

## Section 1348: The Death of Mickey Mouse?†

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*To discourage such "Mickey Mouse" activities as deferring income and seeking tax shelters, Congress enacted section 1348 of the Tax Reform Act of 1969, which provides for a maximum tax on earned income. Professor Asimow discusses the legislative history and mechanics of section 1348 and analyzes in detail the problems which are likely to be presented when it is applied. He probes the definition of earned income and the many problems which can be expected to arise in connection with the limited availability of the maximum tax to businesses in which capital is a material income producing factor. The treatment of tax preferences under the maximum tax and the effect of the new section on the taxation of capital gain is also considered. Finally he addresses the question of whether the intended purposes of section 1348—primarily the death of Mickey Mouse—will be attained.*

The Tax Reform Act of 1969<sup>1</sup> worked a fundamental change in the progressive income tax by imposing a maximum tax on earned income. Under the maximum tax scheme embodied in section 1348,<sup>2</sup>

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1. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487.

2. INT. REV. CODE of 1954, § 1348 [hereinafter cited as CODE]:

(a) GENERAL RULE.—If for any taxable year an individual has earned taxable income which exceeds the amount of taxable income specified in paragraph (1), the tax imposed by section 1 for such year shall, unless the taxpayer chooses the benefits of part I (relating to income averaging), be the sum of—

(1) the tax imposed by section 1 on the lowest amount of taxable income on which the rate of tax under section 1 exceeds 50 percent,

(2) 50 percent of the amount by which his earned taxable income exceeds the lowest amount of taxable income on which the rate of tax under section 1 exceeds 50 percent, and

(3) the excess of the tax computed under section 1 without regard to this section over the tax so computed with reference solely to his earned

earned taxable income cannot be taxed at a rate higher than 50 percent while other kinds of ordinary income are taxable at rates up to 70 percent.

The Treasury Department first proposed that the top bracket for all kinds of income be 50 percent with a special upward adjustment for preferentially taxed items.<sup>3</sup> However, it then altered its position by suggesting to the House Ways and Means Committee a maximum bracket of 50 percent on earned income only.<sup>4</sup> The Ways and Means Committee decided to limit the tax on earned income to 50 percent but without adjustment for tax preferences.<sup>5</sup> The Senate Finance Committee struck out the preferred rate on earned income in an early ses-

taxable income.

In applying this subsection to a taxable year beginning after December 31, 1970, and before January 1, 1972, "60 per cent" shall be substituted for "50 per cent" each place it appears in paragraphs (1) and (2).

(b) DEFINITIONS.—For purposes of this section—

(1) EARNED INCOME.—The term "earned income" means any income which is earned income within the meaning of section 401(c)(2)(C) or section 911(b), except that such term does not include any distribution to which section 72(in)(5), 72(n), 402(a)(2), or 403(a)(2)(A) applies or any deferred compensation within the meaning of section 404. For purposes of this paragraph, deferred compensation does not include any amount received before the end of the taxable year following the first taxable year of the recipient in which his right to receive such amount is not subject to a substantial risk of forfeiture (within the meaning of section 83(c)(1)).

(2) EARNED TAXABLE INCOME.—The earned taxable income of an individual is the excess of—

(A) the amount which bears the same ratio (but not in excess of 100 percent) to his taxable income as his earned net income bears to his adjusted gross income, over

(B) the amount by which the greater of—

(i) one-fifth of the sum of the taxpayer's items of tax preference referred to in section 57 for the taxable year and the 4 preceding taxable years, or

(ii) the sum of the items of tax preference for the taxable year, exceeds \$30,000.

For purposes of subparagraph (A), the term "earned net income" means earned income reduced by any deductions allowable under section 62 which are properly allocable to or chargeable against such earned income.

(c) MARRIED INDIVIDUALS.—This section shall apply to a married individual only if such individual and his spouse make a single return jointly for the taxable year.

3. U.S. TREAS. DEPT., TAX REFORM STUDIES AND PROPOSALS 17, 37, 172-73 (1969). The Treasury proposal would have included in income for maximum tax purposes tax exempt interest, the excluded portion of long-term capital gains, percentage depletion in excess of basis, appreciation on property contributed to charity, and the value of exercised stock options. *Id.* at 136-37.

4. The description of the Treasury Department's position and of the path trodden by section 1348 through the House Ways and Means Committee and the Senate Finance Committee are drawn from the remarks of Edwin S. Cohen before the A.B.A. National Institute on Tax Reform, Jan. 23, 1970, in 23 TAX LAWYER 417, 422-23 (1970).

5. H.R. 13270, 91st Cong., 1st Sess. § 802 (1969).

sion and the provision did not reappear in the bill enacted by the Senate.<sup>6</sup> The Conference Committee readopted the 50 percent ceiling rate on earned income, but it required a reduction of earned taxable income by the taxpayer's "tax preferences."<sup>7</sup> Moreover, the provision which was finally enacted is not effective at all in 1970,<sup>8</sup> provides for a 60 percent ceiling on earned income in years beginning in 1971, and establishes a 50 percent ceiling for all later years.<sup>9</sup>

The legislative history indicates three distinguishable objectives.<sup>10</sup> Since many highly compensated persons were avoiding taxation at rates above 50 percent by utilizing schemes which were unavailable to or not used by many other taxpayers who received the same amount of compensation, the 50 percent limitation was expected to make the tax system more equitable in the sense of treating similarly situated people alike. Secondly, Congress intended to encourage talented people to work harder. Most significantly, Congress wished to induce taxpayers to forego such tax minimizing "Mickey Mouse" activities as deferring income and seeking tax shelters and capital gains.

Part I of this Article explains the mechanics of section 1348. Part II explores the problem of defining earned income and the special problem of deferred compensation. Part III analyzes the effect of section 1348 on the unincorporated business in which capital is a material income producing factor (MIPF) and probes an apparent gap in the coverage of the maximum tax. Part IV addresses the treatment of tax preferences and capital gains under the maximum tax scheme. Finally, part V discusses the purposes of section 1348 and the likelihood that they will be affected by the maximum tax.

## I

### MECHANICS AND OPERATION

In 1972, when section 1348 becomes fully effective, it will take

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6. S. REP. NO. 91-552, 91st Cong., 1st Sess. 309-10 (1969), in 1969-3 CUM. BULL. 423, 619. The Committee questioned whether it was appropriate to single out earned income for relief while imposing higher taxes on other sources, particularly when a given taxpayer might also make use of tax preferences. That objection was presumably solved to some extent by the scale-down for tax preferences ultimately adopted. See notes 348-63 *infra* and accompanying text. The Finance Committee also questioned whether the reduction in tax on earned income would be consistent with the progressive rate structure. Instead of such reduction the Committee scaled down the progressive rates in all brackets—a change later reversed on the Senate floor. S. REP. NO. 91-552, *supra*, at 12, 1969-3 CUM. BULL., *supra* at 430.

7. CONF. REP. NO. 91-782, 91st Cong., 1st Sess. 329 (1969), in 1969-3 CUM. BULL. 644, 675.

8. Tax Reform Act of 1969, Pub. L. No. 91-172, § 804(c), 83 Stat. 487.

9. CODE § 1348(a).

10. See pt. V *infra*.

effect at a 52,000 dollar level of earned taxable income (ETI) on a joint return or a level of 38,000 dollars if the taxpayer is single or the head of a household.<sup>11</sup> In 1971, it will take effect at ETI levels of 100,000 dollars on a joint return, 70,000 dollars on a head of the household return, and 50,000 dollars on a single return. Married individuals must file a joint return in order to take advantage of section 1348.<sup>12</sup> It should also be noted that the taxpayer cannot utilize both section 1348 and income averaging under section 1301, but must elect between the two.<sup>13</sup>

To utilize section 1348, a taxpayer must first segregate his earned income<sup>14</sup> from his other gross income. He then reduces his earned income to "earned net income" (ENI) which is defined as "earned income reduced by any deductions allowable under section 62 which are properly allocable to or chargeable against such earned income."<sup>15</sup> The deductions under section 62 include the deductions attributable to a trade or business carried on by the taxpayer—other than as an employee<sup>16</sup>—and contributions to Keogh plans.<sup>17</sup> In addition, certain expenses of employees must be deducted in computing ENI: reimbursed expenses,<sup>18</sup> expenses for travel, meals and lodging while away from home,<sup>19</sup> transportation expenses,<sup>20</sup> and expenses incurred by outside salesmen.<sup>21</sup> However, moving expenses deductible under sections 62 and 217<sup>22</sup> apparently need not be subtracted from earned income in computing ENI.<sup>23</sup> Other deductible employee expenses, such as dues

11. These are the income levels at which the rate brackets go over 50 percent.

12. CODE § 1348(c). Watts, *The Maximum Tax on Earned Income: Section 1348*, 26 TAX L. REV. 1, 39-40, (1970), points out some of the problems with the joint return requirement.

13. See CODE §§ 1304(b)(6), 1348(a).

14. *Id.* § 1348(b)(1).

15. *Id.* § 1348(b)(2). Watts, *supra* note 12, at 30-32 points out some of the distortions resulting from the deduction allocation provisions of section 1348.

16. CODE § 62(1).

17. Keogh plans are qualified self-employed individuals' retirement plans. *Id.* § 401(c).

18. *Id.* § 62(A). See Rev. Proc. 64-48, 1964-2 CUM. BULL. 993, for an explanation of the treatment of reimbursed employee expenses under section 911.

19. CODE § 62(2)(B).

20. *Id.* § 62(2)(C).

21. *Id.* § 62(2)(D).

22. *Id.* § 217. Moving expenses under section 217 are specifically made deductible in computing adjusted gross income under section 62(8). *Id.*

23. Jon F. Hartung, 55 T.C. No. 1 (Oct. 1, 1970) (five dissenters). In this startling case, taxpayer incurred expenses in moving to a new job abroad. The earned income from the job was excludable under section 911 which allows non-resident United States citizens to exclude income earned from non-U.S. sources up to certain maxima. But section 911 disallows deduction of any amount "properly allocable to or chargeable against" excludable income. The issue therefore was whether the moving expenses, deductible under section 217, could be allocated to earned income. The

and costumes, are not deductible under section 62 from adjusted gross income and, therefore, are not used to reduce earned income in computing ENI.<sup>24</sup>

Next, ENI must be reduced to earned taxable income (ETI). This is done by applying a two-step formula. The first step of the formula is a proportion which allocates deductions *from* adjusted gross income between ENI and other adjusted gross income:<sup>25</sup>

$$\frac{\text{ETI}}{\text{taxable income}} = \frac{\text{ENI}}{\text{adjusted gross income}}$$

More simply, at this stage, ETI equals the product of taxable income times ENI divided by adjusted gross income.

Step two then reduces this figure by an amount reflecting tax preferences.<sup>26</sup> The amount to be subtracted is the difference between 30,000 dollars and the greater of: (a) one-fifth of the sum of the taxpayer's items of tax preference (as defined in section 57) for the taxable year and the four preceding taxable years,<sup>27</sup> or, (b) the sum of the items of tax preference for the taxable year.<sup>28</sup> The resulting figure is earned taxable income (ETI).

Section 1348 then sets forth the method of calculating the tax payable on ETI as well as the tax payable on *unearned* taxable income. The tax on ETI is computed by taking the tax on the largest amount of ETI which is not taxed at a rate above 50 percent<sup>29</sup> and adding to that tax 50 percent of the balance of ETI.<sup>30</sup> The tax on unearned taxable income is the tax computed in the regular way on all taxable income less the tax computed in the regular way on ETI.<sup>31</sup> In other words, the

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court allowed the deduction, reasoning that moving expenses were personal items, not business expenses. See Treas. Reg. § 1.911-2(d)(6) (1957). Since the language used in section 911(a) is the same as in section 1348(b), *Hartung* would apparently be applicable under section 1348 even though moving expenses under section 217 are deductible in computing adjusted gross income under section 62.

24. Thus, unlike the usual situation, it is preferable for the employee's deduction to be *from* adjusted gross income as distinguished from a deduction used *in computing* adjusted gross income.

25. CODE § 1348(b)(2)(A). ETI cannot exceed 100 percent of taxable income. Such a result could occur (in the absence of the provision limiting ETI to 100 percent of taxable income) when the taxpayer's activities producing other than earned income ran at a loss so that adjusted gross income was less than ENI.

26. *Id.* §§ 1348(b)(2)(B)(i) & (ii).

27. *Id.* § 1348(b)(2)(B)(i).

28. *Id.* § 1348(b)(2)(B)(ii).

29. The code section describes this amount as "the lowest amount of taxable income on which the rate of tax under section 1 exceeds 50 per cent. . . ." *Id.* § 1348(a)(1). For example, on a joint return, the lowest amount of tax on which the marginal rate exceeds 50 percent would be 52,000.01 dollars—the penny being taxed in the 53 percent bracket. The description in the text ignores the penny.

30. *Id.* § 1348(a)(2).

31. *Id.* § 1348(a)(3).

tax on unearned income begins at the bracket at which the tax on ETI would have stopped if ETI had been taxed without regard to section 1348. A numerical example of the operation of section 1348 is contained in the Appendix to this Article.

## II

### THE DEFINITION OF EARNED INCOME: PERSONAL SERVICES

#### A. *History of Attempts to Single Out Earned Income*

Distinguishing earned from unearned income has been a recurring problem in American tax law. Under the excess profits taxes of World Wars I and II and the Korean War, special treatment was accorded "personal service corporations."<sup>32</sup> These were corporations whose income was ascribed primarily to the services of the principal stockholders.<sup>33</sup> Under the retirement income credit, only those whose "earned income" exceeded 600 dollars in ten calendar years qualify for the credit.<sup>34</sup> Moreover the benefit is scaled down by amounts of "earned income"<sup>35</sup> in excess of certain amounts. Earned income is defined by reference to section 911(b).<sup>36</sup>

As originally enacted in 1962, the basis on which contributions to Keogh plans were computed was also "earned income."<sup>37</sup> This term was defined as "net earnings from self-employment as defined in section 1402(a)"; but if both services and capital were material income-producing factors, not more than 30 percent of net profits could be attributed to services.<sup>38</sup> The provision concerning capital was stricken in 1966<sup>39</sup> and thus the present version requires only that services be a material income-producing factor. Section 1402(a)<sup>40</sup>—the self-employment tax section—defines "net earnings from self-employment" as gross income from a trade or business (not received by the taxpayer as an employee) less deductions attributable thereto, plus or minus distributive shares from a partnership.<sup>41</sup> There are detailed exceptions for certain rentals and dividends and certain retirement income from partner-

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32. See discussion of the statutes according such treatment in the text accompanying notes 206-09 *infra*.

33. *E.g.*, Internal Revenue Code of 1939, ch. 2, § 725(a), 54 Stat. 987.

34. CODE § 37(b).

35. *Id.* §§ 37(d)(2)(A) & (B).

36. *Id.* § 37(g).

37. Self-Employed Individuals Tax Retirement Act of 1962, Pub. L. No. 87-792, § 3, 76 Stat. 809.

38. CODE § 401(c)(2)(A).

39. Act of Nov. 13, 1966, Pub. L. No. 89-809, § 204(c), 80 Stat. 1577.

40. CODE § 1402(a).

41. *Id.*

ships.<sup>42</sup>

In section 107 of the 1939 Code,<sup>43</sup> special averaging benefits were accorded lump-sum payments received as consideration for rendering personal services.<sup>44</sup> In 1964, this and other special averaging provisions were repealed<sup>45</sup> in favor of the present scheme of averaging found in sections 1301-05.

The definition of earned income under section 1348 is derived from that first incorporated into the Code as part of the "earned income credit." From 1924 to 1931 and from 1934 to 1943, the earned income credit provision permitted modest amounts of "earned income" to be taxed at a lower rate than other kinds of income.<sup>46</sup> Typically, with subsequent variations, a small amount, such as the first 3,000 dollars of income, was automatically treated as "earned" income and an additional 11,000 dollars qualified if it were shown to be in fact earned.<sup>47</sup> Although the earned income credit has long been discarded, its method of defining "earned income" was incorporated by section 213(b)(14) of the Revenue Act of 1926, the forerunner of section 911.<sup>48</sup> In order to induce people to work abroad and thus to increase exports, Congress in section 213(b)(14) excluded from taxation earned income of non-resident citizens from sources outside the United States.<sup>49</sup> The language of section 213(b)(14) was preserved in section 911(b) of the 1954 Code and is incorporated by reference in section 1348.<sup>50</sup>

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42. *Id.* §§ 1402(a)(1)-(3), (10). However, the provisions of the self-employment tax are not determinative in defining earned income under section 911(b). Rev. Rul. 60-178, 1960-1 CUM. BULL. 14. Compare President Nixon's Family Assistance Plan, [H.R. 16311, 91st Cong., 2d Sess. (1970)] which failed of enactment in the 91st Congress. The bill distinguished between earned and unearned income for a variety of purposes. Earned income was defined as remuneration from services as an employee and net earnings from self employment, using Social Security Act definitions, with appropriate exceptions. The more precise approach of section 1402(a) or of the Family Assistance Plan should be considered by Congress if section 1348 is to be redrafted.

43. Internal Revenue Code of 1939, ch. 2, § 107, 53 Stat. 878.

44. Section 107 referred to compensation received for personal services rendered. Under the 1954 Code, section 1301 permitted averaging of compensation from an "employment." An "employment" was defined as an arrangement for the performance of personal services to effect a particular result. CODE § 1301(b) (prior to 1964 amendment).

45. Revenue Act of 1964, Pub. L. No. 88-272, § 232, 78 Stat. 105.

46. *E.g.*, Internal Revenue Code of 1939, ch. 2, § 25(a)(3) & (4), 53 Stat. 18. *Cf.* the Massachusetts income tax, Mass. Gen. Laws Ann. ch. 62, §§ 1, 5(b), 6 (1969).

47. Internal Revenue Code of 1939, ch. 2, § 25(a)(4)(C), 53 Stat. 18.

48. Revenue Act of 1926, ch. 27, § 213(b)(14), 44 Stat. 26.

49. *See* H.R. REP. NO. 1, 69th Cong. 1st Sess., 7 (1926); *Commissioner v. Fiske's Estate*, 128 F.2d 487, 490 (7th Cir. 1942). *See generally* Comment, *Section 911 Tax Reform*, 54 MINN. L. REV. 823 (1970).

50. "The term 'earned income' means any income which is earned income within the meaning of section 401(c)(2)(C) or section 911(b). . . ." CODE § 1348 (b)(1).

Section 911(b) provides: "[T]he term 'earned income' means wages, salaries, or professional fees, and other amounts received as compensation for personal services actually rendered . . . ."<sup>51</sup> In most cases, this definition can be easily applied. However, there are many forms of income which are difficult to classify. These will be examined in the following subsections. The additional problem of distinguishing the return on capital from compensation for services, where capital is a material income-producing factor, is discussed in a later section of this paper.<sup>52</sup>

## B. Analysis of Specific Types of Payments

### 1. Payments for Not Working

One potential problem in applying the section 911(b) definition arises when a taxpayer is paid for not working. In *Earl Groth*<sup>53</sup> the taxpayer received a 22,000 dollar settlement from an employer who had fired him. After finding that the payment was liquidated damages under the employment contract rather than additional compensation for past services, the Board declared that it was not "earned income" under the earned income credit provision of the Revenue Act of 1926.<sup>54</sup> Similarly, payments under a covenant not to compete would not seem to be payments for services actually rendered. Some interesting factual questions will undoubtedly be raised by contracts which require the payee to be a consultant or to hold himself available for consulting. Whether payments under these contracts are for work or for not working will probably depend to a large extent on whether is a real obligation to render services or whether the consulting obligation is a sham.

There is also a substantial question whether payments made in advance of rendering services are for "personal services actually rendered." Under section 162, it has been held that prepayments of compensation are not immediately deductible since the services paid for have not been *actually rendered*.<sup>55</sup> However, if section 1348 does not

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51. Section 911(b) goes on to provide that compensation which is a disguised corporate dividend is not earned income. See text accompanying notes 88-90 *infra*. It further provides that in the case of a trade or business employing both services and capital as material income-producing factors, only a reasonable allowance for compensation for personal services (up to 30 percent of net profits) can be treated as earned income. See pt. III *infra*.

52. See pt. III *infra*.

53. 32 B.T.A. 796 (1935).

54. *Id.* Similarly, damages paid by a city to an improperly fired employee are not earned income under the retirement income credit. Rev. Rul. 60-188, 1960-1 CUM. BULL. 28.

55. Tim W. Lillie, 45 T.C. 54, 62 (1965), *aff'd*, 370 F.2d 562 (9th Cir. 1966); D.K. McColl, 10 P-H Tax Ct. Mem. 126 (1941); Rev. Rul. 58-53, 1958-1 CUM. BULL. 152.



apply to advance payments, substantial inequities will be created as between people paid in advance—such as criminal lawyers—and people paid after rendering services—such as tax lawyers. Since this distinction serves no rational purpose, the regulations should treat advance payments as earned income.

## 2. *Intellectual Property*

Under section 911, if a creative person works for himself and then either sells or licenses his work, the return is from property, not from services, and therefore is not earned income.<sup>56</sup> On the other hand, if he is an employee who has been retained to produce the work, the return is deemed to be from services and is earned income.<sup>57</sup> The anomalies and difficult factual questions raised by this distinction have been avoided by section 1348. Irwin Karp, Counsel for the Authors League of America, argued to the Senate Finance Committee that earned income under the maximum tax should include income from creative works.<sup>58</sup> He proposed that section 1348 incorporate the definition of earned income in section 401(c)(2)(C)—gains (other than capital gains) and “net earnings derived from the sale or other disposition of, the transfer of any interest in, or the licensing of the use of property (other than goodwill) by an individual whose personal efforts created such property.”<sup>59</sup> This suggestion was part of the statute when it emerged from conference.<sup>60</sup>

The reference to section 401(c)(2)(C) obviously solves the problem of the author or composer who receives royalties from either assigning or licensing an interest in his work because it is no longer necessary to decide whether he was functioning as a seller of property or as an employee of his publisher. It also clearly benefits the painter or sculptor

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56. Patent license: John E. Greenawalt, 27 B.T.A. 936 (1933); Ray Harroun, 14 P-H Tax Ct. Mem. 860 (1945) (both earned income credit cases). Copyright royalties: E. Phillips Oppenheim, 31 B.T.A. 563 (1934) (earned income credit). Damages for copyright infringement: Jack Rosenzweig, 1 T.C. 24 (1942), *acquiesced in* 1943 CUM. BULL. 19 (pre-1964 averaging). Permission to reprint previously published article: Frank L. Kluckhohn, 18 T.C. 892 (1952) (nonresident citizen). *See generally* G.C.M. 236, VI-2 CUM. BULL. 27 (1927).

57. G.C.M. 236, VI-2 CUM. BULL. 27 (1927); E. Phillips Oppenheim, 31 B.T.A. 563 (1934) (dictum). *Cf.* Ingram v. Bowers, 57 F.2d 65 (2d Cir. 1932) (Enrico Caruso was employee under recording contract). Not only is this a difficult factual question, it is an irrational distinction in view of the purpose of section 911. If that purpose was to encourage citizens to live abroad and sell American goods [see note 4 *supra*], the works of a creative person—produced on his own or as an employee—should not qualify unless they are sold outside the United States.

58. *Hearings on H.R. 13270 Before the Senate Comm. on Finance*, 91st Cong., 1st Sess., pt. 4, at 3480-88 (1969).

59. CODE § 401(c)(2)(C).

60. *Id.* § 1348(b)(1).

who sells his work outright. Similarly, if an inventor transfers less than all substantial rights under his patent, he receives ordinary income<sup>61</sup> which would be treated as earned income.

