

California Law Review

Volume XXIV

JULY, 1936

Number 5

The Scope and Nature of the California Income Tax

THE TAX IN RELATION TO STATE FINANCES

THE incorporation of an income tax in the state fiscal system resulted from the search for new sources of revenue to alleviate the critical condition of state finances. A sharp decline in state revenues together with increased expenditures caused a surplus of \$31,000,000 on June 30, 1931 to give way to a deficit of some \$11,000,000 two years later. Early in the legislative session of 1933, it became evident that the state would face a deficit of approximately \$51,000,000 in 1935, even with a budget reduced by \$40,000,000, unless it enlarged its tax structure. The legislature set about this task in 1933 by adopting the following measures: increased tax rates on the gross receipts of public utilities¹ and on inheritances,² amendments to the Bank and Corporation Franchise Tax Act increasing the rates on banks and eliminating the offset of real and personal property taxes,³ the imposition of a tax on wine and beer,⁴ and the imposition of a gross receipts tax on contract truck operators to equalize the tax on common carrier highway transportation companies.⁵ Even these combined measures, however, assured only a liquidation of the existing deficit of \$11,000,000; \$40,000,000 of the reduced state budget still remained unprovided for.

Meanwhile the legislature turned its attention to the problem of local property tax relief. It proposed the constitutional amendment⁶ adopted at a special election June 27, 1933, shifting to the state an additional burden, previously borne by the counties through direct property taxation, of approximately \$80,000,000 per biennium for the

¹ CAL. POL. CODE §3664a added by Cal. Stats. 1933, p. 908.

² Cal. Stats. 1933, p. 2693.

³ Cal. Stats. 1933, pp. 40, 687, 692, 869.

⁴ Cal. Stats. 1933, c. 178, p. 625.

⁵ Cal. Stats. 1933, p. 928.

⁶ Senate Constitutional Amendment 30, known as the Riley-Stewart plan. For text of amendment see Cal. Stats. 1933, pp. 3072-3078.

support of the public schools.⁷ The amendment at the same time provided for the abandonment, effective January 1, 1935, of the gross receipts tax on public utilities, which had been levied exclusively for state purposes since 1910, and the return of public utility property to local tax rolls.⁸ As a result, the state, notwithstanding its additional revenue of \$11,000,000, still lacked \$120,000,000 necessary to balance the budget. In this emergency, the legislature adopted a 2½% retail sales tax,⁹ variously estimated to yield between \$80,000,000 and \$112,000,000, and a personal net income tax at rates ranging from 1 to 5%, estimated to yield between \$7,000,000 and \$12,000,000. The Governor's veto of the income tax made it certain that the biennium would close on June 30, 1935, with a deficit; the actual deficit on that date exceeded \$19,000,000.

That deficit threatened to grow dangerously large in the following years. The budget for 1935-37, providing for general fund expenditures of \$228,000,000, exceeded the preceding budget by \$74,000,000. The increase was largely attributable to an appropriation of \$48,000,000 for unemployment relief, increases in appropriations for payments to the aged, orphans and blind, and interest and redemption on relief bonds issued during the 1933-35 biennium. Meanwhile, with the return of public utility property to local tax rolls, the 1935 legislature faced not only the existing deficit, but a loss of approximately \$60,000,000 in revenue. Under these circumstances, it was generally agreed that the imposition of a personal net income tax was not only advisable but inevitable.

The Act finally passed by the legislature and approved by the Governor on June 13, 1935,¹⁰ provides for rates ranging from 1 to 15%, approximately one-fourth the rates imposed by the Federal Revenue Act of 1934.¹¹ Even with the \$18,000,000 estimated revenue from this Act, together with the additional revenue resulting from state taxation of motor vehicles in lieu of county taxation,¹² increase in inheritance,¹³

⁷ CAL. CONST. art. XIII, §15 as amended June 27, 1933.

⁸ CAL. CONST. art. XIII, §14 as amended June 27, 1933. See also CAL. CONST. art. XIII, §14½, adopted June 27, 1933.

⁹ Cal. Stats. 1933, p. 2599.

¹⁰ Cal. Stats. 1935, c. 329, p. 1090.

¹¹ Since dividends from stock are taxable under the state Act at the same rates as other income, whereas under the Federal Act, dividends, although subject to the surtax, are exempt from the normal tax, and since no credit for earned income is granted by the state Act similar to that allowed by the Federal Act it may sometimes happen that the tax will exceed one-fourth the federal tax.

¹² Cal. Stats. 1935, p. 1312.

¹³ Cal. Stats. 1935, p. 1266.

sales,¹⁴ and bank and corporation franchise tax rates¹⁵ and taxation of distilled spirits¹⁶ provided by the 1935 legislature, it is currently estimated that the state deficit on June 30, 1937 will exceed \$40,000,000.

PROVISIONS OF THE ACT

The Act¹⁷ makes no distinction between normal tax and surtax, but provides one rate structure for all net income, including dividends and earned income of individuals, estates and trusts received or accrued on or after January 1, 1935. Residents of the state are taxable upon all their net income, regardless of whether its sources are within or without the state. Non-residents are taxable only upon income from sources within this state.

Estates are taxable upon all their income, including income from sources without the state, which is not properly paid or credited to beneficiaries during their taxable year, if either the decedent, the fiduciary, *i.e.* the executor or administrator, or the beneficiaries are residents of the state.¹⁸ If none of these parties are residents, the tax applies only to income from sources within this state. Similarly, trusts are taxable upon all income to be accumulated for future distribution, regardless of the source from which derived, if either the settlor, the trustee, or the beneficiaries are residents of this state, but are taxable only upon income from sources within this state which is to be accumulated if all of these parties are non-residents.¹⁹ Income of an estate or trust which is properly paid or credited or distributed or distributable to the beneficiaries, and which is not taxable to the estate or trust, is taxable to the beneficiaries in its entirety in the case of resident bene-

¹⁴ Cal. Stats. 1935, p. 1252. Notwithstanding that receipts from the sale of foodstuffs were exempted at the same time the rate of tax was increased from 2½ to 3%, it is estimated that the tax will yield, due largely to improved business conditions, a total of \$145,000,000 during the 1935-37 biennium, approximately \$40,000,000 more than during the 1933-35 biennium.

¹⁵ Cal. Stats. 1935, p. 1245.

¹⁶ Cal. Stats. 1935, p. 1123.

¹⁷ The Act is administered by the Franchise Tax Commissioner, hereinafter referred to as the Commissioner. The Commissioner has issued a comprehensive set of regulations, copies of which may be obtained at a cost of fifty cents per copy from the Superintendent of Documents, Room 214, State Capitol, Sacramento, California.

¹⁸ See §12(a) and (b).

