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**The Entrepreneurship Effect:
An Accidental Externality in the Federal Income
Tax**

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Case law and commentators often speak as if all income-producing activities are taxed similarly. However, that simply is not true for individuals. Although the expenses and losses of business activities generally are deductible from income of any source and net losses can be carried to other tax years, individuals' investment expenses and losses generally are deductible only from investment income. Although many of the provisions restricting investment-related deductions were enacted at different times, and each one has its own rationale, the combined effect of these provisions on individual investors is a systematic preference for business losses over investment losses.

Economists have shown that a tax system that allows full deduction of the losses from an activity effectively shifts part of the risk of that activity to the government. This, in turn, allows the investor to increase investment in that activity without increasing his risk. In other words, the deductibility of a net loss from an activity provides a subsidy for that activity. Federal income tax law therefore implicitly subsidizes entrepreneurship by individuals.

The implicit subsidy for entrepreneurship is strongest for high-income individuals, for a number of reasons, including the progressivity of the federal

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income tax. That is, given progressive marginal income tax rates, taxpayers with significant income from other sources benefit most from the deduction of losses. In addition, as the Article shows, despite progressive taxation, high-income individuals are not disproportionately taxed if the business is successful. In fact, high-income individuals obtain the largest benefit from techniques, such as incorporating the business, that lower the effective tax rate applied to a successful business. These insights highlight the importance of considering tax changes in a larger context. For example, as discussed in the Article, lowering individual income tax rates may actually decrease entrepreneurship by individuals.

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I. INTRODUCTION

Imagine an individual with capital to invest. What prompts that person to start a business, rather than investing in the stock of a publicly traded company, for example? Start-up businesses generally present a substantially greater risk of loss than investments in established ventures do. Of course, entrepreneurial ventures may offer higher upside potential, but is that enough to prompt risk-averse individuals to bear the greater downside risk?

Although there are a variety of non-tax reasons that prompt people to start businesses, the federal tax consequences of the decision should not be ignored. It is a truism that income from capital—such as investment income—is generally taxed more favorably than income from labor—such as wages and salaries—

primarily because of the possibility of indefinite deferral of tax on that income.¹ For these reasons, among others, several scholars have suggested that, in practice, capital may bear little tax.² By contrast, income from labor generally is taxed as it is earned, with relatively few opportunities for deferral.³

In general, a lower-taxed investment should be more attractive, assuming the returns are equal. However, the taxation of income is only part of the picture. The tax treatment of expenses and losses must also be considered. Deductible expenses and losses lower tax liability by lowering “taxable income,” the base to which the federal income tax is applied.⁴ Intuitively, if more expenses and losses

¹ First, gains must be “realized” before they are taxed. The realization requirement provides that income taxation accompanies a “realization,” not “paper” gains and losses. In general, a realization event is the conversion of property into other property that is materially different in kind or extent. See Treas. Reg. § 1.1001-1(a) (as amended in 1996) (“Except as otherwise provided in subtitle A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained.”). Federal income tax law requires realization to tax property (“paper” gains and losses are not taxed). See *Eisner v. Macomber*, 252 U.S. 189, 211–12 (1920). Second, “imputed income,” in this context, the benefit resulting from the ownership of property, is not taxed. Third, under current law, an heir’s basis in property is the fair market value of the property on the date of decedent’s death, generally resulting in a step-up in basis in property retained until death. See I.R.C. § 1014 (2004). These factors combine to defer taxation on the earnings from capital, sometimes forever. In addition, under current law, most dividends are taxed at a lower rate than other income. See I.R.C. § 1(h)(1) (2004) (taxing adjusted net capital gain at rates of five percent and fifteen percent), I.R.C. § 1(h)(11) (defining “net capital gain” to include “qualified dividend income”).

² See, e.g., Noël B. Cunningham, *The Taxation of Capital Income and the Choice of Tax Base*, 52 TAX L. REV. 17, 41 (1996); David F. Bradford, *Fixing Realization Accounting: Symmetry, Consistency and Correctness in the Taxation of Financial Instruments*, 50 TAX L. REV. 731, 739 (1995); Daniel Shaviro, *Risk-Based Rules and the Taxation of Capital Income*, 50 TAX L. REV. 643, 645 (1995); Joseph Bankman & Thomas Griffith, *Is the Debate Between an Income Tax and a Consumption Tax A Debate About Risk? Does it Matter?*, 47 TAX L. REV. 377, 378 (1992); Evsey D. Domar & Richard A. Musgrave, *Proportional Income Taxation and Risk-Taking*, 58 Q.J. ECON. 388 (1944). See also *infra* note 372.

³ Retirement plans provide a mechanism for a service-provider to reduce current taxation. The economic effect of retirement plans is to exempt the return on capital. That is, “[u]nder the Cary Brown thesis, the ability to make an investment with untaxed soft money is usually as valuable as exempting subsequent investment income from tax. ‘Expensing’—deducting an investment immediately—and exempting the subsequent profit from tax are usually equivalent tax benefits.” Calvin H. Johnson, *Soft Money Investing Under the Income Tax*, 1989 U. ILL. L. REV. 1019, 1022 (1989). Because retirement plan contributions are linked to the provision of services, see, e.g., I.R.C. § 401(k) (2004), the net effect is to shelter from taxation the income on capital earned from the income from labor. See *infra* note 103.

⁴ See I.R.C. § 1 (2004) (defining tax base as taxable income), I.R.C. § 63 (2004) (defining taxable income as gross income minus deductions).

of an activity are deductible, a higher nominal tax rate may not be unfavorable because the base to which that higher rate is applied is low.⁵ Thus, in considering tax incentives with respect to various activities, the income side and deduction side must both be considered.

In fact, the ability to deduct losses is particularly important because the ability to deduct losses with respect to a particular activity essentially shifts part

As an example, imagine two single United States taxpayers, Ivan Investor and Brenda Businessowner. Assume that each has \$80,000 of income from a mix of sources such that their next dollars are taxed at a 33% rate. Ivan sells some stock that he has held for more than a year, receiving \$20,000 in before-tax profits. Brenda receives a \$20,000 bonus from a client. Because of the 15% rate applicable to "adjusted net capital gain," see I.R.C. § 1(h)(1)(C) (2004), Ivan will pay less federal income tax than Brenda although each has the same amount of income. The following chart shows the federal tax liability of each with respect to the \$20,000:

	<i>Ivan Investor</i>	<i>Brenda Businessowner</i>
<i>Tax Liability</i>	\$3,000	\$6,600

What if Ivan and Brenda each spent \$15,000 on training course expenses undertaken in connection with their livelihoods, without reimbursement? In that case, Ivan would owe more tax than Brenda! That is because the \$15,000 in expenses would not be deductible for Ivan. Treas. Reg. § 1.212-1(f) (as amended in 1975) ("Among expenditures not allowable as deductions under section 212 are the following: . . . expenses of taking special courses or training . . ."). By contrast, for Brenda, the expenses are likely deductible above the line. See I.R.C. §§ 62(a)(1), 162 (2004); Treas. Reg. § 1.162-5 (1967). The comparison of the federal income tax treatment of Ivan and Brenda with respect to the two events would be the following:

	<i>Ivan Investor</i>	<i>Brenda Businessowner</i>
<i>\$20,000 extra income</i>	\$3,000 tax	\$6,600
<i>\$15,000 training fee</i>	Non-deductible	<\$4,950> tax saved
<i>Net Tax Consequences</i>	\$3,000 tax liability	\$1,650 tax liability

⁵ As an extreme example, imagine a nominal tax rate of 90% applied to certain activities or investments. If the base to which it is applied is minuscule or zero—because of offsetting deductions, for example—then the tax will be less burdensome than a tax of 10% applied to a base of \$1,000.

of the risk of that activity to the government.⁶ Although this economic insight is sometimes applied to the context of portfolio investments,⁷ this Article will show the Internal Revenue Code (Code) provides numerous limitations on the deductibility of individuals' investment-related expenses and losses.⁸ In fact, many Code provisions "basket" individuals' investment-related expenses and losses with investment income, precluding the deduction of a net investment loss even if the taxpayer has substantial other income.⁹ By contrast, business expenses and losses typically are fully deductible from income from any source.¹⁰ Thus, individuals can deduct net business losses from any other income they or their spouses may have.¹¹

Accordingly, as this Article will show, the federal income tax law systematically reduces the risk to an individual taxpayer of business activity but not of investment activity.¹² Thus, although the federal income tax generally

⁶ See Domar & Musgrave, *supra* note 2, see also Barbara H. Fried, *Fairness and the Consumption Tax*, 44 STAN. L. REV. 961, 992 n.84 (1992) ("A tax on gains and a deduction of losses . . . will shift a portion of the upside and downside risk of investment onto the government, thereby reducing the variance of this risk.").

⁷ See, e.g., Cunningham, *supra* note 2, at 30–35 (discussing burden on capital income under a "normative" income tax); Bankman & Griffith, *supra* note 2, at 393–95 (discussing context of an income tax with full loss offsets); Domar & Musgrave, *supra* note 2.

