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In the

Supreme Court of the United States

UNITED STATES OF AMERICA,
Petitioner,

v.

JAMES A. BASYE and
EVELYN E. BASYE, et al.,
Respondents.

No. 71-1022

Washington, D. C.
December 11, 1972

Pages 1 thru 41

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IN THE SUPREME COURT OF THE UNITED STATES

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Petitioner, :

v. : No. 71-1022

JAMES A. BASYE and
EVELYN E. BASYE, et al., :

Respondents. :

- x

Washington, D. C.
Monday, December 11, 1972

BEFORE:

WARREN E. BURGER, Chief Justice of the United States
WILLIAM O. DOUGLAS, Associate Justice
WILLIAM J. BRENNAN, JR., Associate Justice
POTTER STEWART, Associate Justice
BYRON R. WHITE, Associate Justice
THURGOOD MARSHALL, Associate Justice
HARRY A. BLACKMUN, Associate Justice
LEWIS F. POWELL, JR., Associate Justice
WILLIAM H. REHNQUIST, Associate Justice

APPEARANCES:

ERWIN N. GRISWOLD, Solicitor General of the United States, Department of Justice, Washington, D. C. 20530; for the Petitioner.

VALENTINE BROOKES, ESQ., One Embarcadero Center, San Francisco, California 94111; for the Respondents.

C O N T E N T S

ORAL ARGUMENT OF: PAGE

Erwin N. Griswold, Esq., On behalf of the Petitioner. 3

Valentine Brookes, Esq., On behalf of the Respondents. 20

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P R O C E E D I N G S

MR. CHIEF JUSTICE BURGER: We will hear arguments first this morning in No. 71-1022, United States against Basye.

Mr. Solicitor General, you may proceed whenever you are ready.

ORAL ARGUMENT OF ERWIN N. GRISWOLD, ESQ.,

ON BEHALF OF THE PETITIONER

MR. GRISWOLD: May it please the Court:

This is a federal income tax case. It is here on the Government's petition to review a decision of the United States Court of Appeals for the Ninth Circuit. The case arises out of one of the interesting developments in modern society. In California there is a substantial system of both group medical insurance and group medical practice. In this particular case the medical insurance is provided by the Kaiser Foundation Health Plan, Inc. And the medical services are provided by a partnership known as Permanente Medical Group.

The individual taxpayers before the Court are members of this partnership, or their spouses in cases where joint returns were filed. The years involved are 1960 and 1961, except in one case where 1962 and 1963 are also involved.

The case was heard in the district court on a stipulation of facts. The basic stipulation appears at pages

79 to 88 of the Appendix, and attached to the stipulation are the full texts of three substantial documents attached to and a part of the stipulation. And the case turns largely on the effect of those documents and payments made pursuant to them under the federal tax laws. The first of these documents is the partnership agreement of the Permanente Medical Group, usually referred to in this case simply as Medical Group. This partnership agreement appears on pages 102 through 113 of the Appendix.

The next document, appearing at pages 116 through 150 of the Appendix, is the medical service agreement, being a contract entered into as of July 1, 1959 by the Kaiser Foundation Health Plan, which is obligated to produce services under its contract with its members, and the Medical Group which thereby undertook the obligation to provide the services.

Under this contract Medical Group agreed to supply health services to the members of the Health Plan and the Health Plan agreed to make payments to Medical Group. The question at issue in this case relates to a portion of the payments, and I will spell this out in detail in just a moment.

Finally there is in the Appendix at pages 159 through 199 a trust agreement establishing the retirement plan for the Permanente Medical Group. That is the way it

is entitled at the beginning, Trust Agreement Retirement Plan for the Permanente Medical Group on page 159. This is a typical non-vested retirement plan providing for benefits for physicians only and only to the physicians who persist in their connection with Medical Group or related groups for periods stated in the trust.

Q There are no non-medical employees then that are beneficiaries?

MR. GRISWOLD: There are no non-medical employees in this retirement plan. Non-medical employees were taken care of in some way otherwise; how does not appear in the Appendix.

Q Did the plan cover physicians who were not members of the partnership but who were staff employees?

MR. GRISWOLD: Did the plan--

Q Cover physicians, doctors, who were not in the partnership but who were employed by them?

MR. GRISWOLD: Yes, the plan covers physicians who are employees of Permanente Medical Group as well as physicians who are partners in Permanente Medical Group.

The payments involved in this case were made by Health Plan to the Trust, pursuant to the agreement between Health Plan and the partnership Medical Group. Let us now turn more specifically to the agreement.

I would like to call the Court's attention to page

122 of the Appendix, which is in the agreement between Health Plan and Medical Group. Section B-3 of the agreement recites this. This is near the top of page 122.

"Health Plan desires to arrange by contract for all Medical Services in the service area required to satisfy, or convenient or incidental in connection with satisfying, the Medical Service obligations provided in Membership Contracts. Medical Group agrees to provide such Medical Services for the consideration and subject to the terms and conditions set forth in this Agreement."

