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THE MAXIMUM TAX ON EARNED INCOME: AN INEFFECTIVE
AND INEQUITABLE TAX SHELTER DETERRENT

Mildred Blitt Levy*  

1. Introduction

The maximum tax on earned income, section 1348 of the Internal Revenue Code,\(^1\) is designed to deter the use of tax shelter investments\(^2\) by giving tax relief

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1 I.R.C. § 1348

50-PERCENT MAXIMUM RATE ON PERSONAL SERVICE INCOME.

(a) GENERAL RULE—If for any taxable year an individual has personal service 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 highest amount of taxable income on which the rate of tax does not exceed 50 percent,
2. 50 percent of the amount by which his personal service taxable income exceeds the amount of taxable income specified in paragraph (1) of this subsection, 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 personal service taxable income.

(b) DEFINITIONS—For purposes of this section—

1. Personal service income—
   (A) In general—The term 'personal service income' means any income which is earned income within the meaning of section 401(c)(2)(C) or section 911(b) or which is an amount received as a pension or annuity.
   (B) Exceptions—The term 'personal service income' does not include any amount—
      (i) to which section 72(m)(5), 402(a)(2), 402(e), 403(a)(2), 408(e)(2), 408(e)(3), 408(e)(4), 408(e)(5), 408(f), or 409(c) applies; or
      (ii) which is includible in gross income under section 409(b) because of the redemption of a bond which was not tendered before the close of the taxable year in which the registered owner attained age 70 1/2.
2. Personal service taxable income—The personal service 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 personal service net income bears to his adjusted gross income, over
   (B) the sum of the items of tax preference (as defined in section 57) for the taxable year.

For purposes of subparagraph (A), the term 'personal service net income' means personal service 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.


FIFTY-PERCENT MAXIMUM RATE ON EARNED INCOME.

(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 taxable income.

In applying this subsection to a taxable year beginning after December 31, 1970, and before January 1, 1972, "60 percent" shall be substituted for "50 percent" each place it appears in paragraphs (1) and (2).
to taxpayers with high earned incomes and taking it away to the extent they indulge in investments which generate tax preferences.\(^5\) The key to tax shelter deterrence in the present scheme is the 20 percent difference between the top marginal tax rates on earned and unearned income,\(^4\) a differential which offers a substantial incentive to characterize returns to capital as earned income in business enterprises in which both capital and labor are material. The definition of earned income for the maximum tax\(^6\) established by the Code and proposed regulations accurately identifies the group of taxpayers thought to be most susceptible to the lures of tax shelters; but the definition also encourages incorporation to avoid the arbitrary limit on earned income applicable to unincorporated

(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(m)(5), 402(a)(2), 402(c), 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.

2 H. R. REP. No. 9-413, 91st Cong., 1st Sess. 208 (1969), 1969-3 C. B. 200, 300 [hereinafter cited as H. R. REP. No. 91-413]. Most commentators have identified tax shelter deterrence as the major objective of section 1348. See, e.g., Johnson, Minimum and Maximum Taxes After Two Years—A Survey and General Evaluation, 50 TAXES 68 (1972) [hereinafter cited as Johnson]; Halperin, Maximum Tax Not For Those Indulging in Deferred Compensation and Tax Preference, 24 S. CAL. TAX INST. 619, 620 (1972) [hereinafter cited as Halperin]; Watts, The Maximum Tax on Earned Income: Section 1348, 26 TAX L. REV. 1, 4 (1970) [hereinafter cited as Watts]. Three purposes have been suggested by Asimow: (1) increase equity among highly compensated taxpayers utilizing schemes to avoid rates greater than 50 percent and taxpayers who do not; (2) encourage talented people to work harder; (3) induce taxpayers to give up "Mickey Mouse." Asimow, Section 1348: The Death of Mickey Mouse?, 58 CAL. L. REV. 801, 803 (1970) [hereinafter cited as Asimow].

3 I. R. C. § 57. Major items of tax preference included in the 1969 Tax Reform Bill were excess investment interest, accelerated depreciation on real property, accelerated depreciation on personal property subject to a net lease, excess of fair market value of stock options over exercise price, excess depletion over adjusted basis, one-half net long-term capital gain. Tax preference items added in the 1976 Tax Reform Act include the sum of itemized deductions (except personal exemptions, deductions for medical expenses, and casualty losses) in excess of 60 percent of adjusted gross income, and excess depletion. When enacted, earned taxable income eligible for the 50 percent limit was reduced by only the excess of tax preference items over $30,000. I. R. C. § 1348(b)(2)(B)(ii). Since 1976 the $30,000 deduction has been eliminated.

It is generally agreed that the major deterrent effect of section 1348 on investment in tax shelters comes from the effect of tax preference items. See Johnson, supra note 2, at 84; Watts, supra note 2, at 43; Reichler, Proposed rules on Section 1348: An analysis of the 50% earned income maxi-tax, 36 J. OF TAX. 922 (1972) [hereinafter cited as Reichler, 1972].

4 I. R. C. § 1.

enterprises and, by adopting the standard of reasonable compensation for corporations, inadequately limits the recharacterization of income which the maximum tax induces.

The objective of this article is to evaluate the effect of the maximum tax on investment and pay-out decisions of professionals, unincorporated enterprises, and close corporations in light of the stated objectives of the statute. The legislative history, reviewed in the following section, indicates that the tax preference offset to the maximum tax was the result of a last minute compromise which, perhaps only coincidentally, provided a mechanism for tax shelter deterrence. Section III outlines the relevant provisions of the Tax Reform Act of 1976 which substantially reinforced the deterrent effect of the maximum tax by increasing the scope and bite of tax preferences.

Analysis of the effect of the maximum tax on three categories of taxpayers, section IV, indicates that (1) it does tend to deter professionals from indulging in tax shelter investments; (2) the inclusion of the capital gains deduction as a tax preference item reduces the advantage of investment for capital gain at the cost of producing an inequitable result which has no offsetting benefit of tax-shelter deterrence; (3) it introduces a new tax incentive to incorporate for taxpayers for whom there is no tax shelter deterrent effect; and (4) the reduction of the tax rate on earned income to approximately the level of corporate tax rates, combined with "double" taxation of dividends and the differential rate, creates an incentive for close corporations to pay out earnings as compensation and reinvest in the business, if desirable, by lending them back.

The statutory and judicial precedents for defining earned income are discussed in section V. In view of the fact that the definition of earned income was merely incorporated by reference from other unrelated sections of the Code, it is not surprising that the precedents are internally inconsistent and inappropriate for section 1348. In the last section, it is argued that a simple alternative—imposing higher marginal tax rates on all income to the extent of tax preferences and eliminating differential rates on earned and unearned income—would eliminate the inequities of the present system as well as most of the perverse incentives, with minor revenue loss.

II. Legislative History

The overall objective of the Tax Reform Act of 1969 was to close "loopholes" and compensate for the undesirable side effects of prior tax preference provisions which had been introduced to provide incentives for specific objectives. The concept of a maximum tax originated in the Treasury Proposals but


7 Treas. Proposals, supra note 6, at vol. 1, 17.

The tax on appreciated assets at death was considered to be an essential prerequisite for the introduction of the maximum average tax: "Unless this special tax benefit is removed, it would be unfair to provide additional benefits through any reduction in the tax rate applicable to annual dividends, interest, and other income derived mainly from these assets." Id. See Surrey, infra note 23, at 64. The emphasis in the Treasury statement on the unfairness of
section 1348 as enacted was radically different from the original concept. The Treasury proposed a maximum average tax of 50 percent on a broad-based concept of income, primarily as a means of achieving equity among high income taxpayers. Section 1348 provides for a maximum marginal rate of 50 percent on earned income, primarily as a means of deterring the use of tax shelters. Items of excluded income were to be subject to the minimum tax and were to be added to the tax base for the purpose of computing the maximum tax in the Treasury proposal. The items of tax preference in section 57 which are subject to the minimum tax and which reduce the amount of earned income benefitting from the maximum tax consist primarily of deductions which simply defer tax. That these changes in the maximum tax are roughly consistent with the shift in objectives from equity to tax shelter deterrence seems fortuitous in light of the evolution of the section.

The Administrative tax reform recommendations did not include a maximum tax in any form. Section 1348, almost as enacted, was recommended in the House Bill as a mechanism to "reduce the pressure for the use of tax loopholes." The House Report indicated that the Committee believed that the combination of raising the tax rate on capital gains and reducing the top bracket to 50 percent on earned income would provide the necessary incentive. This was based on the assumption that the motive to invest in tax shelters was to protect earned income from high marginal rates by converting it into capital gains. Apparently the process by which this "conversion" takes place was not clearly reducing tax on property income does suggest that the limited application of the maximum tax to earned income was not inconsistent with the Treasury proposals. In fact, the Treasury later supported the maximum tax as proposed by the House. Statement of Edwin S. Cohen, Ass't Sec'y of Treas. for Tax Policy, Before the Senate Finance Comm. on the Provisions of H. R. 13270, The Tax Reform Act of 1969, 91st Cong., 1st Sess. (Comm. Print 1969) [hereinafter cited as Cohen].

The Treasury proposals, which were based on extensive tax reform studies, had the overall objective of eliminating unacceptable tax abuses available to high income taxpayers who could "choose their income sources" and which resulted in large variations in effective average tax rates. Treas. Proposals at 13. Major features of these proposals included: (1) a graduated minimum tax on an expanded income base including items formerly exempt: the deduction for one-half of long-term capital gains, interest on tax-free municipals, percentage depletion in excess of capital invested, and the deduction for untaxed appreciation on assets given as charitable contributions. Id. at 14; (2) allocation of non-business expense deductions (interest, tax casualty losses, charitable contributions, and medical expenses) between taxable income and excluded income. Id. at 14, vol. II, 146; and (3) an optional maximum total tax of 50 percent on income including items covered in the minimum tax. Id. at vol. I, 17, 18, coupled with a change in estate and gift tax to tax appreciation on assets at death. Id. at vol. I, 18.

8 See Watts, supra note 2, at 1-4, for a summary of the legislative history of section 1348. The history appropriately has been described as "very meager." Reichler, Planning for the earned income ceiling despite uncertainties in the rules, 32 J. of Tax. 360, (1970) [hereinafter cited as Reichler, 1970].


10 Section 1348 has been described as the result of a "hurried compromise." Watts, supra note 1, at 1.


13 Id. at 330.

14 Id. The differential between the top rates on ordinary earned income and capital gains was to be reduced to 17.5 percent in the House proposal.

15 See text accompanying note 66 infra. As critics of the proposal said, the taxpayer could have his cake and eat it too. See note 18 infra.
understood, as the House proposal had no tax preference offset to the benefits of section 1348 and would have had little, if any, deterrent effect on the use of tax shelters.

