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## **Schedularity in U.S. Taxation, Its Effect on Tax Distribution, Comparison with Sweden**

Henry Ordower  
*Saint Louis University School of Law*

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Comparison with Sweden

Henry Ordower



Schedularity in U.S. Taxation, its Effect on Tax Distribution, Comparison with Sweden

A condensed version of this paper on U.S. schedularity only will appear in 108 Northwestern University Law Review, in its "100 Years under the Income Tax" Symposium

By

Henry Ordower, Professor of Law  
Saint Louis University School of Law

The United States uses a global model as the basis for its federal income tax system.<sup>1</sup> Characteristic of global systems is the Internal Revenue Code's definition of gross income.<sup>2</sup> The definition includes "all income from whatever source derived" and combines income from all sources under that single rubric of gross income.<sup>3</sup> Taxable income<sup>4</sup> upon which the Code imposes the income tax<sup>5</sup> also appears to combine deductions without regard to their source although the Code distinguishes business deductions<sup>6</sup> from all other deductions.<sup>7</sup>

Several economically developed countries, including Sweden,<sup>8</sup> Germany, and Canada, however, employ a schedular model of taxation. Schedular models classify income and related expenses by schedular class and may compute tax separately for each class.<sup>9</sup> Losses a taxpayer

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<sup>1</sup> Sylvain R.F. Plasschaert, SCHEDULAR, GLOBAL AND DUALISTIC PATTERNS OF INCOME TAXATION 17–24 (1988) (discussing schedular tax systems); Eric M. Zolt, The Uneasy Case for Uniform Taxation, 16 VA. TAX REV. 39, 49–50 (1996). Some scholars follow the usage in the U.S. foreign tax credit literature and refer to schedularity as "basketing" and schedular classes as "baskets." See, for example, Leandra Lederman, A Tisket, A Tasket: Basketing and Corporate Tax Shelters, 88 WASH. U. L. REV. 557 (2011) (recommending increased usage of income baskets to prevent tax sheltering).

<sup>2</sup> Section 61 of the Internal Revenue Code of 1986, as amended (the "Code") (defining gross income, the point from which the computation of taxable income, upon which the Code imposes the income tax, begins). This article refers to sections of the Code as "I.R.C. §" followed by a section number. The Code is Title 26 of the United States Code and assembles and organizes the tax laws of the United States.

<sup>3</sup> *Id.*

<sup>4</sup> I.R.C. §63(a) (defining taxable income as gross income less deductions).

<sup>5</sup> I.R.C. §1 (imposing a tax on the taxable income of individuals, trusts, and estates); I.R.C. §11 (imposing a tax on the taxable income of a corporation).

<sup>6</sup> I.R.C. §62 (combining deductions connected with the taxpayers business activities, other than activities as an employee).

<sup>7</sup> I.R.C. §63 (combining other deductions as itemized deductions).

<sup>8</sup> Sweden's Scandinavian neighbors, Denmark and Norway, both historically used a global model but transitioned to a moderately schedular system common with variations to Sweden and Finland, as well, that the literature refers to as a dual income tax. See, for example, Sijbren Cnossen, Taxing capital income in the Nordic Countries; a model for the European Union? in Sijbren Cnossen ed., TAXING CAPITAL INCOME IN THE EUROPEAN UNION: ISSUES AND OPTIONS FOR REFORM 180 (Oxford 2000)(explaining the characteristics of the dual income tax and recommending it for use throughout the European Union). Among American scholars recommending a dual income tax for the U.S., see Edward Kleinbard, An American Dual Income Tax: Nordic Precedents, 5 NW. J.L. & SOC. POL'Y 41, 42 (2010) (referring to separation of capital income from labor income where they overlap and citing principal English language sources on Nordic dual income taxes). And see *infra* note 27 and accompanying text.

<sup>9</sup> Plasschaert, *supra* note 1, at 1 (defining schedular systems as taxing various types of (net) income separately, global systems aggregating all types of income and deductions and subjecting the aggregate net income to a single,

incurs in one income class generally do not offset income in a different income class, although, in many instances, the taxpayer may carry the losses forward and sometimes backward to diminish taxable income in future or previous years in the same income class. Income not belonging to an income class is not taxable although many schedular jurisdictions include a residual class in order to tax income that otherwise might escape taxation.<sup>10</sup>

Taxing jurisdictions that use schedular systems do not necessarily define their various income classes uniformly. Germany, for example, divides income into seven categories,<sup>11</sup> including a residual category. The German income classes are income from agriculture and forestry,<sup>12</sup> conduct of a trade or business,<sup>13</sup> performance of independent services,<sup>14</sup> employment,<sup>15</sup> capital,<sup>16</sup> property rental and leasing,<sup>17</sup> and residual income.<sup>18</sup> Sweden, on the other hand, currently separates the income of individuals into only three classes.<sup>19</sup> Sweden's three classes of income are personal service income,<sup>20</sup> income from the conduct of a trade or business,<sup>21</sup> and capital income.<sup>22</sup> Germany<sup>23</sup> and Sweden<sup>24</sup> each tax capital income at a preferred

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progressive set of rates, and dualistic and hybrid systems as displaying elements of both schedular and global systems depending on the type of income).

<sup>10</sup> Germany, for example, has a schedular category of residual income ([S]onstige Einkünfte im Sinne des § 22, EStG II. 1. §2(1) 7, defined in EStG II. 8.g) (listing various types of income not included in the other categories, annuities, for example)). "EStG" in this article refers to das Einkommensteuergesetz in der Fassung der Bekanntmachung vom 8. Oktober 2009 (BGBl. I, S. 3366, 3862), das durch Artikel 7 des Gesetzes vom 22. Juni 2011 (BGBl. I S. 1126) geändert worden (Income Tax Law in the Text of the Publication of October 8, 2009, as amended by Article 7 of the Statute of June 22, 2011) (available at <http://www.gesetze-im-internet.de/estg/>).

<sup>11</sup> EStG §2(1) 1-7 (listing the income classes).

<sup>12</sup> Land- und Forstwirtschaft, EStG II. 1. §2(1) 1, defined in EStG II. 8.a).

<sup>13</sup> Gewerbebetrieb, EStG II. 1. §2(1) 2, defined in EStG II. 8.b).

<sup>14</sup> Selbstständige Arbeit, EStG II.1. §2(1) 3, defined in EStG II. 8.c).

<sup>15</sup> Nicht selbstständige Arbeit, EStG II.1. §2(1) 4, defined in EStG II. 8.d).

<sup>16</sup> Kapitalvermögen, EStG II. 1. §2(1) 5, defined in EStG II. 8.e).

<sup>17</sup> Vermietung und Verpachtung, EStG II. 1. §2(1) 6, defined in EStG II. 8.f).

<sup>18</sup> [S]onstige Einkünfte im Sinne des § 22, EStG II. 1. §2(1) 7, defined in EStG II. 8.g) (listing various types of income not included in the other categories, annuities, for example).

<sup>19</sup> Inkomstskattelag (1999:1229) (Income tax law of 1999, as amended ("IL" in the following))(available at <https://lagen.nu/1999:1229#K1R8>).

<sup>20</sup> Tjänst in Swedish, IL 10. kap. 10, 1 §: Till inkomstslaget tjänst räknas inkomster och utgifter på grund av tjänst till den del de inte ska räknas till inkomstslaget näringsverksamhet eller kapital.

2. stk. Med tjänst avses

1. anställning,

2. uppdrag, och

3. annan inkomstgivande verksamhet av varaktig eller tillfällig natur.

(In the income class services is figured income and expenses on account of service to the extent it is not included in the income class conduct of a trade or business or capital. 2d para. With services is intended 1. Employment, 2. Assignment, and 3. Other income yielding activity of lasting or temporary nature. Author's translation.)

<sup>21</sup> Näringsverksamhet in Swedish. IL kap. 13, 1 §: Till inkomstslaget näringsverksamhet räknas inkomster och utgifter på grund av näringsverksamhet. Med näringsverksamhet avses förvärvsverksamhet som bedrivs yrkesmässigt och självständigt. (In the income category conduct of a trade or business is included income and expense on account of a trade or business. With the term trade or business is intended an activity conducted professionally (for profit) and independently. (Author's translation.))

<sup>22</sup> Kapital in Swedish. IL kap. 40, 1 §: Till inkomstslaget kapital räknas inkomster och utgifter på grund av innehav av tillgångar och skulder, och i form av kapitalvinster och kapitalförluster.

rate and all other income, regardless of schedular class on a single rate schedule.<sup>25</sup> Germany also has a special income averaging regime that ameliorates the effect of its progressive rates on extraordinary receipts for low and moderate income individuals.<sup>26</sup> Recent literature refers to Sweden's schedular income tax system, like the systems of Sweden's Nordic neighbors, Denmark and Norway as a "dual income tax" (a subset of a schedular system) because it primarily separates income into capital income, on the one hand, and trade or business and personal service income, on the other hand.<sup>27</sup> Scholars have recommended use of schedular structures to diminish tax planning and improve collection of revenue in the United States.<sup>28</sup>

There may be accelerating convergence between global and schedular systems. Neither the United States' global income tax system nor Sweden's or Germany's schedular systems are free from elements of the other tax model.<sup>29</sup> A purely global system would combine all inclusions in and deductions from income into a single computation of tax liability. A closer look at the Code reveals that the United States tax system in fact is quite schedular. It separates income into several categories and treats each category differently from each other category in computing taxes. Special taxing rules and rates apply to each of investment income, especially capital gains and losses,<sup>30</sup> personal service income,<sup>31</sup> and tax exempt income.<sup>32</sup> Those rules cause each of those categories of income to require computations of tax separate from the

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2. stk Till inkomstslaget kapital räknas inte inkomster och utgifter som räknas till inkomstslaget näringsverksamhet. (In the income category capital is included income and expense on account of ownership of assets and debts in the form of capital gains and capital losses. 2d para. In the category capital is not included income and expense included in the category conduct of a trade or business. (Author's translation.))

<sup>23</sup> EStG IV. § 32d (imposing in Germany separate tax at a 25% rate for capital income).

<sup>24</sup> IL 65 kap. 7 § (imposing a 30 percent rate on individuals' capital income).

<sup>25</sup> EStG IV. § 32a (imposing in Germany a maximum rate of 45%) with a progressive structure from 0% to 45% on the initial 205,401 Euros. In Sweden, under IL kap. 65, 3 §, income from personal services and income from the conduct of a trade or business is subject to communal (kommunal) income tax consisting of a combined municipal and county (landting) income tax on resident taxpayers resident. In 2010 the maximum local tax in Stockholm was 30.5 percent. Sven-Olof Lodin et al., INKOMSTSKATT – EN LÄRO- OCH HANDBOOK I SKATTERÄTT 55 (Lund 2011) ("Lodin, INKOMSTSKATT" in the following). In addition, the personal service and trade or business income in excess of SEK 367,600 is subject to a national income tax of 20% and the amount in excess of SEK 526,200 a national income tax of 25% (expressed as an addition 5% tax on income in excess of SEK 526,200). IL kap. 65, 5 §. IL kap. 65, 5 §, stk. 3 adjusts the 20% and 25% thresholds for inflation.

<sup>26</sup> EStG IV. §33 (rate averaging at five times one-fifth for extraordinary income receipts). The averaging helps taxpayers whose income is less than that amount at which the maximum marginal rate takes effect and will not help taxpayers whose income excluding the extraordinary receipt would be taxed at Germany's maximum marginal rate.

<sup>27</sup> For example, Kleinbard, *An American Dual Income Tax*, supra note 8 at 41, 42 (2010) (referring to separation of capital income from labor income where they overlap and citing principal English language sources on Nordic dual income taxes).

<sup>28</sup> Lederman, *A Tisket, a Tasket*, supra note 1 (recommending increased usage of income baskets to prevent tax sheltering); Yaron Z. Reich, *The Case for a "Super-Matching" Rule*, available at: <http://ssrn.com/abstract=1932850> (recommending better matching of income and expenditure). Consider the passive activity losses and credits limitation under I.R.C. §469, discussed *infra* in text accompanying note 50.

<sup>29</sup> See discussion *infra* in text accompanying and following note 40.

<sup>30</sup> See discussion of investment income, especially capital gain and loss, *infra* in Part I. And compare the schedular feature of the passive activity loss limitations in the United States, I.R.C. §469. Discussed *infra* in text accompanying note 50.

<sup>31</sup> See discussion *infra* in Part II.

<sup>32</sup> See discussion *infra* in Part III.

computation of tax on a taxpayer's aggregate income.<sup>33</sup> Except for the expenses of producing tax exempt income,<sup>34</sup> the United States income tax does not match expenses expressly to income category. Nevertheless, deductions frequently follow the income class. For example, depreciation allowances for property that the taxpayer uses in her trade or business match to the property,<sup>35</sup> capitalization rules attach expenditures to the basis of property or cost of goods sold,<sup>36</sup> and other rules separate expenses in income producing activities from more personal activities.<sup>37</sup> More generally, the Code distinguishes between types of deductions and classifies some deductions as adjustments to gross income<sup>38</sup> that provide a tax benefit to the taxpayer without regard to their aggregate amount and others as itemized deductions that provide a tax benefit only if in the aggregate they exceed the taxpayer's standard deduction.<sup>39</sup>

Insofar as the schedular elements in the United States tax system do not isolate each category of income with its accompanying deductions from each other category and compute a separate tax on the net income from each category, the system is a hybrid of global and schedular. In a pure schedular system expenses from one category never would be deductible from income in a different category nor would expenses overlap categories.<sup>40</sup> But even purportedly schedular systems like Sweden's are not pure. While Sweden isolates losses from services from losses from the conduct of a trade or business, it combines income from personal services with income from the conduct of a trade or business, taxes the combined amount at a single rate, and has a category of basic deductible expenses that overlaps the categories.<sup>41</sup> Sweden also may re-characterize capital income according to its substance as properly belonging in one of the other categories.<sup>42</sup> These features of the Swedish and neighboring tax systems have caused scholars to refer to them as dual income taxes rather than broadly schedular taxes.<sup>43</sup> Germany permits some losses from one category to offset income from other categories.<sup>44</sup>

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<sup>33</sup> I.R.C. §1

<sup>34</sup> I.R.C. §265 (denying a deduction for the expenses of producing tax exempt income).

<sup>35</sup> I.R.C. §§167, 168 (providing an allowance for depreciation).

<sup>36</sup> I.R.C. §§263, 263A (requiring capitalization of expenditures and absorption into the cost of goods sold).

<sup>37</sup> I.R.C. §280A (limiting deductions from the business use of one's personal residence); I.R.C. §183 (limiting deductions from income producing hobby activities).

<sup>38</sup> I.R.C. §62 (defining adjusted gross income as gross income less certain deductions most, but not all, of which relate directly to the taxpayer's business activities. Many tax professionals refer to I.R.C. §62 deductions as "above the line" deductions).

<sup>39</sup> I.R.C. §63(b), (c) (allowing most taxpayers a uniform deduction, called the standard deduction, against the taxpayer's gross income without regard to the actual amount of the taxpayer's expenditures).

<sup>40</sup> See, for example, Lodin, *INKOMMSTSKATT*, *supra* note 25, at 163 (discussing carryforward of loss in personal service income category to the following 5 years and citing IL 10 kap. 16 §). IL 10 kap. 16 § 2 stk. no longer limits the carryforward to five years. Instead it renews the loss annually in computing the following year's income from the services category as the capital loss carryover in I.R.C. §1212(b) renews the capital loss from year to year. .

<sup>41</sup> *Id.* at 70-1.

<sup>42</sup> *Id.* at 67 and see discussion *infra* in Part III.C.

<sup>43</sup> Sven-Olof Lodin, *THE MAKING OF TAX LAW: THE DEVELOPMENT OF THE SWEDISH TAX SYSTEM* (Amsterdam, 2011) (analyzing the history of the Swedish tax system through to its current two tier structure); Kleinbard, *An American Dual Income Tax*, *supra* note 8.

<sup>44</sup> EStG §2 (adds both net income and net loss from the various schedular income categories before imposing the tax on the overall net income under sources under EStG §32a with a special tax rate for net income from capital under EStG § 32d).

Whether global, schedular, or hybrid, income taxation statutes leave ambiguities in their application. Scholars and the media in countries purportedly global or schedular complain of the complexity of the income tax system.<sup>45</sup> In fashioning tax legislation, legislatures from both global and schedular systems borrow from the other model to achieve various policy objectives including limiting tax planning.<sup>46</sup> Of Sweden, Germany, and the United States, none has eliminated tax planning that is inconsistent with the legislative purpose in specific tax statutes.<sup>47</sup> Each country has adopted a general anti-avoidance rule to help combat such tax planning.<sup>48</sup> In each country tax professionals and scholars have complained that the anti-avoidance rules are unnecessary and even unconstitutional.<sup>49</sup>

The United States has turned to schedularity in its personal income tax system on several occasions to combat tax sheltering. The maximum tax on earned income, for example, separated personal service income from investment income at the upper end of the rate schedule to discourage individuals from sheltering personal service earnings with tax advantaged investments.<sup>50</sup> Within a few years following the repeal of the maximum tax on personal service income,<sup>51</sup> the broader schedular feature of the passive activity losses and credits limitation<sup>52</sup> became part of the Code. That provision limits the deduction of losses from activities in which

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<sup>45</sup> See, for example, Stanley Surrey, Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail, 34 LAW AND CONTEMP. PROBS. 685 (1969) (discussing the complexity of the required sub-classifications of the schedular tax system).

<sup>46</sup> Thuronyi, COMPARATIVE TAX LAW (the Hague 2003), Anthony C. Infanti, The Ethics of Tax Cloning, 6 Fla. Tax. Rev. 251 (2003). I.R.C. §469 (limiting deduction of expenses from passive activities to income from passive activities).

<sup>47</sup> See, generally, Henry Ordower, The Culture of Tax Avoidance, 55 SAINT LOUIS U L J 47, 94 (2010).

<sup>48</sup> *Id.* In Germany, see Abgabenordnung [AO] [GENERAL TAX CODE], Bundesgesetzblatt, Teil I [BGBl.I] at 26, § 42 (Ger.); in Sweden 15 ch. 2, 3 §§ Lagen mot Skatteflykt [Tax Avoidance (Flight) Law] 1995:575 (Swed.), available at <https://lagen.nu/1995:575>; and in the United States I.R.C. §7701(o) (a law clarifying the economic substance doctrine).

<sup>49</sup> Crystal Tandon, Economic Substance Codification Would Create More Problems Than It Solves, Says Korb, 118 TAX NOTES 777 (February 18, 2008) (Donald Korb, then chief counsel for the IRS, strongly opposed codification of the economic substance doctrine. Korb was concerned that a statutory provision would restrict the range of arguments that the IRS might make rather than improving the frequency of IRS' success in application of economic substance to abusive tax structures.) .Anders Hultqvist, Skatteundvikande förfaranden och skatteflykt, SVENSK SKATTETIDNINGEN (Swedish Tax Journal) 5/2002 302 (Title: Tax avoidance transactions and tax flight (author's translation)) (detailing the shortcomings of the Swedish general anti-avoidance rule ("GAAR") for lack of consistent application and problems of conflict with other statutory interpretation issues, in particular the need to identify legislative statutory intent where it is necessary to hypothesize that intent in applying the GAAR); Klaus-Dieter Drüen, Unternehmerfreiheit und Steuerumgehung (Entrepreneurial Freedom and Tax Avoidance (author's translation)) 158, 2d column, StuW 2/2008 (raising the constitutional requirement of certainty of rules as a possible barrier to enforcement of a GAAR).

<sup>50</sup> The Tax Reform Act of 1969, PL 91-172, 83 Stat. 685 (1969) added section 1348 to the Internal Revenue Code of 1954, as amended (the "1954 Code") (maximum tax on earned income). The maximum tax on earned income under section 1348 limited the maximum marginal rate of tax on income from labor to 50 percent while the maximum marginal rate on investment income was 70 percent. The Economic Recovery Act of 1981, P.L. 97-34, §101(c)(1) (12/28/90) repealed the maximum tax as renamed the maximum tax on personal service income and leveled the rates on income from labor and investment.

<sup>51</sup> *Id.* But the maximum tax was only one element of personal service income schedularity. The income tax remains schedular in this respect. See discussion *infra* in part II.

<sup>52</sup> I.R.C. §469, added by the Tax Reform Act of 1986 ("TRA 86"), 99 P.L. 514 (October 22, 1986).

the taxpayer does not participate materially<sup>53</sup> to income from similar activities. In 1986, most tax shelters were limited partnerships engaged in a trade or business that generated substantial tax losses and, sometimes, credits.<sup>54</sup> Passive investors purchased limited partnership interests in those activities in order to claim a share of the tax losses that the investors could use to offset income from their primary business activities.<sup>55</sup> Although the investors were limited partners who had neither a decision-making nor an operational role in the limited partnership, partnership tax rules deemed the investors to be engaged in the partnership's business.<sup>56</sup> Each partner included his share of the partnership's tax items – income, loss, deduction, credit – in his own separate tax computation.<sup>57</sup> Thus, the schedular passive activity loss limitations prevent those passive investor partners from using losses from the investment to offset or shelter income from the activities in which the investors participate materially.<sup>58</sup>

The principles of horizontal and vertical equity underlie the development of both global and schedular tax systems in advanced economies. Horizontal equity seems an indisputable precept. The horizontal equity principle is straightforward. It requires that like taxpayers incur like tax burdens. Two taxpayers with identical incomes and identical expenses should pay identical amounts of tax.<sup>59</sup> Identifying which taxpayers are identical is often difficult, but people tend to agree on the principle.

A global system that treats all income alike would seem to identify like taxpayers more readily than a schedular system in which taxpayers would only be like if they had identical amounts of income in each class. Like taxpayers probably always is an approximate concept but a more comprehensive measure of income than what emerges from application of existing tax laws is critical to any fair comparison of taxpayers. Intended<sup>60</sup> and unintended<sup>61</sup> differences between “taxable” income and “real” or “comprehensive” income in all income tax systems render implementation of horizontal equity elusive. Professor Simons presented what has become a classic definition of income:

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<sup>53</sup> I.R.C. §469(c) (defining passive activity as trades or businesses in which the taxpayer does not participate materially); I.R.C. §469(h) (providing a standard for determination of “material participation” as a function of regular, continuous, and substantial activity); I.R.C. §469(i) (substituting a lower participation threshold or “active participation” for real estate activities). Temporary regulations interpreting I.R.C. §469 define “material participation” and “active participation” primarily in terms of hours that the taxpayer devotes to the activity. Treas. Reg. §1.469-5T (material participation).

<sup>54</sup> Henry Ordower, *The Culture of Tax Avoidance*, *supra* note 47, at 56-68.

<sup>55</sup> *Id.*

<sup>56</sup> I.R.C. §702(b) (imputing the source of the income of the partnership to each partner).