The reference in section 1348 to section 401(c)(2)(C) dispenses with the need to inquire whether a creative person is using capital as an MIPF. Although a creative person might well utilize capital as an MIPF—either in the form of equipment (such as a kiln) or in the form of an inventory of unsold works—all of the income qualifies as earned under section 1348. This result seems anomalous because it prefers creative persons over others who sell goods (such as druggists) who cannot claim more than 30 percent of their net income as earned.<sup>62</sup>

Taxpayers other than those commonly considered as creative persons may also benefit by the incorporation of section 401(c)(2)(C). The tailor, for example, who makes suits to order probably utilizes capital as an MIPF in his business—both the equipment he uses and the materials he buys and resells lead to this conclusion.<sup>63</sup> Since the suit seems to be an item of property sold by the person whose “personal efforts” created it, the tailor’s entire net income, not just 30 percent, falls within section 1348.<sup>64</sup> However, there must be some meaningful boundary short of the absurd. To hold that a crop is “created” by the “personal efforts” of a farmer or that a fat herd of cattle is “created” by the “personal efforts” of a rancher seems farfetched but not impossible. It seems more consonant with the purpose of the statute, and less likely to effect strange new anomalies, to assume that crops and livestock were “created” primarily by natural processes, with relatively minor “creative” assistance from farmers or ranchers.<sup>65</sup>

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61. Under section 1235, a transfer of all substantial rights to a patent produces long-term capital gain, regardless of the holding period, regardless of how many inventions have been sold, and regardless of whether the payments are contingent. Although certain transfers to related persons do not come within section 1235, they could also produce long-term capital gain under section 1221. Under pre-1964 income averaging, the winners of taxable contest prizes were deemed to have sold property, not rendered services. Rev. Rul. 58-101, 1958-1 CUM. BULL. 233; Rev. Rul. 55-642, 1955-2 CUM. BULL. 302. They also should be helped by the incorporation of section 401(c)(2)(C) in section 1348.

62. See discussion of this problem in pt. III *infra*.

63. See *Fairfax Mut. Wood Prod. Co.*, 5 T.C. 1279 (1945).

64. This conclusion is substantiated by the fact that the drafting model for section 401(c)(2)(C) was evidently section 1221(3)—the “Eisenhower amendment” denying capital gain benefits to creative works. However, section 401(c)(2)(C) lacks the precise language found in section 1221(3) which limits it to a “copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property . . . .” Thus it follows that section 401(c)(2)(C) is not limited to those traditionally considered to be creative persons.

65. *But see* the suggestion in Comment, *Cattle and Taxes Under the 1969 Tax Reform Act*, 17 U.C.L.A.L. REV. 1251, 1270 (1970) that the income produced by cattle feeding is earned income. A bit of legislative history supports the proposition

### 3. Community Property

At one time, the question of whether a wife's share of community earnings is earned income was very troublesome. Originally, under the earned income credit, the IRS took the position that the wife's share of the husband's community earnings did not qualify as earned income.<sup>66</sup> However, in *McLarry v. Commissioner*,<sup>67</sup> the Fifth Circuit held that the statute referred to all compensation for personal services without reference to who received the compensation. Somewhat more persuasive was the later case of *Graham v. Commissioner*<sup>68</sup> which held that the community was deemed to have rendered the services, not the husband individually. Therefore, the couple was treated as a partnership, and both halves of the income were held to be earned.<sup>69</sup> Although the Tax Court has continued to adhere to the contrary position,<sup>70</sup> the IRS has gone along with *Graham* and *McLarry*.<sup>71</sup> It therefore seems safe to assume that both the husband's and the wife's share of community income earned by the husband will qualify as earned income under section 1348.<sup>72</sup>

### 4. Income in Respect of a Decedent and Death Benefits

To what extent can an amount which would have been earned income in the hands of the earner retain that status when received by another after the earner's death? Since in the case of community property, the wife's share of the husband's community earnings is earned income,<sup>73</sup> one might expect the same treatment of a widow's death benefit<sup>74</sup> or income in respect of a decedent.<sup>75</sup> However, the IRS has ruled

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that farming and ranching are not under section 401(c)(2)(C). At the same time it was enacted, Congress removed the MIPF rule from Keogh plans for the primary purpose of aiding farmers by making all of their income earned (not just 30 percent). This would have been unnecessary if the job was done by section 401(c)(2)(C). See note 216 *infra*.

66. Mim. 3283, IV-9 CUM. BULL. 14, 17 (1925).

67. 30 F.2d 789 (5th Cir. 1929).

68. 95 F.2d 174 (9th Cir. 1938).

69. *Id.* at 176.

70. Mrs. Frank Andrews, 26 B.T.A. 642 (1932).

71. See Rev. Rul. 59-159, 1959-1 CUM. BULL. 26; Rev. Rul. 55-246, 1955-1 CUM. BULL. 92; Rev. Rul. 55-597, 1955-2 CUM. BULL. 15. See Warren R. Miller, 51 T.C. 755 (1969); Richard B. Gantt, 46 T.C. 290 (1966); Charles R. Wilkerson, 44 T.C. 718 (1965) *aff'd per curiam*, 368 F.2d 552 (9th Cir. 1966). These rulings and cases are consistent with the notion that the result in community property states should be the same as in common law states. See *Renoir v. Commissioner*, 321 F.2d 605 (9th Cir. 1963); Daniel M. Ebberts, 51 T.C. 49 (1968).

72. Note that section 1348(c) requires that in the case of married individuals, joint returns must be filed. CODE § 1348(c).

73. *McLarry v. Commissioner*, 30 F.2d 789 (5th Cir. 1929).

74. Death benefits are payments by an employer to a widow (or other survivor) which are excludable under section 101(b) up to 5000 dollars. The balance is taxable unless a gift under section 102.

75. Section 691 provides that "income in respect of a decedent" is taxable to

that a widow's death benefit is not earned income of the recipient under section 911.<sup>76</sup>

The differing policies behind sections 911 and 1348 support a different result in both the widow's benefit and income in respect to a decedent case. It seems unlikely that an individual would be induced to work abroad because amounts paid to his estate or widow would be excluded from income. Thus the purpose of section 911 is not defeated by the IRS' position. But lump sum widow's benefits or large payments of income in respect of a decedent might well prompt the recipient to enter into deferral or tax shelter schemes—the kind of activity that section 1348 was intended to discourage.<sup>77</sup>

##### 5. *Services Rendered by Assistants*

One problem that seems certain to cause difficulty under section 1348 will be the large service firm in which valuable services are rendered by persons other than partners or proprietors. Under the earned income credit the IRS first took the position that income attributable to associates in a professional firm could be considered earned income of the proprietors or partners only if they closely supervised the associates.<sup>78</sup> Later the IRS withdrew<sup>79</sup> from this position in favor of the one stated by the present regulations under section 911:

The entire amount received as professional fees shall be treated as earned income if the taxpayer is engaged in a professional occupation, such as a doctor or a lawyer, even though he employs assistants to perform part or all of the services, provided the patients or clients are those of the taxpayer and look to the taxpayer as the person responsible for the services performed.<sup>80</sup>

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whoever receives it, whether it is the estate or other beneficiary. Since no step-up in basis is available, [CODE § 1014(c)] the entire amount is taxable. For example, if the widow or estate collects salary accrued prior to death, this is income in respect of a decedent.

76. Rev. Rul. 56-524, 1956-2 CUM. BULL. 504.

77. See notes 371-94 *infra* and accompanying text. Furthermore, income in respect of a decedent generally has the same character in the hands of the recipient as it would have had in the hands of the decedent. CODE § 691(a)(3); Treas. Reg. § 1.691(a)-(b)(3) (1957).

78. S.M. 4088, IV-2 CUM. BULL. 26 (1925). See also *Albrecht & Weaver, Inc.*, 9 B.T.A. 560 (1927); *Continental Acct. & Audit Co.*, 7 B.T.A. 330 (1927); *Electro Dental Parlors*, 2 B.T.A. 83 (1925).

79. Mim. 3802, IX-1 CUM. BULL. 121 (1930); G.C.M. 9716, X-2 CUM. BULL. 304 (1931). *Percy A. Yalden*, 20 B.T.A. 372 (1930), an early earned income credit case involving an accounting firm, agreed with the revised view but the point was not squarely involved since the proprietor in fact gave reasonably close supervision to his associates. *Id.* at 373, 377.

80. Treas. Reg. 1.911-2(c)(2) (1963). By virtue of its long existence, this regulation is said to have acquired the force of law. *Foster v. United States*, 329 F.2d 717, 720 (2d Cir. 1964).

This regulation may require a professional firm to reconsider both its record keeping and its method of operation. In a large law firm, for example, many clients may regard an associate, rather than any partner, as being entirely responsible for their work. Such firms may even try to persuade clients to look upon the associates in this manner, thus relieving the partners of some responsibility. When this occurs, the IRS might assert that the earned income of the partners does not include the income generated by the associate. These firms might consider re-establishing some contact between the partner and the client, if only in the form of signing letters and billing. However, this may be unrealistic in such large-volume operations as a group medical practice or a criminal law or workman's compensation practice. In such firms, some new kind of record-keeping will have to be instituted to enable a partner to prove what proportion of income can be attributed to him. Otherwise, he may have to settle for an unfavorable result or face the nightmarish job of reconstructing the services rendered to every client during past years.

Regulation 1.911-2(c)(2) strangely fails to deal with businesses other than professional service firms. There are several possible approaches to this problem. One would be to limit the proprietors or partners in non-professional firms to an earned income figure no higher than a reasonable allowance for compensation. Under the language of section 911(b), this seems to be the correct approach if capital is a material income-producing factor.<sup>81</sup> Another approach would be to re-adopt the IRS' original position under the earned income credit. Under this formulation, if supervision of employees is only perfunctory, none of the income they generate is earned income of the proprietor or partner.<sup>82</sup> Finally, the section 911 regulation might be expanded to include all businesses—not just professions—thus treating all the income generated by employees as the earned income of the partners or proprietors if the customers look to them as ultimately responsible for the services.<sup>83</sup>

The different possibilities can be illustrated by the hypothetical case of a private girls' school. Suppose the proprietor plans the curriculum,

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81. Section 911(b) provides:

In the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income-producing factors, under regulations prescribed by the Secretary or his delegate, a reasonable allowance as compensation for the personal services rendered by the taxpayer, not in excess of 30 percent of his share of the net profits of such trade or business, shall be considered as earned income.

82. See note 78 *supra*.

83. Cf. Fred C. Sanborn, 19 B.T.A. 495 (1930), a case apparently taking this approach. Under the earned income credit, a general agent in the life insurance business was allowed to consider earnings generated by his 25 sub-agents as his earned income since the commissions were paid by the company directly to him and his personal skill in dividing up the territory was vital.

hires nine teachers—giving them latitude in choosing how to teach—counsels students, and teaches one-tenth of the classes himself. Assume that capital is not a material income-producing factor<sup>84</sup> and that the school earns 100,000 dollars per year. Under the reasonable allowance for compensation approach, it might appear that managers of comparable schools are earning only 25,000 dollars. Under the perfunctory supervision approach, it might be held that each of the ten teachers generates one-tenth of the income, leaving only 10,000 dollars as the earned income of the proprietor.<sup>85</sup> But under the approach of regulation 1.911-2(c)(2), since the proprietor is probably looked upon by the community as being ultimately responsible for all the services, the entire 100,000 dollars could be considered earned.

A comparable problem arose repeatedly under the excess profits tax in effect during World Wars I and II and the Korean War. To be a “personal service corporation” and thus entitled to be taxed as a partnership, a corporation had to show that its income was “ascribed primarily” to the activities of the major stockholders.<sup>86</sup> As in the case of section 1348, it was necessary to isolate the income fairly attributable to the owners of the business. A number of cases involved schools. Although the approach of the cases was not consistent, the courts tended to adopt the “perfunctory supervision” approach where the teachers hired by the proprietor were skillful and had discretion in the manner of presenting their material.<sup>87</sup> Despite this authority, it is difficult to see

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84. See note 230 *infra*. In *ShIPLEY School v. McCaughn*, 34 F.2d 281 (3d Cir. 1929), capital was held not to be an MIPF in a girls' school case.

85. *Cf. Isidore Garnets*, 26 B.T.A. 384 (1932) an earned income credit case holding income generated by skilled teachers in a business school not to be earned income of the proprietor.

86. For example, section 200(5) of the Revenue Act of 1921 defined a “personal service corporation” as one whose income “is to be ascribed primarily to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the affairs of the corporation . . . .” Revenue Act of 1921, ch. 136, § 200(5), 42 Stat. 228.

87. The cases involving schools were not consistent. The Commissioner prevailed in *Metropolitan Business College v. Blair*, 24 F.2d 176 (7th Cir. 1928); *Atlanta-Southern Dental College v. Commissioner*, 50 F.2d 34 (5th Cir. 1931). The taxpayer won in *Strayer's Business College v. Commissioner*, 35 F.2d 426 (4th Cir. 1929); *Bryant & Stratton Commercial School*, 1 B.T.A. 32 (1924), *non-acquiesced*, IV-1 CUM. BULL. 4 (1925).

Generally, if the other employees had significant decision-making power and were directly in contact with customers, it was held that the income was not primarily ascribed to the principal stockholders. See *Crider Bros. Comm'n Co. v. Commissioner*, 45 F.2d 974 (8th Cir. 1930) (livestock brokers); *William A. Brady Theatre Co. v. Commissioner*, 42 F.2d 181 (2d Cir. 1930) (stockholders must do more than just supervise); *Cuyahoga Abstract Title & Trust Co. v. Commissioner*, 29 F.2d 448 (D.C. Cir. 1928) (title abstractors); *Farmers National Co.*, 13 T.C. 505 (1949) (farm managers). See also *Fairfax Mut. Wood Prods. Co.*; 5 T.C. 1279 (1945) (manufacturer of custom furniture; employee craftsmen generate income).

why professionals should be treated more favorably than others. Thus, the fairest result would be to apply the approach taken by the section 911 regulation to all businesses where capital is not a material income producing factor.

#### 6. *Stockholder and Partner Salaries and Partnership Distributive Shares*

Section 911(b) specifically provides that earned income does not include compensation "which represents a distribution of earnings or profits rather than a reasonable allowance as compensation for the personal services actually rendered."<sup>88</sup> Thus where services are rendered on behalf of a corporation, the crucial question in many cases will be whether a stockholder's salary is reasonable compensation or dividend.<sup>89</sup> This question is, of course, a familiar headache, but it is worth noting that section 1348 extends the issue to a Subchapter S corporation, where previously it was not encountered.<sup>90</sup> Thus under section 1348, the Subchapter S corporation will have to defend the reasonableness of salary payments, since only they, and not dividends—distributed or undistributed—can be considered earned income.

A similar problem may arise in the case of partnerships. Since a guaranteed payment from a partnership will probably be treated as a salary,<sup>91</sup> even if capital is a material income producing factor in the

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However, where significant decision-making and client contact remained with the stockholders, the presence of skillful employees would not prevent classification as a personal service company. *E.g.*, Farnham Mfg. Co., 13 T.C. 511 (1949) (design of machinery for aircraft manufacturing); H. Newton Whittelsey, Inc., 9 T.C. 700 (1947), *acquiesced in*, 1953-2 CUM. BULL. 7 (ship architect); H.K. McCann Co., 14 B.T.A. 234 (1928) (advertising agency); New Orleans Shipwright Co. v. Commissioner, 27 F.2d 214 (5th Cir. 1928) (contractor). Trout-Ware, Inc., 11 T.C. 505 (1948), *acquiesced in*, 1953-1 CUM. BULL. 6 was a particularly close case. The stockholder in a photographing concern retouched each picture—a process said to be the most critical element in the success of the business. The court held that income was primarily ascribable to the stockholder.

88. CODE § 911(b).

89. *See* Louis D. Beaumont, 25 B.T.A. 474 (1932), *aff'd*, 73 F.2d 110 (D.C. Cir. 1934), *cert. denied*, 294 U.S. 715 (1935), an earned income credit case where the taxpayer failed to prove that any amount received from controlled corporations was compensation. *See* Charles McCandless Tile Serv. v. United States, 422 F.2d 1336 (Ct. Cl. 1970), which held that a portion of a *reasonable* salary payment had to be treated as a dividend.

90. Since the profits of a Subchapter S corporation are taxed to the shareholders whether or not distributed, the question of whether its "salary" payments are a salary or a dividend is immaterial.

91. *Carey v. United States*, 25 AFTR 2d 1395 (Ct. Cl. 1970); Andrew O. Miller, Jr., 52 T.C. 752 (1969). These cases are further discussed in connection with the problem of when capital is an MIPF in the text accompanying notes 323-24 *infra*. *Carey* specifically noted that the salary was reasonable compensation for personal services rendered. Even though payments to a retired partner may be guaranteed pay-

partnership business, the payment will be earned income provided that it does not exceed a reasonable allowance for compensation.

In fact, it may well be that the value of the partner's services will be relevant even if guaranteed payments are not employed. Under the earned income credit, section 185 of the 1939 Code required each partner's share of the partnership's earned income to be determined pursuant to regulations.<sup>92</sup> The regulations provided that no partner's share of the partnership's earned income could exceed reasonable compensation for the value of that partner's services.<sup>93</sup> Thus, if a partner were completely inactive, no part of his distributive share could be treated as earned income.<sup>94</sup> In *Foster v. United States*,<sup>95</sup> the taxpayer was a foreign partner in a service partnership. He argued that all of his distributive share should be treated as earned income from non-United States sources which would be exempt under section 116 of the 1939 Code and section 911 of the 1954 Code. The court held that he could exclude only that fraction of his distributive share which was equal to the fraction of the partnership's net income accruing from foreign sources.<sup>96</sup> The court's theory was that the taxpayer's share of partnership income depended as much upon activities carried on by his partners within the United States as upon his own foreign activities.<sup>97</sup> In ruling that the partnership could not be simply ignored, the court declared that section 185 of the 1939 Code clearly stated the correct rule: the earned income of a partner was determined by the earned income of the partnership.<sup>98</sup> However, this declaration by the Second Circuit should not be read as approving the regulations under section 185 which require an annual appraisal of what is a reasonable allowance for compensation of each partner.<sup>99</sup> Such an annual appraisal would be a severe administrative burden. A better rule would be to require a determination of the earned income of the partnership—the computation of which is trouble enough<sup>100</sup>—and allocate it to each partner according to the size of his distributive share. This would be consistent with the balance of the *Foster* case which refused to depart from the "conduit"

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ments under section 736(a)(2), such payments are not in return for services. Consequently, their treatment as earned income would be analytically the same as the distributive share of an inactive partner. See text accompanying notes 92-101 *infra*.

92. Internal Revenue Code of 1939, ch. 1, § 185, 53 Stat. 70.

93. Treas. Reg. 103 § 19.185-1 (1940).

94. *Id.*

95. 329 F.2d 717 (2d Cir. 1964).

96. *Id.* at 720.

97. *Id.*

98. *Id.* at 719.

99. Treas. Reg. 103 § 185.1 (1939).

100. See the discussion on distinguishing the earned income of partners from that of employees of the partnership at notes 79-87 *supra* and accompanying text.



principle, "under which each partner's share of the net income is composed of a proportionate part of the various items on the partnership return."<sup>101</sup>

### C. *The Special Problem of Deferred Compensation*

#### 1. *Deferred Compensation as Earned Income*

The treatment of deferred compensation arises at various points in the analysis of section 1348. The initial question is whether deferred compensation is earned income as defined in section 911(b). The cases and rulings have consistently treated various forms of deferred compensation as earned income. For example, payments contingent upon a future event, such as insurance renewal commissions, are earned income,<sup>102</sup> and the typical non-qualified deferred payment plan<sup>103</sup> also produces earned income.<sup>104</sup> So does the employer's contribution to a qualified plan.<sup>105</sup> In the case of a disqualifying disposition of stock acquired under a qualified stock option, the income—difference between value and exercise price—is earned income.<sup>106</sup> The latter rule is presumably applicable in the case of income produced by non-qualified stock options<sup>107</sup> or by restricted property under section 83(a).<sup>108</sup>

However, not even the proposition that all deferred compensation payments are earned income under section 911(b) is free from doubt. It has been held that the increments caused by untaxed capital gains,

101. 329 F.2d at 719. See also Thomas Browne Foster, 42 T.C. 974 (1964), involving the same taxpayer in a later year. A thoughtful law review study of *Foster* is Note, 74 YALE L.J. 956 (1965). This approach would be consistent also with the approach taken under the self-employment tax in which the partnership distributive share is regarded as "net earnings from self-employment" except under a very precisely stated set of circumstances involving retirement income. CODE § 1402(a)(10). But see Treas. Reg. § 1.401-10(c)(3)(i) (1963). See also Lawrence L. Tweedy, 47 B.T.A. 341 (1942) holding that where capital is an MIPF, only 20 percent of partnership income (then the maximum allowance) can be earned income to a foreign partner even though he did not contribute any capital.

102. Rev. Rul. 63-99, 1963-1 CUM. BULL. 10; Rev. Rul. 55-497, 1955-2 CUM. BULL. 292 (both under section 911(b)). Similarly, sick pay is earned income. *Chidester v. United States*, 82 F. Supp. 322 (Ct. Cl. 1949).

103. That is, an agreement that the employer will pay in a later year for work done in an earlier year.

104. James D. Mooney, 9 T.C. 713 (1947) *acquiesced in*, 1948-1 CUM. BULL. 2; Mim. 71, 1952-2 CUM. BULL. 170 (an employer's contribution to nonqualified plan, funded or nonfunded, qualifies as earned income under the predecessor of section 911(b)); Rev. Rul. 55-294, 1955-1 CUM. BULL. 368 (pensions paid directly by employer).

105. See note 111 *infra*.

106. Rev. Rul. 69-118, 1969-1 CUM. BULL. 135. However, the capital gain element upon the sale of stock received under a qualified stock option is not earned income. *Id.*

107. See Treas. Reg. § 1.421-6 (1959).

108. See text accompanying notes 192-99 *infra*.

dividends, and interest on the *employee's* contribution to a qualified contributory plan do not qualify as earned income.<sup>109</sup> Instead they are treated as unearned income derived from property.<sup>110</sup> Apparently, however, the untaxed capital gains and other income attributable to the *employer's* contribution to a qualified plan would be earned income.<sup>111</sup>

The obscure status of certain deferred compensation payments is illustrated by the case of *Harold F. Jones*.<sup>112</sup> In consideration for Jones' taking a reduction in salary, stock in his employer (United Sugar) was placed in 1924 in a non-forfeitable, non-qualified trust to be paid to him or his heirs in 20 years.<sup>113</sup> The grantor was CMI, a holding company. The Tax Court held that the dividends on the stock which were paid to Jones in 1935 could not be treated as earned income.<sup>114</sup> Although the taxpayer argued that the stock had been placed in trust as an employment incentive and that he had agreed to a reduction in his earned income to get the trustee stock, the court held that the dividends were received in the capacity of a property-owner. The Tax Court was careful to distinguish previous cases like *William J.R. Ginn*<sup>115</sup> which had held that under *qualified* plans, dividends, interest and other gains attributable to the employer's contribution would qualify as earned income when paid to the employee.<sup>116</sup> *Jones* and *Ginn* together would seem to hold that earnings on the employer's contribution are earned income when distributed under a qualified plan but not when distributed under a non-qualified, funded, non-forfeitable deferred compensation plan.

More significantly, certain forms of deferred compensation are

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109. *William J.R. Ginn*, 47 B.T.A. 41, 49 (1942); I.T. 2370, VI-2 CUM. BULL. 28 (1927) (both involving earned income credit).

110. *See* 47 B.T.A. at 49.