¹⁹ *Ibid.* The Act provides that where the taxability of the income of an estate or trust depends upon the residence of the fiduciary or the beneficiary, and there are two or more fiduciaries, or two or more beneficiaries, the taxable income shall be apportioned according to the number of fiduciaries or beneficiaries that are residents of the state, the apportionment being made in accordance with regulations prescribed by the Commissioner. These provisions will be discussed in a subsequent issue of the Review.

ficiaries, and to the extent derived from sources within this state in the case of non-resident beneficiaries.²⁰

The Act follows the Federal Act with respect to partnerships. Thus partnerships, although not taxable as such, are required to file returns disclosing the members' distributive shares of the partnership income which are taxable to the individual partners whether distributed or not.²¹

To prevent tax avoidance through the creation of corporations to receive and hold the income from securities, the Act provides that a personal holding company—defined as in the Federal Act²²—shall not be regarded as an entity separate and distinct from the shareholders.²³ Accordingly, the income of such a company is taxable to the shareholders to the same extent as if it were received directly by the shareholders, instead of by the company.

Income may be computed under the Act as under the Federal Act, either on the accrual basis or on the basis of cash receipts and disbursements,²⁴ and may be reported either on a calendar year or fiscal year basis.²⁵ Taxpayers are allowed three months and fifteen days after the

²⁰ See §12(c) (2) and (3). The Act, like the Federal Revenue Act, provides that the income of a trust shall be taxable to the grantor if the trust is revocable or if the income is to be accumulated for future distribution to the grantor, or is to be used to pay premiums on life insurance policies on the grantor's life. See §12(g) and (h). In all other cases the income is either taxable to the trust or to the beneficiaries, depending on whether it is to be accumulated or distributed.

²¹ §22.

²² §2(o). In order to be a personal holding company within the meaning of this definition (1) 80% or more of the corporation's gross income for its taxable year must be derived from royalties, dividends, interest, annuities and gains from the sale of stock or securities, and (2) at some time during the last half of the taxable year more than 50% in value of the corporation's outstanding stock must be owned directly or indirectly, by or for not more than five individuals. An individual is considered as owning the stock owned by the members of his family, including brothers, sisters, spouse, ancestors and lineal descendants.

²³ §34.

²⁴ See §16(a) and Regulations art. 16(a)-2. The regulations provide, however, that regardless of the method of accounting employed, income which is constructively received, *i.e.*, credited to or set apart for the taxpayer and unqualifiedly made subject to his demand, must be reported as income for the year so credited or set apart, even though not actually received or reduced to possession. Thus, even though a taxpayer reports on the cash receipts and disbursements basis, interest coupons must be reported as income for the year in which the coupons mature and the interest is payable even though the coupons are not cashed, and interest on bank deposits must be reported as income for the year in which credited even though not withdrawn. See Regulations art. 16(a) 2 and 3. Furthermore, in the case of the death of a taxpayer, the return for the year in which the death occurs must be made on the accrual basis regardless of the method of reporting formerly employed. Thus, income earned prior to the date of death must be reported even though not received, and items incurred may be deducted even though not paid. See §16(d) and (e).

²⁵ See §16(a). A fiscal year is defined in section 2(i) as an accounting period of twelve months ending on the last day of any month other than December.

close of their taxable years, a month longer than under the Federal Act, in which to prepare and file returns,²⁶ and may either pay the entire tax within that time or pay it in three equal installments.²⁷ In all other respects the requirements respecting the filing of returns are the same as under the Federal Act. Thus, a single person must file a return if his net income amounts to \$1,000 or more, or if his gross income amounts to \$5,000 or more regardless of the amount of his net income.²⁸ This rule also applies to a married person not living with husband or wife during any portion of the taxable year,²⁹ and to estates and trusts.³⁰ A husband and wife living together during the entire taxable year must either file a joint return,³¹ or each must file a separate return,³² if the combined net income amounts to \$2,500 or more, or if

Section 16(a) provides that if the taxpayer's annual accounting period is other than a fiscal year, or if the taxpayer has no accounting period, or does not keep books, the income shall be computed on the basis of the calendar year.

²⁶ See §13(b). Failure to file a return within the time specified in the Act not only constitutes a misdemeanor punishable by fine or imprisonment or both, (See §30) but also subjects the taxpayer to a penalty of 25% of the amount of the tax unless it is due to reasonable cause, or unless an extension of time is granted. (See §15(a)(1)). Extensions of time may be granted up to a maximum period of six months. See §13(c).

²⁷ See §14(b). *Cf.* section 56(b), Federal Act of 1934, which permits payment in four equal installments.

²⁸ See §3(a)(1) and (3).

²⁹ *Ibid.*

³⁰ See §4(a)(4) and (5). In addition to filing a return for the estate for which he acts, the executor or administrator must file a return for the decedent for the year in which the decedent died, if the decedent's income from the beginning of the decedent's taxable year until the date of death was equal to or in excess of the credit allowed by section 10(a) and (c) computed without regard to his status as head of a family, or if his gross income for such period amounted to \$5,000 or over.

³¹ A joint return may be filed by a husband and wife only if they were living together at the close of their taxable year. See art. 3-1(a).

³² The Regulations provide, (See par. (a) of art. 3-2) that "If separate returns are filed by a husband and wife, each must report the income from his or her separate property. Furthermore, each must report one-half of the combined income of both from wages, salaries and other compensation for personal services performed by either or both, except that the entire earnings of the wife while living separately must be reported by the wife. If the husband and wife own any community property, and separate returns are filed, each must report one-half of the income from such property whether they live together or separately."

The Commissioner has also ruled, in accordance with the federal practice, that income from community property acquired before June 29, 1927 (the effective date of the amendment to Section 161a of the Civil Code providing that the respective interests of the husband and wife in community property are "present, existing, and equal") is returnable by the husband alone (see *Robbins v. United States* (1926) 269 U. S. 315) and that each may separately return one-half of the income from community property acquired after June 29, 1927. See *United States v. Malcom* (1931) 282 U. S. 792; *Poe v. Seaborn* (1930) 282 U. S. 101 and par. (b) of art. 3-2.

the combined gross income, regardless of the amount of net income,³³ amounts to \$5,000 or more.

With the exception that no credit is allowed for earned income, the exemptions and credits allowed by the Act also parallel those of the Federal Act. Thus, single persons, married persons not living with husband or wife during any portion of the taxable year,³⁴ and estates or trusts³⁵ are granted an exemption of \$1,000. A head of a family³⁶ and a husband or wife living together during the entire taxable year are allowed an exemption of \$2,500.³⁷ In addition, each individual is entitled to a credit of \$400 for each dependent other than husband or wife.³⁸ In the case of a change of status during the taxable year, the Act provides that the above exemptions and credits shall be apportioned under such rules and regulations as are prescribed by the Commissioner, according to the number of months before and after such change.³⁹

³³ A married person living with husband or wife for any part of the taxable year, but not at the close thereof, must file a return if his gross income is \$5,000 or over, or his net income equals or exceeds the credit to which he is entitled under section 10(a) and (c) computed without regard to his status as the head of a family. A husband and wife living together at the close of the taxable year but not during the entire taxable year must either file a joint return or each must file a separate return if their combined gross income is \$5,000 or over, or if their combined net income equals or exceeds the credit to which they are entitled under section 10(a) and (c), computed without regard to the status of either as the head of a family. See note 39, *infra*, as to the credit allowable under section 10(a) and (c).

