

OFFICIAL TRANSCRIPT  
PROCEEDINGS BEFORE

THE SUPREME COURT  
OF THE  
UNITED STATES

ORIGINAL

**CAPTION:** COMMISSIONER OF INTERNAL REVENUE, Petitioner V.  
INDIANAPOLIS POWER & LIGHT COMPANY

**CASE NO:** 88-1319

**PLACE:** WASHINGTON, D.C.

**DATE:** October 31, 1989

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202 289-2260

1                   IN THE SUPREME COURT OF THE UNITED STATES

2 -----X  
3 COMMISSIONER OF INTERNAL REVENUE,       :  
4                                   Petitioner       :  
5                   v.                               :  
6 INDIANAPOLIS POWER & LIGHT               :  
7 COMPANY                                       :  
8 -----X

9   Washington, D.C.

10    Tuesday, October 31, 1989

11                   The above-entitled matter came on for oral argument  
12 before the Supreme Court of the United States at 10:58 a.m.

13 APPEARANCES:

14 LAWRENCE G. WALLACE, ESQ., Deputy Solicitor General,  
15 Department of Justice, Washington, D.C.; on behalf of the  
16 Petitioner.

17 LARRY J. STROBLE, ESQ., Indianapolis, Indiana; on behalf of  
18 the Respondent.

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On behalf of the Petitioner	34



1 MR. WALLACE: Well, I concede that that is an accepted  
2 accounting practice which the company is following, insofar as  
3 I am aware that is the practice approved by the public service  
4 commission. Whether or not it requires that, I am not aware.  
5 But I certainly concede that that is an accepted accounting  
6 practice that is followed by the company in its financial  
7 accounting.

8 QUESTION: Then, it seems strange then that the  
9 government would take the position that it does here on the  
10 taxability of these deposits. What if the deposits were  
11 escrowed? Would you be taking the same position?

12 MR. WALLACE: No, we would not. The position depends  
13 on the fact that the monies come into the dominion and control  
14 of the utility company, and are not segregated from the other  
15 assets of the company, and are subject to its unfettered use.

16 QUESTION: Why does it depend upon that, Mr. Wallace?  
17 I thought you were arguing, in one part of your brief at  
18 least, economic reality. And I don't think whether it is  
19 escrowed or not has very much different -- very much to do at  
20 all with the economic reality of the matter.

21 MR. WALLACE: Well, under our tax system, and in  
22 particular for an accrual basis taxpayer, it has to have a  
23 right to the use of the monies within its own dominion and  
24 control. The cases do establish that as a criterion for  
25 taxability.

1           QUESTION: I suggest that in establishing that, they  
2 are not looking to economic reality, which is what you argue  
3 we ought to look to for the rest of the case, and not to  
4 intent or to such -- such other matters.

5           MR. WALLACE: Well, that is a form of economic reality,  
6 Justice Scalia, in that that means that the company can use  
7 the monies as its own, as it sees fit, to produce whatever  
8 earnings it can produce --

9           QUESTION: But you are taxing those earnings -- you  
10 began your presentation by saying that is not at issue --

11          MR. WALLACE: That is correct.

12          QUESTION: -- whether -- what happens to the earnings  
13 from them. All that is at issue is whether when you get it it  
14 is income. And it seems to me it makes no difference, when  
15 you are dealing with a massive public utility that has many  
16 assets, whether it goes into its own general pot or is put in  
17 escrow. In either case, it seems to me, the company gets  
18 assured the payment of the bill that is going to be later  
19 presented. The economic reality between those two situations  
20 does not seem to me distinguishable.

21          MR. WALLACE: Perhaps there would be a basis for making  
22 such an argument, but that is not the position the  
23 Commissioner has taken. The Commissioner's position is based  
24 on the receipt of funds within the dominion and control of the  
25 utility company. The parties --

1 QUESTION: Mr. Wallace, you mentioned this was a  
2 reviewed decision. Unanimous in the tax courts?

3 MR. WALLACE: It was unanimous. It was reviewed  
4 because the previous decision of the tax court in the City Gas  
5 case had been reversed unanimously by the court of appeals for  
6 the Eleventh Circuit. So, all three lower court decisions  
7 that have addressed this have been unanimous, and somebody had  
8 to have been wrong.

9 QUESTION: Do you have any explanation why it has taken  
10 so long to get this case here? One of the tax years here is  
11 15 years ago, 1974.

12 MR. WALLACE: Well, these things do tend to get sorted  
13 out many years after the taxable years at issue. The  
14 litigation, once it was under way, after the audit was made,  
15 moved forward. The parties stipulated both the facts and the  
16 calculation of the tax consequences that would ensue for the  
17 years at issue should be Commissioner's position prevail. So,  
18 --

19 QUESTION: Well, it gets so that the interest sometimes  
20 exceeds the basic tax, and this certainly isn't justice,  
21 normally.

22 MR. WALLACE: Well, in any event the issue is now  
23 before this Court for resolution. And under the  
24 Commissioner's legal view, there are only two factual  
25 determinations in these stipulated facts recited by the tax

1 court that are critical here, and indeed are dispositive under  
2 his legal view. And in light of those two determinations, the  
3 remaining details of the way this program was administered  
4 become immaterial.

5 One is the one to which we have already adverted, that,  
6 and this is set forth on page 23a of our Appendix to the  
7 Petition in the tax court's opinion, that the deposits were  
8 not segregated from the Petitioner's general funds, the  
9 utility's general funds, and were subject to its unfettered  
10 use and control. And the other critical determination, set  
11 forth on page 20a of the same Appendix, is that the intended  
12 purpose of the deposits was to ensure payment of future  
13 utility bills by the customers required to make the deposits.