111. *Id.*; I.T. 3472, 1941-1 CUM. BULL. 252; I.T. 2996, XV-2 CUM. BULL. 166 (1936) (both nonresident citizens); Mim. 3283, IV-1 CUM. BULL. 14 (1925); I.T. 2370, VI-2 CUM. BULL. 28 (1927) (both involving earned income credit). The four rulings last cited were modified by Mim. 71, 1952-2 CUM. BULL. 170 which indicated that accretions on the employer's and employee's contributions were from sources within the United States and therefore could not qualify as exempt under the income exclusion for non-resident citizens. Also a prior acquiescence in *Ginn*, 1942-2 CUM. BULL. 8, was withdrawn. 1952-2 CUM. BULL. 4. However, Mim. 71 does not appear to suggest that such accretions were other than earned income. *See also* Rev. Rul. 56-125, 1956-1 CUM. BULL. 627 (further application of Mim. 71 principle).

112. 6 T.C. 412 (1946).

113. Although the case does not state whether Jones declared as income in 1924 the value of the contributed stock, that year was presumably barred.

114. 6 T.C. at 430-31.

115. 47 B.T.A. 41 (1942). *Cf.* D.G. Haley, 16 T.C. 1462 (1951) holding that under pre-1964 averaging provisions, a gain upon liquidation of a corporation is not personal service income merely because the stock had been received in return for services.

116. 47 B.T.A. at 48.

specifically excluded from earned income by section 1348. The section first provides that earned income shall not include "any deferred compensation within the meaning of section 404."<sup>117</sup> This exclusion is referred to as the "deferred compensation exception." Section 1348 then puts some forms of deferred compensation back into earned income:

For purposes of this paragraph, deferred compensation does not include any amount received before the end of the taxable year following the first taxable year of the recipient in which his right to receive such amount is not subject to a substantial risk of forfeiture (within the meaning of section 83(c)(1)).<sup>118</sup>

This provision is called the "counter-exception."

## 2. *The Deferred Compensation Exception and Qualified Plans*

The first question which arises is whether the deferred compensation exception refers only to payments under unqualified pension and profit sharing plans or includes payments under *qualified* deferred compensation plans as well.<sup>119</sup> A layman confronted with this question would probably assume that payments under both qualified and unqualified plans were "deferred compensation" in the sense that the taxpayer works in one year and is paid in another. Certainly both kinds are covered by Section 404. However, it has been authoritatively stated that the regulations will take the position that "ordinary income distributions" from a qualified plan will not be treated as deferred compensation.<sup>120</sup>

The Treasury's position is supported by a sound constructional argument. Section 1348 specifically excludes from earned income several kinds of specially treated distributions under *qualified plans*.<sup>121</sup> If the

117. CODE § 1348(b)(1) (emphasis added).

118. *Id.* § 1348(b)(1). Section 83(c)(1) refers to the risk of loss of benefits from termination of employment as one example of a substantial risk of forfeiture. *Id.* § 83(c)(1).

119. A "qualified" pension, profit sharing, or stock bonus plan is one which satisfies the requirements of sections 401(a) and (d). The plan may not discriminate in favor of stockholders or highly compensated employees and must contain elaborate protections for the employees' interests. See generally Scheff, *Qualified Pension Plans*, N.Y.U. 26TH INST. ON FED. TAX. 1027 (1968).

120. Speech by John S. Nolan, Deputy Ass't Sec'y of the Treasury, Oct. 14, 1970, in 33 J. TAXATION 370, 372 (1970).

121. These are: Penalized distribution from Keogh plan where benefits begin before the owner-employee attains the age of 59-1/2 or becomes disabled; where benefits paid to an owner-employee exceed the benefits payable under the plan formula; or where the owner-employee received distribution of entire interest in the plan following willfully-made excess contributions to the plan; CODE § 72(m)(5); special averaging provisions for lump-sum distributions from Keogh plans after age 59-1/2 or disability; and lump-sum distributions from other qualified plans upon death or separation from the service which do not qualify for long-term capital gain treatment under sections 402(a)(2) or 403(a)(2)(A); *id.* § 72(n); long-term capital gain benefit for certain lump-sum distributions from qualified plans, which treatment

deferred compensation exception was designed to exclude income from both qualified and non-qualified plans, there was no need to also exclude from earned income specified distributions under qualified plans. If this argument is sound, it follows that distributions from *qualified* plans, other than those specifically mentioned, are not within the deferred compensation exception.<sup>122</sup> This periodic benefits payable under qualified plans, now taxed under section 72 as ordinary income, should be treated as earned income under section 1348. Similarly, the value of currently taxable life insurance protection, paid for by a qualified trust,<sup>123</sup> would appear to be earned income under section 1348.

### 3. *Unqualified Deferred Compensation: The Role of Section 404*

Assuming that the deferred compensation exception does not refer to payments under qualified plans, the question of whether it encompasses everything else which the layman might consider deferred compensation remains. Evidently it does not. The House bill simply excluded "any deferred compensation payment,"<sup>124</sup> but when section 1348 emerged from the conference committee, it excluded "and deferred compensation within the meaning of section 404."<sup>125</sup> The additional language suggests that there are forms of deferred compensation which are not within the meaning of section 404. A detailed analysis of section 404 therefore is in order.

#### a. *Legislative history of section 404*

Prior to 1942, employers' deductions in connection with either qualified or unqualified deferred compensation plans fell under section 23(a),<sup>126</sup> the general section permitting deduction for ordinary and necessary business expenses, including reasonable compensation to employees.<sup>127</sup> Additional deductions for contributions to qualified pension plans were available under section 23(p).<sup>128</sup> In the Revenue Act of

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was greatly limited by the 1969 amendments; *see id.* § 402(a)(2) & (5); long-term capital gain benefit for certain lump-sum distributions from qualified employee annuity plans. *Id.* § 403(a)(2)(A). This also was sharply limited by the 1969 amendments. *See id.* § 403(a)(2)(C).

122. But it could be argued that qualified plans are within the exception by drawing from section 331 of the House bill (unenacted) which imposed a minimum tax on "deferred compensation" but which specifically exempted qualified plan distributions from its net. See text accompanying notes 170-72, *infra* for further discussion of section 331.

123. Treas. Reg. § 1.72-16 (1963).

124. H.R. 13270, 91st Cong., 1st Sess., § 802(a) (1969).

125. CODE § 1348(b)(1). The reason for this change was not explained.

126. Now *id.* § 162.

127. Internal Revenue Code of 1939, ch. 1, § 23(a), 53 Stat. 12.

128. *See, e.g.,* Wesley Heat Treating Co., 30 T.C. 10, 22-23 (1958), *aff'd*, 267 F.2d 853 (7th Cir. 1959).

1942,<sup>129</sup> Congress amended section 23(p) so that deductions for contributions or compensation under either qualified or non-qualified deferred compensation plans were allowable exclusively under section 23(p) if they also met the requirements of section 23(a).<sup>130</sup> As thus amended, section 23(p) became section 404 of the 1954 Code. There was no essential change in the provision relevant to section 1348 until the 1969 Act.<sup>131</sup>

The provisions in the Revenue Act of 1942 regarding unqualified plans were designed to insure that an employer's deduction would be taken in the same year than an employee had income. Thus the privilege of immediate deductions and deferred income was reserved for contributions to qualified plans. Congress also wanted to insure that accrual of the deduction for contributions did not precede the year of actual payment into trust unless the payment was deferred only because of inability to pay in the year of accrual. Finally, Congress apparently wanted to preclude a deduction as long as an employee's rights were forfeitable.<sup>132</sup>

Thus, under the pre-Tax Reform Act of 1969 version of section 404(a)(5), a deduction was allowed to the employer for a non-qualified plan payment only at the time that the contribution was "paid"—either to a trust or directly to an employee—and only if the payment was then "non-forfeitable." Under the new act, the deduction for a contribution under a non-qualified plan is allowed "in the taxable year in which an amount attributable to the contribution is included in the gross income of employees participating in the plan."<sup>133</sup> The change was designed to overrule the Treasury position that a deduction was lost forever if payment were made under a funded, non-qualified forfeitable plan,<sup>134</sup> and adopt a line of Court of Claims cases allowing a deduction when the amount was ultimately paid to the employee.<sup>135</sup> Thus the Tax Reform Act did not change the purpose of section 404 in re-

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129. Ch. 619, 56 Stat. 798.

130. *Id.* at 863-66.

131. See text accompanying notes 133-36 *infra*.

132. H.R. REP. No. 2333, 77th Cong., 2d Sess. 105-06 (1942), 1942-2 CUM. BULL. 372, 450-51; S. REP. No. 1631, 77th Cong., 2d Sess. 140-41 (1942), 1942-2 CUM. BULL. 504, 607-09.

133. CODE § 404(a)(5). In the case of a plan in which more than one employee participates, deduction is allowed under amended section 404(a)(5) only if separate accounts are maintained for each employee.

134. Treas. Reg. § 1.404(a)-12 (1956).

135. *Buttrey Stores, Inc. v. United States*, 375 F.2d 799 (Ct. Cl. 1967); *Mississippi River Fuel Corp. v. United States*, 314 F.2d 953 (Ct. Cl. 1963); *Russell Mfg. Co. v. United States*, 175 F. Supp. 159 (Ct. Cl. 1959). See also *United States v. Russell Mfg. Co.*, 349 F.2d 13 (2d Cir. 1965) (Treasury's attempt to get a conflicting decision thwarted).

lation to non-qualified plans.<sup>136</sup>

In short, the purpose of section 404 regarding unqualified deferred compensation plans is still to delay the employer's deduction until the year in which the employee has income. Consequently, section 404 serves a function only in connection with a plan in which the employer might claim a deduction prior to the time the employee picks up the income. If such a discontinuity is not possible, section 404 is essentially irrelevant.

*b. "Plans" of deferred compensation*

Section 404 regulates deductions of contributions to both qualified and unqualified pension or profit sharing *plans*.<sup>137</sup> It applies to "compensation . . . paid or accrued on account of any employee under a *plan* deferring the receipt of such compensation."<sup>138</sup> This language suggests that deferred compensation which is not pursuant to a "plan" would not be within section 404 and would, therefore, be earned income under section 1348.<sup>139</sup> However, this would be a hard argument to make in light of section 404(b) which provides:

If there is no plan but a method of employer contributions or compensation has the effect of a stock bonus, pension, profit sharing, or annuity plan, or similar plan deferring the receipt of compensation, Subsection (a) shall apply as if there were such a plan.<sup>140</sup>

Thus it has been held that a deferred compensation provision in an agreement with a single employee is a "method" having the "effect" of a deferred compensation plan and therefore is within section 404.<sup>141</sup>

A somewhat related issue is whether unqualified deferred compensation plans have to be "similar" in structure to qualified plans in order to be within section 404. The legislative history of the section

136. S. REP. NO. 91-552, 91st Cong., 1st Sess. 123 (1969), 1969-3 CUM. BULL. 423, 502.

137. CODE §§ 404(a)(1)-(4).

138. *Id.* § 404(a) (emphasis added).

139. In cases involving death benefits to the wife or family of a deceased employee, the courts have often alluded to the need for a "plan" of death benefits. This seems, however, to be less a function of something in section 404 than protection against the payment being a dividend, gratuitous, unreasonable compensation, or not ordinary and necessary. See *Rubber Associates, Inc. v. Commissioner*, 335 F.2d 75 (6th Cir. 1964); *John C. Nordt Co.*, 46 T.C. 431 (1966); *Barbourville Brick Co.*, 37 T.C. 7 (1961) (concurring opinion). *But see Plastic Binding Corp.*, 26 CCH Tax Ct. Mem. 687 (1967) (deductible payment to widow is a "method" under section 404(b); no "plan" is required).

140. CODE § 404(b).

141. *Sol Jacobs, Jr.*, 45 T.C. 133 (1965) (agreement to pay a pension to a single employee called an "arrangement" which fell under section 404(a)(5)); *Plastic Binding Corp.*, 26 CCH Tax Ct. Mem. 687 (1967). See *Treas. Reg. § 1.404(b)-1* (1956).

would seem to indicate that Congress had in mind only unqualified plans which were similar to qualified plans but which failed to qualify for some reason such as discrimination in favor of highly paid personnel.<sup>142</sup> However, the actual language of section 404 demonstrates no consistent pattern with respect to this issue. Section 404(a), dealing with "plans," is drafted in the disjunctive: "stock bonus, pension, profit-sharing, or annuity plan, or . . . a plan deferring the receipt of compensation."<sup>143</sup> But in section 404(b) dealing with "methods," there seems to be a requirement of similarity. It mentions a "method of employer contributions or compensation [which] has the effect of a stock bonus, pension, profit-sharing, or annuity plan, or *similar* plan deferring the receipt of compensation . . . ."<sup>144</sup> Thus the Tax Court has indicated that an unqualified deferred compensation plan need not provide retirement benefits or otherwise resemble a qualified plan to fall within section 404(a).<sup>145</sup> However, the court has indicated by dictum that if a "method" rather than a "plan" were involved, there might be a requirement of similarity to the standard form of pension, profit-sharing or stock bonus plans.<sup>146</sup>

*c. Deferred compensation not within the scope of section 404*

The case law indicates that at least one kind of payment attributable to service in an earlier year is not deferred compensation within the meaning of section 404. In *Champion Spark Plug Co.*,<sup>147</sup> an employer had a life insurance plan for its employees which did not cover a particular employee who was not insurable because of the dangerous duty to which the company had assigned him. When this employee became completely disabled and lacked insurance protection, the employer gratuitously resolved to pay him an annuity equivalent in value to the amount payable under the insurance program. It was rather questionably held that such payments were not "deferred compensation" within the meaning of the predecessor of section 404 because they were not compensation at all. Rather, they were intended to alleviate the financial hardship of someone who could work no more. Consequently, the obligation to make the payments could be accrued before the payments were made.

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142. See note 132 *supra*.

143. CODE § 404(a).

144. *Id.* § 404(b) (emphasis added).

145. See *New York Seven-Up Bottling Co.*, 50 T.C. 391, 398 (1968). However, the statute is mainly concerned with plans which provide retirement or death benefits. See *New York Post Corp.*, 40 T.C. 882 (1963).

146. See *New York Seven-Up Bottling Co.*, 50 T.C. 391, 398 (1968).

147. 30 T.C. 295 (1958), *non-acquiesced*, 1958-2 CUM. BULL. 9, *aff'd per curiam*, 266 F.2d 347 (6th Cir. 1959). Similarly, see *H.B. Ives Co.*, T.C. Memo 1959-187, *rev'd on other grounds*, 297 F.2d 229 (2d Cir. 1961), *cert. denied*, 370 U.S. 904 (1962).

The regulations also make clear that a plan which provides for dismissal wages, or sickness, accident or unemployment benefits, is not a plan of deferred compensation within the meaning of section 404.<sup>148</sup> The theory behind this position may be that because of uncertainty concerning the amounts which would ultimately be payable, no accrual would be possible prior to payment and hence, there is no reason to place them within section 404. However, the regulations also indicate that if a plan is *primarily* intended to pay unemployment or disability benefits but the employer is obligated to pay the benefits to the employee or his estate even if the contingency does not occur, it is a plan of deferred compensation within the meaning of section 404. Consequently, the accrual of a deduction under such plans cannot precede the payment.<sup>149</sup> A number of cases have followed this regulation.<sup>150</sup>

#### 4. *The Deferred Compensation Exception and Funded Plans*

The deferred compensation exception of section 1348 may require some reconsideration of funded, unqualified deferred compensation plans. Under a funded plan, the employee is taxed in the first year in which his rights are not subject to a "substantial risk of forfeiture" (SROF) as defined in section 83.<sup>151</sup> The *counter-exception* of section 1348, however, allows deferred compensation *received* in the year in which it becomes non-forfeitable within the meaning of section 83 (or in the next year) to be treated as earned income rather than deferred compensation.<sup>152</sup> Hence, there would be a problem if the SROF is removed two years or more before the money is actually received. More precisely, the problem arises if the actual payment is made following the end of the first taxable year after the year in which the SROF was removed. The taxpayer would argue that he received the money "constructively" in the year it was taxed as income. However, the relevant case law indicates that funded deferred compensation is taxable in the year the funding occurs under an "economic benefit" theory—during the year when economic benefit is actually conferred—rather than on a

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148. Treas. Reg. § 1.404(a)-1(a)(2) (1956). See Rev. Rul. 69-478, 1969 INT. REV. BULL. No. 37, at 5 (contributions for purchase of health insurance and life insurance not within section 404).

149. Treas. Reg. § 1.404(a)-1(a)(3) (1956).

150. *Consumers Power Co. v. United States*, 25 Am. Fed. Tax R.2d 1304 (6th Cir. 1970) (death benefit certificates given retiring employees); *Lundy Packing Co. v. United States*, 302 F. Supp. 182 (E.D.N.C. 1969), *aff'd per curiam*, 25 Am. Fed. Tax R.2d 619 (4th Cir. 1970) (sickpay; but employee's balance at retirement is paid to him absolutely); *New York Seven-Up Bottling Co.*, 50 T.C. 391 (1968) (severance pay; benefits guaranteed); *New York Post Corp.*, 40 T.C. 882 (1963) (same); Rev. Rul. 67-215, 1967-2 CUM. BULL. 162; Rev. Rul. 67-289, 1967-2 CUM. BULL. 163.

151. CODE § 402(b).

152. *Id.* § 1348(b)(1).



constructive receipt theory.<sup>153</sup> Therefore, the benefit may well be outside the counter-exception, within the deferred compensation exception, and thus excluded from earned income. Consequently, until this point is clarified by regulations, funded, unqualified deferred compensation payments should be made not later than the end of the first taxable year of the recipient following the removal of the SROF.

### 5. *Impact Upon Unfunded Plans*

Section 1348 will require an even more thorough reassessment of *unfunded* unqualified plans. In an unfunded plan, the income is not taxed until the employee actually receives the payment, whether it is forfeitable or non-forfeitable when earned.<sup>155</sup> If the employee receives his money in a year later than the year in which his rights become non-forfeitable, or in the next year, the deferral compensation exception applies and section 1348 is inapplicable. Thus, benefits under unfunded deferred compensation plans should be forfeitable<sup>156</sup> until the year prior to the year of payment if the maximum tax benefit is desired. The employee will have to decide whether the tax saving is worth the SROF.<sup>157</sup>

### 6. *Contingent Payments*

#### a. *As deferred compensation*

A particularly significant problem concerns payments which are deferred until uncontrollable contingencies occur—for example, the payments to an actor of a percentage of the gross box office receipts from a motion picture, or his “residuals” when the movie is shown on TV.<sup>158</sup> Are such payments within the deferred compensation exception of section 1348? The same question could be asked of an author’s or composer’s royalties or the renewal commissions of an insurance agent. Again, the layman would probably say that this is deferred compensation since the work is done in one year and the payment is

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153. E.T. Sproull, 16 T.C. 244 (1951), *aff’d*, 194 F.2d 541 (6th Cir. 1952). “Economic benefit” and constructive receipt are alternative theories for taxing compensation prior to actual receipt by the employee. See generally McDonald, *Deferred Compensation: Conceptual Astigmatism*, 24 TAX L. REV. 201 (1969).

154. If there never is an SROF, there is a further question as to whether the compensation can be deferred even to the year following the year earned without being within the deferred compensation exception. See text following note 188 *infra*.

155. Ray S. Robinson, 44 T.C. 20 (1965); Rev. Rul. 60-31, 1960-1 CUM. BULL. 174, *modified on other grounds*, Rev. Rul. 70-435, 1970 INT. REV. BULL. No. 34, at 12. See generally McDonald, *supra* note 153.

156. Within the meaning of CODE § 83(c)(1).

157. For further discussion of deferred compensation after section 1348 see text following note 375 *infra*.

158. See note 102 *supra*.

received in a later year. However, it has been authoritatively stated that the regulations will probably provide that contingent compensation is not deferred compensation.<sup>159</sup> This position seems correct for several reasons. One reason not to treat contingent compensation as deferred compensation is the likely attitude of those who bargain out the arrangement. To them, a contingent payment may not be "deferred compensation" because it is not considered to be "earned" until the movie grosses well or the client renews his insurance.<sup>160</sup>

On a conceptual level, it may be strongly argued that such contingent payments are not covered by section 404. Section 404 was intended to postpone an employer's deduction of deferred compensation payments until the year in which the employee has income.<sup>161</sup> However, contingent payments are never deductible in advance of the year when the contingency occurs. They cannot be deducted until "paid" in the case of cash basis taxpayers.<sup>162</sup> Nor can they be accrued before the contingency happens, because only then have all the events occurred which fix the obligation to make the payments.<sup>163</sup> As previously noted the Treasury has not included dismissal wages, or unemployment, medical or accident benefits within section 404, perhaps because accrual could never precede the event giving rise to an obligation to pay.<sup>164</sup> Moreover, contingent compensation agreements seem closely analogous to medical or accident benefit plans in the sense that under each, uncontrollable forces will determine both the existence of liability and amount thereof.<sup>165</sup>

Even more significant is the following statement in the regulations:

This provision [that an amount paid under a "method" of deferred compensation cannot be accrued until the year of payment] is not intended to cover the case where an employer on the accrual basis defers payment of compensation after the year of accrual merely because of inability to pay such compensation in the year of accrual, as, for example, where the funds of the company are not sufficient to enable payment of the compensation without jeopardizing the solvency of the

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159. Speech by John S. Nolan, *supra* note 120.

160. *But see* Ladd v. Riddell, 309 F.2d 51 (9th Cir. 1962). *Ladd* involved the taxation of a 10 percent gross profits interest in a motion picture. The contract referred to this interest as "deferred compensation"—a label adopted by the court.

161. See notes 131-36 *supra* and accompanying text.

162. Treas. Reg. § 1.461-1(a)(1) (1957).

163. *Id.* Of course, if payment is deferred until after the year the contingency occurs, it should be treated as deferred compensation. See speech by John S. Nolan, *supra* note 120.

164. See note 148 *supra*.

165. The kinds of benefits mentioned in regulation section 1.404(a)-1(a)(2) are "among the examples" of "certain types of payments to employees that are not to be regarded as deferred compensation within the meaning of the statute." New York Post Corp., 40 T.C. 882, 888 (1963).

company, or where the liability accrues in the earlier year, but the amount payable cannot be exactly determined until the later year.<sup>166</sup>

What the Treasury appears to have had in mind in this regulation is a bonus based upon the profits of a given year which cannot be paid until the following year when the exact profit figure first becomes ascertainable.<sup>167</sup> However, the wording of the regulation is not limited to the year-end bonus. In the case of an actor's contingent compensation also, "the amount payable cannot be exactly determined until the later year." On the other hand, the regulation requires that liability have accrued in the earlier year, which does not occur in the contingent compensation situation.

The stated reason for the Treasury's apparent position that contingent compensation is not deferred compensation within the meaning of section 404 is that contingent compensation is not generally designed to accomplish tax avoidance.<sup>168</sup> This rationale seems well founded. If the deferred compensation exception of section 1348 is intended to discourage "Mickey Mouse" tax avoidance schemes, there is little reason to include contingent compensation payments within the exception because such plans are not typically designed to avoid taxation.<sup>169</sup> Instead they represent a convenient negotiating device to share the risks of gain and loss between the contracting parties.

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166. Treas. Reg. § 1.404(b)-(1) (1956) (emphasis added). The genesis of the regulation appears to be a statement in the legislative history that section 23(p), the predecessor of section 404, was not intended to apply if compensation is deferred "because of inability to pay such compensation in the year of accrual." H.R. REP. NO. 2333, 77th Cong. 2d Sess. 106 (1942); S. REP. NO. 1631, 77th Cong. 2d Sess. 141 (1942).