"Under the Haig-Simons formulation of the normative [income tax] base, income is a taxpayer's consumption plus change in wealth for a particular period." Noël B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319, 322 (1993) (citing Robert M. Haig, *The Concept of Income—Economic and Legal Aspects*, in THE FEDERAL INCOME TAX 1, 7 (Robert M. Haig ed., 1921), reprinted in AM. ECON. ASS'N, READINGS IN THE ECONOMICS OF TAXATION 54 (Richard A. Musgrave & Carl Shoup eds., 1959); HENRY C. SIMONS, PERSONAL INCOME TAXATION 50 (1938)).

The federal income tax is not a normative income tax. Cf. Cunningham, *supra* note 2, at 22 ("No one believes that a normative income tax based upon the Haig-Simons definition could ever be fully implemented; its importance is as an ideal."). For one thing, "[t]he Haig-Simons definition calls for taxing all accretions of wealth in a uniform manner," see Eric M. Zolt, *The Uneasy Case for Uniform Taxation*, 16 VA. TAX REV. 39, 41 (1996), which the federal income tax does not do.

⁸ See *infra* text accompanying notes 39–156.

⁹ See *infra* text accompanying notes 103, 114.

¹⁰ See *infra* text accompanying notes 33–37.

¹¹ See *infra* text accompanying notes 185–90.

¹² Starting a business is riskier than making a passive investment, in part because the former requires coupling labor with capital, thereby eliminating a form of diversification. As Professor Terry Chorvat explains, "*ceteris paribus*, a diversified portfolio of investments has less risk than an undiversified portfolio of stocks. . . . This arises because there are two types of risk in any investment: idiosyncratic risk and systematic risk. A diversified portfolio will reduce the idiosyncratic risk." Terrence R. Chorvat, *Ambiguity and Income Taxation*, 23 CARDOZO L. REV. 617, 630–31 (2002) (footnotes omitted). Entrepreneurs tend to hold less diversified portfolios than non-entrepreneurs. See WILLIAM M. GENTRY & R. GLENN HUBBARD,

does not subsidize losses from investments, it does enable an individual with an active business to shift to the federal government part of the risk of loss from that business. In effect, the government subsidizes business activity by bearing a portion of the risk. It is as if the individual faced with the investment decision posited at the beginning of the Article would have a silent partner to bear a portion of any losses a business might experience.¹³

Of course, the government, also will reap some of the rewards if the business is successful, through taxation of the profits.¹⁴ And optimistic investors will overestimate the chances that the enterprise will be successful. If, after taxes, a successful passive investment is more profitable than a successful business venture, taxation might discourage entrepreneurship despite the subsidy of business losses. However, an entrepreneurial venture not only has the higher pre-tax upside posited at the beginning of the Article, but, like passive investment, it faces significant opportunities for taxation at rates lower than those applied to labor.¹⁵ In effect, the bundling of capital with labor into an active business can lower the rate of taxation on that labor.¹⁶

ENTREPRENEURSHIP AND HOUSEHOLD SAVING, 4 *ADVANCES IN ECON. ANALYSIS AND POL'Y* 1, Art. 8 (2004), available at <http://www.bepress.com/bejeap/advances/vol4/iss1/art8/> (finding that true of their sample). In addition, many new businesses fail. See PESKA ILMANAKUNNAS & VESA KANNIAINEN, *ENTREPRENEURSHIP, ECONOMIC RISKS, AND RISK INSURANCE IN THE WELFARE STATE: RESULTS WITH OECD DATA 1978-93*, 4 & n.2 (CESifo Working Paper No. 356, 2000) (citing EUROSTAT, *ENTERPRISES IN EUROPE* (Fourth Report 1996)).

¹³ See Michael Livingston, *Risky Business: Economics, Culture and the Taxation of High-Risk Activities*, 48 *TAX L. REV.* 163, 168 (1993) (making this point with respect to investments generally but not focusing on the limitations that apply to individuals' investment but not business losses).

¹⁴ *Cf. id.* Taxation of profit coupled with deductibility of losses reduces the variance of an investment. See Fried, *supra* note 6, at 992 n.84.

¹⁵ For example, an individual entrepreneur whose business is successful can incorporate the business and thereby benefit from income-splitting. One study found that cutting each individual income tax rate by five percentage points would decrease entrepreneurship by thirty percent overall and would decrease it most at the top. JULIE BERRY CULLEN & ROGER H. GORDON, *TAXES AND ENTREPRENEURIAL ACTIVITY: THEORY AND EVIDENCE FOR THE U.S.* (Nat'l Bureau of Econ. Research, Working Paper No. 9015, 2002), available at <http://www.nber.org/papers/w9015>. In contrast, another study found that changes in tax rates had only small effects on entrepreneurial activity. See Donald Bruce & Mohammed Mohsin, *Tax Policy and Entrepreneurship: New Time Series Evidence*, Working Paper (2003), at <http://web.utk.edu/~dbruce/bruce.mohsin.803.pdf>.

Another study, in focusing on the influence of federal income taxes on capital outlays by sole proprietors, found that "a five-percentage-point rise in marginal tax rates would reduce the proportion of entrepreneurs who make new capital investment by 10.4 percent." Robert Carroll et al., *Entrepreneurs, Income Taxes, and Investment*, in *DOES ATLAS SHRUG? THE ECONOMIC CONSEQUENCES OF TAXING THE RICH* 427 (Joel Slemrod ed., 2000). However, that study considered only sole proprietors (selecting only those individual taxpayers who, among other things, filed a Schedule C in both 1985 and 1988). *Id.* at 429. Thus, it ignores the possibility of

Accordingly, this Article argues that the structure of the federal tax system, particularly the federal income tax system, provides a subsidy for entrepreneurship¹⁷ by individuals.¹⁸ The subsidy exists to the extent that the

incorporation of a successful business. *See id.* at 430 (“Analysis of the behavior of entrepreneurs who are organized in other forms of business [besides sole proprietorships] is beyond the scope of this chapter.”). Commentary on the Article points out that “shifts in organizational form for tax purposes (for example, between unincorporated and incorporated businesses) may spuriously change the entrepreneurship status of households.” R. Glenn Hubbard, Commentary on Robert Carroll et al., *Entrepreneurs, Income Taxes, and Investment, in DOES ATLAS SHRUG? THE ECONOMIC CONSEQUENCES OF TAXING THE RICH, supra*, at 457. Strategic incorporation of a successful business is discussed in Part IV.C of this Article. *See infra* text accompanying notes 325–80.

¹⁶ For example, employment tax is imposed on employment income (up to a cap) without any reduction for expenses or other deductions. *See infra* note 347. Self-employment tax, the corresponding tax for the self-employed, is imposed on net earnings from self-employment, which allows for deductions attributable to the trade or business. *See* I.R.C. §§ 1401, 1402 (2004). This also means that the self-employment tax is subject to more manipulation. *See* Patricia E. Dilley, *Breaking the Glass Slipper—Reflections on the Self-Employment Tax*, 54 TAX LAW. 65, 96 (2000).

In fact, because of the absence of information reporting and withholding taxes, self-employment generally provides greater opportunities for tax evasion than employment does. *See* Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 OHIO ST. L.J. 1453, 1503–05 (2003); Cullen & Gordon, *supra* note 15, at 1 (“small business owners can much more easily underreport their taxable income than can wage and salary earners”). Tax evasion is not a focus of this Article.

¹⁷ The term “entrepreneurship” is used in this Article in the sense of creation of a new business venture. *See* Steven H. Hobbs, *Toward a Theory of Law and Entrepreneurship*, 26 CAP. U. L. REV. 241, 241 (1997) (“[T]he heart of entrepreneurship lies in the creation of small ventures by one person or a small group of individuals.”).

This Article does not discuss tax incentives for businesses using venture capital, focusing instead on self-funded new business. *Cf.* AMAR BHIDÉ, *THE ORIGIN AND EVOLUTION OF NEW BUSINESSES* (1999), *quoted in* GENTRY & HUBBARD, *supra* note 12, at 12 n.18 (“More than 80 percent of the *Inc.* founders [studied by Amar Bhidé] bootstrapped their ventures with modest funds derived from personal savings, credit cards, second mortgages, and so on; the median start-up capital was about \$10,000. Only 5 percent raised their initial equity from professional venture capitalists.”). For an analysis of the tax issues in venture capital-funded start-up business, *see* Victor Fleischer, *The Rational Exuberance of Structuring Venture Capital Startups*, 57 TAX L. REV. 137 (2003).

¹⁸ This Article assumes that the individual conducts any business as a sole proprietor unless he incorporates it. Incorporation of a business is discussed in Part IV.C. *See infra* text accompanying notes 325–80.

