The Public Salary Tax Act of 1939

The Public Salary Tax Act of 1939, recently passed by Congress, eliminates for the future the exemption from federal income taxation of the salaries of all public officers and employees who have heretofore enjoyed such exemption, and consents for the future to taxation of federal officers and employees by the states. At the same time it relieves all state and local officers and employees from retroactive federal taxation for past years and requires similar treatment by the states of federal officers and employees. The methods and legal problems involved in accomplishing these results should be of importance to those interested in taxation generally, as well as to the public employees who are personally affected.

The impetus for legislation of this kind was furnished by a message to Congress from the President, dated April 25, 1938, recommending that legislation be enacted removing the reciprocal exemptions of salaries of public employees and also the reciprocal exemptions of interest on public bonds. The Public Salary Tax Act carries out only the first of the President's recommendations. Shortly after this presidential message the Supreme Court decided in *Helvering v. Gerhardt* that compensation of employees of the Port of New York Authority was subject to federal income tax. This case indicated that perhaps the Court was willing, in an appropriate case, to reconsider the century-old doctrine of intergovernmental immunity of public salaries which had been assumed, without much question, to be the law ever since the historic cases of *Dobbins v. Commissioners of Erie County* and *The Collector v. Day.* As a result of the *Gerhardt* decision many state officers and employees who, in good faith, had believed their compensation to be exempt from federal income taxation might be subjected to liability retroactively for as many as twelve years. Because of the hardships and inequities that would result from the enforcement of such retroactive liability the President recommended to the Congress that legislation on the subject of taxing public salaries include express provisions exempting state and local officers and employees from federal income taxation for prior years.

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2 (1938) 83 Cong. Rec. 5683.
3 (1938) 304 U.S. 405.
5 (1870) 78 U.S. (11 Wall.) 113.
6 (1939) 84 Cong. Rec. 507.
While the Public Salary Tax Act was pending in the Senate, the Supreme Court decided *Graves v. O'Keefe*, which squarely overruled *The Collector v. Day* and *Rogers v. Graves* and completely eliminated reciprocal immunity of salaries of public employees, federal and state. Since the *O'Keefe* case made it possible for federal officers and employees to be subject to state income taxation for prior years, the Public Salary Tax Act, as enacted, includes provisions giving them relief comparable to that accorded state and local officers and employees from federal taxation.

The revision of the Supreme Court's views on exemption of public salaries and the legislation effectuating the Court's new view undoubtedly represent important steps forward in tax jurisprudence and increase equity and justice in income taxation. A discussion of the provisions of the Salary Tax Act and some of the problems involved is here presented.

**PROSPECTIVE FEDERAL TAXATION**

The Act is divided into two titles. Title I (sections 1 to 4) deals with taxation of public employees for 1939 and future years. Title II (sections 201 to 211) is devoted to various provisions granting relief to public employees from taxation for prior years by the federal and state and local governments.

Section 1 amends section 22(a) of the Internal Revenue Code, which is the general definition of gross income for income tax purposes. Section 22(a) formerly provided, among other things, that gross income includes income derived from salaries, wages, or compensation for personal service. During consideration of the Public Salary Tax Act it was argued by some that this definition, as its language would indicate, is broad enough to include the compensation of state and local employees. However, that language has been repeatedly re-enacted by Congress in the income tax laws since 1913 without substantial change and during all of that time, until very recently, its administrative interpretation, based on the supposed constitutional doctrine, has been that it did not include the salaries of state and local employees. This led to fear that the Court might apply...
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a theory which it has been suggested was implied in a recent case. This theory is that when there is an administrative interpretation of statutory language and that language is re-enacted in a new statute, the administrative interpretation becomes a part of the law itself and the interpretation cannot be administratively changed thereafter.\(^\text{10}\) To avoid any possibility of the application of this doctrine, section 1 added to the definition language expressly stating that gross income includes compensation for "'personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing.'" Therefore no questions of statutory construction can arise with respect to the taxation of state and local officers and employees\(^\text{11}\) as to the year 1939 or subsequent years.\(^\text{12}\)

Section 2 contains an amendment eliminating the former exemption from tax of teachers in Alaska and Hawaii. Section 3 is more important because it requires the imposition of federal income tax for 1939 and subsequent years upon the salaries of federal "constitutional court" judges taking office on or before June 6, 1932. These are principally judges of district courts, circuit courts of appeals and the Supreme Court. Under earlier decisions of the Supreme Court\(^\text{13}\) they are exempt from federal taxation because of the protection in Article III, Section 1 of the Constitution against diminution of their compensation. It is expected by many that the Supreme Court will overrule these cases on the theory that the imposition of a net income tax to which all other persons are subject does not really constitute a diminution of a judge's salary. If the Court does so, the last vestiges of exemption from federal income tax of compensation for personal services will disappear. The magic date June 6, 1932, appears because on that date the Revenue Act of 1932 was passed which included in gross income the salaries of judges of these courts taking office after that date and amended the acts fixing their compensation accordingly.\(^\text{14}\)


\(^{11}\) Federal officers and employees, of course, have always been subject to federal income tax.