The Administration supported the House version.16 It was rejected by the Senate,17 however, after criticism in the Senate Hearings that it had no effect on taxpayers with unearned income, was inconsistent with progressive tax rates, and would unfairly benefit high income taxpayers.18 The Conference reinstated the House proposal (which was enacted as section 1348) with the additional provisions that the maximum tax would not be available to taxpayers who average19 and that earned income subject to the limit would be reduced by the amount of tax preferences in excess of $30,000.20

Tax preference items in the 1969 Act included excess investment interest and accelerated depreciation, deductions which defer tax on income.21 The only

18 The maximum tax provision was criticized on the grounds that there was incomplete coverage and no disincentive to the use of taxpayers with unearned income. (Hearings on H. R. 13270, Before the Senate Comm. on Finance, 91st Cong., 1st Sess. 601 (1969) [hereinafter cited as Senate Hearings] [report of Comm. on Tax of Assoc. of Bar of City of N.Y.]; permitting both the use of tax shelters and the benefits of the maximum tax (Id. at 3370, 3416 [statement of Stanley S. Surrey]); and inconsistency with progressive tax rates (115 Cong. Rec. S17580, Dec. 22, 1969, 91st Cong., 1st Sess. [Senator Williams]). The Senate Committee on Finance also questioned whether it was appropriate to single out earned income for preference. S. R. REP. No. 91-552, 91st Cong., 1st Sess., 1969-3 C.B. at 619.
21 I.R.C. § 57 (amended Jul. 9, 1975): SEC. 57. ITEMS OF TAX PREFERENCE. [Sec. 57(a)]
(a) IN GENERAL—For purposes of this part, the items of tax preference are—
(1) Excess Investment Interest—The amount of the excess investment interest for the taxable year (as determined under subsection (b)).
(2) Accelerated Depreciation on Real Property—With respect to each section 1250 property (as defined in section 1250(c)), the amount by which the deduction allowable for the taxable year for exhaustion, wear and tear, obsolescence, or amortization exceeds the depreciation deduction which would have been allowable for the taxable year had the taxpayer depreciated the property under the straight line method for each taxable year of its useful life (determined without regard to section 167(k)) for which the taxpayer has held the property.
(3) Accelerated Depreciation on Personal Property Subject to a Net Lease—With respect to each item of section 1245 property (as defined in section 1245(a)(3)) which is the subject of a net lease, the amount by which the deduction allowable for the taxable year for exhaustion, wear and tear, obsolescence, or amortization exceeds the depreciation which would have been allowable for the taxable year had the taxpayer depreciated the property under the straight line method for each taxable year of its useful life for which the taxpayer has held the property.
(4) Amortization of Certified Pollution Control Facilities—With respect to each certified pollution control facility for which an election is in effect under section 169, the amount by which the deduction allowable for the taxable year under such section exceeds the deduction which would otherwise be allowable under section 167.
(5) Amortization of Railroad Rolling Stock—With respect to each unit of railroad rolling stock for which an election is in effect under section 184, the amount by which the deduction allowable for the taxable year under such section exceeds the deduction which would otherwise be allowable under section 167.
(6) Stock Options—With respect to the transfer of a share of stock pursuant to the exercise of a qualified stock option (as defined in section 422(b)) or a restricted stock
major item of excluded income which had been in the Treasury proposal was
the capital gains deduction. The shift from excluded income to deferral deduc-
tions is consistent with the stated purpose of section 1348 to deter tax shelter in-
vestments. Although the list of tax preferences is far from comprehensive, excess interest and accelerated deductions are frequently associated with tax shelters. Many tax shelter investments have the added attraction of realization in the form of capital gains, but treating the capital gains deduction as a tax preference item for the computation of the maximum tax is not entirely consistent with tax shelter deterrence. The benefit of the lower tax on capital gains does not depend on the other tax saving aspects of tax shelters and is not realized at the time the investment decision is made.

The stated rationale for limiting the maximum tax to earned income was that it would have been too costly to reduce the rate on all income to 50 percent. Further, Congress hoped to reduce the disincentive effect on earned income of

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Option (as defined in section 424(b)), the amount by which the fair market value of the share at the time of exercise exceeds the option price.

(7) Reserves for Losses on Bad Debts of Financial Institutions—In the case of a financial institution to which section 585 or 593 applies, the amount by which the deduction allowable for the taxable year for a reasonable addition to a reserve for bad debts exceeds the amount that would have been allowable had the institution maintained its bad debt reserve for all taxable years on the basis of actual experience.

(8) Depreciation—With respect to each property (as defined in section 614), the excess of the deduction for depreciation allowable under section 611 for the taxable year over the adjusted basis of the property at the end of the taxable year (determined without regard to the depletion deduction for the taxable year).

(9) Capital Gains—
    (A) Individuals—In the case of a taxpayer other than a corporation, an amount equal to one-half of the amount by which the net long-term capital gain exceeds the net short-term capital loss for the taxable year.
    (B) Corporations—In the case of a corporation, if the net long-term capital gain exceeds the net short-term capital loss for the taxable year, an amount equal to the product obtained by multiplying such excess by a fraction the numerator of which is the sum of the normal tax rate and the surtax rate under section 11, minus the alternative tax rate under section 1201(a), for the taxable year, and the denominator of which is the sum of the normal tax rate and the surtax rate under section 11 for the taxable year. In the case of a corporation to which section 1201(a) does not apply, the amount under this subparagraph shall be determined under regulations prescribed by the Secretary or his delegate in a manner consistent with the preceding sentence.

(10) Amortization of On-The-Job Training and Child Care Facilities—With respect to each item of section 188 property for which an election is in effect under section 188, the amount by which the deduction allowable for the taxable year under such section exceeds the depreciation deduction which would otherwise be allowable under section 167.

Paragraph (1) shall apply only to taxable years beginning before January 1, 1972. Paragraphs (1) and (3) shall not apply to a corporation other than an electing small business corporation (as defined in section 1371 (b)) and a personal holding company (as defined in section 542).

Seven of the nine original items have been described as “shelter” type deductions. McQueston, What is a Tax Preference?, 29 N.Y.U. Tax Inst. 1413, 1417 (1971).

22 See Halperin, supra note 2, at 621, who criticized the list as “too short.”

23 See Surrey, Pathways to Tax Reform: The Concept of Tax Expenditures 63 (1973), who lists these prominently among the list of deductions frequently associated with major categories of tax shelter investments.

24 Although Surrey includes capital gains in his list, other commentators have noted the inconsistency of including capital gains as a tax preference item if the goal is to deter the use of tax shelters. Johnson, supra note 2, at 81. See text accompanying notes 66, 67 infra. The inclusion of capital gains has been criticized as “overkill.” Halperin, supra note 2, at 621; Johnson, supra note 2, at 84.

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high marginal tax rates. Although these may be legitimate concerns, the limit to earned income weakens the disincentive effect. It is obvious that section 1348 has no deterrent effect on taxpayers with entirely unearned income. Congress may have believed, however, that high income professionals or executives who have little choice between ordinary and capital gain income are the groups most susceptible to the lures of tax shelters.

At least one commentator has concluded that the limitation of the benefit to earned income indicates that "notwithstanding the Congressional disclaimer, the special attributes of earned income are in reality the basic reason for providing a lesser rate of tax for such income." There are suggestions in the legislative history that at least some support for the provision was based on the desire to provide tax relief for income resulting from personal effort and to offset existing tax benefits available to investment income. Perhaps the limitation reflected the concern expressed in the Treasury Proposals which had emphasized that the 50 percent maximum average tax should be introduced only if coupled with a change in the estate and gift tax to tax appreciation on assets at death.

Both "special attributes" of earned income and a desire to offset tax benefits available to capital motivated earlier provisions of the Code which had provided a "break" for earned income. An amendment to provide credit for earned income had been proposed in the original 1913 Act but was rejected because it was too difficult to distinguish earned income from unearned income for the self-employed. Various provisions for credits for earned income existed in the Code prior to 1944.

The Revenue Bill of 1924 provided for a reduction of 25 percent in the surtax on earned income up to $20,000. This proposal was supported on the basis that people with earned income have less ability to pay taxes than people with property income because they must set aside part of their current earnings for old age and sickness. The report accompanying the bill said that

25 H. R. Rep. No. 91-413, supra note 2, at 331. There is, however, little evidence to support the belief that high marginal tax rates have any disincentive effect on effort. Pechman, Federal Tax Policy 66 (rev. ed. 1971) [hereinafter cited as Pechman, Tax Policy].

26 See, e.g., Johnson, supra note 2, at 78.

27 See Surrey, supra note 23, at 105, 106, who describes the purchasers of tax shelter packages and suggests that deterrence should be aimed at that target group.


29 Watts, supra note 2, at 4 (statement of Repr. Mills).

30 Senate Hearings, supra note 18, at 1196 (statement of Senator Muskie). The Treasury also supported the proposal for this reason. Halperin, supra note 2, at 620.

31 Tax benefits accruing to income from property have been summarized as follows: capital gains, percentage depletion, exclusion of interest on municipals, the ability to shift income to other taxpayers or periods, and depreciation. Chomn, supra note 28, at 37. See Anthoine, Tax Reduction and Reform: A Lawyer's View, 63 Colum. L. Rev. 808, 817 (1963) [hereinafter cited as Anthoine]; Pechman, Tax Policy, supra note 25, at 93.


33 For a list of prior statutory provisions, see Reichler, 1970, supra note 8, at 361 n.6.


35 H. R. Rep. No. 179, supra note 34. See also H. R. Rep. No. 767, H. R. 12863, Revenue Bill of 1918, 65th Cong., 2nd Sess. (1918), regarding a proposal to distinguish earned income for purposes of the normal tax. The proposal was rejected because it was considered to be too difficult to distinguish earned income and too difficult to administer. Id. at 4, 5.
Congress had long been inclined to such a provision but had been deterred by the difficulty of finding a "theoretically correct" definition of earned income. To avoid that problem, the 1924 proposal adopted a definition of earned income as "wages, salaries, professional fees, and other amounts received as compensation for personal services actually rendered," and, to permit small businessmen and farmers to benefit from the reduction without proving the percentage of income derived from labor, the provision provided that a minimum of $5,000 was subject to the lower rate. Similar provisions existed in the Code until 1944.

Relief had been provided under the Excess Profits Tax provisions during World Wars I and II for personal service corporations in order to offset benefits to more capital intensive businesses of the exemption in the tax for a percentage of invested capital. Similarly, relief was provided in the form of an alternative method for the computation of the tax during World War II for businesses which failed to qualify as personal service corporations but in which capital was not a material income producing factor.

The basic definition of earned income for section 1348 is derived from these earlier provisions by way of section 911(b). Section 911, which adopted some of the prior definitions, provided an exemption for earned income from sources outside the United States. The asserted purpose of section 911 was to provide an incentive for United States businesses to invest abroad.

Finally, the benefits of the Keogh Plan were originally limited to earned income because the objective was to provide retirement benefits based on personal services. The theory underlying this limit was apparently the same as the theory of the earlier earned income credits; i.e., taxpayers who derive their income from personal services have to save out of current income for retirement.

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37 Credits for earned income were repealed in the Revenue Act of 1943. Anthoine, supra note 30, at 817. Anthoine proposed that an earned income allowance be added to the 1963 Tax Reform Act primarily to counter tax benefits available to property income and because he believed that the taxable capacity of a property owner was not measured by income. Id. He recommended a 10 percent deduction for the first $30,000 of earned income to compute adjusted gross income. Id. at 818.

