Washington Law Review

Volume 66 | Number 1

1-1-1991

Tax-Free Security: Federal Income Taxation of Customer Deposits after Commissioner v. Indianapolis Power & Light Co., 110 S. Ct. 589 (1990)

Alisa Eid

TAX-FREE SECURITY: FEDERAL INCOME TAXATION OF CUSTOMER DEPOSITS AFTER *Commissioner v. Indianapolis Power & Light Co.*, 110 S. Ct. 589 (1990).

Abstract: In *Commissioner v. Indianapolis Power & Light Co.*, the Supreme Court held that a taxpayer receiving a customer deposit to secure future payment for goods or services may exclude that deposit from income if the taxpayer obligates itself to refund the deposit and if the customer retains the right to cancel service at any time. Because these conditions characterize virtually all security deposits, the Court's rule will allow taxpayers to exclude most security deposits from income. This Note examines the Court's decision and suggests that the Court's rule should not be extended to any situation where either the obligation to refund the deposit is not imposed by law or the customer contracts to purchase future goods or services. This restriction will prevent taxpayers from taking advantage of the rule to avoid federal income tax.

The Internal Revenue Code provides that all income, from whatever source derived, shall be included in the taxpayer's gross income for the taxable year.[1] However, when a taxpayer receives money subject to the taxpayer's consensual obligation to repay, as with a loan, courts have held that the money need not be reported as income because the economic benefit of the receipt is offset by the obligation to repay.[2] Because there is no increase in the taxpayer's net wealth, there is no income.[3] These rules become difficult to apply when the taxpayer who receives the money and promises to repay is also a seller of goods or services and the "lender" is the buyer of those goods or services. In this situation, it is unclear whether the money is a loan or an advance payment for the goods or services. This issue arises in cases involving customer security deposits required by a utility to assure prompt payment for service.

Frequently, a utility requires a new customer, or one whose credit is suspect, to make a deposit in some amount greater than the customer's estimated monthly bill before the utility will provide service. This deposit is held by the utility until either the customer establishes good credit by paying all bills promptly for a specified period of time, or until the customer fails to pay his or her bills, in which case the utility keeps the deposit and applies it against the customer's outstanding charges. For federal income tax purposes, the issue is whether the deposit represents an advance payment for utility services, and is thus

1. I.R.C. § 61(a) (1990).

2. *E.g.*, Commissioner v. Tufts, 461 U.S. 300, 307 (1983) ("When a taxpayer receives a loan, he incurs an obligation to repay that loan at some future date. Because of this obligation, the loan proceeds do not qualify as income to the taxpayer.").

3. *See* B. BITTKER & L. LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶6.1 at 6-2 (2d ed. 1989).

income, or whether the deposit may be excluded from income by the utility until its obligation to repay the deposit to the customer disappears, as if it were a loan.

In *Commissioner v. Indianapolis Power & Light Co. (IPL III)*,[4] the United States Supreme Court held that a deposit may be excluded from income if it is held subject to an express obligation to repay and if the customer has made no commitment to purchase services. The Court said that in such situations the taxpayer has no guarantee of being allowed to keep the money, so the deposit should be treated like a loan.

This Note analyzes the Court's opinion in *IPL III,* explains how the decision changes previous deposit law, and, finally, urges that future courts restrict the *IPL III* rule to cases where there is a clear obligation to repay the deposit and where the customer has made no commitment to purchase services. This restriction will prevent the rule from frustrating federal income tax law.

I. TRADITIONAL AND NEW APPROACHES TO DEPOSIT TAXATION

To determine whether a security deposit is taxable, the initial inquiry is whether the taxpayer has received "income." Income is defined generally in section 61 of the Internal Revenue Code (Code), and courts have elaborated on that definition in cases involving both landlord-tenant deposits and other deposits.

A. The Statutory Definition of Income and the Necessity of an Accession to Wealth

The Code defines gross income as all income from whatever source derived.[5] In interpreting the Code's definition of income, the Supreme Court has frequently stated that Congress used this language to exert the full measure of its taxing power.[6] Nevertheless, not every economic benefit to the taxpayer will result in income. Courts have held that income requires, at a minimum, the presence of two elements: an accession to the taxpayer's wealth[7] and an event by which that accession is realized by the taxpayer.[8]

4. 110 S. Ct. 589 (1990), *aff'g* 857 F.2d 1162 (7th Cir. 1988) (*IPL II*), *aff'g* 88 T.C. 964 (1987) (*IPL I*).

5. I.R.C. § 61(a).

6. *E.g.*, Helvering v. Clifford, 309 U.S. 331, 334 (1940).

7. This concept is implicit in section 61's reference to "income," "gains," and other items that would increase a taxpayer's wealth. *See* I.R.C. § 61.

8. *See* B. BITTKER & L. LOKKEN, *supra* note 3, ¶5.2, at 5-17.

Courts have generally considered all funds received to be taxable accessions to wealth unless the receipt of the funds is accompanied by an obligation to repay those funds. In *James v. United States,*[9] the Court held that embezzled funds were income to the embezzler.[10] The Court said that a taxpayer who receives funds without also agreeing to repay the funds has received income.[11] Even though James was under an unqualified duty to repay the money to his employer, the Court considered the embezzled money to be income because there was no consensual agreement to repay it.[12]

In contrast, no taxable accession to wealth exists when a taxpayer accepts money but contemporaneously incurs a consensual obligation to repay that money, as with a loan. For example, in *Commissioner v. Tufts,*[13] the Court held that the receipt of a mortgage loan did not affect the taxpayer's income tax liability. No net accession to the taxpayer's wealth occurred because the increase in the taxpayer's wealth caused by the loan was offset by the obligation to repay the loan.[14]

B. The Analytical Struggle

Traditional analysis of security deposit taxability, which derived from landlord-tenant law, also focused on whether a deposit represented an accession to the taxpayer's wealth. Until *IPL III,* landlord-tenant law provided the analytical framework used to determine the taxability of deposits.