\(^{12}\) The Internal Revenue Code which was thus amended only applies to income for 1939 and thereafter.

\(^{13}\) Evans v. Gore (1920) 253 U. S. 245; Miles v. Graham (1925) 268 U. S. 501.

\(^{14}\) 47 STAT. (1932) 169, 26 U.S.C. (1934) § 22. This provision was upheld by the Supreme Court without actually overruling the earlier cases in O'Malley v. Woodrough (May 22, 1939) 59 Sup. Ct. 838, 83 L. ed. Adv. Ops. 850.
Section 4 of the Act is of great interest to the states because it contains a consent by the United States to taxation by the states of compensation received after December 31, 1938, for “personal service as an officer or employee of the United States, any Territory or possession or political subdivision thereof, the District of Columbia, or any agency or instrumentality of any one or more of the foregoing. . . .” The consent is only to taxation “by any duly constituted taxing authority having jurisdiction to tax such compensation. . . .” The consent is further limited in that it applies only with respect to taxation which “does not discriminate against such officer or employee because of the source of such compensation.” Strictly speaking, this consent is probably not necessary since in *Graves v. O'Keefe* the Court stated that where Congress is silent it will be presumed that there is no objection to taxation by the states of federal employees’ salaries. However, that case and prior cases indicated that possibly Congress could withdraw its employees from state taxation and the consent clearly negatives any intention to do so. Furthermore, the limitations on the consent show that Congress does not intend to permit discriminatory taxation or extension of jurisdiction to tax. If the states avoid unreasonable efforts to collect income taxes from federal employees and merely impose the same taxes upon them which are required of other employed persons, no difficulty should be experienced.

**RETROACTIVE RELIEF FOR STATE AND LOCAL EMPLOYEES**

Section 201 of the Act, the first of the relief provisions, is rather complicated in appearance. Its fundamental provision is that no additional assessments or collection of tax shall be made with respect to state and local employees for years prior to 1938. The difficulty involved in granting relief of the type desired was that there are several groups of state and local employees engaged in proprietary functions such as the operation of state-owned liquor stores, who have long been paying federal income tax. There was no reason to exempt these groups from tax and make refunds to them, but it was impossible adequately to describe either them or the large group which was formerly thought to be exempt. Nearly all of those employees who have been long paying taxes, however, have paid their taxes currently from year to year without protest. On the other hand, the great mass

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15 *Supra* note 7.
of state and local employees who, until the recent decisions, were thought to be exempt have not paid their taxes from year to year or at all, or in a few cases paid and then sought refund. Section 201 therefore draws the line between these two groups by not affecting the liability of those who have paid for years before 1938 without protest, but providing that no tax shall be collected from those who did not pay and refunds shall be made in the few cases where tax was paid but claims for refund were filed. This relief, of course, is not available to independent contractors with state and local governments, who have long been subject to federal income tax.\textsuperscript{17}

Section 202 governs tax for the year 1938 and simply projects forward to 1938 the exemption in section 201. Those state and local employees who did not pay a tax on their 1937 compensation and those who did pay for 1937 but are entitled to refund under section 201 are exempt from federal tax on their compensation for 1938. These persons did not need to file returns on March 15th of this year including such compensation in gross income.

Section 203 provides a further safeguard to state and local officers and employees against federal income taxation for years prior to 1939. Because of their mechanical operation, it is possible that sections 201 and 202 may not cover the cases of a few state and local employees who were honestly thought to be exempt from tax even though they may have paid their tax intending to seek a refund. Section 203 therefore authorizes the Commissioner of Internal Revenue in such cases to make refunds, if he finds that the failure to do so would result in the application of the doctrines in the cases of Helvering v. Therrell,\textsuperscript{18} Helvering v. Gerhardt,\textsuperscript{19} and Graves v. O'Keefe "extending the classes of officers and employees subject to Federal taxation." This discretionary power in the Commissioner should allow him to alleviate any cases of hardship which may arise.