167. *E.g.*, Rev. Rul. 57-88, 1957-1 CUM. BULL. 88 (payments not deferred "beyond the time when it first becomes administratively feasible to make such payment"); Rev. Rul. 55-446, 1955-2 CUM. BULL. 531.

168. Speech by John S. Nolan, *supra* note 120. There is no explanation in the congressional committee reports for the deferred compensation exception. In light of its clearly expressed desire to discourage tax planning and tax avoidance, however, it is not difficult to guess what motivated the Ways and Means Committee to remove deferred compensation from the protection of the maximum tax. H.R. REP. NO. 91-413, 91st Cong., 1st Sess., pt. 1, at 208-09 (1969). The Ways and Means Committee made its disapproval of deferred compensation quite clear in section 331 of H.R. 13270 which, however, was not enacted. *See* H.R. REP. NO. 91-413, 91st Cong., 1st Sess. pt. 1, at 89-91 (1969); *see* pt. III *infra*. On the subject of deterring tax avoidance through section 1348, *see* generally pt. V *infra*. *See* also Watts, *supra* note 12, at 13-15.

169. Since a contingent compensation arrangement typically would bunch the compensation into one or a few years, perhaps at the peak of the taxpayer's career, it would not typically be advantageous as a tax avoidance device. *Cf.* Commissioner v. Oates, 207 F.2d 711 (7th Cir. 1953) (parties renegotiated contingent compensation plan to stretch out the payments); Ray S. Robinson, 44 T.C. 20 (1965) (contingent payments stretched out over several years); Rev. Rul. 60-31, 1960-1 CUM. BULL. 174 (example 5) (same).

A further argument that the deferred compensation exception does not encompass contingent compensation can be drawn from an unenacted provision which passed the House. Section 331(a) of the House bill<sup>170</sup> would have enacted a new section 1354 which would have levied a "minimum tax" on "a deferred compensation payment during the taxable year" in excess of 10,000 dollars. Qualified plans were specifically excepted from the provision, but "deferred compensation" was not otherwise defined, just as it was not defined in the House version of section 1348. The Ways and Means Committee illustrated the provision with the standard kind of unfunded deferred compensation plan which would pay benefits at retirement.<sup>171</sup> The Committee indicated concern with the tax avoidance potential of unfunded deferred compensation plans since the employee's risks under such plans differ little from those involved in *funded* deferred compensation plans under which the income is immediately taxable.<sup>172</sup>

Thus the Ways and Means Committee seemingly had in mind the standard kind of unfunded deferred compensation when it used the term in unenacted section 1354—and presumably also when it used the term "deferred compensation" in section 1348. The tax avoidance potential which the House sensed—because the economic consequences of funded and unfunded plans were similar but the tax consequences differed—it is not present in a contingent compensation plan. Since the amount of liability in a contingent plan is wholly unpredictable, funding of the plan is not realistic.

Thus it seems reasonable to surmise that the House did not intend that contingent compensation be within the deferred compensation exception of section 1348. Since the provision was narrowed still further by the Conference Committee through the reference to section 404, the legislative history supports the argument that contingent compensation is not within the deferred compensation exception.

*b. Counter-exception and contingent payments*

If it is assumed, contrary to the conclusion in the previous subsection, that contingent compensation payments are to be treated as deferred compensation, the question arises whether they might be within the counter-exception. In other words, are contingent payments subject to a substantial risk of forfeiture (SROF), until the year in which they are received? If so, they would be treated as earned income and would be within the maximum tax. However, this will be a difficult position to sustain.

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170. H.R. 13,270, 91st Cong., 1st Sess. § 331(a) (1969).

171. H.R. REP. NO. 91-413, 91st Cong. 1st Sess., pt. 2, at 66 (1969).

172. *Id.* pt. 1, at 90.

For its definition of an SROF, section 1348 turns to section 83(c)<sup>173</sup> which covers only the case of an employee who must continue to render services to receive the compensation. In other words, forfeitability means the possibility that employment will be terminated, an event within the control of the employer or the employee. Although the legislative history of section 83 indicates that section 83(c) sets forth only one non-example of an SROF,<sup>174</sup> the word "forfeiture" implies cutting off rights already secured, as distinguished from rights which never arise until an uncontrollable contingency occurs.<sup>175</sup> Thus, it seems that a contingent payment is never subject to an SROF but is simply unascertainable—both as to its existence and its amount—until the contingency arises.

## 7. Phantom Stock

A "phantom stock plan" is a deferred compensation plan which is unfunded and may be forfeitable or non-forfeitable, but the amount ultimately payable depends upon the appreciation or depreciation in value of the employer's stock.<sup>176</sup> Thus if the stock goes down far enough, nothing will be payable. The question is whether the income will be treated as deferred compensation (not earned income) or contingent compensation (earned income).<sup>177</sup>

There is a superficial similarity between phantom stock and contingent compensation because in both situations the existence and the amount of income depend upon uncontrollable market forces. But this similarity should not obscure some important differences. A phantom stock plan may well be designed to avoid the rather strict requirements imposed by section 83<sup>178</sup> on bargain stock, by section 401<sup>179</sup> on a stock bonus plan, or by section 421<sup>180</sup> in dealing with qualified stock options. In general, like most deferred compensa-

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173. CODE § 83(c).

174. S. REP. NO. 91-552, 91st Cong., 1st Sess. 121 (1969).

175. Thus, under the former version of section 402(b), the timing of the employee's income turned upon the "forfeitability" of the employer's contribution to a funded, nonqualified plan. The regulations indicate that the beneficial interest is non-forfeitable if "there is *no contingency* under the plan which may cause the employee to *lose his rights*"; Treas. Reg. § 1.402(b)-1(a)(2)(i) (1956) (emphasis added). Cf. Charles Wilson, 39 T.C. 362 (1962) (death "terminated" rather than "forfeited" annuity payments).

176. See generally McDonald, *supra* note 153, at 229-32.

177. This statement of the issue assumes, of course, that contingent compensation will not be treated as deferred compensation within the meaning of section 404. See text accompanying notes 160-73 *supra*.

178. CODE § 83.

179. *Id.* § 401.

180. *Id.* § 421.

sation, a phantom stock plan is established to place income in years in which the recipient is in a lower bracket than the years in which the services are rendered. However, contingent compensation contracts delay the receipt of income only until the time when the market generates it. This often produces a bunching of income in the taxpayer's most productive years. Moreover, the market event has a much more intimate connection to the personal efforts of the taxpayer than in the case of phantom stock plans.<sup>181</sup> Thus if the goal of the deferred compensation exception is to discourage tax planning and avoidance,<sup>182</sup> it makes sense to treat a phantom stock plan as deferred compensation and thus outside the maximum tax benefit.

### 8. *Bonus as Deferred Compensation*

Quite frequently, a bonus, such as a Christmas bonus, will relate to the services performed in one year but will be paid in the next year. The question is whether such a bonus is within the deferred compensation exception of section 1348 and thus excluded from earned income, or within the counter-exception and, therefore, treated as earned income.

There are substantial grounds for believing that the payment of a bonus in the year immediately following the year in which it is earned is not deferred compensation within the meaning of section 404. In *Produce Reporter Co.*,<sup>183</sup> the Tax Court held that bonuses, paid out in *monthly installments* during the year *following* the year in which they were earned by employees, could be accrued by the employer in the year when they were earned. In one of the years in question, a ruling from the War Labor Board had to be obtained concerning the method of payment and the bonuses were therefore delayed until the following year. In the other years, however, there was no obvious reason why the bonuses were not paid in the year earned instead of in the following year. Without stating the grounds for its conclusion, the Tax Court permitted accrual in the year prior to payment, since the payments were not deferred compensation under the predecessor to section 404.

As previously pointed out, the regulations exclude from section 404 the payment of a bonus in the year following the year in which it is earned, but only if the employer is unable to make payment in the earlier year—for example, because of lack of funds, or because the

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181. Compare, for example, the use of a commercial made by taxpayer on television (contingent compensation) with the fluctuation of a common stock on the stock market (phantom stock).

182. See note 168 *supra*.

183. 18 T.C. 69 (1952), *acquiesced on this point*, 1952-2 CUM. BULL. 3, *aff'd on other grounds*, 207 F.2d 586 (7th Cir. 1953).

amount is not exactly determinable until the later year.<sup>184</sup> And in three rulings, this regulation was applied to bonuses which were not exactly determinable at the close of the previous year although the formula for payment of the bonuses was then fixed.<sup>185</sup> *Produce Reporter* is good authority for the proposition that a fixed-dollar bonus, paid in installments after the time at which the amount was determinable (but within the next taxable year), is not *deferred* compensation under section 404. The regulation and rulings do not go this far since they cover only the situation in which the amount is unascertained at the end of the preceding year. However, the IRS has acquiesced in the rule of *Produce Reporter*.<sup>186</sup> Of course, a re-examination of that acquiescence is always possible, especially in view of the importance of the point under section 1348. After all, if the rule of *Produce Reporter* is correct, it would seem to encompass a plan providing for the payment over *several years* of a bonus earned in an earlier year—a classic short-term deferred compensation plan.<sup>187</sup> Consequently, it would be prudent to pay the bonus in the year to which it is attributable—the year when earned—perhaps by the distribution of checks at the office Christmas party.<sup>188</sup>

Even if the IRS reconsidered its acquiescence in *Produce Reporter* and characterized a bonus as deferred compensation within the meaning of section 404, it seems likely that the bonus would fall within the counter-exception of section 1348 because it is received in the taxable year *following* the first taxable year in which the right to receive it was not subject to an SROF. The issue would be whether the counter-exception applies to an amount which was *never* subject to an SROF. For

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184. Treas. Reg. § 1.404(b)-1 (1956) (quoted at text preceding note 166 *supra*).

185. Rev. Rul. 61-127, 1961-2 CUM. BULL. 36; Rev. Rul. 55-446, 1955-2 CUM. BULL. 531; Rev. Rul. 57-88, 1957-1 CUM. BULL. 88.

186. 1952-2 CUM. BULL. 3.

187. However, the Tax Court later limited *Produce Reporter* to payments made in the year following the earning of the bonus. *Wesley Heat Treating Co.*, 30 T.C. 10 (1958), *aff'd*, 267 F.2d 853 (7th Cir. 1959). In *Wesley*, the Tax Court described *Produce Reporter* as a "current payment profit-sharing plan." 30 T.C. at 23. But this is not a wholly accurate description since the payments in *Produce Reporter* were made monthly throughout the taxable year following the year in which they were earned, not all at once in that year. Rev. Rul. 57-88, 1957-1 CUM. BULL. 88 is an example of a "current payment" plan since payment was made in a lump-sum early in the following taxable year.

188. However, in 1970, the contrary is true. Payment of the bonus in 1971 would place it in a year in which it would have a good chance to qualify for earned income relief at the 60 percent level; the provision is not operative in 1970 at all. See note 9 *supra*. Deferral from 1971 to 1972 would place the bonus in a year in which section 1348 cuts in at the 50 percent level rather than the 60 percent level. See note 9 *supra*. A calculated risk would be involved—whether to risk forsaking the benefit at the 60 percent level in order hopefully to have it taxed at 50 percent. Bonuses earned in 1972 and the year following should, for safety's sake, be paid in the year earned. Hopefully, by that time, the IRS will have clarified the point.

example, take compensation earned in 1973 but paid in 1974. The taxpayer would argue that 1973 is the first year in which the right to receive the amount was not subject to an SROF, that 1974 is the following year, and therefore, the bonus is within the counter-exception. The IRS might argue that the statutory language contemplates only a payment which at some time was subject to an SROF because it is meaningless to talk of the first year in which the right to receive was not subject to an SROF when there *never* was an SROF.

Although the point is quite obscure—and there is no legislative history explaining why the counter-exception was inserted—the taxpayer's position is the more reasonable. For one thing, the taxpayer's construction represents the more literal reading of the statutory language. The section simply does not say that the amount in question need ever have been subject to an SROF. The taxpayer's argument also seems more consonant with the legislative policy of deterring the more extreme forms of deferred compensation. In the case of an unfunded deferred compensation plan, Congress was not concerned by a deferral of one year after the year in which the SROF is removed. Yet this could well occur many years after the performance of the services which created the forfeitable right. It would seem that the deferral of only one year after performance of the services, where no SROF was ever imposed, is a lesser affront to the policy against deferred compensation. In such a case, the amount is taxed to the employee much sooner than in the case in which deferred compensation is paid in the year following removal of the SROF. It would be a pointless construction indeed which placed the situation where an SROF is used under the protection of the maximum tax and that where no SROF is used outside its mantle.

### 9. *Independent Contractors*

An additional problem with the deferred compensation exception is that it may not apply to independent contractors. The reference in section 1348 is to section 404. Section 404(a) refers to compensation which "is paid or accrued on account of *any employee* under a plan deferring the receipt of such compensation."<sup>189</sup> Thus it might be argued that the deferred compensation exception is applicable only to employees and not to independent contractors such as attorneys or under-

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189. CODE § 404(a). On the other hand, section 404(b) alludes to a "method" of compensation having the effect of a "plan deferring the receipt of compensation" without any reference to employees. However, it would be hard to argue that the reference in section 1348 to section 404 was to section 404(b), not to section 404(a). Section 404(b) simply expands upon section 404(a), so as to include "methods" as well as "plans." Section 404(a) sets forth the general principles and would thus seem to be the referent of section 1348.



writers. In light of the apparent desire to discourage deferred compensation, such an interpretation would make little sense. This argument reflects the kind of confusion that results from accepting in its entirety for the purposes of one Code section the definition taken from an unrelated Code section. Although section 404 is part of a series of Code sections dealing with *employee* plans, the benefits of section 1348 extend to taxpayers other than employees. It would thus be anomalous to limit its exceptions to employees.<sup>190</sup>

Moreover, since other amendments made in the 1969 Act clearly cover independent contractors, the new Act indicates a policy of treating them the same as employees.<sup>191</sup> Thus, despite the statutory mutilation needed to excise the reference to employees in section 404, it should be held that Congress intended to exclude from maximum tax benefits the deferred compensation of independent contractors.

#### 10. *Property Received in Connection With Services: Section 83*

Section 83 defines the tax consequences in the event that a taxpayer performs services and receives in connection therewith non-transferable property subject to an SROF.<sup>192</sup> Under section 83(a), he must include in income the value of the property when it is either no longer subject to the SROF or becomes transferable. Alternatively, under section 83(b) the employee may elect to include the property in income in the year in which he receives it, notwithstanding the SROF and the non-transferability of the property. It has been authoritatively stated that the regulations will treat as earned income the income defined by section 83.<sup>193</sup> This position seems correct.

If the employee elects to include the income immediately upon receipt, it might be argued that the income is not "earned income" since section 911(b) provides that "earned income" means amounts re-

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190. Incorporation of definitions from another section is done to avoid duplication and prolixity; a good measure of practicality and common sense is necessary to interpret such a provision. Warren R. Miller, 51 T.C. 755 (1969). Watts, *supra* note 12, at 15-17, agrees for somewhat different reasons that non-employees are covered by the deferred compensation exception.

191. Thus section 83 covers transfers of property to any person in connection with the performance of services. CODE § 83. Section 217, permitting the deduction of moving expenses, previously covered only employees but was explicitly expanded to cover self-employed individuals. *Id.* § 217. Unenacted section 1354 of the House bill, dealing with a minimum tax on deferred compensation, also made clear that it applied to independent contractors. H.R. 13270, 91st Cong., 1st Sess. § 331(a) (1969). Of course, this argument cuts both ways: it may be argued that since Congress explicitly covered independent contractors in some instances, its failure to do so in section 1348 evidences a desire not to. More likely, of course, this is an inadvertent ambiguity caused by the hasty drafting of a mammoth piece of legislation.

192. CODE § 83.

193. Speech by John S. Nolan, *supra* note 120.

ceived as compensation for personal services "actually rendered." Presumably, if the SROF arises from a requirement of continued employment, the taxpayer's present income is an advance payment for services to be rendered in future years. As we have seen, it is arguable that an advance payment is not earned income.<sup>194</sup> Since there seems to be no good reason to distinguish advance payments from current payments the IRS is right not to press the point.

If the employee does not make the section 83(b) election and is not taxed until the year the SROF is removed or the property becomes transferable, it might be argued that the value of the property is deferred compensation since the income falls in a year later than the year first earned. However, since section 83(h) specifically states that the employer's deduction is taken under section 162, this would seem to mean that section 404 is not to be consulted.

Even if the income under section 83(a) were deferred compensation, it would probably be within the counter-exception as an "amount received" in the year in which the right to receive it is not subject to an SROF. However, this interpretation is not without difficulties since the restricted property was "received" in a year earlier than the time it became non-forfeitable. The IRS has surmounted this difficulty, however, by asserting that the property is "deemed to have been received" at the time it becomes non-forfeitable.<sup>195</sup>

One might also argue that section 83(a) income is not all "earned income" because the appreciation in the property from the time the employee receives it until the time he is taxed upon it—as distinguished from its value when he received it—is attributable to the market, not his earnings. However, the same thing is true in a qualified pension or profit sharing plan in the sense that the benefits include appreciation in the employer's contribution while it was held in trust. Yet there seems to be no question that the entire benefits traceable to the employer's contribution are earned income.<sup>196</sup> Similarly, the IRS' position regarding a disqualifying disposition of a qualified stock option<sup>197</sup> indicates that the entire amount of section 83(a) income is earned. The IRS ruled that the entire amount of ordinary income upon a disqualifying disposition—the value of the stock when purchased less the option price—is earned income, even though it includes appreciation in the value of the

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194. See text following note 53 *supra*.

195. Speech by John S. Nolan, *supra* note 120. Watts, *supra* note 12, at 26-27 argues persuasively that SROF under section 1348 should have the same broad meaning as under section 83(c)(1).

196. See note 111 *supra*. However, as pointed out in text preceding note 110 *supra*, the IRS in the past has held that the appreciation on contributions by the employee to the plan would not qualify as earned income.

197. See CODE § 421(b).

underlying stock after the date the option is given.<sup>198</sup> However, the capital gain also recognized at that time—the amount realized upon disposition less the value of stock when the option was exercised—is not considered “earned income.”<sup>199</sup>

### 11. *Non-qualified Stock Options*

Under the regulations, the value of a non-qualified stock option is generally taxed in the year in which it is exercised.<sup>200</sup>

Again, it has been authoritatively stated that the income attributable to a non-qualified option will not be treated as deferred compensation.<sup>201</sup> The stated reason is that the income is not “deemed to *arise*” until the year exercised.<sup>202</sup> Another ground on which this conclusion may be reached is that the regulations provide that “the deductibility to the employer of the option value is determined under section 162 or other provision of the Code which is applicable to such payment.”<sup>203</sup> Presumably, the “other provision” referred to in the regulation is not section 404 but section 212 under which an individual might compensate employees of a corporation with an unqualified stock option.<sup>204</sup>

## III

### EARNED INCOME IN THE UNINCORPORATED BUSINESS

#### A. *Capital as a Material Income Producing Factor (MIPF)*

One of the most serious sources of difficulty to be encountered in applying section 1348 will be the question of whether the taxpayer is engaged in a trade or business in which capital is a material income-producing factor (MIPF). Section 911(b), which is incorporated by section 1348, provides:

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198. Rev. Rul. 69-118, 1969-1 CUM. BULL. 135.

199. *Id.* It does seem reasonable to assume that capital gain can never be earned income, since capital gain by definition is based upon a sale or exchange of property which is the antithesis of amounts received as compensation for personal services. But a contrary argument can be premised on the fact that section 1348 specifically excludes from earned income certain distributions taxed as capital gain. See note 121 *supra*. This suggests that other capital gain could be earned income if it otherwise qualified. Watts, *supra* note 12, at 7-9 agrees that the appreciation element under section 83(a) is earned income.

200. Treas. Reg. § 1.421-6(d) (1959). See *Commissioner v. LoBue*, 351 U.S. 243 (1956).

201. Speech by John S. Nolan, *supra* note 120.

202. *Id.* (emphasis in original).

203. Treas. Reg. § 1.421-6(f) (1959).

204. See *id.* § 1.421-6(a) which provides that the regulations cover the grant of an option made by someone other than the employing corporation. Cf. § 404(a) (deduction for deferred compensation must meet the requirements of either section 162 or section 212 as well as section 404). See Watts, *supra* note 12, at 22-25, who feels that such options should be treated as deferred compensation.

In the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income producing factors, under regulations prescribed by the Secretary or his delegate, a reasonable allowance as compensation for the personal services rendered by the taxpayer, not in excess of 30% of his share of the net profits of such trade or business, shall be considered as earned income.<sup>205</sup>

### 1. *History of the Statutory Test of Capital as an MIPF*

Prior to section 911(b) Congress used the test of capital as an MIPF to invoke or deny benefits on a number of occasions. In the excess profits statute of 1917,<sup>206</sup> Congress conferred a lower tax rate on corporations having only a nominal capital, or no capital at all. This act was the genesis of the formulation in the 1918 and 1921 excess profits act—carried forward in the World War II and Korean War excess profits statutes—in which special tax benefits were given to “personal service corporations,” defined in part as those in which capital was not an MIPF.<sup>207</sup> A related provision of the World War II statute accorded special benefits if capital was not an “important income producing factor.”<sup>208</sup> Under the “earned income credit,” which was in the law from 1924 to 1931 and 1934 to 1943, the definition of “earned income” had a percentage limitation when capital was an MIPF.<sup>209</sup>

In Subchapter R of the 1954 Code (now repealed) a partnership or proprietorship could elect to be taxed as a corporation only if its capital was an MIPF.<sup>210</sup> Under the family partnership statute—originally enacted in 1951<sup>211</sup> and now section 704(e)<sup>212</sup>—which permits income to be split up among family members, qualification is much easier where capital is an MIPF.

Finally, when Congress first enacted provisions dealing with quali-

205. CODE § 911(b).

206. War Revenue Act of 1917, ch. 63, § 209, 40 Stat. 307. See *Treas. Reg.* § 41, arts. 71-74 (1918).

207. Such corporations were taxed as partnerships under the World War I statute and could elect to be taxed as partnerships under the later statutes. Internal Revenue Code of 1939, ch. 2, § 725, 54 Stat. 987; Excess Profits Tax Act of 1950, ch. 1199, § 449, 64 Stat. 1176. Provision was also made in section 303 under the World War I Acts for a “partial personal service corporation.” See generally, Comment, *Taxation of Personal Service Companies*, 41 COLUM. L. REV. 296 (1941).

208. Internal Revenue Code of 1939, ch. 2, § 722(c)(2), 56 Stat. 914. See generally 7A J. MERTENS, *LAW OF FEDERAL INCOME TAX* § 42.136 (1955).

209. Revenue Act of 1924, ch. 234, § 209(a), 43 Stat. 263; Internal Revenue Code of 1939, ch. 2, § 25(a)(3) & (4), 53 Stat. 18.

210. Internal Revenue Code of 1954, ch. 736, § 1361, 68A Stat. 350, *repealed*, Act of Apr. 14, 1966, Pub. L. No. 89-389, § 4, 80 Stat. 111.