The subsidy is not surprising, given our culture:

Americans love small business. Despite the notoriously high rate of early failure, every year hundreds of thousands of undaunted Americans launch small businesses. The folklore of the independent entrepreneur being the backbone of American self-reliance and work ethic is a more persuasive argument for favorable tax incentives than any reality-based economic consideration.

taxpayer has both capital¹⁹ and income from sources other than the business against which the losses can be offset. For a variety of reasons, including the fact that high-income individuals experience taxation at the highest marginal tax rates, they are the ones who have the greatest incentive to invest capital in business²⁰ rather than in passive investments.²¹

This insight has implications for the evaluation of tax legislation from a policy perspective. For example, the recently enacted Jobs and Growth Tax Relief Reconciliation Act of 2003²² lowered individual income tax rates and lowered the rate of tax on most dividends to a maximum rate of fifteen percent.²³ Although, at first blush, lower tax rates might seem to spur entrepreneurial activity, in fact, the effect may be the opposite. Lower tax rates reduce the value of deductions, the importance of which is discussed below.²⁴ In addition, the cap on the tax rate on dividends makes investment in stock, including stock in

Ronald F. Wilson, *Federal Tax Policy: The Political Influence of American Small Business*, 37 S. TEX. L. REV. 15, 64 (1996). Professor Marjorie Kornhauser remarks:

Americans imbue earned income with an aura of morality and virtuousness that unearned income, particularly inherited income, does not have. Consequently, we Americans admire the person who acquires her wealth by means of her own talent and industry, while at the same time, we distrust (though perhaps also envy) the idle rich who live off of their clipped coupons.

Marjorie E. Kornhauser, *The Morality Of Money: American Attitudes Toward Wealth and the Income Tax*, 70 IND. L.J. 119, 119–20 (1994).

¹⁹ This Article uses the term “capital” in contradistinction to labor. That is, human capital is encompassed in the term “labor,” as it is used in this Article, not “capital.”

One study found that starting a business is positively correlated with receiving an inheritance. See Douglas Holtz-Eakin et al., *Entrepreneurial Decisions and Liquidity Constraints*, 25 RAND J. ECON. 334, 342 (1994).

²⁰ It might seem that because high-income individuals experience taxation at the highest marginal tax rates, if a business were successful, they would bear the greatest tax burden. However, that does not take into account possibilities for minimizing tax on successful business. This issue is discussed *infra* in Part IV.B.

²¹ The passive investment this paper focuses on is portfolio investment. However, because Code section 469 denies individuals a deduction for a net passive activity loss, an individual’s passive investment in the active business of another does not experience full loss offsets. See I.R.C. § 469(a) (2004). Of course, disallowed passive activity losses can be carried forward to a year in which the taxpayer has passive activity income against which to offset it. See I.R.C. § 469(b).

²² Jobs and Growth Tax Relief Reconciliation Act of 2003, 108 Pub. L. 27, §§ 301–02, 117 Stat. 752, 758 (2003). Those provisions are scheduled to sunset at the end of 2008. See *id.* § 303, at 764.

²³ See I.R.C. §§ 1(h)(1)(C), (3)(B) (2004).

²⁴ See *infra* text accompanying notes 159–61. Lower individual tax rates also reduce the benefits of incorporating a successful business. See *infra* text accompanying notes 325–80.

publicly held corporations, relatively more attractive, which should encourage the flow of capital to these investments.

Following this Introduction, the Article is divided into three principal parts. Part II considers the various provisions that limit the deductibility of individuals' investment-related expenses (in Section A) and losses (in Section B). As this Part shows, each provision has its own rationale or justification as an exception to what purports to be, in the standard conception of the federal income tax, the general deductibility of profit-seeking expenses. However, together these separate provisions systematically restrict the deduction of expenses and losses in individuals' investment but not business activities.

Part III of the Article demonstrates that investors can invest more in risky assets in the presence of an income tax than in the absence of such a tax, without increasing their risk of loss. Thus, the deductibility of losses subsidizes risk-taking. However, because of the limitations on the deductibility of investment losses, discussed in Part II, individuals generally do not experience such a subsidy with respect to their passive investments.

Part IV builds on Parts II and III, arguing that the greater loss offsets allowed to individuals' business investments creates an incentive for taxpayers to allocate capital to businesses rather than investments, effectively combining capital and labor. Section A analyzes applicable case law to show that the essential ingredient for an individual's activity to constitute a trade or business is labor. Section B argues that the incentive to combine labor and capital exists primarily for high-income taxpayers. Finally, Section C demonstrates that high-income taxpayers benefit from favorable tax treatment if the business is successful, as well. In fact, high-income taxpayers, who are those who would otherwise be taxed at the highest rates, benefit most from the lower rates that a successful business may experience. The Article therefore concludes that the federal income tax system implicitly provides an incentive for entrepreneurship by high-income individuals.

II. THE FEDERAL INCOME TAX TREATMENT OF LOSSES IN PROFIT-SEEKING ENDEAVORS: THE TWO FACES OF THE CODE

A standard conception of the federal income tax treatment of individuals is that the Code recognizes two principal categories of activities in which individuals engage: profit-seeking and personal (consumption) activities.²⁵ As the Supreme Court has stated:

²⁵ See, e.g., BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS*, Vol. 3 ¶ 20.1.1 (2002) ("Whatever the nature of the taxpayer's economic activities . . . virtually all expenses incurred in business or profit-oriented transactions [may be] deducted. This stands in sharp contrast to the legislative treatment of taxpayers' personal activities, which give rise to only a few circumscribed deductions."); Michelle B. O'Connor,

For income tax purposes Congress has seen fit to regard an individual as having two personalities: “one is [as] a seeker after profit who can deduct the expenses incurred in that search; the other is [as] a creature satisfying his needs as a human and those of his family but who cannot deduct such consumption and related expenditures.”²⁶

This quotation depicts a world in which an individual with expenses related to a portfolio of investments will be able to deduct those expenses to the same extent as expenses related to employment or self-employment. However, this picture is incomplete and misleading. In fact, although individuals’ investment and business activities are sometimes portrayed as experiencing the same treatment,²⁷ subject to limited, context-specific exceptions, close examination of the Code reveals that it systematically subdivides profit-seeking endeavors into business and investment activities.

More technically, with respect to deductions, the Code distinguishes among (1) “[p]ersonal, living, and family expenses,” which generally are non-deductible;²⁸ (2) activities “for the production or collection of income”²⁹ or “for

The Primary Profit Objective Test: An Unworkable Standard?, 27 LOY. U. CHI. L.J. 491, 491–92 & n.4 (1996) (referring to bifurcation into two categories as courts’ historical approach); William D. Popkin, *The Taxpayer’s Third Personality: Comments on Redlark v. Commissioner*, 72 IND. L.J. 41, 41 (1996) (“In the traditional analysis, taxpayers have two personalities—a business and personal personality—concerned respectively with profit-seeking and pleasure-seeking.”); see also *infra* text accompanying note 26.

²⁶ *United States v. Gilmore*, 372 U.S. 39, 44 (1963) (footnote omitted) (quoting S. SURREY & W. WARREN, *CASES ON FEDERAL INCOME TAXATION* 272 (1960)); see also *supra* note 25.

²⁷ See Amy J. Oliver, *Improving the Tax Code to Provide Meaningful and Effective Tax Incentives for Higher Education*, 12 U. FLA. J.L. & PUB. POL’Y 91, 94–95 (2000) (“The tax system classifies all expenses made by individuals in terms of their prevailing purpose, either business or personal. . . . The tax code, therefore, operates on the premise that it can differentiate between business and personal expenses. . . . Sections 162 and 212 . . . attempt to draw such a line by allowing deductions only for ordinary expenses incurred in business or other profit-seeking activities.”). *Id.* (footnotes omitted); see also Allan J. Samansky, *Child Care Expenses and the Income Tax*, 50 FLA. L. REV. 245, 252 (1998) (“A basic principle of our income tax is that expenses incurred in businesses or profit-seeking activities are deductible, while personal expenses are not.”) (footnote omitted).

²⁸ I.R.C. § 262 (2004); but cf. William J. Turnier, *Personal Deductions and Tax Reform: The High Road and the Low Road*, 31 VILL. L. REV. 1703 (1986). Professor Turnier argues:

[P]ersonal deductions should perform three basic functions in a tax system. First, they should be a means whereby receipts are adjusted so that the base which is subject to tax is indeed income. Second, they should be a means whereby the base is made consistent with the fiscal role which has been assigned to an income tax in our society. Lastly, they can, on occasion, provide a means whereby our tax system is made compatible with fundamental values embraced by our society.

the management, conservation, or maintenance of property held for the production of income,”³⁰ and “transaction[s] entered into for profit,”³¹ all of which face many deduction-side restrictions; and (3) “trade or business” activities, which experience few limits on deductibility.³² For convenience, the three categories of activities may be referred to as “personal,” “investment,” and “business,” respectively.