14 The Commissioner's position originated in a 1972  
15 revenue ruling which we cite that considered the implications  
16 for utility deposits of a series of three decisions rendered  
17 by this Court and of related lower court decisions. Those  
18 decisions, and this Court's previous decisions in the area,  
19 are unchallenged by the Respondent here, and of course  
20 unchallenged in the courts below.

21 Those decisions established that advanced payments for  
22 goods and services to be provided in the future, that an  
23 advance payment is taxable income in the year of receipt. And  
24 the difficult question which was decided in this series of  
25 cases is the one suggested by Justice O'Connor's question at



1 the outset, whether that should be true for accrual basis  
2 taxpayers, whether to that extent the Commissioner had  
3 authority to set aside the accrual basis taxpayers' accounting  
4 method and insist on conformity in this respect for the  
5 advance payments received on an annual accounting method. And  
6 that was the decision made in various factual situations in  
7 the Auto Club of Michigan case, the American Automobile  
8 Association case, and finally in Schlude against the  
9 Commissioner.

10 And, as the court put it in the American Automobile  
11 Association case, the deferral of the advance payment for  
12 accounting purposes, and I am quoting now, doubtless presents  
13 a rather accurate image of the total financial structure is  
14 sound for financial accounting purposes, but fails to respect  
15 the criteria of annual tax accounting, and may be rejected by  
16 the Commissioner. And in those decisions the court relied on  
17 Section 446(b) of the current code and its predecessor,  
18 Section 41 of the 1931 code, which gives the Commissioner  
19 authority when he determines that the taxpayer's accounting  
20 method does not accurately reflect income to require, in his  
21 discretion, that the taxpayer use a method that does  
22 accurately reflect income.

23 QUESTION: And your position is that the deposits here  
24 should be treated as advance payments, I take it?

25 MR. WALLACE: That is precisely our position.

1           QUESTION: But the problem I have with that, or maybe  
2 it isn't a problem -- you tell me if I am wrong. If you have  
3 a 12-month cycle and you get an advance payment for the 12  
4 months, then the utility, over the period of 12 months,  
5 recognizes 12 months of income, right? It doesn't recognize  
6 income in December, it recognizes two months of income in  
7 January.

8           MR. WALLACE: That -- that is correct.

9           QUESTION: All right. But under your view, under the  
10 security deposit, you would recognize 13 months of income,  
11 because you have to accrue each month.

12          MR. WALLACE: Well, there is --

13          QUESTION: And so it seems to me that the government is  
14 getting more under the security deposit theory than it would  
15 under the advance payment theory. So you have bettered  
16 yourself. Or is that wrong?

17          MR. WALLACE: It operates precisely the way an advance  
18 payment operates.

19          QUESTION: But an advance payment is attributable to a  
20 month. And so for the month that it applies, you don't accrue  
21 it.

22          MR. WALLACE: Well, that is correct. And the advance -  
23 -

24          QUESTION: So you are getting an extra month.

25          MR. WALLACE: Well, but the security deposit, when it

1 would be applied against a month in which the customer  
2 defaults in his obligation, or when it is refunded, the  
3 taxpayer would get the same credit for it. It would operate  
4 precisely the same --

5 QUESTION: Well, at the very end of the cycle -- at the  
6 very end of the cycle it works out, although, of course, at  
7 that point the utility now has a new customer and it starts  
8 all over again.

9 MR. WALLACE: Well, that might not be the very end of  
10 the cycle. The customer may default in January and the  
11 security deposit may be applied to pay that bill at that time,  
12 and the utility would get the credit for it. Just as if it  
13 took an advance payment that was designated for the December  
14 bill, it would have to wait until the very end of the cycle.  
15 I mean, that doesn't really differentiate the economic effect  
16 of treating the security deposit the same as an advance  
17 payment when it's intended for the same purpose. And that is  
18 to assure payment of the income that the utility is concerned  
19 about in getting either the advance payment or the security  
20 deposit. The security deposit amounts to a label on it,  
21 whereas here it is intended to secure the future payment of  
22 bills for goods or services to be provided. But it is not  
23 meaningfully different from the advance payment that is  
24 collected on that same understanding.

25 QUESTION: Mr. Wallace, what would you do with a

1 security deposit that secures both the covenants in a normal  
2 security deposit and also could be applied to the last month's  
3 rent, if unpaid -- or services?

4 MR. WALLACE: Well, that is the difficult factual  
5 question that sometimes has to be determined in these cases,  
6 as the court of appeals for the Eleventh Circuit in the City  
7 Gas Company recognized --

8 QUESTION: And what test would you propose be applied  
9 to one of these mixed applicability cases?

10 MR. WALLACE: We agree completely with the court of  
11 appeals for the Eleventh Circuit in the City Gas Company,  
12 which agreed with the Commissioner's position in that case,  
13 that the primary purpose of the particular deposit is  
14 determinative. Here, there's really no doubt about the  
15 purpose of the security deposit. It not only was a finding by  
16 the tax court, but under the rules of the Public Service  
17 Commission, it can be required only of customer after an  
18 objective inquiry into their credit worthiness, and only of  
19 the 5 percent, as it turns out, of customers with respect to  
20 whom the utility may be -- have a basis for concern about  
21 payment of the future bills. If it were a deposit to secure  
22 the property of the utility company it would be presumably  
23 required of all customers. But those who are required to pay  
24 it are those who are determined to be credit risks.