Thus, all of the payments provided by the agreement are expressly stated to be in consideration of the services rendered by Medical Group. Similarly at the bottom of page 124 of the Appendix. It is agreed that, and I quote the last two lines on 124, "Within the Service Area, Medical Group shall provide to all Members all Medical Services required by or incident to Membership Contracts."

And then at the top of page 126 appears Section C-3 of the contract under the heading "Compensation for Medical Services." And the first sentence of C-3 reads, "As full consideration for rendering Medical Services as required by Sections C-1 and C-2, Medical Group shall receive the compensation provided in Part III hereof." And this leads us to Part III of the contract, Article H, beginning on page 137 of the Appendix and continuing for the next several pages.

It is there provided in the introduction to Article H, "As base compensation to Medical Group for Medical Services to be provided by Medical Group hereunder, Health Plan shall pay to Medical Group the amounts specified in this Article H."

And then H-1 provides for the per member price and provides for a payment based on the number of members, the initial per member price for July, 1959 and each succeeding month--it appears near the bottom of page 137--was $2.61329 per member per month. But continuing with Article H, it appears that this base compensation consists of several items. Incidentally, I may say that at the time the contract was entered into there were 350,000 members. That meant coverage of some 900,000 persons, because members were families. I understand that something close to three million persons are now covered by the general plan.

But there are further provisions for adjustment to the per member price in Sections H-2 and H-3 on pages 138 and the top of page 139. And then we come to the paragraph which gives rise to this case. This is paragraph H-4 on page 139 of the Appendix, and it is headed "Provision for Savings and Retirement Program for Physicians." And since this is the key to the case, I would like to read the paragraph.

"In the event that Medical Group establishes a savings and retirement plan or other deferred compensation

plan approved by Health Plan, Health Plan will pay, in addition to all other sums payable by Health Plan under this Agreement, the contributions required under such plan to the extent that such contributions exceed amounts, if any, contributed by physicians." As the plan was established, the physicians made no direct contribution. "Provided, however, that Health Plan shall commence contributions July 1, 1959, and provided further that Health Plan's obligation to make such contributions shall continue only so long as this agreement or any continuation or extension generally similar to this Agreement shall remain in effect."

And it appears later in the Appendix at page 162 that the rate of Health Plan's contribution to this trust shall be 12 cents per member per month. And with 350,000 members, that worked out to about $500,000 per year. And the record shows that over a period of four years something over $2 million was paid by Health Plan into the retirement trust.

Following the execution of the Medical Service Agreement, that is, the agreement between Health Plan and Medical Group, the trust agreement was entered into. It was actually signed about December 30, 1959, but it was effective as of July 1, 1959, the date when the agreement between Health Services and Medical Group became effective, and nothing turns on the fact that there was some delay in working

out and finally signing the trust agreement.

As I have already indicated, the trust agreement is entitled "Retirement Plan for the Permanente Medical Group," and it is a typical non-vested retirement trust. It provides for benefits only to physicians, but it includes not only the partners in Medical Group but also physicians who are employees of the Group. It provides for tentative credits for each physician based upon his age, experience, and length of service. It provides that these credits may be forfeited if the physician leaves the partnership or its employ, except under certain circumstances. In that event, the forfeited amounts are creditable to the other physicians who are beneficiaries of the trust.

As the respondents here agree and expressly state at page 4 of their brief, in no event is any amount refundable to Health Plan.

Q Mr. Solicitor General, if a physician's interest---a partner physician's interest--is forfeited, then I take it the Internal Revenue Service in some way would recognize the extent of his, shall I call it loss, at that time in the year of forfeiture?

MR. GRISWOLD: No, Mr. Justice. I think we get to that question only if we assume that the payments are income to the trust. But if it is decided, as we contend, that the payments are always income to Medical Group, then it simply

becomes a question of what is the distributable share of each partner's income in that trust each year. And the payment to the trust, we contend, is income to the Medical Group partnership and is a part of the income which must be shown on the information return of the partnership and allocated to the partners in proportion to their interest in the partnership income. Therefore, what happens to any particular physician's interest in the trust is irrelevant as far as this case is concerned.

Q That I understand. But I wondered whether he does not have a loss of some kind at the time of forfeiture that might be assertable.

MR. GRISWOLD: I do not believe so, Mr. Justice. He simply has, perhaps, a reduced income from the trust which will affect him, but this is from the point of view of the tax law as we contend, the same as if the payment was made to Medical Group and Medical Group then made a payment to the retirement trust. That would not be income to the partner when it was paid to the retirement trust, and it would not be a loss to the partner if he had a forfeiture.

I think this all turns on the somewhat subtle but nevertheless controlling issue in this case, Are these payments income to Medical Group?--which we contend they are--Or are they income to the retirement trust which is the basis which the court below decided.

Q Mr. Solicitor General, I suppose the retirement plan for general employees other than physicians involves a substantial number of people and a substantial amount of money. Are those employees taxed on the deferred income on the year in which it is contributed to the pension fund or when they receive it at the end of the line?