<sup>57</sup> I.R.C. §§701, 702(a) (taxing partners on their shares of the partnership's tax items).

<sup>58</sup> I.R.C. §469. Henry Ordower, *The Culture of Tax Avoidance*, *supra* note 47, at 56-68.

<sup>59</sup> Henry Ordower, *Horizontal and Vertical Equity in Taxation as Constitutional Principles: Germany and the United States Contrasted*, 7 FLA. TAX REV. 259, 271 (2006).

<sup>60</sup> Policy-based exclusions from income such as gifts under I.R.C. §102, life insurance proceeds under I.R.C. §101, municipal bond interest under I.R.C. §103, and deductible items, for example, allowances for depreciation under I.R.C. §168, that differ from economic reality.

<sup>61</sup> Exclusion of unrealized gains, but compare I.R.C. §1256 for an exception requiring marking to market of certain assets, non-imputation of income from owner occupied residences and services within family-type units, as well as valuation uncertainty for non-cash items, for example, steamship ticket case.



[p]ersonal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and the end of the period in question. In other words, it is merely the result obtained by adding consumption during the period to “wealth” at the end of the period and then subtracting “wealth” at the beginning.<sup>62</sup>

Professor Simons definition comes closer a comprehensive income concept than do existing statutory definitions, but he acknowledges that payments in kind and imputed value from consumption of one’s own services and property present formidable problems of valuation.<sup>63</sup> This article will use the term “comprehensive income” to refer to the Simons<sup>64</sup> definition with the clarification that the imputed use value of owned property like one’s personal residence as well as non-taxable rendition of services for oneself and members of one’s household ought to be includable in the measure of consumption.

The principle of vertical equity led to the development of the progressive rate structures characteristic of the development of personal income tax systems in advanced economies. Its application and limitations have proven to be more of a challenge than horizontal equity.<sup>65</sup> Vertical equity departs from the principle that as one’s income or, possibly, wealth, increases, one can and should contribute more of that income to supporting governmental services.<sup>66</sup> The wealthier one is, the less likely that an increased tax burden will diminish the individual’s welfare in any material way. Conversely, the less wealthy one is, the more likely that an increased tax burden will diminish the individual’s welfare materially. Recognizing these fundamental welfare propositions, governmental services may include an element of redistribution of some of that income to less wealthy or lower income individuals through various subsidies. The welfare states of northern Europe during the twentieth century all relied

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<sup>62</sup> Henry C. Simons, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 50 (Chicago 1938). See, also elaboration on the algebraic formula in Michael J. McIntyre, Appendix: Algebraic Expressions of Haig/Simons Income, Haig/Simons Consumption and Realized Income, 30 WAYNE L.REV. 1087 (1984).

<sup>63</sup> *Id.* at 52-54.

<sup>64</sup> Usually referred to as the Haig-Simons definition owing to other works in the field by Robert M. Haig, "The Concept of Income—Economic and Legal Aspects" in THE FEDERAL INCOME TAX: A SERIES OF LECTURES DELIVERED AT COLUMBIA UNIVERSITY IN DECEMBER, 1920 1–28. (New York 1921).

<sup>65</sup> The classic work cataloging arguments for progressive taxation is Walter J. Blum and Harry Kalven, Jr., THE UNEASY CASE FOR PROGRESSIVE TAXATION (Chicago, 1953). The German Constitutional Court, in holding that taxpayers whose jobs and family structure required them to maintain permanently two residences must be treated the same as taxpayers whose secondary residence was purportedly temporary but who might have a series of temporary placements, observed with respect to horizontal and vertical equity that: "... taxpayers who have the same ability to pay should be taxed equally (horizontal tax equity), while (in the vertical direction) taxation of higher incomes should be *measured against* the taxation of lower incomes. Decision of December 4, 2002, BVerfGE 107, 27, 46. Author’s translation. Emphasis added. The German reads: "...Steuerpflichtige bei gleicher Leistungsfähigkeit auch gleich hoch zu besteuern (horizontale Steuergerechtigkeit), während (in vertikaler Richtung) die Besteuerung höherer Einkommen im Vergleich mit der Steuerbelastung niedriger Einkommen angemessen sein muss." For further discussion of the decision, see Henry Ordower, Horizontal and Vertical Equity in Taxation as Constitutional Principles, *supra* note 59, at 303-5 (2006).

<sup>66</sup> Estate taxes in the United States, Germany, and Sweden (repealed in 2007) rely on the vertical equity principle, as did the general wealth taxes that both Germany and Sweden formerly had. (Cites and elaboration).

on steeply progressive income taxes to accomplish the leveling of resource distribution throughout the society.<sup>67</sup>

Progressive structures have been under siege for the past several decades.<sup>68</sup> Both corporate and individual income taxes have been under steady tax rate reduction pressure although among the proposals to reduce rates, none have abandoned the vertical equity principle completely. Each proposal would apply a zero rate of tax to some low income individuals. Downward rate pressure in part has been a function of concerns about the international tax competition that has accompanied increasing globalization of the world economy. People at the upper end of the income and wealth spectrum often have the ability to move capital offshore and, in some cases, hide that capital.<sup>69</sup> Some high income individuals even have expatriated to low tax jurisdictions. Similarly, major corporations may avail themselves of transfer pricing techniques and other tax planning tools to shift income to related and subsidiary entities in lower tax jurisdictions.<sup>70</sup>

Even if the basic income tax remains gently or steeply progressive, it is unlikely to be the only revenue source for a government. The United States, Germany, and Sweden all have additional taxes on the revenue or income from individuals' personal services.<sup>71</sup> Each country

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<sup>67</sup> **Cites to welfare state literature.**

<sup>68</sup> Flat tax proposal cites, decreasing individual and corp maximum marginal tax rates.

<sup>69</sup> See, generally, Henry Ordower, United States National Report on Burden of Proof in Tax Matters at IV.A.4 (2011) (available at <http://eatlp.org/uploads/public/Burden%20of%20Proof%20-%20USA.pdf>, the website of the European Association of Tax Law Professors in conjunction with the 2011 Meeting in Uppsala, Sweden); publication in BURDEN OF PROOF IN TAX MATTERS (Amsterdam, forthcoming), and *infra* note 144 and accompanying text. The IRS, as well as the tax authorities in several European jurisdictions, increasingly have sought to identify and tax income from accounts and complex structures that conceal income otherwise taxable in the U.S. or the other jurisdictions, including Switzerland and Liechtenstein. See, generally, Ordower, Tax Avoidance Culture, *supra* note 47, at 123-125. The IRS offered reduced penalty settlement initiatives in 2009 and 2011 to encourage taxpayers who had not reported income and assets they lodged offshore to voluntarily disclose that income and those assets. IRS, 2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers (available at <http://www.irs.gov/Businesses/International-Businesses/2011-Offshore-Voluntary-Disclosure-Initiative-Frequently-Asked-Questions-and-Answers>). In order to provide expanded jurisdiction and enforcement tools to the IRS with respect to offshore accounts, Congress passed and the President signed the Foreign Account Tax Compliance Act ("FATCA") as Title V of the Hiring Incentives to Restore Employment Act, PL 111-147 (March 18, 2010) (imposing reporting requirements on foreign financial institutions for accounts that U.S. persons beneficially own, imposing additional reporting requirements on U.S. persons with respect to their foreign accounts; and adding penalties for non-compliance).

<sup>70</sup> See discussion in Part I.C. *infra*.

<sup>71</sup> Social security, self-employment, and Medicare taxes in the U.S., I.R.C. §§ 3101, 1401; Sozialversicherungsabgaben (Arbeitnehmer) a) Gesetzliche Krankenversicherung b) Gesetzliche Rentenversicherung c) Gesetzliche Arbeitslosenversicherung d) Soziale Pflegeversicherung (Social security contributions (Employees) a) Statutory health insurance b) Statutory pension insurance c) Statutory unemployment insurance d) Statutory long-term care insurance) in Germany (information from the website of the European Commission, Taxation and Customs Union at [http://ec.europa.eu/taxation\\_customs/tedb/taxDetail.html?id=2461/1341228665&taxType=SSC+employees](http://ec.europa.eu/taxation_customs/tedb/taxDetail.html?id=2461/1341228665&taxType=SSC+employees)); Arbetsgivaravgifter (Employers' social security contributions) (*id.* at [http://ec.europa.eu/taxation\\_customs/tedb/taxDetail.html?id=888/1329868800&taxType=SSC+employers](http://ec.europa.eu/taxation_customs/tedb/taxDetail.html?id=888/1329868800&taxType=SSC+employers)) in Sweden are imposed on the employer only and on self-employed individuals.

also has consumption-based taxes,<sup>72</sup> and, if not currently, then historically, property<sup>73</sup> or wealth-based taxes, including taxes on transmission of wealth such as estate, inheritance and gift taxes.<sup>74</sup> While wealth transmission taxes often are progressive in rate structure, the other taxes that do not use net income for their base tend to be regressive in rate structure or impact. For example, broad-based taxes on consumption, like value added taxes, usually take a larger share of the incomes of lower income individuals than of higher income individuals because higher income individuals may invest part of their income while lower income individuals must consume all or nearly all their income for their food, clothing, shelter, and related items. Some of the non-income taxes like wage income-based social security taxes correlate directly with income. Others correlate less directly. The tax bases for sales tax, value added tax, wealth tax, and property tax are independent of the taxpayer's income but all are likely to increase as the taxpayer's income increases. The increases, however, are not necessarily proportional to income.

Historically, all the taxes that did not utilize net income as their base, except wealth and wealth transmission taxes,<sup>75</sup> used a substantially flat tax rate or even a declining rate structure rather than a progressive, graduated rate scale like the scales that have characterized the income tax in the United States and Europe. With limited exceptions, consumption<sup>76</sup> and property<sup>77</sup>

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<sup>72</sup> In Germany, Umsatzsteuergesetz in der Fassung der Bekanntmachung vom 21. Februar 2005 (BGBl. I S. 386), das durch Artikel 6 des Gesetzes vom 16. Juni 2011 (BGBl. I S. 1090) geändert worden ist ("UStG") (Turnover tax in the version promulgated February 21, 2005, which was revised by Article 6 of the law of June 16, 2011). Germany's turnover tax for all practical purposes is a value added tax; in Sweden, Mervärdskattelagen (Value Added Tax Law) 1994:200, (1994-03-30), as amended ("ML") available at <https://lagen.nu/1994:200#K7R1>; in the U.S., excise taxes under subtitles D and E of the Code, but the states impose the bulk of consumption taxes in the U.S. in the form of sales and complementary use taxes.

<sup>73</sup> In the U.S., state or local governmental units impose *ad valorem* real property taxes so that the taxes are not uniform throughout the U.S. Sweden imposes a real property tax on the value of real estate under Fastighetstaxeringslag (1979:1152) (12-20-79) available at <https://lagen.nu/1979:1152>; Germany imposes a real property tax as well, Grundsteuergesetz vom 7. August 1973 (BGBl. I S. 965), das zuletzt durch Artikel 38 des Gesetzes vom 19. Dezember 2008 (BGBl. I S. 2794) geändert worden ist (Real Property Tax Law of August 7, 1973, most recently amended by Article 38 of the law of December 19, 2008) available at [http://www.gesetze-im-internet.de/grstg\\_1973/BJNR109650973.html#BJNR109650973BJNG000100314..](http://www.gesetze-im-internet.de/grstg_1973/BJNR109650973.html#BJNR109650973BJNG000100314..)

<sup>74</sup> The U.S. imposes a tax on the transmission of wealth at death under I.R.C. §2001 et seq. (estate tax) and a complementary tax on the lifetime gratuitous transmission of wealth under I.R.C. §2501 et seq. (gift tax). Germany has a relatively new combined inheritance and gift tax law, Erbschaftsteuer- und Schenkungsteuergesetz in der Fassung der Bekanntmachung vom 27. Februar 1997 (BGBl. I S. 378), das zuletzt durch Artikel 14 des Gesetzes vom 8. Dezember 2010 (BGBl. I S. 1768) geändert worden ist (Inheritance and Gift tax law in the version promulgated February 27, 1997, most recently amended by the law of December 8, 2010) ("ErbStG"). The German Constitutional Court struck down the earlier version of the Germany inheritance and gift tax law, along with the German wealth tax, because of the difficulty determining the fair value of property uniformly. BVerfGE 93, 165, (June 22, 1995) (striking down the inheritance tax); BVerfGE 93, 121, (June 22, 1995) (striking down the wealth tax). Sweden repealed its inheritance tax in 2004.

<sup>75</sup> Gift, inheritance, and estate taxes, for example.

<sup>76</sup> Sales and value added taxes sometimes impose a lower or zero rate on necessities, groceries, children's clothing, etc. in order to counteract some of their regressivity. For example, Sweden imposes a general VAT rate of 25 percent on goods and services but a 12 percent rate on various food product (but less compellingly also on transient accommodations including hotels, restaurant meals, and various collectibles) and a six percent rate on books, newspapers, magazines, and admission to sports and entertainment venues. ML (Sweden VAT) 7 kap. 1 §. Compare, Section 114.014 RSMo reduces the general sales tax by three percent (from 4.225 to 1.225 percent) on most food items in Missouri.

taxes generally apply a uniform rate. The social security tax in the United States applies a flat rate to gross wages<sup>78</sup> but has a wage cap<sup>79</sup> so that a zero rate applies to wages in excess of the cap amount. Germany similarly caps its social security contributions but, unlike the United States, the caps vary from contribution to contribution.<sup>80</sup> As a result of the cap, the social security tax has a reverse graduated rate scale.<sup>81</sup> Also except for wealth transmission taxes and, in the United States the self-employment tax, those other taxes do not take expenses into account. For example, the social security and Medicare taxes provide no allowance for expenses wage earners incur in producing those wages,<sup>82</sup> but the complementary self-employment and Medicare taxes for self-employed individuals allow deductions for all business expenses in determining the amount or earnings subject to the tax.<sup>83</sup>

Analysis of the relationship between a taxpayer's overall tax burden and her income or wealth would be incomplete without taking taxes other than income taxes into account. In response to those globalization concerns and pressure from the wealthy and corporate communities, legislatures have relied increasingly on regressive taxes.<sup>84</sup> Hence the historically progressive taxes, estate taxes, wealth taxes and income taxes have trended toward declining

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<sup>77</sup> Some jurisdictions distinguish between commercial and residential properties. Jerome R. Hellerstein and Walter Hellerstein, *STATE AND LOCAL TAXATION: CASES AND MATERIALS* at 100 (St. Paul 2001)..

<sup>78</sup> I.R.C. §3101(a) (imposing a 6.2 percent rate -- temporarily 4.2 percent -- on an individual's income from employment). I.R.C. §3111(a) imposes a like tax on the employer but with no temporary reduction. The employee probably bears some or all of the employer's tax in the form of lower wages. Cites

<sup>79</sup> For 2012, the wage cap above which no social security (or self-employment) tax applies is \$110,100. See U.S. Social Security Administration, 2012 Social Security Changes, available at

<http://www.socialsecurity.gov/pressoffice/factsheets/colafacts2012.htm> (last visited January 2, 2012). I.R.C. §3121(a)(1) (excluding from the base for the social security tax amounts exceed the Social Security contribution base under section 230 of the Social Security Act. That base changes with inflation.

<sup>80</sup> *Supra* note 71. Pension and unemployment taxes reach only the first 67,200 Euros and the health care related taxes reach the first 45,900 Euros of wage and benefit income.

<sup>81</sup> See discussion *infra* in Part II.D.

<sup>82</sup> I.R.C. §3101 imposes the tax on wages defined in I.R.C. §3121 as the gross amount of wages with deductions only for salary reduction arrangements for health insurance and flexible spending arrangements (items the Code treats as if they were employer provided non-taxable benefits). Note, however, that wage earners do not fare well under the income tax either as business expenses of most employees are less usable itemized deductions under I.R.C. §63 rather than adjustments to gross income under I.R.C. §62, *supra* note 38. The Code limits those deductions further by subjecting them to the 2 percent floor on miscellaneous itemized deductions under I.R.C. §67.

<sup>83</sup> I.R.C. §1401 (imposing the tax); I.R.C. §1402(a) (defining net earnings as gross income less deductions attributable to the activity).

<sup>84</sup> Those more regressive taxes impact the less wealthy populace and may be less vulnerable to lobbying because no effective, organized and well-funded constituency complains about and lobbies against them..

rates or repeal<sup>85</sup> while traditionally more regressive consumption taxes like value added taxes have borne an increasingly critical share of the revenue burden.<sup>86</sup>

This paper exposes the embedded schedularity of the United States federal income tax system. The system is schedular in the three principal areas of investment income, personal services income, and tax free income. This paper compares and contrasts these schedular areas with features of schedular tax systems like Sweden or Germany, primarily Sweden, and seeks to ascertain whether each schedular feature enhances or undercuts horizontal and vertical equity of the income taxes. Part I addresses investment income, with emphasis on capital gain. Part II focuses on income from personal services, including the earned income credit and carried interests, and identifies multiple discrete sub-classes of personal service income. Part III examines tax exempt income as a schedular class. Part IV observes that Congress has used schedular elements to accomplish distributional policy goals, initially in order to protect progressivity, but more recently that usage has shifted to increase overall regressivity in taxation. Part IV concludes that United States taxation seems to be moderately schedular and that schedularity in the United States contributes to regressivity in taxation. Finally, Part IV observes that abandoning a global and broad-based income tax system in favor of a national sales or other consumption based tax in which invested, rather than consumed, income is not taxable<sup>87</sup> would only make taxation in the United States more regressive than it already is. At the same time, abandoning a progressive rate structure in the income tax in favor of a flat tax<sup>88</sup> would eliminate an already deteriorating barrier to regressivity.

**Part I. Capital Gain and other Investment Income.** This part addresses some schedular elements that have been part of the United States income tax system for many years. Among those durable schedular elements, preferential treatment of long term capital gains, and

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<sup>85</sup> Germany and Sweden both had wealth taxes and inheritance taxes, see note 74 *supra*, that were a function of wealth or passage of wealth. Currently neither Germany nor Sweden has a wealth tax and Sweden no longer has an inheritance tax. Similarly, the U.S. estate tax disappeared in 2010 and, when it returned in 2011, Congress limited it to very large estates until 2013, P.L. 111-312 amended I.R.C. §2001(c) to reduce the maximum estate tax rate to 35 percent and I.R.C. §2011(c) to provide a inflation adjusted basic exemption amount of \$5 million so that the estate tax applies only to estates greater than \$5 million. Both provisions are temporary and expire at the end of 2012. Unless Congress amends the law further, as it is likely to do, the maximum rate would increase to 50 percent and the exemption decline to \$1 million.

<sup>86</sup> For example, the share of governmental revenues that the value added tax produced in Sweden from the year 2000 to 2010 increased gradually from 16.88 percent to 21.29 percent. European Commission Taxation and Customs Union, available at [http://ec.europa.eu/taxation\\_customs/tedb/taxDetail.html?id=531/1330473600&taxType=VAT](http://ec.europa.eu/taxation_customs/tedb/taxDetail.html?id=531/1330473600&taxType=VAT). During the same period, the personal income tax in Sweden accounted for a decreasing percentage of tax revenue, declining from 29.86 percent to 25.28 percent. *Id.* available at [http://ec.europa.eu/taxation\\_customs/tedb/taxDetail.html?id=1701/1330905600&taxType=PIT](http://ec.europa.eu/taxation_customs/tedb/taxDetail.html?id=1701/1330905600&taxType=PIT). In addition, recent financial crises and risks that governments like Greece and Spain will default on sovereign debt suggest that governments are relying more heavily on sovereign debt to offset shortfalls in tax revenue.

<sup>87</sup> Sales taxes and other consumption taxes only tax expenditures for consumption of goods or services that the taxpayer will not use to produce income.

<sup>88</sup> “Flat tax” is a misnomer, of course. A personal flat tax would be a capitation tax that would not be a function of income at all, while those who support a flat tax really mean a flat rate of tax. Even then, no serious proponent of a flat tax proposes anything flatter than a two rate system with a zero rate for low income individuals.

now dividends<sup>89</sup> along with opportunities to defer personal services income<sup>90</sup> and even convert it into capital gain<sup>91</sup> have contributed to the increasing wealth disparity in the United States.<sup>92</sup>

A. **Capital Gain (and Qualified Dividends).** Probably the most prominent and enduring schedular feature of the United States income tax is its capital gain preference.<sup>93</sup> Taxation of net capital gain<sup>94</sup> at lower rates than ordinary income<sup>95</sup> long ago became embedded into the United States' global tax system. Except for a brief period during the late 1980s,<sup>96</sup> the United States income tax has favored long term capital gain and, concomitantly, disfavored capital loss<sup>97</sup> among losses that individuals may deduct.<sup>98</sup> Similarly, Sweden's income tax applies a preferential rate schedule of thirty percent to investment income from capital, and Germany's income tax applies a twenty-five percent rate.<sup>99</sup>

Income from capital<sup>100</sup> in both Sweden and Germany includes a far broader range of investment income sources and transactions such as dividends and interest on indebtedness than does the concept of capital gain in the United States.<sup>101</sup> Historically, Germany did not tax gain from the sale of capital assets at all but now includes gain from the sale of most intangible financial assets in the class of capital income.<sup>102</sup> In 2003 Congress did extend the lowest rate

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<sup>89</sup> *Infra* Part I.A.

<sup>90</sup> *Infra* Part II.C.

<sup>91</sup> *Infra* Part II.C.

<sup>92</sup> Thomas L. Hungerford, Changes in the Distribution of Income Among Tax Filers Between 1996 and 2006: The Role of Labor Income, Capital Income, and Tax Policy (Congressional Research Service, Dec. 29, 2011, R42131) (

<sup>93</sup> The favorable treatment is of net capital gain defined under I.R.C. §1222(11) as the excess of net long term capital gain over net short term capital loss. See discussion *infra* in note 111 and accompanying text. The tax advantage for net capital gain is automatic but complex with several subcategories of net capital gain.

<sup>94</sup> I.R.C. §1(h) (reducing the maximum rate for individuals on net capital gain to 15, 25 or 28%).

<sup>95</sup> I.R.C. §1(a) – (e) imposes a maximum rate of 39.6 percent on individual taxpayers' taxable income other than net capital gain and qualifying dividends.

<sup>96</sup> TRA 86, *supra* note 52, temporarily eliminated the preferential treatment of net capital gains when it repealed the 60 percent net capital gain, *infra* note 111, deduction for individuals. TRA 86 also capped the maximum rate on net capital gain at 28 percent and retained the supporting definitions so that Congress easily could reinstate some form of net capital gain preference as rates might rise on ordinary income. Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 (the "Blue Book"), H.R. 3838, 99<sup>th</sup> Cong., P.L. 99-514 (October 22, 1986) (Washington 1987) at 178-80.