In general, business expenses and losses are deductible from income of any source—business, investment, and even personal income.³³ In other words, provisions for the deductibility of business expenses and losses do not require “baskets.”³⁴ Even certain assets that would otherwise constitute capital assets were they not used in business activity do not give rise to capital losses when resulting in recognized losses.³⁵ Because the losses are ordinary in character, they can be deducted from any income. Furthermore, individuals’ non-employee business expenses are deductible “above the line”³⁶ so they need not be traded off against the standard deduction and are not subject to a number of additional limitations, discussed below.³⁷ In contrast, important restrictions apply

Id. at 1704.

²⁹ I.R.C. § 212(1) (2004).

³⁰ I.R.C. § 212(2).

³¹ I.R.C. § 165(c)(2) (2004).

³² See, e.g., I.R.C. §§ 162, 165(c)(1) (2004).

³³ See I.R.C. § 162.

Income from a hobby or from finding money on the street might not constitute business or investment income. On the income side, the Code generally does not make a distinction among business, investment and personal sources of income. See I.R.C. § 61 (2004); *but cf.* I.R.C. § 1221 (2004) (defining capital assets, which affects which gains are taxed at preferential capital gains rates). There is an exception in the rules applicable to nonresident aliens with United States-source income:

[I]ncome that is effectively connected with the conduct of a U.S. trade or business is taxable—after allowable deductions—at the graduated rates applicable to U.S. citizens and resident aliens; . . . income from U.S. sources that is not effectively connected with a trade or business in the United States is taxed—without an allowance for deductions—at a flat rate of thirty percent.

Stephanie C. Evans, Note, *U.S. Taxation of International Athletes: A Reexamination of the Artiste and Athlete Article in Tax Treaties*, 29 GEO. WASH. J. INT’L L. & ECON. 297, 301 (footnotes omitted); see also I.R.C. §§ 871(a), (b), 873 (2004).

³⁴ See I.R.C. §§ 162, 165 (2004); see also *infra* note 108 and accompanying text.

³⁵ See I.R.C. § 1231 (2004); see also *infra* text accompanying note 121.

³⁶ See I.R.C. § 62(a)(1) (2004).

³⁷ See *infra* text accompanying notes 39–102.

specifically to investment losses and investment expenses.³⁸ These restrictions are discussed in the following Sections.

A. *Restrictions on the Deductibility of Investment Expenses*

There are a number of restrictions on the deductibility of investment expenses, each of which may be separately justified, according to the standard conception of the treatment of individuals' profit seeking expenses. One example is that individuals' investment expenses (other than those attributable to rental and royalty income)³⁹ are treated as "below the line" deductions, that is, as itemized deductions.⁴⁰ Itemized deductions must be traded off against the

³⁸ Some of the deduction-side limitations on investment expenses apply to other expenses as well; investment expenses are not always treated uniquely. However, no other group of expenses is subject to all of these restrictions. Of course, the tax treatment of investments is not entirely unfavorable, in that, for example, investment assets benefit from such things as accelerated depreciation. *See* I.R.C. §§ 167(a)(2), 168 (2004). However, business assets benefit from these provisions as well. *See* I.R.C. § 167(a)(1) (2004). The focus of this Part is the numerous provisions of the Code that limit the deductibility of investment-related expenses or losses but impose no limitation on business-related expenses or losses.

³⁹ *See* I.R.C. § 62(a)(4) (2004). The legislative history of this provision is not clear on why rent and royalty-generating activities are treated differently from such things as investing in stocks and bonds. However, it appears that activities that produce rents or royalties were considered more "business" oriented than investment oriented. *See* H.R. REP. NO. 78-1365, pt. 1, at 22-23 (1944) (listing six categories of deductions allowable in arriving at adjusted gross income, including deductions "attributable to rents and royalties" and referring to the allowable categories as generally limited to "certain business expenses and losses . . . from sales or exchanges of property."); *cf.* 451 STANDARD FEDERAL TAX REPORTS § 29.22(n)-1 (CCH 1945). ("To be deductible for the purposes of determining adjusted gross income, expenses must be those directly . . . connected with the conduct of the trade or business. For example, taxes are deductible in arriving at adjusted gross income only if they constitute expenditures directly attributable to the trade or business or to property from which rents or royalties are derived."). Categorizing the expenses of activities that produce rents or royalties as above-the-line deductions also avoids questions about whether those activities constitute trades or businesses.

There are important differences in required activity level between holding stocks and bonds for their dividends and interest, on the one hand, and renting out property, on the other. Interestingly, the "passive activity loss" provision, Code section 469, provides special rules for rental real estate activities, including a \$25,000 offset that is subject to phase-out based on the taxpayer's adjusted gross income. *See* I.R.C. § 469(i) (2004).

⁴⁰ *See* I.R.C. §§ 62, 63 (2004). Unreimbursed employee business expenses are also treated as itemized deductions, and in fact constitute miscellaneous itemized deductions. *See* I.R.C. §§ 62, 67(b) (2004).

The distinct treatment is not justifiable under a normative income tax. *See supra* note 7. As Professors Martin Burke and Michael Friel stated in the most recent edition of their popular Federal Income Tax casebook, with respect to the below the line status of an investment management fee:

standard deduction;⁴¹ an individual taxpayer should elect to itemize deductions if the aggregate of itemized deductions exceeds the standard deduction to which he is automatically entitled.⁴²

In other words, an individual can claim a \$5,000 above-the-line deduction, such as a business expense, even if he also takes the standard deduction. However, an individual with a \$5,000 deduction that must be itemized, such as most investment expenses,⁴³ will not benefit from deducting it if the standard deduction (\$9,500 for married taxpayers filing a joint return for the 2003 tax year⁴⁴) exceeds the aggregate of his itemized deductions.

The legislative history of the enactment of itemized deductions reflects Congress's intent to make business expenses deductible in computing adjusted gross income, the intermediate measure of income used for a number of purposes.⁴⁵ It is not particularly clear why Congress chose to favor business

This is a curious result because it seems that taxpayers should always be allowed to deduct expenses incurred in the production of taxable income. There is no good policy reason to deny above the line treatment to this expense, and yet Congress has done so. . . . By contrast, were the management fee a business expense, it would be deductible above the line and would not be subject to the potential wastage or disallowance that below the line deductions face.

J. MARTIN BURKE & MICHAEL K. FRIEL, *TAXATION OF INDIVIDUAL INCOME* 14 (6th ed. 2002).

⁴¹ See I.R.C. § 63(a), (b) (2004).

⁴² The standard deduction requires no proof of any expenditures, varies depending on the individual's filing status, and is increased for the aged and blind. See I.R.C. § 63(c) (2004).

Most high-income individuals itemize their deductions. In 1994 IRS Statistics of Income data analyzed by Professors Shuldiner and Shakow, over ninety percent of individuals with income of \$100,000 or more itemized deductions. See Reed Shuldiner & David Shakow, *Lessons from the Limitation on Itemized Deductions*, 93 *TAX NOTES* 673, 683 tbl.4 (2001). Interestingly, that data showed that:

[T]he percentage of taxpayers taking the standard deduction is greater for adjusted gross income exceeding \$500,000 than it is for adjusted gross income under \$500,000. Generally, one would expect that itemized deductions increase with income. Thus, the percentage taking the standard deduction should decline with income. The most likely explanation is that section 68 is forcing taxpayers to take the standard deduction.

Id. at 683.

⁴³ See I.R.C. §§ 62, 67 (2004); *but cf.* I.R.C. § 62(a)(4) (2004).

⁴⁴ See I.R.C. § 63(c)(1) (2004) (defining standard deduction), I.R.C. § 63(c)(2) (providing certain basic standard deduction amounts, unadjusted for inflation, and referring to applicable percentage for joint returns), I.R.C. § 63(c)(4) (specifying inflation adjustment), I.R.C. § 63(c)(7) (providing 200% as applicable percentage for 2003 and 2004); Rev. Proc. 2002-70, 2002-2 C.B. 845, 848 § 3.09(1) (providing inflation-adjusted standard deduction for unmarried individual for 2003).

⁴⁵ See H.R. REP. NO. 78-1365, pt. 1, at 23 (1944) ("In the usual case . . . the deductions which are to be made from gross income in arriving at adjusted gross income are limited to

expenses over other profit-seeking expenses.⁴⁶ In addition, the distinction has never been pure, in that various non-business expenses have also been favored with above-the-line deductibility.⁴⁷

In addition to the disadvantage of characterization as itemized rather than above-the-line deductions, most investment expenses are subject to the two-percent floor on miscellaneous itemized deductions.⁴⁸ This means that amounts below two percent of adjusted gross income (AGI)⁴⁹ are entirely disallowed.⁵⁰ Accordingly, these deductions are subject to a floor that increases proportionately with AGI. For example, for purposes of computing regular tax

certain business expenses and losses which are treated as losses from sales or exchanges of property.”).