MR. GRISWOLD: Mr. Chief Justice, that depends on-- in the first place, there is nothing in this record about this whatever.

Q Taking a typical one that we are familiar with--

MR. GRISWOLD: Taking a typical one, if the retirement plan is for employees and if it is non-discriminatory so that it meets the standards of Sections 401 and following of the Internal Revenue Code, then the amounts paid into it would be deductible by Medical Plan and would not be taxable to the employees until they were paid out to the employees. This plan is quite clearly not within Section 401. In the first place, it is discriminatory because it applies only to the top salaried people, the physicians. But even more clearly, it is not exclusively for employees and their beneficiaries, which are the only things to which the retirement trust provisions in Section 401 apply. In the years involved here, at least 1960-61, there was no provision whatever in the law for deduction of retirement benefits for

self-employed persons, and partners are, of course, self-employed persons as partners in law offices have known with respect to the tax law for a long time.

Q Mr. Solicitor General, I take it that the Government's theory is that the money is paid to the trust and it is for the use and benefit of the partnership and is income to it?

MR. GRISWOLD: Yes, Mr. Justice, that is exactly it.

Q The individual partner would only actually benefit by it if he does not leave the partnership and retire as pursuant to the plan. At the time he does something that results in the forfeiture, he will already have paid taxes on a certain amount of money that was income to the partnership and is now in the trust. Does he not, when he leaves the partnership, resigns or something, he has no kind of a capital loss?

MR. GRISWOLD: He may, Mr. Justice, have perhaps even an ordinary loss. He may have a deduction for a loss. There is no basis in this record for determining that, and there is no issue in this case as to that except as it bears on the remaining problem.

Q It would be a very odd situation in the tax law, would it not, if you based taxes on some income and it does not even enter your basis in some property?

MR. GRISWOLD: Yes, it would certainly increase his

basis in the partnership. It would certainly increase his basis in the partnership. Indeed, there has been confusion in this case about this. It is a complicated case, but let me point out--

Q Mr. Solicitor General, this was my question and perhaps I did not phrase it very well. But it seemed to me that on the Government's theory, if there is taxability to the partnership and hence to the underlying partners, that there had to be some kind of a deduction eventually in the event of departure from the partnership and forfeiture.

MR. GRISWOLD: Mr. Justice, I think my answer was quite inadequate and perhaps illustrates the difficulty of the case to one who has been working on it for months. It is quite plain that the increase in income not offset by a corresponding withdrawal of funds from the partnership would increase each partner's basis in the partnership and would be taken into account in one way or another when--

Q Money that went into buildings that he could not take away with him when he left?

MR. GRISWOLD: Money he withdrew from the partnership. Incidentally, in the foldout just before page 203 is the computation of the amounts allocated to each partner in this case by the revenue agent, and I think this illustrates the same thing, because I believe that there was an error by the revenue agent in calculating the deficiencies because he

apparently allocated the payment to the trust on the basis of the retirement formula in the trust. But the payments should have been allocated only to partners and to partners on a pro rata basis, since that is the way that all earnings in excess of drawing accounts were distributable under the partnership agreement.

This question is covered by paragraph 24 of the stipulation at page 87, down at the bottom. "The parties agree that any recomputations of the various sums involved in these actions, which may be required by the Court's adjudication herein, will be made,verified and settled by counsel." And I feel fairly confident that after this Court's decision, that can be done.

But in the interim, the counsel cannot agree upon such recomputations. The sums may be settled by the Court upon application and ten days notice. And I mention this because it may be what threw the court below off the track, the same way that I think I was thrown off the track, and I would like to avoid suggesting the same error here.

This case can be made to appear, and very likely is, very complicated. There is even a considerable discussion in the respondents' brief to the effect that the Government is proceeding on the entity theory of partnerships while it is said that the conduit theory is applicable. It seems odd that we should still be discussing such things in 1972. I

think it is by now accepted that partnerships are both entities and aggregates and are so treated in the tax law. They are treated as entities for the purpose of filing information returns. But partnerships are not taxed under our law and never have been. The tax is imposed on the partners. They are not taxed on their income actually received from the partnership. What they are taxed on is their distributive share of the partnership income whether they receive it or not.

I do not want to oversimplify this case, but I would like to suggest that the question at issue here was resolved many years ago and that the case, on careful examination, involves no question which has not been long-established in our tax law. The first of two cases is the venerable classic, Lucas against Earl decided in 1930 in an opinion by Justice Holmes. That case involved an agreement between husband and wife under which the income of the husband became the joint property of both spouses. It was contended and the Ninth Circuit held that the income was taxable half to the husband and half to the wife. But this Court reversed Justice Holmes in his well-known opinion, and said: "This case is not to be decided by attenuated subtlties There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts

however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us, and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree on that from which they grew."

The other case is Heiner v. Mellon in 304 U.S. That involved a partnership and involved income which, under the applicable state law, could not be paid. And the Court held that it was nevertheless income to the partnership and came within the distributable share.