<sup>97</sup> I.R.C. §1211 (capital losses only deductible to the extent of capital gains plus, for individuals, \$3000 per year). An individual taxpayer may carry unused capital losses forward indefinitely. I.R.C. §1212(b).

<sup>98</sup> I.R.C. §165 (allowing a deduction only for losses incurred in the taxpayer's trade or business, transactions engaged in for profit, and casualty losses). If a taxpayer incurs losses in activities not intended primarily to produce income, the losses are not deductible at all. They are non-deductible family or living expenses. I.R.C. §262(a).

<sup>99</sup> EStG §32d (Germany, some exceptions apply); IL 65 kap., 5§.

<sup>100</sup> This article will use the terms "income from capital" and "investment income" interchangeably.

<sup>101</sup> EStG §20 (Germany defines income from capital broadly to include, in addition to gain from the sale or exchange of shares and other assets that are taxable on sale, dividends, interest, royalties, etc.); IL 41 kap., 1§ "Till inkomstslaget kapital räknas inkomster och utgifter på grund av innehav av tillgångar och skulder, och i form av kapitalvinster och kapitalförluster." (Sweden: In the capital income class is included income and expenses attributable to ownership of assets and debt interests and in the form of capital gains and losses. (author's translation)).

<sup>102</sup> While gain from the sale or exchange of intangible financial assets is taxable capital income under EStG §20, gain from the sale or exchange of tangible property, which would be capital gain in the U.S., is not within any of the

category of net capital gain to most corporate dividend distributions.<sup>103</sup> The repeal of Code provisions that allowed corporations to distribute appreciated assets to their shareholders without recognizing their corporate level gain set the stage for the reduction in the income tax rate on corporate dividends.<sup>104</sup> After repeal all corporate level transactions, including distributions, attracted a corporate level tax. That tax made the inclusion and tax at shareholder level a full second level of tax on the same income and eased the argument that reducing that second level tax was appropriate. Reducing the shareholder tax also was consistent with the treatment of the shareholder's gain on the sale of shares that the shareholder had owned for more than a year.<sup>105</sup> However, the rate preference for qualifying dividend income ostensibly is only temporary.<sup>106</sup>

The capital gain preference in the United States is not purely schedular as it does not sharply separate capital gain from other income. For example, a taxpayer having a net ordinary loss not subject to the limitations of the passive activity losses and credits limitation<sup>107</sup> and net capital gain in the same year would offset her capital gain with the ordinary loss. Thus, rather than carrying the ordinary loss forward to offset ordinary income in the future, the net capital gain consumes the tax benefit of the ordinary loss with income that otherwise would be taxable at a preferential rate.<sup>108</sup> The converse is not true. An individual taxpayer may deduct only \$3000 of net capital loss from the ordinary income per tax year<sup>109</sup> but may carry any additional net capital loss forward indefinitely.<sup>110</sup> More generally and unlike the rate consistency for

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schedular income classes in Germany and, therefore, not subject to the German income tax. See discussion of items not within a schedule being nontaxable under schedular systems *infra* in text accompanying note 407.

<sup>103</sup> Section 302 of the Jobs and Growth Tax Relief Reconciliation Act of 2003, P.L. 108-27 (May 28, 2003) added I.R.C. §1(h)(11) to the Code (reducing the maximum rate to 15% on qualifying corporate dividends that individuals receive). The statute adds qualified dividends to net capital gain for purposes of computing the individual taxpayer's tax. However, the statute does not define the qualifying dividend income as capital gain. Accordingly, qualifying dividend income does not fall into the net long term or short term computation so that capital losses are not deductible against qualifying dividend income. See the description of the net capital gain computation *infra* in text accompanying note 111.

<sup>104</sup> I.R.C. §§336, 337, and 311 before their amendment by TRA 86, *supra* note 52. The rule that corporations do not recognize gain when they distribute appreciated property in kind to their shareholders, often referred to as the General Utilities doctrine, arose from the holding in *General Utils. & Operating Co. v. Helvering*, 296 U.S. 200 (1935) (holding that the distribution of a dividend in kind was not taxable to the distributing corporation).

<sup>105</sup> I.R.C. §1(h). The shareholder's gain is capital and preferred rate long term capital gain after a one year holding period. I.R.C. §1222(3) (defining long term capital gain).

<sup>106</sup> Under the current Code, the rate preference will cease to apply to qualifying dividends after 2012. The statute's original sunset date was December 31, 2010. Section 303 of the Jobs and Growth Tax Relief Reconciliation Act of 2003, *supra* note 103. P.L. 111-312 (Dec. 17, 2010) extended the sunset date to December 31, 2012. Some members of Congress have sought to make the preferential dividend rate permanent.

<sup>107</sup> I.R.C. §469(e)(1)(A)(ii) (defining capital gains not in the ordinary course of business as income which is not passive activity income).

<sup>108</sup> I.R.C. §172 (carrying net ordinary losses forward to subsequent and backward to previous taxable years with the net operating loss deduction).

<sup>109</sup> I.R.C. §1211(b) (limiting the deduction of capital loss to the amount of capital gain plus \$3000 per year). Under §1211(a) corporations may deduct capital losses only from capital gains.

<sup>110</sup> I.R.C. §1212(b) (carrying an excess net capital loss as a capital loss into the next tax year, there renewing the loss indefinitely). Corporations, on the other hand, may carry capital losses back 3 years and forward 5 years before they expire. I.R.C. §1212(a).

investment income in Sweden and Germany, the favored net capital gain classification<sup>111</sup> is internally hybrid, as it takes short term capital gain that is not favored gain into account in its computation. Net capital gain is the excess of net long term capital gain<sup>112</sup> over net short term capital loss.<sup>113</sup> Net long term capital gain would become net capital gain if the taxpayer has no net short term capital loss. Short term capital losses offset long term capital gains while only long term capital gains ultimately would become part of the favored rate category of net capital gain.<sup>114</sup>

The Swedish income tax also does not separate capital income, generally, and capital gain and loss specifically, from other income classes. Some capital income, Sweden classifies as income from services (*tjänst*) or income from a trade or business (*näringsverksamhet*).<sup>115</sup> For example, special rules characterize gains from the sale of personal use assets in the income from services class.<sup>116</sup> Without regard to the actual cost basis of the personal use assets, Sweden imputes an adjusted basis equal to 25% of the sale price less selling expenses and taxes gains on those assets only to the extent the gains exceed 50,000 SEK (approximately US \$8000) in the aggregate in a year.<sup>117</sup> Further only 70 percent of capital loss is deductible in the capital income class and zero if from personal use assets.<sup>118</sup> However, capital losses incurred in the taxpayer's trade or business (*näringsverksamhet*) are fully deductible<sup>119</sup> to the extent the taxpayer has capital gains in the same income class.<sup>120</sup>

Tax provisions favoring capital gain and, more generally, investment income reflect underlying policy considerations ranging from arguments that capital gain is not income at all<sup>121</sup> to the economic threat of international tax competition in a world of mobile capital.<sup>122</sup> Among the more compelling capital gain arguments in realization based income tax systems<sup>123</sup> are (i)

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<sup>111</sup> I.R.C. §1222(10) (defining net capital gain as the excess of net long term capital gain over net short term capital loss).

<sup>112</sup> I.R.C. §1222 (7) (defining net long term capital gain as the excess of long term capital gains over long term capital losses). Long term capital gains and losses are gains and losses from the sale or exchange of capital assets held for more than one year. I.R.C. §1222(3),(4). With certain exceptions, capital assets are all property the taxpayer holds. I.R.C. §1221.

<sup>113</sup> I.R.C. §1222 (6) (defining net short term capital loss under as the excess of short term capital loss over short term capital gain). Short term capital gains and losses are gains and losses from the sale or exchange of capital assets held for not more than one year. I.R.C. §1222(1),(2).

<sup>114</sup> Net short term capital gain under I.R.C. §1222 (5) is taxed as ordinary income, so there is only a separate rate schedule for long term capital gains that make up net capital gain.

<sup>115</sup> See discussion *infra* in text accompanying and following note 367 relating to Sweden's sensitivity to conversion of service or trade or business income into capital income.

<sup>116</sup> IL 10 kap. 1 § 3 stk. (including gain under IL 52 kap. in the service income class).

<sup>117</sup> IL 52 kap. 2 § (computation and inclusion of certain gains from personal use property).

<sup>118</sup> IL 52 kap. 5 § (70 percent limit on deduction of capital loss and no deduction for personal capital loss).

<sup>119</sup> IL 52 kap. 6 § (full deduction for capital loss in the trade or business).

<sup>120</sup> IL 25a kap. 5 § 2 stk. (limitation on deduction of capital loss to income from capital).

<sup>121</sup> Walter J. Blum, A Handy Summary of Capital Gain Arguments, 35 TAXES 247 (1957) (summarizing and refuting a number of common arguments for not taxing capital gain).

<sup>122</sup> *Id.* does not address capital mobility and tax competition since those were not so much of concern 55 years ago, but see discussion *infra* in text accompanying and following note 132.

<sup>123</sup> *Id.* And, see, Ilan Benshalom & Kendra Stead, Realization and Progressivity, 3 COLUM. J. TAX LAW 43 (2012) (arguing that the realization requirement also prevents progressivity in taxation).



that the realization requirement for taxation of gain tends to lock in capital<sup>124</sup> and may discourage transfers of assets necessary to economic development<sup>125</sup> and (ii) that capital gains are artificial income rather than any real economic profit because they are attributable to inflation in significant part and should not be subject to income tax at all.<sup>126</sup> As to the current and temporary preferential treatment of dividends in the United States, there has been continuous debate concerning so-called double taxation in the corporate income tax. Double taxation is characteristic of traditional corporate tax structures, which tax the corporation when it earns income<sup>127</sup> and then also tax the shareholders when they receive dividend distributions from the corporation out of its earnings.<sup>128</sup> Because of the shareholder level tax on dividends, capital formation with debt on which the corporation may deduct its periodic payments of interest enjoys an economic advantage over equity on which periodic payments of dividends are not deductible. Counter-balancing the debt advantage is the fact that the corporation has an obligation to pay the deductible interest but no obligation to declare and pay dividends. Proposals to integrate corporate and shareholder taxation are numerous and generally seek to limit the incidence of taxation to a single level. Most proposals favor a deduction<sup>129</sup> or credit<sup>130</sup> mechanism rather than conduit treatment similar to that of a partnership.<sup>131</sup>

**B. Investment Income, International Tax Competition, Capital Mobility, and Tax Avoidance.** Under the broader definition of income from capital in Germany and Sweden, any inflation argument loses its force. While income producing assets may increase in value as a result of inflation and yield more interest or rent for their use, inflationary loss in buying power equally would cause salaries to rise. Most likely the broad investment income definitions reflect

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<sup>124</sup> Lock-in refers to the economic disincentive to dispose of property and pay tax on the gain when the taxpayer simply may continue to hold the property and never pay tax on the gain embedded in the property. The taxpayer may monetize the gain without paying tax by using the property as security for a loan. In the U.S., I.R.C. §1014 (causing property held by an individual at death to take a new basis equal to the property's value at date of death) exacerbates the lock-in problem.

<sup>125</sup> In order to ameliorate the lock-in effect on certain property, especially real estate, so that it might become available for its highest and best use, Congress enacted the like-kind exchange rule (not applicable to securities) to enable taxpayers to exchange one property for another without recognizing gain. I.R.C. §1031 (permitting the tax deferred exchange of similar properties). Compare the use of exchange funds for very wealthy taxpayers, David J. Herzig, *Am I the Only Person Paying Taxes?: The Largest Loophole for the Rich – Exchange Funds*, 2009 MICH. ST. L. REV. 503 (2009).

<sup>126</sup> Germany does not tax most capital gains, *supra* note 102 and accompanying text. Among other jurisdictions, the United Kingdom does not view capital gain as income. Vast literature on capital gain arguments in the United States and other countries, including .

<sup>127</sup> I.R.C. §11, for example.

<sup>128</sup> I.R.C. §§ 301, 312. Cite to articles on tax integration.

<sup>129</sup> Under a deduction method, the corporation is subject to tax on its income but may deduct the dividends it pays on share capital just as it may deduct interest on borrowed capital. This proposal would have the additional benefit of eliminating the incentive to borrow rather than raise capital through equity investment.

<sup>130</sup> Under a credit mechanism, the shareholder grosses corporate distributions up by the amount of tax the corporation paid on the distributed earnings and then takes a credit for the corporate tax treating it in the same manner as a withholding tax.

<sup>131</sup> In a partnership, the partners include their proportional shares of the partnership's income or loss in their own tax computation when the partnerships earn the income. In the presence of active trading of corporate shares, the conduit method is complicated since the ownership of a share may change from day to day or even several times in a single day. Transparency also generates liquidity concerns since shareholders may receive income without receiving a distribution of cash to enable them to pay the tax on the income.

legislative concern with capital mobility<sup>132</sup> and international tax competition.<sup>133</sup> Investors may move their capital with relative ease to lower tax or no tax jurisdictions. Even in the absence of tax havens and deep tax planning, rate differentials between neighboring countries impact taxpayers' decisions on investment of capital. The European Union has harmonized the value added tax to some degree<sup>134</sup> and recently the European Commission proposed its working group's recommendations for a common consolidated corporate tax base as a directive.<sup>135</sup> Even though the European Parliament modified and adopted the proposal with a five year phase in for the enactment of a mandatory, rather than the European Commission's proposed voluntary, common consolidated corporate tax base,<sup>136</sup> the European Union has not harmonized the corporate and individual income taxes as yet. There remains tax competition even among member states of the European Union.<sup>137</sup> Several countries have objected to the working group's proposals for a common consolidated corporate tax base that would allocate corporate group

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<sup>132</sup> Capital mobility has both an operational element and an investment aspect. Operationally, businesses increasingly require no long term commitment to a specific location because they generate their income from intangible, intellectual property rather than physical plants. The cost of moving operations from one location to another requires no large capital outlay. For those businesses that do require large capital outlays, nations compete by providing various subsidies. On the investment side, capital mobility reflects the willingness of investors to invest without regard to national borders. .

<sup>133</sup> International tax competition consists of tax rates and structures that encourage the movement of capital into a taxing jurisdiction. For example, a country may enact a very low corporate income tax rate in order to attract capital investment or may provide favorable tax treatment to specific types of activities.

<sup>134</sup> COUNCIL DIRECTIVE 2006/112/EC of 28 November 2006 on the common system of value added tax, Official Journal of the European Union L 347/1 (11/12/06) (current version of the VAT harmonization directive at 15% minimum) and Council Directive 282/2011 of 15 Mar. 2011, O.J. 23 Mar. 2011, L 77/1 (providing implementing measures for the 2006 directive). Marie Lamensch, New Implementing Regulation 282/2011 for the 2006 VAT Directive, 20 EC TAX REVIEW 162 (2011) (explaining the features of the implementing regulation).

<sup>135</sup> See, European Commission, Brussels, COM(2011) 121/4, 2011/0058 (CNS) Proposal for a COUNCIL DIRECTIVE on a Common Consolidated Corporate Tax Base (CCCTB) (2011) at 14, available at [http://ec.europa.eu/taxation\\_customs/resources/documents/taxation/company\\_tax/common\\_tax\\_base/com\\_2011\\_12\\_1\\_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/com_2011_12_1_en.pdf). (CCCTB Proposal in the following). The EC describes the proposal on its website at [http://ec.europa.eu/taxation\\_customs/taxation/company\\_tax/common\\_tax\\_base/index\\_en.htm](http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm) as follows:

The European Commission on 16 March 2011 proposed a common system for calculating the tax base of businesses operating in the EU.

The proposed Common Consolidated Corporate Tax Base (CCCTB), would mean that companies would benefit from a "one-stop-shop" system for filing their tax returns and would be able to consolidate all the profits and losses they incur across the EU. Member States would maintain their full sovereign right to set their own corporate tax rate.

<sup>136</sup> EP, Legislative resolution of 19 April 2012 on the proposal for a Council directive on a Common Consolidated Corporate Tax Base (CCCTB) (COM(2011)0121 – C7-0092/2011 – 2011/0058(CNS)) (available at <http://www.europarl.europa.eu/sides/getDoc.do?type=TA&reference=P7-TA-2012-0135&language=EN&ring=A7-2012-0080>) (EP CCCTB resolution).

<sup>137</sup> Corporate income tax rates in the EU range from a low of 10 percent in Bulgaria to 34 percent in Belgium. Key Data on World Taxes, Income Tax Rates, Tax Rates Comparison Table, Business & Finance Worldwide, [www.worldwide-tax.com](http://www.worldwide-tax.com) (as of August 23, 2011) available at <http://www.worldwide-tax.com/#partthree> (last visited 11-08-11) In the U.S., there is considerable tax competition among the states with respect to income taxes and subsidies to attract business. Texas, for example, has no income tax. More recently, the North American Free Trade Agreement has opened the door to tax competition, at least as to location of corporate entities, but individuals would have to expatriate from the United States to free themselves from the U.S.' income tax that taxes its citizens and permanent residents on their worldwide income.

income among the member states in which the group operates.<sup>138</sup> Harmonization of income tax rates is probably less likely to gain unanimous acceptance among the member states of the European Union. While tax competition within the European Union seems likely to continue for immediate future, the European Parliament has studied the question and does not see the competition as having any material impact on labor migration.<sup>139</sup>

Moreover, low and zero tax jurisdictions render capital mobility an even greater threat, especially when those jurisdictions also offer strong bank secrecy protections and stable governments and economies like Switzerland and Liechtenstein. Investors may place their capital safely in those countries but not report the investment return on that capital to their home country tax authorities and not pay tax on the income. Even if taxpayers are taxable on their worldwide income, as they are in the United States,<sup>140</sup> or taxable on investment income when the taxpayers are resident in the country seeking to tax them, as is the case in both Germany and Sweden,<sup>141</sup> in the absence of third party reporting of payments,<sup>142</sup> the taxing authority's ability to detect the income and tax it in the home country is challenging.<sup>143</sup>

During the past several years, the IRS has sought aggressively to identify, tax, and penalize United States persons who do not report income they earn outside the United States.<sup>144</sup>

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<sup>138</sup> Controversial because several member states have objected to the working group's proposals. See, Matthew Gillieard, Eight member states show CCCTB yellow card, *INTERNATIONAL TAX REVIEW* (May 24, 2011) available at <http://www.internationaltaxreview.com/Article/2835775/Eight-member-states-show-CCCTB-yellow-card.html> (last visited 11-08-11).

<sup>139</sup> European Parliament, Tax Competition in the E.U. (1998), available at [http://www.europarl.europa.eu/workingpapers/econ/105/part1a\\_en.htm](http://www.europarl.europa.eu/workingpapers/econ/105/part1a_en.htm) (last visited January 4, 2012). The working paper is sorely out of date and may no longer accurately reflect the movement of labor in light of the economic downturn, introduction and difficulties with the euro currency and admission of additional countries to the E.U. but the working paper raises many of the important E.U. issues on tax harmonization.

<sup>140</sup> U.S. citizens and permanent residents are taxable in the U.S. on all their income "from whatever source derived." I.R.C. §61. Except for a limited exclusion for personal service income earned abroad, I.R.C. §911 (excluding an inflation adjusted \$80,000 of earned income plus a housing allowance), the U.S. uses a tax credit for foreign taxes paid under I.R.C. §901 (or a deduction I.R.C. §164(a)(3) to prevent taxation of the same income both in the U.S. and abroad where earned.

<sup>141</sup> Germany taxes the worldwide income of German residents and German citizens residing abroad who are employees of a German employer. EStG §1. If the individual moves to a lower tax jurisdiction, the worldwide income tax liability in Germany continues for 10 years following the individual's departure from Germany. Gesetz über die Besteuerung bei Auslandsbeziehungen (Aussensteuergesetz) (8. Sept. 1972, most recently amended 8 Dezember 2010) ("AStG") (Law of taxation of international transactions (International tax law)) §2. Swedish residents are taxable on their worldwide income. IL 3 kap. 8 § (worldwide income taxability for those with unlimited tax liability in Sweden ("obegränsat skattskydighet"), including individuals who were resident in Sweden previously with continuing connections to Sweden which they presumptively have for 5 years following departure from Sweden, IL 3 kap, 7 §).

<sup>142</sup> In the U.S. a series of third party information reporting requirements provide the IRS the opportunity to match the third party information with what taxpayers report on their returns. Third parties must report many business payments under I.R.C. §6041, interest under I.R.C. §6049, dividends under 6042, etc.

<sup>143</sup> To a limited degree, tax information exchange agreements with automatic reporting of information would facilitate matching for taxpayers who receive payments outside the home country. See, generally, Henry Ordower, United States of America Experience with and Administrative Practice concerning Mutual Assistance in Tax Affairs, in Roman Seer and Isabel Gabert, general reporter and ed., *MUTUAL ASSISTANCE AND INFORMATION EXCHANGE* 569 (Amsterdam, 2010).

<sup>144</sup> See, *supra* note 69.

The German tax authorities also have sought to identify German taxpayers using foundations in Liechtenstein to secrete assets and income and even have purchased lists of such German taxpayers that bank employees in Liechtenstein sold to the German authorities in violation of Liechtenstein bank secrecy laws.<sup>145</sup> In 2000, the Organization for Economic Cooperation and Development<sup>146</sup> reported on unfair tax competition and identified a number of jurisdictions as tax havens.<sup>147</sup> Since that report, many of the listed jurisdictions have entered into tax information exchange agreements with the OECD countries.<sup>148</sup>

**C. Deferral, Transfer Pricing, and Retention of Capital.** In addition to the loss of tax revenue from taxpayers' failure to report income earned outside their home country, is the loss of tax revenue from "deferral."<sup>149</sup> The earnings from a corporation's active conduct of business generally are not taxable currently to its shareholders even if the shareholders control the corporation and even if the shareholders are subject to the taxing jurisdiction of a country other than that having taxing jurisdiction over the corporation.<sup>150</sup> Deferral generally refers to shifts of profit to controlled corporations in lower tax jurisdictions so that the incidence of home country taxation is deferred until the income is repatriated through distributions from the controlled corporation.<sup>151</sup>

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<sup>145</sup> Henry Ordower, *The Culture of Tax Avoidance*, *supra* note 47 at 107-110.

<sup>146</sup> Better known by its acronym the OECD. The OECD has 34 member countries and its goal, as its website states: "our goal continues to be to build a stronger, cleaner, fairer world."

[http://www.oecd.org/pages/0,3417,en\\_36734052\\_36761800\\_1\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/pages/0,3417,en_36734052_36761800_1_1_1_1_1,00.html)

<sup>147</sup> OECD, *Towards Global Tax Co-operation, REPORT TO THE 2000 MINISTERIAL COUNCIL MEETING AND RECOMMENDATIONS BY THE COMMITTEE ON FISCAL AFFAIRS, Progress in Identifying and Eliminating Harmful Tax Practices* (2000), available at <http://www.oecd.org/dataoecd/9/61/2090192.pdf> (last visited November 3, 2011).