1. Landlord-Tenant Law: Advance Rent and "True" Security Deposits

Questions of security deposit taxability arise most frequently in the landlord-tenant context. Generally, payments made pursuant to a lease of property are divided into two categories: those that serve as advance payments of rent, and those that secure performance of covenants under the lease. A deposit that is an advance payment of rent is income when received,[15] regardless of whether the taxpayer uses a

9. 366 U.S. 213 (1961).

10. James, a union official, embezzled in excess of $738,000 over four years from his union employer and an insurance company with which the union did business. James did not report this amount as income during the taxable years at issue. *Id.* at 214.

11. *Id.* at 219.

12. *Id.* The Court reversed the conviction for tax fraud, however, because the element of willful evasion of federal income tax was not proven. *Id.* at 221–22.

13. 461 U.S. 300 (1983).

14. *Id.* at 307.

15. Gilken Corp. v. Commissioner, 176 F.2d 141, 145 (6th Cir. 1949); Clinton Hotel Realty Corp. v. Commissioner, 128 F.2d 968, 969 (5th Cir. 1942). A corollary to this rule is that

cash or accrual method[16] of accounting.[17] Conversely, a refundable deposit that secures the landlord against the tenant's breach of the lease is not income upon receipt.[18]

The conventional explanation of the non-taxation of deposits to secure property is that the deposits will never be an accession to the taxpayer's wealth. Even if the taxpayer keeps all or part of a deposit as the result of property damage, this is compensation for his loss and does not increase the taxpayer's net worth.[19] In contrast, an advance payment is an accession to the taxpayer's wealth because it is not offset by any related deduction.

In cases where the purpose of a deposit was unclear because it could potentially have secured both kinds of items, courts applied a primary-purpose test.[20] Courts determined whether the deposit was primarily intended to secure an income-producing or nonincome-producing item[21] and categorized the deposit respectively as an advance payment or a security deposit. Despite the apparent simplicity of this test, courts often had difficulty drawing the line between security deposits and advance payments.[22]

---

deposits that secure the payment of rent are considered advance payments of rent. *E.g.*, J. & E. Enters. v. Commissioner, 1967 T.C.M. (P-H) ¶67,191.

16. Under the cash method of accounting, all items that constitute gross income (whether in the form of cash, property, or services) are included for the taxable year in which they are actually or constructively received. Treas. Reg. § 1.446-1(c)(i) (as amended in 1987).

In contrast, under accrual-method accounting, income is included for the taxable year when all the events have occurred that fix the right to receive such income and the amount thereof can be determined with reasonable accuracy, whether or not payment has been received. *Id.* § 1.446-1(c)(ii).

17. Treas. Reg. § 1.61-8(b) (1957).

18. Astor Holding Co. v. Commissioner, 135 F.2d 47, 48 (5th Cir. 1943); Gilken Corp. v. Commissioner, 10 T.C. 445, 451 (1948), *aff'd*, 176 F.2d 141 (6th Cir. 1949).

19. Indianapolis Power & Light Co. v. Commissioner, 857 F.2d 1162, 1167 n.9 (1988) (*IPL II*), *aff'd*, 110 S. Ct. 589 (1990). A taxpayer may keep only that amount of a security deposit that equals the amount of his loss. *E.g.*, Boral v. Caldwell, 223 Cal. App. 2d 157, 35 Cal. Rptr. 689, 692 (1963). Although the taxpayer will have to declare that portion of the deposit kept as income in the year in which his obligation to repay disappears, the income will be offset by a mirror deduction in the amount of the repair necessitated by the damage to the property. Therefore, there will be no enhancement of the taxpayer's net wealth.

20. *See, e.g.*, Hirsch Improvement Co. v. Commissioner, 143 F.2d 912, 915 (2d Cir. 1944); *Gilken*, 10 T.C. at 454.

21. As used in this Note, the term "income-producing item" means an item that will be income when received (such as rent). A "nonincome-producing item" is one that will not generate net income (such as a covenant securing against property damage). *See supra* note 19 and accompanying text.

22. For example, in Clinton Hotel Corp. v. Commissioner, 128 F.2d 968 (5th Cir. 1942), the court examined a deposit that secured both payment of rent and performance of other non-rental covenants and was to be applied to the rent for the last year of the lease. The court held the

2. *Non-Lease Security Deposits: The Problem of Classification*

When traditional deposit analysis is applied to deposits outside the landlord-tenant context, the deposits do not fit neatly into either the advance-payment-of-fixed-rent category or the security-for-property category. The reason is that most non-lease deposits are designed to secure payment for an undetermined quantity of goods or services to be provided in the future. A deposit required by a utility company to assure prompt payment of bills is a case in point. Although the deposit secures an income-producing item (payment for goods or services), the deposit is not truly akin to an advance payment because the customer is not obligated to buy any services from the utility, the deposit will rarely match any fixed amount owed the utility, and the customer can generally be assured of a refund by paying his or her bills on time. Nor is the deposit truly security for property interests because there are relatively few nonincome-producing items that are the subject of covenants in such agreements.[23] Thus, what exists in most non-lease cases is a hybrid—security for an income-producing item—and the Internal Revenue Service (IRS) and the courts have struggled in their attempts to pigeonhole this hybrid into either conventional category.

3. *Solutions Offered*

Prior to *IPL III,* the IRS and the courts reached differing conclusions about the taxability of customer deposits.

a. *The IRS Answer*

The IRS ruled that a deposit to guarantee a customer's payment of an amount owed a utility should be taxable upon receipt.[24] The IRS so held when considering whether deposits required of new customers by a water company to guarantee payment for water were income.[25] The IRS relied on the landlord-tenant principle that a deposit intended primarily to secure the payment of rent is considered

deposit did not constitute income because it was "obvious that there were many things to which [the deposit] might become applicable besides" the last year's rent. *Id.* at 970.