Let me turn to a hypothetical example. Let us assume a large law firm with a hundred or more partners and as many associates. For convenience I will call it Ropes & Cromwell. Let us assume that it has a large and important client, which we will call International Conglomerates, Inc. The cient has worldwide operations and is constantly confronted with legal problems. It has its own legal staff, but it relies heavily on the services provided by Ropes & Cromwell. International Conglomerates is much interested in the continuity of the services of the individual members of Ropes & Cromwell.

In the past, Ropes & Cromwell has billed at appropriate intervals and these have been paid. Now let us suppose that Ropes & Cromwell suggest to the corporation

that hereafter ten percent of the bill be paid to the law firm's retirement fund. Obviously enough, this would make no difference under Lucas v. Earl and the Culbertson case, the entire amount would be taxable to the partnership. I do no think it would make any difference that the law firm's retirement fund was a non-vested one under which no partner had any immediate right. The payment to the retirement plan would still be income to the partnership of Ropes & Cromwell because it is a payment made on account of services rendered by the partnership and taxable to the partnership under Lucas v. Earl.

Now let us suppose that instead of a payment to the firm's retirement fund, the payment is made to a trust for such of the wives of the partners of Ropes & Cromwell as survive the partners. Here no partner would have any right to receive any specific amount. I suggest, though, that the payments would still be clearly income to the partnership.

And, finally, let us assume that International Conglomerates came to Ropes & Cromwell and said, "We are very much interested in the continuity of your firm and in encouraging people to stay here in order that they may have background and experience in our work, with the result that when we have a problem we may go to someone who already knows a great deal about our business and the way we operate. Accordingly, we want to join with you in establishing a non-

vested pension plan under which we will make regular annual payments, and the plan will eventually provide retirement payments but only to those members and employees of the firm who satisfy length of service requirements.

That, it seems to me, is what we have here, putting the respondents' case in its strongest terms. But such a payment would still be a payment by International Conglomerates, Inc. on account of services rendered by Ropes & Cromwell and would thus, under Lucas v. Earl and Culbertson, be income to Ropes & Cromwell. Since it is income to Ropes & Cromwell, each partner of Ropes & Cromwell would be taxable on his distributive share of that income, whether distributed or not. And even though it could not be distributed, as this Court held in Heiner v. Mellon.

In this case, the payments made to the retirement fund by Health Plan were made on account of the services rendered by Medical Group and pursuant to the compensation contract between Health Plan and Medical Group, which specifically provided for the payment of these retirement amounts as part of the compensation--that is in quotation marks--payable to Medical Group for medical services to be provided by Medical Group hereunder.

The whole point here is the payments are income to the partnership which performed the services. We do not get to the question of the right to receive payments from

the retirement trust until the payments made by the Health Plan for the services of Medical Group are treated as income to the retirement trust. But the payments are not income to the retirement trust. They are income to Medical Group under the clear teaching of Lucas against Earl. And since the payments are income to Medical Group, it does not matter that the partnership Medical Group by its contract caused these amounts to be payable to the retirement fund in such a way that no one had an immediate vested right to get cash and no partner could currently receive his share. In this respect, the situation is like that in another good old case, Griffiths against the Commissioner, where the Court held that the taxability of the income currently could not be defeated despite the technically elegant arrangement which had been set up to divert the taxability.

For the reasons which I have indicated since the diversion of earned income, that is, the amounts paid pursuant to a contract for personal services rendered, runs directly foul of one of the fundamental principles of income taxation, that earned income is taxable to him who earns it no matter what diversionary arrangement is made for its payment. The decision below is erroneous and should be reversed.

MR. CHIEF JUSTICE BURGER: Thank you, Mr. Solicitor General.

Mr. Brookes.

ORAL ARGUMENT OF VALENTINE BROOKES, ESQ.,

ON BEHALF OF THE RESPONDENTS

MR. BROOKES: Thank you, Mr. Chief Justice, and may it please the Court:

To a substantial extent, the Solicitor General has argued another case than the one before you. Let me first refer to his example about the mythical law firm of Ropes & Cromwell. He suggested that the facts there were that the law firm suggested that ten percent of what had been its normal retainer should be paid to a trust, which was to establish a retirement plan. Let me read you what the parties stipulated in this case.

"The primary purpose"--

Q Where is that?

MR. BROOKES: I beg your pardon. It is on page 83 of the record, Your Honor, and it is in the stipulation of facts. It will also appear virtually in haec verba in the opinion of the Court of Appeals, which is on page 32 of the Appendix to the petition for certiorari. The stipulation is that:

"The primary purpose of the retirement plan was to create an incentive for physicians to remain with Medical Group, or other groups of physicians contracting to serve Health Plan members, and thus to insure Health Plan that it

would have a stable and reliable group of physicians providing medical services to its members" and so on.

Then it states that the retirement plan was patterned after one which was in effect already in Southern California between another medical group and this same Health Plan, and finally that: "The payments which Health Plan agreed to, and did make to the plan, were paid solely to fund the retirement plan, and were not otherwise available to Medical Group or to the individual members or employees thereof."