⁴⁶ The Senate Finance Committee Report seems to reflect a notion that those activities the expenses of which are not deductible from gross income are those likely to have few deductible expenses:

Fundamentally, the deductions . . . permitted to be made from gross income in arriving at adjusted gross income are those which are necessary to make as nearly equivalent as practicable the concept of adjusted gross income, when that concept is applied to different types of taxpayers deriving their income from varying sources. Such equivalence is necessary for equitable application of a mechanical tax table or standard deduction which does not depend upon the source of the income. For example, in the case of an individual merchant or store proprietor, gross income under the law is gross receipts less the cost of goods sold; it is necessary to reduce this amount by the amount of business expenses before it becomes comparable . . . to the salary or wages of an employee in the usual case. Similarly, the gross income derived from rents and royalties is reduced by the deductions attributable thereto . . . in order that the resulting adjusted gross income will be on a parity with the income from interest and dividends in respect of which latter items no deductions are permitted in computing adjusted gross income.

S. REP. NO. 78-885, pt. 1, at 24–25 (1944).

⁴⁷ See Keith E. Engel, *Deducting Interest on Federal Income Tax Underpayments: A Roadmap Through a 50-Year Quagmire*, 16 VA. TAX REV. 237, 284 & n.192 (1996). Expenses relating to rents and royalties are above-the-line deductions, see I.R.C. 62(a)(4) (2004), although the activities that produce them might be considered investment activities. See Engel, *supra*, at n.192. Their inclusion as above-the-line deductions obviates the need for a determination whether activities such as renting out apartments or owning a mine constitute business activities under *Higgins v. Commissioner*, 312 U.S. 212 (1941), discussed below. See *infra* text accompanying notes 202–09.

⁴⁸ See I.R.C. §§ 62, 67, 212 (2004); *but cf.* I.R.C. § 62(a)(4).

⁴⁹ Adjusted gross income consists of gross income minus above-the-line deductions. See I.R.C. § 62.

⁵⁰ The two-percent floor is a form of phase-out. See Samuel A. Donaldson, *The Easy Case Against Tax Simplification*, 22 VA. TAX REV. 645, 723 n.380 (2003). In 1998, the Joint Committee on Taxation estimated that approximately one-fourth of individual taxpayers were affected by at least one phase-out, phase-in, or floor. STAFF OF THE JOINT COMM. ON TAXATION, 105TH CONG., PRESENT LAW AND ANALYSIS RELATING TO INDIVIDUAL EFFECTIVE MARGINAL TAX RATES 17 (Comm. Print 1998).

liability, a taxpayer with \$10,000 of AGI loses the first \$200 of miscellaneous itemized deductions, a taxpayer with \$100,000 of AGI loses the first \$2,000 of miscellaneous itemized deductions, and a taxpayer with \$1,000,000 of AGI loses the first \$20,000 of miscellaneous itemized deductions.⁵¹ Any remaining miscellaneous itemized deductions will be aggregated with the taxpayer's other itemized deductions before reduction by the "[o]verall limitation on itemized deductions,"⁵² if applicable, which is discussed below.⁵³

The two-percent floor was added in 1986, as part of comprehensive changes that lowered federal income tax rates while broadening the tax base.⁵⁴ The legislative history reflects a concern both with expenditures that are more personal than profit-seeking in nature and for reducing required record-keeping:⁵⁵

The Congress concluded that the prior-law treatment of employee business expenses, investment expenses, and other miscellaneous itemized deductions fostered significant complexity, and that some of these expenses have

⁵¹ The remaining miscellaneous itemized deductions, if any, are aggregated with the taxpayer's other itemized deductions. Those deductions are then reduced by applying section 68, if applicable. The remaining itemized deductions are compared with the standard deduction; the taxpayer should elect to itemize if remaining itemized deductions exceed the standard deduction.

⁵² See I.R.C. § 68 (2004). A few deductions are not subject to the overall limitation on itemized deductions. See I.R.C. § 68(c).

⁵³ See *infra* text accompanying notes 66–71.

⁵⁴ See Tax Reform Act of 1986, Pub. L. 99-514, § 132(a), 100 Stat. 2085, 2114 (1986).

⁵⁵ Professor Debby Geier sums the rationales up as follows:

While some may view section 67 as nothing but a bald revenue grab by Congress to make the legislative ledgers balance, others view it with more equanimity. Many deductions taken by folks under sections 162 and 212 prior to the enactment of section 67 had only a very tenuous relationship to any income-producing activity and had personal-consumption benefits as well. The deduction for *The Wall Street Journal* subscription is a classic example. Such unjustifiable deductions were difficult, if not impossible, for the IRS to monitor in any effective way. Thus, some see section 67 as having achieved significant simplification for most folks who typically don't incur sufficient deductions of the type subject to section 67 to require them to keep records, as well as significant administrative simplification for the IRS.

Deborah A. Geier, *Some Meandering Thoughts on Plaintiffs and Their Attorneys' Fees and Costs*, 88 TAX NOTES 531, 533 (2000). Of course, some taxpayers will need to keep records regardless, because they will not know the aggregate amount of their itemized deductions—or even their AGI—until year end. See Robert J. Peroni, *Reform in the Use of Phase-Outs and Floors in the Individual Income Tax System*, 91 TAX NOTES 1415, 1418 (2001) (“Section 67 . . . [makes] it difficult for taxpayers to figure out prior to the end of the tax year whether they will be able to deduct any of their miscellaneous itemized deductions. Given that fact, many taxpayers will likely keep records just in case they do exceed the 2 percent floor.”).

characteristics of voluntary personal expenditures. For taxpayers who anticipated claiming such itemized deductions, prior law effectively required extensive record-keeping with regard to what commonly are small expenditures. Moreover, the fact that small amounts typically were involved presented significant administrative and enforcement problems for the Internal Revenue Service. These problems were exacerbated by the fact that taxpayers frequently made errors of law regarding what types of expenditures were properly allowable under prior law

The use of the deduction floor also takes into account that some miscellaneous expenses are sufficiently personal in nature that they would be incurred apart from any business or investment activities of the taxpayer. For example, membership dues paid to professional associations may serve both business purposes and also have voluntary and personal aspects; similarly, subscriptions to publications may help taxpayers in conducting a profession and also may convey personal and recreational benefits. Taxpayers presumably would rent safe deposit boxes to hold personal belongings such as jewelry even if the costs, to the extent related to investment assets such as stock certificates, were not deductible.⁵⁶

Thus, investment expenses otherwise deductible under section 212 of the Code are considered sufficiently personal in nature to be at least partially disallowed.

Miscellaneous itemized deductions also are entirely disallowed in computing alternative minimum taxable income, the tax base of the alternative minimum tax (AMT).⁵⁷ The AMT is a tax that may be imposed on individuals and corporations in addition to the regular tax.⁵⁸ Essentially, with respect to the taxpayers to which it applies,⁵⁹ the AMT targets so-called “tax preference items” that escape taxation under the regular tax.⁶⁰ In effect, “[t]he AMT denies any deduction for the expenses of the production or collection of income,”⁶¹ that is,

⁵⁶ STAFF OF THE JOINT COMM. ON TAX’N, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 78–79 (Comm. Print 1987).

⁵⁷ See I.R.C. § 56(b)(1)(A)(i) (2004) (disallowing any deduction for miscellaneous itemized deductions).

⁵⁸ See I.R.C. § 55 (2004).

⁵⁹ The tax generally applies above an exemption amount; that amount for the 2003 tax year was \$40,250 or \$58,000 for individuals, depending on filing status. Note that alternative minimum tax is the amount imposed *in addition to* the regular income tax. See I.R.C. § 55(a). The exemption amount therefore essentially imposes a zero rate on the first dollars that exceed the taxpayer’s regular taxable income and do not exceed the exemption under the alternative minimum tax. However, the exemption is phased out at high levels of alternative minimum taxable income. See I.R.C. § 55(d)(3).

⁶⁰ See I.R.C. §§ 55(b)(2), 56 (2004).

⁶¹ Laura Sager & Stephen Cohen, *How the Income Tax Undermines Civil Rights Law*, 73 S. CAL. L. REV. 1075, 1092 n.97 (2000).

for expenses related to investment activities.⁶² Although the legislative history does not explain the reason for the disallowance,⁶³ the reasons probably are similar: “doubts about the legitimacy of the deductions.”⁶⁴

The Treasury Department commented in 1994:

By mismeasuring economic income, the current law treatment of section 212 expenses can distort the after-tax return on investments involving section 212 expenses. Taxpayers for whom section 212 expenses are limited or disallowed might find other investments relatively more attractive. . . .