211. Internal Revenue Code of 1939, ch. 2, § 191, 65 Stat. 511.

212. CODE § 704(e).

fied retirement plans for self-employed individuals in 1962,<sup>213</sup> it limited the income on which contributions could be based to not more than 30 percent of net income in businesses where capital was an MIPF.<sup>214</sup> However, notwithstanding this limitation, 2,500 dollars of net profits could be deemed attributable to services.<sup>215</sup> This rule was dropped in 1966<sup>216</sup> in favor of the present formulation which allows the entire income of a business in which services are an MIPF to be used as the basis for Keogh plan contributions, including income attributable to capital.<sup>217</sup>

## 2. *Problems with Precedents and Per Se Rules*

Relatively few cases and rulings have considered the materiality of capital as an income producing factor under the non-resident citizen exclusion,<sup>218</sup> earned income credit,<sup>219</sup> family partnerships,<sup>220</sup> Subchapter R,<sup>221</sup> the retirement income credit,<sup>222</sup> or Keogh plans.<sup>223</sup> But a vast amount of litigation on the point was spawned by the "personal service corporation" classification under the World War I version of the excess profits tax.<sup>224</sup> However, that body of case law and rulings is of somewhat questionable value in interpreting the phrase "material income-producing factor" in section 911(b). Caution is always in order when applying the case law under one provision to another, particularly when they are as remote as a 1918 excess profits tax and a 1969 limitation of tax on earned income. For one thing, the purposes of the MIPF formula in the two provisions seem entirely different. The personal service corporation under the excess profits tax was needed because the method of taxing corporations provided for a deduction of a percentage of invested capital. Since a personal service business in which capital was not an MIPF would have little invested capital, it would be inequitably taxed.<sup>225</sup> Thus the materiality of capital was central in analyzing

213. Self-employed Individuals' Tax Retirement Act of 1962, Pub. L. No. 87-792, 76 Stat. 809. This aspect of the legislation was repealed in 1966.

214. *Id.* § 2.

215. *Id.*

216. Act of Nov. 13, 1966, Pub. L. No. 89-809, § 204(c), 80 Stat. 1577. See the denunciations of the 30 percent rule at 112 CONG. REC. 12,263, 12,266, 12,272 (House), and 12,412-14, 12,418 (Senate) (1969).

217. CODE § 401(c)(2)(A)(i).

218. *Id.* § 911.

219. See note 209 *supra*.

220. See note 212 *supra* and accompanying text.

221. See note 210 *supra* and accompanying text.

222. CODE § 37(a).

223. *Id.* § 401(c)(2)(A).

224. See notes 206-08 *supra* and accompanying text.

225. Mitchell Advertising Agency, Inc., 10 B.T.A. 1311 (1928), *acquiesced in*, VII-2 CUM. BULL. 27 (1928); H.R. REP. No. 767, 65th Cong. 2d Sess. 16-17 (1918),

whether a particular corporation was entitled to avoid the corporate excess profits tax. Since classification as a personal service corporation meant an escape from the high war-time excess profits tax, the courts were justified in defining the MIPF formula broadly.<sup>226</sup>

However, the MIPF formula is extremely arbitrary in the context of section 1348. Since the value of services often will be far more than 30 percent of net profits, even though capital is an MIPF, the MIPF test can be justified only as an administrative convenience to avoid arguments about how much is reasonable compensation for services. Consequently, application of the 30 percent rule will frequently lead to injustice.<sup>227</sup> Furthermore, to the extent that income properly attributable to services is taxed in excess of the 50 percent bracket by reason of application of the MIPF test, taxpayers will be prompted to seek tax shelter for such income, the result which Congress sought to avoid.<sup>228</sup> It follows, therefore, that the severity which characterized the application of the personal service corporation provision under the excess profits tax is misplaced when the problem arises under sections 911(b) and 1348.

An even larger obstacle to applying the excess profits tax and earned income credit case law in determining when capital is an MIPF under section 911(b) is that the IRS has gradually altered its position regarding the question of when capital is an MIPF. The regulations, under the World War I excess profits tax, which were adhered to under the World War II and Korean War excess profits taxes, provided:

If the use of capital is necessary or more than incidental, capital is a material income-producing factor . . . if a substantial amount of capital is used to finance or carry the accounts of clients or customers, it will be inferred that because of competition or other reasons such practice is necessary and more than incidental in order to secure or hold business which otherwise would be lost . . . in general, the larger the amount of the capital actually used the stronger is the evidence that capital is necessary and is a material income-producing factor .

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quoted in J. SEIDMAN, LEGISLATIVE HISTORY OF EXCESS PROFITS TAX LAWS 1946-1917, at 323 (1947).

226. *E.g.*, *Edward P. Allison Co. v. Commissioner*, 63 F.2d 553 (8th Cir. 1933); *Crider Bros. Comm. Co. v. Commissioner*, 45 F.2d 974 (8th Cir. 1930), *cert. denied*, 283 U.S. 834 (1931); *Conklin-Zonne-Loomis Co. v. Commissioner*, 29 F.2d 698 (8th Cir. 1928), *cert. denied*, 279 U.S. 681 (1929).

227. The arbitrariness of the 30 percent rule was admitted by Congress when it dispensed with the test under Keogh plans. See note 216 *supra*.

228. See pt. V *infra*.

229. *Treas. Reg.* 62, art. 1531-32 (1922). See similar language in *Treas. Reg.* 109, § 30.725-2(e) (1941); *Treas. Reg.* 130, § 40.449-2(e) (1951). The latter regulation is quoted at 7A J. MERTENS, *LAW OF FEDERAL INCOME TAX* § 42.19, at 68 (1955).

Apparently, the Treasury did not contemplate that any particular professions or other businesses were automatically personal service corporations because capital could never be an MIPF. The initial regulations reflect a strict view of the statute that was also evident in the case law.<sup>230</sup>

The earned income credit regulations, however, took a much less precise approach. Apparently because of the amount of litigation generated by the excess profits tax,<sup>231</sup> the regulations simply provided:

No general rule can be laid down defining the trades or businesses in which personal services and capital are material income-producing factors, but this question must be determined with respect to the facts of the individual case.<sup>232</sup>

Originally, the provision giving special benefits to income earned abroad by nonresident citizens—the predecessor of section 911—referred directly to the earned income credit statute<sup>233</sup> for the definition of earned income.<sup>234</sup> Thus, although the earned income credit has been put to an apparently unmourned death,<sup>235</sup> its definition of earned income was transplanted into the forerunner of section 911(b). However, the regulations under section 911 do not contain any statement at all regarding the meaning of the phrase “material income producing factor,” not even one as meaningless as that in the earned income credit regulation.<sup>236</sup> The regulations under Keogh plans prior to 1966,<sup>237</sup>

230. See note 226 *supra*. This strict approach is well illustrated by the cases involving educational institutions. Generally, if the equipment was distinctive to the kind of education dispensed—if it went beyond blackboard, desks and chairs [Shipley School v. McCaughn, 34 F.2d 281 (3d Cir. 1929)]—it was held that the equipment was an MIPF. For example, the following equipment was an MIPF: The airplanes in a flying school [Graham Flying Serv. v. Commissioner, 167 F.2d 91 (8th Cir.), *cert. denied*, 335 U.S. 817 (1948)], the dental equipment in a dentistry school [Atlanta-Southern Dental College v. Commissioner, 50 F.2d 34 (5th Cir. 1931)]; and the typewriters and other teaching equipment in a business school [Metropolitan Business College v. Blair, 24 F.2d 176 (7th Cir. 1928); Isidore Garnets, 26 B.T.A. 384 (1932)]. *Contra*, Bryant & Stratton Commercial School, Inc., 1 B.T.A. 32 (1924), *non-acquiesced*, IV-1 CUM. BULL. 4 (1925); Posse-Nissen School of Phys. Educ. v. United States, 25 F.2d 748 (D. Mass. 1928); all were held to be material income producers. Since in all these cases the students paid both for teaching and to utilize and be taught upon the distinctive equipment, the two were held to be inseparable. Atlanta-Southern Dental College v. Commissioner, *supra* at 36.

231. The definition of personal service corporations under the World War I tax alone is said to have produced 14,000 lawsuits. 86 CONG. REC. 12,350 (1940).

232. Treas. Reg. 69, art. 1662 (1926).

233. Internal Revenue Code of 1939, ch. 2, § 25(a)(3) & (4), 53 Stat. 18.

234. *Id.* § 116(a), 53 Stat. 48.

235. 5 J. MERTENS, LAW OF FEDERAL INCOME TAX § 32.07 (1969).

236. This definitional failure is surprising since section 911(b) specifically gives legislative power to the Secretary to define the meaning of capital as an MIPF.

237. Treas. Reg. § 1.401-10(c)(3)(ii) (1963).

as well as the retirement income credit regulations,<sup>238</sup> are equally unenlightening.

Yet another approach to the problem of defining an MIPF was taken in the regulations under the family partnership provision<sup>239</sup> and under Subchapter R.<sup>240</sup> The two regulations are identical except that the bracketed language is in the Subchapter R regulation, but not in the family partnership provision, and the italicized language is in the family partnership provision, but not in the Subchapter R regulation.

The determination of whether capital is a material income-producing factor must be made by reference to all the facts of each case. Capital is a material income-producing factor if a substantial portion of the gross income of the business . . . is attributable to the employment of capital in the business conducted by the enterprise. *In general* capital is not a material income-producing factor where [gross] income of the enterprise consists principally of fees, commissions, or other compensation for personal services performed by the [owners] *members* or employees of the [enterprise] *partnership*. [Thus an enterprise engaged in rendering professional services such as law, accounting, medicine, or engineering, ordinarily is not an enterprise in which capital is a material income-producing factor.] On the other hand, capital is ordinarily a material income-producing factor if the operation of the business requires substantial inventories or a substantial investment in plant, machinery, or other equipment.<sup>241</sup>

Thus the Treasury apparently adopted a form-of-income test, since the regulation states that businesses whose gross income consists "principally" of fees, commissions or other compensation for personal services actually rendered never utilize capital as an MIPF.

Perhaps the Treasury's sudden shift to a form-of-income test for Subchapter R and family partnership purposes can be explained by the fact that it is in the Government's interest to establish that capital is *not* an MIPF under those provisions.<sup>242</sup> However, the contrary is true for purposes of the excess profits tax, the earned income credit, the retirement income credit, Keogh plans, non-resident citizens' benefits and, of course, section 1348.<sup>243</sup> It will be interesting to see whether the form-of-income test, which makes it rather easy to establish that capital is *not* an MIPF in a service business, will be preserved, since its preservation under section 1348 will diminish the revenue.

There is considerable support for the proposition adopted by the

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238. *Id.* § 1.37-2(a) (1965).

239. See note 212 *supra* and accompanying text.

240. See note 210 *supra* and accompanying text.

241. Treas. Reg. § 1.1361-2(e)(2) (1960); *id.* § 1.704-1(e)(1)(iv) (1964).

242. See text accompanying notes 210-11 *supra*.

243. See text accompanying notes 206-09 & 213-17 *supra*.



Subchapter R and family partnership regulations that *professionals* never utilize capital as an MIPF. In addition to scattered cases and rulings,<sup>244</sup> the 1961 Senate Finance Committee report on Keogh plans seems to assume that the capital of doctors and lawyers is never an MIPF, since it used them as examples without looking at the particular facts.<sup>245</sup>

Nevertheless, the position that *service businesses* never utilize capital as an MIPF is highly suspect. It was taken in regulations interpreting statutes under which it was in the Treasury's interest to prove capital not an MIPF. These regulations have not been consistently followed<sup>246</sup> and they are obviously not in accord with reality. Capital is probably material, for example, in such service businesses as the operation of a taxi-cab, a moving van, or a circus. Moreover, a per se rule that service businesses never utilize capital as an MIPF seems contrary to congressional intent. Since an across-the-board cut in top-bracket rates was considered too expensive,<sup>247</sup> the ceiling applies to earned income alone. Thus income attributable to the employment of capital—whether or not accompanied by services—should not come within section 1348. Therefore, a further examination of the question of when capital is a MIPF is undertaken only after the caveat that the bulk of case au-

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244. Rev. Rul. 67-158, 1967-1 CUM. BULL. 188 (contains a statement that capital is not an MIPF in a world-wide accounting firm); Rev. Rul. 57-141, 1957-1 CUM. BULL. 14 (retirement income credit); S.M. 4088, IV-2 CUM. BULL. 26 (1925). Mim. 3283, IV-1 CUM. BULL. 14 (1925). In Percy A. Yalden, 20 B.T.A. 372 (1930), *acquiesced in*, X-1 CUM. BULL. 72 (1931), involving auditors, the IRS conceded that capital was not an MIPF.

The leading authority for the proposition that capital is never an MIPF in a service business is Hubbard-Ragsdale Co. v. Dean, 15 F.2d 410 (S.D. Ohio), *aff'd per curiam*, *id.* at 1013 (6th Cir. 1926).

Otherwise expressed, where the intrinsic nature of the business is the rendition of a 'service' to another, as in the case of real estate brokers, lawyers, doctors, or even artisans, who need not supply materials, the use of capital is merely incidental. The individual thus sells only experience, knowledge, or skill, intangible in its nature and existing independent of capital, either in the sense of money or other tangible property.

*Id.* at 411. Yet this case held that capital was an MIPF for a livestock broker who worked on commission but who extended credit and utilized the facilities of a live-stock exchange.

245. S. REP. No. 992, 87th Cong., 2d Sess. 12-13 (1961). The committee also assumed that capital was always an MIPF for a grocer, service-station operator, contractor and stock broker. *Id.*

246. In a family partnership case, the Tax Court declared that each case must be decided on its own facts, despite the regulation. Although the taxpayer was a wool broker whose income came from commissions, the presence of large receivables resulted in a finding that capital was an MIPF. Jeremiah J. O'Donnell, 23 CCH Tax Ct. Mem. 210 (1964). See also Fred J. Sperapani, 42 T.C. 308 (1964) discussed at text accompanying notes 280-82 *infra*, and Howard T. Lewis, 42 T.C. 885 (1964), discussed at text accompanying notes 294-302 *infra*.

247. See Speech by Edwin S. Cohen, *supra* note 4.

thority—primarily decided under the excess profits tax<sup>248</sup>—may be outdated because of a change in the IRS' attitude and that the positions taken by the IRS under Subchapter R and family partnerships are suspect in the context of section 1348.

### 3. *The Definition of Capital*

An initial question in delineating the scope of capital for purposes of section 1348 is whether "capital" is defined according to accounting terminology as stated capital, paid-in surplus, and earned surplus on the balance sheet, or in terms of the economist's concept of *assets*—meaning income producing property. Although there is some confusion in the case law as a result of occasional references to the capital section of the balance sheet,<sup>249</sup> the weight of authority adopts the position that capital is defined as *assets*. And it seems to have been generally assumed that land and buildings are also "capital" quite as much as machines and equipment.<sup>250</sup> The following subsections will discuss further refinements regarding the types of assets that might be considered capital by courts when determining whether capital is an MIPF.

#### a. *Leased assets*

Leased assets are treated as capital to the same extent as owned assets.<sup>251</sup> Thus where a taxpayer operated a hotel by leasing all of the tangible assets, the court held that capital was an MIPF.<sup>252</sup> Consequently, such devices as selling and leasing back income producing assets, or splitting the assets between entities which lease and those which own, will not avoid the 30 percent rule. Nor should it matter whether a taxpayer is the exclusive user of non-owned assets. For example, a computer would seem to be an MIPF to a computer dating service, even though used on a time-sharing basis. In fact, if taxpayer belongs to a trading exchange, the membership could be treated as capital which is

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248. The cases cited in the following discussion are excess profits tax cases unless otherwise noted.

249. *E.g.*, *Atlantic Coast Distrib. v. Commissioner*, 33 F.2d 733 (4th Cir. 1929).

250. Rev. Rul. 66-326, 1966-2 CUM. BULL. 281 (§ 911—farming on leased land—capital is always an MIPF regardless of the value of farm equipment). It should be noted that the inclusion of land in the definition of capital makes the definition broader than that usually employed by economists because the economist generally splits the factors of production into the three categories of land, labor and capital. P. SAMUELSON, *ECONOMICS* 42 (7th ed. 1967).

251. *Fairfax Mut. Wood Prods. Co.*, 5 T.C. 1279 (1945); *Newam Theatre Corp.*, 1 B.T.A. 887 (1925); Rev. Rul. 66-326, 1966-2 CUM. BULL. 281; *Wm. A. Brady Theatre Co. v. Commissioner*, 42 F.2d 181 (2d Cir. 1930) (dictum). *But see* *Mountain View Sanatorium Co. v. Huntley*, 25 F.2d 1016 (D. Ore. 1927).

252. *Cotton Hotel Co. v. Bass*, 7 F.2d 900 (W.D. Tex. 1925).

an MIPF.<sup>253</sup>

*b. Assets used to pay expenses*

The cases have differentiated between assets and expenses.<sup>254</sup> Thus, the fact that the taxpayer has substantial expenses, which are deductible in the year they are incurred, does not mean that the large amounts of cash necessary to pay such expenses will be treated as capital and an MIPF.<sup>255</sup> Only if the expenditures must be capitalized—thus creating assets—will this possibility arise. Again, however, note that leased assets, even though the rent is deductible, are treated as owned assets for the purpose of determining whether capital is an MIPF.<sup>256</sup>

*c. Start-up costs*

In a recent case, *Daniel A. Robida*,<sup>257</sup> the Tax Court held that certain forms of gambling produce earned income. If so, can the gambler's stake be considered a form of capital which might be an MIPF in his business. If so, not more than 30 percent of the net profits could be treated as earned. Even Mr. Robida, the slot machine player *par excellence*, presumably could not count on winning after playing his first quarter. One rarely succeeds at the race track unless he has enough capital to get through a streak of losers. If the assets needed by the gambler to survive until he begins to win are treated as an MIPF, a similar problem would arise in the case of money expended by a young lawyer until he establishes a clientele or entry fees paid by a golf pro.

However, the cash required to pay start-up costs is akin to cash retained to pay expenses and the courts have consistently refused to treat cash used to pay expenses as capital.<sup>258</sup> Moreover, start-up costs are characteristic of almost every business and such non-distinctive assets are not treated as MIPF's.<sup>259</sup>

The start-up cost problem is illustrated by *Jelindo A. Tiberti*,<sup>260</sup>

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253. See *Hubbard-Ragsdale Co. v. Dean*, 15 F.2d 410, 412 (S.D. Ohio 1926), which holds that capital includes the facilities of a livestock exchange to which the taxpayer belonged and that these facilities were an MIPF in taxpayer's live stock brokerage business.

254. *E.g.*, *Warren R. Miller, Sr.*, 51 T.C. 755 (1969) (retirement income credit); *Howard T. Lewis, Jr.*, 42 T.C. 885 (1964) (Subchapter R); *Fuller & Smith v. Routzahn*, 23 F.2d 959 (N.D. Ohio 1927); *Bryant & Stratton Commercial School, Inc.*, 1 B.T.A. 32 (1924); *Frieda Hempel*, 6 CCH Tax Ct. Mem. 743 (1947) (nonresident citizen).

255. See, *e.g.*, *Frieda Hempel*, 6 CCH Tax Ct. Mem. 743 (1947).

256. See Rev. Rul. 66-326, 1966-2 CUM. BULL. 281, 282.

257. 29 CCH Tax Ct. Mem. 86 (1970). See Notes 331-47 *infra* and accompanying text for a full discussion of the case.

258. See text accompanying notes 254-56 *supra*.

259. See note 292 *infra*.

260. 21 CCH Tax Ct. Mem. 961 (1962).

a family partnership case involving a contracting firm. The firm required large amounts of cash on hand to obtain bonding. On this ground alone, the Tax Court held that capital was an MIPF. But this cash can fairly be characterized as a start-up cost for new contracting jobs. It seems no different in substance from retaining cash to pay the premiums on the bonds—an example of cash used to pay expenses. Indeed, it seems that if the firm had sufficient goodwill to obtain bonding without retaining cash, such goodwill would probably not be treated as an MIPF.<sup>261</sup> Consequently, the *Tiberti* case seems wrongly decided and should not be followed under sections 911(b) and 1348.

*d. Accounts receivable*

Many cases, buttressed by the excess profits tax regulations,<sup>262</sup> held that large-scale extension of credit to customers caused capital to become an MIPF.<sup>263</sup> Although many of the cases involved the granting of credit as a distinct profit-making activity,<sup>264</sup> others involved non-interest bearing receivables in the familiar sense of payment for services long after their rendition.<sup>265</sup> The theory behind holding that non-interest bearing receivables were capital, and potentially an MIPF, was that collection delays required that the expenses of the business during the collection period be financed by substantial capital.<sup>266</sup>

Although a few service businesses still operate on a non-credit basis—both the gypsy fortune-teller and the criminal lawyer generally collect in advance—such businesses are becoming rather scarce. A doctor who insisted on immediate cash from his patients would probably

261. See text accompanying notes 271-76 *infra*.

262. See text preceding note 229 *supra*.

263. See, e.g., *Crider Bros. Comm'n Co. v. Commissioner*, 45 F.2d 974, 977 (8th Cir. 1930), *cert. denied*, 283 U.S. 834 (1931).

264. E.g., *Denver Live Stock Comm'n Co. v. Commissioner*, 29 F.2d 543 (8th Cir. 1928). *Cliver-Wright-Rainey Co.*, 2 B.T.A. 561 (1925) involved similar loans by a cotton broker.

265. E.g., *James N. Bennett*, 21 CCH Tax Ct. Mem. 903 (1962) (when a family partnership provides draftsmen on request, receivables make capital an MIPF). Most of such cases involved middlemen or commission-brokers who had to pay sellers immediately but gave the buyer credit. E.g., *Garrow, MacClain & Garrow v. Bass*, 88 F.2d 574 (5th Cir.), *cert. denied*, 302 U.S. 697 (1937); *Dreyer Comm'n Co. v. Hellmich*, 25 F.2d 408 (8th Cir. 1928); *Hubbard-Ragsdale Co. v. Dean*, 15 F.2d 410 (S.D. Ohio), *aff'd per curiam*, 15 F.2d 1013 (6th Cir. 1926); *Jeremiah J. O'Donnell, Jr.*, 23 CCH Tax Ct. Mem. 210 (1964) (family partnership); *John Dais Co.*, 2 B.T.A. 1167 (1925). In *Wagner-Taylor-Edson Co.*, 7 B.T.A. 268 (1927), an insurance broker and agent utilized capital as an MIPF because he often had to pay the insurance company before the insured remitted his premium. Cf. *Farnham Mfg. Co.*, 13 T.C. 511 (1949) (receivable from related company ignored).

266. *Fred J. Sperapani*, 42 T.C. 308 (1964) (*Subchapter R*); *Kossar & Co.*, 4 B.T.A. 1164 (1926); *Jeremiah J. O'Donnell, Jr.*, 23 CCH Tax Ct. Mem. 210 (1964) (family partnership).

not have any patients. But treating receivables as capital for purposes of applying the 30 percent test produces an unfortunate result. It is doubtful whether Congress intended to discriminate against criminal lawyers in favor of tax lawyers simply because one offers credit and the other does not. Thus it would be better to treat the accounts receivable problem exactly the same as cash retained to pay expenses. The cases have consistently held that such cash should not be treated as capital for purposes of determining whether capital was an MIPF.<sup>267</sup>

Similarly, granting credit in service businesses has now become so routine that it is like an office or a desk—wholly non-distinctive. This non-distinctive character is typical of assets which are not MIPF's.<sup>268</sup> For these reasons, the cases holding that non-interest bearing accounts receivable are an MIPF should not be followed under section 1348. Obviously, however, if the receivables play a more significant role in the production of income—for example, by generating large amounts of interest—they may well be an MIPF.<sup>269</sup>

#### *e. Intangibles*

Intangible assets can invoke the 30 percent rule quite as readily as tangible assets. Thus there seems little doubt that valuable contracts, franchises, patents, or secret formulas can be capital and MIPF's.<sup>270</sup>

The status of internally generated goodwill as an MIPF is less certain. For example, will the lawyer whose good reputation enables him to charge more than his competitor run afoul of the 30 percent rule? The same question would apply to goodwill acquired through advertising which also permits the taxpayer to charge more for his services than his less-publicized competitor. Conceptually, this type of goodwill would seem to be an asset and an MIPF. True, there has been no asset created in the tax sense because there is nothing which has a basis, but the same thing can be said of a secret formula whose development costs have been expensed. Sometimes, the goodwill of a service business is sold and sometimes it perishes with the person who generated it—but either way, it seems fair to call it an intangible asset which enables the practitioner to earn more for the same amount of work than his competitor.

