RESPONDENT'S BRIEF

No. 99

In the Supreme Court of the United States

October Term, 1929

Robert H. Lucas, as Commissioner of Internal Revenue,
Petitioner,

vs.

Guy C. Earl,
Respondent.

BRIEF FOR RESPONDENT.

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Pernau Publishing Company, 536 Clay Street, San Francisco

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I.

STATEMENT OF THE CASE.

In 1901, long before the Federal Income Tax law was passed, the respondent and his wife made an agreement in writing whereby all of the property of both should thereafter be held by them in joint tenancy. The agreement covered both the property the parties then had and also any they might thereafter acquire. As to the latter, the provision of the agreement is that all after-acquired property, including the earnings of either spouse, "shall be treated and considered and hereby is declared to be *received*, held, *taken* and owned by us as joint tenants and not otherwise, with the right of survivorship." The clear purpose of the parties was to provide that it should be a legal incident of their relation as husband and wife that all their property should have the character of their joint property.

The agreement has never been abrogated either expressly or by failure to comply with its terms. On the contrary it has been consistently observed and followed by the parties ever since it was made. The question in the case is whether, in view of this agreement, income derived in after years from the earnings of the husband should be considered for tax purposes as exclusively his income or as the joint income of him and his wife.

II.

THE VALIDITY AND OPERATION UNDER THE CALIFORNIA LAW OF THE AGREEMENT BETWEEN THE RESPONDENT AND HIS WIFE.

The validity and operation of the agreement are of necessity determined by the law of California where the agreement was made and where the parties have at all times resided.

The agreement is one specifically authorized by statute in that State. Chapter III, Provision 1, Part 3, Title 1, of the California Civil Code, entitled "Husband and Wife", fixes the incidents which attach or pertain to the marital relation, such as the respective rights and duties of the parties. Among other things, it fixes their property rights. Their property rights as so fixed are in general those of what is known as the community property system.

But husbands and wives are expressly permitted by the same Code sections that establish the community property system to change by agreement between them the incidents as to property which attach or pertain to their relation.

Section 159 of the Code says:

> "A husband and wife cannot by any contract with each other alter their legal relations except as to property."

Section 161, before its recent amendment long after the present controversy arose, read:

> "A husband and wife may hold property as joint tenants, tenants in common, or as community property."

Section 158 of the Code reads:

> "Either husband or wife may enter into any engagement or transaction with the other * * * respecting property, which either might if unmarried."

The Supreme Court of California has held that under these Code sections the mutual consent of the parties is alone a sufficient consideration for an agreement between husband and wife changing the incidents of their relation as to property (*Wren v. Wren*, 100 Cal. 276, 279). There can be no question therefore, and none is made, but that the agreement in the present case was a valid and binding one.

As to the effect of such an agreement, as to how it operates, the Supreme Court of California has also held that it operates to change the status of the property from what would have been its status under the community property system as established by the Code to that which the agreement between the parties provides. This is illustrated in *Wren v. Wren*, just referred to. Under the California law the earnings of a married woman are not her property but are community property, exactly as are the earnings of the husband, and therefore an action for the recovery of such earnings must be brought by the husband and cannot be brought by the wife. In *Wren v. Wren*, a married woman brought in her own name an action to recover for personal services rendered by her to the defendant, and in order to show her right to maintain such an action alleged in her complaint that *prior to the rendition of the services* she and her husband had orally agreed that what was received because of such services should be her separate property. The defendant objected to her right to maintain the action, contending that the agreement did not have the effect of giving her a cause of action for the reason that the relinquishment by the husband of his right to her earnings was by way of gift and that future earnings, something not yet in existence, could not be the subject of an oral gift. To this contention the Supreme Court of California replied that it did not view the agreement simply as one involving a gift, that the Code permitted the parties by agreement to alter their legal relations as to property and that the effect of the agreement was to make the future earnings of the wife her separate property. It was held accordingly that the cause of action for the recovery of her earnings was her cause of action.