How taxpayers change their investment patterns in response to limitations on section 212 expenses depends on several factors, most importantly on the after-tax return on the investments and on the type of expense subject to the section 212 limitation. The greater the difference between after-tax returns of investments involving limited section 212 expenses and other investments, the more taxpayers will choose alternative investment opportunities. . . .⁶⁵

Under the regular (non-AMT) federal income tax, most itemized deductions (but not the investment interest deduction and certain others),⁶⁶ as computed after the reduction on miscellaneous itemized deductions, are further reduced for

⁶² A 1994 Treasury Department Report found that the “AMT disallowance . . . affects only a small fraction of investment expenses The treatment . . . probably has little aggregate economic effect.” Treasury Dep’t, Report to the Congress on Section 212 Expenses and the Alternative Minimum Tax (1994), reprinted in *Treasury Sees No Need to Allow AMT Taxpayers to Deduct Investment Expenses*, TAX NOTES TODAY, 94 TNT 255-5 (Dec. 30, 1994) [hereinafter *Treasury Report*]. The Report stated that, in 1991, only about 148,000 individuals reporting miscellaneous deductions were subject to the AMT. *Id.* “Their miscellaneous deductions which counted as AMT preferences equaled \$3.4 billion.” *Id.* In the intervening years, many more individuals have become liable for the AMT. See Leonard E. Burman et al., *The AMT: Projections and Problems*, 100 TAX NOTES 105, 105 (2003) (“Although it has historically applied to only a very small share of taxpayers, the tax is projected to grow rapidly over the next decade, transforming it from a class tax to a mass tax. . . . By 2010, the AMT will affect 33 million taxpayers—about one-third of all taxpayers—up from 1 million in 1999.”).

⁶³ Gregg D. Polsky, *A Correct Analysis of the Tax Treatment of Contingent Attorney’s Fee Arrangements: Enough with the Fruits and the Trees*, 37 GA. L. REV. 57, 73 (2002).

⁶⁴ Geier, *supra* note 55, at 534; see also Sager & Cohen, *supra* note 61, at 1092 (focusing on the circumstances surrounding the enactment of the AMT’s disallowance of miscellaneous itemized deductions).

⁶⁵ *Treasury Report*, *supra* note 62.

⁶⁶ Itemized deductions not subject to section 68 are the deduction for medical expenses, which is subject to a 7.5% floor under section 213; the deduction for investment interest, which is deductible only from investment income under section 163(d); gambling losses, which are deductible only from gambling income under section 165(d); and uncompensated casualty and theft losses allowed by section 165.

individuals with AGI over a certain amount.⁶⁷ The so-called “overall limitation on itemized deductions” of section 68⁶⁸ operates to reduce most itemized deductions by a lump sum computed as three percent of AGI,⁶⁹ except that the deductions will not be reduced below twenty percent of the amount the taxpayer can otherwise claim.⁷⁰ For example, a taxpayer with itemized deductions of \$10,000 and AGI exceeding the applicable amount by \$1,000 would reduce itemized deductions by \$30 (three percent of \$1,000). A taxpayer with itemized deductions of \$50,000 and AGI exceeding the applicable amount by \$1,500,000 would reduce itemized deductions by \$40,000 (eighty percent of \$50,000).⁷¹

⁶⁷ See I.R.C. § 68 (2004). Professors Shuldiner and Shakow found that, for the 1994 tax year, of those individuals itemizing deductions, 100 percent of those with AGI over \$200,000 were affected by section 68. Shuldiner & Shakow, *supra* note 42, at 682 tbl.3. This is not surprising; section 68 requires the reduction of itemized deductions of those taxpayers with AGI over a specified threshold (which remains under \$200,000). See I.R.C. §§ 68(a), (b); Rev. Proc. 2002-70, 2002-2 C.B. 845, 848 § 3.10. In 1994, 69.7% of those itemizing and with AGI between \$100,000 and \$200,000 were affected. Shuldiner & Shakow, *supra* note 42, at 682 tbl.3. Almost all high-income individuals itemize their deductions. See *id.* at 683 tbl.4; see also *supra* note 42.

⁶⁸ See I.R.C. § 68. The limitation was enacted as part of the Revenue Reconciliation Act of 1990 and its initial sunset provision was repealed by the Omnibus Budget Reconciliation Act of 1993. Shuldiner & Shakow, *supra* note 42, at 673. It is currently scheduled to phase out from 2006 through 2009, I.R.C. § 68(f), cease to exist for a year, I.R.C. § 68(g), and then be reinstated when the Economic Growth and Tax Relief Reconciliation Act of 2001 sunsets, see Pub. L. 107-16, §§ 901(a)(1), (b), 115 Stat. 38, 150 (2001). Professors Shuldiner and Shakow note that “[t]he phasedown of section 68 has no effect in determining whether a taxpayer is more likely to be subject to the ‘3 percent rule’ (now 2 or 1 percent [in 2006 through 2009]) relative to the ‘80 percent rule’ (now 53.33 percent or 26.67 percent [in 2006 through 2009]). The phasedown does, however, make it less likely that taxpayers will be forced to take the standard deduction.” Shuldiner & Shakow, *supra* note 42, at 679.

⁶⁹ Because of the length of the section 68 phase-out range, “most taxpayers covered by section 68 will be within the phase-out range and thus will be subject to the 3 percent rule rather than either the 80 percent rule or the standard deduction.” Shuldiner & Shakow, *supra* note 42, at 675–76.

⁷⁰ See I.R.C. § 68(a)(2); Shuldiner & Shakow, *supra* note 42, at 674; Calvin H. Johnson, *Simplification: Replacement of the Section 68 Limitation on Itemized Deductions*, 78 TAX NOTES 89, 89 (1998). The provision is stated as a reduction by eighty percent of the otherwise allowable itemized deductions. See I.R.C. § 68(a). Reduction by eighty percent will leave twenty percent remaining.

⁷¹ Three percent of \$1,500,000 is \$45,000, which is larger than the \$40,000 reduction. Given the way section 68 functions, “the 80 percent rule can be the operative bound on the 3 percent rule only if the taxpayer’s itemized deductions exceed five times the allowable standard deduction.” Shuldiner & Shakow, *supra* note 42, at 676. For married taxpayers filing jointly in 2003, this meant that the taxpayer’s itemized deductions would have to be at least \$47,500 for the eighty percent rule to apply. *Cf. id.* (providing similar calculation for 2001). For 2003, the standard deduction for married taxpayers filing jointly was \$9,500. See *supra* note 44 and accompanying text.

It is also possible that the reduction in itemized deductions will reduce those deductions to less than the amount of the standard deduction, in which case the taxpayer will take the standard deduction in lieu of itemizing.⁷² For example, a taxpayer with itemized deductions of \$10,000 and AGI exceeding the applicable amount by \$100,000 would reduce itemized deductions by \$3,000 (three percent of \$10,000) and, if married, would claim the larger standard deduction of \$9,500.⁷³ All taxpayers with AGI over the applicable amount and itemized deductions in excess of the standard deduction will pay more tax than they otherwise would,⁷⁴ regardless of whether the reduction has the effect of reducing the itemized deduction or prompting them to take the standard deduction.⁷⁵

The legislative history of section 68 is not very helpful; it states simply that the intent of the provision is to limit itemized deductions.⁷⁶ However, contemporaneous commentators stated that many of the legislators were

⁷² See Shuldiner & Shakow, *supra* note 42, at 679. Shuldiner and Shakow state, based on the 1994 IRS Statistics of Income data they analyze, that “[w]hile it is not possible to determine whether a taxpayer was forced to take the standard deduction by operation of section 68, the data do suggest that a significant number of taxpayers fall into that category.” *Id.* at 683.

⁷³ This was the standard deduction for married couples filing a joint return for the 2003 tax year. See *supra* note 44 and accompanying text.

⁷⁴ Like the overall limitation on itemized deductions, the phase-out of personal exemptions increases the effective tax rate applicable to those who experience it. The phase-out of personal exemptions effectively creates a surtax of about four percent of income within the range of the phase-out. Calvin H. Johnson, *Simplification: Replace the Personal Exemptions Phaseout Bubble*, 77 TAX NOTES 1403, 1403 (1997). For 2003, the phase-out range was \$209,250 to \$331,750 for married taxpayers filing joint returns. Rev. Proc. 2002-70, 2002-2 C.B. 845, 849 § 3.15. This raises those taxpayers’ average tax rates. Taxpayers with income exceeding the amount for complete phase-out of personal exemptions experience complete elimination of the exemptions for that tax year. Those taxpayers also experience an increase in average tax rates but not to the same extent because the surtax ceases on income above the level at which personal exemptions have been eliminated. See Johnson, *supra*, at 1404. The result is a disproportionate burden on families with total income for the year within the phase-out range than on those with total income that exceeds the range. Professor Johnson has called for repeal of the provision on that basis as well as others. See *id.* at 1404–05 (pointing out the extraordinary complexity and illogic of the mechanics of the provision). Professor Johnson proposed replacing the phase-out with an explicit increase of one percentage point in the top two marginal rates. *Id.* at 1406–07. He pointed out that the increase would raise slightly more revenue than the phase-out of personal exemptions, *id.* at 1407, while shifting the tax burden to the higher end of the income spectrum. See *id.* (“The proposal is pro-family. It promotes efficiency by cutting unnecessarily high tax rates, without shifting tax to those less able to pay. It simplifies the tax law and yields a fairer rate structure. Who then could resist it?”).