25 QUESTION: Mr. Wallace, could you -- I don't understand

1 how you reconciled the Commissioner's Revenue Ruling 79-229  
2 with what you are urging upon us here. That's discussed by  
3 the Respondent at pages 35 and 36 of his brief. And what it  
4 sets for, essentially, is that the Commissioner has decided  
5 that when a livestock producer receives a payment, whether  
6 that payment will be considered to be income, and on the other  
7 side a deduction, or rather just a deductible --whether it be  
8 considered income for the prepayment of food for the cattle,  
9 or on the other hand a deposit, will be determined on the  
10 basis of the totality of the circumstances, not on the  
11 automatic sort of a rule that you are urging here. How do you  
12 reconcile that with this case?

13 MR. WALLACE: Well, there are, as a matter of fact,  
14 many exceptions that have been developed in revenue rulings  
15 and in a revenue procedure that the Commission has adopted and  
16 in statutes that Congress has enacted, that allow deferral --

17 QUESTION: Statutes -- Congress is allowed to be  
18 inconsistent. I just want to talk about the Commissioner  
19 here.

20 MR. WALLACE: -- that allow deferral of payments under  
21 which, you know, the possible full sweep of the holdings of  
22 this Court in the trilogy of cases I have mentioned has been  
23 receded from. And this can be done permissibly through  
24 administrative practice or by Congress, and some of the  
25 administrative concessions have perhaps been made with a view

1 toward preserving those victories to the extent they have been  
2 preserved.

3 QUESTION: If I understand you, you are acknowledging  
4 it is inconsistent.

5 MR. WALLACE: Well, there may be an inconsistency in  
6 the -- in the sense that the Commissioner found that in that  
7 factual context it was necessary to make a different type of  
8 factual inquiry, and there would be different material  
9 questions. There is, in our view, no inconsistency and no  
10 necessary symmetry between the way the Commissioner treats the  
11 recipient of the deposit and the way the tax laws treat the  
12 customer. And I think that can be an unnecessary distraction.

13 If I may, for example, in an ordinary sales  
14 transaction, if a business purchases an airplane or a boat or  
15 a truck for use in its business, it may pay cash and the  
16 vendor may have to treat that as income when received. But  
17 the purchaser may well be required to amortize the payment  
18 over a period of the useful life of the item that was  
19 purchased. And that is true whether the vendor was an  
20 American company subject to federal income tax or whether a  
21 similar boat was purchased from a foreign company not subject  
22 to federal tax at all.

23 QUESTION: But you wouldn't treat -- you wouldn't treat  
24 the purchaser differently if it were a utility company as  
25 opposed to a livestock dealer. You would apply the same

1 standards to them, wouldn't you?

2 MR. WALLACE: That is correct, and -- but, what is  
3 required in each case is to determine what the purpose of the  
4 particular receipt is. And here, when there is no doubt that  
5 the purpose was to secure in advance, to ensure the payment  
6 for goods and services to be delivered in the future, that is  
7 a basis for determining, whether it is a utility or a  
8 livestock producer; there is just a different context in which  
9 to make a factual inquiry. That is the basis for determining  
10 that that is to be treated no differently from any other form  
11 of advance payment for future goods or services, when that is  
12 the reason that the money is received, and when the money is  
13 subject to the dominion and the control of the utility upon  
14 receipt.

15 QUESTION: Mr. Wallace, the Seventh Circuit, as I  
16 understand it, took the position that you have to look at the  
17 facts and circumstances of each case, and they upheld the  
18 determination of the tax court. Now, your complaint with that  
19 is that they should have followed a flat rule of some sort?

20 MR. WALLACE: Well, the facts and circumstances that  
21 they looked at, and that the tax court looked at, seem  
22 immaterial to us, and therefor will give rise, if each court  
23 is to look at them in each case, to erratic results that don't  
24 reflect the economic reality of the situation.

25 QUESTION: Well, do you -- does your rule give one

1 uniform result for all deposits required by utility companies  
2 from customers?

3 MR. WALLACE: It -- it does once a determination is  
4 made that the deposit is primarily for the purpose of assuring  
5 payment for goods or services to be delivered in the future,  
6 and that the deposit is not required to be escrowed or  
7 otherwise segregated and kept from the dominion of the utility  
8 company. The Seventh Circuit emphasized in its analysis that  
9 interest was to be paid on the funds here, which seems to us  
10 not to distinguish the case from an ordinary advance payment  
11 in which there often is a discount given to the customer for  
12 making the payment in advance. Interest simply recognizes the  
13 time value of money, and --

14 QUESTION: Well, is there some one factor -- factor in  
15 your analysis that is controlling, so that you could say it  
16 wasn't a facts and circumstances test, or is it just you think  
17 there should have been different facts and circumstances  
18 considered, or perhaps a different result reached on the same  
19 facts and circumstances?

20 MR. WALLACE: Well, any -- any criterion that we look  
21 to can be considered to be facts and circumstances. I have  
22 tried to explain why we think the criteria that we have  
23 mentioned are controlling and make the situation  
24 indistinguishable from an advance payment, in terms of either  
25 its economic effect or its intended purpose. The facts and



1 circumstances that are recited by the tax court and the court  
2 of appeals seem to us to be demonstrably immaterial in this  
3 case. On many of the deposits interest won't even be paid by  
4 the utility. It is required to pay interest under the amended  
5 regulations only if it has held the deposit for 12 months.  
6 And if the customer has terminated service before that time,  
7 or if the customer has paid its bills on time for nine months,  
8 it is required under the Public Service Commissions rules to  
9 refund the deposit before the 12 months has elapsed.