38 Reichler, 1970, supra note 8, at 361.
39 H. R. Rep. No. 45, H. R. 4280, Bill to Provide Revenue to Defray War Expenses, 4, 65th Cong., 1st Sess. (1917). Invested capital was defined as follows: paid in cash, plus actual cash value of other property paid in, plus paid in or earned surplus. Goodwill, including trademarks and franchises, was not included unless paid for in cash or property in which case it was limited to the amount paid. Id.
41 Section 911 was limited substantially in the 1976 Tax Reform Act. See Tax Reform Act: Law & Explanation § 821-23 (1976).
42 Asimow supra note 2, at 807; Andrew O. Miller, Jr. v. Comm'r, 52 T.C. 752, 761 (1969).
44 The minority of the Senate Committee objected to this argument, pointing out that self-employed doctors, lawyers and small business men were not forced to retire and could
Secondary policy objectives of section 1348 suggested as a rationale for limiting the maximum tax to earned income are similar to the objectives underlying the earlier tax relief provisions. But there is no similarity in section 1348 to the form or scope of the “predecessors.” Prior earned income credits gave relatively small benefits, primarily to people with moderate incomes, while the maximum tax benefits only high income taxpayers. Relief under the excess profits taxes was intended to offset benefits available to physical capital but the relief was directed to a specific tax benefit. If an implicit objective of section 1348 was to provide relief to earnings from human capital to offset benefits available to physical capital, it is at best a shotgun approach.

Despite the differences in scope and objectives, Congress merely adopted the definitions of earned income for the self-employed utilized in prior code sections. The Treasury placed the burden of defining earned income for corporate employees on the reasonable compensation standard of section 162. Although the limit on earned income, like the limit on deductions under section 162, is necessary to prevent the distribution of earnings on capital from being taxed as compensation, it is unlikely that anyone seriously considered whether the section 162 test was adequate in view of the increased incentive under section 1348 to pay out earnings as salaries rather than to accumulate within the corporate solution.

III. The Tax Reform Act of 1976

The potential for the maximum tax on earned income to achieve its policy build up their practices, hire associates and continue to benefit well beyond the usual years for an employee. See S. R. Rep. No. 992, supra note 43, at 56. There is some parallel between that argument and the one presented in text accompanying notes 92-96 infra, that earned income as defined for professionals includes more than returns to labor. The minority argument suggests that earnings from associates may be a kind of deferred income. If it is merely deferred income, it is appropriate to categorize it as earned income for the purpose of section 1348 since the 1976 Tax Reform Act, but it was not appropriate when other forms of deferred income were denied the benefits of the maximum tax. The argument presented infra is that such income is a return to goodwill and thus it is not consistent with the concept of earned income to include earnings from paid assistants in section 1348. The critical question would seem to be whether the value of such goodwill is enhanced by the passage of time or produces additional income without regard to the personal efforts of the employer; if so it should be an asset. If it represents income which could have been earned earlier, but has been deferred, then receipt of income on goodwill in the form of fees paid for the work of associates is merely deferred compensation.

45 See Chomnie, supra note 28, at 37; Ehrlich, Tax Planning As Affected by the Maximum Tax on Earned Income, 29 N.Y.U. Tax Inst. 1471, 1484-88 (1971) [hereinafter cited as Ehrlich]; Johnson, supra note 2, at 78. Taxpayers affected by I.R.C. section 1348 since 1972 are married taxpayers filing a joint return with more than $52,000 of earned taxable income and individuals or heads of households with more than $38,000 of earned taxable income, Ehrlich, supra at 1484. See Manwell, Personal Tax Planning Takes on New Meaning in View of Comprehensive Changes, 32 J. of Tax. 168 (1970) [hereinafter cited as Manwell], for estimates of the tax savings due to section 1348 under alternative assumptions. 46 See Pechman, Tax Policy, supra note 25, at 93.

47 I.R.C. § 1348(b)(1) incorporates I.R.C. § 911(b) which provides for a reasonable allowance to be defined under Treasury Regulations. Treas. Reg. §§ 1.1348-3(a)(1)(i), T.D. 7446, 1977-1 C.B. 252, refers to I.R.C. § 911(b) for the definition of reasonable compensation.

48 For example, see the substantial doubt about the adequacy of the reasonable compensation standard expressed by Senator Gore in his exchange with Mr. Cohen. Senate Hearings, supra note 18, at 713-14. Senator Gore's concern seemed directed primarily at unusually large salaries paid to corporate executives in publicly held corporations. As Mr. Cohen suggested, the real problem is in the closely held corporation where salaries are not negotiated at arms length.
objective of deterring tax shelter use was severely limited in the provision as enacted in 1969 by the incomplete coverage of tax preferences and the $30,000 exemption. Increased concern over the syndication and marketing of tax shelter investments, especially to the unwary, led to stronger provisions in the Tax Reform Act of 1976.49

The main problems posed by tax shelters were apparently identified by Congress as leverage and deferral.50 The 1976 Act attempted to curb abuses associated with tax shelters primarily by limiting the amount deductible by investors from external investments to the amount at risk for investments other than real estate, limiting cash taxpayers' deductions for prepaid interest, limiting the total amount of investment interest which can be deducted, and restricting retroactive allocation of losses in limited partnerships,51 the major vehicle for tax shelter investment.

The minimum and maximum tax provisions were strengthened as a means of deterring tax shelters "without interfering with economically meritorious investments."52 Two major items were added to tax preferences for individuals and other noncorporate taxpayers: excess itemized deductions and the excess of deductible intangible drilling costs of productive oil and gas wells over the amount that would have been deductible if the costs had been capitalized. In addition, the tax preference item for accelerated depreciation was expanded to cover all leased personal property.53

In addition to the limitations on deductions and additions to tax preference items, which evidence the concern over leverage and tax deferral, two changes were made in section 1348 itself.54 The 50 percent maximum tax was expanded to cover most deferred compensation,55 and the $30,000 preference exemption was eliminated.

One other major change is relevant for this article. The Estate and Gift Tax was amended to provide for taxation of post-1976 appreciation on assets transferred at death.56 Although there is no direct relationship between this amendment and the maximum tax, assuming that the 50 percent rate is deemed sufficiently progressive,57 this change has eliminated one of the major obstacles


50 *Tax Shelters*, supra note 49, at 11 et seq. The shift to concern over the advantage of deferral may have been prompted by Surrey, *Pathways*, supra note 23, at 108-13.


54 I.R.C. § 1348.


56 I.R.C. § 1023.

57 There was criticism in the Senate that the maximum tax would destroy the progressiveness of the tax structure. See text accompanying note 18 *supra*, and Surrey, *Pathways*, *supra* note 23, at 66-67. It is assumed for the purpose of this paper that a top marginal rate of 50
to the extension of the maximum tax to unearned income.\textsuperscript{58}

IV. Analysis of Section 1348

The basic mechanics of section 1348 can be summarized as follows.\textsuperscript{59} Earned income is first reduced to earned net income by subtracting the section 62 adjusted gross income deductions allocable to earned income. This amount is reduced to earned taxable income by multiplying taxable income by the ratio of earned net income to adjusted gross income and then subtracting total preference income. The tax liability is computed by the following steps: (1) compute the amount of tax on income up to the 50 percent bracket; (2) multiply earned income in excess of that income taxable at less than or equal to 50 percent by 50 percent; (3) compute the difference between total tax on taxable income without regard to section 1348 and the total tax on earned income without regard to section 1348; and (4) add the tax computed in steps (1), (2), and (3). The effect of this procedure is to limit the tax on earned income to a maximum marginal rate of 50 percent, and increase the tax on earned income to the extent of tax preferences to the top marginal rate which would be reached in the absence of section 1348.

Section 1348 is a deterrent to tax shelter investments because it reduces the tax savings which they generate. Investments which generate deductions in excess of income in early years are attractive because the deductions reduce taxable income and thereby reduce tax liability on income from other sources.\textsuperscript{60} This tax savings can be viewed as reducing the initial cost of the investment or as increasing the return,\textsuperscript{61} but the effect is to make tax shelters relatively more attractive than alternative investments which do not create deductions in the early years. By reducing the marginal tax rate to 50 percent, the maximum tax reduces the initial tax saving from 70 percent to 50 percent of the deductions generated, for the taxpayer with only earned income. To the extent that the deductions are tax preference items, the tax savings are reduced further because the marginal rate on an equivalent amount of earned income is increased from 50 percent to a maximum of 70 percent.\textsuperscript{62}

The tax savings associated with a tax shelter investment do not depend on the source of the income sheltered.\textsuperscript{63} The same benefit is achieved whether the income sheltered is salary income, professional fees, dividends, or the taxed portion of capital gains. Section 1348, however, deters tax shelter investment only to the extent that the taxpayer has sufficient \textit{earned} income to reach the 50 percent is sufficient progressive and the evaluation of the maximum tax is limited to considerations of horizontal equity and effectiveness in light of the stated objectives.

\textsuperscript{58} See text accompanying note 7 supra.
\textsuperscript{59} See CHOMMIE, supra note 28, at 99. For more detailed explanations of how I.R.C. § 1348 operates see Asimow, supra note 2, at 804-05; Johnson, supra note 2, at 77 et seq.; see generally Manwell, supra note 45.
\textsuperscript{60} See Surrey, Pathways, supra note 23, at 100-19 for a full discussion of the tax advantages of tax shelter investments.
\textsuperscript{61} Krane, Economic Analysis of Tax Sheltered Investments, 54 TAXES 806, 811 (1976) [hereinafter cited as Krane].
\textsuperscript{62} Id. at 813.
\textsuperscript{63} See Surrey, Pathways, supra note 23, at 103.
percent rate, and it has no deterrent effect on tax shelter investments by the very wealthy whose income is derived primarily from prior investments.\textsuperscript{64} To this extent, the maximum tax is inadequate with respect to its objective, but it cannot be said that it is inequitable because it operates by providing tax relief to taxpayers with high earned income who do not indulge in tax shelters rather than by penalizing those who do. It is a disappearing carrot, not a stick.

The initial tax savings from tax shelter investments is not permanent. Deductions generated in the early years will normally be offset by income in the future if the investment yields positive (or zero) economic returns. This future income may be taxed at higher or lower rates depending both on the taxpayer's tax bracket at the time it is realized and also whether the return is realized in the form of ordinary income or capital gain. But the deferral benefit of the tax shelter exists regardless of the tax rate imposed in the future.\textsuperscript{65}

Section 1348 not only reduces the initial benefit of tax shelters but also reduces the likelihood that the tax rate on the deferred income will be lower in the future. First, if the investment is held for future income over the life of the investment, the income will be unearned income and subject to tax at a top marginal rate of 70 percent, while the initial period deductions offset income taxed at the maximum rate of only 50 percent. The attraction of tax shelters is reduced in this respect only for taxpayers whose income is primarily earned at the time the investment is made. Again, this is a disappearing carrot.