Again, in a very similar case,

Kaltschmidt v. Weber, 145 Cal. 596,

the Supreme Court of California said (p. 599):

> "And so also he (the husband) may under sections 158 and 159 of the Civil Code, contract with her (his wife) by an agreement that her personal earnings shall be her separate property and this may apply to future as well as past earnings *and the effect of such an agreement will be to convert such earnings from the status of community property to that of separate property of the wife.*"

An even more striking illustration of the operation of such agreements between husband and wife under the California Code sections is afforded by

Perkins v. Sunset, etc. Company, 155 Cal. 712.

Under the California law a cause of action for personal injuries suffered by a married woman, is community property and an action for damages by reason of them must be brought by the husband (*Moody v. Southern Pacific Co.*, 167 Cal. 786). But in the *Perkins case* such an action was brought by the wife who made the claim that prior to her suffering the injuries she and her husband had made a general agreement that all community property should be her separate property and also that after her injuries her husband had relinquished to her all interest in the particular cause of action by reason of them.

The rule generally prevalent elsewhere prevails in California that a cause of action for personal injuries cannot be assigned even after it has arisen, much less in advance of its arising. The defendant contended that this rule precluded the husband from transferring the cause of action to his wife and on this ground sought to reverse the judgment rendered in favor of the wife by the trial court. The Supreme Court held, however, that no point of assignment or transfer was involved, that under the Code sections as they had been construed by the courts the effect or operation of the agreement between the plaintiff and her husband was to change the status of after-acquired property from community into her separate property so that the cause of action was her separate property when it arose and she could maintain an action upon it and the judgment in her favor was a proper one.

While *Wren v. Wren* and *Kaltschmidt v. Weber,* to which we have referred, are both cases where by agreement the earnings of the wife were to be her separate property, it would seem hardly to require the citation of authority to show that the same effect should be given to agreements, such as the one now before the Court, changing the status of earnings of the husband. Under the California law the earnings of either spouse, while they are living together, are community property and subject to the control and beneficial enjoyment of the husband. There is no difference whatever between them. This being true, it would seem to follow necessarily that an agreement between husband and wife changing the status of the husband's earnings, would have exactly the same effect as a similar agreement as to the wife's earnings. But if there be any doubt about the matter, it in

turn is settled by the decision of the California Supreme Court in

Cullen v. Bisbee, 68 Cal. 695.

There a married woman brought suit upon a promissory note and the defense was made that the note was not her property but community property and therefore the property of her husband. The note was one given to her during coverture and in return for future services to be rendered, not only by her, but by her husband as well. If those future services were community property, the note given for them was necessarily community property and the defense was good. It appeared, however, that prior to the rendition of the services the plaintiff and her husband had agreed that the note to be given in consideration of them should be her separate property. The court held that this agreement was effective, that it made, not only her future personal services, but her husband's future personal services as well, her separate property, and that therefore the promissory note received by her in consideration of such services to be rendered was her separate property. The language of the court is (italics ours):

> "The effect of the transaction and the circumstances attending it were that Cullen (the plaintiff's husband) prior to the execution of the note made a gift to his wife of her future services in performance of the contract *and of his own services as well.* It is settled that this is a valid transaction between them under the sections of the Code above cited. (Sections 158, 159, 160, C. C.) *Wren v. Wren,* 100 Cal. 279, *Kaltschmidt v. Weber,* 145 Cal. 599. The consequence of this gift is that the consideration of the note (i. e., the services of both the plaintiff and her husband) was the separate property of the wife."

The effect or manner of operation of such agreements between husband and wife as the one now before the court is then something that has been definitely and certainly established. It is that under the permission given by the Code sections husbands and wives may, in California, by agreement, substitute for those legal incidents as to property which the statute attaches to their marital relations in the absence of an agreement, such incidents as they may agree upon. The agreement takes the place of the statute as fixing the property incidents of their relation and those incidents are determined and given effect exactly as if they were prescribed by a statute instead of by an agreement. They are in fact prescribed by statute since the statute as construed says that if the parties make an agreement as to the property incidents of their marriage relation, such an agreement shall govern and their property rights be as prescribed by it.

