litigation was finally terminated in the taxpayer's favor. The Supreme Court determined that 1917 was the year that the income must be reported and set forth the claim of right doctrine as follows:

> "If a taxpayer receives <u>earnings</u> under a claim of right <u>and</u> <u>without restriction as to its disposition,</u> he has received income which he is required to return, even though it may be still be claimed that he is not entitled to retain the money, and even though he may still be adjudged

[2] At the time plaintiffs received the funds at issue they were cash-basis taxpayers. After they purchased the gas service station, plaintiffs adopted the accrual method of accounting for the business.

liable to restore its equivalent." *Id.* at 424. (Emphasis added.)

The claim of right doctrine is based on the premise that if the taxpayer has free use of the funds without restriction from the time of receipt, the taxable year in which that receipt occurs is the year to fix tax liability.

Before fixing the year of tax liability, the court's analysis begins with the characterization of the funds received by plaintiffs. In this case, plaintiffs received financial assistance from Shell in the form of acquisition incentive payments (payments). *(See* Shell Jobber Acquisition Incentive Program Letter Agreement, Def's Ex C-1.) Were these payments income to plaintiffs?

Shell through its jobber, Pioneer Energy Co., made payments to plaintiffs for its right to enter the central Oregon gasoline market. Plaintiffs agreed to permit Shell to be the preferred and designated brand of gasoline sold at plaintiffs' station. Shell believed that location was the key to its successful entrance into the central Oregon market. Plaintiffs financially benefitted from Shell's eagerness to gain a commercial presence in central Oregon.

Plaintiffs performed no personal services for Shell. The court does not agree with defendant's allegations that the Shell payment was received by Mr. Couch "pursuant to an agreement for the performance by him of services." (Def's Ex H-2.) As previously stated, the agreement between the parties was not a personal services contract. (Ptfs' letter to the court dated May 11, 2000.) Plaintiffs had no obligation to Shell other than to brand their station "Shell" for the next 10 years. Such an obligation was not dependant upon plaintiffs' performance of services.

The payments were income to plaintiffs for the following reasons. A taxpayer, who uses the cash method of accounting as did plaintiffs in this case, must report

income when it is actually or constructively received. IRC §451(a) and accompanying regulations. Income is constructively received by a taxpayer when it is "credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time." IRC §1.451-2(a). (Emphasis added.) Where the taxpayer's control of the receipt of income is subject to substantial limitations or restrictions, the income is not constructively received by the taxpayer. *Id.*

The important fact in this case is that plaintiffs received the payments in exchange for their agreement to brand the station. This was not a limitation or restriction; it was the essence of the agreement between the parties. It is true that the payments were credited to plaintiffs' account held by the escrow agent and vendors and set aside for plaintiffs. The application of the payments is important. The property acquired with these payments was placed in the name of the plaintiffs, free and clear with no ownership rights vested in Shell. Plaintiffs constructively received these payments when the payments were applied to secure plaintiffs' ownership interest in the station and its improvements.

Plaintiffs argue that a string was attached to the receipt of the payments. The string was the potential for future repayment of the entire amount. "The funds were to be used for the purchase of the station, to be operated as a Shell station, and required to be re-paid if, at any time during the 10 years after the agreement, the station changed brands." (Ptfs' letter to the court dated May 11, 2000.) Plaintiffs argue that under the claim of right doctrine the income should not be taxed in the year of receipt but amortized over a 10 year period or not taxed at all.

Plaintiffs' liability to fully refund the payments in the event plaintiffs debranded the station any time within 10 years from the date of the agreement imposed no substantial restriction on their *immediate* use of the funds. In 1997, under the terms of the agreement,

plaintiffs applied the funds to the purchase of their station and its improvements without restriction or limitation. If plaintiffs failed to fulfill their 10 year obligation with Shell, they lost the entire amount of the payment. An allowable tax deduction based on the return of the full amount of the payment to Shell could be claimed in that tax year.

The court regrets the fact that plaintiffs did not understand the income tax consequences of permitting Shell to be their benefactor rather than their lender. The payments were not loans because there were no set terms of repayment with a fixed rate of interest. The agreement was simple: plaintiffs received payments in exchange for branding their station "Shell" for 10 years from the date of the agreement. After constructive receipt of the payments in the amount of $192,780, plaintiffs owned assets solely in their name of a comparable or greater value. Plaintiffs must recognize income to the full amount of the payments received in the year of actual and constructive receipt, which was 1997.

In response to Mr. Nissen's claim that the underpayment penalty does not apply in this situation, the court has no authority to waive lawfully assessed penalties. Plaintiffs can seek an administrative review from the Director of the Oregon Department of Revenue by writing a letter to her and asking her to exercise the discretionary authority delegated to the agency by the legislature.

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CONCLUSION

IT IS THE DECISION OF THE COURT that the advance incentive payment in the amount of $192,780 received by plaintiffs from Shell through its jobber Pioneer Energy Co. in 1997 was taxable income.

FURTHER, IT IS THE DECISION OF THE COURT that the advance

incentive payment is not self-employment income.

FURTHER, IT IS THE DECISION OF THE COURT that plaintiffs’ request that the underpayment penalty be waived is denied.

Dated this _____ day of August, 2000.

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JILL A. TANNER
MAGISTRATE

IF YOU WANT TO APPEAL THIS DECISION, FILE A COMPLAINT IN THE REGULAR DIVISION OF THE OREGON TAX COURT, FOURTH FLOOR, 1241 STATE ST., SALEM, OR 97310. YOUR COMPLAINT MUST BE SUBMITTED WITHIN 60 DAYS AFTER THE DATE OF THE DECISION OR THIS DECISION BECOMES FINAL AND CANNOT BE CHANGED.

THIS DOCUMENT WAS SIGNED BY MAGISTRATE JILL A. TANNER ON AUGUST 14, 2000. THE COURT FILED THIS DOCUMENT ON AUGUST 14, 2000.