10 QUESTION: Suppose -- suppose, Mr. Wallace, that I  
11 establish a scheme, I am a marketer of furniture, or whatever,  
12 and I establish a scheme where I let people make advance  
13 payments. But those advance payments, just to guarantee them  
14 that they will get them back if I don't come across with the  
15 goods later on when they are due, those advance payments are  
16 put into escrow. Would I have to report as income those  
17 advance payments?

18 MR. WALLACE: I believe not, Mr. Justice. I believe  
19 not.

20 I would like, if I may, to reserve the balance of my  
21 time.

22 QUESTION: Please proceed, Mr. Stroble.

23 ORAL ARGUMENT OF LARRY J. STROBLE

24 ON BEHALF OF THE RESPONDENT

25 MR. STROBLE: Thank you, Mr. Chief Justice, and may it

1 please the Court:

2 Since at least 1921 the Indianapolis Power & Light  
3 Company has collected customer security deposits as a security  
4 against potential bad debt losses, and it has collected them  
5 from certain of its customers. These deposits have always  
6 been treated as current liabilities to customers for both  
7 financial regulatory purposes as well as for tax purposes.

8 QUESTION: Why were they not segregated?

9 MR. STROBLE: The rules for collection, refunding and  
10 payment of interest on these deposits is prescribed by the  
11 state Public Service Commission. The Commission sets the  
12 guidelines for whether they -- how they are collected and how  
13 they are to be treated after they are collected. And the  
14 state rule essentially imposes no limitation on the liability  
15 -- on the utility's use of the funds.

16 QUESTION: You mean if they were segregated some state  
17 rule would be violated?

18 MR. STROBLE: No, they could have been segregated, but  
19 there was simply no reason to segregate them.

20 QUESTION: Then my question is why weren't they  
21 segregated to avoid all this litigation?

22 MR. STROBLE: If -- perhaps they would have been had  
23 that been an announced position in 1921, that they would be  
24 taxed if they were not segregated. It is conceivable that the  
25 parties might have undertaken to set up such an arrangement.

1 QUESTION: Well, does the company now escrow the funds?

2 MR. STROBLE: To my knowledge the company is continuing  
3 to follow the practice it always has and continues to follow  
4 exactly what the state Public Service Commission's regulations  
5 prescribe.

6 QUESTION: I guess I am not following this. Is it the  
7 -- do you understand it to be the government's position that  
8 if these funds had been segregated, although not escrowed, the  
9 tax would not have been payable? I mean, if that is their  
10 position, you ought to advise your client that way. That  
11 seems to me that is a pretty easy way to handle the problem.

12 MR. STROBLE: Well, that does seem --

13 QUESTION: But I didn't understand that to be the  
14 government's position, that all you had to do was segregate  
15 it.

16 MR. STROBLE: Well, that seems to be what they have  
17 said in their brief.

18 QUESTION: Not escrowed, just segregated.

19 MR. STROBLE: We have never seen why segregation of  
20 these funds should be an important distinction. Our position  
21 has been that these funds -- these security deposits have many  
22 of the same ear marks as a loan, as a borrowing of money,  
23 because the security deposits are offset by an obligation to  
24 refund upon conditions which essentially lie within the  
25 control of the customer from whom they are collected. It is a

1 clear principle that the collection or the receipt of borrowed  
2 money is not taxable income. And that is true even if the  
3 funds are not segregated or escrowed. And there is a very  
4 clear reason why that is so.

5 Under our federal income tax system, as this Court has  
6 recognized in past cases, there must be an increase in wealth,  
7 an accession to wealth, before income is properly reportable.  
8 That is just a fundamental and a common sense proposition of -

9 -

10 QUESTION: But if these sums were segregated, I take it  
11 it would be a indication that these funds were not available  
12 for just any use that the company wanted to make with -- of  
13 them.

14 MR. STROBLE: It would --

15 QUESTION: Whereas the loan proceeds, you borrow money  
16 to use for the general corporate purposes, I suppose.

17 MR. STROBLE: Well, as in the case of a loan, the  
18 company does have to stand ready at any time to make a refund  
19 to a customer whenever the conditions that have been  
20 established are met. The deposits are collected under the  
21 obligation that at such time as the customer shows that he is  
22 credit worthy, the funds have to be returned to the customer.

23 QUESTION: Yeah, but if the -- if the company goes  
24 broke it may not have the money to refund these. If the funds  
25 were segregated in a separate fund you wouldn't be using them

1 for other purposes.

2 MR. STROBLE: It's -- the Indiana Public Service  
3 Commission could have prescribed such a rule. I think the --

4 QUESTION: Well, the company could have followed such a  
5 policy, too, so it's a peculiar argument.

6 MR. STROBLE: The company could have accepted the funds  
7 and set them into a separate bank account.

8 QUESTION: What sort of a test do you think should  
9 govern the taxability of these monies?

10 MR. STROBLE: We think that the test that should govern  
11 is essentially the tests that the tax court and Seventh  
12 Circuit applied: are the amounts in question --

13 QUESTION: So you think it makes a difference whether  
14 interest is paid on it or not?

15 MR. STROBLE: We think that the payment of interest is  
16 one factor that should be considered. That the job of the  
17 courts, the lower courts and the tax court, is to determine  
18 whether the payment in issue has been received as a security  
19 deposit, so that it is securing the performance of a customer,  
20 and it is returnable to that customer at such time as the  
21 deposit has served its purpose. Or whether, alternatively,  
22 the amount is an advance payment for goods and services, so  
23 that it has been received to buy future utility services.