Q Mr. Brookes, I presume that the stability which that paragraph refers to would benefit Medical Group as well as Health Plan, would it not?

MR. BROOKES: Yes, Your Honor. The point that I seek to make is that the initiative was taken by Health Plan and was for its benefit, according to the stipulation, and it was so understood by both courts below. The opinion of the Court of Appeals is more voluminous and it speaks of the facts more fully than the district court does. There were no findings of fact in the district court other than the opinion. The Court of Appeals in the opinion, which will appear at page 32 in the petition for certiorari--and again I might make quotations from page 39 of the petition, this is the appendix to the petition and in that case I would call your attention to the shift of pages--the Court of Appeals says

the primary purpose of the retirement plan is to insure Kaiser a stable and reliable pool of physicians providing medical service to its members. The plan accomplishes this purpose by creating an incentive for physicians to devote their careers to Kaiser members, and so on. This is virtually from the stipulation in haec verba. But then at page 39 of the appendix to the petition, the court interprets that language again. In distinguishing a circuit court case, Hulbert, which had been cited by the Government below, the court said that Hulbert was not in point because though the partnership, had it chosen not to enter the sales agreement or had it entered a different one on different terms, would have received the whole of the payments as current income. In this case, and I am quoting the Court of Appeals, the parties stipulated that "the payments which Kaiser agreed to and did make to the trust, were paid solely to fund the retirement plan, and were not otherwise available to Permanente"--that is the partnership--"or to the individual members or employees thereof."

Then, turning to the next page--

Q Mr. Brookes, before you go to that--

MR. BROOKES: Yes, Mr. Chief Justice.

Q --I am having a little difficulty seeing how your material in Section 16, page 83 and 84 differs from the hypothetical that the Solicitor General has suggested. Would

you pinpoint what you think is the distinguishing factor.

MR. BROOKES: Yes, Your Honor. In the hypothetical which the Solicitor General suggested, he suggested that the law firm made the suggestion to its client that a portion of what had theretofore been paid as the retainer, ten percent, should be paid into a retirement fund and become deferred income. The stipulation, as construed by the Court of Appeals and also by me, says that this is not what happened there, that this money that was paid into the trust would not otherwise have been available; it would not otherwise have been paid for the benefit of the partners and their employees.

Q Is that a recital which can control the economic reality, do you think?

MR. BROOKES: I think the answer is that probably the result is the same in either case, Your Honor. But I do wish the facts to be before the Court, and if these two different thrusts of initiative do make a difference, then I think the Court should be aware that the Court of Appeals below decided the case on an understanding of the facts which it drew from the stipulation of facts, which was to the effect that the initiative here came from Health Plan rather than from the partnership, and the partnership did not ask Health Plan to take some of the current earnings it would otherwise have received and defer them.

Now, Mr. Chief Justice and may it please the Court, there are cases which we discuss at some length in our brief which hold that this initiative, the question of who suggests the deferment, is irrelevant. The cases that I refer to involve what we call non-funded plans. This is where the employer merely refrains from paying sums to the employee, holds them in its treasury, and pays them later at some time agreed upon by the parties. This is a type of retirement fund.

Q Mr. Brookes, to get back for just a moment to the line of questioning that the Chief Justice was pursuing, in paragraph 16 of the stipulation on page 84 of the record which you had earlier read to us, the last sentence there, "The payments which Health Plan agreed to, and did make to the trust, were paid solely to fund the retirement plan, and were not otherwise available to Medical Group or to the individual members or employees thereof." It seems to me a natural reading of that last sentence would mean that the funds, after paid to the retirement plan, were not otherwise available. Are you suggesting that that means that Health Plan would not have made these payments in any other form than as a payment to the retirement plan?

MR. BROOKES: Yes, I am, Your Honor, not solely from that language, however. And, incidentally, the Court of Appeals adopted the interpretation which I am urging, which is

drawn in part from the language earlier in paragraph 16, which starts out by saying, "The primary purpose of the retirement plan was to create an incentive for physicians to remain with the Medical Group"--and then omitting some words--"to insure Health Plan that it would have a stable and reliable group of physicians providing medical service."

Q Mr. Brookes, if the medical partnership was to have received $100,000 a year, Health Plan said, "We will pay you the hundred thousand, but we will also pay $25,000 because of some particular benefit we want Health Plan-wise to the retirement fund." Is that what the argument is?

MR. BROOKES: This is what I have just stated, yes, Your Honor. This is not my only argument, however. I am seeking to get the facts before the Court.

Q I gather the argument is the hundred thousand would be income, and the twenty-five thousand the parties agreed should not be income because it was not pre-paid for medical services rendered?