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267. See text accompanying notes 254-56 *supra*.

268. See note 292 *infra*.

269. See text accompanying notes 314-17 *infra*.

270. Fred J. Sperapani, 42 T.C. 308 (1964) (exclusive right to report and sell transcripts for federal agencies; Subchapter R); John E. Greenawalt, 27 B.T.A. 936 (1933) (patents and patent licenses); H.D. & J.K. Crosswell, Inc., 6 B.T.A. 1315 (1927) (exclusive franchise); Scheffler Hair Colorine Co., 1 B.T.A. 61 (1924) (secret formula). *But see* Fred C. Sanborn, 19 B.T.A. 495 (1930) (valuable franchise not relied on).

Of the three cases which have explicitly faced the problem, two held that internally generated goodwill was not an asset for the purpose of determining whether capital is an MIPF.<sup>271</sup> The other case, however, suggested that it was.<sup>272</sup> Typically, the cases mention the existence of goodwill and pay no more attention to it.<sup>273</sup> Calling such goodwill an asset would create severe administrative problems, for who can say which practitioner has goodwill and which does not. Moreover, it seems reasonable to suggest that internally generated goodwill is submerg'd in the community's evaluation of a service—along with the utility of the service, the need for it and the supply of it—and it is too elusive a factor to be grappled with as a separate asset.

*Purchased* goodwill, however, should perhaps be treated as an asset. Since it has a basis for tax purposes,<sup>274</sup> it can easily be isolated and identified. If the taxpayer thought the goodwill valuable enough to buy it, perhaps the tax law should take him at his word and treat it as a potential MIPF.<sup>275</sup> Similarly a covenant not to compete might also be viewed as capital materially productive of income. If the covenant is realistic, it must mean that the covenantee can produce a measurably higher income without the covenantor's competition. Moreover, a covenant not to compete seems closely analogous to a territorially exclusive franchise which also could well be treated as an asset for purposes of determining whether capital is an MIPF.<sup>276</sup>

After determining what assets are to be treated as "capital," the courts will face the more formidable task of deciding whether capital is an MIPF in the particular business. The following subsections will discuss the inadequacy of the tests formulated thus far by the case law and suggest a criterion which might provide more guidance.

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271. *American Lawyers Co.*, 21 B.T.A. 370 (1930), *acquiesced in*, X-1 CUM. BULL. 9; *Bryant & Stratton Commercial School, Inc.*, 1 B.T.A. 32 (1924), *non-acquiesced*, IV-1 CUM. BULL. 4 (1925); in both cases, goodwill was on balance sheet but was internally derived.

272. *Metropolitan Business College v. Blair*, 24 F.2d 176 (7th Cir. 1928) (advertising produced goodwill which was carried on the balance sheet at 67,000 dollars. The court thought it might well be considered an MIPF). *Cf. Wagner-Taylor-Edson Co.*, 7 B.T.A. 268 (1927) (goodwill, not services, produced insurance broker's renewal commissions); *Wm. Morris Enterprises*, 1 B.T.A. 946 (1925) (fame of actor represented produced income for theatrical agent, not agent's own services).

273. *E.g. McManus-Heryer Brokerage Co. v. Brooks*, 41 F.2d 28 (W.D. Mo. 1930); *Hubbard-Ragsdale Co. v. Dean*, 15 F.2d 410 (S.D. Ohio 1926); *Botsford-Constantine & Tyler*, 10 B.T.A. 565 (1928), *acquiesced in*, VII-1 CUM. BULL. 4 (1928); *H.D. & J.K. Crosswell, Inc.*, 6 B.T.A. 1315 (1927).

274. CODE § 1012.

275. *American Lawyers Co.*, 21 B.T.A. 370 (1930), *acquiesced in*, X-1 CUM. BULL. 2 (dictum).

276. *See* CODE §§ 1253, 1241. *But see King Broadcasting Co.*, 48 T.C. 542, 547-50 (1967), which suggests that a franchise should be likened to an empty store. If this characterization were correct, it would suggest that the franchise is a non-

#### 4. Definition of Material Income Producing Factor

##### a. Obvious and not-so-obvious cases

Some apparently obvious cases of materiality or immateriality can readily be visualized. For example, consider the real estate broker whose income is derived solely from selling houses, who is paid in full immediately upon sale and whose only business assets are a leased office, a chair, a car, a desk, and a filing cabinet. His assets have been held to be "incidental," which is a way of asserting that they are not a material income-producing factor.<sup>277</sup> In a pinch, business could be transacted without any of the assets mentioned, although it would obviously be cumbersome to do so. In other words, the broker's business assets are required only in the sense that they are convenient and customary but they could be dispensed with if necessary. On the other hand capital is generally material when the taxpayer is engaged in selling, or manufacturing and selling, a product.<sup>278</sup>

Unfortunately, however, the distinction between firms selling products and firms selling services is often obscure. Many businesses conventionally thought of as "service" businesses transfer something tangible to customers. Thus a law firm may "produce" and "sell" a will; a photographer "produces" and "sells" a photograph.<sup>279</sup> This kind of confusion is well illustrated by *Fred J. Sperapani*<sup>280</sup> in which the Tax Court treated a court reporter for federal agencies as selling a product—the transcript—to the various agencies and litigants. *Sperapani* was a Subchapter R case. To permit the taxpayer to be taxed as a corporation, the court had to find that capital was an MIPF. Yet the Subchapter R regulations<sup>281</sup> declare that capital is never material in a service

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distinctive asset which would not be an MIPF. See text accompanying notes 291-94 *infra*. But the Tax Court's analysis in *King Broadcasting* overlooks the point that the franchise confers highly distinctive monopolistic benefits within the franchise area.

277. Warren R. Miller, 51 T.C. 755 (1969).

278. *McManus-Heryer Brokerage Co. v. Brooks*, 41 F.2d 280 (W.D. Mo. 1930); *Sanford H. Hartman*, 43 T.C. 105 (1964), *acquiesced in*, 1965-2 CUM. BULL. 4 (family partnership selling imported goods); *Fred J. Sperapani*, 42 T.C. 308 (1964) (Subchapter R); *Crestwood Publishing Co.*, 29 T.C. 789 (1958) (magazine publisher; capital "important income-producing factor" under World War II statute); *Gus Grissman Co.*, 10 T.C. 499 (1948); *Fairfax Mut. Wood Prod. Co.*, 5 T.C. 1279 (1945) (custom furniture). *But see Pogetto v. United States*, 306 F.2d 76 (9th Cir. 1962) (slight inventory in family partnership not MIPF); *Atlantic Coast Distrib. v. Commissioner*, 33 F.2d 733 (4th Cir. 1929); *Howard T. Lewis*, 42 T.C. 885 (1964); *Innes-Behney Optical Co.*, 7 B.T.A. 982 (1927), *acquiesced in*, VI-2 CUM. BULL. 3 (1927) (slight inventory of opera glasses; lens grinding machinery).

279. *See Trout-Ware Inc.*, 11 T.C. 505 (1948), *acquiesced in*, 1953-1 CUM. BULL. 6 where a photography company was held to be a personal service corporation. There was no analytical discussion of whether the company sold services or products.

280. 42 T.C. 308 (1964).

281. Treas. Reg. § 1.1361-2(e)(2) (1960).

business. The Tax Court escaped this dilemma by finding that the taxpayer dealt in goods, not services. But the equation of a manufactured item with a service embodied in tangible form—such as a transcript, will or photograph—can only promote confusion. Since a business clearly dealing in services may certainly employ capital as an MIPF, and since a business selling goods sometimes may not,<sup>282</sup> there seems to be little real point in torturing the distinction. Perhaps it would promote clarity to drop the distinction altogether and look directly to the precise role played by the particular assets in the production of income.

For many years, the courts have grappled with the chore of formulating the role which assets must play in the business in order to be treated as MIPF's. They have given birth to such vapid statements as:

If the nature of the business is such that it cannot be carried on at all without the constant use of capital, and such use of capital plays a vital part in the successful conduct of the business, it cannot be said that its use in the business is merely incidental . . . .<sup>283</sup>

and

When the use of capital goes further and gives character to a sizeable portion of the operations of the corporation, the percentage of gross income directly attributable to capital sources required to render capital a material income producing factor need not be very great.<sup>284</sup>

Equally unhelpful are such labels as "incidental,"<sup>285</sup> "considerable amount of capital,"<sup>286</sup> "indispensable,"<sup>287</sup> or "important" in producing income as distinguished from "remote."<sup>288</sup>

When these question-begging formulations are applied to concrete fact situations, the result is often quite obscure. An actuary does his figuring through computer time-sharing. Is the capital more or less material in producing income than the computer used by a computer dating service? A janitorial service firm maintains the property of its clients through the use of expensive machinery. Is the capital employed more or less material than the planes owned by a flying school?<sup>289</sup> A

282. *E.g.*, *Pogetto v. United States*, 306 F.2d 76 (9th Cir. 1962); *Howard T. Lewis*, 42 T.C. 885 (1964); *Innes-Behney Optical Co.*, 7 B.T.A. 982 (1927), *acquiesced in*, VI-2 CUM. BULL. 3 (1927).

283. *Hubbard-Ragsdale Co. v. Dean*, 15 F.2d 410, 411 (S.D. Ohio), *aff'd per curiam*, 15 F.2d 1013 (6th Cir. 1926).

284. *Edward P. Allison Co. v. Commissioner*, 63 F.2d 553, 558 (8th Cir. 1933).

285. This word is often used in this context. *E.g.*, *Treas. Reg. 62 art. 1531 (1922)*.

286. *Atlanta-Southern Dental College v. Commissioner*, 50 F.2d 34, 36 (5th Cir. 1931).

287. *Isidore Garnets*, 26 B.T.A. 384, 387 (1932) (earned income credit).

288. *Bryant & Stratton Commercial School*, 1 B.T.A. 32 (1924), *non-acquiesced*, IV-1 CUM. BULL. 4 (1924).

289. *Graham Flying Serv. v. Commissioner*, 167 F.2d 91 (8th Cir.), *cert. denied*, 335 U.S. 817 (1948) (planes and hangars owned by flying school treated as MIPF).



law firm needs an expensive library since one of its vital tasks is doing legal research. Is the capital employed more or less material than the title reports owned by an abstracting company?<sup>290</sup> Almost all decent sized service businesses need their own distinctive—and often substantial—assets to operate. The following subsection of this Article proposes a test that will hopefully replace the illusory criteria furnished by existing case law.

*b. A proposed test*

The following test is designed to furnish a workable and logical standard. If assets are *required* by the business—as opposed to being merely for the *convenience* of customers or the person rendering the service<sup>291</sup>—they are an MIPF unless they fall within one of two classes: First, they are the kinds of assets needed in virtually every business, such as an office or a desk, rather than being *distinctive* of a particular business;<sup>292</sup> second, they are the *tools-of-the-trade* of skilled persons and of *relatively small value* in comparison to gross income from the business.

Thus, a lawyer could do his research in the county law library instead of his own library, could forsake his automatic tape-driven typewriter, and, in a true emergency, could even manage without Xerox machines. Therefore, these assets can be regarded as not required by the business but utilized for the lawyer's convenience.<sup>293</sup> Similarly, an accountant could dispense with his computer and go back to doing tax returns by pencil. But a computer dating service could not (truthfully) function without its computer since its customers are presumably paying for a solution to their social problems resulting from the ministrations of that magical device. This is an asset which could not be dispensed with and, therefore, is not a mere convenience.

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290. *St. Paul Abstract Co. v. Commissioner*, 32 F.2d 225 (8th Cir. 1929) (abstract books are an MIPF).

291. This definition assumes that the service provided is something other than supplying these particular assets for the convenience of customers. In other words, while lockers at the airport are for the "convenience" of airport customers, they are not within this exception. The text further assumes that the taxpayer cannot isolate precisely what percentage of income is attributable to capital. If he can, he could prove that it was immaterial. See text accompanying notes 314-17 *infra*.

292. The cases have consistently held that the kind of assets every business has—those which are not distinctive to the kind of business involved—cannot be considered material income producers. *E.g.*, *Fuller & Smith v. Routzahn*, 23 F.2d 959, 963 (N.D. Ohio 1927).

293. *Hurst, Anthony & Watkins, Inc. v. Heiner*, 26 F.2d 734 (W.D. Pa. 1928); *J.L. Kelso Co.*, 1 B.T.A. 1264 (1925). Thus the desks and blackboards in a school could be dispensed with if necessary and would not be an MIPF. See note 230 *supra*. To illustrate this point, the court stated in *J.L. Kelso Co.*, *supra*, that "it was once said that Mark Hopkins on one end of a log in the words and a student on the other end constituted a university." 1 B.T.A. at 1265.

The more troublesome of the two exclusionary tests is the second—tools-of-the-trade of skilled persons with relatively small value. *Howard T. Lewis*<sup>294</sup> involved a doctor whose main source of income came from operating a nutritional clinic. He sought to treat the clinic as a corporation under Subchapter R but to do so he had to prove that capital was an MIPF. The Tax Court did not answer the MIPF issue with a bland citation to the Subchapter R regulation which states that capital is not an MIPF where the source of income comes from fees.<sup>295</sup> Instead, it analyzed the way in which capital contributed to the earnings of the business. The clinic had land, buildings, and furniture with a book value of 57,000 dollars.<sup>296</sup> Under the test proposed by this Article, these would seem to be either convenience assets or non-distinctive assets typical of every business.<sup>297</sup> The court pointed out that no special and unique equipment was used in the clinic, only the normal doctor's office equipment which was characterized as tools-of-the-trade.<sup>298</sup> Apparently the book value of the equipment was only a few hundred dollars.<sup>299</sup> Unsurprisingly, capital was held not to be an MIPF.<sup>300</sup>

In *Lewis*, the court found "not controlling" the authorities cited by the taxpayer, but cited only one—*Beulah H. Nichols*.<sup>301</sup> In *Nichols*, a

294. 42 T.C. 885 (1964). See also *Innes-Behney Optical Co.*, 7 B.T.A. 982 (1927), *acquiesced in*, VI-2 CUM. BULL. 3 (1927).

295. Treas. Reg. § 1.1361-2(e)(2) (1960).

296. 42 T.C. at 887-88.

297. See *id.* at 892-93.

298. *Id.* at 890, 893-94.

299. *Id.* at 887-88. Similarly, see *H. Newton Whittelsey, Inc.*, 9 T.C. 709 (1947), *acquiesced in*, 1953-2 CUM. BULL. 7 (ship engineering corporation in which everyone used a drawing board; IRS concedes capital not MIPF); *H.S. Jaudon Eng'r Co.*, 15 B.T.A. 161 (1929) (surveying and drafting instruments); *Cocks-Clark Eng'r Co.*, 8 B.T.A. 468 (1927), *acquiesced in*, VII-1 CUM. BULL. 7 (1929) (photo-engraver); *Rhoades, Brownson & Kampman, Inc.*, 2 B.T.A. 194 (1925), *acquiesced in* IV-2 CUM. BULL. 14 (1925) (skillful weighers and graders of rubber; tools and scales worth 8,000 dollars, gross income equals 100,000 dollars; held tools of the trade and not MIPF).

300. A questionable part of the opinion in *Lewis* is the court's treatment of drugs and vitamins. Although taxpayer kept these items in inventory, he did not charge anything extra for dispensing them; they were included in the set ten dollar monthly charge. The record did not support any allocation of income to the inventory. The court felt that the inventory was not an MIPF. Yet the failure to make a separate charge would not seem determinative. If taxpayer failed to prove that the contribution of the profit on inventory was immaterial, see text accompanying notes 314-17 *infra*, this inventory would appear to be an MIPF. In essence, *Lewis* was operating a medical practice (in which capital was not an MIPF) and a pharmacy which produced income by buying drugs and vitamins at wholesale and selling them at retail. Income from the latter was primarily produced by assets—the inventory—not by services. See note 278 *supra*. However, the *Lewis* treatment of this issue is supported by case law involving optometrists who also sold lenses and eyeglass frames. *Innes-Behney Optical Co.*, 7 B.T.A. 982 (1927), *acquiesced in*, VI-2 CUM. BULL. 3 (1928); *Payton v. United States*, 425 F.2d 1324 (5th Cir. 1970) (*semble*).

301. 32 T.C. 1322 (1959), *acquiesced in*, 1960-2 CUM. BULL. 6 (alternative holding).

family partnership case involving a radiologist, the court indicated that capital was an MIPF. Although *Lewis* does not state its basis for distinguishing *Nichols*, the difference in the two cases may have been the differing value of the distinctive equipment employed in relation to gross income. The equipment of a radiologist may have too great a value not to be treated as an MIPF.<sup>302</sup> In both *Nichols* and *Lewis*, the patient was paying for a skillful person to use certain distinctive equipment. In both cases also, the equipment could be considered tools-of-the-trade. But the nutritional clinic used equipment of modest value, while the radiologist used equipment of much greater value relative to gross income. These Tax Court decisions are thus consistent with the "tools-of-the-trade with relatively small value" test.

Since the test requires the valuation of equipment, it will undoubtedly cause administrative difficulties. Moreover, making distinctions between professionals based upon the relative proportion of assets to gross income or upon the absolute value of equipment will cause painful arbitrariness. For example, such a test would discriminate against persons just starting to practice. Suppose it costs a dentist 20,000 dollars<sup>303</sup> to purchase the equipment to begin practicing and that in the first year of practice, his gross income is 15,000 dollars. Since the value of assets in the first year would equal more than 100 percent of gross income, capital would be an MIPF under any reasonable percentage test.<sup>304</sup> In the fifth year, however, if the dentist's gross income were 100,000 dollars, the value of assets would be only 20 percent of gross income and capital might not be an MIPF. Since it seems impossible to draw a rational and equitable line between the various kinds of doctors and dentists, the IRS would be well advised to follow its prior rulings which concede that capital is never an MIPF for professionals.<sup>305</sup>

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302. The fair market value of the equipment is not given in *Nichols* although the depreciated book value of tangible equipment is given as about 3,900 dollars. However, the writer was informed by a specialist in medical office management that it would cost 70,000 dollars in equipment to set up a radiology practice.

303. The cost of equipment for a dentist starting out in practice is about 22,000 dollars. Brandhorst, *Dental Economics*, 37 J. AM. COLL. OF DENTISTS 119 (1970). Capital was held to be an MIPF in the case of a dental clinic. *Atlanta-Southern Dental College v. Commissioner*, 50 F.2d 34 (5th Cir. 1931); *Electro Dental Parlors*, 2 B.T.A. 83 (1925) (*semble*). Both, however, involved much more than a single practitioner or small partnership. Both involved a substantial staff of employed dentists, so that in both cases, the decision was grounded at least partly upon the fact that the income generated by employees was not primarily attributable to the stockholders.

304. See note 307 *infra*.

305. See notes 244-45 *supra*. However justifiable this policy may be in the light of fairness and administrative convenience, the IRS's stated rationale for it is less than persuasive. In Rev. Rul. 57-141, 1957-1 CUM. BULL. 14, involving the retirement income credit, the IRS declared that capital was not an MIPF for doctors or dentists

Even if capital is never an MIPF for professionals, the problem of applying the tools-of-the-trade test remains in the cases of other service businesses. No doubt, a plumber or a barber<sup>306</sup> can assert that his tools are of relatively small value compared to his gross income. But what of an independent testing laboratory, a crop duster or the owner of a convalescent hospital? These are businesses in which skilled persons utilize tools of the trade but in which the investment in assets is quite heavy relative to gross income.

One approach to the problem might be to treat capital as an MIPF only if the value of the tools-of-the-trade exceed in value 50,000 dollars or one-third of gross income, whichever is greater. In other words, using the one-third test, even if the assets produced a high 25 percent annual return, the income attributable to capital would not exceed 8.3 percent of gross income. This would be well under the 10 percent breaking point suggested by the cases dealing with unrelated investments as an MIPF.<sup>307</sup> The value of the assets would be presumed to be their adjusted basis at the end of the taxable year and the taxpayer could prove that the assets are worth less than their book value. If the taxpayers in certain kinds of enterprises tended to cluster around the percentage line which the IRS selected so that persistent difficulties of administration occurred, it could enact a consistent rule to the effect that capital is or is not an MIPF in that kind of business. It has apparently

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or other professionals "who have large investments in office equipment." The reason was:

Inasmuch as the amount of capital employed has only an incidental effect on the amount of profits derived from professional fees, the growth of the profession being dependent primarily on the reputation and technical skill . . . , it is held that such capital is not a [MIPF].

But as a matter of common sense, this is not true. The professional who must make a great investment in assets must charge more than his counterpart who can practice with slight investment. And this difference must represent more than just the depreciation on the equipment; it would indeed be strange if it did not also represent a profit on the capital invested. Capital invested on a radiology practice must fetch a return, just like capital invested in any other business. The fees collected include a return on capital and a return on labor.

306. If any barbers are earning enough to take advantage of section 1348 in the Age of Aquarius.

307. See cases discussed at text accompanying notes 314-17 *infra*. The 8.3 percent figure comes from multiplying one-third (the maximum ratio of value of assets to gross income) times one-fourth (the hypothetical high rate of return on assets). This yields one-twelfth or 8.3 percent. If 50,000 dollars were more than one-third of gross income, the proposed test would permit the income derived from capital to be well in excess of 10 percent of gross income. If, for example, gross income were 60,000 dollars, and the value of the assets were 40,000 dollars, one-third of gross income would be 20,000 dollars but the business would still be deemed one in which capital is not an MIPF. Yet if the assets were earning at the rate of 25 percent per annum, they would be producing 10,000 dollars of income per year, which would be 16.6 percent of gross income. However, the proposed test was designed to exclude many relatively small businesses from the MIPF test to facilitate ease of administration.

done exactly that in the case of professionals.<sup>308</sup>

Using a percentage of income guideline is not entirely without precedent. In *Danco Co.*,<sup>309</sup> the Tax Court interpreted for the first time the provision in the World War II excess profits tax giving special benefits where capital was not an *important* income-producing factor. The business—manufacturing custom sheet metal products—was one in which capital would have been treated as a *material* income producer under well established tests.<sup>310</sup> But the Tax Court stated a new test. Since net profits were a high percentage of “invested capital”—between 100 percent and 425 percent—capital was not an *important* income producing factor. However, later cases decided under the excess profits tax reverted to the traditional tests of whether capital was *material*.<sup>311</sup>

Although the suggested guidelines may leave the matter in a somewhat untidy mess,<sup>312</sup> the Congress is ultimately responsible. Unless presence of capital as an MIPF in all service businesses is ignored—which seems contrary to the will of Congress—the problem must be faced. It is an inadequate solution to assert that the matter depends on all the facts and circumstances;<sup>313</sup> this leaves too much to the discretion of the examining agent and will probably lead to an inordinate amount of litigation. Regulatory guidelines seem to be the only equitable and feasible solution until Congress reconsiders the problem.

### c. *Capital present but not required*

Sometimes, a business has investments which are materially productive of income but are not required to perform the primary function of the business. Such assets have been held MIPF's if the gross income attributable to them is material in relation to the gross income from the business itself.<sup>314</sup>

These cases are much easier to deal with than the cases in which income is produced by an indivisible combination of services and es-

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308. See notes 244, 245 & 305 *supra*. The use of regulatory “safe harbors” has proved useful in other contexts. *E.g.* Treas. Reg. § 1.482-2(d)(4) (1968).