24 QUESTION: Well, an advance payment has to be returned  
25 if the service isn't rendered.

1 MR. STROBLE: Justice Kennedy, that is exactly correct,  
2 but the situation in which it has to be returned is exactly  
3 the opposite of what we have here. In the case of an advance  
4 payment, if the seller who has received the payments performs  
5 his obligations under the contract, namely delivering the  
6 goods, he gets to keep the payments he has received. And it  
7 is on that basis that there is clear there has been an  
8 increase in wealth that justifies taxation.

9 In the case of a security deposit, if it is the  
10 customer that performs the secured obligations, then the  
11 amounts have to be returned to the customer. So it is --

12 QUESTION: But, the reality of the utility business is  
13 that you can't pick and choose your customer. You could --  
14 you could never elect that you just didn't want to serve that  
15 customer.

16 MR. STROBLE: There is an obligation to --

17 QUESTION: And so that differs, makes a substantial  
18 difference between the security deposit in this industry and  
19 the security deposit in, say, a furniture business where you  
20 might decide that you are just not going to deliver.

21 MR. STROBLE: I think that is a valid observation, that  
22 there is a difference between a regulated industry and the  
23 private commercial setting where many of the advance payment  
24 cases originally arose. In the public utility setting, it is  
25 a state-mandated obligation that the utility serve the

1 customer. And the receipt of the security deposit is not the  
2 consideration that triggers that obligation to return goods  
3 and services.

4 QUESTION: So, from a practical standpoint, it really  
5 is just an advance payment, isn't it? Other than the interest  
6 factor.

7 MR. STROBLE: Well, another reason why it is not the  
8 equivalent of an advance payment is that it is subject to a  
9 refund.

10 QUESTION: Well, so is the advance payment if the  
11 customer elects to terminate the service.

12 MR. STROBLE: Well, I think in a normal advance payment  
13 situation the customer would want to make certain that it had  
14 assured what it was going to receive for its advance payment.  
15 There would typically be an agreement that in exchange for  
16 this advance payment so many dollars of goods and services  
17 will be delivered at a certain time in the future.

18 QUESTION: But, as we have already established, a  
19 utility always has to deliver services. It can't unilaterally  
20 discontinue service, absent nonpayment.

21 MR. STROBLE: But that is a obligation that is imposed  
22 independent of the deposit, or as a separate obligation that  
23 is not a countervailing or a mutual obligation that arises for  
24 the reason of having received this deposit. Government once  
25 says that you have received the deposit, it should be treated

1 as the equivalent of an advance payment, that the deposit  
2 should be treated as if it has bought future goods and  
3 services. What we are saying is that the payment in question  
4 is not, the deposit is not the thing which triggers the  
5 obligation to supply services to the customer.

6 QUESTION: Mr. Stroble, are you sure that that is true.  
7 It is true that with respect to most of its customers the  
8 utility has an obligation to provide services. I would think,  
9 however, that when the state regulating commission approved  
10 this requirement of an advance payment for certain people it  
11 is saying you don't have to serve these people unless they  
12 make the advance payment. I mean, isn't that the deal?

13 MR. STROBLE: Well --

14 QUESTION: So, it's general obligation to serve all  
15 comers is suspended with respect to some particularly  
16 economically shaky individuals. Isn't that right?

17 MR. STROBLE: Well, the facts of the case as they were  
18 disclosed by the record is that the -- this utility, except in  
19 very rare cases, would supply service to any customer, would  
20 allow them to hook up to the system, would turn on the  
21 electricity and sell them electricity. It was only at such  
22 time as that customer had failed to pay bills and had received  
23 disconnection notices that a deposit would be requested.

24 QUESTION: Fine. But at that point you couldn't say  
25 that the customer was getting nothing for the advance payment.



1 He was getting further service. The Commission, the utility  
2 had no obligation to provide any further service at that  
3 point, unless he made the payment. Right?

4 MR. STROBLE: In most cases the record discloses that  
5 the customer who fails to make any payment, either a deposit  
6 or an actual payment on the delinquent utility bills, would be  
7 disconnected for failure to pay the utility bill.

8 QUESTION: So he is getting something for the payment,  
9 continuing service, which the utility would not otherwise have  
10 any obligation to provide.

11 MR. STROBLE: It is true that a customer who absolutely  
12 refused to pay a deposit could be disconnected from the  
13 system.

14 QUESTION: That is to say, all the customers from whom  
15 you demand these prepayments.

16 MR. STROBLE: But in that event -- in that  
17 circumstance, I think we still have to ask the question is the  
18 deposit collected for the purpose of buying these future goods  
19 and services. Or is it there as a standby -- still there as a  
20 standby security device collected only for use in the event of  
21 an actual default by that customer?

22 QUESTION: Is what counts what it is collected for, and  
23 not at all what it is paid for? Do you look at just one side  
24 of that? I -- It's not a trick question, I don't know the  
25 answer.

1 MR. STROBLE: I think you're right. I mean, I think  
2 the question is --

3 QUESTION: I mean, I am sure that he is paying it only  
4 to get more electricity. Right? To have your service  
5 continue. It is clear from that side what he is doing it for,  
6 right?