³⁴ §10(a).

³⁵ §12(d).

³⁶ §10(a). A head of a family is defined in the Regulations (art. 10-2) as one who actually supports and maintains in one household one or more individuals who are closely connected with him by blood relationship, relationship by marriage, or by adoption, and whose right to exercise family control and provide for these dependent individuals is based upon some moral or legal obligation.

³⁷ §10(a). If separate returns are filed by husband and wife, each may take one-half of the exemption allowed them for the period they were living together or by agreement between them, the exemption may be taken by either or divided between them in any proportion. See art. 10-1.

³⁸ §10(b). A dependent must be chiefly supported by the taxpayer and must be under eighteen years of age or incapable of self-support because mentally or physically defective.

³⁹ §10(c). This section further provides that for the purpose of such apportionment a fractional part of a month shall be disregarded unless it amounts to more than half a month in which case it shall be considered as a month. The Commissioner's Regulations under this section follow art. 25-7 of Fed. Reg. 86. In accordance with these regulations, a person having the status of head of a family for the six months of the taxable year and the status of a single person for the balance of the year, would be entitled to an exemption of \$1,750, *i.e.*, $\frac{6}{12}$ of \$2,500 plus $\frac{6}{12}$ of \$1,000.

A husband and wife living together during six months of the taxable year only are together entitled to an exemption of \$1,250, *i.e.* $\frac{6}{12}$ of \$2,500 for the period they live together plus \$500 for each, *i.e.* $\frac{6}{12}$ of \$1,000 for the balance of the year. Thus, if a joint return is filed, (which could be done only if they were living together at the close of the taxable year, see note 31, *supra*), an exemption of \$2,250 could be

The definitions of net income⁴⁰ and gross income⁴¹ are the same as in the Federal Act, except in their specific provision that compensation

taken. If separate returns are filed, each would be entitled to an exemption of \$1,125, i.e. $\frac{1}{2}$ of \$1,250 plus \$500. Since the exemption allowed for the period they were living together may by agreement be taken by either or divided between them in any proportion whatsoever, one could take a total exemption of \$1,750 in which event the other would have an exemption of \$500.

The credit for dependents is apportioned according to the number of months of the taxable year during which the taxpayer furnished the chief support of a person having the status of a dependent. Thus, if a person is a dependent for only six months of the taxable year the taxpayer may take a credit of \$200, i.e. $\frac{1}{2}$ of \$400.

In the case of death the exemption is apportioned according to the status before death and according to an assumed status as a single person for the remaining months of the year in which the death occurred. Thus, if a head of a family reporting on a calendar year basis dies on June 30 the executor or administrator of the estate in reporting the income of the decedent for the six months period prior to death may take an exemption of $\frac{1}{2}$ of \$2,500 plus $\frac{1}{2}$ of \$1,000, or a total exemption of \$1,750. If the decedent had been a married person living with husband or wife for the six months prior to death, the executor or administrator reporting the income for such period could take an exemption of $\frac{1}{2}$ of \$1,250 (assuming an equal division of the exemption for married persons between the decedent and the surviving spouse which would be the case unless the executor or administrator and the surviving spouse agreed upon some other division), plus $\frac{1}{2}$ of \$1,000, or a total exemption of \$1,125. If the decedent had been a single person during the six months prior to death, the executor or administrator reporting the income for that period may take an exemption of $\frac{1}{2}$ of \$1,000 plus $\frac{1}{2}$ of \$1,000 or a total exemption of \$1,000.

The above Regulation is apparently based upon the premise that the death of the taxpayer does not close his taxable year. Accordingly, the return for the decedent is made for a full twelve months period and a corresponding exemption for a full twelve months period is allowed. It was evidently considered improper to allow the exemption at the \$2,500 rate for a decedent married person or head of a family for the months of the year after death, as to do so involves the absurd implication that a person is living with husband or wife or maintaining a household and supporting a relative therein after death. Is it not equally absurd, however, to assume that a person has the status of a single person after death? This assumption engenders incongruous results. A single person's estate, for example, is allowed a full \$1,000 exemption for the year of his death, while an exemption is allowed the decedent for the same period. The aggregate exemption of the estate and decedent, assuming, as is generally the case, that the estate reports upon the same calendar or fiscal year basis as the decedent, is then \$2,000, or twice the exemption the decedent would have been allowed had he remained alive.

Although the Commissioner maintains a consistency between the state and federal interpretations of identical statutory provisions by following the federal regulation, it would seem more logical to provide that the total exemption of a decedent should be limited to that proportion of the exemption for a full taxable year as the number of months before death bears to twelve months, and to limit the exemption of an estate for its first taxable year to that proportion of \$1,000 which the number of months following the death of the decedent bears to twelve months. Thus, in the case of a single person reporting on a calendar year basis and dying on June 30, an aggregate exemption of but \$1,000 could be taken by the decedent and the estate for the year in which the death occurred.

⁴⁰ Net income is defined as gross income less the deductions allowed. §6.

⁴¹ Gross income includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid,

of officers and employees of the state or political subdivisions thereof shall be included in gross income. The Act likewise follows the Federal Act in providing that amounts paid under life insurance policies by reason of the death of the insured, gifts, compensation for personal injuries or sickness, and the rental value of dwelling houses furnished ministers of the gospel shall be excluded from gross income and exempt from tax.⁴²

The provisions of the Federal Act relating to the basis for determining gains or losses from the sale or other disposition of property, the recognition of such gains or losses, the limitations upon the taxation of capital gains and the deduction of capital losses are incorporated in the state Act.⁴³ The provisions of the Federal Act governing the deduction of expenses, taxes, interest, depreciation, depletion, obsolescence, charitable contributions, are for the most part not incorporated by reference,⁴⁴ but expressly set forth in the state Act with variations applicable only to non-residents.⁴⁵

Deficiency assessments for any year under the Act, as under the Federal Act, must be proposed within three years after the filing of the return for such year.⁴⁶ This rule, however, does not apply to assessments based on fraudulent returns nor to additional assessments for periods for which no returns are filed, which may be imposed at any time without limitation.

Overpayments of tax for any year either through a clerical mistake or otherwise, and regardless of whether or not paid under protest or under demand from the Commissioner, may be refunded to the tax-

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, and includes any salary, wages or compensation of any officer or employee of this state, or any political subdivision, district or municipality thereof. §7.

⁴² §7(b).

⁴³ See section 7(d) and (e) incorporating by reference sections 111, 112, 113 and 117 of the Federal Revenue Act of 1934.

⁴⁴ §8.

⁴⁵ Since non-residents are taxable only upon income from sources within this state they are allowed the deductions provided for in section 8 only in so far as these are related to income from sources within this state. See §8(n). The validity of restricting the deductions of non-residents in this manner is settled. *Shaffer v. Carter* (1920) 252 U. S. 37; *Travis v. Yale and Towne Mfg. Co.* (1920) 252 U. S. 60. Section 8(1) limits deductions for charitable contributions of non-residents, to contributions to (1) corporations or associations organized under the laws of this state; to (2) the Vocational Rehabilitation Fund, authorized by section 12 of the World War Veterans' Act, and to (3) this state or its political subdivisions for exclusively public purposes.