Conversely, in Gilken Corp. v. Commissioner, 176 F.2d 141, 145 (6th Cir. 1949), on facts nearly identical to *Clinton,* the court concluded that the deposit was advance rent because it was to be applied to the rent for the last months of the lease term.

23. An example would be damage to meters. *E.g.,* City Gas Co. of Fla. v. Commissioner, 1984 T.C.M. (P-H) ¶ 84,044, at 84,163 (*City Gas III*) ("Charges for damage to meters and other nonincome items did not make up a significant portion of the total final charges.").

24. Rev. Ruling 72-519, 1972-2 C.B. 32.

25. *Id.* at 32–33.

advance rent. Apparently construing this to mean that a deposit is income if it secures an item that will be income when received,[26] the IRS ruled that a deposit to secure future payment for goods should be considered an advance payment.[27]

b. The Tax Court Approach

The Tax Court[28] usually considered the kind of item a deposit secured in classifying the deposit, but the court also attached great weight to the right of the taxpayer to control the ultimate disposition of the deposit.[29] For example, if a landlord could either apply a deposit to a tenant's last month's rent or refund the deposit when the last month's rent was paid, the landlord retained ultimate control over the deposit.[30] In such cases, the Tax Court never characterized a deposit as a security deposit, but rather deemed it an advance payment of rent.[31]

Nevertheless, the Tax Court also advocated looking through the form of a transaction to find its true substance.[32] Thus, when a taxpayer lacked ultimate control over a deposit in form only, the Tax Court has found that the deposit was income to the taxpayer upon receipt.[33]

c. Other Courts' Approaches

Federal district and circuit courts have been inconsistent in their treatment of both lease and non-lease deposits.[34] These courts, however, were generally more willing than the Tax Court to call a deposit

26. *See* Commissioner v. Indianapolis Power & Light Co., 110 S. Ct. 589, 595 n.9 (1990) (*IPL III*).

27. Rev. Ruling 72-519, 1972-2 C.B. at 33.

28. The Tax Court (formerly the Board of Tax Appeals) is an Article I court which has only "deficiency" jurisdiction (apart from some declaratory judgment cases) and so is only available to a taxpayer who has already paid his tax in full. *See generally* H. DUBROFF, THE UNITED STATES TAX COURT: AN HISTORICAL ANALYSIS (1979).

29. *See* Burke & Friel, *Tax Free Security: Reflections on Indianapolis Power and Light*, 12 REV. OF TAX'N OF INDIVIDUALS 157, 167 (1989).

30. *E.g.*, J. & E. Enters. v. Commissioner, 1967 T.C.M. (P-H) ¶67,191.

31. Burke & Friel, *supra* note 29, at 167.

32. *Id.* at 162.

33. *See, e.g.*, August v. Commissioner, 17 T.C. 1165, 1169 (1952) (holding that where lessor and lessee agreed that lessor would "refund" security deposit over the last nine months of the lease simultaneously with lessee's payment of rent the transaction was merely a meaningless exchange of checks and the deposit was actually advance rent). For a more detailed discussion of *August*, see *infra* text accompanying notes 130–33.

34. Burke & Friel, *supra* note 29, at 173. For a review of the courts' treatment of lease deposit cases, see *id.* at 162–69; Prescott, *Customer Deposits: Tax-Free Security or Prepaid Income?*, 41 FLA. L. REV. 773, 782–87 (1989).

taxable income, even when the taxpayer did not have ultimate control over the deposit's disposition. This was true when the courts believed that the deposit would eventually be applied as payment for goods or services.[35] Occasionally, the courts applied the rule of substance-over-form when they viewed a payment as merely a façade for another transaction.[36]

4. The Eleventh and Seventh Circuit Split

The split that existed between the Eleventh and Seventh circuits in the utility deposit cases prior to *IPL III* exemplified the confusion caused by the diverse approaches taken to security deposit analysis.

a. The Eleventh Circuit: City Gas Co. of Florida v. Commissioner

In *City Gas Co. of Florida v. Commissioner* (*City Gas II*),[37] the Eleventh Circuit held that utility deposits were income when received if the primary purpose of the deposits was to act as a prepayment for goods or services.[38] The *City Gas II* taxpayers were three Florida gas companies.[39] All three utilities required new customers to make deposits to secure payment of all bills for service rendered to the customers.[40] The deposits were to be refunded upon termination of service after they were applied against any outstanding charges.[41] The utilities paid four-percent or higher interest on customer deposits.[42] Any unclaimed deposits escheated to the state after fifteen years.[43]

In a previous disposition, the Tax Court had held that the deposits were not includable in the utilities' income.[44] Rejecting the primary-

35. *See, e.g.*, Van Wagoner v. United States, 368 F.2d 95 (5th Cir. 1966) (holding that a "deposit premium" paid at the inception of an insurance policy was an advance payment because it stood in the place of a regular premium and because there was a high probability the deposit would eventually be applied to the policy). For a more detailed discussion of *Van Wagoner*, see *infra* text accompanying notes 98–104.

36. *See, e.g.*, United States v. Williams, 395 F.2d 508 (5th Cir. 1968) (holding that a "loan" to a taxpayer was actually an advance payment under a timber lease). For a more detailed discussion of *Williams*, see *infra* text accompanying notes 113–20.

37. 689 F.2d 943 (11th Cir. 1982), *rev'g* 74 T.C. 386 (1980) (*City Gas I*). On remand, the Tax Court applied the Eleventh Circuit's test and held that the deposits were income. 1984 T.C.M. (P-H) ¶ 84,044 (*City Gas III*).

38. *City Gas II*, 689 F.2d at 946.

39. *Id.* at 944.

40. *City Gas I*, 74 T.C. at 388. The deposit was $15 for a residential customer and an amount twice the estimated monthly bill for a commercial customer. *Id.* at 388–89.

41. *Id.* at 389.