<sup>148</sup> In May 2009, the OECD removed the final three countries from its list of uncooperative tax havens. List of Unco-operative Tax Havens, available at [http://www.oecd.org/document/57/0,3746,en\\_2649\\_33745\\_30578809\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/57/0,3746,en_2649_33745_30578809_1_1_1_1,00.html) (last visited November 3, 2011). See, generally, Roman Seer and Isabel Gabert, general reporter and ed., *MUTUAL ASSISTANCE AND INFORMATION EXCHANGE* (Amsterdam, 2010) (assembling national reports and a general report on the current status of treaties and information exchange agreements for the 2009 Congress of the European Association of Tax Law Professors), *supra* note 143.

<sup>149</sup> Cite

<sup>150</sup> I.R.C. §11 (imposing a tax on a domestic corporation's earning); in Germany, there is a separate tax statute for the earnings of domestic corporations and other entities, *Körperschaftsteuergesetz* (KStG) (Corporation Tax Law) of August 31, 1976, new version of October 15, 2002, as amended through June 22, 2011 §1 (German entities subject to corporation tax on their worldwide income) and §2 (foreign entities taxable only on German source income); in Sweden IL 6. Kap, 3 § (tax liability on worldwide income for Swedish legal entities (*obegränsat skattskyldighet*)) and foreign entities have limited tax liability ("*begränsat skattskyldighet*") in Sweden, IL 6 kap., and are only taxable on income from Swedish sources. IL 6 kap. 11 § (listing Swedish income sources including the operation of business from a permanent establishment in Sweden).

<sup>151</sup> See, generally, Reuven S. Avi-Yonah, Diane M. Ring, and Yariv Brauner, *U.S. INTERNATIONAL TAXATION: CASES AND MATERIALS* at 270 *et seq.* (New York 2011). In 2004, U.S. legislation effectively reduced the U.S. tax rate repatriated earnings of a controlled foreign corporation to a maximum of 5.25% temporarily for a single tax year to encourage investment in the U.S. and increase employment in the U.S. The rate reduction resulted from a dividends received deduction of 85 percent of the amount of the dividend if the recipient invested the funds in the U.S. under a domestic reinvestment plan. I.R.C. §965 (added by the American Jobs Creation Act of 2004, PL 108-357 (Oct. 22, 2004)). Proposed legislation in 2011 would repeat the decreased rate on repatriation even though the

Often the profit shift occurs through the pricing of transactions between the foreign corporation and its shareholders. While the price ought to reflect the arms' length price that unrelated persons would set for the transaction, considerable uncertainty reigns in transfer pricing,<sup>152</sup> so that disagreements between taxpayers and tax collectors over transfer pricing are commonplace.<sup>153</sup> Shareholders frequently place intellectual property – formulas, processes, patents – critical to the operation of their business in foreign corporations based in low tax jurisdictions. By so doing, the domestic owner of the low taxed foreign corporation accrues payment of a royalty to the foreign corporation thereby shifting profits offshore.<sup>154</sup> Despite the complexities of offshore deferral, the loss of revenue from it is somewhat easier to estimate than failure to report income earned abroad.<sup>155</sup>

Various rules limit deferral in some abusive circumstances. In the case of controlled foreign corporations (“CFCs”),<sup>156</sup> narrow exceptions limit deferral in the United States for certain types of income<sup>157</sup> and in Sweden<sup>158</sup> and Germany<sup>159</sup> if the CFC's earnings are in a low or no tax jurisdiction. The United States imputes the earnings of a CFC to its United States shareholders as if the corporation distributed them proportionally as dividends.<sup>160</sup> Similarly, both Sweden and Germany impute the low-taxed income to the Swedish or Germany owners based upon their respective proportional ownership in the CFC,<sup>161</sup> with a credit for the taxes paid in the foreign jurisdiction after grossing the imputation amount up for the taxes paid in the foreign jurisdiction.<sup>162</sup> Supplementing the anti-deferral regime of the CFC rules in the United

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earlier effort seems to have accomplished little to stimulate the U.S. economy. The concept, however, is that deferral traps the revenues offshore and only a rate reduction would free them for U.S. use.

<sup>152</sup> I.R.C. §482 (allowing the IRS to allocate income between or among related parties to prevent tax avoidance).

<sup>153</sup> See, e.g., Avi-Jonah, Ring, and Brauner, U.S. INTERNATIONAL TAXATION at 192 *et seq.*

<sup>154</sup> For example, drug manufacturers.

<sup>155</sup> Estimates on unreported income in general are particularly limited because measurement lacks solid data while estimates of deferral have better information from corporate balance sheets and income statements that report the financial results of overseas operations.

<sup>156</sup> I.R.C. §957 (defining CFC as a foreign corporation in which United States shareholders own, directly or constructively more than 50 percent of the stock by voting or value); I.R.C. § 951(b) (defining U.S. shareholder as a 10 percent or greater direct or constructive owner of the stock of the CFC). In Germany, see AStG §7 (defining a controlled foreign corporation (Zwischengesellschaft (translation: intermediary corporation) as a foreign corporation owned more than 50 percent by taxpayers who are taxable on their worldwide income in Germany (and certain taxpayers if the CFC is effectively connected with a permanent establishment in Germany). In Sweden, see IL 39a. kap.1 §, 2 § (defining CFC as a foreign corporation in which taxpayers who are taxable on their worldwide income in Sweden (and certain other taxpayers if the CFC is effectively connected with a permanent establishment in Sweden) at least 25 percent, directly or indirectly, by voting or value).

greater shareholder I.R.C. §951 taxing the subpart F income of a CFC to its U.S. shareholders).

<sup>157</sup> So-called subpart F earnings under I.R.C. §952 (characterizing certain income of a CFC as subpart F income, including certain insurance income, investment income and foreign base company income with the focus on subpart F income as those sources of income which are not related to the foreign corporation's location and could equally have been placed in the U.S).

<sup>158</sup> IL 39 a. kap. 1 § (including in the CFC definition that the income of the foreign corporation be subject to a low rate of tax defined in 5 § relative to the tax in Sweden on 55 percent of the income).

<sup>159</sup> AStG § 8 (low taxed income but not from the active conduct of manufacturing business and various other activities similar to the U.S. rule).

<sup>160</sup> I.R.C. §951(a).

<sup>161</sup> Sweden IL 39 a. kap. 13 §; Germany AStG §7.

<sup>162</sup> Sweden Lag (1986:468) om avräkning av utländsk skatt 1. Kap. 3 § (1986.06.05); Germany AStG §12.

States are the passive foreign investment company statutes.<sup>163</sup> United States shareholders who invest in, but do not control so that they are not CFCs, passive foreign investment companies<sup>164</sup> must either elect to include their shares of the foreign corporations' income currently<sup>165</sup> or have their gain from sale of their shares taxed as ordinary income with interest on the deferred tax.<sup>166</sup>

D. **Imputed Income.** Far less prominently visible in its schedularity than the capital income preferences but possibly even greater in its distributional impact is the non-statutory exclusion of the use value of owner occupied residential real property.<sup>167</sup> Among the most economically sound and tax efficient investments one could have made in the United States from around 1945 until 2008 was a house or apartment for one's own use. During that period single family homes appreciated substantially and steadily in value.<sup>168</sup> In many instances, the gain on sale was not taxable either because of an express statutory exclusion<sup>169</sup> or because the owner died while owning the dwelling so that the owner's estate received a new fair market value basis at death that eliminated the historical built-in gain in the property.<sup>170</sup> For much of the period the owner could buy and sell personal residences while deferring any gain on sale until the owner no longer reinvested the sale proceeds in another personal residence.<sup>171</sup>

Renters get no tax deduction for their rental payments because rental payments are non-deductible family and living expenses.<sup>172</sup> Renters pay their rent with money available after they have paid income tax on their income. Owners do not pay for the use of their property. Rather they forego income they might otherwise have received on the capital they invest in home ownership. In effect, owners devote their foregone income to home occupancy and yet are not subject to tax on the foregone income. Not imputing income to the owner's use of her own property creates a strong economic bias in favor of home ownership over home rental.

In other contexts in which one foregoes income from capital, a taxable market exchange is likely to be present. For example and subject to a broad exception for lodging provided for the

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<sup>163</sup> I.R.C. §1291 et seq.

<sup>164</sup> I.R.C. §1297 (defining passive foreign investment company by the percentage of income or assets not from the active conduct of a business).

<sup>165</sup> I.R.C. §1293 (taxing the U.S. shareholders currently on their shares of a qualified electing fund's ordinary income and capital gain); I.R.C. §1295 (allowing the investor to elect qualified electing fund status for the investment).

<sup>166</sup> I.R.C. §1291.

<sup>167</sup> Boris I. Bittker and Martin J. McMahon, Jr., *FEDERAL INCOME TAXATION OF INDIVIDUALS 3-9* (Boston 1988) (discussing the exclusion of imputed income from home ownership and services performed for oneself or one's family).

<sup>168</sup> **Statistics on home prices.** Housing prices retreated significantly in 2008 during the financial crisis and that led to a rash of foreclosures that has continued to the present.

<sup>169</sup> I.R.C. §121 (excluding \$250,000 of gain on the sale of a qualifying personal residence, \$500,000 for married taxpayers). In 1997, current I.R.C. §121 replaced an exclusion that applied only to taxpayers who were age 55 or older. Section 312(a) of the Taxpayer Relief Act of 1997, PL 105-34 (Aug 5, 1997).

<sup>170</sup> 1014(a) (changing the basis of property received by gift from a decedent's estate to the fair market value of the property on the decedent's date of death).

<sup>171</sup> Until 1997, I.R.C. §1034 permitted the taxpayers to defer the recognition of gain on the sale of a personal residence. Section 312(b) of the Taxpayer Relief Act of 1997 repealed I.R.C. §1034.

<sup>172</sup> I.R.C. §262 (family and living expenses not deductible).

employer's convenience on the employer's business premises,<sup>173</sup> a property owner who provides rent free use of property to an employee in exchange for the employee's services – a market exchange of property use for services – must include income under the exchange equivalency doctrine.<sup>174</sup> Provision of rent free use of property to a family member as a gift, however, has not attracted a tax.<sup>175</sup> Lending money without interest to an employee in exchange for services – a market exchange -- or to a family member -- a gift -- results in imputed interest income to the lender under a statute.<sup>176</sup>

Measurement of the amount of income to impute to a non-cash exchange may be complicated and problematic.<sup>177</sup> In the case of property or use of property in exchange for services, the exchange of services for services, or the exchange of property for property, judicial decisions assume that the exchange is at arm's length so that the values of the exchanged items are equal. Thus, it is necessary only to determine the value of one of the exchanged items in order to know the value of the other.<sup>178</sup> Nevertheless, determining the value of either side of the exchange can be challenging. Congress avoided the valuation conundrum in the case of imputed interest by standardizing the imputed interest from a low or no interest loan artificially relative to an interest index of certain federal debt.<sup>179</sup>

Historically, Sweden imputed income from the owner's use of any residence she owned.<sup>180</sup> Once residences became subject to the income tax, rather than only subject to a property tax, Sweden used fair rental value for the imputation.<sup>181</sup> As price levels increased for residential property, however, the inclusion became disproportional to the more liquid income of the owner/occupant, so Sweden standardized the inclusion to an average return on the value of the invested capital.<sup>182</sup> The resulting decrease in the standard inclusion left many taxpayers with

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<sup>173</sup> I.R.C. §119 (lodging provided on the employer's business premises for the convenience of the employer), discussed *infra* in part I.B.2.

<sup>174</sup> Philadelphia Park Amusement Co. v. U.S., 126 F.Supp. 184 (Ct. Cl 1954), (holding that an exchange at arm's length means that the values of the exchanged property interests must be equal).

<sup>175</sup> Cites to cases not imputing income.

<sup>176</sup> I.R.C. §7872 (imputing interest on low and no interest loans). Judicial decisions before enactment of I.R.C. §7872 in 1984 held that a lender was free to lend without imputation of income. *Dean v. Commissioner*, 35 TC 1083 (1961) (holding that non-interest bearing loans from a corporation did not generate income taxable to the borrower because the interest, if paid, would have been deductible). Section 172(a) of the Deficit Reduction Act of 1984, PL 98-369, added section 7872 to the Code.

<sup>177</sup> See *infra* in text accompanying note 183 for discussion of Sweden's concerns with imputing income from self-use in a rapidly inflating real property market.

<sup>178</sup> Philadelphia Park, *supra* note 174. Rev. Rul. 79-24, 1979-1 C.B. 60 (imputing income to both parties to a transaction conducted through a barter exchange).

<sup>179</sup> The IRS determines and publishes the imputation rates, called applicable federal rates, monthly as I.R.C. §1274 requires. Sweden follows a similar approach using the government borrowing rate (statslåneräntan) plus 1 percent for imputation purposes. IL 61 kap. 15, 16, 17 §§ (interest benefits use a comparison rate of the government borrowing rate plus 1 percent for loans in Swedish kronor and a comparable local rate if loans are denominated in another currency). In Sweden, the borrower generally has a deduction for the interest, but the deduction is from the favored capital income class while the inclusion is ordinary personal service income or income from a trade or business. See, Lodin, INKOMMSTSKATT, *supra* note 25, at 151.

<sup>180</sup> Lodin, INKOMMSTSKATT, *supra* note 25, at 242.

<sup>181</sup> *Id.*

<sup>182</sup> *Id.*, beginning in 1954.

a net annual tax loss from their dwelling since repairs, depreciation and other expenses exceeded the standardized income inclusion.<sup>183</sup> Ultimately, Sweden abandoned imputation for owner occupied dwellings in favor of an *ad valorem* property tax and later a smaller real property fee at municipal level.<sup>184</sup> Since 1991, Sweden imputes income only to owner occupants of condominiums and cooperatives<sup>185</sup> and whenever the owner occupies only a portion of a building and uses the remainder as rental property, a business use.<sup>186</sup> Sweden continues to use fair market value for condominiums and cooperatives and owner occupied portions of a rental building.<sup>187</sup> Other countries continue to impute income to the owner/resident of a dwelling.<sup>188</sup>

In the United States, the costs and expenses of producing income that is exempt from tax generally are not deductible.<sup>189</sup> Despite the failure of the United States income tax to impute income from use of a dwelling to its resident owner, some of the costs and expenses of producing that non-taxable income nevertheless are deductible. Both the interest the owner pays to acquire and hold the residence<sup>190</sup> and the real property taxes that state and local governments impose on the property<sup>191</sup> are deductible. Other expenses such as repairs and depreciation are not deductible, not because they are expenses of producing tax exempt income but because the ownership and maintenance of the home is a non-deductible personal living expense.<sup>192</sup>

In terms of the distribution of the tax benefits of home ownership, poor and moderate income individuals tend to be renters, not owners.<sup>193</sup> While many middle income individuals enjoy the benefits of home ownership, the wealthier the individual, the more valuable her home is likely to be. The amount of imputed use value from the home increases with its value. Accordingly, the wealthier one is the more economic income one has when one includes that

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<sup>183</sup> *Id.* at 243.

<sup>184</sup> *Id.*

<sup>185</sup> *Andelshus* (singular and plural) in Swedish includes both condominiums where the ownership of the units is direct and cooperatives where the ownership of the units is indirect. IL 2 kap. 16 § (defining “*andelshus*” for tax purposes as having three or more owners and separate apartments for at least three owners). See discussion of *andelshus* in Lodin, *INKOMMSTSKATT*, *supra* note 25, at 248.

<sup>186</sup> IL 22 kap. 2 § (includes in the taxpayer’s income property or services taken for private use from one’s business). And see discussion in

<sup>187</sup> IL 61 kap. 2 § (valuing income received in other than cash at its fair market value).

<sup>188</sup> The United Kingdom, for example. See, generally, Richard Goode, *Imputed Rent of Owner-Occupied Dwellings under the Income Tax*, 15 J. FIN. 504 (1960) (discusses the economic impact of taxation of imputed rental income on owner occupied dwellings).

<sup>189</sup> I.R.C. §265 (a) (denying a deduction for the expenses of producing tax exempt income). Similarly, Sweden IL 9 kap. 5 § (expenses of producing nontaxable income not deductible).

<sup>190</sup> I.R.C. §163(h)(2)(D) (allowing a deduction for qualified residence interest within I.R.C. §163(h) that generally denies a deduction for personal interest). Qualified residence interest is acquisition indebtedness, including refinancing indebtedness, of a taxpayer’s primary and secondary residences but not more than \$1 million in the aggregate. In addition, qualified residence interest is home equity indebtedness limited to the fair market value of the taxpayer’s primary and secondary residence, but not more than \$1 million. I.R.C. §163(h)(3)

<sup>191</sup> I.R.C. §164(a)(1).

<sup>192</sup> I.R.C. §262 (denying any deduction for personal, living, and family expenses).

<sup>193</sup> During the late twentieth and early years of the 21<sup>st</sup> centuries, low and moderate income individuals gained increasing access to subprime mortgage financing and became able to own homes. The 2008 financial events included loss of employment for many lower and moderate income workers who became unable to pay their mortgage indebtedness and had to relinquish their homes in the face of foreclosure. Cites.



imputed use value from home ownership without any increase in income tax.<sup>194</sup> The income tax becomes increasingly regressive relative to that economic income or wealth.

E. **Capital Income Preference and Regressivity.** In the United States, the tax rates have not always favored capital gain.<sup>195</sup> Moreover, the maximum rate applicable to investment income exceeded the maximum rate applicable to labor income for more than a decade.<sup>196</sup> Currently, capital gain and investment income is favored widely over income from labor, especially if one takes social security taxes into account.<sup>197</sup> Whether or not recipients of investment (capital) income and gain are somehow fundamentally worthier and better able to deploy their resources for the good of the national economy as a whole, as some might argue,<sup>198</sup> whether or not investment income and capital gain are economically different from income from labor, and whether or not capital mobility threatens home country investment in the absence of favorable rates of tax on investment income, the ability to defer taxation of the increased value of one's property that characterizes realization based income tax systems, the favored rate applicable to capital gain, and the favored, or even zero, rates applicable to certain types of investment income including qualifying dividends,<sup>199</sup> interest on state and local obligations,<sup>200</sup> the inside increase in value of life insurance investments,<sup>201</sup> and the zero (or even negative when one considers the availability of deductions) rate applicable to imputed use value income from owner occupied residences tend to be regressive relative to income and wealth. Low and moderate income and low and moderate wealth individuals generally have minimal or no capital gains or investment income.<sup>202</sup> They own little property and are unlikely to own property that appreciates significantly in value or generates any sizeable investment return.

II. **Income from Labor.** Unless one believes that capital gains are not income and never should be subject to the income tax at all, the distributional impact of the capital gain and dividend schedular-based preferences in the United States is fairly straightforward. Those preferences are regressive relative to income and wealth.<sup>203</sup> Less straightforward is the combined effect of the variety of schedular features in the taxation of income from personal services, including additional, negative income tax rate brackets under the earned income

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<sup>194</sup> See, Goode, *supra* note 188, at 504-5 (accepting as an economic premise that owner use of owned property generates economic income to the owner).

<sup>195</sup> *Supra* note 96. The decision to impose the same rate on capital gain as on ordinary income may have served the collateral functions of (i) diminishing the revenue cost of TRA86 and (ii) creating a revenue spike as taxpayers rushed to take advantage of the lower capital gain rate that continued until the effective date of TRA86.

<sup>196</sup> See discussion of the maximum tax on earned income, *supra* note 50, and accompanying text.

<sup>197</sup> See discussion of social security type taxes, *infra*, in part I.B.

<sup>198</sup> **Cites to economics literature**

<sup>199</sup> I.R.C. §1(h)(11) (temporary).

<sup>200</sup> See discussion of tax exempt interest *infra* in text accompanying note 412.

<sup>201</sup> I.R.C. §§101, 72.

<sup>202</sup> Joseph Campbell, Household Finance 61 J. OF FIN. 1553 (Aug. 2006) (stating that most households in the bottom quartile of the wealth distribution hold only liquid assets and vehicles, with a minority participating in real estate through home-ownership).

<sup>203</sup> See previous section I. and Hungerford, Changes in the Distribution of Income, *supra* note 92 at 5. Double taxation of corporate profits, note 128 *supra*, and accompanying text ameliorates the regressive impact of the preferences to some degree.

credit,<sup>204</sup> exclusions from gross income,<sup>205</sup> taxes on wages,<sup>206</sup> deferrals of compensation under pension and profit sharing plans and non-qualified deferred compensation plans,<sup>207</sup> limitations on deductions,<sup>208</sup> and the conversion of personal services into property yielding capital gain.<sup>209</sup> With respect to distributional impact, those schedular features are more nuanced than capital gain and dividends. The Code added schedular elements to wage or service income based taxes with the maximum tax on earned income<sup>210</sup> in order to discourage taxpayers from sheltering service income with investment losses. Although Congress repealed the maximum tax on earned income in 1981, Congress enhanced the schedularity of personal service income, and, to a lesser extent investment income, by adding the passive activity loss limitations.<sup>211</sup> The passive activity loss limitations prevented taxpayers from deducting losses from active business in which the taxpayers did not participate materially from the income their personal services generated.

Schedular elements in the rules governing income from services affect both the rate of tax<sup>212</sup> and the tax base.<sup>213</sup> In fact, it might be more accurate to observe that several discrete schedules apply to income from personal services. Sometimes those schedules are a function of the type of services the taxpayer performs.<sup>214</sup> In addition, benefit distributions under social security may offset the long term regressivity of the social security tax.<sup>215</sup> Nevertheless, taxes on personal service income seem to be regressive overall, as the following paragraphs illustrate.

While the United States purports to apply a uniform rate schedule to taxable income, other than net capital gain,<sup>216</sup> special rules exclude much income from services from gross income.<sup>217</sup> Since those exclusions routinely affect similarly compensated taxpayers dissimilarly, the exclusions cause the effective rate schedule for income from services to be anything but

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<sup>204</sup> I.R.C. §32 (providing a refundable credit or negative income tax for certain personal service income). See discussion *infra* in section II.A..

<sup>205</sup> See discussion *infra* in sections II.B..

<sup>206</sup> For example, I.R.C. §3101 (the Social Security tax in the U.S.). See discussion *infra* in section I.D. of the Social Security tax as tax, rather than retirement savings.

<sup>207</sup> See discussion *infra* in section I.B.4.

<sup>208</sup> For example, I.R.C. §62(a)(1) (excluding employee business expenses from the adjustment to gross income for trade or business expenses); I.R.C. §67 (limiting the deduction of employee business expenses along with other miscellaneous itemized deductions).

<sup>209</sup> See discussion *infra* in section II.C. 3)).