MR. BROOKES: No, Your Honor, my point would not be that the parties would so agree but rather I would turn to the substance of their agreement, and this gets to what is the most critical point in this case, in my opinion, which is that as to the taxpayers the amounts paid into the trust were wholly contingent and forfeitable. They had no enforceable right to them until the lapse of conditions which had not

occurred at this time. They must either serve 15 years or serve ten years and become 65 before any of their accounts cease to be tentative. But even after the attainment of these conditions, they must continue to make themselves available, even after retirement, for consultation purposes and refrain from competition. If they fail to live up to those conditions, then too they forfeit, even though their payments had begun up to the time of the second type of conditions of forfeiture.

Q On your theory, when is, if ever, anything taxable to the partners?

MR. BROOKES: When they get it, Your Honor.

Q Does your approach and your analysis of these facts tie in with the history of the Permanente Group and Health Plan; were they not born out of the same ball of wax originally?

MR. BROOKES: Oh, I think not, except in the most general way, Your Honor. There had been a predecessor partnership. Health Plan had been in existence for years prior to the execution of any of the contracts that are in the record here. Indeed, it entered into the employment agreement, if I may so term it, with the partnership six months before the establishment of the funded plan. So, there was a period of six months in which it was contemplated there might be such a plan, but it was not in being and yet

the physicians were working under the partnership agreement and the other agreement with Health Plan. These were not, however, simultaneously born.

Q Are you suggesting that the two organizations, Health Plan and the Medical Group, just came together by accident?

MR. BROOKES: No, I am not, Your Honor. The Health Plan was established by a funding of a large sum from a prominent California family for the purpose of providing pre-paid, low-cost medical care on a non-profit basis. It existed. It had a hospital. It acquired more. It found that it could not operate them without physicians. It also found that it could not balance the budget if outside physicians selected by the patients were employed at normal fee rates. So, it became necessary to establish a relationship with a group of physicians who had provided exclusively with their services. It is the outgrowth of years of experience which has produced the documents in the record here. There was a prior partnership, a prior partnership agreement. The one before you was entered into in 1959, and the record does not state how long back in history the prior relationship of Health Plan with other partnerships had been created, and I do not know.

Q It is a very celebrated development in medical practice, of course, in California.

MR. BROOKES: So it is, Mr. Justice, and the essential key to its success is the availability of a group of physicians under the exclusivity conditions which exist here. The court below used the language "exclusivity"; it was not original with me. I am borrowing their language, and it is exclusive in both directions. That is to say, Health Plan contracts to have the medical services performed exclusively by the physicians who are either partners of or employees of the partnership, and in turn the partnership contracts that its partners and its employees will perform no services for any other health plan but this one. There is a limited provision for their having private practice, in which case their earnings go into the partnership as well. But their private practice is not permitted to interfere with their services for Health Plan, because they must provide their full time or the equivalent thereof for Health Plan.

The Court of Appeals, in further response to your question, Mr. Justice Rehnquist, as to whether I correctly interpret that one sentence in the stipulation isolated from the balance of the stipulation, said that the agreement provides that Kaiser's contributions to the plan are to be in addition to all other sums payable by Kaiser. "Thus, had Permanente elected not to establish the retirement plan, it could not have received additional current income."

It then states: "Nor is there any evidence in the

record"--this is at page 40 of the appendix to the petition for certiorari--"Nor is there any evidence in the record to suggest that Permanente agreed to accept less direct compensation from Kaiser in exchange for the retirement plan payments. That Kaiser would not have been willing to make the payments except into the trust under the conditions imposed is consistent with the primary purpose of the retirement plan: to insure Kaiser a stable and reliable group of physicians....We therefore conclude that Permanente"--there is a deletion at this point, Mr. Chief Justice--"We therefore conlcude that Permanente, never having had the right to receive the income, could not have diverted it to others."

This, I believe, distinguishes this case from the hypothetical of the law firm that was assumed for argument purposes by the Solicitor General.

Q You are not conceding, as I understand it, Mr. Brookes, at all that in the Solicitor General's hypothetical case that the result would be other than the result that you contend for in this case?

MR. BROOKES: Mr. Justice, I am glad you gave me the chance, the opportunity, of making that clear. I do not concede that that difference--that the case depends upon that difference. My case is--

Q You are suggesting the Court might find it

does but--

MR. BROOKES: The Court might so find it and I think also the difference may create a climate for the approach to the case, and I would like that climate, which I consider to be somewhat adverse, to be removed. The law probably makes no difference, no distinction. The rules are quite clear in the status of employees or independent contractors, that the result we argue for would follow because their interests in the retirement payments are entirely forfeitable and contingent. Even in the event of a non-qualified plan where there are employees, Congress has stated its policy, and its policy is with a funded but non-qualified plan. This is a funded plan and a non-qualified plan.

The payments by the employer to the trust or into the fund are not current income to the employee if their rights are non-forfeitable at the time that the payments are made, Section 402(b) of the Code so states. We cannot claim that we come under the umbrella of that section because we are independent contractors, we are not employees. It is true that some of the physicians are employees, but they are employees of the partnership and paradoxically the Government does not seek to tax them. On the contrary, it seeks to tax the amounts paid to the retirement fund for their possible future benefit to the partners and would allow the partners no deduction for the amounts that are actually potentially

receivable by the employees. And the paradox becomes complete because of the fact that this so works out, this plan, that it is quite possible that ultimately the only beneficiaries will be the employees. If the partners all peel off one by one and leave no one but those persons who are presently employees as participants in the plan, all forfeitures go to the benefit of those remaining in the plan, and I have indicated by hypothesis that they are employees. They may later become partners, but at this time they are employees and maybe the sole beneficiaries.