42. *Id.*

43. *Id.* at 388.

44. *Id.* at 391.

purpose test[45] and placing its traditional emphasis on taxpayer control over the deposit,[46] the Tax Court held that the deposits were not advance payments because they were refundable to the customers.[47] Thus, so long as the utilities did not have control over the ultimate disposition of the deposits, the Tax Court was willing to treat the deposits as nontaxable.[48]

The Eleventh Circuit reversed.[49] Citing previous lease cases and a revenue ruling,[50] the court held that tax treatment of the payments would depend on whether they were primarily intended: (1) to act as a prepayment for goods or services, or (2) to secure either performance of nonincome-producing covenants or against damage to property.[51] Because the court admitted the possibility of only these two categories, the Eleventh Circuit's primary-purpose test included in income all deposits to secure income-producing items.[52]

On remand, the Tax Court applied the primary-purpose test and held that the deposits' primary purpose was to secure payment for gas.[53] The deposits were, therefore, taxable upon receipt as advance payments.[54]

b. *The Seventh Circuit:* Indianapolis Power & Light Co. v. Commissioner

In contrast to the Eleventh Circuit in *City Gas II,* the Seventh Circuit in *Indianapolis Power & Light Co. v. Commissioner* (*IPL II*)[55] found that utility deposits were not income if they were primarily intended to act as security, regardless of whether they secured an income-producing or nonincome-producing item.[56] As did the utilities in *City Gas II,* Indianapolis Power & Light Company (IPL) required

45. *Id.* at 394.

46. *See supra* text accompanying notes 29–31.

47. *City Gas I,* 74 T.C. at 394 ("[T]he full amount of a deposit received by one of [the utilities] was, unconditionally, subject to refund to the customer. If the refund was not effected, the amount would ultimately escheat to the State.").

48. Burke & Friel, *supra* note 29, at 171.

49. City Gas Co. of Fla. v. Commissioner, 689 F.2d 943, 950 (11th Cir. 1982) (*City Gas II*).

50. *See supra* notes 24–27 and accompanying text (discussing Revenue Ruling 72-519, 1972-2 C.B. 32).

51. *City Gas II,* 689 F.2d at 946.

52. Seago, *Recent Cases Focus on When Deposits are Includable in Income,* 70 J. TAX'N 38, 38 (1989).

53. City Gas Co. of Fla. v. Commissioner, 1984 T.C.M. (P-H) ¶84,044, at 84,162–63 (*City Gas III*).

54. *Id.* at 84,163.

55. 857 F.2d 1162 (7th Cir. 1988), *aff'd,* 110 S. Ct. 589 (1990).

56. *Id.* at 1170.

some of its customers to make deposits to guarantee payment of their bills.[57] A deposit was refunded if a customer paid all bills promptly for either nine successive months or ten out of any twelve months, provided the customer did not make late payments for any two consecutive months.[58] The utility originally paid three-percent interest on deposits held at least six months.[59] Later, state law was changed to require payment of six-percent interest on deposits held over twelve months.[60] Unclaimed deposits escheated to the state after seven years.[61]

Affirming its position in the initial *City Gas* decision,[62] the Tax Court held that the deposits were not income because the utility did not have control over the ultimate disposition of the deposits.[63] The court noted that the utility did not have a right to decide how the deposits would be used until the customers failed to pay their bills promptly and that the utility consistently treated the deposits as belonging to the customers.[64]

The Seventh Circuit affirmed.[65] The court, however, applied a different primary-purpose test than did the Eleventh Circuit in *City Gas II.* The Seventh Circuit asked whether the primary purpose of the deposits was to secure future performance or to serve as an advance payment of income.[66] Thus, the court focused not on the type of item secured, as did the Eleventh Circuit,[67] but on the intent of the parties regarding the deposit.

In determining whether the deposits' primary purpose was security, the Seventh Circuit placed special emphasis on IPL's obligation to pay interest on the deposits.[68] The court said that the value of a deposit

57. The utility required about five percent of its customers to make deposits in an amount equal to twice their estimated monthly bills. The customers were chosen because their credit was suspect. Indianapolis Power & Light Co. v. Commissioner, 88 T.C. 964, 966 (1987) (*IPL I*), *aff'd*, 857 F.2d 1162 (7th Cir. 1988), *aff'd*, 110 S. Ct. 589 (1990).

58. *Id.* at 968.

59. *Id.* at 967.

60. *Id.*

61. *Id.* at 969.

62. *See supra* text accompanying notes 44–48.

63. *IPL I*, 88 T.C. at 977–78.

64. *Id.*

65. Indianapolis Power & Light Co. v. Commissioner, 857 F.2d 1162, 1163 (1988) (*IPL II*), *aff'd*, 110 S. Ct. 589 (1990).

66. *Id.* at 1170.

67. *See supra* text accompanying notes 51–52.

68. Nearly every court that has decided a deposit case has considered the payment of interest very important in characterizing the deposit as either security or an advance payment. In fact, the Seventh Circuit went so far as to suggest that this single factor "substantially reconciles the line of cases addressing the taxability of customer deposits." *IPL II*, 857 F.2d at 1169 n.11.

was twofold. First, it gave the recipient the opportunity to generate a return.[69] Second, it saved the recipient at least a portion of the costs that would arise if the other party defaulted.[70] As the rate of interest paid by the utility approached the rate it could earn, the return factor lost its importance and the value of the deposit was more truly security.[71] The court admitted, however, that in many cases the differential between the interest rate paid and the probable return would be difficult to determine.[72] The court concluded, therefore, that a reviewing court would also have to consider other factors to determine the primary purpose of the customer deposit.[73]

Applying this analysis, the court considered both the interest IPL paid on the deposits[74] and the circumstances surrounding the deposits.[75] The court concluded that the primary purpose of the deposits was security. Thus, the deposits were not income.[76] The Supreme Court granted certiorari to the IRS to resolve this conflict between the circuits.[77]