<sup>210</sup> Section 1348 of the 1954 Code, *supra* note 50 and accompanying text.

<sup>211</sup> I.R.C. §469, *supra* note 52 and accompanying text.

<sup>212</sup> For example, I.R.C. §32 (providing a refundable credit or negative income tax for certain personal service income).

<sup>213</sup> For example, I.R.C. §132 (excluding certain compensation amounts from gross income as non-taxable fringe benefits).

<sup>214</sup> For example, ministers may exclude the value of housing received as compensation or a housing allowance. I.R.C. §107. And see discussion of carried interests *infra* in section I.C. 3)).

<sup>215</sup> Consider the effect of the OASDI benefit formula on the regressivity of the social security tax.

<sup>216</sup> I.R.C. §1 (providing a graduated marginal rate schedule with a minimum rate bracket of zero and a maximum rate bracket of 35 percent, but segregating net capital gain and qualified dividend and taxing them under a reduced marginal rate schedule under I.R.C. §1(h)).

<sup>217</sup> Contributions for the service provider's benefit to a qualified retirement plan or individual retirement account under I.R.C. §401 or I.R.C. §408 respectively excluded from application of I.R.C. §83 by I.R.C. §83(e)(2); I.R.C. §132 (excluding certain fringe benefits from gross income).

uniform. A simple example suffices. Consider three taxpayers who receive total compensation of \$100,000 each. The first taxpayer defers no compensation into a retirement or cafeteria plan and receives no part of her compensation in fringe benefits; the second defers \$15,000 into his retirement plan;<sup>218</sup> and the third defers \$15,000 into a retirement plan, directs \$4000 into a cafeteria plan,<sup>219</sup> and receives \$1000 worth of excludable fringe benefits.<sup>220</sup> Gross income from services for the first taxpayer is \$100,000, \$85,000 for the second and \$80,000 for the third. Assume the taxpayers have equal personal exemptions<sup>221</sup> and each claims the standard deduction,<sup>222</sup> so that the differential in gross income from services translates into an identical differential in taxable income.<sup>223</sup> The ability to defer income into a retirement plan, direct income into a cafeteria plan, and receive non-taxable fringe benefits are all items related to income from services and are not available for other sources of income. Although income from services becomes part on the general taxable income computation to which the uniform rate applies,<sup>224</sup> income from services is particularly schedular because it is subject to so many unique adjustments not applicable to other types of income. Those adjustments make income from services likely to generate disparities in tax payable for taxpayers having equal amounts of income from their services. The following paragraphs explore in greater detail some of the schedular features of income based taxes in the United States that are unique to income from services.

**A. The Earned Income Credit.** For low income individuals, the earned income credit<sup>225</sup> effectively creates a series of negative income tax brackets for income from the taxpayer's personal services.<sup>226</sup> The brackets are a function of the number of the taxpayer's dependent children.<sup>227</sup> The maximum amount of personal service income to which the credit applies is also a function of the number of the taxpayer's dependent children.<sup>228</sup>

The earned income credit serves a purpose similar to the general child benefit in Sweden which the state pays to the parent of each child resident in Sweden,<sup>229</sup> in that it provides

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<sup>218</sup> I.R.C. §408 (an individual retirement account, for example).

<sup>219</sup> I.R.C. §125 (a cafeteria plan consisting of excludable benefits such as a flexible spending plan for medical expenditures, childcare, etc.).

<sup>220</sup> I.R.C. §132 (excludable fringe benefits including parking, public transit passes, gym use, employee discounts, etc.).

<sup>221</sup> I.R.C. §151 (deduction for personal and dependency exemptions).

<sup>222</sup> I.R.C. §63(c) (standard deduction in computing taxable income).

<sup>223</sup> I.R.C. §63(a) (defining the computation of taxable income to which the tax rate applies under I.R.C. §1).

<sup>224</sup> I.R.C. §1 (rates of tax).

<sup>225</sup> I.R.C. §32 (earned income credit). For a tax provision targeting low income taxpayers who tend not to be the most educated of U.S. taxpayers, the earned income credit is rather computationally complex.

<sup>226</sup> I.R.C. §32(b). Until the end of 2012, the earned income credit effectively has eight negative brackets. It has four direct negative brackets of 7.65, 34, 40, and 45 percent for taxpayers having respectively 0, 1, 2, or 3 or more children respectively. The phase-out discussed *infra* in note 236 and accompanying text creates four additional phase-out brackets.

<sup>227</sup> The statute uses the term "qualifying child." I.R.C. §32(b) (providing percentages and ceiling amounts of earned income to which to apply the credit); I.R.C. §32(c)(3) (defining qualifying child substantially as a dependent child under I.R.C. §151).

<sup>228</sup> I.R.C. §32(b)(2).

<sup>229</sup> The child benefit (barnbidraget), currently Swedish kronor 1050 (approximately \$175) monthly per child plus additional amounts for each child after the first in the household Socialförsäkringsbalk (Social Insurance Code)

supplemental support for dependent children.<sup>230</sup> The relationship of the rate and maximum amount of the credit to the number of the taxpayer's dependent children is consistent with that support purpose.<sup>231</sup> Unlike the Swedish child benefit, however, Congress made employment a condition for receipt of the benefit in the United States in order to encourage single mothers to work rather than rely on welfare.<sup>232</sup> The Swedish payments are direct subsidies that depend upon the number of dependent children a recipient has but are independent of the recipient's income.<sup>233</sup> Sweden seems to have followed the United States' lead, however, in encouraging employment rather than dependence on welfare programs with when it introduced its earned income tax credit recently.<sup>234</sup>

The earned income credit is specific to personal service income, so that the taxpayer receives no credit on income the taxpayer may have from sources other than her personal services.<sup>235</sup> On the other hand, income from other sources may diminish the amount of the credit in determining whether and the extent to which the credit becomes subject to a phase-out.<sup>236</sup> The phase-out diminishes the amount of the credit by a percentage of the excess of the taxpayer's income from all sources over a phase-out threshold amount the statute specifies.<sup>237</sup> Like the relationship between the number of the taxpayer's dependent children and both the credit percentage and maximum amount of income amount subject to the credit,<sup>238</sup> the phase-out

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(2010:110), 15 kap., 3 § (general child benefit), 8 § (additional for multiple children). For a chart of the allowances, see Försäkringskassan, Barnbidrag och flerbarnstillägg [Social Insurance Fund, Child Supplements and additions amounts for multiple children] (available at [<sup>230</sup> I.R.C. §32\(b\)\(1\) \(increasing the percentage credit for one or two children \(and, temporarily I.R.C. §32\(b\)\(3\)\(A\) for 3 or more children\).](http://www.forsakringskassan.se/privatpers/foralder/barnet_fott/barnbidrag!/ut/p/b1/hZHNrqJAEIwf5T4A0g0osAS7RUBaVEBkQ_gXIB9bFOHph3szyaxmplZVyamT8-WwAeuzQRO9yyLqy7aJ7t93sAolDliqChUgnYAEdHkr443MaSsdsmfWN5JBRIV-xQo6AKicBs0N7-qy6ieMrFHVzo5h2TtZG-VESpZFRbL7SMTXuDp_1s7h0nFizRwc-nFRICMs3bzqsiZLI7ZvPIOqblC-b6_tob1WHO2cVV1yuSXtc3MHAyxFlzB5tPu4CcQWVynAe3Os-5x7bQVIGdKzffj6miEuMwT4yyjgf4wGG-S3RR2VzaKj5Tvqu4w-Z_Lg5_EfvpdZIIY8BED-dtYkDQDddnnNUziRW_Gsw_pACE_V2OnTbTpWYJiIE1jEwRPA0CRucyQxBoRkkKADhMjBE_cxntDG6vEwWnJup97RVRWEEv48_E76J-Qib2l0TzO6iCPaZH2Yt33_s8dlSqOC9exLv0OtNSDFt4enEQunZys9dFGfgdsIozNwsn3ivFfznOpXUpOJUdPSqkXK2SBLP49gFpnN82PBh64I6yF-dpKn73oLpZTfKo7P8Ksps3dg4zBw8qPOXGsU-6ZAt-cW54x6tUiXcRenUGm_KSplLoxs2zpj_u9WxoSIPji6xfDIL8X/dl4/d5/L2dBISEvZ0FBIS9nQSEh/).</p>
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<sup>231</sup> I.R.C. §32(b) (describing percentages and maximum amounts of the credit).

<sup>232</sup> I.R.C. §32(a) (making the credit a function of earned income).

<sup>233</sup> Barnbidraget, *supra* note 229. Similar minimum child benefits are common in the EU, including the Netherlands (Algemene Kinderbijslagwet – AKW (general child supplement law)), Germany (Kindergeld (money for children under the income tax)), Ireland (child benefit), etc. but the conditions of the benefit differ significantly from country to country and may affect the parents' income tax liability.

<sup>234</sup> Jobbskatteavdraget in Swedish. IL 67, kap. 5 – 10 §§ (tax reduction for income from services for certain taxpayers) (2009). See Lodin, INKOMMSTSKATT, *supra* note 25, at 46 -48 (explaining that the tax reduction is computationally complex and uncertain, but that the Swedish legislature intended to encourage taxpayers to work with the tax reduction to make work more valuable than reliance on social welfare benefits).

<sup>235</sup> I.R.C. §32(a)(1) (applying the credit to earned income only). I.R.C. §32(c)(2) (defining earned income).

<sup>236</sup> I.R.C. §32(b) (phasing out the credit based on the excess of the taxpayer's modified adjusted gross income (or personal service income, if greater) over certain threshold amounts).

<sup>237</sup> *Id.*

<sup>238</sup> *Supra* note 227 and accompanying text.

percentages and the phase-out thresholds likewise are a function of the number of the number of the taxpayer's dependent children.<sup>239</sup> The credit phase-out is a steeply progressive setoff to the credit itself. The earned income credit is refundable, so that any taxpayer who qualifies for the credit receives a payment from the government in addition to a refund of the amount of income, but not social security,<sup>240</sup> tax an employer may have withheld from the taxpayer's wages.<sup>241</sup>

Computation of the earned credit slightly favors wage earners over self-employed individuals up to the phase-out threshold because self-employed individuals diminish the base for computation of the credit by the amount of their business expenses but wage earners do not.<sup>242</sup> The earned income tax credit is a moderately progressive feature of the United States income tax as the phase-out causes it to diminish as the taxpayer's income increases. It is moderately progressive insofar as it benefits lower income individuals, but, within the set of lower income individuals, those with higher incomes from personal services, which are less than or equal to the maximum credit base, receive larger credits than do lower income individuals.<sup>243</sup> Although combined with the regular income tax, the earned income credit requires separate computations and is schedular in nature.

**B Personal Service Income Exclusions.** While the earned income credit is specific to low income individuals with respect to their personal service income, there also are items of personal service income that the Code excludes from gross income.<sup>244</sup> Most of these exclusions do not target a specific income class as the earned income credit does. Often the statutory provisions even prohibit discrimination in favor of highly compensated employees in distribution of the benefit.<sup>245</sup> Non-discrimination requirements suggest that the exclusions are distributionally neutral. Yet, whenever the benefit excludes items from the gross income of some taxpayers while others must pay for the items with after tax dollars,<sup>246</sup> distribution of the benefit in fact

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<sup>239</sup> I.R.C. §32(b) (providing phase-out percentages of 7.65, 15.98, 21.06 and 21.06 respectively for taxpayer's having zero, one, two, and three or more qualifying children of modified adjusted gross income in excess of \$5280 for taxpayer's with no qualifying children and \$11,610 for all other taxpayers).

<sup>240</sup> As discussed *infra* in text accompanying and following note 373, the social security tax is a tax on personal service income and is refundable only in those instances in which the taxpayer paid more than the maximum social security tax for the year, for example, when the taxpayer had two or more employers during the year.

<sup>241</sup> Under the Code, there are non-refundable credits that reduce the amount of tax the taxpayer otherwise would have to pay but not below zero. I.R.C. §26 (limiting certain credits to the amount of the taxpayer's tax liability). Refundable credits are amounts the taxpayer receives without regard to the taxpayer's tax liability. I.R.C. §6401 (treating excess refundable credits as overpayments). I.R.C. §6402(a) (requiring the IRS to refund overpayments).

<sup>242</sup> I.R.C. §32(c)(2)(A) defines earned income as wages plus net earnings from self-employment. Net earnings from self-employment is gross income from self-employment less expenses incurred to produce the income. I.R.C. §1402(a) (defining net earnings from self-employment).

<sup>243</sup> For example, an individual with 3 children and wages of \$5000 receives a credit of \$2,250 while another taxpayer with 3 children and wages of \$8,890 (the maximum earned income amount to which a credit applies) receives a credit of \$4000.50.

<sup>244</sup> I.R.C. §119 (excluding meals and lodging for the convenience of the employer); I.R.C. §132 (excluding various fringe benefits), for examples.

<sup>245</sup> For example, I.R.C. §132(j)(1) (requiring that no-additional cost fringe benefits and employee discounts be available to a class of employees that does not favor highly compensated individuals).

<sup>246</sup> For example, I.R.C. §119 (excluding from gross income certain meals and lodging where the employee's payment for the meals and lodging would be non-deductible living expenses under I.R.C. §262(a) (personal, living

discriminates in favor of a class of individuals whose employers provide such benefits. Those individuals receive a discrete class of income that is subject to a zero rate of tax.

1) **Meals and Lodging.** Prominent among those exclusions is the exclusion from gross income for meals and lodging provided on the employer's premises for the convenience of the employer. The exclusion allows both high income and low income taxpayers to exclude possibly significant amounts of income from services from their gross incomes.<sup>247</sup> The classic case for exclusion of meals and lodging from gross income suggests, albeit probably incorrectly, that meals and lodging are not income at all.<sup>248</sup> Provision of meals and lodging may enhance the employer's profitability more than the value of the meals and lodging. Employees who remain on the employer's premises during meal and rest periods may work more than employees who leave the employer's premises. In some businesses, babysitting, for example, the employee's constant availability for the employer's needs is indispensable. Nevertheless, meals and lodging also benefit to the employee.<sup>249</sup> Since the employee would not have received the meals and lodging if he had not performed services for the employer, the value of the meals and lodging is part of a market exchange of services for the benefit and like cash payments is income to the employee.<sup>250</sup>

Sweden has no similar statutory exclusion. Recognizing that employer provided meals go beyond any incidental and *de minimus* benefit, Sweden specifically limits its statutory exclusion to snacks and drinks for the employee's comfort while working but not if the food

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and family expenses)). Compare the exclusion for the rental value of a parsonage under I.R.C. §107, which also is compensation for personal services.

<sup>247</sup> *Id.*

<sup>248</sup> *Benaglia v. Commissioner*, 36 B.T.A. 838 (B.T.A. 1937), acq. 1940-1 CB 1, (holding that gross income does not include meals and lodging provided to a hotel manager of luxury resort and his family because the manager had to be available 24 hours each day and, therefore had to accept meals and lodging as a condition of his employment). Congress enacted I.R.C. §119 and codified and clarified the rules on the exclusion soon after the decision. The decision seems too broad insofar as the meals and lodging replace meals and lodging for which the manager otherwise would have had to pay. The receipt in exchange for services certainly seems to be a market exchange for value of services for meals and lodging that is a benefit and income to the employee. The Board of Tax Appeals, the predecessor to the United States Tax Court, may have decided to exclude the value of the meals and lodging because, at retail, the value was so disproportionate to the manager's salary that he would have been left with little cash compensation after payment of the tax and other measures of value to the employee were speculative.

<sup>249</sup> Compare, however, instances in which the meals and lodging would be deductible under I.R.C. §162 because they duplicate what otherwise would be living expenses as when the employee has to be away from home on business.

<sup>250</sup> I.R.C. §61. Rare would be an employer who would be sufficiently altruistic to retain an employee whose services produced less value to the employer than the employer's cost of wages and benefits paid to the employee. If the employer's provision of meals and lodging duplicates the employee's living expense, the exclusion is easier to understand. In such instances, the exclusion would operate similarly to the deduction for ordinary service provider business expenses under I.R.C. §162. Compare I.R.C. §62(a)(2)(A) (classifying reimbursed expenses as adjustments to gross income (above the line deductions) and I.R.C. §274(e)(3) (excepting certain reimbursed expenses from the deduction disallowance for entertainment expenses. For example, if an employee must work away from home a certain number of days and the employer provides housing, the expense would be duplicative to the employee and would be deductible under I.R.C. §162.

constitutes a meal.<sup>251</sup> Employees in Sweden who receive meals or lodging from their employers must include their value in the income from personal services.<sup>252</sup> Sweden avoids the subjective element in the valuation of the meals by providing a statutory standard amount for the inclusion for meals that an employer provides.<sup>253</sup> Decisional law, however, requires inclusion in income for meals the employee accepts rather than applying a broad constructive receipt<sup>254</sup> inclusion to meals the employer makes available to the employee.<sup>255</sup>

Resident resort managers probably are not the primary beneficiary of the meals and lodging exclusion. They are likely less common than residential building superintendents in New York City who live in the buildings they service.<sup>256</sup> Similarly, many household workers, including nannies, home care workers for the elderly or disabled, maids and butlers under the provisions of the statute may exclude from their gross incomes the value of the meals and lodging they receive in their employers' homes.<sup>257</sup> For some household workers like foreign *au pairs* who use the household work to give them an opportunity to live in the United States for a limited period, compensation may be limited to meals and lodging.<sup>258</sup> While Sweden has no similar exclusion that would apply to household workers, Sweden does have a lower statutory inclusion for household workers' lodging and meals than would apply to other employment settings,<sup>259</sup> and *au pairs* may fit the category of interns or trainees for whom the statute permits further adjustment to the inclusion if meals and lodging are the primary form of compensation.<sup>260</sup>

The exclusion from gross income for meals and lodging in the United States also may disserve some low paid workers. Those workers would receive a larger earned income credit if

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<sup>251</sup> IL 11 kap. 11§ Personalvårdsförmåner (benefits for comfort of personnel)(excludes items such as food and drink on the job but IL 11 kap, 12§ expressly limits food and drink to items that do not make up a meal). Sweden does not tax the employee if the employee does not accept the benefit.

<sup>252</sup> Inkomst från tjänst (income from services). IL 10 kap., 10.1 §, *supra* note 20.

<sup>253</sup> IL 61 kap. 3 § (setting the value of a day's meals at 250% of the average lunch cost in Sweden). See note 259 *infra* for discussion of the lower value applies to household workers receiving meals and lodging from their employers and note 260 *infra* and accompanying text for adjustment to inclusion where meals and lodging are predominate form of compensation.

<sup>254</sup> The concept of constructive receipt is that an item becomes income when the taxpayer has the power to take the item even if the taxpayer does not take it. For example, constructive receipt requires the taxpayer to include interest that a financial institution credits to his account in the year of the credit rather than when the taxpayer withdraws the interest in order to take possession of it.

<sup>255</sup> Lodin, INKOMMSTSKATT, *supra* note 25, at 140 (discussing the decision in which an employee who was vegetarian did not accept available meals and was not taxed on their value because the employer did not offer vegetarian meals).

<sup>256</sup> **Stats on number of resident supers**

<sup>257</sup> I.R.C. §119. At the lower end of the household worker wage scale, many workers do not report their incomes in order to avoid paying social security taxes or because they are undocumented workers who fear deportation if they are detected. Because they do not enter the income tax system, they also fail to claim the earned income credit to which they might be entitled.

<sup>258</sup> See the website for the J-1 visitor visa program at <http://j1visa.state.gov/programs/au-pair/>.

<sup>259</sup> IL 61 kap., 3 a § (setting the value of lodging at 20 Swedish kronor – approximately \$3.00 – per day, and the value of meals at 50 Swedish kronor per day – approximately \$8.00 -- for 2 or more meals). For the higher amount for other employment contexts, see note 253 *supra*.

<sup>260</sup> IL 61 kap., 21 § (unspecific downward adjustment in inclusion for meals and lodging for trainees and similar where cash compensation is minimal).

the value of the meals and lodging were includable in their gross incomes.<sup>261</sup> The additional social security tax those workers with dependent children might pay on the imputed wage amount from meals and lodging generally will be less than the increased earned income credit and, on the benefit side, may enhance the workers' social security benefits when they reach retirement age.<sup>262</sup>

**2) Excluded Fringe Benefits.** Fringe benefits<sup>263</sup> are items of value that a service recipient, generally an employer, gives to a service provider, generally an employee, in non-cash form.<sup>264</sup> Both in the United States and Sweden, the value of many fringe benefits is excludable from gross income.<sup>265</sup> Excludable fringe benefits make up a separate class, or, in Sweden, subclass of personal service income that the recipients do not include in their tax computations.<sup>266</sup> While the items in the class of excludable fringe benefits are not identical in the United States and Sweden, many are similar. For example, fringe benefits include items (i) to improve the quality of the working environment,<sup>267</sup> enable the employee to consume the employer's services without cost,<sup>268</sup> purchase goods the employer sells at a price lower than that offered to the public,<sup>269</sup> and even subsidize the employee's commuting cost.<sup>270</sup>

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<sup>261</sup> I.R.C. §32 and discussion *supra* in text accompany and following note 225. The additional social security and Medicare tax payable currently at the combined employer/employee rate of 15.6 percent (reduced temporarily to 13.6 percent) under I.R.C. §3101 is still less than the 40 percent maximum earned income credit under I.R.C. §32(b).

<sup>262</sup> The Social Security benefit formula is a function of the amount the recipient has paid into the social security system through the tax on wages. See, generally, the Social Security Administration website at <http://socialsecurity.gov/pubs/10035.html> on benefits.

<sup>263</sup> Förmåner in Swedish.

<sup>264</sup> Westin, WG&L TAX DICTIONARY, *supra* note 62 at 301 (Valhalla 2000).

<sup>265</sup> Among other excludable fringe benefits in the United States are I.R.C. §132 (exclusion of certain fringe benefits); I.R.C. §106 (exclusion of employer provided coverage under an accident or health plan); I.R.C. §79 (exclusion of group term life insurance); I.R.C. §125 (cafeteria plans). Similar Swedish exclusions appear primarily in parts of IL 11 kap. listing items included or excluded from the personal service income class. Many exclusions parallel U.S. exclusions including IL 11 kap. 18 § (exclusion of certain health care benefits); 20 § (health insurance); 19 § (group life insurance).

<sup>266</sup> In the U.S., for example, I.R.C. §3121(a) (excluding fringe benefits from wages for purposes of the social security and Medicare taxes); I.R.C. §32(a) (basing the earned income credit on earned income); I.R.C. §32(c)(2) (defining earned income as wages, etc. only if the amounts are includable in gross income).