Q But is not this, Mr. Brookes, what the statute provides for, one status for partner and another status for employee. Your quarrel there is with the statute, is it not?

MR. BROOKES: No, Your Honor, we seek to rely upon the statute. We do not believe that the Government's position based upon Lucas against Earl is sound because it is not derived from the statute. Lucas against Earl is certainly a distinguished and important case, but to illustrate, Your Honor, how statutes may change, what has been the law in the past, if Mr. Earl is still alive, he can derive the benefits from the statute which he could not derive under the method he attempted in Lucas against Earl, because all he need do now is file a joint return with his wife, and he would get the split income benefits that he

sought by the device that was denied him. So, statutes do change things, and we rely upon the statute. And we have discussed this at considerable length in our brief, and I would like--it is difficult to discuss a statute in oral argument without the statute before you, but I--this is not such a complex statute as that. First, the Section 701 which appears in the appendix to respondents' brief, which is the white one, it appears at page 3 of the appendix. The appendix is separated from the rest by a blue insert sheet. It says that "A partnership as such shall not be subject to the income tax....Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities."

The point that we see in that section is that Congress is thinking of a partnership not as an entity conducting business but rather as an aggregate of individuals, of persons, carrying on business as partners. It is consistent with that thrust, that emphasis, that Section 703, which appears on page 5 of our appendix, says that "The taxable income of a partnership shall be computed in the same manner as in the case of an individual except that"--and none of the exceptions is applicable here, and the Government has never contended that any of them was applicable here.

So, it says that "The taxable income of a partnership shall be computed in the same manner as in the case of an

individual."

There is history behind these code sections. They are derived--the language which I have read is derived without significant change from the prior code. This Court construed the prior code in Neuberger to adopt in the context then before it the aggregate theory rather than the entity theory. There are lots of words used for these theories and though the Court used both the entity language and the unit language and it also referred to the partnership as an association of individuals and it allowed a partner to offset his individual, non-capital losses against his share of the partnership's non-capital losses, even though the statute could more readily have been construed in the other way under the doctrine of sui generis which the Court refused to apply because it thought, and I quote, that "Congress has recognized the partnership both as a business unit and as an association of individuals. But," they said, "this weakens rather than strengthens the Government's argument that the privileges are distinct and that the unit characteristics of the partnership must be emphasized."

And interestingly at that point they cited among the cases a case from the Court of Claims, the Craik case. And the Craik case involved a non-resident who was a member of a resident partnership. The question was whether he was taxable upon the entire distributive share of his income of

the partnership or merely a portion of it. Some of the partnership income was also from foreign sources as he resided abroad. And the Court of Claims used the language undoubtedly referred to by this Court in referring to the Craik case, that at common law each partner was the agent for the other partners in carrying out their common purpose. The income earned by the partnership was regarded as having been earned by the individual partners either by himself individually or through his agents, the other partners. The court below used the term that the partnership was acting only as the agent of its members and it used it in this context, in this sense; in the petition and in the brief both, the Government has sought to make capital of the use of the term agent, but this is the classical concept of the relationship of one partner to the other, and in the Craik case which this Court spoke of approvingingly in Neuberger, the Court did say that each partner was regarded as having earned the income. The statute says in Section 701 that the businesses done by individuals, by persons doing business in the form of a partnership and it says that the income of the partnership shall be computed in the same manner as in the case of an individual. If those instructions are applied, then we see that the fact that the payments into the trust by Health Plan create only forfeitable and contingent rights in the taxpayers is controlling. Under volumes of doctrine,

including many decisions from this Court, whether on the cash or the accrual basis, a taxpayer does not have income so long as his claims to whatever the property is remain contingent and forfeitable. That rules has been applied consistently in deferred compensation cases.

Lucas against Earl has never been applied in deferred compensation cases. It has been cited by the Government time after time in deferred compensation cases, as it was in both courts here, and it has been rejected in all of those cases, including the two courts below here. And the reason is, Mrs. Earl received money in 1921 and it was at that time that Mr. Earl was held taxable upon it. He was not held taxable upon any income in an earlier year before somebody received it. And so it should be here. These individuals should be taxable when they receive their income and not before.

Q Of course in Lucas against Earl you did not have the added ingredient of a partnership.

MR. BROOKES: This is true, Your Honor. The Code has further answer to the Government's position, and that is it says that--this is Section 704. It appears in the appendix to our brief and the relevant part is on page 5; it is the first words of Section 704. "A partner's distributive share of income, gain, loss, deduction, or credit shall"--and so on--"be determined by the partnership

agreement." Then it goes on--and I was mistaken, this is the critical language. "A partner's distributive share of any item of income shall be determined in accordance with his distributive share," unless the agreement of the parties provides to the contrary.