C. *The Supreme Court:* Commissioner v. Indianapolis Power & Light Co.

In *Commissioner v. Indianapolis Power & Light Co. (IPL III)*,[78] the Supreme Court did not limit its analysis of IPL's deposits to categorizing them as either advance payments for goods or services or security for a property interest. Nor did the Court attempt to discern the deposits' primary purpose. Instead, the Court examined the taxpayer's dominion over the deposits to determine whether they were income. For a deposit to be taxable income, the Court said the taxpayer must have complete dominion over the deposit.[79] The Court illustrated what it meant by "complete dominion" by comparing a

69. *Id.* at 1168.
70. *Id.*
71. *Id.* at 1168–69.
72. *Id.* at 1170 n.12.
73. *Id.*
74. IPL paid three- to six-percent interest on the deposits during the period in question. *See supra* text accompanying notes 59–60.
75. The Tax Court found that IPL did not have control over the deposits because the customers could control the timing of the refunds and that IPL did not intend for the deposits to serve as advance payments. Indianapolis Power & Light Co. v. Commissioner, 88 T.C. 964, 977–78 (1987) (*IPL I*), *aff'd*, 857 F.2d 1162 (7th Cir. 1988), *aff'd*, 110 S. Ct. 589 (1990).
76. *IPL II*, 857 F.2d at 1170.
77. Commissioner v. Indianapolis Power & Light Co., 110 S. Ct. 589, 592 (1990) (*IPL III*).
78. 110 S. Ct. 589 (1990).
79. *Id.* at 593 ("The key is whether the taxpayer has some guarantee that he will be allowed to keep the money.").

loan to an advance payment. A taxpayer who receives a loan has no guarantee of keeping the funds because of the obligation to repay.[80] Thus, the taxpayer does not have complete dominion over a loan. In contrast, a taxpayer who receives an advance payment is assured of keeping the money, so long as the taxpayer fulfills its contractual obligation.[81] Therefore, the taxpayer has complete dominion over an advance payment.

IPL had no assurance that it would keep its deposits because its customers had made no commitment to buy electricity in the future. A customer could terminate service the day after a deposit was made and ask for a refund.[82] Moreover, even if the customer used electricity, IPL was obligated to repay the deposit when the customer established creditworthiness.[83] The customer was assured of a refund simply by paying the bills in a timely fashion. As a result, IPL lacked ultimate control over the deposits and the deposits more nearly resembled loans than advance payments.[84] IPL, therefore, did not have the complete dominion over the deposits necessary to justify present inclusion in income.[85]

The Court said that whether a deposit is more like a loan or an advance payment must be determined by looking to the relative rights of the parties at the time the deposit was made.[86] The Court rejected the Commissioner's argument that in substance the deposits were advance payments because the majority of customers chose to apply the payments to their electric bills.[87] The Court said that the utility's repayment of a deposit to a customer and the customer's subsequent decision to apply the repayment to his or her utility bill were two discrete transactions that could not be combined to produce a different tax result.[88]

---

80. *Id.* at 592–93.
81. *Id.* at 594.
82. *Id.* at 594 n.6.
83. *Id.* at 593.
84. *Id.* at 595.
85. *Id.*
86. *Id.* at 594–95.
87. The utility kept 57.7% to 69% of its deposits during the years in question. Indianapolis Power & Light Co. v. Commissioner, 88 T.C. 964, 969 (1987) (*IPL I*), *aff'd*, 857 F.2d 1162 (7th Cir. 1988), *aff'd*, 110 S. Ct. 589 (1990).
88. *IPL III*, 110 S. Ct. at 594 n.8. To illustrate why the exchange-of-checks operation more accurately reflected the economic substance of the transaction, the Court hypothesized a loan between two parties involved in an ongoing commercial relationship:

> At the time the loan falls due, the lender may decide to apply the money owed him to the purchase of goods or services rather than to accept repayment in cash. But this decision does not mean that the loan, when made, was an advance payment after all. The lender in effect has taken repayment of his money . . . and has chosen to use the proceeds for the

The Court also disagreed with the Seventh Circuit's conclusion that payment of interest on deposits was an important factor in characterizing those deposits.[89] The Court pointed out that payment of interest has little to do with the degree of taxpayer control. For example, the Court reasoned that even though banks pay interest on their customers' deposits, the deposits are not income.[90] The Court concluded, therefore, that interest is of no help in determining whether a taxpayer has dominion over a deposit.[91]

II. ANALYSIS OF *COMMISSIONER v. INDIANAPOLIS POWER & LIGHT CO.*

This Note examines the effects of *IPL III* and how *IPL III* should be applied in future cases. Part A explores the effect that *IPL III* will have on non-lease deposit law. The discussion focuses on the switch from the primary-purpose test to the complete dominion test and on how *IPL III* overrules prior deposit law. Part B urges that the *IPL III* rule be applied only to cases factually similar to *IPL III.* This Note suggests two methods by which courts can avoid misapplication of *IPL III* in cases where the results would be inconsistent with federal income tax law.

A. *Effect of* Commissioner v. Indianapolis Power & Light Co. *on Non-Lease Deposit Law*

1. *Primary Purpose Test Discarded*

After *IPL III,* courts need not determine the primary purpose of a non-lease deposit or the type of item secured by the deposit. The only consideration is the taxpayer's control over the deposit, no matter what the deposit is intended to secure. The *IPL III* approach is preferable to prior court treatment of non-lease deposits because prior analysis was unsuited for non-lease deposit cases.

The primary-purpose test was difficult to apply and produced contrary results in cases with similar facts. Using the primary-purpose test, courts often found it impossible to determine from an agreement just what a deposit was intended to secure.[92] As a result, the outcome

---

purchase of goods from the borrower . . . . It is this element of choice that distinguishes an advance payment from a loan.

Id. at 594–95.

89. *Id.* at 593.

90. *Id.* at 593–94.

91. *Id.* at 594.