⁷⁵ That is, lowering the amount deductible will increase taxable income, the tax base. See I.R.C. § 1 (2004) (defining tax rates applicable to individuals’ taxable income), I.R.C. § 63 (2004) (defining taxable income).

⁷⁶ H.R. CONF. REP. NO. 101-964, at 1030–33 (1990).

concerned with increasing progressivity.⁷⁷ Calvin Johnson has argued that the effect of section 68 is an implicit one-percent tax on AGI for individuals with AGI that exceeds the applicable threshold,⁷⁸ who are high-income individuals.⁷⁹ As Professor Johnson explains, this increases the effective tax rate for these individuals by more than one percentage point because AGI is a larger figure than taxable income, the tax base of the income tax.⁸⁰ He further notes that “[s]ection 68 was justified by its proponents as a disguised tax hike, raising revenue from top-bracket taxpayers without raising the explicit section 1 rates.”⁸¹

Professor Edward McCaffery has pointed out that the tax rates in section 1 are well-publicized, particularly when they change, and that “the single highest rate bracket is socially prominent, whereas each person’s individual highest rate bracket is individually prominent.”⁸² He has argued that the prominence⁸³ of the

⁷⁷ See J. Andrew Hoerner, “Pease Plan” Emerges as Key Issue in Debate Over Tax Progressivity, 49 TAX NOTES 498, 498–99 (1990); Gene Steuerle, *Budget Act 1990: Revival of the Progressivity Debate*, 49 TAX NOTES 1251, 1252 (1990); see also Donaldson, *supra* note 50, at 724 n.392.

⁷⁸ Johnson, *supra* note 70, at 90; see also Shuldiner & Shakow, *supra* note 42, at 674 (“Where the 3 percent rule applies, the effect of section 68 is to raise the marginal tax rate on the last dollar of income rather than to reduce the tax benefit on the last dollar of itemized deduction.”). That is because, in the range in which the three percent rule is operative, the dollar value of a deduction is not affected by section 68. See *id.* at 678. For example, if a taxpayer with \$10,000 of otherwise allowable itemized deductions has \$50,000 of adjusted gross income in excess of the applicable amount, those deductions will be reduced by \$1,500 to \$8,500. If the taxpayer discovers that, in fact, he is entitled to an additional \$1,000 itemized deduction, the itemized deductions allowed by section 68 will be \$9,500. Because the \$1,000 additional deduction will not be reduced by section 68, the marginal value of that deduction will be determined by multiplying the deduction by the taxpayer’s marginal rate.

⁷⁹ The AGI threshold for 2003 was \$139,500, except that it was \$69,750 for married individuals filing separately. Rev. Proc. 2002-70, 2002-2 C.B. 845, 848 § 3.10.

⁸⁰ Johnson, *supra* note 70, at 90. AGI is larger than taxable income because AGI is not reduced by the standard deduction (or itemized deductions) or personal exemptions. See *id.* (“[F]or taxpayers with itemized deductions of 25 percent of AGI, it would take a tax stated to be 1.59 percent of taxable income to give the same revenue as 1.19 percent of AGI tax.”) (footnote omitted).

⁸¹ *Id.* at 92; see also Shuldiner & Shakow, *supra* note 42, at 693 n.95 (“While it is possible that section 68 and its companion, section 151(d) (phaseout of personal exemptions), were repealed in a rare attempt at simplification, there is another intriguing explanation. Just as an earlier Bush administration sought to hide an increase in marginal tax rates through the use of phaseouts, the current Bush administration may well have sought to hide a decrease in marginal rates through the repeal of the same provisions.”).

⁸² See Edward J. McCaffery, *Cognitive Theory and Tax*, 41 UCLA L. REV. 1861, 1887 (1994).

⁸³ “Prominence refers to the practice of attaching particular and disproportionate importance to highly visible or easily recallable events or facts. . . . Individuals are apt to overreact to disasters that are well-publicized on television in predicting the future; in analyzing

section 1 rates vis-à-vis hidden or partially hidden rate increases explains Congress's propensity for hidden increases.⁸⁴ He lists the phaseouts of itemized deductions and personal exemptions among the "cognitive tricks" employed by Congress.⁸⁵

Unlike many provisions, section 68 never explicitly phases out.⁸⁶ In fact, it operates over a large range of income, limited only by the twenty-percent floor on itemized deductions contained in section 68 and the option to take the standard deduction.⁸⁷ As Professors Reed Shuldiner and David Shakow have pointed out, a result of the lump sum reduction of deductions is that any net zero transaction consisting of gross income and an itemized deduction will produce a positive tax for a taxpayer subject to the three-percent rule because, by definition, gross income increases AGI but itemized deductions do not reduce it.⁸⁸ This

present facts, individuals are apt to give disproportionate weight to their own immediate, local experiences, and so on." *Id.* at 1886–87. "Framing" is also relevant. "Framing refers to the well-documented phenomenon under which individuals react to the purely formal way in which a question is presented or 'framed.'" *Id.* at 1905.

⁸⁴ *Id.* at 1887, 1890 ("[T]he doubly non-prominent technique . . . may be the most attractive move available to the legislator. A second-best move is to expand the domain of the higher rate brackets, implicating *only* individual prominence, not social prominence.").

That is, an explicit increase in tax rates is both highly visible and likely to be perceived as a government imposition on the taxpayer. On the other hand, the overall limitation on itemized deductions is buried far from the marginal rates; the marginal rates are in section 1, while the overall limitation on itemized deductions is in section 68. The impact of section 68 on a given taxpayer is non-obvious. See Johnson, *supra* note 74, at 1404 ("For a household consisting of a couple and three children (i.e., five exemptions), the surtax is between 3.8–4.2 percent of the taxpayer's income, again depending on the bracket. For a household with 10 exemptions, the surtax could be 8.3 percent.") (footnote omitted); *id.* ("The phase-out taxes are complicated enough that the most expert tax economists in the country sometimes make mistakes describing them."). In addition, it may be viewed as a reduction in benefits granted by the tax system rather than an unadulterated burden; it may be more palatable to a taxpayer to be faced with a cutback of a tax-reducing exemption than to be faced with an increase in tax, even if they have the same economic effect. See McCaffery, *supra* note 82, at 1874 ("A standard lesson from prospect theory in particular and cognitive theory more generally is that people are especially averse to losses. For example, people will not use credit cards if a merchant advertises a 3% penalty for using them, but they will do so if the same merchant advertises a 3% bonus for using cash: being penalized appears worse than forsaking a bonus, although the two outcomes are economically equivalent. Similarly, people consistently attach more disutility to losing a sum of money or a valuable possession than they do to failing to gain the same sum or good, even controlling for wealth effects.").

⁸⁵ *Id.* at 1898 & nn.86–87.; see also Peroni, *supra* note 55, at 1425 ("[The language of the House committee report] is another way of saying that the purpose of section 68 was to raise effective tax rates on higher-income taxpayers in a nontransparent fashion.").

⁸⁶ See I.R.C. § 68 (2004); Shuldiner & Shakow, *supra* note 42, at 675–76.

⁸⁷ Shuldiner & Shakow, *supra* note 42, at 674–75.

⁸⁸ *Id.* at 678–79.

effect holds even for itemized deductions not subject to section 68, such as the deduction for investment interest.⁸⁹ The particular tax burden on leveraged investments is probably a side effect of the Congressional response to tax shelters of limiting the deductibility of investment interest.⁹⁰ Regardless, the net result is the equivalent of a lower tax rate on the deduction side than on the income side.⁹¹

⁸⁹ *Id.*

For example, if Lisa Leverage, an unmarried individual, earns \$1,000 of investment income but spends \$1,000 on investment interest, the income will be included in her gross income, I.R.C. § 61(a)(4) (2004), and the deduction will be allowed in full because her investment interest does not exceed her investment income, I.R.C. § 163(d) (2004). The interest deduction will be an itemized deduction. *See* I.R.C. §§ 62, 67(b)(2) (2004). Assume that Lisa has \$10,000 in other itemized deductions, none of which are subject to the two-percent floor on miscellaneous itemized deductions, *see* I.R.C. § 67(a) (2004), but all of which are subject to reduction by section 68. If her AGI, apart from the investment transaction, exceeds the applicable amount of section 68 by \$50,000, the reduction in the \$10,000 of itemized deductions will be \$1,500. However, once the investment transaction is considered, AGI exceeds the applicable amount by \$51,000: the \$1,000 of investment income increases AGI but the \$1,000 of interest expense does not reduce AGI because investment expense is a below-the-line (itemized) deduction. Accordingly, the \$10,000 of deductions subject to section 68 will be reduced by \$1,530 instead of \$1,500. The net zero investment transaction will therefore cost Lisa \$30 (three percent of the income amount) although investment interest deductions are not themselves subject to section 68.