⁴⁶ §19.

payer or credited against taxes due from him.⁴⁷ The Act provides, however, that no such credit or refund shall be made unless a claim for refund is filed within three years from the time the return was filed or within two years after the overpayment was made, whichever period expires the later.⁴⁸

The provisions of the Act respecting interest on delinquent assessments,⁴⁹ the provisions for protesting proposed deficiency assessments,⁵⁰ and for appeals⁵¹ are similar to the federal provisions, with the State

⁴⁷ §20. It has been argued that a taxpayer cannot recover taxes in the event of the unconstitutionality of the Act or of an erroneous ruling by the Commissioner, unless he paid them under protest pursuant to notice and demand from the Commissioner and then instituted action against the State Treasurer within ninety days after the Commissioner's notice and demand. This argument is based upon section 21 which provides "Any taxpayer claiming that the tax computed and levied against him is void in whole or in part may pay the tax under protest and bring an action against the State Treasurer for the recovery of the whole or any part of the amount paid. The protest must be in writing under oath and must state in detail the grounds upon which the claim is founded. Such action must be filed within ninety days after the notice and demand for the payment of the tax under sec. 19 hereof; . . ."

This argument completely ignores section 20 which provides "If in the opinion of the commissioner, or State board, as the case may be, a tax has been computed in a manner contrary to law or has been erroneously computed by reason of a clerical mistake on the part of the commissioner or said board, or, if any tax, penalty or interest has been paid more than once, or has been erroneously or illegally collected, or has been erroneously or illegally computed, such fact shall be set forth in the records of the commissioner, and the amount collected in excess of what was legally due shall be credited on any taxes then due from the taxpayer under this act, and the balance refunded to the taxpayer; but no such credit or refund shall be allowed or made after three years from the time the return was filed by the taxpayer or within two years from the time the tax was paid, whichever period expires the later, unless before the expiration of such period a claim therefor is filed by the taxpayer." It is clear that this section does not require that taxes be paid under protest or pursuant to notice and demand from the Commissioner as a condition to obtaining a refund thereof. On the contrary, since it specifically authorizes refunding of taxes which have been "computed in a manner contrary to law" or which have been "illegally collected" or "illegally computed" overpayments of taxes may clearly be recovered by filing claims for refund regardless of the grounds upon which the claims are based and regardless of whether paid under protest, in pursuance of notice and demand from the Commissioner or otherwise. See Opinion of Attorney General, by H. H. Linney, Deputy, No. 10579.

⁴⁸ §20.

⁴⁹ §15. Delinquent assessments bear interest at the rate of 1% per month from the due date until the date paid. Deficiency assessments bear interest at the rate of 6% per annum from the due date of the return on which based until the date assessed, and at the rate of 1% per month from such date until the date paid if not paid within 10 days after the date assessed.

⁵⁰ §19. Taxpayers are allowed sixty days after the mailing of notice of a proposed deficiency assessment within which to file a protest. The protest must be in writing, under oath, and must state the grounds upon which the protest is based.

⁵¹ §§19, 20. If the Commissioner overrules a taxpayer's protest to a proposed deficiency assessment, the taxpayer is allowed thirty days from the date of the mailing of notice of such action to appeal to the State Board of Equalization.

Board of Equalization occupying a position corresponding to that of the United States Board of Tax Appeals.⁵²

While the Act is based largely upon the Federal Revenue Act of 1934, it contains, like most state acts, many provisions not found in the Federal Act. Subsequent articles will analyze these provisions, particularly those peculiar to California. The constitutionality of some of the more important features of the Act, however, must first be considered.

THE TAX DISTINGUISHED FROM A PROPERTY TAX

State income tax laws must observe not only the jurisdictional limitations on the taxation of income from sources outside the state, and on the taxation of the income of non-residents, and other limitations imposed by the United States Constitution, but also the provisions of the respective state constitutions. While income taxes are expressly prohibited in only one state constitution, that of Florida,⁵³ they are effectively barred in certain other states by constitutional provisions respecting property taxes.

The underlying premise of judicial decisions in such instances has been that an income tax is essentially a property tax and must, accordingly, meet the requirement common to state constitutions that property be taxed in proportion to value at uniform rates. This premise has been based on the theory either that (1) to tax income from property is to tax the property from which the income is derived,⁵⁴ or that (2) income itself, regardless of source, is property and a tax thereon is therefore a property tax.⁵⁵ Under the first theory, the tax, if imposed at gradu-

⁵² The Act provides (§§19, 20, 21) that within sixty days after the determination of the State Board of any appeal from the action of the Commissioner, either the Commissioner or the taxpayer may petition the Supreme Court to review the decision of the board. The California Supreme Court recently held, however, that the State Board of Equalization cannot exercise judicial functions and that accordingly its decisions may not be reviewed by the court. *Standard Oil Co. of Calif. v. State Board of Equalization* (June 23, 1936) 92 Cal. Dec. 7; *Carson Estate Co. v. State Board of Equalization* (June 23, 1936) 92 Cal. Dec. 12.

⁵³ FLA. CONST. art. 9, §11.

⁵⁴ *Opinion of the Justices* (1915) 220 Mass. 613, 108 N. E. 570; *Trefry v. Putnam* (1917) 227 Mass. 522, 116 N. E. 904; *Maguire v. Tax Comm.* (1918) 230 Mass. 503, 120 N. E. 162, *aff'd* in *Maguire v. Trefry* (1920) 253 U. S. 12; *Eaton Crane & Pike Co. v. Commonwealth* (1921) 237 Mass. 523, 130 N. E. 99; *Hart v. Tax Comm.* (1921) 240 Mass. 37, 132 N. E. 621; *Opinion of the Justices* (1929) 266 Mass. 583, 165 N. E. 900; *Opinion of the Justices* (1930) 84 N. H. 559, 149 Atl. 321.

⁵⁵ *Board of Revenue of Montgomery County v. Montgomery Gas-Light Co.* (1879) 64 Ala. 269; *Eliasberg Bros. v. Grimes* (1920) 204 Ala. 492, 86 So. 56, 11 A. L. R. 300; *Ex parte Morrill-Doyle Realty & Ins. Co.* (1925) 213 Ala. 697, 106 So. 63; *State v. Pinder* (1919) 30 Del. 416, 108 Atl. 43; *Bachrach v. Nelson* (1932) 349 Ill. 579, 182 N. E. 909; *Opinion of the Justices* (1915) 77 N. H. 611, 93 Atl. 311; *Kelley v. Kalodner* (Pa. 1935) 181 Atl. 598; *Evans v. McCabe* (1932) 164 Tenn. 672, 52 S. W. (2d) 159; *Jensen et al v. Henneford* (Wash. 1936) 53 P. (2d) 607;

ated rates, or if imposed only on income in excess of certain amounts, or if imposed on some classes of taxpayers but not on others, would fail to comply with the requirement that all property be taxed in proportion to value at a uniform rate. Even though the tax were imposed at a uniform rate and were applicable to all income from property without any exemptions or exceptions whatsoever, property would still not be taxed in proportion to its value under this theory, since the value of property does not always vary in proportion to its income, and it may have value even though no income is derived therefrom. Under the second theory, a tax at a uniform rate applicable to all income of all taxpayers would meet the requirements that all property be taxed in proportion to value at a uniform rate, but a graduated tax or a tax applicable to the income of some classes of taxpayers only, or a tax applicable only to income in excess of certain amounts, would not comply with these requirements.