7 QUESTION: Why do you think an advance payment is  
8 properly treated as income right then?

9 MR. STROBLE: In the three cases which Mr. Wallace  
10 alluded to, the Automobile Club of Michigan, the Triple A case  
11 and the Schlude case, the Commissioner fought very hard for  
12 the proposition that there are circumstances under which the  
13 accrual method of accounting can be deviated from. Under the  
14 all events test of the accrual method you would only recognize  
15 income as the utility services are provided, as the customer  
16 is billed, and at that point income would be recorded on the  
17 books, even though payment, cash payment, had not actually  
18 been received.

19 Those cases held that, at least in certain  
20 circumstances, it is appropriate to tax a party upon the  
21 receipt of prepayments for those goods and services. It is in  
22 that situation that the government is permitted to deviate  
23 from the normal accrual method that otherwise governs  
24 taxability. The reason is that in that situation the amounts  
25 in question are identifiable, or are identified with the

1 future delivery of goods and services. As long as the seller  
2 provides those goods and services he gets to keep the money.  
3 He is not under an obligation to refund the money. And for  
4 that reason the increase in wealth has occurred.

5 QUESTION: Well, he is under an obligation if he  
6 doesn't furnish it.

7 MR. STROBLE: If he doesn't furnish -- if he doesn't  
8 live up to his contract, then he has to return the, he has to  
9 return the deposit. But as long as he lives up to his  
10 contract --

11 QUESTION: Nevertheless, meanwhile he has returned it  
12 as ordinary income.

13 MR. STROBLE: Yes, that -- that's correct. Our  
14 position is that the distinction there is that in the case of  
15 a customer security deposit, if the customer performs as  
16 agreed, then the deposit does have to be refunded. In other  
17 words, if each side performs their mutual obligations, the  
18 deposit is refunded to the customer. And that is just the  
19 exact opposite of an advance payment, where the performance of  
20 each party's mutual obligations results in the seller being  
21 entitled to retain the payment.

22 The Commissioner's approach produces a serious problem  
23 that needs to be addressed, and it relates to this question of  
24 proper tax treatment of an accrual method taxpayer. As we  
25 just noted, an accrual method taxpayer reports income as the

1 goods and services are delivered and billed for, and at that  
2 point income is put on the books for tax purposes. In the  
3 taxpayers case, in this utility's case, income was recognized  
4 as the utility meter was read and as the customer was billed.  
5 So as soon as the income was recognized an account receivable  
6 was then put on the books.

7 The advance payment rule says that depending on the  
8 facts, a prepayment of cash can be taxed at the time it is  
9 received, even though, under the normal accrual method,  
10 recognition of income would be deferred until the goods are  
11 actually delivered. This was the holding of the three  
12 trilogy, so-called trilogy cases, of the late '50s and early  
13 '60s.

14 But what the Commissioner is doing here is taking what  
15 was an exception to the all events test, the prepayment rule,  
16 and basically applying that in tandem with the accrual method.  
17 The result is a distortion of income, or a double counting of  
18 income, essentially along the lines that Justice Kennedy  
19 alluded to in Mr. Wallace's presentation. He is basically  
20 applying a cash method to the deposit, and an accrual method  
21 to the goods and services, simultaneously. It is being  
22 imposed simultaneously on the same series of transactions.  
23 Because what happens is the deposit is included in income when  
24 collected, and the utility, under its normal accrual method of  
25 accounting, is also required to report income as it delivers

1 services to its customers.

2 QUESTION: Excuse me, you would have that same problem  
3 if it were, even if it were considered, whether it is  
4 considered a security deposit or a prepayment. Wouldn't you  
5 have the same problem?

6 MR. STROBLE: Well, I think there is a difference, and  
7 perhaps an example might help me better illustrate it. Let us  
8 take the example of a taxpayer that collects a security  
9 deposit, such as we have here. We'll say it's a \$25 security  
10 deposit. So it is collected in year one.

11 QUESTION: I am sorry. I asked you the wrong question.  
12 Suppose it were concededly a prepayment. You have no doubt,  
13 you receive it as a prepayment.

14 MR. STROBLE: Yeah.

15 QUESTION: Wouldn't the same thing happen?

16 MR. STROBLE: I don't think so.

17 QUESTION: I mean, that is just a function of what  
18 happens when you get a prepayment.

19 MR. STROBLE: I don't think so, because what happens in  
20 that case is the utility receives a prepayment for a given  
21 utility service, it would have no reason to send out a bill to  
22 that customer or to accrue any additional income, because it  
23 has already received the payment, with those identifiable  
24 goods and services. In other words, if a customer says this  
25 is a prepayment for goods and services, I would not then

1 separately bill that customer for those services, and I  
2 wouldn't accrue any additional income.

3 QUESTION: You wouldn't report that payment until the  
4 services were provided 12 months later?

5 MR. STROBLE: Well, if it was a true prepayment, as you  
6 has posited in your example --

7 QUESTION: And you're on an accrual basis.

8 MR. STROBLE: And I'm on the accrual basis, under the  
9 trilogy cases I would report that as income at the point I  
10 collected it, no question.

11 QUESTION: At the point you collected it.

12 MR. STROBLE: But I would not then again accrue income  
13 as I delivered those services to that customer. That's, I  
14 think, the problem that is developing in this case, is --

15 QUESTION: Well, you don't accrue it when you, at the  
16 end, at the twelfth month. What happens at the twelfth month  
17 is, if you do deliver the services, you return the money and  
18 you get a deduction for the return of the money, which in  
19 effect offsets the accrued income you are receiving that  
20 month. It works out.