<sup>267</sup> I.R.C. §132(a)(3) (working condition fringe which would be any item where if the employee paid for it, the payment would be deductible by the employee under I.R.C. §162 (ordinary and necessary business expenses) or I.R.C. §167 (depreciation or amortization) and I.R.C. §132(j)(4) (on site athletic facility for the use of employees and their spouses and dependents). IL 11 kap. 11 § Personavårdsförmåner (benefits for the comfort of employees); IL 11 kap. 8 § (items of limited value in conjunction with the employee's performance of services).

<sup>268</sup> I.R.C. §132(a)(1) (no additional cost fringe such as a travel pass for airline employees). Sweden has no corresponding exclusion. IL 11 kap. 13 §. If, however, the employee may fly stand-by only, the included value is 40 percent of the lowest normal fare for the flight. IL 63 kap. 13 §. Similarly, an annual pass for train travel has a value of only 5 percent of the value of a similar pass for public sale if the pass has additional restrictions of stand-by use only and more restrictive limitations on available travel time.

<sup>269</sup> I.R.C. §132(a)(2) (employee discounts). Similarly in Sweden IL 11 kap. 13 § (excludable employee discounts).

<sup>270</sup> I.R.C. §132(a)(5), (f) (qualified transportation fringe). Sweden does not provide a similar fringe but includes the commuting benefit in the employee's income. IL 10 kap. 9 § (time for inclusion of railway pass); IL 10 kap. 10 § (time for inclusion of vehicle fuel). Unlike the U.S., however, Sweden allows a limited deduction for commuting costs in excess of SEK 10,000 (approx. \$1700) per year. IL 12 kap. 26 §.



Absent a statutory exclusion, employees must include the fair market value of non-cash compensation they receive,<sup>271</sup> and the employer may deduct (or capitalize) the amount the employee includes.<sup>272</sup> Whenever the employee may exclude the value of the benefit from income, the employer's deduction is limited to the employer's cost of providing the benefit.<sup>273</sup> While the more limited employer's deduction and commensurate greater taxable income may offset, usually only partially, the tax that the employee would have had to pay if the benefit were includable in the employee's income, the exclusion nevertheless remains irreconcilable with the principle of horizontal equity. Two individuals receiving equal amounts of comprehensive income may pay different amounts of tax if the comprehensive income of one but not the other includes excludable fringe benefits. The taxpayer with excludable fringe benefits has less taxable income than the taxpayer with no such benefits.<sup>274</sup>

To some degree, horizontal equity might yield to administrative necessity. The exclusion of *de minimus* fringe benefits,<sup>275</sup> for example, purportedly is a matter of administrative practicality: where "the value ... is so small as to make accounting for it unreasonable or administratively impractical."<sup>276</sup> Sweden similarly excludes *de minimus* items so long as they are available to all employees, are not (1) discounts, (2) usable other than at the employer's place

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<sup>271</sup> I.R.C. §83(a) (inclusion of the value of property received for services).

<sup>272</sup> I.R.C. §83(h) (deduction of the value of non-cash compensation). While I.R.C. §83(h) refers to the employer's deduction when the employee includes an item in income, the deduction is always subject to the capitalization requirements if the employee's services involve the realization of longer term property. Treas. reg. §1.83-6(a)(4) (capitalizing the amount of the service provider's inclusion).

<sup>273</sup> I.R.C. §162(a) (deduction for ordinary and necessary business expenses). I.R.C. §83 quantifies the ordinary and necessary business expense and fixes both the amount of the inclusion and the deduction. Absent a special rule, the deduction is the actual cost to the employer rather than the value to the employee. However, if the employer pays the employee with appreciated property, the employer recognizes gain as if the employer sold the property to the employee for the fair market value of the property. Treas. reg. §1.83-6(b).

<sup>274</sup> Similarly, see Lodin, INKOMMSTSKATT, *supra* note 25, at 138: Ett grundläggande syfte med beskattningen av förmåner är att åstadkomma neutralitet mellan olika avlöningsformer. ... Grundtanken är ... att personliga levnadskostnader ska finansieras med beskattade medel. ... [A]vsteg från denna princip lockar parterna att utnyttja avlöningsformer som de vid neutral regler rimligen inte skulle övervägt, vilket leder till snedvridande effekter av olika slag." (A basic goal of taxation of benefits is to achieve neutrality among various forms of compensation. ... The basic thought is that personal living expenses should be financed with after tax resources. ... [D]epartures from this principle encourage the parties to exploit forms of compensation they would not have considered in the face of neutral rules. This leads to various types of distortive effects. (Author's translation))

<sup>275</sup> I.R.C. §132(a)(4), (e) (respectively exclusion and definition of *de minimus* fringe). IL 11 kap. 8 § (items of limited value) and IL 11 kap. 11 § (items for comfort of employees), *supra* note 267.

<sup>276</sup> I.R.C. §132(e) (*de minimus* fringe definition). The *de minimus* category in the United States also includes an eating facility for employees on or near the employer's business premises made available on a non-discriminatory basis as long as revenues from the facility equal the direct operating cost of the facility. I.R.C. §132(e)(2). Revenue of the facility includes the direct operating costs of providing meals to employees that are excludable under I.R.C. §119. While employees may be indifferent to whether their exclusion is under I.R.C. §119 or I.R.C. §132(a)(4), employers are not. I.R.C. §274(n)(1) limits the deduction for meals to 50 percent of the expense unless under I.R.C. §132(n)(2)(B) the meals are *de minimus* fringe benefits under 132(e). See the recent legal memorandum from Chief Counsel, August 31, 2011 CC:TEGE:EOEG:ET:2 - POSTU-129381-09, UILC: 119.00-00, 132.04-02, Release Date: 12/23/2011, TNT December 27, 2011 available at <http://services.taxanalysts.com/taxbase/tnt3.nsf/%28Number/2011+TNT+248-24?OpenDocument&Login> on the interplay between I.R.C. §132(e)(*de minimus* fringe benefits) and I.R.C. §274(n) (limitation on deductibility of meals to 50 percent on cost) concluding that meals for airline workers on planes are not *de minimus* fringe benefits so the airline's deduction is limited to 50 percent.

of business, or (3) exchangeable for cash.<sup>277</sup> If the benefits truly are *de minimus*, they would not distort horizontal equity in any meaningful way. Other fringe benefits, air travel passes for example, simply enable employers to substitute valuable nontaxable benefits for cash compensation at a cost to the employers that is less than the additional cash compensation that would be necessary to provide the same value to the employee.<sup>278</sup> For other benefits, the employer may save little or no cost in providing the nontaxable benefit, but the employee might demand a greater wage if that benefit were not in her compensation package.<sup>279</sup> And, while the deductibility condition<sup>280</sup> underlying the exclusion of working condition fringe benefits<sup>281</sup> is misleading insofar as employee business expenses generally are disfavored as itemized deductions<sup>282</sup> and subject to the two percent floor on miscellaneous itemized deductions,<sup>283</sup> valuation of the actual benefit to the employee is extremely subjective and uncertain. The exclusive use of an office, its size and furnishings, may have considerable value to an executive employee because the office helps define the employee's status. A work station for a rank and file employee may give that employee no status and, thus, little or no value. In either case, quantifying the value to the employee might prove futile. While Sweden does not have an identical exclusion for working condition fringes, it does exclude property and services that the employer provides if they are necessary to performance of the employee's job and the separate value to the employee is small and difficult to ascertain.<sup>284</sup>

In many instances the correlation between the tax exemption of the benefit and the value to the employee is straightforward. Both cafeteria plans<sup>285</sup> and qualified transportation fringes<sup>286</sup> enable employees to pay for certain benefits through a salary reduction arrangement. The salary

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<sup>277</sup> IL 11 kap., 11 § Personalvårdförmåner (personal care benefits excludable from income). “Med personalvårdsförmåner avses förmåner av mindre värde som inte är en direkt ersättning för utfört arbete utan består av enklare åtgärder för att skapa trivsel i arbetet ...” (Personal care benefits means benefits of small value that are not direct compensation for services but consist of simple means to create a comfortable work environment ... (Author's translation)) Similarly in Sweden, IL kap. 11, 8 § (working condition fringes if value to the employee is limited).

<sup>278</sup> For example, no additional cost services like air passes for airline employees under I.R.C. §132(a)(1) cost the employer little but may have substantial value to the employee who otherwise might have to pay for a commercial flight for family members and herself. The stand-by rule and complexity of airfares make determination of the value of the benefit difficult. Sweden includes the value of the benefit but standardizes the method for determining value in order to avoid the valuation issue. IL 63 kap. 13 §, *supra* note 268.

<sup>279</sup> For example, qualified transportation fringes under I.R.C. §132(a)(5) may require the employer to pay for a rail or bus pass for each employee; group term life insurance under I.R.C. §79; health insurance under I.R.C. §105, etc.

<sup>280</sup> I.R.C. §132(d) (defining something as a working condition fringe only if the employee's purchase of the item would be allowable as a deduction to the employee under I.R.C. §162 or I.R.C. §167).

<sup>281</sup> I.R.C. §132(a)(3), (d) (respectively exclusion and definition of working condition fringe), *supra* note 267.

<sup>282</sup> I.R.C. §62(a)(1) (allowing employee business expenses as adjustments to gross income only if the employer reimburses the expenditure) is a provision that treats employer reimbursements more favorably than expenses an employee bears.

<sup>283</sup> I.R.C. §67(a) (miscellaneous itemized deductions become itemized deductions under I.R.C. §63 only to the extent they exceed in the aggregate 2 percent of the taxpayer's adjusted gross income under I.R.C. §62).

<sup>284</sup> IL 11 kap. 8 § (Varor och tjänster av begränsat värde (goods and services of limited value)).

<sup>285</sup> I.R.C. §125 (cafeteria plans of benefits under which the employee may direct part of her compensation to a group of benefits or take cash compensation).

<sup>286</sup> I.R.C. §132(f)(4) (no constructive receipt if the employee could have taken cash rather than the qualified transportation fringe but took the fringe benefit).

the employee directs to the plan is excludable from the employee's gross income.<sup>287</sup> While the employer could offer each of the cafeteria plan benefits to employees without any inclusion in the employee's income, employers who are unwilling to pay for the benefits may make them available to the employees through the cafeteria plan.

**C Compensation Deferrals.** Exclusions for meals and lodging<sup>288</sup> and fringe benefits<sup>289</sup> form a class of non-taxable personal service income available to some, but not all, taxpayers. Availability of the exclusion to the employee is a function of the nature of the employment<sup>290</sup> and decisions of employers to make the exclusions available to their employees. Most of that class of excluded income remains wholly unavailable to self-employed individuals.<sup>291</sup> However, the ability to defer part of one's personal service income and save it for a later point in the individual's life is a universally available opportunity in the United States.

Not all deferral techniques are equally beneficial<sup>292</sup> nor are all techniques available to all taxpayers. Nevertheless, each taxpayer who has income from personal services has access to one or more deferral methods.<sup>293</sup> The maximum amount of the available deferral differs depending on the nature of the deferral plan.<sup>294</sup> As a group, individuals with higher incomes defer more personal service income than do individuals with lower incomes because higher income individuals need to consume a smaller percentage of their income for current living expenses.<sup>295</sup> A recent Congressional Research Service publication observed with respect to individual retirement accounts:<sup>296</sup>

IRAs have often been differentiated from other tax benefits for capital income as the plan focused on moderate income or middle class individuals. The IRA has been successful to the extent that more of the benefits are targeted to moderate-income individuals than is the case for many other tax benefits for capital (e.g., capital gains tax reductions). Nevertheless, data on participation and

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<sup>287</sup> I.R.C. §125(a).

<sup>288</sup> Part I.B.2 *supra*.

<sup>289</sup> Part I.B.3 *supra*.

<sup>290</sup> For example, only employees whose duties require them to be available on the employer's premises at all times may exclude the value of lodging under I.R.C. §119.

<sup>291</sup> Exceptions for certain medical insurance under I.R.C. §162(l).

<sup>292</sup> For example, the income deferred to an IRA remains subject to social security and Medicare taxes while an employer contribution to a profit sharing plan is not. I.R.C. §3121(a)(5) (excluding employer contributions to qualified plans and SEP IRAs and all distributions from IRAs and employer plans from the definition of wages subject to the social security and Medicare taxes).

<sup>293</sup> Pension plans, profit sharing plans, 401k, 403b, SEP IRAs, etc.

<sup>294</sup> Lower contribution limits apply to traditional IRAs than apply to employer plans. Compare I.R.C. §219(b) contribution limits with I.R.C. §415 contribution limits for employer plans.

<sup>295</sup> **Stats**

<sup>296</sup> Individual retirement accounts ("IRAs") under I.R.C. §219 are available to taxpayers for whom an employer does not maintain a retirement plan. Subject to contribution limitations under I.R.C. §219(b), currently an inflation adjusted \$5000, taxpayers may contribute a portion of their personal service income to an IRA and deduct the amount of the contribution under I.R.C. §219(a). The deductible amounts a taxpayer contributes to an IRA remain subject to social security and Medicare taxes. In lieu of deferral, individuals may select a Roth IRA to which contributions are not deductible but distributions are not includable in income. I.R.C. §408A, discussed *infra* in text accompanying note 312.

usage of IRAs suggest that the benefits still accrue primarily to higher-income individuals.<sup>297</sup>

1) **Statutory Qualified Deferral Plans and Roth IRAs.** Deferred compensation arrangements vary widely in their characteristics. Most qualified plans<sup>298</sup> permit the employer to deduct the full amount of employee compensation that passes into the plan's trust.<sup>299</sup> Similarly, payments that a recipient of services makes to a service provider who is not an employee are deductible under the usual rules of deductibility even if the service provider transfers them to an IRA and claims current deduction for deferral of the compensation.<sup>300</sup> In either the case of a qualified plan or the service provider's deductible transfer of personal service income to an IRA, the employees (or non-employee service providers) do not include the amounts of compensation passing into the plan (or which the non-employee contributes to a retirement arrangement) even if their shares of the plan or arrangement are fully vested.<sup>301</sup> Moreover, the plan's trust, including an IRA account, is exempt from tax on its investment earnings or gain from the sale of its assets.<sup>302</sup> The employee or service provider becomes taxable when and to the extent that the plan makes distributions to the employee.<sup>303</sup>

Whether those distributions are from the deferred income or the investment return on the deferred income, the recipient includes them as ordinary income,<sup>304</sup> but not wages for purposes of the social security and Medicare taxes.<sup>305</sup> The employer's contributions to a qualified plan

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<sup>297</sup> Thomas L. Hungerford and Jane G. Gravelle, Individual Retirement Accounts (IRAs): Issues and Proposed Expansion 16, Congressional Research Service 7-5700, RL30255 (January 6, 2012).

<sup>298</sup> I.R.C. §401(a) (defining qualified pension, profit sharing, etc. plans).

<sup>299</sup> I.R.C. §404(a) (allowing a deduction for contributions to a plan that would have been deductible as compensation if paid to the employee under I.R.C. §162(a) (ordinary and necessary business expense) as long as the plan is qualified under I.R.C. §401(a)). Contribution limitations restrict the amount of contributions that employers and employees may make to the plan.

<sup>300</sup> For example, an IRA under I.R.C. §§219, 408. But a service recipient receives a deduction only when the service provider includes the amount in income if the service recipient makes the payment to a third party in a manner that the provider need not include the amount in income. I.R.C. §§83, 404(d).

<sup>301</sup> Treas. reg. § 1.402(a)-1(a)(1)(i) (deferring inclusion of contributions to an employee's trust until the time of actual distribution). Although I.R.C. §402 implies that the employee does not include the deferred compensation until the employee receives distributions from the trust, apparently no statute expressly excludes the compensation from the employee's income when the employer transfers funds to the trust.

<sup>302</sup> I.R.C. §501(a), subject to the unrelated business income tax under I.R.C. §511 if the trust engages in an unrelated business or is a partner in a partnership or a member of a limited liability company that engages in a trade or business. I.R.C. §702(b) (tax character of partnership items preserved in the hands of the partners).

<sup>303</sup> I.R.C. §402(a) (distributees from exempt I.R.C. §401 trusts taxable on trust distributions under the rules of I.R.C. §72 (relating to annuities)).

<sup>304</sup> *Id.*

<sup>305</sup> I.R.C. §3121(a)(5) (excluding payments from or to a trust under I.R.C. §401(a) exempt from tax under I.R.C. §501(a)). Similarly, for self-employed individuals I.R.C. §1401 imposes the tax on net earnings from self-employment. The self-employed individual is an owner-employee under I.R.C. §408(k) (relating to simplified employee pension IRA (SEP IRAs) so that the contribution from the trade or business to a SEP IRA is deductible under I.R.C. §404(a)(8), (h) (classifying self-employed individuals as employees; treating SEP IRAs as plans under I.R.C. §404) as a trade or business expense reducing the self-employed individual's net earnings from self-employment and leaving only the net after deductible contributions to retirement plans subject to the self-employment tax. And see, I.R.C. §3121(k)(1) (excluding payments to a SEP IRA from the definition of wages).

also are not wages,<sup>306</sup> but the service provider's voluntary deferrals to an IRA or an employer's plan are wages subject to the social security and Medicare taxes when earned and deferred.<sup>307</sup> The employee's interest in the plan remains deferred ordinary income even if someone other than the employee receives it after the employee's death. Distributions from the plan retain their ordinary income character as income in respect of a decedent.<sup>308</sup> Unlike other property interests an individual may hold at death, the vested interest in the plan does not get a new basis at death.<sup>309</sup> Accordingly, this separate class of deferred personal service income differs from both (i) ordinary compensation income not just in the deferral but also, in the case of a qualified plan, because the employer's contributions are not subject to social security and Medicare taxes and (ii) wholly excludable income in the form of meals and lodging<sup>310</sup> and fringe benefits<sup>311</sup> because those benefits never become subject to the income, social security, and Medicare taxes.

Roth IRAs are a variant on the deferred personal service income model.<sup>312</sup> Unlike other IRAs, the individual may not deduct her contribution to the Roth IRA,<sup>313</sup> but distributions from the Roth IRA are not includable in the income of the recipient, whether the recipient is the individual who contributed to the Roth IRA or an individual who inherited the Roth IRA.<sup>314</sup> Since the Roth IRA, like other IRAs, is not taxable on its earnings, it is economically equivalent to a regular IRA whenever rates of investment return and the owner's tax rate remain constant.<sup>315</sup> Also like other IRAs, the amounts that an individual contributes to the Roth IRA are wages (or self-employment income) subject to the social security (or self-employment) and Medicare taxes.<sup>316</sup>

In addition to its national pension system that has broader coverage than social security does in the United States,<sup>317</sup> Sweden has rules similar to the United States' rules for qualified plans, including both employer provided *pensionförsäkring*<sup>318</sup> (pension insurance) and *individuellt pensionssparande*<sup>319</sup> (individual pension savings). The employer may deduct payments for *pensionförsäkring* to provide employer funded plans, and the employee becomes

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<sup>306</sup> I.R.C. §3121(a)(5) (employer contributions not wages).

<sup>307</sup> I.R.C. §3121(a)(5)(C), (D), for example (voluntary wage reductions).

<sup>308</sup> I.R.C. §691 (treatment of income in respect of a decedent).

<sup>309</sup> I.R.C. §1014 (property received from a decedent takes a fair market value basis at date of death).

<sup>310</sup> I.R.C. §119 and part I.B.2 *supra*.

<sup>311</sup> Part I.B.3 *supra*.

<sup>312</sup> I.R.C. §408A (defining and providing rules for Roth IRAs).

<sup>313</sup> I.R.C. §408A(c)(1) (denying deduction under I.R.C. §219 for contributions to a Roth IRA).

<sup>314</sup> I.R.C. §408A(d).

<sup>315</sup> A simple example illustrates this observation. If one individual subject to tax at 30 percent invests \$1000 in a regular IRA that doubles in value over some years until withdrawal and pays tax at 30 percent on the \$2000 she receives, her net after tax from the IRA is \$2000 less \$600 tax for \$1400. If the same individual used a Roth IRA, she would pay \$300 tax upon contribution and reduce her investment to \$700. The \$700 comparably invested would double to \$1400 and become subject to no further tax on withdrawal. Incidence of the estate tax (if any) on the IRA or Roth IRA in a decedent's estate should not affect this equivalence because of the deduction for the estate tax under I.R.C. §691(c) (relating to income in respect of a decedent) that will eliminate the impact of the higher estate tax on the regular IRA.

<sup>316</sup> I.R.C. §§3121, 1401.

<sup>317</sup> Lodin, *INKOMMSTSKATT*, *supra* note 25, at 165 (discussing the three pillars of the pension system).

<sup>318</sup> *Id.* at 166.

<sup>319</sup> *Id.* at 170.

taxable in the personal service income category (*inkomst från tjänst*) when the employee receives distributions from the plan.<sup>320</sup> The insurer (since it is a form of insurance) or pension provider is taxable at a decreased rate of tax on the internal build-up in value of the employee's account.<sup>321</sup> Although trusts do not exist under Swedish law, individuals may contract with commercial or investment banks to establish tax-deferred savings accounts similar to U.S. IRAs. Under those arrangements, the individual may deduct the funds she transfers to the account, defer tax on the earnings in the account, and pay tax in the personal service income category when she receives distributions from of the account funds.<sup>322</sup>

**2) Non-qualified Deferral Arrangements.** Not all deferred personal service income belongs to the classes the preceding paragraphs describe.<sup>323</sup> In some instances the service recipient may neither deduct nor capitalize the compensation for tax purposes until the service provider includes the amount in her income.<sup>324</sup> An employer may give an employee an ownership interest in the employer's business – corporate shares, for example -- both to reward the employee's efforts and to secure the employee's continuing loyalty and service. In order to deter the employee from accepting the ownership interest, selling it to a third party, and quickly changing employment, the employer might attach a condition of a required period of continued service to the ownership interest. If the employee terminates her employment during the required service period, the ownership interest terminates. Under that condition, the employee need not include the value of the ownership interest in her income until the interest ceases to be subject to a risk of forfeiture.<sup>325</sup> The employee must include the value of the interest as ordinary income<sup>326</sup> and wages<sup>327</sup> subject to the social security and Medicare taxes<sup>328</sup> when the risk of forfeiture no longer applies. The employer may deduct or capitalize the amount the employee included when the employee includes it in her income.<sup>329</sup>

The employee may avoid ordinary income characterization of the post-transfer appreciation in the value of the interest by electing to include its value when she receives it subject to the risk of forfeiture.<sup>330</sup> The election would make sense if the employee is certain that she will continue to work in the business and believes that the interest is likely to appreciate rapidly in value. However, if she later forfeits the interest, she will not be able to deduct as a

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<sup>320</sup> *Id.* at 166.

<sup>321</sup> *Id.* at 168.

<sup>322</sup> *Id.* at 170.

<sup>323</sup> Text accompanying notes 288 to 316 *supra*.

<sup>324</sup> I.R.C. §83(h) (deferring the service recipient's deduction, or capitalization, as the case may be, of property the service recipient transfers to another person, albeit irrevocably, until the service provider includes the value of the property in her gross income).