309. 14 T.C. 276 (1950) (alternative holding).

310. Because it manufactured and sold a product. *E.g.*, Fairfax Mut. Wood Prods. Co., 5 T.C. 1279 (1945). See cases cited at note 278 *supra*.

311. *E.g.*, Crestwood Publishing Co., 29 T.C. 789 (1958). See E.P.C. 35, 1949-1 CUM. BULL. 134, 135.

312. If the book value of assets were to decline below 50,000 dollars (or one-third of gross income) due to depreciation, a business might switch suddenly to one in which capital was no longer an MIPF. To get around this problem, perhaps the guidelines should provide that the status of a business as one in which capital is or is not an MIPF will not change merely by reason of depreciation or the replacement of used equipment with new equipment.

313. *E.g.*, Rev. Rul. 56-416, 1956-2 CUM. BULL. 15.

314. Jeremiah J. O'Donnell, Jr., 23 CCH Tax Ct. Mem. 210 (1964) (family partnership); Rev. Rul. 66-56, 1966-1 CUM. BULL. 87 (Keogh plans).

sential assets. Where the assets are an essential element in the production of income, it is virtually impossible to segregate the percentage of income attributable to capital from that attributable to services. But it is possible to determine exactly what percentage of gross income is attributable to unrelated assets. Not surprisingly, the cases were unable to establish any fixed line below which the gross income from unrelated assets would not be material. Typically, where the gross income was in excess of around ten percent, it was found material,<sup>315</sup> and one case went down as low as six percent.<sup>316</sup>

The presence of unrelated assets may pose a serious problem to partnerships which make partnership investments but which otherwise do not use capital as an MIPF. Consider, for example, the law firm which takes stock in lieu of a fee in connection with handling a public offering. If such stocks produce dividend income which is material—in excess of about ten percent—in relation to partnership gross income, capital may be considered an MIPF. Similarly, even an isolated capital gain could make capital an MIPF for a given year.<sup>317</sup> Therefore, if gross income from investments is substantial in relation to other gross income, the partnership should consider separating investment assets from the entity conducting the service business.

##### 5. Defining "Net Profits"

Section 911(b) requires that if capital is an MIPF, a reasonable allowance for compensation, not in excess of 30 percent of "net profits" of the trade or business, is earned income. The IRS has ruled that "net profits" means "commercial or book profits," not "net income" as defined by the Code for tax purposes.<sup>318</sup> This ruling introduces considerable confusion into the calculation of earned income because it introduces an accounting concept rather than a tax concept as the relevant test. For example, if income is reduced by amortization of purchased goodwill for accounting purposes, this would seem to reduce the amount which could be claimed as earned income where capital is an MIPF. On the other hand, if straight-line depreciation is used for accounting purposes but accelerated depreciation is used for tax purposes, the maximum allowance for compensation could be in excess of 30 percent of taxable income.

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315. For a summary of these cases, see *Edward P. Allison Co. v. Commissioner*, 63 F.2d 553, 557-58 (8th Cir. 1933).

316. *Conklin-Zonne-Loomis Co. v. Commissioner*, 29 F.2d 698 (8th Cir. 1928), *cert. denied*, 279 U.S. 871 (1929).

317. *Seaboard Mills, Inc.*, 5 B.T.A. 575 (1926), *acquiesced in*, VI-1 CUM. BULL. 5 (1927).

318. Rev. Rul. 60-178, 1960-1 CUM. BULL. 14.

The use of a commercial accounting standard, rather than a tax standard, opens up some attractive planning possibilities. It will encourage the use of accounting conventions which would make book profits higher than taxable income. However, the incorporation of commercial accounting standards can only muddy further an already intolerably confusing area.<sup>319</sup> Consequently, the IRS should reconsider its prior position<sup>320</sup> and declare that "net profits" are to be computed solely by reference to income tax standards.

#### 6. *Planning to Avoid the 30 Percent Rule*

It does not require a crystal ball to predict that prosperous, unincorporated businesses which sell, or produce and sell, a product are going to be confronted with the 30 percent rule. Many service businesses are also likely to face the 30 percent limitation on earned income, although this is much less predictable. Consequently, it is imperative to try to plan around this problem.

As previously pointed out, it is very unlikely that leasing assets, instead of purchasing them, will have any effect in diminishing the materiality of capital as an income producer because leased assets are treated the same as purchased assets.<sup>321</sup> Nor does it matter whether the funds required to purchase the assets are invested or borrowed.<sup>322</sup>

The most promising solution to the problem is to take a salary. The case law strongly supports the proposition that a guaranteed payment from a partnership will be considered earned income even though capital is an MIPF to the partnership.<sup>323</sup> Although this solution creates the new problem of proving the reasonableness of the guaranteed payment as compensation for services, often far more than 30 percent of the partnership profits will be a reasonable salary. If the partnership can spare the cash needed to pay the salary, it has nothing to lose and everything to gain by using the salary approach.

Section 704(b)<sup>324</sup>—dealing with the allocation for tax purposes of partners' distributive shares—may also provide some opportunities for planning in this context. Suppose the partnership has two distinct income-producing activities. One produces purely earned income, but capital is an MIPF in the other. Possibly, they will be viewed as two separate business for the purpose of determining the applicability of the

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319. Cf. Asimow, *Principle and Prepaid Interest*, 16 U.C.L.A.L. REV. 36, 53-54 (1968).

320. See note 318 *supra*.

321. See text accompanying notes 251-53 *supra*.

322. *Fairfax Mut. Wood Prods. Co.*, 5 T.C. 1279, 1282 (1945).

323. See text accompanying notes 90-91 *supra*; Note, 74 YALE L.J. 956, 971 (1965).

324. CODE § 704(b) provides that partner's distributive shares of income can be allocated by the partnership agreement unless the principal purpose is to avoid taxes.

30 percent limitation, but this cannot be counted on. Thus, suppose the partnership examined eyes and prescribed glasses (optometrists) in addition to selling lenses and frames (opticians). Capital might well be an MIPF in the optical activity,<sup>325</sup> but not in the optometry activity.<sup>326</sup> If only one of the partners were in a position to advantageously utilize section 1348, the partnership agreement might allocate the optometry profits to him. Consequently, he could receive his entire partnership distributive share free of the 30 percent limitation.<sup>327</sup>

In the case of the sole proprietor, however, the guaranteed payment approach is impossible—unless he wishes to form a family partnership, which would be relatively easy since capital is an MIPF.<sup>328</sup> If this is impractical, the only remaining solution may be to incorporate and draw a salary. This approach, however, again presents the issue of reasonableness of salary payments.<sup>329</sup> In addition, the incorporation raises a new spectre—section 269. Under section 269, if the principal purpose of an incorporation is to avoid taxes by securing the “benefit of a deduction, credit, or other allowance” which would not otherwise be enjoyed, the tax benefit sought can be denied.

A full treatment of section 269 is beyond the scope of this Article. However, the benefit of section 1348 might be included within the term “other allowance,” as multiple surtax exemptions have been.<sup>330</sup> Therefore, the incorporation of a sole proprietorship could become a very delicate matter. If there are other significant purposes for the incorporation, they should be carefully documented in order to bolster the argument that tax avoidance was not the principal purpose.

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325. Because a material part of income comes from the profit on the sale of goods. See note 278 *supra*. But see *Payton v. United States*, 425 F.2d 1324 (5th Cir. 1970) (*semble*); *Innes-Behney Optical Co.*, 7 B.T.A. 982 (1927), *acquiesced in*, VI-2 CUM. BULL. 3 (1927).

326. See notes 244-45 *supra*.

327. See Rev. Rul. 67-158, 1967-1 CUM. BULL. 188. It is not likely that the suggested allocation would run afoul of the tax avoidance rule of section 704(b) since it has a real, nontax economic effect, at least as long as entered into before the amounts of the allocated items can be reasonably estimated. Treas. Reg. § 1.704-1(b)(2) (1956). Cf. *Stanley C. Orrisch*, 55 T.C. No. 39 (Dec. 2, 1970); Note, 74 YALE L.J. 956, 973-74 (1965).

328. CODE § 704(e)(1).

329. *Id.* § 162(a)(1). But see *Charles McCandless Tile Serv. v. United States*, 422 F.2d 1336 (Ct. Cl. 1970) which holds that a portion of a *reasonable* salary payment must be treated as a dividend.

330. *Coastal Oil Storage Co. v. Commissioner*, 242 F.2d 396 (4th Cir. 1957) is the leading case. Section 269 has also been invoked to disallow tax benefits claimed by the person acquiring control of the corporation. *E.g.*, *Luke v. Commissioner*, 351 F.2d 568 (7th Cir. 1965). Cf. *Borge v. Commissioner*, 405 F.2d 673 (2d Cir. 1968).



*B. The Gap in The Definition of Earned Income: Services Rendered to One's Self*

Section 911(b) contains a peculiar gap. It treats as earned income a wage or salary—compensation of an employee—unless it is a dividend. It also treats as earned income “professional fees and other amounts received as compensation for personal services actually rendered.” Thus the compensation of an independent contractor who renders a service is earned income. Finally, earned income includes “a reasonable allowance as compensation for the personal services rendered” (up to 30 percent of net profits) in the case of a trade or business in which both services and capital are MIPF's.<sup>331</sup>

But what about a reasonable allowance for compensation to a person, such as a gambler,<sup>332</sup> who is engaged in a trade or business (not as an employee or independent contractor) in which capital is not an MIPF? This was the problem faced by the Tax Court in the recent case of *Daniel A. Robida*,<sup>333</sup> in which the taxpayer was a “manipulator” of slot machines. Unfortunately, the Tax Court does not explain his technique. Evidently, he knew how to make the one-armed bandits pay off consistently. Since he conducted this worthwhile activity while abroad, he urged that his income was “earned income” and thus excludable under section 911. The Tax Court agreed:

Gambling income could in many circumstances be passive income, which like rental income, dividends, interest, royalties, etc., could fairly be characterized as being derived from the use of property or the investment in gambling facilities. No stated Congressional purpose would be served by encouraging the passive or casual gambler to pursue his gambling abroad rather than at home, any more than by encouraging the investor to clip his coupons on the Riviera rather than at Palm Beach.<sup>334</sup> We do not, however, think that petitioner's income derived from his manipulation of slot machines necessarily constitutes gambling income. Petitioner did not “win” his income on his stake. Rather he earned his income by his diligent application of an unusual skill or knowledge gained during his previous employment with a manufacturer of slot machines which enabled him to extract money

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331. CODE § 911(b).

332. The IRS takes the position that gambling winnings are not earned income. Rev. Rul. 55-171, 1955-1 CUM. BULL. 80, 86.

333. 1970 P-H Tax Ct. Mem. 454. See also the previous Tax Court case, 34 P-H Tax Ct. Mem. 497 (1965), *rev'd on other grounds*, 371 F.2d 518 (9th Cir. 1967). In the later case, the Tax Court noted that the “disreputability” of taxpayer's occupation was immaterial in deciding whether his income was excludable under section 911(a), although it agreed that Congress probably did not want to encourage the pursuit of disreputable businesses.

334. However, if the citizen is winning from noncitizens and repatriating the money, his gambling may be helpful to the balance of payments (author's footnote).

from these machines, wherever he could find them. No amount of his income was derived from the use of his capital.<sup>335</sup>

In this passage, the Tax Court appears to have confused two different problems: First, whether the taxpayer's income was "earned income" under section 911 and second, whether capital was an MIPF.<sup>330</sup> If capital was not an MIPF, the characterization of any part of Robida's winnings as earned income presents conceptual difficulties. Certainly, it is neither a wage nor a salary. Nor does it seem to be an "amount received as compensation for personal services actually rendered," since the IRS has interpreted this language to mean services rendered *to another*.<sup>337</sup>

The most logical way out of this dilemma is an expansive reading of the phrase permitting a reasonable allowance for services in a trade or business in which capital and services are both MIPF's. The suggested construction would permit a reasonable allowance for the value of services—up to 100 percent of net profits—in a trade or business in which capital is *not* an MIPF. Thus the sentence limiting the allowance to 30 percent of net profits where capital is an MIPF would be read as implying that a reasonable allowance for services in excess of 30 percent is justified where capital is not an MIPF. This construction is warranted because it is irrational to limit the allowance for the value of services to 30 percent of net profits where capital is an MIPF and to zero when it is not.<sup>338</sup>

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335. 1970 P-H Tax Ct. Mem. 454, 458-59.

336. For a full discussion of this issue, see notes 257-61 *supra* and accompanying text.

337. Rev. Rul. 66-326, 1966-2 CUM. BULL. 281. See also Doyle J. Dixon, 16 T.C. 1016 (1951) (pre-1964 averaging). Cf. the cases under section 911(b) involving creative persons discussed at text accompanying notes 56-65 *supra*. These cases held that the returns from the sale or license of the work of a writer or inventor were from property, not services. Hence none of it could be considered wages, salaries or professional fees. John E. Greenawalt, 27 B.T.A. 936 (1933) (earned income credit), involved a patent licensor. The IRS contended successfully that this was a trade or business in which capital (the patents) was an MIPF; hence a reasonable allowance for services, up to the maximum allowance, was justified. In Frank L. Kluckhohn, 18 T.C. 892 (1952), E. Phillips Oppenheim, 31 B.T.A. 563 (1934), and Ray Harroun, 1945 P-H Tax Ct. Mem. 780, inventors and creators of literary property were not permitted to treat *any part* of their returns as earned income. The Tax Court did not discuss the question of whether they were in a trade or business in which capital was an MIPF. It dealt only with the language concerning "wages, salaries, or professional fees, and other amounts received as compensation for personal services actually rendered." It should be added that the problem concerning creative people has been solved in a way different from that suggested by the author. See text accompanying notes 56-65 *supra*.

338. There is little law on the question of how extensive services must be in order to be considered an MIPF. In Steve Lodzieski, 1944 P-H Tax Ct. Mem. 1056, the lessor of a few houses spent two days a month collecting the rent. Services were held not an MIPF. However, a somewhat stronger showing of the value of the services

Another way out of the problem would be to interpret the phrase "personal services actually rendered" to include services rendered to one's self.<sup>340</sup> This approach has merit since taxpayers in non-service businesses where capital is an MIPF have routinely been accorded the benefit of a 30 percent allowance for services, even though the services were rendered to themselves.<sup>341</sup>

However the approach just suggested can be criticized because it fails to insure that the taxpayer be engaged in a trade or business before he is entitled to an allowance for the services rendered to himself. Thus taxpayers engaged in investing securities—not a trade or business<sup>342</sup>—could claim entitlement to earned income. But estimating the value of one's service to himself in outguessing the stock market would be a bottomless administrative bog. This problem does not arise under the approach first suggested<sup>343</sup> because that approach provides for an allowance for services only in a trade or business.

If the *Robida* decision is followed, the courts will have to grapple with the question of what other forms of gambling will produce earned income. It should not be decisive that taxpayer bets only on sure things (as apparently was the case in *Robida*) rather than using his analytical skills to bet only when the odds are favorable. If there is no difference, it would seem that the persistently successful horseplayer can avail himself of section 1348 since nobody can consistently win at the track without skillful analysis of form. The successful pool hustler also relies on skill. Few people can consistently make money at poker games without skillful bluffing and insight. Presumably the winner of the Irish Sweepstakes or the numbers game is out of luck, as well as the person who languidly places a chip on the red or the black. Based on *Robida*, however, the successful horse player, pool shark, or professional poker player who can establish that skillful gambling is his trade or business has won a tax advantage.

This should lead to some interesting trials in which the IRS urges that daily doubles were the result of blind luck while the taxpayer insists

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probably would have justified some allowance. See John W. Willmott, 2 T.C. 321 (1943), *acquiesced in*, 1943 CUM. BULL. 25; Rev. Rul. 64-1, 1964-1 CUM. BULL. 7; Rev. Rul. 56-417, 1956-2 CUM. BULL. 17; Rev. Rul. 56-416, 1956-2 CUM. BULL. 15.

339. Yet this was the result of the intellectual property cases cited in note 337 *supra*, where an allowance for services equal to 20 percent of net profits (then the maximum allowance) was permitted to a patent licensor since capital was an MIPF but no such allowance was permitted to inventors or authors where capital was not an MIPF.

340. However, this would require the IRS to reconsider its position. See note 337 *supra*.

341. See, e.g., Rev. Rul. 66-326, 1966-2 CUM. BULL. 281.

342. E.g., *Higgins v. Commissioner*, 312 U.S. 212 (1941).

343. See text accompanying notes 338-39 *supra*.

that they were the fruit of intensive study and analysis. Although such trials would be entertaining, the point at issue seems irrelevant to the purpose of section 1348—discouraging tax shelter schemes.<sup>344</sup> Big winners, at games of skill or chance, tend to enter into such schemes.<sup>345</sup> Moreover, since it will often be impossible to know whether winnings are the result of skill or luck, it would promote administrative convenience to treat all gambling winnings as earned income if gambling is the taxpayer's trade or business.

*Robida* suggests that various sorts of income from *illegal* activities will also qualify as earned income because of the court's indication that the "disreputability" of *Robida's* occupation was immaterial.<sup>346</sup> The income of the embezzler, extortionist, or armed robber is as much a consequence of personal activity as was *Robida's* income. If it is not necessary to show that services were rendered for another person, and *Robida* seems to be good authority for that proposition, it is difficult to see why obviously illegal activities would not qualify as sources of earned income. Strangely enough, this may not be a bad result. In the embezzlement cases, the real struggle is often between the government and the defrauded person. When the embezzler's income is taxable in the top bracket, there is likely to be little if anything left for the victim.<sup>347</sup> Limiting the rate of tax on the embezzled funds to 50 per cent might leave more for the person defrauded.

#### IV

##### SECTION 1348, TAX PREFERENCES, AND CAPITAL GAINS

###### A. *Reduction for Items of Tax Preference*

The new minimum tax on tax preferences exacted by section 56<sup>348</sup> is somewhat less than devastating. For one thing, many items commonly classified as loopholes are not treated as tax preferences.<sup>349</sup> More significantly, in determining his minimum tax the taxpayer is entitled to deduct from his tax preferences the sum of 30,000 dollars

344. See text accompanying notes 371-94 *infra*.

345. See, e.g., *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966) (Irish Sweepstakes).

346. 1970 P-H Tax Ct. Mem. 454, 459.

347. See, e.g., *United States v. Rochelle*, 384 F.2d 748 (5th Cir. 1967).

348. Tax Reform Act of 1969, § 301, 83 Stat. 580.

349. For example, intangible drilling expenses [CODE § 263(c)]; interest on state and municipal bonds [*id.* § 103]; or the gifts to charities (other than private foundations) of appreciated capital gain property, [*id.* § 170(b)(1)(D)]. The more significant items treated as tax preferences are one-half of the excess of net long-term capital gain over net short-term capital loss [*id.* § 57(a)(9)], the value at exercise of a qualified stock option [*id.* § 57(a)(6)], the excess of percentage depletion over basis, *id.* § 57(a)(8) excess investment interest until 1972 [*id.* § 57(a)(1)], and the excess of real property accelerated depreciation over straight-line. *Id.* § 57(a)(2).

plus income tax paid for the year.<sup>350</sup> Relatively few taxpayers have tax preferences in excess of 30,000 dollars a year plus their annual income tax. Finally, the minimum tax is imposed at the rate of only 10 percent.<sup>351</sup>

Section 1348, however, imposes a much more stringent sanction against the use of tax preferences. Under section 1348, ETI must be reduced dollar-for-dollar for tax preferences in excess of 30,000 dollars.<sup>352</sup> The result for the taxpayer whose ETI would otherwise be high enough to enable him to take advantage of the maximum tax is that every such dollar of tax preference bumps a dollar of ETI into brackets above 50 percent.<sup>353</sup> Actually, the effect of a tax preference item on ETI is worse than that because the same dollar of tax preferences can be used year after year to increase the tax on earned income. This is because earned income is reduced by the greater of the sum of tax preferences for the taxable year (less 30,000 dollars) or a *five year average* of tax preferences (less 30,000 dollars).<sup>354</sup> Thus, a large item of tax preferences can keep coming back like a bad penny. Assuming that it is the only item of tax preference involved, it reduces earned income 100 percent (less 30,000 dollars) in the first year, and 20 percent (less 30,000 dollars) in each of the next four years.

There are, however, two related and serious ambiguities in calculating the five year average: whether tax preferences for 1969 and previous years are to be included in the numerator of the five year average; and whether 1969 and previous years are to be included in the denominator. There are several possible alternatives.

First, even though there were no "tax preferences" as defined in section 57 for 1969 and previous years, items which would have been tax preferences if section 56 had then been in effect would be included in the numerator and all such years included in the denominator.

Second, since section 57 was not in effect for 1969 and previous years, there could have been no "items of tax preference as defined in section 57" for those years. Thus the amount of tax preferences in those years would be deemed to be zero in the numerator of the fraction, but those years would be included in the denominator of the fraction.

Third, the numerator includes only items of tax preference for 1970 and subsequent years and the denominator only includes 1970 and subsequent years. Thus there would not be a five year moving average until 1974. It has been authoritatively stated that the regula-

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350. *Id.* § 56(a).

351. *Id.*

352. *Id.* § 1348(b)(2)(B). See text accompanying notes 26-28 *supra*.

353. See Appendix *infra*, for an example of this phenomenon.

354. CODE § 1348(b)(2).

tions will adopt the third position.<sup>355</sup>

It makes little sense to include pre-1970 tax preferences in the numerator of the fraction.<sup>356</sup> The reason is that the minimum tax on tax preferences and the incorporation of this concept in section 1348 was designed to deter the use of various tax avoidance mechanisms<sup>357</sup> and it is obviously not possible to deter the use of such mechanisms in years prior to the enactment of section 57. Moreover, inclusion of pre-1970 "preferences" in the numerator is really a form of retroactive taxation without warning that seems most unfair. Either the second or third solution would avoid the unfair taxation of pre-1970 preferences—although both are hard to find in the literal language of the provision.

Assuming that the choice is between the second and third alternatives, it is obvious that the third alternative is more severe than the second. Assume a large item of tax preference in 1970. Under the third alternative, 50 percent of the item (less 30,000 dollars) would reduce earned taxable income in 1971, 33-1/3 percent of it (less 30,000 dollars) would reduce ETI in 1972, 25 percent of it (less 30,000 dollars) would reduce ETI in 1973, and 20 percent of it (less 30,000 dollars) would reduce ETI in 1974.<sup>358</sup> Under the second alternative, only 20 percent of the item (less 30,000 dollars) would reduce ETI in years 1971 to 1974.<sup>359</sup>

Since the objective of the statute appears to be to reduce earned taxable income by only one-fifth of a tax preference item for a previous year, the second alternative seems to be more in accord with congressional intent. Under either alternative, the effective tax on an item of long-term capital gain can run over 50 percent which seems to be a more punitive result than Congress intended. Assume, for example, that in 1972 the married taxpayer has a long-term capital gain of two million dollars. Assume also that his earned taxable income before adjust-

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355. Speech by John S. Nolan, *supra* note 120. Watts, *supra* note 12, at 32-28, prefers a fourth approach which would fall between approaches 2 and 3. This solution uses a denominator of 5 and treats the amount of the current year's preference as though it was also the amount of preferences in pre-1970 years.

356. Some support for the proposition that Congress did not intend to pick up pre-1970 years in the moving average can be gleaned from the Conference Committee report: "Tax preferences for this purpose are the same as those applicable to individuals under the minimum tax." CONF. REP. NO. 782, 91st Cong., 1st Sess. 329, in 1969-3 CUM. BULL. 644, 675. Obviously, in pre-1970 years, there were no tax preferences "applicable to individuals." The provision was added in Conference so that this is the only legislative history on the point.