92. In Oak Indus. v. Commissioner, 1987 T.C.M. (P-H) ¶87,065, at 87,306, the court said, "[t]here is no indication on the [cable TV] subscription agreement as to which of [the

turned on the court's artificial reading of the relative weight the parties gave to their "intentions."[93] The test also yielded inconsistent results in cases with similar facts because courts disagreed over what the primary-purpose test was.[94] Most importantly, the primary-purpose test and its implicit reliance on the advance payment/security-for-property distinction served only to obscure the question whether "security" for future income is income when received.[95] For these reasons, the Supreme Court correctly rejected both the lease-deposit analysis and the primary-purpose test.

2. *Complete Dominion Test Adopted*

The *IPL III* decision marks the beginning of the application of complete dominion analysis to security deposit cases. In *IPL III,* the utility's dominion over its deposits was determined in light of the agreement of the parties at the time the deposits were made. Two aspects of the security deposits demonstrated a lack of dominion. First, the utility held the deposits subject to an express obligation to repay.[96] Second, IPL's customers made no commitment to purchase services in the future.[97] According to the second requirement of the Court's test, a taxpayer that receives a deposit from a customer but no commitment to purchase services has not received income. Presumably, a customer must agree to purchase some specific quantity of goods or services before the customer's deposit can be considered income. This requirement essentially collapses a complete dominion inquiry into that of an advance payment. This overrules prior cases in which courts have found a deposit to be income when received even though there was no commitment to purchase any services.

The requirement that there be a commitment to purchase services before a deposit is considered income will drastically narrow the range of deposits that are income. This effect can be demonstrated by apply-

---

agreement's] purposes was primary." As a result, the court had to consider other factors to determine the deposit's primary purpose.

93. *See supra* note 22 and accompanying text.

94. *See supra* text accompanying notes 66–67 (discussing the differences between the Eleventh and Seventh circuits' primary purpose tests).

95. From an economic point of view, it is unclear why a deposit that will be applied to a future bill should produce tax results different from a deposit to secure payment of the bill. In the latter case, the taxpayer will refund the deposit when payment of the bill is received; in essence this is merely a meaningless exchange of checks. Burke & Friel, *supra* note 29, at 167–68. *But see* Indianapolis Power & Light Co. v. Commissioner, 857 F.2d 1162, 1167 n.9 (7th Cir. 1988) (*IPL II*) (arguing that in economic substance there is also no distinction between an advance payment and a deposit to secure property), *aff'd,* 110 S. Ct. 589 (1990).

96. Commissioner v. Indianapolis Power & Light Co., 110 S. Ct. 589, 593 (1990) (*IPL III*).

97. *Id.* at 594.

ing *IPL III*'s dominion test to the factually similar case of *Van Wagoner v. United States.*[98] In *Van Wagoner,* the Fifth Circuit considered whether commissions retained from "deposit premiums" paid to an insurance broker at the inception of insurance policies were income. The exact amount of a premium (and therefore the commission) would not be known until the end of the period to which the premium applied.[99] A deposit was required if the insured had a poor credit rating.[100] The deposit premium was credited to the insured's account at the end of the insured period and any excess over what was owed for the premium was either refunded or, if the policy was renewed, credited to the new policy.[101] The policies could be cancelled at any time, in which case the deposits (and commissions) were refunded.[102]

The *Van Wagoner* court held that the deposits were income when received.[103] It did not matter to the court that the amount of any one deposit might exceed the amount ultimately owed by the customer because service could be cancelled at any time. The court held the deposits were income because the taxpayer had complete and unrestricted use of the commissions retained from the deposits and, if the policy was not cancelled, the deposits would be applied to the premiums.[104] After *IPL III,* however, courts will be unable to find that a taxpayer has dominion over such deposits because the taxpayer's customers can cancel service at any time. The deposits, therefore, are no longer income to the taxpayer.

As the *Van Wagoner* example demonstrates, using the dominion test will prevent current taxation of non-lease security deposits in virtually all cases. This is so for two reasons. First, the *IPL III* test prohibits a court from finding complete dominion if there is an obligation to repay the deposits. Security deposits, however, are by nature refundable upon the fulfillment of the contractual obligations.[105] Thus, deposits are almost always held subject to an obligation to repay.[106] Second,

98. 368 F.2d 95 (5th Cir. 1966).

99. The policies insured oil drilling rigs and the premiums were based on the amount of use of the rigs and the areas in which they were operated during the period. *Id.* at 96.

100. *Id.*

101. *Id.*

102. *Id.*

103. *Id.* at 98.

104. *Id.*

105. A security deposit is defined as "[m]oney deposited by tenant with landlord as security for full and faithful performance by tenant of terms of lease, including damages to premises. It is refundable unless the tenant has caused damage or injury to the property . . . ." BLACK'S LAW DICTIONARY 1217 (5th ed. 1979). In non-lease cases, because the deposit secures payment, the deposit generally is refundable unless the customer fails to pay his or her bills.

106. No recent case has involved a deposit that was not in some measure refundable.

the *IPL III* test prevents a court from finding complete dominion unless there is a commitment by the customer to purchase some fixed amount of goods or services from the taxpayer. Outside of the landlord-tenant area, however, a customer rarely, if ever, makes a commitment to purchase any fixed amount of goods or services. Thus, with non-lease deposits, the taxpayer will have no guarantee of keeping the money and, therefore, will not have complete dominion over the deposit.