The California tax, if it were a property tax under either theory, would unquestionably fail to meet the usual requirements of such a tax. It is graduated, it does not apply to the income of corporations, and it allows varying exemptions and credits to taxpayers, depending on their status and the number of their dependents. Section 1 of Article XIII of the California Constitution provides that "All property in the state, except as otherwise in this constitution provided,⁵⁶ shall be taxed in proportion to its value"⁵⁷ and has been interpreted as requiring property taxes to be levied at a uniform rate,⁵⁸ and without exemptions.⁵⁹ Were this provision alone considered, the validity of the California Act would depend upon whether or not the California Supreme Court regarded the income tax as a property tax. Section 11 of Article XIII, however, provides that:

"Income taxes may be assessed to and collected from persons, corporations, joint-stock associations, or companies resident or doing business in this State, or any one or more of them, in such cases and amounts, and in such manner, as shall be prescribed by law."

Bronson v. Henneford (Wash. 1936) 53 P. (2d) 607; Petroleum Navigation Co. v. Henneford (Wash. 1936) 55 P. (2d) 1056; Culliton v. Chase (1933) 174 Wash. 363, 25 P. (2d) 81. See also Reed v. Bjornson (1934) 191 Minn. 254, 253 N.W. 102, followed in Thompson-Parker Holding Co. v. Bjornson (1934) 191 Minn. 271, 253 N.W. 110.

⁵⁶ Since income taxes are otherwise provided for in the constitution, this exception removes any possibility of conflict with section 1 of article XIII.

⁵⁷ "Property" is defined in section 1 of article XIII of the constitution as including "moneys, credits, bonds, stocks, dues, franchises, and all other matters and things, real, personal and mixed, capable of private ownership."

⁵⁸ People v. Townsend (1880) 56 Cal. 633; Cottle v. Spitzer (1884) 65 Cal. 456; Fatjo v. Pfister (1897) 117 Cal. 83; Rode v. Siebe (1898) 119 Cal. 518; Redman v. Weisenheimer (1929) 102 Cal. App. 488.

⁵⁹ Mackay v. San Francisco (1896) 113 Cal. 392.

It would be difficult to devise language more specifically providing for a separate tax or more completely insuring its freedom from any restrictions common to property taxes. The phrase "*or any one or more of them*"⁶⁰ empowers the legislature to tax the income of some while exempting the income of others. The provision that income taxes may be levied "*in such cases and amounts*"⁶¹ as shall be prescribed by law gives the legislature discretion as to exemptions, the income to be taxed and the amount of tax imposed thereon.⁶² The constitution thus spe-

⁶⁰ During the consideration of section 11 of article XIII in the Constitutional Convention of 1879, Mr. Jones offered an amendment, rejected by the Convention, striking out the words, "or any one or more of them." He argued as follows: "... It does seem to me wrong that the Legislature should have power to levy an income tax upon certain companies or certain individuals, and leave out the rest ... If an income tax is imposed, it should be imposed uniformly upon all classes of persons, corporations, or associations. That was the only idea I had in that part of the amendment. When you say 'any one or more of them,' it seems to me this is the logical conclusion, that the Legislature may discriminate between persons as well as between corporations and associations." 3 DEBATES AND PROCEEDINGS OF THE CONSTITUTIONAL CONVENTION OF THE STATE OF CALIFORNIA, 1878-1879, p. 1325.

⁶¹ It has been contended recently that graduated income taxes were unknown at the time of the adoption of the constitution in 1879 and that, therefore, section 11 does not authorize such taxes. Investigation discloses, however, that prior to 1879 graduated income taxes were in effect in a number of states. Acts of Virginia 1852, c. 17, par. 2, p. 14; *ibid.* 1852-53, c. 8, par. 1, p. 20; *ibid.* 1855-56, c. 9, par. 6, p. 11; *ibid.* 1859-60, c. 3, par. 8, pp. 59-60; Laws of Georgia 1862, Title XVIII, pp. 176-177; *ibid.* 1863-64, Title XX (No. 75), p. 81; North Carolina Laws of 1864, c. 27; *ibid.* 1866, c. 21, Schedule A; *ibid.* 1866-67, c. LXXII, Schedule A, class 3, §1, p. 100; West Virginia Laws 1862-3, c. 64, par. 8. See E. R. A. SELIGMAN, *THE INCOME TAX* (1914) 437-438, 440-441, 444; *Progressive Taxation in Theory and Practice* (1894) 9 PUBLICATIONS OF THE AMERICAN ECONOMIC ASSOCIATION 7-222. The federal income taxes in effect from 1862 to 1870 were likewise imposed at graduated rates to which, of course, residents of California were subject and with which they were accordingly familiar. 12 Stat. (1862) 473-475; 13 Stat. (1864) 281; 13 Stat. (1865) 479; 14 Stat. (1867) 477-478. See the remarks of Mr. Ayers, 2 DEBATES AND PROCEEDINGS OF THE CONSTITUTIONAL CONVENTION OF THE STATE OF CALIFORNIA, 1878-1879, p. 947, describing the federal income tax and its graduated rate schedule. See also article V, section 4(d) of the "Sketch of the Framework for a New Constitution of California" submitted by E. Stennes in a letter to the Convention, providing for a "progressive income tax, at graduated rates." 1 DEBATES AND PROCEEDINGS OF THE CONSTITUTIONAL CONVENTION OF THE STATE OF CALIFORNIA, 1878-1879, pp. 260-261.

⁶² Brief mention should be made of sections 11 and 21 of article I of the California Constitution. Section 11 provides "All laws of a general nature shall have a uniform operation." Section 21 provides "No special privileges or immunities shall ever be granted which may not be altered, revoked, or repealed by the Legislature; nor shall any citizen, or class of citizens, be granted privileges or immunities which, upon the same terms, shall not be granted to all citizens." Even without the complete freedom given the legislature by the constitution in the matter of income taxes there would be little possibility of a holding that the exemptions in the act or its graduated rates conflicted with these sections. *Ex parte Smith and Keating* (1869) 38 Cal. 702; *Ex parte Sohncke* (1905) 148 Cal. 262; *Mordecai v. Board of Supervisors* (1920) 183 Cal. 434; *People v. Richfield Oil Co.* (1928) 204 Cal. 301;

cifically confers upon the legislature powers with respect to income taxation that it specifically denies with respect to property taxation. It makes not only separate provision for a separate tax, thus making any identification of an income tax as a property tax improbable, but endows it with characteristics foreign to a property tax, thus making such an identification impossible.