The point is that a partner is not taxable inflexibly on x-percentage of the net income of the partnership. He used to be under the old code. There is a difference now. His distributive share is of an item of gross income as well as of net income. The purpose of this was to permit persons who contribute appreciated property to a partnership and buy a partnership interest based on the appreciated value to be the sole taxpayers on that appreciated value if the property is sold for a profit. So that the gain which the partners have bought by admitting the new partner will not be taxable to all of them proportionately.

Q What happens--and I am just asking for information--what happens if part of the income of the partnership in a particular year is invested in a capital asset, which of course would be presumably depreciable? Is any of the property that was so invested figured in the distributive share of a partner?

MR. BROOKES: If it was sold--

Q Not sold. Let us say the partnership bought a building.

MR. BROOKES: The point of appreciation in value above basis would be related to the depreciation to be taken by the partnership, not to the number of years.

Q That in subsequent years, I understand.

MR. BROOKES: In subsequent years, yes.

Now, the statute and the regulations recognize this, permit the parties to vary the depreciation amongst themselves. So that the depreciation may go to the party who contributes the appreciated asset rather than being enjoyed by the partners who have not contributed the appreciated asset. And, conversely, in the example I gave a moment ago, if that property, that building should be sold, the statute permits that partner to be the one exclusively taxable upon that appreciation which has now become gain.

So, the distributive share may be only of one item of gross income. And my point is that a distributive share is a proportionate share. A case the Government relies on, Heiner against Mellon--

Q Have you answered the Justice's question?

MR. BROOKES: I answered what I thought was his question.

Q Assume a partnership gets $200 in income. $100 of it they distribute to the partners, $100 of it they buy a chair with it. That is all taxable to the individual partners?

MR. BROOKES: I did not so understand the question. Yes, Your Honor. So it would be. But there is nothing forfeitable or contingent on that. But certainly.

Q I understand, but nevertheless the amount the partnership puts into the chair is taxable to the partner?

MR. BROOKES: Oh, yes, of course it is.

Q Say two fifty-fifty partners and they buy a hundred dollar chair; although they had $200 of otherwise net income, they would each have a distributive share that year of $100, would they not?

MR. BROOKES: Yes, they do, Your Honor.

Q And the partnership would own a $100 chair that would be depreciable over its expected life.

MR. BROOKES: They are just treated like an individual or a corporate taxpayer. Their taxable income determines if they were individuals. And if an individual has income and he buys a depreciable asset, his income is not reduced thereby. He gets depreciation in the future. So, it would be here. But the point that I am seeking to make goes off from that, Your Honor, and it is about the word "distributive." The statute now permits distributive shares to relate to items of gross income, not merely to the sum of net income, and the word "distributive" was construed by this Court as meaning proportionate. And here no partner knows what his proportionate share of this item of income is, if it

is income. Of course, we deny that it is income. But if it were deemed to be income of the partnership, his proportionate share is unknown. It is dependent upon future events.

Q And you do not know what is going to happen to the chair either, do you?

MR. BROOKES: It is purchased from taxable income which has come in and should be taxed. But there was no deferment of receipt there, Mr. Justice White. Here there is non-receipt and not only deferment of receipt but the contingency of possible non-receipt.

My time has expired.

Q Mr. Brookes, I should ask a question when the red light is on, but suppose everything were exactly the same as it is here except that Health Plan paid this amount to Medical Group and Medical Group in turn promised to pay it over to the trust and did in fact pay it over to the trust. Any question about its taxability to the partners under those circumstances?

MR. BROOKES: Your Honor, only if the documents could be so construed that Medical Plan had no alternative. But to do this--but the fact that that is not the case is very important here.

Q How does it differ?

MR. BROOKES: Medical Plan has never received this income. In the case which you have spoken of, Medical Plan

has received it but is obligated to do something with it. The doctrine of receipt and non-receipt is obviously important in the income tax law. The plan here came into being under the thrust of the initiative of, let me call it, the employer; and Medical Plan has no control over it. Now, I grant, Your Honor, that you have given me a hypothetical in which they can only do one thing with it. They can only pay it over to a trust, and I assume the other provisions are the same as they are here, that they cannot get it back except under conditions of possible forfeiture. Yet, the fact that they have received it could be regarded as all important. Here they have not received anything.

Q Because they have agreed not to?

MR. BROOKES: Well, yes, Your Honor, they have agreed not to.

Q That is, the earning entity has agreed not to. To me this is--

MR. BROOKES: The stipulation of facts may answer your question, Your Honor. Page 84 of the record, it says, "No payments were made to the trust during the years in question by Medical Group or by an individual or by individual participants in the retirement plan." That is the last sentence of a paragraph on page 84 of the record, Your Honor.

MR. CHIEF JUSTICE BURGER: Thank you Mr. Brookes.

Thank you, Mr. Solicitor General.

[Whereupon, at 11:08 o'clock a.m. the case was submitted.]

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