Section 204 provides that refunds shall not be made under sections 201 and 203 where they are barred by the statute of limitations. Section 205 provides that sections 201, 202, and 203 shall not apply with respect to compensation "to the extent that it is paid directly or indirectly by the United States or any agency or instrumentality thereof." Thus state agricultural college professors paid out of federal grants will continue to be liable for tax for years prior to 1939.\textsuperscript{20}

\textsuperscript{17} Metcalf & Eddy v. Mitchell (1926) 269 U. S. 514.
\textsuperscript{18} (1938) 303 U. S. 218 (upholding federal taxation of state bank liquidators).
\textsuperscript{19} Supra note 3.
\textsuperscript{20} One of these professors was held taxable in Hanson v. Landy (D. Minn. 1938) 24 Fed. Supp. 535.
Retroactive Relief for Federal Employees

Sections 207 and 208 relate to taxation by the states of officers and employees of the Federal Government. Since *Graves v. O'Keefe* clearly made the federal officers and employees subject to state taxation for years prior to 1939, and since this would be as much of a hardship upon them as the federal taxation of state employees for those years, some protection to them seemed desirable. Doubtless most of the states would, of their own volition, grant relief to federal employees. However, states such as California, Montana, Mississippi, and Kentucky, where state constitutions have been held to forbid the refund or cancellation of taxes after liability therefor has once attached, might find it difficult or impossible to grant such relief. Provisions in a federal statute requiring the relief, however, will presumably override state constitutional limitations.

Section 207 squarely provides that no collection of any tax imposed by any state or local taxing authority on the compensation of federal officers or employees received before 1939 shall be made. Included are officers and employees of agencies and instrumentalities of the United States except those employed by agencies and instrumentalities which are private, such as national banks, who have always been paying state taxes. It will be seen that this section raises an interesting constitutional question as to the power of Congress to exempt its employees from state taxation. There is good reason to believe that such power exists; there have been a number of cases upholding express limitations by Congress upon the power of the states to tax federal agencies or instrumentalities. This has been particularly true with respect to the limitations upon the taxation of national banks. And as has already been stated, the Court in *Graves v. O'Keefe* indicated that Congress may have power to withdraw federal employees from state taxation. It may be supposed, therefore, that section 207, if it is ever attacked, will be held constitutional.

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*Estate of Stanford* (1899) 126 Cal. 112, 54 Pac. 259; *Trippet v. State* (1906) 149 Cal. 521, 86 Pac. 1084.

*In re Clark's Estate* (Mont. 1937) 74 P. (2d) 401.

*McDonald v. State Tax Comm.* (1930) 158 Miss. 331, 130 So. 473.


Section 208 adopts a different approach in protecting federal employees from state taxation. It provides that Title II, granting relief to state employees, shall not apply to the officers and employees of any state after the Secretary of the Treasury determines and proclaims that it is the policy of that state to collect tax from any federal employee, other than employees of the private instrumentalities such as national banks, with respect to his compensation received before 1939. After such a determination by the Secretary of the Treasury with respect to any state, the Bureau of Internal Revenue would commence to assert tax deficiencies against the employees of that state for years prior to 1939. This provision is justifiable: inasmuch as liberal and fair treatment is being given by the federal government to state employees, the federal government is entitled to expect that the states will reciprocate by granting similar liberal and fair treatment to similarly situated federal employees. If this reciprocity breaks down and any state deliberately refuses to grant such relief to federal employees, no reason appears why relief from the federal tax should be given to the employees of that state. It is, of course, contemplated that no state will take any action which will necessitate such a determination by the Secretary of the Treasury.

Section 209 grants relief from retroactive taxation for years prior to 1939 to the group of judges of constitutional courts, taking office on or before June 6, 1932, whose compensation is for the first time expressly made taxable by section 3 of the Act. For the same reasons that it is fair to relieve other public employees from retroactive taxation, it is desirable to relieve these judges from retroactive federal taxation.

Section 210 provides, merely to eliminate any doubt, that wherever used in the Act, " "officer or employee" includes a member of a legislative body and a judge or officer of a court.

This completes a consideration of the important features of the Public Salary Tax Act of 1939. It accomplishes a long-advocated and needed reform, now fully sanctioned by the Supreme Court, and at the same time prevents the hardship which would otherwise result from the unexpected collection of taxes for prior periods. It ranks as one of the important legislative enactments of the Seventy-sixth Congress.

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