Not only the provisions of the constitution, however, but the debates of the constitutional convention⁶³ give convincing evidence that the convention, in providing for an income tax separately from the property tax, intended it as a separate and distinct tax, applicable to income from property as well as to other income, without the restrictions of a property tax.⁶⁴ The convention rejected an amendment to Section 11 expressly providing that "no tax shall be assessed upon income directly derived from property taxed." And while some of the delegates did not favor the taxation of both property and the income therefrom as a matter of policy, they were unwilling to lay the income

In re Wilmerding (1897) 117 Cal. 281; *Bacon Service Corporation v. Huss* (1926) 199 Cal. 21; *In re West* (1925) 75 Cal. App. 591; *Ludlow Saylor Wire Co. v. Wollbrinck* (1918) 275 Mo. 339, 205 S. W. 196; *Standard Lumber Co. v. Pierce* (1924) 112 Ore. 314, 228 Pac. 812; *Featherstone v. Norman* (1930) 170 Ga. 370, 153 S. E. 58; *Reed v. Bjornson* (1934) 191 Minn. 254, 253 N. W. 102. See also *Knowlton v. Moore* (1900) 178 U. S. 41; *Magoun v. Ill. Trust Co.* (1898) 170 U. S. 283; *Fox v. Standard Oil Co.* (S. D. W. Va. 1934) 6 Fed. Supp. 491, (1935) 294 U. S. 87; *State Board of Tax Commissioners v. Jackson* (1931) 283 U. S. 527. *Cf. Stewart Dry Goods Co. v. Lewis* (1935) 294 U. S. 550.

⁶³ The courts may resort to the proceedings in the Constitutional Convention to ascertain the intentions and purposes of the framers of the constitution. *People v. Stephens* (1882) 62 Cal. 209, 235; *Older v. Superior Court* (1910) 157 Cal. 770, 776; see the comprehensive note in (1931) 70 A. L. R. 5-46.

⁶⁴ Mr. Dudley, the author of section 11, argued in its support as follows:

"I offer this additional Section . . . for the reason . . . that any system of taxation that is confined entirely to raising revenue by levying a per cent upon property values, is radically wrong; . . . there are in this State a variety of corporations and associations that have in the past shirked their just proportions of taxation; and I believe that the only method in the world to reach them is to tax gross receipts or income. This proposition will not make it obligatory to levy such a tax, but it provides that the Legislature may levy a tax upon persons or corporations, or any class of corporations, and that this tax may be different in amounts in different cases, to meet the exigencies of the case. That is, the Legislature may discriminate. I have no fear that any legislature will be unjust, and I believe that they will, in every instance, discriminate and discriminate properly, for the very purpose of effecting justice. The first section of this Article, as adopted by the committee, is in very nearly the words of the old constitution—that is, that taxation shall be equal and uniform . . . the injustice and inequality of the present system of taxation grew out of the construction by the Courts of that very expression. If we adopt it in this new constitution, with that expression unmodified and unchanged, and the Legislature are compelled to apply this unbending, unyielding rule, the same injustice will exist in the future that has existed in the past." 2 DEBATES AND PROCEEDINGS OF THE CONSTITUTIONAL CONVENTION OF THE STATE OF CALIFORNIA, 1878-1879, p. 945.

tax open to judicial construction as a property tax subject to the limitations of Section 1 of Article XIII, at least so far as residents or non-residents doing business in the state are concerned.⁶⁵

These constitutional provisions alone, however, would not forbid the construction of the tax as a property tax in its application to non-

⁶⁵ The objections raised to the amendment make clear how completely the members wished to insure the freedom of the income tax from any restrictions applicable to property taxes.

"MR. WYATT. . . . As I understand it, this Section was drawn up and presented to the Committee of the Whole, and adopted by the Committee as a sort of safety valve upon our financial system, so that none of these rich men can find a loophole by which to escape their share of the public burden. And this is a safety valve in case the Supreme Court should make an iron-bound rule, as they have done before, which will allow certain men to escape taxation. I hope, therefore, that the safety valve will not be taken off, and that we may hold it and make it useful in compelling men to pay their taxes. There are certain companies and individuals who habitually avoid taxation. An income tax will reach them when nothing else will. . . . I hope there will be no amendment on which to base any construction that may destroy the usefulness of the section. This section is like the Lord's Prayer, it covers the whole ground. . . ."

"MR. DUDLEY. . . . I object to the amendment . . . for the reason that this provision has to be construed; and if the Legislature should attempt to collect an income tax, the question as to whether the property from which that income was derived had been taxed before, would have to be settled in every case, by the Courts, and the result would be that the whole thing would be defeated through legal quibbles and technicalities. Take these foreign insurance companies, and I am not so sure that their tables and desks would not be construed as being the property from which their income was derived. . . . Now, there is no objection to the principle of the amendment; the objection is, that it lays the Section open to construction." 3 DEBATES AND PROCEEDINGS OF THE CONSTITUTIONAL CONVENTION OF THE STATE OF CALIFORNIA, 1878-1879, p. 1325.

It may be noted that following the placing of the constitution in the custody of the Secretary of State, the convention adopted an address to the people setting forth the salient differences between the constitution of 1849 and the new one. A point of order was raised that the address was the unauthorized "act of a few gentlemen" and a member subsequently entered a protest against it. (3 DEBATES AND PROCEEDINGS OF THE CONSTITUTIONAL CONVENTION OF THE STATE OF CALIFORNIA, 1878-1879, pp. 1521, 1523). The address stated: "The Legislature is empowered to establish an income tax. But this is only permissive, and is intended to reach incomes derived from property not otherwise reached by taxation, such as foreign corporations, gas companies, and the like." 3 DEBATES AND PROCEEDINGS OF THE CONSTITUTIONAL CONVENTION OF THE STATE OF CALIFORNIA, 1878-1879, p. 1523. This statement, while specifically mentioning only income from property not otherwise taxed, does not by its terms preclude the application of the tax to other income. Its failure to enumerate other income reflects the emphasis placed by the Convention upon the income mentioned, and not an intention of the Convention to exclude all other income. The debates demonstrate that the delegates actually envisaged the taxation of such other income. While they were primarily concerned with the imposition of a tax on individuals and corporations not reached by the property tax, they were at the same time concerned not to defeat their objective by any restrictions on the legislature which might render such a tax ineffectual. They desired to counteract the rigidity of the property tax with some other tax of more flexible application. They accordingly gave the legislature unqualified powers, including the power to tax income from property already taxed.

residents deriving incomes from sources within this state but not doing business here. Section 11 does not expressly authorize an income tax on this group although the legislature can unquestionably provide for such taxation under the well-recognized rule that it has unlimited power except as restricted by the constitution.⁶⁶ If the income tax, however, were construed as a property tax, the absence of an express provision for this application of the tax, would mean that it was not "otherwise in this Constitution provided," within the meaning of Article XIII, Section 1, and it would accordingly be subject to the limitations of that section. As it does not conform to those limitations, it could not apply under either theory regarding it as a property tax to those non-residents who receive income from California sources but do no business here. The extent to which its validity would thereby be impaired would depend upon the meaning of "doing business" as used in Section 11. It would remain practically unaffected if that term were defined to mean "that which occupies the time, attention and labor of men for the purpose of a livelihood or profit."⁶⁷ If, however, the term were more narrowly defined so as to exclude, for example, isolated transactions,⁶⁸

⁶⁶ *In re Madera Irrigation District* (1891) 92 Cal. 296; *Beals v. Amador County Supervisors* (1868) 35 Cal. 624. See also *Yosemite Lumber Co. v. Industrial Accident Commission* (1922) 187 Cal. 774; *Macmillan Co. v. Clarke* (1920) 184 Cal. 491; *Sheehan v. Scott* (1905) 145 Cal. 684, 79 Pac. 350; *City of Monterey v. Jacks* (1903) 139 Cal. 542; *People v. County of Glenn* (1893) 100 Cal. 419; *Hobart v. The Supervisors of Butte Co.* (1860) 17 Cal. 23; *Smith v. Judge of the Twelfth District* (1861) 17 Cal. 547.