21 MR. STROBLE: That seems to solve the problem as long  
22 as we contain everything within a given taxable year.

23 QUESTION: That's right. So the only real problem is  
24 that you get a double charge the first month, which is evened  
25 out at the end, but you get a double charge -- which is in the

1 government's advantage. But I am saying that always happens  
2 to an accrual -- to an accrual taxpayer whenever you get an  
3 advance payment. So it doesn't prove your case. All it says  
4 is if it is an advance payment, yeah, that ought to happen.  
5 But that still leaves you with the question of whether it is  
6 an advance payment or not.

7 MR. STROBLE: If it is an advance payment, then it  
8 would normally be identifiable with some goods and service  
9 that would permit the taxpayer to avoid that second, that  
10 accrual, that separate accrual and the double counting that  
11 would occur in the first year. If it is not an advance --

12 QUESTION: Whereas a security deposit is carried on  
13 indefinitely and might not relate to the first year, so the  
14 government tends to maximize income to a greater extent under  
15 security deposits than with advance payments.

16 MR. STROBLE: Exactly. The government is picking up,  
17 in the one example, 13 months in a 12-month period, or in my  
18 example, the government is accruing, basically double counting  
19 the income for a given period of service.

20 QUESTION: Of course, I guess the government could  
21 argue it's the way we structure the hypothetical, it's the way  
22 we are assuming the advance payment is designated. We are  
23 assuming it is designated for the twelfth month.

24 MR. STROBLE: It seems that an advance payment has to  
25 be designated to some particular identifiable good or service.

1 I mean, I think that is part of the problem from the  
2 accounting standpoint, and ultimately this is a question of  
3 whether the utility's income is being clearly reflected. An  
4 advance payment would be something that you could identify  
5 with a good or service to be delivered in the future. But a  
6 deposit is not intended to be a prepayment. It is intended to  
7 sort of stand by as a security device. Consequently, we have  
8 no way of identifying it with some future periods utility  
9 service when it is collected. And for that reason the normal  
10 accrual accounting rules apply in accounting for our utility  
11 service delivery in the future.

12 That strikes us as really an over reaching, really  
13 getting the best of both worlds. The best of the cash method  
14 and the best of the accrual method, overlaid on top of one  
15 another, and a distortion of the taxpayer's income, which is  
16 directly contrary to the advance payment rules that -- and to  
17 the security deposit rules, which ultimately govern this case.

18 This other area that we see the Commissioner over  
19 reaching in, essentially trying to take an advantage that is  
20 not a fair advantage, is to criticize the facts and  
21 circumstances test, which the tax court and the Seventh  
22 Circuit utilized here, as being too vague. And then, when  
23 addressing the treatment of the person who pays a deposit,  
24 providing that a facts and circumstances analysis is the only  
25 way to determine a proper tax treatment.



1 As Justice Scalia mentioned in Revenue Ruling 79-229  
2 dealing with a cash-basis farmer, the question is whether a  
3 given amount is a deductible advance payment or, on the other  
4 hand, is it a non-deductible deposit.

5 QUESTION: Mr. Stroble, although Mr. Wallace didn't  
6 make the point, doesn't that case, or that ruling deal with  
7 cash-basis taxpayers?

8 MR. STROBLE: It deals with the question whether a  
9 cash-basis taxpayer should be --

10 QUESTION: But then does it have any bearing on how we  
11 treat accrual-basis taxpayers who get income up front?

12 MR. STROBLE: I think it does in an environment where  
13 we say we are going to make an exception to the normal accrual  
14 method and tax the receipt of the cash as a prepayment, if it  
15 really is a prepayment. So in that sense the Commissioner is  
16 using a form of cash method when he tries to accelerate the  
17 taxation at a point earlier than it normally would be  
18 recognized under an accrual method. So I think in that sense  
19 the treatment of a cash --

20 QUESTION: But you don't object to that? You --

21 MR. STROBLE: If it is a true advance payment, we  
22 wouldn't object to it.

23 QUESTION: You don't object to it. But you are saying  
24 it is applying a form of non-accrual accounting to the accrual  
25 taxpayer.

1           MR. STROBLE: It is. And the treatment of a cash basis  
2 deposit payor, or deposit payee, has relevance. The real  
3 question is, in that Revenue Ruling, is this particular sum a  
4 deposit or is it an advance payment? And the ruling states  
5 that whether a particular expenditure is a deposit or a  
6 payment depends on the facts and circumstances of each case,  
7 which is exactly what the tax court and the Seventh Circuit  
8 said here. And the ruling goes on to say that when it can be  
9 shown that the expenditure is not refundable, and is made  
10 pursuant to an enforceable sales contract, then in that case  
11 it will not be considered a deposit. So those are the very  
12 points that we think are important in trying to evaluate the  
13 taxability of the person that receives the deposit.

14           QUESTION: But does the ruling say the converse? That  
15 if it is refundable it will be treated as --

16           MR. STROBLE: In, it enumerates four or five factors  
17 that are to be looked at, and clearly the question of whether  
18 it is refundable and whether or not it is part of an  
19 enforceable sales contract for specific goods and services are  
20 key factors in making that determination. I think the  
21 Commissioner would allow a consideration of the overall set of  
22 circumstances to try to arrive at that decision, but clearly,  
23 the refundability becomes a key point. We think that really  
24 it shouldn't make any difference which side of the coin you  
25 are looking at, as long as the issue is does the deposit serve

1 as a true security deposit or does it serve as a -- an advance  
2 payment for goods and services.