In practice, then, the dominion test operates as a per se rule of exclusion from income of non-lease security deposits.[107] This rule applies whenever there is an express obligation to repay a deposit coupled with the ability of the customer to cancel service at any time. Because the deposit recipient in this situation has no guarantee of keeping the money, this result is consistent with other areas of tax law[108] and with the goal of federal income tax law to tax only realized accessions to wealth.[109]

B. The Commissioner v. Indianapolis Power & Light Co. *Rule Should be Restricted to "Easy" Cases*

IPL III announced a new rule: a customer deposit held subject to an obligation to repay coupled with the customer's ability to cancel service at any time equals a tax-free security deposit. *IPL III* was an "easy" case in which to apply the rule, both because the utility had a statutory obligation to repay the deposits and because its customers made no commitment to purchase any electricity. In factually similar situations the *IPL III* rule should work well. However, when the obligation to repay is not imposed by law or there is a commitment to purchase future services, courts should engage in a more searching scrutiny of the facts and apply the reasoning, but not the form, of the *IPL III* test to reflect the different substance of the transaction.

---

107. This is an ironic result considering that the Eleventh Circuit's test had been criticized because it would always require inclusion in income of deposits held to secure income items. *E.g.*, Seago, *supra* note 52, at 38 ("Generally, the taxpayer cannot win if [the Eleventh Circuit's] primary purpose test is applied because the deposit is intended as security for payment, an income-producing covenant."). *But see* Burke & Friel, *supra* note 29, at 174 (arguing that the Eleventh Circuit's test better comports with an economic benefit analysis and thereby causes less distortion of income).

108. *See supra* text accompanying notes 9–14.

109. *See supra* text accompanying notes 6–8.

1. A Nominal Obligation to Repay Should Not be Decisive

In *IPL III,* the Court's decision was simplified because state law defined the relations of the utility and its customers. Thus, the Court could presume that the utility's promise to refund the deposits to its customers was conclusive of its actual intent. In future cases, however, courts should avoid relying too heavily on the existence of a promise to repay. The characterization of a payment as a loan usually turns on more than a simple obligation to repay. Therefore, when the rights and obligations of the parties are not prescribed by statute or regulation, courts should consider the other factors traditionally used in identifying a loan to determine whether a bona fide obligation to repay exists.

A loan is money received subject to a contractual obligation to repay the sum at some future time, with or without an additional sum for its use.[110] Although some courts have treated a mere obligation to repay as adequate justification for excluding deposits from income,[111] most courts consider all of the circumstances surrounding the deposit in making this determination.[112] Where the circumstances indicate that the obligation to repay should be disregarded, courts are willing to do so.

In *United States v. Williams,*[113] the taxpayer granted the right to cut and purchase timber on 6,525 acres of his land for a period of 66 years.[114] The initial price was three dollars per cord.[115] The grantee paid $19,575 for the first year, plus made a "loan" to the taxpayer in the amount of $176,175.[116] The taxpayer agreed to repay the loan in annual installments by crediting the installments against the yearly payments due him for the use of the land and timber.[117] The Fifth

110. *E.g.,* Murphy v. Carron, 536 S.W.2d 30, 32 (Mo. 1976). For federal income tax purposes, however, interest on a loan will generally be imputed if it is not stated. *See* I.R.C. § 7872 (1990).

111. *E.g.,* Mantell v. Commissioner, 17 T.C. 1143, 1148 (1952):

> However, we cannot conclude therefrom as does the [Commissioner] that the provision for the repayment of the security deposit to the lessees lacked substance and was in fact a provision for the prepayment of rent. Such an express provision cannot easily be disregarded when, as here, the legal rights of the parties, and of third parties also, may be substantially different depending on whether the clause provides that the deposit is to be returned to the lessees or applied to the rent of the final period.

112. *See* John Kelley Co. v. Commissioner, 326 U.S. 521, 526 (1946); Prescott, *supra* note 34, at 801.

113. 395 F.2d 508 (5th Cir. 1968).

114. *Id.* at 509.

115. *Id.*

116. *Id.*

117. *Id.*

Circuit held that the loan was an advance payment on the timber contract, citing the well-recognized premise that in federal tax cases the substance of the transaction, rather than its form, is decisive.[118] The court found that the loan lacked the fundamental characteristics of a true loan. It was not repayable at a definite date, no promissory note was ever executed, and the loan and the lease were interdependent—neither would have been made without the other.[119] Finally, the court noted that the total amount paid to the taxpayer exactly matched ten years' rent under the contract. Therefore, the court held that the loan was taxable as an advance payment.[120]

The *Williams* court reached a sound result by carefully considering factors in addition to the obligation to repay. Similarly, in applying the *IPL III* rule in future cases when, as in *Williams,* the validity of the repayment obligation is unclear, courts should consider the surrounding circumstances in addition to the express promise to repay to determine whether a deposit is held subject to a genuine obligation to repay. Circumstances that indicate a valid repayment obligation include: the existence of a written agreement to refund,[121] a fixed date for repayment,[122] a high likelihood of repayment,[123] the deposit's independence from other transactions,[124] and the intent of the parties to enforce repayment.[125] Only if these factors are considered can a court reconcile the intent of federal income tax laws to tax realized accessions to taxpayers' wealth with the right of taxpayers to exclude from income receipts held subject to bona fide liabilities.

The *IPL III* Court anticipated "hard" cases such as *Williams* when it said that it was not attempting to devise a test for transactions where the nature of the parties' bargain is legitimately in dispute.[126] Thus, the Court preserved the ability of future courts to find complete dominion even where the deposit is nominally refundable or where it is characterized as a loan.

118. *Id.* at 510.
119. *Id.* at 511.
120. *Id.*
121. Bain v. Commissioner, 1989 T.C.M. (P-H) ¶89,310, at 89,1544.
122. *Id.*
123. Illinois Power Co. v. Commissioner, 792 F.2d 683, 690 (7th Cir. 1986).
124. *Williams,* 395 F.2d at 511.
125. *Bain,* 1989 T.C.M. (P-H) at 89,1544.
126. Commissioner v. Indianapolis Power & Light Co., 110 S. Ct. 589, 595 (1990) (*IPL III*).