357. Thus the Senate Finance Committee, which deleted section 1348, gave as one of its reasons concern that tax preferences would be employed in conjunction with the 50 percent ceiling. S. REP. NO. 91-552, 91st Cong., 1st Sess. 310, in 1969-3 CUM. BULL. 423, 619. This indicates concern mainly with *current* tax preferences.

358. CODE § 1348(b)(2)(B)(i).

359. *Id.*

ment for tax preferences in years 1972 to 1976 is one million dollars. Using the third alternative approach, the capital gain will be taxed at an effective rate of 51 percent.<sup>360</sup> Under the second approach, the effective rate on the capital gain is 50.5 percent.<sup>361</sup> And in none of the years is the "minimum tax on tax preferences" involved at all because, in this example, the sum of the items of tax preference never exceeded 30,000 dollars plus income tax in any tax year.<sup>362</sup>

If Congress intended to tax long-term capital gain at a rate in excess of 50 percent, there is no evidence of that intent. Since the provision dealing with tax preferences was added in conference, it probably received little study. Therefore, it is suggested that the Treasury reconsider its present position<sup>363</sup> and utilize the second alternative rather than the third.

### B. *The Alternative Tax and Section 1348*

Another troublesome problem presented by section 1348 is the relationship between that section and the alternative tax under section 1201(b).<sup>364</sup> Section 1201(b), as amended by the Tax Reform Act of 1969, sets forth a favorable method of taxation of long-term capital gain. It provides that the tax rate on the first 50,000 dollars of the excess of the net long-term capital gain over the net short term capital loss cannot exceed 25 percent. And for 1970 and 1971, the tax on the balance of section 1201 gain cannot exceed 29½ percent and 32½ percent respectively.<sup>365</sup> It may be argued, however, that the alternative

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360. This figure is reached in the following manner:

Year	Tax Without the Capital Gain	Tax With Capital Gain	Difference
1972	\$492,060	\$1,365,980	\$ 873,920
1973	492,060	536,060	44,000
1974	492,060	526,060	34,000
1975	492,060	526,060	34,000
1976	492,060	526,060	34,000

Aggregate Differences \$1,019,920

The aggregate of the tax increases over the five year period, solely by reason of the capital gain, is \$1,019,920, which is 51 percent of the two million dollar capital gain. This example assumes the availability of the alternative tax on capital gains. This proposition is not altogether free from doubt. See text accompanying notes 364-70 *infra*.

361. The figures used to reach this result are the same as those in note 360 *supra* except that the tax without the capital gain is 526,060 dollars in 1973. The aggregate differences are thus 1,009,920 dollars or 50.5 percent of the two million dollar capital gain.

If the time span in this example had been 1971 to 1975, the percentages would have been 45.2 percent under the second approach and 43.4 percent under the third approach.

362. CODE § 56(a)(1).

363. See note 355 *supra*.

364. CODE § 1201(b). The tax under this section is an alternative to the tax imposed by section one of the Code—the usual income tax rate schedule.

365. *Id.* § 1201(c)(2).

tax under section 1201(b) cannot be used in conjunction with the limitation of tax on earned income under section 1348.

Section 1348 states that "the tax imposed by section 1"<sup>366</sup> shall be as set forth in section 1348(a).<sup>367</sup> In particular, in computing the tax on unearned income, section 1348(a)(3) refers to "the excess of the tax computed *under section 1* without regard to this section over the tax *so computed* with reference solely to his earned taxable income."<sup>368</sup> But the alternative tax on long-term capital gains is "in lieu of"—different than—the section one tax. Thus, if section 1348(a)(3) had stated that the tax on unearned income shall be "the excess of the tax computed under section 1 *or section 1201*" the alternative tax could be used in conjunction with section 1348. But it does not say that. Consequently, it may well be argued that the language of section 1348 precludes the use of the alternative tax.

The significance of this point can be illustrated in the example given in the appendix to this article. That calculation assumes the availability of section 1201. But if the taxpayer must forego section 1201 as the price of utilizing section 1348, he would have paid 2640 dollars more in taxes than if he had not utilized section 1348 at all.<sup>369</sup> Yet he would have had no choice since section 1348 is not an elective provision. However, despite the literal language of sections 1348 and 1201, it seems most unlikely that Congress intended that the alternative tax and the maximum tax be mutually exclusive. Certainly, Congress might have made such an intention clear, as it did when it specifically stated that taxpayers had to elect between section 1348 and income averaging.<sup>370</sup> If Congress had intended that the alternative tax be foregone, it surely would have said so. This seems to be one of those cases in which literal—but plainly inadvertent—language must be ignored or twisted out of shape to avoid reaching an absurd result.

## V

### SECTION 1348: AN EVALUATION

#### A. *Disincentives to Tax Avoidance Schemes*

The primary goal of section 1348 was to deter the use of tax gimmickry such as deferred compensation, incorporation of highly-paid in-

366. *Id.* § 1. Section 1 is the income tax rate schedule generally applicable.

367. *Id.* § 1348(a).

368. *Id.* § 1348(a)(3) (emphasis added).

369. Based on the figures in the Appendix, if section 1348 were not available but the alternative tax was used, the tax would have been 93,580 dollars. But if section 1348 were used without the alternative tax, the tax payable would be 96,220 dollars—or 2640 dollars more than the tax would have been if section 1348 had never been passed.

370. CODE § 1304(b)(6).



dividuals, sheltering high bracket earned income, and attempting to convert ordinary income into capital gain—in short to exterminate Mickey Mouse.<sup>371</sup>

Of course, specific tax avoidance techniques can be thwarted by specific legislation, and the Tax Reform Act did put many such gimmicks to death. But preventing tax avoidance requires statutes of great sophistication and complexity, statutes which only invite new evasive efforts. And even if the drafting problem is surmounted, the resistance of the taxpayers affected is bound to be fierce. Hence the most expedient solution was to kill the Mouse with sugar, not rat poison, by providing a monetary incentive to take one's compensation without any gimmicks.

The disincentive rationale seems to have been an after-thought. The Treasury originally proposed a 50 percent ceiling rate on all kinds of income (adjusted upward, however, for tax preferences). The stated rationale was equity—it was not fair to ask some people to pay taxes at rates over 50 percent when others similarly situated were managing to avoid these rates.<sup>372</sup> But the equity rationale was downplayed by the Ways and Means Committee in favor of the anti-tax-avoidance rationale.

In any event, tax lawyers with whom the author has discussed the matter think Congress was correct in anticipating that section 1348 will discourage many prevalent forms of tax planning.<sup>373</sup> At this writing, of course, all such conversation is hypothetical in nature since the provision is not operative in 1970 and not very significant in 1971.<sup>374</sup>

It is logical, however, to assume that clients will be more willing to accept compensation when earned rather than deferring its receipt. The desirability of unqualified deferred compensation must be thoroughly reassessed.<sup>375</sup> If the tax bracket for the year to which compensation is

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371. H.R. REP. NO. 91-413, 91st Cong., 1st Sess., pt. 1, at 208 (1969); 115 CONG. REC. 17,553 (daily ed. Dec. 22, 1969) (Senator Long); *id.* 13,034, 13,049 (daily ed. Dec. 23, 1969) (Representatives Mills and Byrnes).

372. U.S. TREAS. DEP'T., TAX REFORM STUDIES & PROPOSALS 17, 173 (1969).

373. Economic studies show, however, that tax-motivated investment activity is rarer than tax lawyers might suspect. See R. BARLOW, H. BRAZER & J. MORGAN, ECONOMIC BEHAVIOR OF THE AFFLUENT 2-3, 151-72 (1966). Holland indicates that relatively few executives take time from business to worry about tax planning. Holland, *Effect of Taxation on Effort: Some Results for Business Executives*, in PROCEEDINGS OF THE 62ND ANNUAL CONFERENCE OF THE NATIONAL TAX ASSOCIATION 428, 501-12 (1970) [hereinafter cited as PROCEEDINGS].

374. Tax Reform Act of 1969, Pub. L. No. 91-172, § 804(a), 83 Stat. 685, made section 1348 effective only for taxable years beginning after December 31, 1970.

375. See Hettenhouse, *The Executive Compensation Package: A Cost-Benefit Appraisal*, in PROCEEDINGS, at 408, 419-24, 427. In Hettenhouse's analysis, unqualified deferred compensation (with payments at retirement) is the most efficient form of compensation under prior law. These findings have been reconsidered under the Tax Reform

deferred is expected to be above 50 percent, section 1348 will impose a direct disincentive effect. This can be avoided only by use of an SROF<sup>376</sup> but that would impose substantial and presumably unwanted additional risks. When the tax bracket for the year to which compensation is deferred is expected to be below 50 percent (and below the bracket in the year in which it is earned), section 1348 is not directly involved. However, it will have an indirect disincentive effect where the marginal rate for the earning year is over 50 percent. Deferred compensation imposes a time-value of money cost since it is better to have the money to invest when earned rather than later. Waiting also imposes the risk of the intervening bankruptcy of the employer. Because of the 50 percent ceiling rate in the earning year, the cost of accepting the money then will be decreased. Since the cost of waiting is unaffected, many taxpayers may decide to take the money when earned.

It also seems likely that many tax shelter plans will appear less attractive. It may not pay to enter into a highly risky oil deal, simply because the entire contribution is deductible in the year of payment,<sup>377</sup> to shelter income which cannot be taxed at a rate higher than 50 percent. Similarly, risky real estate ventures that are desirable because they are highly leveraged and will generate high depreciation in early years,<sup>378</sup> hopefully offset at least in part by capital gain later on,<sup>379</sup> will also become less attractive. This is partly because of the reduced need to shelter other income and partly because of limitations imposed by the new Act on accelerated depreciation,<sup>380</sup> interest deductions,<sup>381</sup> depreciation recapture,<sup>382</sup> and long term capital gain.<sup>383</sup>

So also the desirability of incorporating entertainers or athletes will have to be reassessed. There is little point in seeking to utilize the lower corporate income tax rate since the maximum corporate rate is 48 percent and the maximum individual rate under section 1348 would be 50 percent. The elimination of capital gain on employer contributions distributed in a lump sum from qualified plans will also make the corporate form less attractive.<sup>384</sup> Although incorporation does permit the

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Tax Act. Lewellen & Hettenhouse, *Impact of the Tax Reform Act on the After-Tax Cost of Executive Compensation*, 33 J. TAXATION 240 (1970). It is stated that unqualified deferred compensation remains the most efficient vehicle. But none of the executives in the study had marginal rates above 50 percent in *both* the earning year and the payout year. Yet this is the case in which section 1348 is most significant.

376. CODE § 1348(b)(1).

377. *Id.* §§ 613(b)(1), 263(c).

378. *Id.* § 167(b),(c),(j),(k).

379. *Id.* §§ 1221, 1231.

380. *Id.* §§ 167(j), 56, 57(a)(2).

381. *Id.* §§ 163(d), 57(a)(1) & (b).

382. *Id.* § 1250(a)(1).

383. *Id.* § 1201(b),(c),(d).

384. See note 121 *supra*.

taxpayer to utilize the remaining advantages of qualified deferred compensation plans and other fringe benefits, it also presents the continuing complexities of the corporate form, the perennial concern about reasonable compensation, the personal holding company provisions,<sup>385</sup> reallocations under section 482,<sup>386</sup> the accumulated earnings tax,<sup>387</sup> and the collapsibility rules.<sup>388</sup>

Moreover, long-term capital gain will seem markedly less attractive. Along with other tax preferences in excess of 30,000 dollars, it will bump earned income out of section 1348 and into higher brackets—both in the year realized and for the next four years.<sup>389</sup> Since the alternative tax benefit will apply only to the first 50,000 dollars of long-term capital gain and since it will be subject to the minimum tax on tax preferences,<sup>390</sup> it would seem that the bloom is off that particular rose, at least as far as persons with high earned incomes are concerned. Even more severely dealt with are qualified stock options since the compensation element is treated as a tax preference twice—upon exercise and upon disposal of the stock.<sup>391</sup>

It does seem fair to point out, however, that even though Mickey Mouse has incurred severe injuries, he certainly has not expired. It seems inevitable that a great deal of tax planning in connection with section 1348 will be forthcoming. Thus if a taxpayer is engaged in a business in which capital is a material income-producing factor, he must consider incorporating and taking a salary in order to avoid the 30 percent rule.<sup>392</sup> Partnerships will have to go considerable lengths to prove the reasonableness of both distributive shares and guaranteed payments,<sup>393</sup> and to prove that income generated by employees is the earned income of partners.<sup>394</sup> No doubt there will be massive efforts to optimize the section 1348 benefit by deferring income from 1970 into 1971 and from 1971 into 1972. Moreover, there will probably be elaborate plans to place large items of tax preferences into years without a large earned income. If tax preferences do shift ETI from the 50 percent

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385. CODE §§ 541-47.

386. *Id.* § 482. See *Rubin v. Commissioner*, 26 Am. Fed. Tax R.2d 5051 (2d Cir. 1970).

387. CODE § 531.

388. *Id.* § 341.

389. See text accompanying notes 360-62 *supra*, illustrating taxation of long-term capital gain at a rate in excess of 50 percent—without involving the minimum tax on tax preferences.

390. CODE §§ 56-58.

391. See Rendell, *Qualified Stock Options: Post-1969 Use Hinges on Careful Planning*, 32 J. OF TAXATION 356 (1970); Lewellen & Hettenhouse, *supra* note 375, at 242.

392. See text accompanying notes 321-30 *supra*.

393. See text accompanying notes 89-101 *supra*.

394. See text accompanying notes 78-87 *supra*.

to the 70 percent brackets, new efforts to shelter this income are inevitable. Finally, for taxpayers who think small, tax preferences of less than 30,000 dollars per year will be unaffected by either the minimum or maximum taxes. In short, reports of the death of Mickey Mouse have been exaggerated. Perhaps all this illustrates that tax avoidance can be much more effectively remedied by legislation directed at the abuse as distinguished from attempts to buy off the taxpayer.

### B. *Creating an Incentive for High Bracket People to Work*

A much less important purpose of section 1348 was to limit tax rates on highly skilled people in order to encourage them to work.<sup>395</sup> However the economic data on this point indicates that the extent to which leisure is substituted for work as a result of high tax rates is greatly overestimated.<sup>396</sup> For every taxpayer who works less because of high tax rates, it appears that another may work more in order to maintain the same disposable income. Many executives have no choice other than working to capacity regardless of tax rates.<sup>397</sup> Even professionals have difficulty turning away work because of the unfavorable effect on firm goodwill. Others are in a position to shift the higher taxes to their customers. Apparently the intellectual and ego satisfaction that the highly compensated taxpayer finds in his work is likely to be more significant as a work incentive than the amount of money retained after taxes.<sup>398</sup> Consequently, the incentive to work effect of the maximum tax will probably be minimal.

### C. *Tax Relief for High-Bracket Taxpayers*

A still less important purpose of section 1348 was based on equitable considerations. The idea was to grant tax relief to those unfortunate few taxpayers who were ignorant of tax shelters or unwilling or unable to utilize them, and who were therefore paying tax on earned

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395. H.R. REP. NO. 91-413, 91st Cong., 1st Sess., pt. 1, at 209; JOINT COMM. ON INTERNAL REVENUE TAXATION, 91ST CONG., 1ST SESS., SUMMARY OF H.R. 13,270, THE TAX REFORM ACT OF 1969, at 102 (Comm. Print 1969); 115 CONG. REC. 13,035 (daily ed. Dec. 23, 1969) (Representative Mills).

396. See generally T. SANDERS, EFFECTS OF TAXATION ON EXECUTIVES (1951); Holland, *Effect of Taxation on Effort: Some Results for Business Executives*, in PROCEEDINGS, *supra* note 373, at 428, 441-479; Break, *Income Taxes and Incentives to Work: An Empirical Study*, 47 AM. ECON. REV. 529 (1957); R. BARLOW, H. BRAZER & J. MORGAN, ECONOMIC BEHAVIOR OF THE AFFLUENT (1966). However, the latter study did point out that such disincentives as it did uncover were strongest among those in the 50-59 percent brackets. *Id.* at 142-43. All of these studies can be questioned on the ground that they rely on inherently unreliable interview data.

397. However, Holland's study did indicate a more marked disincentive effect among executives in regard to taking on side ventures in addition to their regular jobs. Holland, *supra* note 396, at 442, 463-71.

398. See note 396 *supra*.

income at rates in excess of 50 percent.<sup>399</sup> This rationale again suggests that it makes more sense to remove the tax shelters than to attack the problem via the back door.

However, this rationale raises the more pointed question of whether equity is in fact promoted by taxing earned income at a rate lower than unearned income. The same equitable argument could be made in favor of the select group of people paying tax on *unearned* income at marginal rates over 50 percent.<sup>400</sup> There is a body of opinion to the effect that the return on labor should be taxed at a lower rate than the return on land or capital.<sup>401</sup> Perhaps the soundest basis for this position is that the taxation of capital is accompanied by an allowance for depreciation so that the taxpayer can set aside tax free funds for the renewal of his asset. This, of course, is not permitted in connection with the taxation of earned income since there is no depreciation allowance for wearing out the body.<sup>402</sup> Nor is there any deduction of many business costs—such as commuting—or such start-up costs as expenditures for higher education.<sup>403</sup> Thus there is merit in arguing that earned income should be taxed at lower rates than other kinds of income,<sup>404</sup> but it is at least questionable whether section 1348 is the proper vehicle. The inequities of taxation of earned income are as pronounced in the lower

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399. This was the main rationale for the Treasury proposal [see note 372 *supra*] but was downplayed by Congress. See, however, JOINT COMM. ON INTERNAL REVENUE TAXATION, *supra* note 395; 115 CONG. REC. 13,035, 13,049 (daily ed. Dec. 23, 1969) (Representatives Mills and Minish).

400. The Treasury avoided this problem in its initial recommendations by applying the limitation to all forms of income—but with an upward adjustment for tax preferences. See note 3 *supra*. The favoritism for earned income was one of the reasons for Senate Finance Committee deletion of the maximum tax. See note 6 *supra*.

401. *E.g.*, H.R. REP. No. 179, 68th Cong., 1st Sess. 5-6 (1924), quoted in J. SEIDMAN, LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 1938-1861, at 724-25 (1938). See also Anthoine, *Tax Reduction and Reform: A Lawyer's View*, 63 COLUM. L. REV. 808, 816-18 (1963).

402. This argument is criticized in R. GOODE, THE INDIVIDUAL INCOME TAX 93-95 (1964), since the body has no cost basis. However, there would seem to be a cost basis for the body consisting of the value of the nutrients and medicines, consumed over the years, for which no deduction was allowed. Of course, the amount is not ascertainable, but the productive capacity of the body—purchased at great cost—is wearing out all the same.

403. Of course, it might be more logical to correct the inequities—by allowing a superior system of tax-sheltered retirement in lieu of an allowance for depreciation, and by allowing amortization of educational costs and deduction of business costs like commuting. R. GOODE, *supra* note 402, at 255-58; J. PECHMAN, FEDERAL TAX POLICY 87-88 (1966) are critical of taxing earned income differently from unearned income.

404. At the same time, it is important to note that a preference for one kind of income creates new economic distortion in the form of disfavoring other kinds of income. For example, section 1348 may create disincentives to saving or investing by taxing the periodic returns at a higher rate than earned income. Further examination of this important question is beyond the scope of this Article.

brackets as in the higher and it is therefore hard to justify bestowing a tax benefit on earned income only to those with incomes in excess of 52,000 dollars per year and not to those who are less affluent. In this respect, section 1348 suffers from the reverse of the problem of the earned income credit which was employed from 1924 to 1931 and 1934 to 1943. The earned income credit applied only to modest sums and thus did not go far to rectify the inequity. Perhaps a combination of the earned income credit and section 1348 might be employed to make a serious assault on the present inequity of the taxation of earned income.

#### CONCLUSION

This Article has traced the legislative history of section 1348 and illustrated its operation. It has surveyed some areas which can be expected to cause difficulty in the administration of section 1348: the definition of earned income, deferred compensation, capital as a material income-producing factor, tax preferences, and the alternative tax. Hopefully, many of the ambiguities found will be cleared up by regulations. Finally the Article has inquired whether section 1348 will fulfill its goals and concluded that it may both deter and spawn tax gimmickry. It is not likely to encourage much work or to make the income tax significantly more equitable. In any event, it seems certain that the new section will be of great significance to highly compensated individuals and will play a vital role in tax planning in the years to come.

## Appendix

### ILLUSTRATIVE CALCULATION UNDER SECTION 1348

#### 1. Assumptions:

a) A married attorney without children has gross income in 1972 of \$190,000 from his law practice (earned income) and deductions attributable to his law practice of \$70,000.

b) He also owns rental property which produces gross income of \$200,000 (not earned income) and deductions of \$140,000. The deductions include \$42,000 of real property depreciation in excess of straight-line depreciation (an item of tax preference).

c) He has long-term capital gain of \$40,000 (half of which is an item of tax preference).

d) He has deductions from adjusted gross income of \$20,000.

#### 2. Calculations:

a) Earned income = \$190,000.

b) Earned net income (ENI) = \$120,000 (\$190,000 - \$70,000).

c) Tax preferences taken into account = \$32,000 (realty depreciation in excess of straight line [\$42,000] + half of net long-term capital gain [\$20,000] less \$30,000).

d) Adjusted gross income (AGI) = \$200,000 (gross income [\$430,000] less deductions from law practice [\$70,000], from rental activity [\$140,000] and under section 1202 [\$20,000]).

e) Taxable income = \$180,000 (AGI [\$200,000] less items deductible from AGI [\$20,000]).

f) Earned taxable income (ETI) = \$76,000.

i) Step 1:  $y^{405} = \frac{\text{Taxable income} \times \text{ENI}}{\text{AGI}}$

$$y = \frac{\$180,000 \times \$120,000}{\$200,000}$$

$$y = \$108,000$$

ii) Step 2:

$$\text{ETI} = y - \text{tax preferences}$$

$$\text{ETI} = \$108,000 - \$32,000$$

$$\text{ETI} = \$76,000$$

#### 3. Tax payable

The tax payable is \$92,620, computed as follows:

405. "y" is the figure derived in the first stage of computing ETI.

a) Tax on \$52,000 (largest amount of ETI not taxed above the 50 percent bracket)		\$18,060
b) Tax on balance of ETI at 50 percent (balance of ETI is \$24,000 [\$76,000-\$52,000])		\$12,000
c) Tax on unearned income computed under section 1201(b): <sup>406</sup>		
i) Tax on \$160,000 (i.e. taxable income [\$180,000] less 50 percent of the net section 1201 gain [\$20,000])	=	\$83,580
ii) Plus 25 percent tax on net section 1201 gain [\$40,000]		\$10,000
Subtotal		\$93,580
iii) Less tax on ETI [\$76,000] at section 1 rates		31,020
		62,560
Total tax		<u>\$92,620</u>

4. If section 1348 had not been applicable, the tax would have been \$93,580. Thus the saving was \$960.

5. This example illustrated the significance of reducing ETI dollar-for-dollar by tax preferences in excess of \$30,000. Had this not been required, the total tax would have been \$89,500—or a saving of \$4080 instead of \$960. This difference can be explained by the fact that the \$32,000 of tax preferences (in excess of \$30,000) removed \$32,000 of ETI from the 50 percent bracket and placed \$12,000 of it into the 58 percent, \$12,000 into the 60 percent, and \$8,000 into the 62 percent bracket.

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406. The alternative tax provides for a maximum tax of 25 percent on the first 50,000 dollars of the excess of net long-term capital gain over net short-term capital loss. But see text accompanying notes 364-70 *supra*, querying whether the alternative tax can be used in conjunction with section 1348.