III.

IT NECESSARILY FOLLOWS FROM THE MANNER IN WHICH THE AGREEMENT BETWEEN THE RESPONDENT AND HIS WIFE OPERATES UNDER THE CALIFORNIA LAW THAT THE INCOME OF BOTH, INCLUDING THE PERSONAL EARNINGS OF BOTH, IS TO BE TAXED AS THE JOINT INCOME OF BOTH, AND NOT AS COMMUNITY PROPERTY.

Two things follow as necessary results of the agreement between the respondent and his wife operating in lieu of or by way of substitution for the statute. The first is that after-acquired property has from the very beginning the status or character agreed upon by the parties. Not

only is this a necessary result logically but the State Supreme Court has declared such to be the law. It must be taken therefore that in this case the after-acquired earnings of the husband had from the very beginning the status or character of joint property and never had the status or character of property acquired or held by the husband as his separate property or as community property.

The second result is that it is wholly immaterial that the property rights of the respondent and his wife are those prescribed by agreement and not by statute. The agreement is the equivalent and has the effect of a statute.

So viewing the case, the answer to the question which is now presented to the Court would seem to be clear. The case is one of income received and held by husband and wife as joint tenants. They so receive and hold it as an incident of their marriage relation. It follows that it should be considered as such for income tax purposes. This is certainly true unless there be a distinction between income derived from personal earnings and other income. But neither the California law nor the Federal Tax law make any such distinction. The California law makes the income of the respondent from his personal earnings the joint property of him and his wife in the same manner as all other income and the Federal law taxes income according to its character under the local law as community or separate, or joint income, without distinction between income from personal services and other income.

All this seems perfectly simple and perfectly clear but if anything is needed to further clarify it, it can be had by assuming that in this case the California statute expressly provided that all income of either husband and wife, including the personal earnings of either, should be the joint property of both. No one would think of questioning that under a statute so fixing the property incidents of the marital relation in California, all the income of both spouses from every source would be joint income and taxable as such. But that is exactly this case. The California statute, as construed by the Supreme Court of that state, prescribes that if husband and wife agree upon the property rights incident to their relation, the rights actually incident by law to the relation shall be those agreed upon. In this case the parties have so agreed and the effect and operation of the agreement is exactly that of a statute framed in the words of the agreement.

IV.

THE BASIC PRINCIPLE OF THE INCOME TAX LAW IS THAT IT IS A TAX ON INCOME BENEFICIALLY RECEIVED. APPLYING THIS PRINCIPLE THE INCOME IN THIS CASE MUST BE TAXED AS THE JOINT INCOME OF THE RESPONDENT AND HIS WIFE.

Regardless of all technical considerations as to just how the agreement between the respondent and his wife operated upon his subsequent earnings, there can be no doubt that the agreement was effective to prevent the respondent from receiving or at any time holding his earnings as their exclusive beneficial owner. It is clear

that the beneficial ownership of the respondent's earnings was at all times in him and his wife jointly. This simple fact is not questioned by the Government and cannot be and it would seem to be decisive.

The basic idea of the Income Tax law is that it is a tax on incomes beneficially received. This is the economic justification for the law. It is the idea upon which primarily its provisions have been drawn. For example, the tax is not on incomes as such, that is, on all income, but on net income alone. The idea of net income is beneficial gain to the taxpayer.

The same idea is found in the provisions respecting income of trustees. The tax is not on the income of the trustee or trustees but on the income of the beneficiaries under the trust. The share of each beneficiary in the trust income is taxed only as a part of his individual income. There are exceptions to this in certain cases, but those cases are of a character which emphasizes the fact that they are exceptions and that the general principle upon which the act proceeds is that it is income beneficially received that is the subject of the tax.

The same idea underlies the provisions that partnerships shall not pay an income tax on their income but each partner must pay a tax on his share of the partnership income as a part of his income beneficially received.