2. *An Obligation to Repay Should Yield to a Commitment to Purchase Services*

In *IPL III,* the Court could readily hold that the deposits were not taxable because the utility's customers retained the right to cancel service at any time. Thus, IPL had no guarantee that it would keep the deposits. However, if courts carelessly apply the *IPL III* rule in cases where there is both an obligation to repay *and* a commitment to purchase services, courts may allow clever taxpayers to circumvent federal income tax laws.

The question may arise whether a landlord can escape present taxation by artfully structuring an advance payment of rent as a deposit to "secure" the future payment of rent. For example, the landlord could require a refundable deposit in the amount of the last month's rent as security for payment of the last month's rent. Before *IPL III,* no case had gone so far as to suggest that this scheme could successfully avoid taxation.[127] However, given the *IPL III* focus on an obligation to repay, it is plausible that a landlord could structure a contract in this way, then claim he or she had insufficient dominion over the deposit to qualify the deposit as advance rent.[128] This result would be inconsistent with the goal of taxing realized accessions to wealth and at odds with well-settled case law.[129]

In previous cases, courts have emphasized substance over form and held that when there is only a meaningless exchange of checks, a deposit to secure payment of rent should be treated as an advance payment of rent. In *August v. Commissioner,*[130] the court held that a deposit that was to be refunded in ten installments over the last seven months of a lease was actually advance rent.[131] The court examined the circumstances surrounding the repayments, including the facts that the repayments were to be made just after payments of the last

127. Burke & Friel, *supra* note 29, at 167.

128. This problem was anticipated by the Commissioner in the Seventh Circuit *IPL* case. In that case, the court said:

> In its simplest terms, the IRS's argument is that deposits to secure rent must be taxed the same as advance payments because otherwise lessors desiring the non-tax advantages associated with advance payments could obtain them and at the same time avoid the resulting adverse tax consequences by structuring the deal as a deposit.

Indianapolis Power & Light Co. v. Commissioner, 857 F.2d 1162, 1167 (7th Cir. 1988) (*IPL II*), *aff'd*, 110 S. Ct. 589 (1990).

The Seventh Circuit, however, seemed willing to accept this result. The court said, "[w]e therefore hold that deposits to secure payment of an income item *such as rent* can be a distinct category from advance payments for tax purposes." *Id.* at 1169–70 (emphasis added).

129. *See supra* note 15 (deposits that secure the payment of rent are considered advance rent).

130. 17 T.C. 1165 (1952).

131. *Id.* at 1169.

months' rent and that the lease had been rewritten to make the deposit refundable, in contrast to an earlier lease that had characterized it as advance rent.[132] The court concluded that the deposit was income because, "[f]or all practical purposes, the $28,000 was applied upon rentals for the last few months of the lease term."[133]

Faced with a similar situation, however, the *IPL III* Court appeared to give more weight to form than substance. The Court stated that a customer's decision to apply a deposit to a current bill instead of taking a cash refund was really two steps instead of one.[134] Thus, the two steps could not be treated as one for tax purposes and the deposits were not advance payments. In adopting this formalistic view, the Court apparently foreclosed the ability of future courts to treat two transactions as substantively one. If the parties' agreement says that the deposit will be refunded upon payment of the last month's rent, then presumably there are really two transactions and a court may not combine them to find an advance payment of rent. This appears to deprive courts of an effective way to police deposit agreements for compliance with the intent of federal income tax laws.

However, this need not, and should not, be the interpretation given to *IPL III* by future courts. In *IPL III,* the Court decided a case in which the utility's customers unquestionably retained the right to cancel service at any time. The Court did not say that the exchange-of-checks operation would also be conclusive in a case where the taxpayer cast the deposit as "refundable" only to evade income tax properly payable. In fact, the Court expressly declined to make a rule for such "hard" cases.[135] By admitting that in some cases parties may attempt to disguise the nature of their bargains, the Court implicitly acknowledged that where deposits are actually advance payments, they should be treated as such. Future courts should, therefore, elevate substance over form and hold that the *IPL III* rule does not apply when a taxpayer receives a commitment to purchase goods or services from a customer. This restriction of the Court's rule is appropriate to ensure compliance with the spirit of the tax laws.

132. *Id.* at 1168–69.

133. *Id.* at 1169.

134. *See supra* note 88 and accompanying text.

135. Commissioner v. Indianapolis Power & Light Co., 110 S. Ct. 589, 595 (1990) (*IPL III*) ("We need not, and do not, attempt to devise a test for addressing those situations where the nature of the parties' bargain is legitimately in dispute.").

III. CONCLUSION

In *Commissioner v. Indianapolis Power & Light Co.* (*IPL III*), the United States Supreme Court held that because a taxpayer did not have complete dominion over a deposit to secure payment of future bills, the deposit should not be included in income when received.[136] The test for dominion devised by the Court asks whether the taxpayer has an obligation to repay the deposit and whether the customer retains the right to cancel service at any time. If the answer to both questions is yes, the deposit is not income and may be held tax-free by the taxpayer. The *IPL III* test will allow taxpayers to exclude virtually all deposits from income because of the nature of most deposit arrangements. Excluding the deposits from income was an appropriate result on the facts of *IPL III* because it is not the purpose of federal income tax laws to tax receipts that the taxpayer has no assurance of ever retaining. Future courts, however, should apply the *IPL III* rule only to factually similar cases. When the obligation to repay is not imposed by law or the customer has made a commitment to purchase future services, courts should scrutinize the facts more closely and apply the test to fit the substance of the transaction. In cases where the obligation to repay is not fixed by statute or regulation, courts should employ the factors traditionally used to identify a loan to determine whether the taxpayer has incurred a bona fide obligation to repay. Likewise, when a taxpayer receives a refundable deposit to secure payment for future goods or services that its customer has committed to purchase, courts should apply the rule of substance-over-form and hold that the deposit is taxable upon receipt as an advance payment. These applications of the Court's test will best balance the policy of taxing realized accessions to wealth against the right to exclude from income receipts held subject to a genuine obligation to repay.

Alisa Eid

136. *Id.* at 596.