<sup>325</sup> I.R.C. §83(a).

<sup>326</sup> *Id.*

<sup>327</sup> I.R.C. §3121(a).

<sup>328</sup> I.R.C. §3101.

<sup>329</sup> I.R.C. §83(h), treas. reg. §1.83-6(a)(4) (characterizing the deduction under I.R.C. §83(h) as a rule of capitalization where the payment relates to creation or purchase of a long term asset or inventory); 162(a), 263, 263A. See, generally, Henry Ordower, Seeking Consistency in Relating Capital to Current Expenditures, 24 VA. TAX REV. 263, 285-7 (2004) (explaining the I.R.C. §83(h) capitalization requirement).

<sup>330</sup> I.R.C. §83(b)(1).

loss the amount she included in income under the election<sup>331</sup> or recover social security and Medicare taxes paid on the earlier included amount. The employee's basis in the interest is the amount she included in her income at the time of the election.<sup>332</sup> As long as the employee holds the interest for more than one year, the post-election appreciation becomes long term capital gain,<sup>333</sup> rather than ordinary compensation income, upon sale of the interest.<sup>334</sup> The employee's election controls the timing and amount of the employer's deduction so that the inclusion and deduction or capitalization are identical in amount and timing.<sup>335</sup>

Variants on the compensatory transfer subject to a risk of forfeiture include contractually binding, unfunded promises to pay compensation the future<sup>336</sup> and funded transfers into trusts that remain subject to the claims of the service recipient's creditors.<sup>337</sup> Sweden similarly taxes employees on a cash basis of accounting so that a voluntary deferral before the employee performs the services avoids constructive receipt and defers the compensation until the time of actual payment.<sup>338</sup> Highly compensated individuals have used the former type of deferred compensation successfully when the service recipient is a safe credit risk so that the service provider has little concern that the service recipient might not make the payment when it becomes due.<sup>339</sup> Historically, an accrual basis service recipient could deduct the future compensation currently<sup>340</sup> while the service provider as a cash basis taxpayer would include the payment only when received.<sup>341</sup> Current rules in the United States defer the deduction until the service provider includes the income.<sup>342</sup> Sweden does not defer the deduction for the accrual basis service recipient.<sup>343</sup>

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<sup>331</sup> *Id.*

<sup>332</sup> Treas. reg. §1.83-2(a), -4(b). I.R.C. §1012 (basis of property equals cost).

<sup>333</sup> I.R.C. §§1222(2), (11), 1(h) (defining long term capital gain; net capital gain; favorable marginal rate for net capital gain).

<sup>334</sup> Treas. reg. §1.83-2(a).

<sup>335</sup> I.R.C. §83(h).

<sup>336</sup> Rev. Rul. 60-31, 1960-1 C.B. 174 (providing examples of unfunded promises to pay compensation in the future that are not includible in the employee's income until actually received), modified by Rev. Rul. 70-435, 1970-2 C.B. 100. See, generally, A. Thomas Brisendine, E. Thomas Veal and Elizabeth Drigotas, *Deferred Compensation Arrangements*, 385 -4th T.M. A-13-20 (2011).

<sup>337</sup> Colloquially referred to as rabbi trusts. See, generally, Henry Ordower, *A Theorem for Compensation Deferral: Doubling Your Blessings By Taking Your Rabbi Abroad*, 47 *THE TAX LAWYER* 301 (1994) (explaining the operation of a "rabbi trust" and developing a mathematical methodology for determining whether or not to defer compensation income).

<sup>338</sup> IL 10 kap 8 § (wage income taxable when available for the recipient's use or disposition). Lodin, *INKOMMSTSKATT*, *supra* note 25, at 161-2.

<sup>339</sup> A sport promoter or team, for example. *Robinson v. Commissioner*, 44 T.C. 20 (1965), acq. 1970-2 C.B. xxi (boxing contract with deferred payments not includible until paid).

<sup>340</sup> Under normal accrual accounting rules, the obligation to pay the service provider accrued upon rendition of the services even if the payment was deferred. I.R.C. §461(a), (h)(4) (method of accounting, time for accrual).

<sup>341</sup> I.R.C. §451(a) (method of accounting controls inclusion). Treas. reg. §1.451-1(a) (inclusion when received if cash basis).

<sup>342</sup> Since 1942, I.R.C. §404(a)(5), or its predecessor provision of the Internal Revenue Code of 1939, as amended, matched the employer's deduction with the employee's inclusion. Since 1978, a similar matching rule, I.R.C. §404(d), applies to the deduction for service recipients when the service provider is an independent contractor. See, generally, Brisendine et al., *Deferred Compensation Arrangements*, *supra* note 336, at A-65-6.

<sup>343</sup> Lodin, *INKOMMSTSKATT*, *supra* note 25, at 319.

In the funded version of the deferred compensation arrangement, the cash basis service provider avoids constructive receipt because the fund remains subject to the claims of the service recipient's creditors. A series of private letter rulings concluded that no transfer occurs for tax purposes<sup>344</sup> until the service provider receives distributions of the fund or, if earlier, the fund ceases to be subject to the claims of the service provider's creditors.<sup>345</sup> Like the risk of forfeiture deferrals, both the unfunded promise to pay compensation in the future and the funded trust subject to claims of the service recipient's creditors ultimately result in ordinary compensation income to the service provider.<sup>346</sup> The funded trust arrangement differs from the risk of forfeiture arrangement in that the transfer to the trust is wages for social security and Medicare tax purposes.<sup>347</sup>

**3) Carried Interests and other Capital Income Conversions.** A further variant on the deferred personal service income schedule enables the service provider to convert personal service income into preferred forms of income, including long term capital gain, tax exempt income, and qualifying dividend income. The current public debate concerning the conversion of personal service income into preferred income types has focused primarily on the investment management industry.<sup>348</sup> In this variant, the service provider manages the investment decisions or operations of a tax transparent investment entity.<sup>349</sup> The tax transparent entity, often a private equity or hedge fund that invests in or actively trades securities and financial instruments, yields,

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<sup>344</sup> No transfer of property under I.R.C. §83(a) occurs. Private Letter Ruling 8113107 (December 31, 1980)(ruling that the arrangement for a rabbi involved no transfer because of the continuing claims of the employer's creditors to the fund).

<sup>345</sup> Ordower, A Theorem for Compensation Deferral, *supra* note 337, at 313. Rev. Proc. 92-64, 1992-2 C.B. 422 (providing model trust provisions for rabbi trusts).

<sup>346</sup> I.R.C. §409A currently governs such deferred compensation arrangement and limits the timing and terms of those arrangements. Failure to comply with I.R.C. §409A causes the compensation to become taxable to the service provider immediately, and, concomitantly, allows the service recipient to take the compensation, if business related, as a deduction under I.R.C. §162 or a capitalizable item under I.R.C. §263 or I.R.C. §263A.

<sup>347</sup> I.R.C. §3121(v).

<sup>348</sup> See, Victor Fleischer, Two and Twenty: Taxing Partnership Profits in Private Equity Funds, 83 N.Y.U. L. REV. 1, 57-58 (2008) (arguing that some or all the profits a partnership allocates to service provider partners is ordinary income from services rather than a distributive share of the partnership's income). There is an ongoing discussion of whether or not to alter U.S. tax rules to treat some profits interests for investment fund managers as ordinary income rather than as a share of the partnership's profit having the same character as the income has to the partnership – possibly long term capital gain. The most recent proposal pending, but currently stalled, in the U.S. Congress is the American Jobs and Closing Tax Loopholes Act of 2010, H.R. 4213 (last action June 22, 2010), would add section 710 to the IRC and tax all or part of income from the carried interest as ordinary rather than capital for investment service partnerships.

<sup>349</sup> Tax transparency refers to inclusion of the tax items of the entity in its owners' separate incomes rather than being taxable to the entity itself. I.R.C. §701 (partners not partnership subject to tax). In addition to partnerships, limited liability companies having more than one member are tax transparent because they are partnerships for tax purposes unless they elect corporate classification. Treas. reg. §301.7701-3(b)(1) (classifying domestic eligible entities with more than one member as partnerships). Similarly, many non-U.S. companies in which at least one owner has unlimited liability or in which no owner has unlimited liability but that elect to have subchapter K of the Code govern their U.S. owners are partnerships for U.S. tax purposes. Treas. reg. §301.7701-3(b)(2) (classifying foreign eligible entities as associations taxable as corporations or partnerships that are tax transparent). The literature refers to the regulation as the "check the box" regulation.



at least in part, qualified dividends, capital gain, and tax exempt interest income.<sup>350</sup> As compensation, the service provider receives an interest in the profits, but not the capital, of the entity.<sup>351</sup> Judicial decisions<sup>352</sup> and IRS pronouncements<sup>353</sup> enable service partners to avoid any inclusion in their incomes when they receive the profits interest. As the entity earns its income, the service provider receives and includes in income a distributive share of the entity's profits.<sup>354</sup> The tax character of the share to the service provider is "determined as if such item were realized directly from the source from which realized by the [entity]..."<sup>355</sup> Thus, in addition to deferring the personal service income from the moment of performance of services to the moment of allocation of the entity's profits, the service provider receives a share of the entity's income that might consist of long term capital gain, qualified dividend income, and tax exempt income, types of income that the Code favors. Since the profits interest is not includable in income when the service provider receives it, it also is not subject to the social security and Medicare taxes.<sup>356</sup> When the entity allocates a share of its profits to the service provider, the income retains its partnership level character and, accordingly, also is not subject to the social security and Medicare taxes.<sup>357</sup>

Conversion of personal service income into preferred income categories, however, is not a concern only in the investment services industries. The early judicial decisions that ultimately led to the IRS's safe harbor for assigning a zero value to a profits only interest in a partnership<sup>358</sup> were in the real estate development industries.<sup>359</sup> The opportunity to convert service income into

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<sup>350</sup> On private equity and hedge funds, see generally, Eddy Wymeersch, ed. ALTERNATIVE INVESTMENT FUND REGULATION, INTERNATIONAL BANKING AND FINANCE LAW SERIES v. 16 (the Netherlands 2012) (analyzing and presenting the regulation of hedge funds, private equity funds, and sovereign wealth funds in a number of jurisdictions); Henry Ordower, The Regulation Of Private Equity, Hedge Funds And State Funds, United States National Report, 58 AM. J. COMP. L.—SUPPLEMENT 1 295 (2010); and Henry Ordower, Demystifying Hedge Funds: A Design Primer, 7 U. CAL. DAVIS BUSINESS L. J. 323 (2007).

<sup>351</sup> The literature refers to the interests as "carried interests."

<sup>352</sup> The leading decision is *Campbell v. Commissioner*, 59 T.C.M. (CCH) 236 (1990), aff'd in part, rev'd in part, 943 F.2d 815 (8<sup>th</sup> Cir. 1991) (holding that the profits interest a service partner received was includable when received but had no ascertainable fair market value. Since the partnership might never have profits, the partner should have no inclusion).

<sup>353</sup> Rev. Proc. 93-27, 1993-2 C.B. 343 (limiting the current inclusion of profits interests to those with a readily ascertainable fair market value generally established by sale within two years of receipt). See, I.R.S. Notice 2005-43, 2005-1 C.B. 1221 (providing a proposed safe harbor that would allow a service provider to include the liquidation value (which should be zero) of a profits-only interest in income on the date of grant). Compare the discussion, *supra* in text accompanying note 330, of the elective inclusion of transfers subject to a risk of forfeiture under I.R.C. §83(b). There also it would be possible for the transferred property to have a zero value. Unlike the I.R.C. §83(b) election, however, the interests here are not subject to any risk of forfeiture, so no election is necessary.

<sup>354</sup> I.R.C. §702(c).

<sup>355</sup> I.R.C. §702(b).

<sup>356</sup> I.R.C. §3121(a) (no wages if no income).

<sup>357</sup> I.R.C. §702(b) (retention of entity level income characterization and the entity is not rendering services to third parties so no part of its income is self-employment income to its partners). I.R.C. §1402(a) (defining net income from self-employment).

<sup>358</sup> Rev. Proc. 93-27, *supra* note 353.

<sup>359</sup> *Diamond v. Commissioner*, 56 TC 530 (1971), aff'd. 492 F.2d 286 (7<sup>th</sup> Cir. 1974) (holding that a partner who received a profits interest for services and sold the interest within two years of receipt was taxable on the proceeds

capital gain is present whenever a partner receives a profits interest in exchange for his services.<sup>360</sup> With some exceptions for literary and artistic production,<sup>361</sup> taxpayers often may convert their personal services into property that will generate capital gain upon sale. For example, a taxpayer who builds a house but does not hold it for sale in the ordinary course of his business<sup>362</sup> will have capital gain on the sale of the house at a gain.<sup>363</sup> The Code does not seek to segregate the personal services or business activity contribution to the value of a taxpayer's property from the market appreciation in the value of the property, so that gain from the disposition of property either is all capital or all ordinary.<sup>364</sup> The Swedish tax system confronts the conversion of property from capital to trade or business and *vice versa* adjusting the basis of the property to fair market value at the time of conversion.<sup>365</sup> Where the conversion is from trade or business to personal use of property, the taxpayer may have to include or recapture previous deductions for depreciation and other expenses as income in the trade or business class where the value of the property at the time of conversion exceeded its tax basis.<sup>366</sup>

While the Swedish tax law manifests greater statutory sensitivity to separating capital income from trade or business<sup>367</sup> and personal service income<sup>368</sup> than does the Code, "Sweden has the second largest private equity sector in Europe (as a share of GDP), ...."<sup>369</sup> In Sweden, as in the United States, there is an opportunity to convert personal service income into favored

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as ordinary income, the interest having an ascertainable fair market value when received); *Campbell v. Commissioner*, *supra* note 352.

<sup>360</sup> See, Henry Ordower, *Taxing Service Partners to Achieve Horizontal Equity*, 46 *THE TAX LAWYER* 19 (1992) (arguing that receipt of the profits interest with indeterminate value should remain an open transaction with future distributions, rather than allocations of a share of the partnership's income, remaining compensation income so that the service partner invests with after tax money like all other partners). See, also, Bradley T. Borden, *Profits-Only Partnership Interests*, 74 *BROOKLYN L. REV.* 1283 (2009) (arguing that the receipt of the share of the entity's income should not be treated as a distributive share but as compensation income disregarding the intervening passage of the income through the partnership). Some opponents of the recently legislative proposals to tax part or all of the income received from a compensatory profits interest as ordinary income argue that the legislation would overreach and adversely affect industries it did not target, including real estate.

<sup>361</sup> I.R.C. §1221(a)(3) (excluding literary and artistic property inter alia that the holder or recipient from the holder in a non-taxable transaction holds from the capital asset definition).

<sup>362</sup> I.R.C. §1221(a)(1) (excluding property held for sale to customers in the ordinary course of the taxpayer's business from the capital asset definition).

<sup>363</sup> I.R.C. §1221(a) (defining capital asset as property not within one of the exceptions).

<sup>364</sup> *Biedenharn Realty Co. Inc. v US*, 526 F2d 409 (5<sup>th</sup> Cir. 1976) (holding that even pre-development appreciation in the value of real estate is ordinary income upon sale where the taxpayer engages in sufficient activity for the property to fall within the exception of I.R.C. §1221(a)(1)).

<sup>365</sup> IL 41 kap. 6 §, 14 kap. 16 § (adjusting basis to fair market value).

<sup>366</sup> IL 26 kap. 2 § (preventing the taxation of gain from real property as capital to the extent of earlier deductions).

<sup>367</sup> IL 41 kap. 1 § 2 st (excluding from capital income, income properly attributable to a trade or business (näringsverksamhet)). See *supra* note 22.

<sup>368</sup> IL 41 kap. 4 § 1 st (defining part of income from sale of an interest in a closely-held corporation (fämansföretag) as income from personal services (tjänst)); IL 41 kap. 4 § 2 st (likewise, income from sale of an interest in a partnership (handelsbolag)); and IL 41 kap. 5 §

<sup>369</sup> Randall Jackson, *Sweden Proposes Increasing Tax Rate on Private Equity Funds*, *Worldwide Tax Daily*, 2012 WTD 64-4 (4/3/12).

capital income with “carried interests”<sup>370</sup> and the Swedish administration has proposed legislation to tax carried interests as ordinary income beginning in 2013.<sup>371</sup>

**D. Social Security Taxes.** Unlike the earned income credit’s inclusion of income from other sources for purposes of diminishing the amount of the credit,<sup>372</sup> the social security tax<sup>373</sup> and the complementary self-employment tax<sup>374</sup> are strictly personal service income based taxes. While ambiguity of source often blurs the line between income from capital and income from personal services,<sup>375</sup> income from sources other than personal services has no relevance to the imposition of the social security tax.<sup>376</sup> Both taxes have two bracket regressive rate structures.<sup>377</sup> The taxes apply a positive flat rate of tax to personal service income up to a cap<sup>378</sup> and then a zero rate to all personal service income in excess of the cap.<sup>379</sup> Thus a wage earner with a salary of \$1.1 million or a self-employed individual with net earnings from self-employment pays the same amount of social security or self-employment tax as a wage earner with a salary or individual with an amount of net earnings from self-employment only one-tenth as large. The social security tax is additionally regressive in that the employee probably bears the burden of the employer’s share of the tax in lower wages as well the employee’s share of the tax.<sup>380</sup> Exceptions exist for various categories of employment (employees of states, for example).<sup>381</sup> Moreover, certain compensatory benefits, including employer funded retirement plans<sup>382</sup> and fringe benefits,<sup>383</sup> that tend to benefit higher income individuals more than lower income

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<sup>370</sup> Profits interests in a tax transparent entity, *supra* note 351 and accompanying text. Lars Samuelson, Ny fondbeskattning och andra anpassningar till gränsöverskridande fondverksamhet, 13 SKATTENYTT (forthcoming 2012); Sven-Åke Bergkvist, Martin Nilsson, Niklas Hagbard, och Carl Beyer, Skatteverkets Offensiv mot riskkapitalbranschen, 4 Svensk Skattetidning 332 (2011) (discussing and disputing the Swedish tax authority’s position that the carried interest from a Jersey or Guernsey limited partnership to a Swedish investment fond taxpayer is income from the conduct of a trade or business rather than capital income).

<sup>371</sup> Jackson, *supra* note 369.

<sup>372</sup> See discussion of the phase-out *supra* note 236 and accompanying text.

<sup>373</sup> I.R.C. §3101(a) (imposing the old age, disability and survivors tax on wages).

<sup>374</sup> I.R.C. §1401(a) (imposing the old age, disability and survivors tax on self-employment income).

<sup>375</sup> See discussion *supra* in text accompanying and following note 348.

<sup>376</sup> For most purposes the social security tax and the self-employment tax operate in tandem, so that references to the social security tax will include the self-employment tax unless this article expressly states otherwise.

<sup>377</sup> See, Hungerford, *supra* note 92, at 6 (addressing the regressivity of the tax).

<sup>378</sup> Other than a de minimus amount to which the tax does not apply. I.R.C. §1402(b)(2) (\$400 amount to which the tax does not apply).

<sup>379</sup> I.R.C. §3101 (imposing a 6.2 percent tax on wages received, temporarily reduced to 4.2 percent on wages received, and on wages paid, so that the employer and the employee each pay a tax. I.R.C. §1401 imposes a 12.4 percent tax on net earnings from self-employment income, temporarily reduced to 10.4 percent). I.R.C. §§1402(b)(1), 3121(a)(1) (determining the cap under section 230 of the Social Security Act, currently \$110,100 in 2012).

<sup>380</sup> Senate Report No. 94-36 to the Tax Reduction Act of 1975 at 11, PL 94-12 (Feb. 18, 1975) (acknowledging, in setting the amount of the earned income credit, that the employee bears both the employee’s and the employer’s share of the social security tax: “[t]he credit is set at 10 percent in order to correspond roughly to the added burdens placed on workers by both employee and employer social security contributions.”)

<sup>381</sup> I.R.C. §3121(b).

<sup>382</sup> I.R.C. §3121(a)(5). See discussion *supra* in section I.A.4.

<sup>383</sup> I.R.C. §3121(a)(20) follows upon I.R.C. §132 and excludes many fringe benefits from the social security tax base that are excluded from gross income. See discussion *supra* in section I.A.3.

individuals are not wages or earnings from self-employment under the social security tax definition.<sup>384</sup>

Since the social security tax only encompasses one specific type of income in its base, it is a schedular tax. Its rate structure is unique and, as a tax, is unquestionably regressive relative to both income and wealth. While the social security tax is a mandatory imposition upon taxpayers, it differs from other taxes in several respects. Unlike the income tax, the social security tax is not universal.<sup>385</sup> It does not apply to the full set of taxpayers to whom the income tax applies.<sup>386</sup> Moreover, payment of the tax for a specific number of years or marriage to someone who paid the tax for the required number of years entitles the taxpayer to obtain specific governmental benefits not available to those who are exempt from the tax or not married to a payer of the social security tax. Although money is fungible so that the money the government receives from the social security tax is indistinguishable from all other tax revenue, the formula for distribution of the benefits ameliorates the regressivity of the social security tax to some degree.<sup>387</sup> Thus, the social security tax arguably is not a tax at all but a mandatory contribution to an insurance pool.<sup>388</sup>

**III. Exclusions from Gross Income.** Common to both schedular and global models are various items of income that are tax free. Statutes in the United States,<sup>389</sup> Germany,<sup>390</sup> and Sweden<sup>391</sup> specifically identify tax free items of income. The statutory exclusions may be necessary under a global system like the United States where “gross income means all income from whatever source derived.”<sup>392</sup> If a receipt is income, it is includable. Items of income the statute specifically enumerates are only illustrative of items includable in gross income.<sup>393</sup> Whether Congress intended to exercise its taxing power to the fullest extent permitted by the Sixteenth Amendment<sup>394</sup> or simply parroted the language “from whatever source derived” of the Amendment, Congress introduced the list of specific inclusions in the gross income provision

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<sup>384</sup> I.R.C. §3121(a).

<sup>385</sup> Congressional Budget Office, Trends in the Distribution of Household Income Between 1979 and 2007 (2011) available at <http://www.cbo.gov/ftpdocs/124xx/doc12485/10-25-HouseholdIncome.pdf>.

<sup>386</sup> I.R.C. §3121(b), *supra* note 381.

<sup>387</sup> U.S. General Accounting Office, Distribution of Benefits and Taxes Relative to Earnings Level (2004) (observing that social security benefit formulas are designed to be progressive but may not distribute benefits to compensate for the regressivity of the tax); Karen Smith & Eric Toder, Lifetime Distributional Effects of Social Security Retirement Benefits (Working Paper, 2001) (similar). *Contra*, Julia Lynn Coronado, Don Fullerton & Thomas Glass, The Progressivity of Social Security (Nat’l Bureau of Econ. Research, Working Paper No. 7520, 2000) (testing social security assumptions and concluding the system is regressive overall).