Second, the chance of paying a substantially lower tax rate in the future is reduced for the investor who sells the investment for capital gain because the capital gains deduction is a tax preference item. The opportunity to shelter income taxable at high marginal rates by deductions taken in the early years and to have the later gain on the asset (including the amount of prior deductions which reduced the basis) taxed at much lower rates is the "conversion" aspect of tax shelters which prompted Congressional concern in 1969.\textsuperscript{66}

The inclusion of the capital gains deduction as a tax preference item for section 1348 creates a seriously inequitable result,\textsuperscript{67} however, because the penalty is imposed only on taxpayers with high earned incomes at the time the gain is realized and it is imposed indiscriminately, without regard to whether or not the investment initially sheltered other earnings. Unlike the other aspects of the maximum tax, this effect operates as a stick for all taxpayers with substantial earned incomes, not as a carrot which disappears only if the taxpayer indulges in

\textsuperscript{64} This characteristic of the maximum tax has been noted by virtually all commentators. \textit{See}, e.g., Ehrlich, \textit{supra} note 45, at 1491; Johnson, \textit{supra} note 2, at 78.

\textsuperscript{65} See Surrey, \textit{Pathways}, \textit{supra} note 23, at 109. The benefit of deferral can be described as an interest free loan or as the present value of money in hand, but whether or not tax shelters also have leverage or capital gains benefits, the common characteristic of all tax shelters is deferral. \textit{Id}.

\textsuperscript{66} H. R. Rep. 91-413, \textit{supra} note 2. The House Report compared the marginal tax rates on capital gain and earned income and suggested that the narrowing of the differential would deter conversion. \textit{See also} Cohen, \textit{supra} note 7, at 26, who referred to many devices for the conversion of ordinary income into capital gain nurtured by the natural desire to avoid very high marginal tax rates as an argument in support of section 1348.

\textsuperscript{67} See Surrey, \textit{Pathways}, \textit{supra} note 23, who deplored the fact that in 1969 Congress rejected proposals which would have eliminated the advantages of deferral and focused instead on the "lesser factor of the capital gain ingredient" in tax shelters (\textit{id.} at 117) despite the fact that he also asserted that the tax benefit from capital gain "overshadowed all other items" in its effect on the taxes paid by the wealthy. \textit{Id} at 64.
tax shelters. This inequity cannot be justified by its tax shelter deterrence, because, unless there is a unique correlation between tax shelters and investment for capital gain rather than ordinary income, the later penalty does not alter the relative attractiveness of tax shelter and non-tax shelter investments.

Section 1348 treats three different groups of taxpayers differently for the purpose of defining earned income. For simplicity, the three groups can be considered as ideal types: the professional whose income is entirely returns to labor and whose investments are external to his trade or business; the unincorporated entrepreneur whose income consists of a mix of returns to labor and returns to capital and who invests within his trade or business; and the shareholder-employee of a close corporation whose income is a mix of returns to capital and labor and who invests within his corporation.

It is useful to classify the business and investment decisions into two analytical time periods in order to see the differential effect of section 1348 on these three groups. The first period, called the accumulation period, is the time when the investment decision is made. Section 1348 affects the investment decisions of the professional by reducing the attractions of tax shelter investments. The second period, called the take-out period, is the time when the decision is made to take out the return on the investment. Section 1348 reduces the attractiveness of capital gains relative to ordinary income in the take-out period for all three groups if they have high earned income at that time. But it also provides an incentive for the entrepreneur and corporation to recharacterize investment earnings as earned income in order to benefit from the maximum tax.

A. Accumulation Period

First, consider the effect of section 1348 on $100 of incremental income for the high income professional. The deterrent effect on tax shelter investments can be demonstrated by a simple numerical example in which the benefit of tax shelters is treated as an increase in the amount of after tax income available for investment.

Before section 1348, the $100 of incremental income would be taxed at 70 percent, leaving only $30 left to invest. If an investment could be made which yielded first-year deductions of $100, the amount of after tax income left to invest could be increased by $70. Given the non-tax economic returns to any investment, the tax shelter investment was relatively more attractive. After section 1348, the benefit from tax shelter investments is substantially less. The tax on the incremental $100 is only 50 percent in the absence of tax preference items. If the professional invests in a shelter yielding $100 of deductions, to the extent that these are tax preference items within the meaning of section 57, the other-

68 See text accompanying notes 81-86 supra for a summary of the definition of earned income for the three groups.
69 Illustrating the effect of tax shelters by comparing the amount of after tax income available to invest is somewhat misleading because it suggests that the same after tax return will be available per dollar of investment on tax shelters as on other investments, and ignores the fact that most of the tax savings will have to be repaid later. See Krane, supra note 61, for an excellent description of the way to compare the true after tax returns on alternative investments.
wise potential $50 "tax saving" is reduced to $30: $100 of the professional's remaining taxable earned income becomes subject to tax at the marginal rate of 70 percent rather than 50 percent. Section 1348 reduces the tax savings generated by tax shelter investments and there is a relatively greater incentive for the professional to invest in non-tax shelter alternatives for any given non-tax economic return. 70

The maximum tax has different effects on the entrepreneur during the accumulation period. To the extent that some of the net profits of the entrepreneur's business are earned income and subject to the maximum tax, the entrepreneur also has a somewhat greater after tax income to reinvest in his business. Assuming that capital is a material income-producing factor, however, this benefit is severely limited by the 30 percent rule: a maximum of 30 percent of his net profits is all that can be characterized as earned income regardless of the percentage of income which is actually a return to capital.71 The tax is reduced on only $30 of each $100 of incremental income, which results in an increase over pre-section 1348 after tax income of only $6.

The entrepreneur's incentive to invest within his trade or business is not significantly affected by section 1348. Many internal capital investments create deductions in excess of their initial period earnings and, in fact, shelter other income,72 but do not create tax preference items. For example, accelerated depreciation on personal property may well reduce profits below the income actually attributable to the entrepreneur's labor, but they are not tax preference items.73 Accelerated depreciation on real estate used in an unincorporated business will generate tax preferences. The incidental deterrent effect of section 1348 for that kind of investment, however, is probably minimal in most manufacturing or distributing enterprises and section 1348 is unlikely to alter the entrepreneur's investment decisions.

Assuming that corporate tax rates are 50 percent, section 1348 does not significantly alter the amount of after tax income available to the corporation. Before section 1348, the corporation could reinvest within the corporate solution subject to its 50 percent tax rate.74 Reinvestment within the corporation was attractive because if earnings were paid as compensation they would have been subject to tax at a marginal rate of 70 percent. After section 1348, the close corporation is indifferent between paying earnings from labor or prior capital investments as compensation to the shareholder-employee (subject only to the limit of reasonable compensation) and retaining them in the corporation. If reinvestment of earnings is economically desirable, the shareholder employee can

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70 See Asimow, supra note 2, who predicted that section 1348 would be a good deterrent to really risky "Mickey Mouse" deals. Id. at 866.
72 The opportunity to shelter earned income and convert it to capital gain internally in business enterprises has been noted by Surrey & Warren, Federal Income Taxation 679 (1960 ed.).
73 Of course, similar deductions in external investments made by the professional will not become tax preferences either. However, they will not shelter his earned income unless there is a net operating loss from the investment as a whole.
74 There is no risk from the penalty tax on accumulated earnings, I.R.C. §§ 531-37, if the earnings are reinvested. But see T.M. 202-3d., at A-20, which points out that reasonable compensation problems frequently arise in closely-held companies with substantial accumulated earnings.
accomplish this by lending money to the corporation. At approximately the same tax cost as reinvesting within the corporation solution, the close corporation employee-shareholders can obtain greater flexibility in investment decisions. The corporation can make internal investments (either with retained earnings or with loans from the shareholder) which shelter labor earnings but do not create tax preferences. The relative attraction of these investments is not affected by section 1348.

Analysis of the effects of section 1348 on accumulation period decisions indicates that it does tend to achieve its major objective as a deterrent to tax shelter investments by high income executives and professionals. The differential rates on earned and unearned income and the effect of tax preferences provide the appropriate incentives without deterring entrepreneurs and corporations from making internal investments with essentially similar initial period deductions.

B. Take-Out Period

The only effect of the maximum tax on take-out period decisions of the professional is to reduce the tax advantage of capital gains. It is virtually impossible for the professional to recharacterize earnings from investments as earned income and, unless he chooses capital gain, the returns will be subject to the maximum marginal rate on unearned income. In contrast, the entrepreneur can recharacterize unearned income as earned income to a limited extent, and section 1348 creates the incentive to do this during the take-out period. As long as the total amount claimed as compensation does not exceed reasonable compensation, 30 percent of net profits can be characterized as earned income even though some might actually be return to capital.

Before section 1348, the corporation had some incentive to take out earnings as compensation in order to avoid double taxation of dividends. Section 1348 affects that decision in two ways. First, it reduces the counter-incentive to retain earnings for expansion which resulted from the former differential between corporate tax rates and personal tax rates on earned income. Second, it increases the tax advantage of taking out earnings as compensation by increasing the differential between the double tax on dividends and the tax on earned income. The only limit on this recharacterization of income is the section 126 limit of reasonable compensation.

To the extent that corporations and entrepreneurs recharacterize income as earned income, section 1348 leads to an additional revenue loss. Even the intended revenue loss from the reduction of tax rates on earned income has no offsetting benefit of tax shelter deterrence for these taxpayers. Further, the arbitrary limit on earned income provides an enormous incentive for the entrepreneur to incorporate. Therefore, section 1348 achieves its primary objective

75 See Asimow, supra note 2, at 867; Watts, supra note 2, at 43.
76 See note 72 supra.
77 See text accompanying notes 72, 73 supra; Asimow, supra note 2, at 866.
78 The desirability of paying out earnings as compensation and reinvesting via shareholder loans is enhanced by the fact that it is important to establish a pattern for proving reasonable compensation. See text accompanying notes 145-47 infra.
79 See Asimow, supra note 2. Asimow also suggests that to the extent entrepreneurs are
at the cost of inducing undesirable side effects and by providing tax relief which does not contribute to tax shelter deterrence.

V. Definition of Earned Income

If the objective of section 1348 is to discourage tax shelter investments, the definition of earned income must serve two functions. First, it must be sufficiently comprehensive to reduce the attraction of tax shelters for the target group of taxpayers. Second, it must prevent the recharacterization as earned income of earnings from capital in order to avoid giving unintended tax relief which does not yield offsetting benefits in the form of tax shelter deterrence. Although there is little evidence that the 91st Congress gave much consideration to the problem when it incorporated unrelated Code provisions and their accompanying Regulations, the definitions of earned income roughly reflect these two functions.