The same idea underlies the provisions that corporations shall pay a certain rate of tax on their incomes but no surtax and that stockholders shall not pay the normal income tax on corporation dividends but for the purpose of the surtax shall include such dividends in their individual incomes. It is recognized that while a corporation is a legal entity, the real beneficiaries of its income are its stockholders. Accordingly the stockholders are relieved from paying the normal tax on dividends received since that tax is in effect paid by the corporation, and, on the other hand, since the corporation pays no surtax, the dividends are taken into account in determining the surtaxes of the individual stockholders.

Such being the primary purpose of the statute it would seem that in every case where the question arises regarding some certain income or item of income, "Whose income is it for tax purposes?" the touch-stone to be applied is, "Whose income is it beneficially?" It is certainly *not* in accord with the purpose of the Act that anyone should pay a tax upon income he does not beneficially receive, either actually or potentially. It certainly *is* in accord with the purpose of the Act that everyone should pay a tax upon income that he does beneficially receive, either actually or potentially.

It is the touch-stone which this Court has itself applied to such cases. If we read correctly *United States v. Robbins*, 269 U. S. 315, in which it was decided that as between husband and wife the community income under the community property system of California was to be taxed as the income of the husband and not as the income of husband and wife, the fundamental fact upon which the court proceeded was that the husband, in spite of certain restrictions upon his exclusive power over community property, had the disposal and beneficial enjoyment of it.

It is certainly the touch-stone which this Court applied in *Old Colony Trust Co. v. Commissioner*, 279 U. S. 716. There an employer, as a part of its engagement with an employee, agreed to pay the income tax upon the latter's salary. The question presented to the court was whether or not the amount of the tax which the employer so agreed to pay should for the purposes of the tax be added to the employee's salary as part of the latter's income. It was held that it should be. It was so held upon the ground that while the employee did not actually receive the amount of the tax he did receive it in effect since it went to the discharge of a burden resting upon him, since, in other words, he had the benefit of it.

If this touch-stone be applied to the present case, it is decisive. There is no doubt that the income here involved was not received beneficially in its entirety by the respondent but was so received by both the respondent and his wife as joint tenants.

V.

THE REASONS ADVANCED BY COUNSEL FOR THE GOVERNMENT WHY THE INCOME INVOLVED SHOULD NOT BE TAXED ACCORDING TO THE CHARACTER IN WHICH THE SAME WAS RECEIVED BOTH LEGALLY AND BENEFICIALLY.

It being clear that under the agreement between the respondent and his wife his subsequent earnings were not in their entirety beneficially received and held by him but were so received and held by him and his wife as joint tenants, and it being clear as well that under the California law the effect of the agreement was to make his earnings as they accrued joint property of himself and his wife instead of community property, what are the reasons advanced on behalf of the Government why the income should not be taxed as joint income but as the income exclusively of the respondent?

(a) The Reason Advanced in the Lower Court.

The reason advanced in the lower court was not the same as that now advanced in the brief before this Court. The reason advanced in the lower court was primarily that the effect of the agreement was only that of an equitable assignment, that the earnings of the respondent were in the first instance his property alone and that it was only after he received them that the agreement operated to give his wife an interest in them, that accordingly at the moment of their receipt there was an instant of time in which the legal title to the earnings vested in the husband alone and that therefore they were subject to tax as a part of his income.

This line of reasoning or argument flies directly in the face of the decisions of the Supreme Court of California as to the effect of such agreements between husband and wife. Those decisions, as we have pointed out, hold that such agreements do not operate by way of assignment but by way of establishing the incidents as to property which attach to the relation of husband and wife so that as to after-acquired property they do not operate by way of changing the character or status of the property after it is acquired but operate to fix the character or status in which it is acquired.

The line of reasoning or argument on behalf of the Government in the court below also ignores the very apparent fact, that even if it were true that the agreement operated by way of an equitable assignment and there was at the moment of the receipt of the property an instant of time when the husband held it as exclusively his own, he would so hold it only as a naked trustee. In ignoring this fact the argument flies directly in the face of the basic principle or purpose of the income tax law to tax income beneficially received and likewise in the face of the particular rule that income received as a trustee is taxable not as income of the trustee but as income of the beneficiary.