⁶⁷ *BOUVIER'S LAW DICTIONARY*. This definition is followed by the Board of Tax Appeals in construing the provision of the federal revenue act allowing deductions of expenses "in carrying on any trade or business." *Thomas F. Sheridan v. Comm'r* (1926) 4 B.T.A. 1299; *Appeal of Albert M. Briggs* (1927) 7 B.T.A. 409, 412; *Kissel v. Comm'r* (1929) 15 B.T.A. 1270, 1275; *Northrup v. Comm'r* (1929) 17 B.T.A. 950, 955. It is likewise quoted with approval in *Flint v. Stone Tracy* (1911) 220 U.S. 107, 171, and in *Daggett v. Burnett* (1933) 65 F. (2d) 191, 193. See also *Von Baumbach v. Sargent Land Co.* (1917) 242 U.S. 503; *Wilson v. Eisner* (1922) 282 Fed. 38, 41. For similar definitions see *Plant v. Walsh* (1922) 280 Fed. 722; *George R. Barse Live Stock Co. v. Range Valley Cattle Co.* (1897) 16 Utah 59, 65, 50 Pac. 630.

⁶⁸ See *Goldberg v. Comm'r* (1929) 36 F. (2d) 551, 552; *Bedell v. Comm'r* (1929) 30 F. (2d) 622, 625; *Glenn v. Averill* (1930) 20 B.T.A. 1196, 1199, interpreting section 204(a) of the Federal Revenue Acts of 1921 and 1918 allowing deductions for "net losses resulting from the operation of any trade or business *regularly carried on* by the taxpayer" (*italics added*), holding that the deduction could not be taken for losses sustained in isolated transactions. See also *Jameson v. Simonds Saw Co.* (1906) 2 Cal. App. 582, 585; *Equitable Trust Co. v. Western Land and Power Co.* (1918) 38 Cal. App. 535, 537; *Cooper Mfg. Co. v. Ferguson* (1885) 113 U.S. 727, 734; *Doe v. Springfield Boiler and Mfg. Co.* (1900) 104 Fed. 684, 687; *Moore Dry Goods Co. v. Commercial Industrial Co.* (1921) 276 Fed. 590, 593; all of these cases deal either with the service of process on or the qualification of corporations to do business.

the tax, if a property tax, would be invalid with regard to the income of non-residents from such transactions.

Even a narrow definition would not open the way to construing a tax on income as a tax on the property from which derived except possibly with regard to such income as rent. Income from the sale of property would still be taxable, since it is established that a tax on such gains is not a tax on the property sold.⁶⁹ Income from personal services would likewise be taxable since personal services are not regarded as property. No property tax has ever been levied on the voice of a Caruso, though all of his income may have been derived therefrom. Even rent actually derived from property could no more be identified with it than income derived from a voice could be identified therewith. The distinction between a voice and its income is more obvious, but not more real, than the distinction between property and its income.

The theory that to tax income is to tax the property from which the income is derived had its origin in *Pollock v. Farmers Loan and Trust Co.*,⁷⁰ invalidating a federal income tax on the ground that where the source of income was property, the tax was in effect a direct tax not apportioned according to population. Not only has this case been severely attacked⁷¹ but much of its force was destroyed in *Brushaber v. Union Pacific Railroad Company*,⁷² wherein the court declared that "... the conclusion reached in the Pollock case did not in any degree involve holding that income taxes generally and necessarily came within the class of direct taxes on property." Cases like *United States Glue Company v. Town of Oak Creek*,⁷³ upholding state taxation of net income from interstate commerce and *Peck and Company v. Lowe*,⁷⁴ upholding federal taxation of net income from exporting goods, notwithstanding the court's repeated pronouncements of the restrictions of the United States Constitution respecting the taxation of interstate commerce, and the taxation of exports, indicate a departure from the *Pollock* case. Finally, the great majority of the state cases completely

⁶⁹ *Willcuts v. Bunn* (1931) 282 U. S. 216; *Pierson v. Lynch* (1933) 263 N. Y. Supp. 259, *aff'd* 189 N. E. 684.

⁷⁰ (1895) 157 U. S. 429, 158 U. S. 601.

⁷¹ See Jones, *Pollock v. Farmers' Loan and Trust Co.* (1895) 9 HARV. L. REV. 198; Whitney, *The Income Tax and the Constitution* (1907) 20 HARV. L. REV. 280; Morrow, *The Income Tax Amendment* (1910) 10 COL. L. REV. 379; Riddle, *The Supreme Court's Theory of a Direct Tax* (1917) 15 MICH. L. REV. 566; Note (1926), 26 COL. L. REV. 852.

⁷² (1916) 240 U. S. 1, 16-17.

⁷³ (1918) 247 U. S. 321.

⁷⁴ (1918) 247 U. S. 165.

repudiate its doctrine.⁷⁵ Even states which still follow it are unwilling to accept all of its implications.⁷⁶

The alternate theory, however, that income itself, regardless of source, is property, would obstruct the application of an income tax to all income of non-residents not doing business here,⁷⁷ but deriving income from sources within the state. This theory is concisely presented in the leading case of *Eliasberg Bros. Merc. Co. v. Grimes*:

"... Money or any other thing of value, acquired as gain or profit from capital or labor, is property; in the aggregate, these acquisitions constitute income; and in accordance with the axiom that the whole includes all of its parts, income includes property and nothing but property, and therefore is itself property."⁷⁸

This analysis makes two false assumptions: that all income is received in the form of property, and that income can be identified with the form in which it is received. It may be received in many forms other than property, and it is characterized not by the form, which