Earned income is defined in three categories. The first category, which includes professionals, treats income as presumptively earned under certain circumstances. It identifies the target group. Thus wages, salaries, professional fees, etc. and earnings from employed assistants for the performance of personal services if the individual is himself individually and personally responsible for the services performed are earned income. In addition, income within the meaning of section 401(c)(2)(C), "gains . . . derived from . . . property (other than good will) by the individual whose personal efforts created such property" is earned. The second category, which includes entrepreneurs, arbitrarily limits the amount of income which can benefit from section 1348 to 30 percent of net profits. This limit applies where capital is a material income producing factor, i.e., "if a substantial portion of the gross income of the business is attributable to

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80 The target group is described by Surrey, supra note 23 at 106, as consisting of doctors, actors, executives, lawyers, and investment bankers.
83 I.R.C. § 401(c)(2)(C). See also § 1348(b)(1)(A).
the employment of capital.\textsuperscript{85} In the third category, which is corporation employees (including employees of professional corporations), section 1348 applies to income as long as it is a reasonable allowance for the personal services actually rendered.\textsuperscript{86} The second and third categories attempt to limit the tax benefits for taxpayers who are not within the target group.

The underlying concept of earned income—income produced by labor—is the thin thread of continuity which runs through these three categories.\textsuperscript{87} But there is some tension between a conceptual definition of earned income and a definition which achieves the desired tax objectives.\textsuperscript{88} This tension is reflected in the statute itself and the proposed regulations, as well as in the judicial decisions which provide the only precedent for interpreting the rules for section 1348.\textsuperscript{89} The problem of achieving consistency and fairness\textsuperscript{90} in defining earned income is increased to the extent that the courts have attempted to interpret the rules in a manner consistent with objectives of prior law—objectives which are dis-

\textsuperscript{85} Treas. Reg. § 1.1348-3(a)(3)(ii), T.D. 7446, 1977-1 C.B. 252. This regulation reinforces the presumption that professional income is earned income by stating that:

\[ \text{the practice of his profession by a doctor, dentist, lawyer, architect, or accountant will not, as such, be treated as a trade or business in which capital is a material income-producing factor even though the practitioner may have a substantial capital investment in professional equipment or in the physical plant constituting the office from which he conducts his practice since his capital investment is regarded as only incidental to his professional practice.} \]

Similarly, Treas. Reg. § 1.1348-3(a)(3)(iii), T.D. 7446, 1977-1 C.B. 252, excludes any income within I.R.C. § 401(c)(2)(C) from the 30 percent rule even though a substantial capital investment may be involved.


\textsuperscript{87} The basic input in earned income is time was recognized to some extent in the legislative history. See Cohen, \textit{supra} note 7, at 26; H. R. REP. No. 91-413, \textit{supra} note 2. Statements there indicate that one of the objectives was to encourage taxpayers to use their time productively, rather than using it to seek tax shelters.

\textsuperscript{88} The concept of earned income itself is not easy to specify. For example, if wage rates are above long-run competitive equilibrium rates, is the difference a return to labor? What if the disequilibrium is caused by artificial restrictions on supply such as licenses? Is the additional return a return to labor or a return to the license—a kind of capital asset? As a practical matter the distinction may depend on whether or not the license is purchased—compare New York taxi medallions with physician licenses—but conceptually, if one is an asset, so is the other. Conversely, if the assets of a business return above normal returns, might it not be due to the efforts of management and thus returns to labor? See text accompanying notes 93-96 infra.

Unlike "dividend," earned income is an economic concept and not just a taxable event. See Kingson, \textit{The Deep Structure of Taxation: Dividend Distribution}, 85 \textit{YALE L.J.} 861, 865 (1976). For tax purposes it is more important for the definition to be related to the objective of the particular Code provision than to match a theoretically sound definition. It is on the former level that the section 1348 definition is vulnerable.

\textsuperscript{89} There have been no cases decided under section 1348 to date. The precedents discussed in this paper are based on the prior Code provisions discussed in the text accompanying notes 92-44 infra.

\textsuperscript{90} To be consistent, if the taxpayer's time is the basic input into the production of earned income, and time produces above average returns to an investor (including a tax shelter investor) or gambler, the returns should be earned income. The Tax Court has held that gambling gains are earned income under I.R.C. § 911. Robida v. Comm'r, 29 T.C.M. 407 (1970), \textit{aff'd}, 460 F.2d 1172 (9th Cir. 1972). Gambling gains are, however, specifically excluded from the definition of earned income for section 1348 under Treas. Reg. § 1.1348-3(a)(1)(ii) T.D. 7446, 1977-1 C.B. 252. See Asimow, \textit{supra} note 2, at 858-60, who argues that it would be too difficult to determine the amount which should be compensation for a taxpayer investing in securities, but that gambling should be treated as earned income if gambling is the taxpayer's trade or business, given the objective to deter tax shelters. Considering objectives, above average gains from time spent choosing among tax shelters should not be earned income, but there is no conceptual difference between them and gambling gains. See Vanderpool, \textit{Robida and Tobey: The New Test for Section 911 "Earned Income,"} 27 \textit{TAX LAWYER} 493 (1973), for an analysis of the broader implications of \textit{Robida}.
tistinguishable from the objective of the maximum tax.

**A. Income Presumptively Earned**

On their face, the regulations for section 1348, which establish the category of income which is presumptively earned, are overinclusive in that they treat

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91 The only predecessor provision which shares the basic objective of section 1348 to prevent recharacterization of return on capital as compensation is the I.R.C. § 162 limit on reasonable compensation.

92 Treas. Reg. § 1.1348-3(a)(1)(i), T.D. 7446, 1977-1 C.B. 252:

For purposes of section 1348 and the regulations thereunder, the term "earned income" means any item of gross income which is earned income within the meaning of section 401(c)(2)(C) or section 911(b) unless the item constitutes deferred compensation as defined in paragraph (b) of this section or is otherwise excluded by application of this paragraph. Thus, subject to such exceptions, the term includes—

(A) Wages, salaries, professional fees, bonuses, amounts includible in gross income under section 83, commissions on sales or on insurance premiums, tips, and other amounts received, actually or constructively, as compensation for personal services actually rendered regardless of the medium or basis of payment.

(B) Compensatory payments for personal services made prior to the time such services are actually rendered, provided such advance payments are not made for a purpose of minimizing Federal income taxes by reason of the application of section 1348, and are either customary in the particular profession, trade, or business, or are made for a bona fide business purpose.

(C) Prizes and awards in recognition of personal services includible in gross income under section 74, amounts, includible in gross income under section 79 (relating to group-term life insurance purchased for employees), and amounts includible in gross income under section 1379(b) (relating to contributions to qualified pension plans in the case of certain shareholder-employees); and

(D) Gains (other than gain which is treated as capital gain under any provision of chapter 1) 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.

The term does not include such income as dividends (including an amount treated as a dividend by reason of section 1373(b) and § 1.1373-1), other distributions of corporate earnings and profits, gambling gains, or gains which are treated as capital gains under any provision of chapter 1. The term also does not include amounts received for refraining from rendering personal services or engaging in competitive activity or amounts received as consideration for the cancellation of an employment contract.


Earned income and employed assistants. 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, dentist, lawyer, architect, or accountant, 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.


Whether capital is a material income-producing factor must be determined 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, as reflected, for example, by a substantial investment in inventories, plant, machinery, or other equipment. In general, capital is not a material income-producing factor where gross income of the business consists principally of fees, commissions, or other compensation for personal services performed by an individual. Thus, the practice of his profession by a doctor, dentist, lawyer, architect, or accountant will not, as such, be treated as a trade or business in which capital is a material income-producing factor even though the practitioner may have a substantial capital investment in professional equipment or in the physical plant constituting the office from which he conducts his practice since his capital investment is regarded as only incidental to his professional practice.


This subparagraph does not apply to 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 by an individual whose personal efforts created such property which
earnings from capital as earned income. There are also some areas in which it is difficult to determine whether particular activities are included or excluded from the category.

One example of overinclusiveness is the treatment of the entire amount of income for the performance of personal services as earned income, even though the services are performed by assistants. Earnings to the employer in excess of wages paid for the labor of others are clearly returns to some form of capital. Although it is difficult to define the nature of the capital precisely, it probably should be included in the general concept of goodwill. Goodwill, which has been defined as the sum of intangible assets which add to favorable earning capacity, is treated as an asset for purposes of the capital gains tax. If goodwill is an asset, earnings attributable to it are certainly returns to capital, and the inclusion of substantial income generated by paid assistants in the section 1348 definition of earned income is inconsistent with the conceptual definition of earned income.

Similarly, the inclusion of all income from the sale of property created by the personal efforts of the taxpayer even if capital is a material income-producing factor in the section 1348 definition of earned income is overinclusive. To the are, by reason of subparagraph (1) (i) of this paragraph, treated as earned income. Thus, for example, a research chemist's substantial capital investment in laboratory facilities which he uses to produce patentable chemical processes from which he derives gains within the meaning of this subdivision would not be considered a material income-producing factor.

93 The return may be return on working capital, risk capital or prior investments made by the employer in on-the-job training. The fact that the capital was produced by prior labor, and that earnings may have been reduced when the time was spent, does not destroy its capital characteristic once it is "reinvested" for returns in the future. The return may also be a return from valuable licenses which give the employer a "monopoly" position. See T.M. 202-3d, supra note 74, at A-3, where it is noted that incorporated professionals may risk having some of their earnings treated as a distribution on profits where they are a return on goodwill. There does not seem to be a valid basis, either conceptually or to achieve the objective of section 1348, to distinguish earnings from associates in professional corporations from those in partnerships.

94 Eustice, Contract Rights, Capital Gain and Assignment of Income—the Ferrer Case, 30 Tax L. Rev. 1, 20 (1964) [hereinafter cited as Eustice]. Asimow, supra note 2, at 843, defines goodwill as an intangible asset which leads to the ability to charge more than competitors. Under that definition, part of the professional fees earned directly by the taxpayer-employer are also attributable to goodwill and should not be earned income. See note 93 supra.

95 Goodwill is treated as an asset for the purpose of the capital gains tax. United States v. Woolsey, 326 F.2d 287, 291-92 (5th Cir. 1963). See Eustice, supra note 94, at 30, who describes this as a "well-entrenched aberration."

96 Income need not be earned income for section 1348 just because it is ordinary income, not capital gain. However, earnings attributable to an asset which does receive capital gain treatment should not be "earned" for section 1348. Asimow, supra note 2, at 846, recognizes this but argues that goodwill should not be treated as a material income producing factor because it is hard to tell whether it exists. Substantial earnings from paid assistants might be good evidence that it does exist.

There is also discussion in the literature about whether payments for a covenant not to compete should be earned income for section 1348. Asimow, supra note 2, at 808, says that these payments are likely to be "earned" if there is a real obligation to provide consulting services. Reichler, 1972, supra note 3, at 324, questions this conclusion. Watts, supra note 2, at 9, argues that such payments should be earned, but that they would be hard to distinguish from goodwill. Because the definition of earned income is for services "actually rendered" it is doubtful that payments not to render services would be considered earned income. Clearly such payments should not be; the time of the taxpayer is not used and such payments are indistinguishable conceptually as well as practically from goodwill.