O'Malley-Keyes v. Eaton, 24 Fed. (2d) 436;
Young v. Guichtel, 28 Fed. (2d) 789;
Bowers v. New York Trust Co., 9 Fed. (2d) 548.

It likewise flies directly in the face of the repeated ruling of the Board of Tax Appeals that under the community property system, in a case where husband and wife agree that the latter's earnings are to be her separate property, the earnings of the wife are to be taxed as part of her income and not as a part of her husband's.

Louis Gassner, 4 B. T. A. 1071;
E. C. Busche, 10 B. T. A. 1345;
Francis Krull, 10 B. T. A. 1096;
Allen Harris, 10 B. T. A. 1374.

We understand these rulings have been acquiesced in by the Government. But under the community property system of California the earnings of the wife while the parties are living together are in exactly the same category as earnings of the husband. There is no distinction whatever between them. Both are community income. If an agreement between husband and wife may change the status of the earnings of one for income tax purposes, there is no possible reason why it should not similarly operate to change the status of the earnings of the other.

(b) The Reason Advanced in This Court.

The brief of the Government in this Court does not advance the claim made in the court below as to the manner in which such agreements as the one before the Court operate. Presumably it does not do so because counsel have realized that the claim is directly opposed to the rulings of the State Supreme Court and that, because such rulings are rulings as to the local law, they are binding on the Federal courts.

Instead, the claim is now advanced that it was the purpose of Congress, as expressed in the Income Tax law,

> "that salaries, wages and compensation for personal services are to be taxed as an entirety and therefore must be returned by the individual who has performed the services which produced the gain" (Brief for the Petitioner, p. 6).

This claim is the sum and substance of the brief for the Government before this Court. No other argument or contention to support the position of the Government is advanced.

The claim is one that is without support either in the language of the Act or in the decisions of the courts construing it. Not only this, but it is directly opposed to provisions of the Act and to regulations of the Treasury Department which either prescribe or permit that com-

pensation for personal services be not taxed as an entirety and be not returned by the individual performing the services.

The only language of the income tax law to which counsel refer in support of their position as to its meaning is that of Section 213, as to which they say:

> "Section 213 defines gross income and includes therein 'gains, profits and income derived from salaries, wages or compensation for personal services'."

Counsel do not explain how this language supports the contention either that compensation for personal services is to be taxed as an entirety in a case where it is not beneficially received as an entirety, or that compensation for personal services must be returned by the individual who performed the services in a case where such individual is not the person who beneficially receives it. Their argument as set forth in their brief consists practically in the bald assertion that the language of the Act just quoted above supports their position. We do not follow them. To us just the contrary seems clear.

It is to be noted that by the language of the Act it is not "salaries, wages or compensation for personal service" that are to be included in gross income. That which is to be included is "gains, profits and income derived" from salaries, wages or compensation for personal service. Since it is not the salary, the wage or the compensation that is to be included, but only the gain, profit or income that may be derived therefrom, it would seem plain that salaries, wages or compensation for personal service are not to be taxed as an entirety unless in their entirety they are gains, profits and income. Since, also, it is the gain, profit or income to the individual that is to be taxed, it would seem plain that it is only the amount of such salaries, wages or compensation as is gain, profit or income to the individual, that is, such amount as the individual beneficially receives, for which he is to be taxed.

These conclusions as to the meaning of the Act are made even plainer when the language quoted and relied upon by counsel for the Government is read in its context. Omitting certain immaterial portions, Section 213, as in effect for the years involved here, read:

> "For the purposes of this Title * * * the term 'gross income'
>
> (a) Includes gains, profits and income derived from salaries, wages or compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer * * *."