3 The approach used by the Seventh -- by the tax court  
4 and the Seventh Circuit are faithful to the general principle  
5 recognized by this Court, that it is only amounts which really  
6 produce some form of increase in wealth which should be  
7 taxable, and that as long as the amount is offset by an  
8 obligation to refund, that increase in wealth has not  
9 occurred. And it is only a review of the total relationship  
10 between the parties that a fair evaluation can be made of  
11 whether there has been a sufficient transfer of rights to  
12 justify taxation.

13 The Commissioner's approach is essentially an arbitrary  
14 per se rule that disregards the most critical facts to be  
15 considered in making that determination. The result of using  
16 the Commissioner's approach is to distort income, to  
17 mischaracterize and misaccount for the actual earning of  
18 income, which should be the purpose of good tax accounting.  
19 For those reasons we believe that the Seventh Circuit and the  
20 unanimous tax court properly evaluated the facts before it,  
21 and concluded that these were true security deposits, and not  
22 some form of disguised advanced payment.

23 Unless there are any questions --

24 QUESTION: Thank you, Mr. Stroble. Mr. Wallace, do you  
25 have rebuttal?

1 REBUTTAL ARGUMENT OF LAWRENCE G. WALLACE

2 ON BEHALF OF THE PETITIONER

3 MR. WALLACE: Yes, Mr. Chief Justice.

4 This Court's trilogy of decisions were decided by  
5 divided votes in favor of the government, five to three, five  
6 to four and five to four. As I think much of the exchange has  
7 illustrated, there was a substantial and coherent position  
8 expressed in the dissenting opinions in those cases --

9 QUESTION: Mr. Wallace, can I interrupt you just a  
10 second on those three cases? It seems to me that if those, if  
11 you had lost those three cases a fortiori you would lose here.

12 MR. WALLACE: Yes, Mr. Justice.

13 QUESTION: Now, isn't it true that those cases  
14 basically said that we will make an exception from normal  
15 accrual accounting procedures for payments received in  
16 advance, as in those cases. So what we have here is whether -

17 -

18 MR. WALLACE: That is correct.

19 QUESTION: -- we construe an exception broadly or  
20 narrowly.

21 MR. WALLACE: Well, that is correct. And those cases  
22 are not challenged here, and Congress has tinkered with the  
23 results in Sections 455 and 456 of the code, and has adopted  
24 other rules where it saw fit to do so for prepaid subscription  
25 income for newspapers and magazines, and for dues to non-

1 profit membership organizations, such as the auto club. But  
2 otherwise has left them in effect. And once what admittedly  
3 was a coherent position taken in dissent is behind us in those  
4 three cases, it seems to me that the coherent position now in  
5 applying the implications of those three cases to the  
6 utility's situation is the position that has been taken in the  
7 Commissioner's Revenue Ruling.

8           Otherwise, you get into what the court of appeals here  
9 admitted was functionally similar situations being treated  
10 differently, such as getting an advance payment of the twelfth  
11 month's rent, or getting a deposit equivalent to the twelfth  
12 months rent that will be returned after twelve months of rent  
13 has been paid. Why -- there is no possible reason why those  
14 two situations should result in different tax consequences.

15           And the tax court and the court of appeals, by  
16 enumerating a number of factors to be looked into, has invited  
17 an inquiry into whether a prepayment to secure the payment of  
18 future income differs from an advance payment of that future  
19 income, when there really is no meaningful difference between  
20 the two inquiries. And it is hard to see how any of these  
21 factors bear on them. And that is not going to be a criterion  
22 for even-handed administration of the tax laws.

23           When the so-called security deposit is given to assure  
24 the payment of the future income, it is a receipt of that  
25 income. And the only question is the timing of its

1 recognition, and that was settled in this Court's trilogy of  
2 cases, that the Commissioner did have authority to insist that  
3 when that income is received in advance by the accrual basis  
4 taxpayer, he has to recognize it at that time.

5 QUESTION: Mr. Wallace, there is no significant  
6 economic difference between, let's assume a security deposit  
7 not for payment of future rent, but for not destroying the  
8 property, which you acknowledge is not taxable immediately.  
9 Correct?

10 MR. WALLACE: That is never converted into income.

11 QUESTION: All right. Well, but there is really no  
12 economic difference between that and between the tenant buying  
13 the landlord insurance against the tenant's destruction. And  
14 if the tenant did that, I assume that would be income to the  
15 landlord, wouldn't it? If the landlord required the tenant to  
16 pay for an insurance policy that would cover any destruction  
17 by the tenant. So, you know, if you play the economic reality  
18 game, all sorts of things would be income that aren't income.  
19 And I -- I am just not impressed with the fact that the  
20 economic realities are thus and so. That doesn't seem to me  
21 the way the tax code is played.

22 MR. WALLACE: Well, but the code does not give  
23 controlling significance to labels that are meaningless,  
24 either, when the same payment is being made between two  
25 parties to a transaction and it is called one thing or

1 another. That, the code does not do, and I think it would not  
2 lead to even-handed administration of the tax laws for the  
3 decision here to invite that approach to the issue.

4 CHIEF JUSTICE REHNQUIST: Thank you, Mr. Wallace. The  
5 case is submitted.

6 (Whereupon, at 11:53 a.m., the case in the above-  
7 entitled matter was submitted.)  
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No. 88-1319 - COMMISSIONER OF INTERNAL REVENUE, Petitioner V. INDIANAPOLIS POWER & LIGHT

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