98 Treas. Reg. § 1.1348-3(a)(3)(iii), T.D. 7446, 1977-1 C.B. 252. Income from property created by personal efforts was originally excluded from the section 911 definition of earned income. G.C.M. 236 C.B. VI-2, 27 (1926). This exclusion carried over to the original
extent that substantial capital may be used to produce the property, part of the selling price is clearly a return to capital. There is also an opportunity to defer income from selling the property. Although deferred compensation has been included in section 1348 since the 1976 Tax Reform Act, the possibility of deferring income and retaining the benefits of the maximum tax was denied other taxpayers when the provision was created. If the sale of the property is deferred, part of the income may be gain from appreciation. Treating such gain as earned income may well be inconsistent with the treatment of appreciation on other forms of property initially received as compensation.

These two provisions are vague as well as overinclusive. The standard for determining whether income earned by assistants is earned income is that the taxpayer is himself individually and personally responsible for the services performed, a criterion which led to considerable litigation under earlier sections of the Code. The examples stated in the proposed regulation (doctors, dentists, lawyers, architects, and accountants) not only appear to be heavily influenced by traditional notions of the definition of a "professional" but also by equally irrelevant state law restrictions on limitation of liability. Similarly, if the utilization of substantial capital is not to be used as a criterion for deciding whether or not property qualifies as property created by the personal efforts of the taxpayer, what criterion is to be used?

That the income category which is presumptively earned is overinclusive and that its boundaries are vague are not serious criticisms, however. To the extent

Keogh Plan, but it was later amended to eliminate the disparity between treatment of salaries and contracts for cash advances and the sale, lease or rental of property of authors and inventors. Reichler, 1971, supra note 54, at 1324. Section 401(C)(2)(C) was added to H.R. 10 and was incorporated into the section 1348 definition of earned income at the urging of the Author's League of America. Senate Hearings, supra note 18, at 3484 (statement of Irwin Karp).

It may be that this use of capital can be distinguished because it is not purchased with an intent to obtain an economic return on capital. In that sense it is a "raw material" input like the parts used in a repair service. See note 128 infra. But if this distinction exists, it is not susceptible to factual determination. The inclusion of all income from property produced by the taxpayer's efforts without regard to the use of capital is inconsistent with the 30 percent limit applied to other taxpayers where capital is material. The fact that copyrights, etc., are denied capital gains treatment, I.R.C. § 1221(3) is not an adequate reason for distinguishing these earnings from other returns to capital; not all ordinary income is earned income, and concepts developed to distinguish ordinary income from capital gain do not provide useful guidelines for defining earned income. However, the converse is apparently true: the fact that assets represent future streams of income from personal services is one of the bases for denying the sale of such assets capital gains treatment. Jackson Hill v. Comm'r, 47 T.C. 613, 620 (1967).

See text accompanying note 54 supra.

See Jackson Hill v. Comm'r, 47 T.C. 613 (1967), where the entire amount received from the sale of a TV series was treated entirely as ordinary income. Presumably that would also be earned income under § 1348. But see Lane, Sol Diamond: The Tax Court Upsets the Service Partner, 46 S. Cal. L. Rev. 239 (1973), who suggests that later appreciation on property received as personal service compensation might be taxed as capital gain.


See Asimow, supra note 2, at 812.

See G. Rousku v. Comm'r, 56 T.C. 548, 552 (1971), where the taxpayer's argument that licensing requirements for auto repair shops indicated that the activity was professional was dismissed by the court as an irrelevant "semantic" issue. See also Treas. Reg. § 1.1348-3(a), (6) T.D. 7446, 1977-1 C.B. 252, examples 1, 3, which reflect a "professional" bias.

See Asimow, supra note 2, at 809. The example of the research chemist in Treas. Reg. § 1.1348-3(a)(3)(iii), T.D. 7446, 1977-1 C.B. 252, indicates that such property may not be limited to the kinds of property denied capital gain treatment by I.R.C. § 1221(3): patents are noticeably absent from that list.
that the presumptions identify a group of taxpayers likely to be susceptible to tax shelters because they have large amounts of ordinary income,\textsuperscript{106} the rules are appropriate for the purpose of carrying out congressional intent to deter tax shelter investments. The deterrent as well as the benefit is merely extended to some unearned income, and the situations covered probably present little opportunity for converting income from capital investments financed by accelerated deductions into earned income. If a secondary objective of the maximum tax was to redress the inequity of existing provisions thought to discriminate against investments in human capital,\textsuperscript{107} the presumptions of section 1348 identify the correct groups of taxpayers.

B. Miscellaneous Provisions

The section 1348 definition of earned income incorporates older concepts derived from sections of the Code relating to personal service corporations\textsuperscript{108} but it departs from prior law in other ways. For example, gambling gains are specifically excluded from earned income.\textsuperscript{109} A more substantial departure from prior law is the rule that guaranteed payments received from a partnership are included in the 30 percent limit if capital is a material income-producing factor in the partnership trade or business.\textsuperscript{110} Under prior law, such payments were treated as earned income if they were for personal services rendered.\textsuperscript{111} While this unexplained change does prevent partnerships from evading the 30 percent limit (while sole proprietorships cannot), it increases the incentive to incorporate and it does not seem to be consistent with the overall objective of section 1348, since there is no reason to exclude service partners from the target group. Further, in view of the confusing and largely inapplicable precedents and serious inequities created by the 30 percent rule, it is doubtful that enlarging its scope is a worthwhile endeavor.

\textsuperscript{106} See also note 80 supra. Krane, supra note 61, at 806 n. 1, suggests that some people go into tax shelters as a means of financing current consumption and others because a reduction of current taxes is its own reward.

\textsuperscript{107} Asimow, supra note 2, at 889 n. 403, apparently believes that such redress is desirable but doubts that section 1348 is the right vehicle because the inequities are more pronounced at lower income levels. See CHOMMIE, supra note 28, at 37; Pechman, Tax Policy, supra note 25, at 93.

\textsuperscript{108} See text accompanying note 38 supra. The personal service corporation concept is incorporated in Treas. Reg. § 1.1348-3(a)(1)(i)(A), T.D. 7446, 1977-1 C.B. 252:

Thus, subject to such exceptions, the term includes—

(A) Wages, salaries, professional fees, bonuses, amounts includible in gross income under section 83, commissions on sales or on insurance premiums, tips, and other amounts received, actually or constructively, as compensation for personal services actually rendered . . . .

\textsuperscript{109} See note 90 supra.


\textsuperscript{111} E. L. Carey v. United States, 427 F.2d 763 (Ct. Cl. 1970); Lawrence L. Tweedy v. Comm'r, 47 B.T.A. 341 (1942). The taxpayer's argument in those cases was based on I.R.C. § 707(c) which says that "to the extent determined without regard to the income of the partnership, payments to a partner for services . . . shall be considered as made to one who is not a member of the partnership." In Andrew O. Miller, Jr. v. Comm'r, 52 T.C. 752, 762 (1969), the court said that the additional phrase, "but only for the purpose of section 61(a) . . . and section 162(a)," in I.R.C. § 707(c) was not intended to preclude similar treatment under section 911. In Rev. Rul. 231, 1974-1 C.B. 240 (the only ruling on section 1348) the Commissioner said that if income in a partnership came solely from professional fees, where capital is not a material income-producing factor, all fees would be treated as earned for section 1348. This position does not negate the Treasury Regulation which applies to guaranteed payments where capital is material.
C. Capital as a Material Income Producing Factor

The limitation on earned income to 30 percent of net profits in unincorporated enterprises where both personal services and capital are material income-producing factors\(^{112}\) is clearly designed to prevent taxpayers who are not within the target group from gaining excessive benefits from the maximum tax. Precedents based on earlier Code sections which utilized the material income-producing test are as varied as the sections themselves.\(^{113}\) Although there is some doubt that these precedents would be followed under section 1348,\(^{114}\) a sampling of the earlier cases is indicative of the difficulty involved in relating the conceptual question of whether capital is material to the specific objectives of the Code provision.

The initial problem created by the 30 percent rule is defining the scope of the trade or business of an unincorporated taxpayer. The incentive to blur the lines between separate business activities in order to use deductions from one to shelter earnings from another has been reduced by the counter-incentive created by section 1348.\(^{115}\) It is now desirable to split off activities in order to avoid having the 30 percent limit applied to substantial amounts of earned income.\(^{116}\)

Existing precedent indicates that it is permissible to split off segments of a trade or business into separate entities to obtain tax benefits,\(^{117}\) but if the activities are not separated, the existence of only a small proportion of income from capital may prove fatal to the taxpayer's claim that capital is not a material income-producing factor. For example, in *Seaboard Mills, Inc.*,\(^{118}\) a corporation which acted as a selling agent for cotton mills and which derived 84 percent of its income from commissions was denied personal service corporation status for excess profits tax relief, because 16 percent of its income from commissions was denied personal service corporation status for excess profits tax relief, because 16 percent of its income had been produced by

\(^{112}\) Treas. Reg. § 1.1348-3(a) (3) (i), (ii), T.D. 7446, 1977-1 C.B. 252. Labor as well as capital must be material. Steve Lodzieski v. Comm'r, 3 T.C.M. 1056 (1944) (labor not material where two days per week spent collecting rent).

\(^{113}\) The provisions include earned income credits and excess profits tax relief. See text accompanying notes 38-40 supra; 704(e) (family partnerships); § 911(b) (foreign earned income credit); and former § 1361 (tax option corporations). For comprehensive discussions of prior cases, see Note, *Capitalizing on Section 1348: Capital as a Material Income-Producing Factor; Problems in Facing It, Plans to Get Around It*, 22 Amer. L. Rev. 135 (1972) [hereinafter cited as Note, Amer. L. Rev.]; Note, *The Taxation of Personal Service Corporations*, 41 Colum. L. Rev. 296 (1941) [hereinafter cited as Note, Taxation]; Moore, *Capital as a Material Income-Producing Factor for 1348 Purposes: An Analysis*, 38 J. of Tax. 329 (1973) [hereinafter cited as Moore]. Most of the cases were decided under the excess profits tax provisions. Note, Amer. L. Rev. supra note 2, at 857, who says that it was appropriate to construe capital as material strictly under excess profits tax provisions in order to prevent evasion, but that it has been less strictly construed under section 911. Under section 704(e), the objective has been to make it difficult to show that capital is material in order to prevent income splitting.

\(^{114}\) See Note, Amer. L. Rev., supra note 113, at 141.

\(^{115}\) See note 79 supra.

One commentator has suggested that if a personal service corporation contains some activities in which capital is material but is not subject to the 30 percent rule, the activities in which capital is material would compete unfairly with similar activities not integrated with personal service businesses. Reichler, 1970, supra note 8, at 362.

\(^{116}\) Asimow, supra note 2, at 855, suggests as one of the tax planning ideas which result from section 1348 is that separate activities be split off. See also Watts, supra note 2, at 10.\(^{117}\) Reichler, 1970, supra note 8, at 362. It is not clear whether Treas. Reg. § 1.1348-3(a) (3) (i), T.D. 7446, 1977-1 C.B. 252, precludes a partner from separating the guaranteed payment by claiming it as earnings from his separate trade or business. *Id.* at 305. Guaranteed payment is defined in Treas. Reg. § 1.707-1(c).