<sup>388</sup> The health insurance requirement in the universal health insurance legislation from 2010, currently being challenged in the federal courts is similar.

<sup>389</sup> Ch. 1, Subchapter B, Part III of the Code (listing specific exclusions from gross income, including, for example, life insurance proceeds under I.R.C. §101).

<sup>390</sup> Steuerfreie Einnahmen, EStG II.2. §3 (items specifically constituting tax free receipts). For example, EStG II.2. §3 2. specifically excludes unemployment compensation and other welfare benefits.

<sup>391</sup> IL kap. 8 Skattefria inkomster (tax-free income (author’s translation)). For example, IL kap. 8, 2 § specifically excludes gifts and inheritances, 3 § excludes Swedish lottery winnings. .

<sup>392</sup> I.R.C. §61(a).

<sup>393</sup> I.R.C. §61(a) (defining gross income and listing some items includable in gross income).

<sup>394</sup> USCS Const. Amend. 16 reads in part: “[t]he Congress shall have power to lay and collect taxes on incomes, from whatever source derived, ...”

with the parenthetical phrase “including but not limited to.” This parenthetical leaves no doubt that the statute does not intend to exclude items not on the list. Accordingly, specific statutory authority should be critical to exclude an item that is “income” from the tax concept of gross income, but it is not.

The IRS (and its predecessor agency) never sought to tax various items of income even before Congress enacted an express statutory exclusion for those items. Among the excluded items were gifts,<sup>395</sup> personal injury awards,<sup>396</sup> various welfare benefits, and social security payments,<sup>397</sup> for which Congress had enacted no statutory exclusions. Moreover, despite an express statutory inclusion,<sup>398</sup> the United States Supreme Court held stock dividends to be unrealized and nontaxable capital appreciation and not income within the ambit of the Sixteenth Amendment to the United States Constitution.<sup>399</sup> In addition, a common, albeit probably incorrect, understanding of Constitutional jurisprudence led many to conclude that interest that state governments paid on their borrowings would be exempt from taxation.<sup>400</sup>

Difficulty in determining value may have led the Board of Tax Appeals to hold that the value of meals and lodging an employee received as part of and a condition of his employment was not income to the employee despite absence of a statutory exclusion at the time.<sup>401</sup> Similarly, various fringe benefits that may have been part of employee compensation proved difficult to value and tax, including air travel passes for airline employees and their families, employee discounts, parking, and gymnasium use, so that Congress ultimately chose to exclude

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<sup>395</sup> Currently excludable under I.R.C. §102.

<sup>396</sup> Currently excludable under I.R.C. §104(a)(2). See a 1918 Opinion of the Solicitor General, 31 op. Att’y Gen. 304, 308 and see T.D. 2747, 20 Treas. Dec. Int. Rev. 457 (1918). As recently as 2006, a taxpayer successfully argued that a longstanding, non-statutory exclusion for non-physical injuries rendered a statutory change to the exclusion unconstitutional. *Murphy v. IRS*, 460 F.3d 79 (D.C. Cir. 2006). On rehearing, however, the court vacated its earlier decision and held that the statute controlled and rendered the award taxable. *Murphy v. IRS*, 493 F.3d 170 (D.C. Cir. 2007), cert. denied, 553 U.S. 1004 (2008).

<sup>397</sup> I.R.C. §86 assumes social security benefits are generally excludable from gross income in that it currently includes a portion of social security benefits for some taxpayers.

<sup>398</sup> Revenue Act of September 8, 1916, § 2(a), ch. 463, 39 Stat. 756 reads in part: “the net income of a taxable person shall include . . . dividends, . . . Provided, That the term "dividends" as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, . . . out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, . . . which stock dividend shall be considered income, to the amount of its cash value.”

<sup>399</sup> *Eisner v. Macomber*, 252 US 189 (1920) (holding stock dividends not income under the 16<sup>th</sup> Amendment). Like capital appreciation in general, the rules governing tax basis, I.R.C. §§1012, 1011, 307, defer but do not eliminate the tax on the capital appreciation that the dividend incorporates into the distributed shares. The dividend shares would not be excludable permanently from the taxpayer’s income but would await disposition of the shares in a taxable transaction. The intervening death of the holder of the shares might preclude permanently taxation of the gain because the shares would take a date of death fair market value basis under I.R.C. §1014.

<sup>400</sup> *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429 (U.S. 1895) (holding that the taxation of interest from state or local obligations was repugnant to the Constitution). I.R.C. §103 (statutory exclusion for interest on state and local obligations). But see *South Carolina v. Baker*, 485 U.S. 505 (1988) (holding bondholders of unregistered state obligations taxable on the interest under the bond registration requirements of I.R.C. §103(j)(1) and not in violation of the Tenth Amendment; and stating that inter-governmental immunity was not a barrier to a non-discriminatory tax on interest paid on state and local bonds).

<sup>401</sup> *Benaglia v. Comm’r.*, *supra* note 248, 36 BTA 838 (1937), acq. 1940-1 CB 1. Congress enacted a statutory exclusion, currently I.R.C. §119, following the decision.

their value from gross income so long as the employer restricted the benefit in specific ways that the statute describes.<sup>402</sup> The IRS never has sought to tax the imputed use value of property the taxpayer owns and uses for herself, her family, or her friends<sup>403</sup> and has not taxed the value of services a taxpayer performs without compensation for herself, her family, or her friends in the absence of a market exchange like a barter arrangement.<sup>404</sup> The IRS did try without success to tax imputed interest on funds the taxpayer lent without interest to others, including family members.<sup>405</sup> A statutory change imputed and taxed interest on below market and no interest loans.<sup>406</sup>

Under a schedular system like Sweden's, on the other hand, statutory exclusions should be unnecessary insofar as income is excludable unless it fits within one of the statutory income classes.<sup>407</sup> A simple example illustrates this principle of having to fit within a schedular class and the difference between the American global and Swedish schedular systems. Assume that a taxpayer finds \$100 dollars and may keep it rather than returning it to its rightful owner. In the United States, the money is income to the finder and includable in the finder's gross income.<sup>408</sup> In Sweden, the \$100 found money does not fit into any schedular income classification and, accordingly, is not includable in the finder's taxable income. The result in Germany is the same as Sweden.

Under a schedular system, expenses that the taxpayer incurs to produce non-taxable income, whether statutorily excluded or outside a schedular class, are not deductible. Insofar as expenses relate to non-taxable income, they have no schedule on which to offset taxable income. The United States' treatment of expenses incurred to produce non-taxable income is similarly schedular. Expenses a taxpayer incurs to produce non-taxable income are not deductible.<sup>409</sup> When an expense attributable to the production of income overlaps taxable and non-taxable

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<sup>402</sup> I.R.C. §132 (excluding various fringe benefits from gross income). The history of this exclusion is interesting because the IRS publicly stated that it was going to promulgate regulations to tax the value of certain fringe benefits, including travel passes. An uproar in certain taxpayer communities, airline employees, for example, ensued, and Congress impose a moratorium on fringe benefit regulations while it fashioned a statute, now I.R.C. §132. See, also, discussion of I.R.C. §132 *supra* in text accompanying note 265.

<sup>403</sup> Despite public discussion of the tax expenditure that deductibility of mortgage interest under I.R.C. §163(h)(3) provides, failure of the income tax system to impute income from the use of an owner occupied residence generally provides a far greater subsidy than the mortgage interest deduction insofar as it excludes the full investment return from the owner occupied residence that the owner receives as use. See, also, discussion of imputed income, *supra* in Section I.A.4.

<sup>404</sup> Marvin A. Chirelstein, *FEDERAL INCOME TAXATION: A LAW STUDENT'S GUIDE TO THE LEADING CASES AND CONCEPTS* 26 (New York 2009).

<sup>405</sup> *Dean v. Commissioner*, *supra* note 176, 35 TC 1083 (1961) (holding that non-interest bearing loans from a corporation did not generate income taxable to the borrower because the interest, if paid, would have been deductible).

<sup>406</sup> I.R.C. §7872 (imputing interest on low and no interest loans, as added by the Deficit Reduction Act of 1984, PL 98-369 (July 18, 1984).

<sup>407</sup> *Lodin*, *INKOMMSTSKATT*, *supra* note 25, at 85. Similarly in Germany, receipts that increase a taxpayer's wealth and are income under an economic definition of income are excludable when they fail to fit any of the statutory schedular categories. Klaus Tipke and Joachim Lang *et al.*, *STEUERRECHT* 260 (Cologne 2008).

<sup>408</sup> I.R.C. §61.

<sup>409</sup> I.R.C. §265.

categories,<sup>410</sup> tracing to or allocating the expense between deductible and non-deductible categories frequently is complicated and uncertain.<sup>411</sup> Allocation of interest expense to the taxpayer's carrying tax exempt investments rather than other uses of borrowed funds has proven challenging. Congress has intervened on several occasions to limit the tax benefit of the interest deduction.<sup>412</sup> In 1986, Congress added rules requiring financial institutions to allocate interest pro rata between taxable and tax exempt obligations.<sup>413</sup> Similarly, in 1984 Congress limited the corporate dividends received deduction<sup>414</sup> when a corporation used debt financing to acquire portfolio stock.<sup>415</sup>

The Code currently groups together some forty provisions that exclude specific items from gross income<sup>416</sup> that otherwise probably would be includable in gross income.<sup>417</sup> Some of those provisions reflect reasonably straightforward policy decisions of exclusion,<sup>418</sup> but most of the express exclusions primarily codify historical practice or judicial decisions.<sup>419</sup> Others of those provisions, in conjunction with complementary basis limitation rules, defer the recognition of gain, rather than excluding the income permanently.<sup>420</sup> In addition, there are several exclusions or partial exclusions scattered elsewhere in the Code<sup>421</sup> and numerous tax deferral provisions.<sup>422</sup> Among the deferral provisions, those that defer recognition of realized gain on the

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<sup>410</sup> I.R.C. §212 (allowing a deduction for expenses in producing income or preserving property held for the production of income).

<sup>411</sup> Treas. reg. §1.265-1(c) (requiring that allocable expenses be allocated and expenses allocable to both taxable and tax exempt income be allocated reasonably based upon facts and circumstances).

<sup>412</sup> I.R.C. §265(a)(2). With limitations for interest incurred to carry tax exempt investments, other than to produce income, and investment interest, interest is deductible under I.R.C. §163.

<sup>413</sup> I.R.C. §265(b) added by PL 99-514, §902(a),(d).

<sup>414</sup> I.R.C. §243 (allowing a deduction for 70 percent of dividends a corporation receives from another corporation, increasing to 80 or 100 percent for stock ownership of 20 percent, 80 percent or more, respectively)

<sup>415</sup> I.R.C. §246A (limiting the dividends received deduction for debt financed percentage of the portfolio stock).

<sup>416</sup> Part III of subchapter B of chapter 1 of the Code.

<sup>417</sup> I.R.C. §61.

<sup>418</sup> I.R.C. §112 (combat zone compensation).

<sup>419</sup> For example, I.R.C. §102 (gifts); I.R.C. §103 (state and local bond interest); I.R.C. §104(a)(2) (personal injury recoveries).

<sup>420</sup> I.R.C. §109, in conjunction with the I.R.C. §1019 basis rule, defers, rather than excludes, income from a lessee's improvement of the lessor's land by not increasing the lessor's basis by the value of the improvement. With this provision, Congress reversed the effect of the decision in *Helvering v. Bruun*, 309 U.S. 461 (U.S. 1940) (holding that on termination of a lease, the lessor realizes the value of tenant improvements in excess of value of improvements replaced). Similarly, the recipient of gift takes the donor's basis for purposes of determining gain, rather than the fair market value of the property at the date of the gift. I.R.C. §1015. Less clear in the case of gifts is whether or not they would be includable in the recipient's gross income in the absence of the I.R.C. §102 exclusion. See, *supra*, note 395 and accompanying text.

<sup>421</sup> For example, individuals may elect to exclude some or all the income from their services that they earn while living outside the United States, I.R.C. §911 (election to exclude up to an inflation adjusted \$80,000 of income earned abroad); Corporations may exclude through a deduction part or all of a dividend they receive from a corporation in which they own shares. I.R.C. §243 (allowing a dividends received deduction ranging from 70 – 100 percent depending on the percentage of ownership in the dividend paying corporation).

<sup>422</sup> Deferral of gain on exchange of certain like kind properties. I.R.C. §1031. Exchange of property for corporate shares (I.R.C. §351) or partnership interests (I.R.C. §721). Deferral of ordinary income from services in qualified plans. I.R.C. §401.

disposition of property,<sup>423</sup> like the stock dividends in *Macomber*,<sup>424</sup> might become exclusions from gross income if the holder of the property receiving the deferral dies before selling the property in a taxable transaction.<sup>425</sup>

While the exclusions from gross income form a schedular class of zero rate income, the historical underpinnings of many of the exclusions render conclusions about their basic distributional fairness difficult to draw. For example, Congress may have intended the exclusion for life insurance proceeds<sup>426</sup> primarily to benefit middle class widows and orphans by not taxing the limited insurance proceeds they received on the death of the family's breadwinner. Had Congress foreseen the extensive use of high face amount life insurance policies in estate planning for wealthy individuals and business ownership of life insurance on employees, Congress might have restricted the exclusion. The exclusion from gross income for the value of cash gifts<sup>427</sup> benefits a broad range of taxpayers. As with the tendency of wealthier individuals to carry larger amounts of life insurance and deliver a larger exclusion of proceeds<sup>428</sup> to their beneficiaries than less wealthy individuals, by virtue of the size of gifts they make, wealthier donors also tend to be able to provide a larger benefit from the exclusion of gifts<sup>429</sup> to their donees than do less wealthy donors.

More clearly skewed toward higher income individuals is the exclusion of interest from state and local governments.<sup>430</sup> Whether the exclusion resulted from the erroneous assumption that Congress did not have the power to tax interest that state and local governments pay<sup>431</sup> or from a decision to subsidize state and local borrowing off the budget,<sup>432</sup> the exclusion distributes the tax benefit inefficiently by misdirecting a portion of the subsidy intended for state and local government to high bracket taxpayers. Rather than pricing their obligations at a tax exempt

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<sup>423</sup> Under I.R.C. §1001, a taxpayer realizes gain on the disposition of property when she sells it for money or exchanges it for other property (or services) in an amount or having a value greater than the taxpayer's adjusted basis under I.R.C. §1011 in the property she relinquishes. The taxpayer includes the realized gain in her gross income when she recognizes that gain. In general, realization and recognition of gain occur simultaneously, but various statutory provisions defer the recognition of realized gain and transfer the taxpayer's basis in the property she relinquishes to the property she receives in the exchange. I.R.C. §1001(c) (requiring recognition of realized gain unless a statute defers the gain; I.R.C. §1031(d), for example, preserves the taxpayer's historical basis to defer, but not eliminate the realized gain, by transferring the old basis rather than allowing the taxpayer the customary purchase price basis under I.R.C. §1012).

<sup>424</sup> *Eisner v. Macomber*, *supra* note 399.

<sup>425</sup> I.R.C. §1014 (giving the recipient of a decedent's property a basis in the property equal to the value of the property at the decedent's date of death).

<sup>426</sup> I.R.C. §101 (excluding life insurance proceeds from gross income).

<sup>427</sup> In the case of gifts from a living donor, I.R.C. §1015 (continuing the donor's basis in appreciated property in the hands of the donee) coordinates with I.R.C. §102 (excluding gifts from gross income) and preserves appreciation that has not been taxed as yet in the property so that the appreciation will be taxed to the donee. In this respect, I.R.C. §102 partially defers the inclusion of the value of a gift rather than excluding that value from gross income permanently.

<sup>428</sup> I.R.C. §101.

<sup>429</sup> I.R.C. §102.

<sup>430</sup> I.R.C. §103 (excluding interest on state and local obligations).

<sup>431</sup> See discussion in note 400 *supra*.

<sup>432</sup> Until 1967, tax expenditures were not part of the budgeting process. Joint Committee on Taxation, A Reconsideration of Tax Expenditure Analysis (JCX-37-08) 2 (May 12, 2008) available at <http://www.jct.gov/publications.html?func=startdown&id=1196>



interest rate equivalent to the after tax rate on taxable bond interest for taxpayers in the highest marginal rate bracket, state and local bond issuers found that they had to price to a lower than maximum bracket taxpayer in order to sell all the obligations.<sup>433</sup> Highest bracket taxpayers who purchased the obligations were able to capture part of the subsidy for themselves in the form of a higher than market after tax interest rate.<sup>434</sup> Misallocation of the subsidy to those high bracket taxpayers violates the notion of vertical equity by distributing tax revenue from lower to higher bracket taxpayers.

Some gross income exclusions may inure to the benefit of someone other than person claiming the exclusion. While state courts historically excluded information concerning the taxability of personal injury awards from gross income,<sup>435</sup> most awards are a function of settlement, not trial. Plaintiffs' attorneys negotiating settlement certainly consider taxability in agreeing on a settlement amount, so that the exclusion inures, in part at least, to the tortfeasor and its insurer. Extension of the exclusion to deferred payments exacerbated the misallocation of the exclusion.<sup>436</sup> Similarly, exclusion of life insurance proceeds from gross income renders life insurance a more attractive investment product,<sup>437</sup> and the failure to tax the inside build-up in the value of the investment enables insurers to pay a lower rate of return on the invested funds that a fully taxable investment would pay. The exclusion for meals and lodging and many fringe benefit exclusions encourage employees to accept lower salaries than they otherwise might demand in the absence or taxability of the benefit. A rent free apartment for superintendents in apartment buildings and travel passes for many airline employees are critical pieces of their compensation.

Overall exclusions from gross income appear neutral on their face but they are not. Some exclusions like fringe benefits<sup>438</sup> and meals and lodging<sup>439</sup> treat otherwise like taxpayers dissimilarly and violate the basic tax premise of horizontal equity. Some pay for items with dollars taxed at a zero rate while most pay with after tax dollars. Similarly, to the extent a personal injury award replaces lost income,<sup>440</sup> the exclusion treats the injured individual more favorably than other individuals who are fully taxable their income from services. The exclusion for scholarships<sup>441</sup> both decreases the cost to the scholarship provider<sup>442</sup> and allows the

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<sup>433</sup> This was especially true as state and local bond authorities lent their tax exempt borrowing authority to encourage private development in their communities. Considerable competition in issuing tax exempt obligations arose driving exempt interest rates higher.

<sup>434</sup> For example, if market interest rates are 10 percent and the highest marginal income tax rate is 35 percent, a tax exempt obligation should bear interest at 6.5 percent to make its rate competitive with the taxable 10 percent interest rate. However, if the issuer must pay interest at 7.5 percent in order to sell the obligations and make them competitive for a 25 percent bracket taxpayer, the 35 percent bracket taxpayer also get 7.5 percent which is equivalent to an 11.54 percent taxable rate.

<sup>435</sup> I.R.C. §104(a)(2) (excluding personal injury awards from gross income).

<sup>436</sup> *Id.* (parenthetical).

<sup>437</sup> I.R.C. §101 (excluding life insurance proceeds from gross income).

<sup>438</sup> I.R.C. §132.

<sup>439</sup> I.R.C. §119.

<sup>440</sup> I.R.C. §104(a)(2) (excluding the full amount of the personal injury award whether the award replaces lost income or otherwise). Sweden, by comparison, excludes only 40 percent of a personal injury award. IL 10 kap. 2 § 4. (personal injury awards as income from personal services); IL 11 kap. 38 § (including 60 percent of the award in income).

<sup>441</sup> I.R.C. §117 (excluding amounts received as a scholarship from gross income).

scholarship recipient to pay for education with pre-tax income while others must pay for their educations with after tax funds.<sup>443</sup> Given the trend of colleges and universities to award scholarships based on merit, without regard to the student's available resources, rather than on the basis of need, the scholarship exclusion's violation of the horizontal equity principle seems especially troubling.<sup>444</sup>

Even those exclusions which appear distributionally neutral undermine progression and tend to bolster regressivity by removing significant amounts of income from the general tax base. For most exclusions, tax credits would deliver the tax subsidy and achieve the policy objective of the exclusions without affecting progression.<sup>445</sup> Including items currently excluded and providing a credit for the previously excluded income either at the taxpayer's lowest marginal rates or a proportional rate would ameliorate the regressive impact of exclusion.

**IV. Conclusion.** The United States federal income tax is moderately schedular in structure and creates nearly separate tax bases for capital gains and other investment income, personal services income, and income exemptions. Each of those schedular elements treats taxpayers with like comprehensive incomes, but differing elements making up the comprehensive income, dissimilarly. In addition each schedular element on balance tends to contribute to regressivity in taxation. Accordingly, with limited exceptions for features like the earned income credit<sup>446</sup> and the passive activity loss limitations,<sup>447</sup> schedularity in the United States violates the fundamental notions of horizontal and vertical equity.

Recent support in the literature for a national sales tax or a consumption-based income tax in the United States<sup>448</sup> highlights both the trend toward eliminating progressive taxes and the point that many tax professionals view consumption taxes as a variation of the income tax base rather than a fundamentally distinct tax.<sup>449</sup>

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<sup>442</sup> See discussion of misdirected benefits *supra* note 435 and accompanying text.

<sup>443</sup> With exceptions for education to improve one's existing skills in business, deductible under I.R.C. §162 (ordinary and necessary business expenses), education expenses generally are non-deductible living expenses. I.R.C. §262. A limited deduction is available under I.R.C. §222 and there are also limited Hope and Life Learning Credits under I.R.C. §25A.

<sup>444</sup> Cites to university policies on financial aid and scholarships.

<sup>445</sup> Cites to proposals on municipal bond interest.

<sup>446</sup> I.R.C. §32. See discussion *supra* in Part II.A. 1).

<sup>447</sup> I.R.C. §469.

<sup>448</sup> See, generally, essays in Tax Analysts, THE VAT READER: WHAT A FEDERAL CONSUMPTION TAX WOULD MEAN FOR AMERICA (2011).

<sup>449</sup> See, e.g., Laurence J. Kotlikoff and David G. Tuerck, The Case for the FairTax, Testimony Submitted to the House Ways and Means Committee, July 26, 2011, 2011+TNT+144-49 (supporting a retail sales tax based consumption tax with a family allowance to lower income taxpayers as a replacement for income, estate and gift and social security taxes). Similarly, Michael Graetz, Statement (favoring enactment of a value added tax in conjunction with a \$100,000 personal income tax exemption and lower individual and corporate income tax rates), 2011 TNT 144-48 (July 26, 2011). See, generally, House of Representatives, Way and Means Committee, Hearings on Tax Reform and Consumption-Based Tax Systems (July 26, 2011) for further statements on a consumption-based tax.