It will be noted at once that no distinction is made between "gains, profits and income" which are derived from personal earnings and those which are derived from other sources, derived as rents, for example, from real property. So far as the text indicates, one is to be taxed exactly as the other. Unless "gains, profits and income" from other sources are to be taxed as an entirety, regard-

less of how they are beneficially received, there can certainly be no inference that "gains, profits and income" from earnings for personal service are to be so taxed. But it is manifest that "gains, profits or income" from other sources are not to be so taxed. It would hardly be claimed that rent payable under a lease to two persons, either separately or jointly or to one of them for the benefit of both, should be taxed as an entirety and not as divided between them in accordance with their beneficial interests.

The fair inference from the text of the Act is, we submit, that "gains, profits and income" from whatever source are to be taxed alike and that they are to be taxed to the individuals who get a gain, profit or income and to the extent of the respective gain, profit or income of such individuals, in other words, in accord with their beneficial interests.

We have stated that the contention of counsel is directly opposed to provisions of the Act. So far as we are aware, in every case where the Act deals with compensation for personal service which is not in its entirety beneficially received by the person performing the service, the provision is that it shall be taxed as the income of those who beneficially receive it and in the amounts in which they beneficially receive it. This would seem to be decisive as to the purpose of the Act.

The outstanding instance of compensation which is not beneficially received in its entirety by the person rendering the service is that of service rendered by a member of a personal service partnership, a member of a law firm, for example. The compensation for services so rendered is not taxable in its entirety either as part of the income of the firm or as a part of the income of the particular partner rendering the service. It is not even taxable directly. It is taxable only indirectly to the extent to which it enters into and forms a part of the net earnings of the firm. It is only the share of each partner in the net earnings, that is, his beneficial interest, that is subject to the tax. The income upon which a partner in such a firm is required by the law to pay a tax has no necessary relation whatever to the compensation that may have been received for personal service rendered by him. The income upon which he must pay a tax is determined exclusively by his beneficial interest in the income of the firm. Even if a partner in such a firm performed no service at all, had retired, for example, yet if he had an interest in the earnings of the firm he would be taxable for such interest and his partners would not be.

Exactly the same thing was true as to personal service corporations under the Income Tax law in effect in the years 1920 and 1921, the years involved here. Section 218, subd. (e) of both the Act of 1918 and the Act of 1921, provide:

> "Personal service corporations shall not be subject to taxation under this Title but the individual stockholders thereof shall be taxed in the same manner as the members of partnerships."

Another striking instance where compensation for personal service is not taxable as income of the person rendering the service is that of the earnings of either husband or wife under the community property system. In California, since its community property law was changed in 1927, and in other community property states both before and since that time, husbands and wives may under the Regulations of the Treasury (Art. 31, Regulations 45 and 62) render separate tax returns and may each report as gross income one-half of the community income. This applies to the earnings of the spouses as well as to other community income. The regulation is manifestly based on the fact that the wife, under the community property system, is taken to have a one-half interest in the community property and in the community income. In other words, in such instances neither the earnings of the husband nor of the wife are taxable in their entirety. They are divided between husband and wife and taxed according to their respective beneficial interests.

Another illustration of the same thing is the taxation of the earnings, prior to 1917, of a married woman in California, living with her husband. Under the decision of this Court in *United States v. Robbins,* above referred to, all community income in that state had to be returned as the income of the husband. This included the earnings of a wife living with her husband. The result was that such earnings were not returnable in any amount as the earnings of the person rendering the service, that is, the wife, but as the earnings of the person who, as we read the decision of this Court, beneficially received them, that is, the husband.

We repeat our statement that the contention of counsel that it was the purpose of the Federal Tax Act to tax gains, profits and income derived from personal service as an entirety and that they should be included in the return of the individual rendering the service, is wholly without support and is in fact contrary to the true purpose of the Act. That purpose, we submit, is plainly that taxable income from whatever source derived should be taxed to those persons who beneficially receive it and in the proportions in which they so receive it. If this be true, it is decisive of this case for it is not questioned and cannot be questioned that the income in controversy here was beneficially received by the respondent and his wife jointly and not by the respondent exclusively.

Respectfully submitted,

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