\(^{118}\) Seaboard Mills, Inc. v. Comm'r, 5 B.T.A. 575 (1926).
capital. The court said that the test did not depend on whether the capital was used in the same business.

The nature of the capital as well as the amount of earnings derived from it has been important in prior cases. For example, capital has been held not to be material for a real estate broker where it was only "incidental" and for a physician where it was "not distinctive." The proposed regulations incorporate these precedents but it is not clear whether or not the fact that the capital is non-distinctive or incidental would be relevant to determining if it is material in trades or businesses which are not "professional."

The character of the business itself may be determinative, as indicated by Hubbard-Ragsdale Co. v. Dean, where the court held that a livestock-broker who operated on a pure commission basis was not a personal services corporation for the purpose of excess profits tax relief because the business was "mercantile." The regulations carry over this precedent by including investment in inventories as one indication that capital is a material income-producing factor. That investment in inventory can be significant without regard to whether it is held for resale or merely used as a cooperating input in a business which essentially provides personal services is indicated by a recent case in which a car repair business was held to be one in which capital was material, in part because the income produced by repair work could not have been produced without the necessary parts. That the reasoning underlying any of these decisions is not necessarily limited to the context in which it was developed is strikingly illustrated by Sperapani where the fact that the taxpayer sold a tangible product rather

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119 Id. at 581.
120 Id. See also Jeremiah J. O'Donnell, Jr. v. Comm'r, 23 T.C. Mem. 210, 223 (1964), where the court held that a partnership could qualify under I.R.C. § 704(e) whether or not the capital was used in the business if it produced a substantial portion of the income. But see Hubbard-Ragsdale Co. v. Dean, 15 F.2d 410 (S.D.Ohio 1926) where the court said that the fact that capital was used in the business was significant.
124 In Hubbard-Ragsdale Co. v. Dean, 15 F.2d 410 (S.D.Ohio 1926) the court rejected the argument that the fact that capital was only incidental or nominal was relevant to the determination that a livestock-broker business was a personal service corporation, saying that a mercantile business was not like a lawyer or doctor.
125 15 F.2d 410 (S.D. Ohio 1926).
126 Id. But see Moore, supra note 113, at 330. His review of the cases indicates that taxpayers in the same line of business have been treated differently depending on operating policies. In Hubbard-Ragsdale, the court held that capital was material despite the fact that all business was conducted on a commission basis. See also Fairfax Material Wood Products Co. v. Comm'r, 5 T.C. 1279, 1282 (1945) (not paid by commission relevant to determination that custom furniture parts manufacturer was not a personal service corporation); Fuggeto v. United States, 306 F.2d 76 (9th Cir. 1962) (sales on commission basis relevant to determination that capital not material in sales division of canned products company under section 704(e)).
129 Fred J. Sperapani, 42 T.C. 308 (1964). There the court held that use of duplicating machines and the sale of transcripts from a court reporting service indicated that capital was material. This decision was reached in order to permit the business to qualify for the election to be taxed as a corporation under section 1361. There was no reason to make it difficult to establish that capital was material for that provision, but similar tests should not be applied for the purpose of section 1348. If the sale of transcripts is the sale of a commodity, rather than a service, then the sales price would not be a "fee" and the business could not qualify under the general definition of earned income, but rather would be considered as a business which had substantial inventories.
than a pure service was one of the decisive factors in the determination that capital was a material income-producing factor.

Intangibles, particularly goodwill, raise serious problems. The fact that goodwill was excluded from the assets which could be counted to reduce excess profits taxes was one of the factors justifying preferential treatment for personal service corporations. That facts was recognized by the court in *American Lawyers Co.* which said that if the existence of internally generated goodwill were to make capital material, the entire scheme would be destroyed. To the extent that the maximum tax may be intended to offset other tax benefits available only to physical capital, that rationale may also be appropriate for determining whether capital is material under section 1348.

Quantity rather than quality of income-producing capital should be the criterion for determining whether capital is material under section 1348. The importance of the actual proportion of the income generated by capital was recognized by the Tax Court in *Danco*, where it held that a taxpayer who manufactured custom sheet metal products was entitled to excess profits relief because its annual net income ranged from 100 to 425 percent of total invested capital and surplus. This approach has not been followed consistently and many courts have held that capital was material even when it accounted for far less than 50 percent of gross revenues. Where the rule is that 30 percent of *net* profits can be called earned income it is obviously unfair to categorize a trade or business as one in which capital is material where less than 50 percent of *gross* revenues can be attributed to capital.

If precedent which classified an activity as one in which capital is material...
even though only a small percentage of net income was generated by capital is applied under section 1348, it will increase the incentive to incorporate to achieve the benefits of the more flexible reasonable compensation test. Only those taxpayers too unsophisticated to incorporate or those with significant non-tax reasons for operating as partnerships or sole proprietorships will be subject to the 30 percent limit. Even if incorporation to avoid the harsh effect of the rule is not in itself an undesirable effect, the result is to shift the burden of limiting maximum tax benefits to the definition of reasonable compensation.

D. Reasonable Compensation

Considering the importance of the reasonable compensation test in limiting earned income under section 1348, surprisingly little attention has been devoted to analysis of the adequacy of the precedents in light of the objectives of the maximum tax. The criterion for reasonable compensation as a limit to earned income for section 1348, like the criterion for capital as a material income-producing factor, should be based on a quantitative analysis which relates net earnings (after employee-shareholder salaries) to capital invested in the corporation. Unfortunately, cases decided under section 162 focus on a variety of factors.

139 A number of commentators have suggested that the interpretation of capital as a material income-producing factor would be likely to lead to much future controversy. See, e.g., Asimow, supra note 2, at 835; Ehrlich, supra note 45, at 1489; Reichler, 1971, supra note 54, at 1489. There probably will be little controversy, however, because of the option to incorporate.


141 The test for reasonable compensation under section 1348 is the same as under section 162. Treas. Reg. § 1.1348-3(a)(1)(i) T.D. 7446, 1977-1 C.B. 252. That regulation provides the only limit on earned income paid as compensation by a corporation.

142 No commentators have devoted much attention to analyzing the precedent of section 162 in the context of the maximum tax. See note 48 supra, (Senator Gore's concern over its adequacy as a limit to earned income). However, Senator Gore seemed primarily concerned with General Motors, while the real basis for concern is in close corporations. Reasonable compensation cases have arisen almost exclusively in close corporations in the past. See T.M. 202-3d, supra note 74, at A-4; Dixon, Planning Reasonable Compensation, 19 N.Y.U. TAX INST. 181, 182 (1961) [hereinafter cited as Dixon].


144 The factors most often listed and cited were identified in Mayson Mfg. Co. v. Comm'r, 178 F.2d 115, 119 (6th Cir. 1949) as follows:

Although every case of this kind must stand upon its own facts and circumstances, it is well settled that several basic factors should be considered by the Court in reaching its decision in any particular case. Such factors include the employee's qualifications; the nature, extent and scope of the employee's work; the size and complexities of the business; a comparison of salaries paid with the gross income and the net income; the prevailing general economic conditions; comparison of salaries with distributions to stockholders; the prevailing rates of compensation for comparable positions in comparable concerns; the salary policy of the taxpayer as to all employees; and in the case of small corporations with a limited number of officers the amount of compensation paid to the particular employee in previous years. The action of the Board of Directors of a corporation in voting salaries for any given period is entitled to the presumption that such salaries are reasonable and proper.

One commentator, in reviewing the decisions on reasonable compensation, has said: "[H]ow the Tax Court comes to a conclusion that a certain amount is reasonable... is, of course, a
none of which bears a close resemblance to the appropriate quantitative test.

One of the factors which have been given some weight in previous cases, the history of compensation within the taxpayer corporation, actually operates to reduce the effectiveness of the reasonable compensation test for the purpose of limiting income which benefits from the maximum tax. Under prior law, the fact that a salary compensation agreement contingent on earnings or profits has been in existence for a number of years prior to the tax year in question as well as the fact that the Commissioner failed to challenge it in earlier years is evidence that the amount of compensation paid under the agreement is reasonable. Although this evidence is not necessarily taken at face value where the original bargain may not have been established by arm's-length negotiation, the fact that some consideration may be given to past practice presently encourages close corporations to raise salaries to establish the necessary evidence if the deduction should be challenged in the future.

Before the advent of section 1348, the incentive to do this in early years was limited by the increased tax liability incurred if earnings were paid out rather than retained for future growth. The elimination of any significant differential between corporation tax rates and the top marginal rate on earned income has eliminated this significant barrier to establishing formulas for paying out a large proportion of earnings as compensation during the corporation's growing years.

A recent trend in reasonable compensation cases has been to disallow salary deductions, even though they may be reasonable when judged by other factors, when the corporation pays no dividends. The case which is considered to have established this trend is Charles McCandless, where the court held that the "conspicuous absence" of any return on equity capital compelled the conclusion that "purported compensation payments necessarily contained a distribution of corporate earnings." This trend does at least begin to focus on the relationship mystery." Wolder, How the Tax Court Treats Reasonable Compensation, 39 Taxes 473 (1961) [hereinafter cited as Wolder]. For more comprehensive discussions of the standards for reasonable compensation, see Dixon, supra note 142; McLean & Martin, Is "Reasonable" Enough? The McCandless Doctrine, 54 Taxes 642 (1976) [hereinafter cited as McLean]; see T.M. 202-3d, supra note 74.

145 See Brodsky, What Constitutes Reasonable Compensation, 19 N.Y.U. Tax Inst. 169, 180 (1961) [hereinafter cited as Brodsky]; Dixon, supra note 142, at 188; T.M. 202-3d, supra note 74, at A-7. For an example of consideration by the Tax Court given to prior patterns of compensation, see Harry Sufrit, Inc. v. Comm'r, 8 T.C. M. (P-H) 465 (1945) (prior approval by Commissioner of use of same formula as evidence of reasonableness).

146 See, e.g., Reppel Steel & Supply Co., Inc. v. Comm'r, 35 T.C. M. (P-H) 368, 378 (1976); Pepsi-Cola Bottling Co. v. Comm'r, 528 F.2d 176, 182 (10th Cir. 1975).

147 See Moore, supra note 113, at 331, who recommended that close corporations begin increasing salaries to establish a basis for proving reasonable compensation for section 1348. The tactic is even more effective if all close corporations do it, because another criterion is the salaries paid by comparable corporations. See Dixon, supra note 142, at 183-84; see T.M. 202-3d, supra note 74, at A-8.

148 See Greene, Compensation or Dividend?, 14 J. of Tax. 194, 195 (1961) who points out that courts have held that when salaries have been kept low in order to retain earnings for growth, that fact can justify higher salaries in future years.


between reasonable compensation and the return on equity, but the emphasis on
the payment of dividends rather than on the relationship between annual
dividends, growth in retained earnings, and total equity, is misplaced when
the question is the extent to which return to capital has been recharacterized as return to labor. If more earnings have been retained in the corporation, equity
will be higher and a larger proportion of earnings should be attributed to capital,
but in any one year the amount considered to be earned by capital should be the
sum of dividends and retained earnings.

