ABSTRACT

The Story of Earl: How Echoes (and Metaphors) from the Past Continue to Shape the Assignment of Income Doctrine

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Lucas v. Earl, decided in 1930, is one of the most famous and often-cited Supreme Court tax decisions. The opinion is perhaps most famous for Justice Holmes's use of the "fruit and tree" metaphor. In short, the metaphor suggests that income (the fruit) should be taxed to the "tree" that bore it. Aside from the metaphor, the opinion contains very little of interest. Holmes does not give a very detailed statement of facts, nor does he provide us with any analysis beyond that which is suggested by the metaphor. All we know from the opinion is that Mr. and Mrs. Earl entered into a contract to own all property and income equally with rights of survival. As it turns out, the story behind the opinion is full of rich information about the taxpayers, early California history, and the battle over how community property spouses should be taxed on community income.

"The Story of Earl" begins with the life of Guy Chafee Earl, the taxpayer in the case. Earl was born in 1960 in Red Bluff, spent his boyhood in the Inyo Valley, a place he called "the enchanted valley, and later moved with his family to Oakland, where he attended high school and the University of California. Earl became an attorney and, with his brother, Edwin Tobias Earl, bought up land and water rights to found the Great Western Power Company. Great Western later merged into Pacific Gas and Electric. Guy Earl and his brother were powerful young men when California was young. Edwin invented the refrigerated rail car and was a newspaper publisher in Los Angeles in the early 1900s. Guy served as President of the Board of Regents of the University of California and was a long time board member of Pacific Gas and Electric.

The famous tax case involving Guy Earl and his wife, Ella, occurred because in 1901 Guy and Ella had entered into an agreement that everything they earned or owned would be held by them as joint tenants with right of survivorship. The agreement was intended as a will substitute that would pass property directly from Guy to Ella in the event of his death without having to go through probate. There was no income tax in effect in those days. Thus, tax-planning was not a motivating factor in the agreement.

When the modern income tax was enacted in 1913, returns were made by individual taxpayers, not by spousal units. There was one single rate and so if a husband and wife did aggregate income, it would be taxed at marginally higher rates than the rates that would apply if they filed separately. As rates rose during World War I, community property spouses argued that they were entitled to split all community income and file separate returns, with each spouse reporting only half the income on the separate returns. Because rates were progressive, the ability to split income between two taxpayers saved a significant amount in taxes. This income-splitting rule was recognized for all community property states other than California. Guy and Ella Earl claimed they had a right to split their income pursuant to their marital agreement. If allowed to do so, their tax savings would mirror the tax savings enjoyed by community property spouses. The Board of Tax Appeals disallowed the proposed split in income, but the Court of Appeals for the Ninth Circuit ruled in favor of the Earls. Ultimately, the Supreme Court refused to allow the Earls to split their income for tax purposes. Mr. Earl, as the earner of the income and the only

taxpayer entitled to receive the salary from his employer, was required the report all his earned income on his separate tax return. Income from their jointly owned property, by contrast, could be split and reported on separate returns.

"The Story of Earl" places the legal arguments made by both sides in historical context. The tax years at issue were 1920 and 1921. During these years, California spouses were not only denied the benefit of income splitting enjoyed by spouses in other community property states, but were also penalized for owning community property. Treasury took the position that the husband was taxed on 100% of the community income, even the earnings of the wife, since he, as manager of the community, had full control. Husbands in common law states by contrast enjoyed less control over jointly owned property after common law states began passing married women's property acts in the mid nineteenth century. Because the Earls' agreement converted their community property into separate property, they were not subject to the Treasury rule taxing California husbands on 100% of the community income. Thus, the Commissioner conceded early on in the Earl litigation that half of the income produced by jointly owned separate property was appropriately taxed to Mrs. Earl.

At the time of the *Earl* litigation, Treasury was attempting to pull back from its community property position in the other community property states by arguing that the real issue was "control" and that husbands in all community property states should be taxed on 100% of community income. Legislation to this effect was introduced, but Congress refused to pass it. Treasury then agreed that the decision should be made by the Supreme Court and thus agreed to participate in a number of test cases which were intended to be appealed quickly to the Court. *Poe v. Seaborn*, one of these test cases, reached the Supreme Court shortly after *Earl*, and established the rule once and for all that community property spouses could continue to split income for tax purposes. By this time, California community property had undergone enough changes to clarify that both spouses were equal "owners" of community income. After *Seaborn*, income-splitting by California spouses was also approved by the Supreme Court.

Also of historical interest during the Earl litigation were the roles of the Attorney General, the Treasury, the Internal Revenue Service and their lawyers in tax litigation. Lawyers for the Commissioner at the Board of Tax Appeals proceeding were lawyers from the Bureau of Internal Revenue, as the Service was then known. On the appeal to the Ninth Circuit, the Commissioner was represented by attorneys from the Office of the Attorney General. The senior lawyer on the appeal was Mabel Walker Willebrandt, the first woman to head the Tax Division and a legend in her own right. Ms. Willebrandt was a graduate of the University of Southern California Law School and practiced law in California before joining the Harding administration as an assistant attorney general. She understood California community property and was an early advocate for tax rules that allowed California spouses to split income. It is ironic that in her last year in office she was required to sign briefs that argued against the Earls' argument for why they, as California spouses, should be allowed to split income for tax purposes.

In the end, *Earl* can be understood as a decision that was necessary to protect the progressivity of the modern income tax. But "The Story of Earl" shows us that tax cases can often tell us more about social history than is readily apparent from the published opinion.