⁷⁵ *Sims v. Ahrens* (1925) 167 Ark. 557, 271 S. W. 720; *Stanley v. Gates* (1929) 179 Ark. 886, 19 S. W. (2d) 1000; *Baker v. Hill* (1929) 180 Ark. 387, 21 S. W. (2d) 867; *Savannah v. Hartridge* (1850) 8 Ga. 23; *Waring v. Savannah* (1878) 60 Ga. 93; *Featherstone v. Norman* (1930) 170 Ga. 370, 153 S. E. 58, followed in *Meikleham v. Norman* (1930) 170 Ga. 398, 153 S. E. 71; *Diefendorf v. Gallet* (1932) 51 Idaho 619, 10 P. (2d) 307; *In re Opinion of the Justices* (Me. 1935) 178 Atl. 621; *Hattiesberg Grocery Co. v. Robertson* (1921) 126 Miss. 34, 88 So. 4; *State v. Gulf M. & N. R. Co.* (1925) 138 Miss. 70, 104 So. 689; *Fernwood Lumber Co. v. State Tax Comm.* (1933) 167 Miss. 273, 149 So. 727; *Glasgow v. Rowse* (1869) 43 Mo. 479; *Ludlow-Saylor Wire Co. v. Wollbrinck* (1918) 275 Mo. 339, 205 S. W. 196; *Bacon v. Ranson* (1932) 331 Mo. 985, 56 S. W. (2d) 786; *O'Connell v. State Board of Equalization* (1933) 95 Mont. 91, 25 P. (2d) 114; *Mills v. State Board of Equalization* (1934) 97 Mont. 13, 33 P. (2d) 563; *Maxwell v. Kent-Coffey Mfg. Co.* (1933) 204 N. C. 365, 168 S. E. 397; *Crescent Mfg. Co. v. Tax Comm.* (1924) 129 S. C. 480, 124 S. E. 761.

⁷⁶ Thus, Massachusetts accepts the general rule that a covenant to pay taxes on leased property does not extend to income taxes. In *Stony Brook R. Corp. v. Boston and M. R. R.* (1927) 260 Mass. 379, 157 N. E. 607, the court held that a covenant to pay "all public taxes . . . on the property, franchise or capital stock" of the lessor did not apply to an income tax, and declared that income "is not commonly thought of as property, but as a gain derived from property, or some other productive source." For other Massachusetts cases see *Boston and P. R. Co. v. Old Colony R. Co.* (1929) 269 Mass. 190, 169 N. E. 157; *Cadman v. American Piano Co.* (1918) 229 Mass. 285, 118 N. E. 344. The Illinois court in *Young v. Ill. Athletic Club* (1923) 310 Ill. 75, 82, 141 N. E. 369, 371, declared that, "the nature of the tax itself, which is a tax made on the net income of the individual, is such as to preclude the idea of a tax against property." See also *Dennehy v. Barnheisel* (1920) 218 Ill. App. 91; *Catawissa R. Co. v. Phila. & R. R. Co.* (1916) 255 Pa. 269, 99 Atl. 807; *Little Schuylkill Nav. R. and Coal Co. v. Philadelphia* (1918) 69 Pa. Sup. Ct. 122; and *Sharon R. Co. v. Erie R. Co.* (1920) 268 Pa. 396. The cases on covenants to pay taxes are collected in *Notes* (1920) 9 A. L. R. 1566; (1924) 30 A. L. R. 991; and (1926) 45 A. L. R. 756.

⁷⁷ It would probably also obstruct the application of the tax to such income of non-residents doing business here as is derived from sources other than their business.

⁷⁸ (1920) 204 Ala. 492, 494, 86 So. 56, 58.

varies, but by the gain or profit which it represents. A landlord might receive his rent and a creditor payment of his account in the form of services; an employee might receive his salary by the discharge of his obligation; a debtor might derive gain by discharging his indebtedness for less than its face amount. In all of these cases income is realized, but not in the form of property.⁷⁹ Even if it were received in the form of property, however, it could not therefore be identified with it, any more than its receipt in the form of a forgiven debt would identify it as a forgiven debt. The distinction between income and the form of its receipt is made abundantly clear by *Hitner v. Lederer*⁸⁰ holding a salary taxable as income even though paid in tax-exempt bonds. The tax was not upon tax-exempt bonds, but upon the gain which they represented to the recipient. In the words of the court, "It is the appellant's income which is taxed and not the means with which it is paid."⁸¹

Income would be even more clearly distinguished from the form of its receipt if computed upon a net basis. It would then be, not the aggregate gains for the year, but the gain represented by the difference between aggregate gains and allowable deductions at the close of that period of time. That gain would be an unknown quantity at the particular moments of the receipt of items constituting the gain. Net income, as distinguished from property, would be characterized not only by gain, but by a value which could not be determined until the tax period had lapsed. The distinction is aptly set forth by Justice Peaslee, dissenting in *Opinion of the Justices*:

"A man's property is the amount of wealth he possesses at a particular moment, while his income is the amount of wealth obtained during some specified period. The two are measured by different standards. One is measured by amount and present possession. The other is determined by receipts, and quantity and time are necessary elements of the measure employed. In the measure of property, present ownership is an essential element, and lapse of time can have no place. In the measure of income, lapse of time is an essential element, and present possession can have no place. Each is

⁷⁹ See *Old Colony Trust Co. v. Comm'r* (1929) 279 U. S. 716; *United States v. Kirby Lumber Co.* (1931) 284 U. S. 1; *Burnett v. Wells* (1933) 289 U. S. 670; *Helvering v. Coxe* (1936) 56 Sup. Ct. 498; *Douglas v. Willcuts* (1935) 296 U. S. 1; *Ralph Kitchen* (1928) 11 B.T.A. 855; *George Matthew Adams* (1929) 18 B.T.A. 381; *Frank D. Yuengling* (1933) 27 B.T.A. 782, *aff'd* (1934) 69 F. (2d) 971.

⁸⁰ (1933) 63 F. (2d) 877.

⁸¹ (1933) 63 F. (2d) 877, 878. To carry the example further, *A*, *B*, and *C* all receive a salary of \$10,000 a year. *A*'s salary is paid in tax-exempt bonds. *B*'s salary is paid by forgiveness of an indebtedness owed his employer, and *C*'s salary is paid in money. Certainly each has income, *i.e.* gain from labor. *A*'s salary is taxable even though received in a form that is tax-exempt, *B*'s salary is taxable even though received in a form that has no marketable value and could not be taxed as property. Taxability in both cases arises solely because the salaries represent gain. *C*'s salary is taxable for the same reason.

measurable, but a common measure cannot be applied to both. The two are as incommensurate as a line and an angle."⁸²

The California Constitution recognizes the distinction by providing for separate taxes. In the absence of constitutional restraints, the income tax seems clearly applicable to all income derived from sources within the state of non-residents not doing business here unless it can be restrained by some theory more compelling than the one which would identify income with property by ignoring their essential differences.

Roger John Traynor,
Frank M. Keesling.

SCHOOL OF JURISPRUDENCE,
UNIVERSITY OF CALIFORNIA.

SACRAMENTO,
CALIFORNIA.

⁸² (1915) 77 N. H. 611, 618, 93 Atl. 311. See cases cited note 75, *supra*; the Arkansas, Georgia, Mississippi, Missouri and Montana cases cited suggest that the income tax is an excise tax; the South Carolina and Wisconsin cases support it as a personal tax. See also Brown, *Nature of the Income Tax* (1933) 17 MINN. L. REV. 127; Harsch, *State Income Taxation as Affected by Property Tax Limitations* (1931) 6 WASH. L. REV. 97.