When the courts do conclude that the claimed compensation is unreasonable,
they arbitrarily pick a number somewhere between the Commissioner’s determina-
tion of reasonable compensation and the taxpayer’s claim. Whether there is
any rationale other than compromise to the amount determined to be reasonable
by the courts, it seems clear that the amount allowed is unrelated to the amount
of equity in the corporation. This is true even though the opinions themselves
frequently contain sufficient financial data to use an estimate of a reasonable
return to capital as one indication of the reasonableness of compensation.

Finally, in reasonable compensation cases, the courts pay almost no atten-
tion to whether the business is inherently capital intensive. In *Nor-Cal Adjusters*, for example, the court apparently gave consideration to the fact that
the company neither plowed back earnings nor paid dividends and noted that a
prudent investor would expect some return on capital in determining that the
compensation was unreasonable, but paid no attention to the fact that the capital

152 Some courts do look at retained earnings which have been reinvested for growth as a
factor which tends to justify not paying dividends. See, e.g., Way Engineering Co., Inc v. Comm’r, 44 T.C. M. (CCH) 206 (1975) (compensation unreasonable); Osborne Motors, Inc. v. Comm’r, 45 T.C. M. (CCH) 660, 692 (1976) (compensation reasonable). However, where earnings are accumulated and the business is not growing the court is likely to use that as an argument that compensation is unreasonable. See T.M. 202-5d, supra note 74, at A-20. The accumulation of retained earnings, whether or not reinvested should be a factor which indicates that return on capital has not been paid as compensation.

Another factor noted by the courts is whether or not the company has been successful. See, e.g., Charles McCandless Tile Service v. United States, 422 F.2d 1336, 1340 (Ct. Cl. 1970). The factor is viewed by the courts as an indication that dividends should have been paid, and, therefore, as evidence that compensation is unreasonable. Profitability is an indication that the capital has been invested successfully and that some of the profits are returns to capital, but whether or not dividends have been paid does not help determine if capital income has been recharacterized as compensation.

153 Edwin’s, Inc. v. United States, 501 F.2d 675 (7th Cir. 1974) is exceptional in that the
court considered the fact that net profits had been more than 20 percent of invested capital to
be a significant factor in determining reasonable compensation. 501 F.2d at 677.

154 See, e.g., *McCandless*, 422 F.2d at 1336, where the court arbitrarily determined that
15 percent of net profits was a reasonable return on capital; see also *Pepsi Cola*, 528 F.2d at 176, where the taxpayer claimed $80,000, $106,000, and $117,000 for the 1968, 1969, and 1970 tax years, the Commissioner allowed only $40,000 each year, and the court allowed $50,000, $54,000, and $57,000.

155 See, e.g., Way Engineering Co., Inc. v. Comm’r, 44 T.C. M. (CCH) 206 (1975),
where the accumulated retained earnings were $431,000 (cash needs of the business were
$500,000 and paid-in capital was small), and taxable income was $209,000. Despite the fact
that a pre-tax return on equity of 20 percent would have yielded only about $86,000, the court
disallowed some of the claim compensation, because compensation paid to the principal
shareholders equalled taxable income which represented a “very large inroad” into profits.

the court noted that the business was a service-type corporation, *id.* at 688, but held that the
compensation was unreasonable because the corporation had paid no dividends on common stock.


158 *Id.* at 843.
invested in the insurance adjusting business was minimal. And in *Charles Schneider & Co., Inc.*, the court noted that only two percent of net earnings before executive compensation and taxes was set aside for retained earnings, but made no attempt to relate that amount to the amount of capital invested in the furniture and upholstery business.

On the surface, it appears that the failure of the courts to consider the nature of the business in reasonable compensation cases and their tendency to hold that claimed compensation is unreasonable even when the business is primarily a personal service business makes the reasonable compensation test a more stringent limitation on recharacterization of earnings than the material income producing test for unincorporated enterprises. But the courts seldom relate the amount of compensation to either the sum of annual dividends and retained earnings or to the rate of return on invested capital, and the amount allowed as reasonable compensation is unlikely to be as little as 30 percent of net profits. The gap between the “15 percent dividend rule” of *McCandless* and the 70 percent unearned income rule is certainly sufficient to make incorporation attractive.

VI. Summary and Conclusions

The maximum tax on earned income, as strengthened by the 1976 Tax Reform Act, operates as a deterrent to tax shelter investment by high income executives and professionals. Although it is impossible to determine whether it is quantitatively effective, the indirect mechanism of offering tax relief and taking it away to the extent of tax preferences is qualitatively effective. The definition of earned income for section 1348, which contains the presumption that certain sources of income are returns to labor, singles out a target group of taxpayers thought to be susceptible to the lures and risks of tax shelter investments. By penalizing tax preferences rather than eliminating the deductions which create them, the maximum tax reduces the benefits of accelerated deductions attributable to external investments with minimal deterrence of capital investments which generate similar accelerated deductions if they are made within an enterprise.

The maximum tax is, however, subject to serious criticism on other grounds. The primary objection has been that it destroys the progressive structure of the income tax. While that is a serious indictment, it is a question of fundamental social policy beyond the scope of this article. The analysis presented here indicates that section 1348 can be criticized because it creates inequitable results by branding some non-tax shelter deductions as tax preferences. And, as with most legislation designed to accomplish a specific objective by changing certain incentives, the maximum tax also changes other incentives in unintended and probably undesirable ways.

The benefit of the maximum tax rate was limited to earned income because Congress apparently believed that the revenue loss of extending it to all income

159 *Id.* at 838.
161 *Id.* at 153.
would be too large, and that it would be inequitable to lower tax on income from property which already had substantial tax advantages. The cost of this choice is to limit the tax-shelter deterrent effect of section 1348 to taxpayers with high earned incomes. In order to implement this limit, earned income must be defined. The definition adopted attempts to fulfill two criteria: to be sufficiently expansive to achieve the tax-shelter deterrent objective for the target group of taxpayers, and to be sufficiently restrictive to prevent the recharacterization of income from capital as income from labor for those taxpayers who have both the ability and incentive to do so.

The three categories of income established by the statute and the regulations do achieve a crude approximation to the desired results. The category of income which is presumptively earned, although overinclusive, accurately identifies taxpayers who have large amounts of ordinary income and little opportunity to invest within their trade or business in capital which yields accelerated deductions. But the limit on earned income to 30 percent of net profits in unincorporated enterprises in which capital is a material income-producing factor is easily avoided by incorporation, and it is inequitable to those enterprises which do not incorporate. Existing precedent for determining when capital is material is largely based on qualitative factors. As a result, capital is probably "material" in many enterprises where it produces only a small contribution to net profits. Even if a quantitative approach were utilized, the discrepancy between the 30 percent limit and the far more liberal standards applied to compensation received from corporations would induce incorporation.

The limit for corporations is the reasonable compensation test of section 162. Again, existing precedent is largely based on qualitative factors, and courts seldom look at the rate of return measured by dividends plus retained earnings as a percent of equity in deciding whether the amount deducted for salaries includes some disguised return on capital. The risks of the modest reductions in allowable deductions when compensation is found to be unreasonable are not sufficient to outweigh the effect of the maximum tax on the close corporation's incentive to pay earnings produced by capital as compensation to shareholder-employees.

The tax shelter deterrent objective is accomplished primarily by the effect of tax preferences on the maximum tax. For every dollar of tax preference items, a dollar of the taxpayer's earned income is taxed at the marginal rate which would apply if all income were unearned. Thus, if a taxpayer has all unearned income, there is no penalty for tax preferences and section 1348 has no deterrent effect on tax shelter investments. As that taxpayer does not benefit from the maximum tax, that result is not inequitable. Tax preferences include two items, however, which are not related to tax shelter investments: excess personal deductions and capital gains. Many tax shelter investments are sold for capital gain rather than held for ordinary income, but all capital gains deductions are tax preferences whether or not the original investment was a tax shelter. Neither the capital gains tax preference nor the excess deduction tax preference affects the decision to invest in a tax shelter. Including them as tax preferences for the purpose of section 1348 is inequitable because it imposes a penalty on high income taxpayers only if they have high earned income.
In view of the fact that the maximum tax achieves the objective of tax shelter deterrence at a substantial cost in terms of horizontal equity and unintended effects, it is appropriate to ask whether there is a more desirable alternative. One way to eliminate the major adverse effects created by section 1348 itself, and still retain the selective deterrent effect of the tax preference mechanism, is to extend the maximum tax to all income\textsuperscript{162} and impose a direct penalty on tax preference items for all taxpayers who benefit from the maximum tax.\textsuperscript{163} The tax revenue loss from this proposal would be minimal,\textsuperscript{164} and the 1976 Estate and Gift Tax reform has eliminated one of the major benefits to property income by providing for tax on appreciation of assets transferred at death. Treating earned and unearned income alike under the maximum tax would extend its tax shelter deterrent effect to all taxpayers regardless of the source of their income. Further, it would eliminate the present inequitable effect of including the capital gains deduction and excess personal deductions as tax preference items.

Because there would be no need to define income, the unworkable and inequitable 30 percent rule for unincorporated enterprises could be eliminated. The maximum tax would no longer provide an incentive to incorporate, and the burden on the reasonable compensation test would be reduced. If the maximum tax remained at 50 percent, however, close corporations would still be indifferent between paying out earnings as compensation and retaining them for reinvestment within the corporate solution.\textsuperscript{165} On the other hand, the incentive to recharacterize earnings as compensation to avoid double taxation of dividends would be reduced, because the difference in rates would be reduced from approximately 35 percent to about 25 percent.

The fundamental criticism of the maximum tax, that it is inconsistent with a progressive tax structure, would, of course, retain its validity. But, unless there is some equitable reason to favor earned income, elimination of a differential which depends on the source of income rather than the amount would not make the tax structure less fair. If the tax shelter deterrent effect of section 1348 is sufficient to justify its continued existence, the maximum tax should be extended to unearned income. The benefits could be retained and the principal weaknesses eliminated by removing the distinction between earned and unearned income and setting a dollar limit on the amount of income which could benefit from the maximum tax.

\textsuperscript{162} Early hints of the Carter Administration tax reform package indicate that this is under consideration. According to a recent newspaper article, the reform will seek fairness and simplicity rather than income redistribution. One proposal being considered is to remove the distinction between earned and unearned income by lowering the top tax on unearned income to 50 percent. Chicago Daily News, Mar. 14, 1977, at 10, col. 1.

\textsuperscript{163} This could be done by imposing a flat or graduated rate or by retaining the present tax rates above 50 percent and the present layering mechanism for calling them into play.

\textsuperscript{164} Only about two billion dollars per year is collected from brackets above 50 percent, S.R. REP. No. 94-938, Report of the Senate Finance Committee on H. R. 10612, 114, 94th Cong., 2nd Sess. (1976), 63 CCH SPECIAL NO. 7 (Jun. 16, 1976).

\textsuperscript{165} If this effect of the maximum tax is undesirable, it could be reduced by a modest increase in the top rate of, perhaps, five percent.