As Professors Shuldiner and Shakow point out, the existence of the interest deduction implicitly requires at least an equal amount of investment income because investment interest is deductible only in the amount of investment income. *See* Shuldiner & Shakow, *supra* note 42, at 693. The same is true for gambling losses. *See id.* Thus, in any instance in which investment interest is deductible, the taxpayer will bear an additional tax burden. *See id.* (“We are at a loss to find a justification for what is in effect an oddly structured excise tax on gambling and leveraged investments.”). All itemized deductions create a similar effect but those limited to particular sources of income are the most severe.

The burden on gambling may result from a moral judgment. *Commissioner v. Groetzinger*, 480 U.S. 23, 27 (1987), is instructive in that it demonstrates the Court’s conflict over whether to treat gambling as a trade or business—which was the only way to let Groetzinger avoid another tax on phantom gambling gains under law applicable at the time. *See id.* at 25–26 & n.3 (although Groetzinger had a \$2,032 net gambling loss, IRS argued that, under 1978 law, a portion of his \$70,000 gambling loss deduction was a tax preference item that would subject him to alternative minimum tax of \$2,142); *see also infra* text accompanying notes 210–21.

⁹⁰ *See, e.g.*, Calvin Johnson, *What’s a Tax Shelter?*, 68 TAX NOTES 879, 882 (1995) (“Shelters are explained by debt.”); *see also* Daniel N. Shaviro, *Rethinking Anti-Tax Shelter Rules: Protecting the Earned Income Tax Base*, 71 TAXES 859, 867 (1993) (discussing the limitation on investment interest as an anti-tax shelter rule).

⁹¹ This, in turn, eliminates the taxpayer’s ability to invest more in higher return assets without increasing risk. *See supra* text accompanying notes 4–6.

As Professors Shuldiner and Shakow also point out, the negative tax consequences do not stop there. The artificially increased AGI also decreases the taxpayer's personal exemptions.⁹² Any AGI increase in the phase-out range of the limit on personal exemptions will have this effect, though it will not be as startling as with respect to a net zero transaction. For example, a taxpayer with \$300,000 of income and \$100,000 of expenses to produce that income will have \$100,000 more AGI if the expenses are investment-related than if they are business-related. If the family consists of husband, wife, and two dependent children and the activity is investment-related, for the 2003 tax year, the family would lose seventy-two percent of its four personal exemptions (which function like deductions in the tax calculation), a disallowance of \$8,784.⁹³

Although Professors Shuldiner and Shakow do not explicitly mention this, the two-percent floor on miscellaneous itemized deductions causes the same type of problem for the individual taxpayers to whom it applies⁹⁴—and a tax burden that is cumulative with the burden discussed above. That is, a net zero transaction will increase AGI, thereby increasing the floor below which no miscellaneous itemized deduction is available, in effect disallowing deduction of an amount equal to two percent of the net zero amount.⁹⁵ In fact, because the two-percent floor applies prior to the overall limitation on itemized deductions,⁹⁶ a net zero transaction can have the effect of subjecting five percent of the net zero amount

⁹² Shuldiner & Shakow, *supra* note 42, at 693 & n.93 (example based on gambling gains and losses, which have the same effect for this purpose as investment income and investment interest expense).

⁹³ In the phase-out range, the percentage of personal exemptions available is reduced by two percentage points for every \$2,500. I.R.C. § 151(d)(3) (2004). Four personal exemptions total \$12,200 (\$3,050 * 4). The phaseout range for 2003 for married taxpayers filing jointly for 2003 was \$209,250 to \$331,750. Rev. Proc. 2002-70, 2002-2 C.B. 845, 849 § 3.15(2).

⁹⁴ See Shuldiner & Shakow, *supra* note 42, at 679 (“In general, any phase-out based on adjusted gross income (or a similar amount) will cause a differential rate on income and deductions. Thus, for example, the phaseout of deductible contributions to individual retirement accounts—which is a phaseout of an above-the-line deduction—and the phaseout of the HOPE credit—which is a phaseout of a tax credit—have similar effects.”).

⁹⁵ The Lisa Leverage transaction is an example. See *supra* note 89. In that example, the \$1,000 of investment income, though economically zeroed out by the \$1,000 interest expense, would raise the two-percent floor by \$20 (two percent of \$1,000) through the \$1,000 increase in AGI. The result would be the disallowance of an additional \$20 in miscellaneous itemized deductions, such as investment expenses (other than investment interest and expenses to produce rents and royalties; the latter are not itemized deductions, see I.R.C. § 62(a)(4) (2004)).

⁹⁶ See I.R.C. § 68(a) (2004) (referring to “otherwise allowable” itemized deductions), I.R.C. § 68(d) (“This section shall be applied after the application of any other limitation on the allowance of any itemized deduction.”).

to taxation.⁹⁷ Of course, taxable income is the tax base, not the tax, so the additional tax borne will depend on the taxpayer's top marginal rate.⁹⁸

Although the effect of the differential tax rates applied to income and deductions is most dramatic for transactions that are net zero and that involve an itemized deduction limited to the amount of related gross income (such as the investment interest expense and gambling losses discussed by Professors Shuldiner and Shakow or deductions under Code section 183(b)(2)), in fact, a similar consequence results from any itemized deduction. That is, itemized deductions do not lower AGI but the income against which they can be offset raise AGI. Thus, even a transaction that does not net to zero (e.g., \$2,000 of investment income and \$1,000 of investment interest expense) results in a higher tax on the income than the deduction because it is the additional income that increases reductions based on AGI.

In addition, the same effect holds for itemized deductions that are not linked to specific types of income. For example, expenses (other than interest) to produce dividend income are miscellaneous itemized deductions but are not limited by the amount of investment income. If a taxpayer has income from investments, that income, like all income, will increase the cut-back of the two-percent floor and the three-percent rule of section 68. However, deductions that reflect the expenses that give rise to that income will not reduce the cut-back. In this case, the deduction reduced by the additional income may well be the investment deduction itself. However, the same events may also reduce an entirely unrelated deduction, such as the medical expense deduction, which is subject to a floor of 7.5% of AGI.⁹⁹

⁹⁷ For example, if, in the Lisa Leverage example, see *supra* note 89, the \$10,000 of itemized deductions included miscellaneous itemized deductions of at least \$20, then the addition of the \$1,000 of gross income and the concomitant increase in AGI would decrease miscellaneous itemized deductions by \$20. The remaining itemized deductions (\$9,800 excluding the \$1,000 of investment interest) would be further reduced by three percent of AGI, \$1,530 in the above example. See *supra* note 89 (hypothesizing AGI exceeding the applicable limitation of I.R.C. § 68 by \$51,000 once the investment income is included). Thus, on these hypothetical facts, the additional \$1,000 of income from a net zero transaction involving income and an itemized deduction resulted in the taxation of an additional \$50, five percent of \$1,000.

The taxation of a full five percent of the amount of a net zero transaction will occur in any instance in which a taxpayer subject to the three-percent rule has miscellaneous itemized deductions remaining after application of the two-percent floor (or remaining after application of the two-percent floor to AGI less the income from the net zero transaction). The Lisa Leverage example illustrates this point. See *supra* notes 89, 95.

⁹⁸ For example, a \$50 increase in taxable income, as in the Lisa Leverage example discussed in notes 89 and 97, *supra*, taxed at a rate of 30%, results in a tax increase of \$15, a 1.5% surtax on the \$1,000 of income.

⁹⁹ See I.R.C. § 213(a) (2004).

Additionally, itemized deductions that are not miscellaneous have the same effect. For example, assume that a taxpayer decides to give fifty percent of her income to charity. Assume that she has \$100,000 of income from wages, no other gross income, and no above-the-line deductions. Her AGI is therefore \$100,000.¹⁰⁰ If she gives \$50,000 to her church (the maximum deductible under section 170),¹⁰¹ she will have a \$50,000 itemized charitable contribution deduction in addition to any other itemized deductions that she may have. Given the large charitable contribution deduction, the taxpayer will elect to itemize, and, because of the relatively low AGI in this example, itemized deductions will not be reduced under section 68. However, any miscellaneous itemized deductions that the taxpayer may have will be reduced by \$2,000, two percent of her AGI. So long as the taxpayer has any miscellaneous itemized deductions (such as unreimbursed employee business expenses), those deductions will be taxed at a higher rate than her wage income is.

These examples demonstrate that making a deduction itemized rather than above-the-line has the effect of increasing the rate of tax on any income associated with that deduction.¹⁰² The effect is the most pronounced where the Code expressly links the deduction to certain types of income, because the income must by definition exist for the deduction to be allowed. Nonetheless, the effect extends beyond that more narrow category of cases. Thus, the below-the-line status of most investment-related expense deductions, by disallowing part of an otherwise available deduction, has the effect of raising the tax rate on those expenses.

As indicated above, a specific type of expense, interest expense, also is treated less favorably when it relates to investments rather than business activity. While individuals' business interest is fully deductible, their investment interest is deductible only from investment income.¹⁰³ This restriction addresses two

¹⁰⁰ I.R.C. § 62 (2004).

¹⁰¹ I.R.C. § 170(b)(1)(A) (2004).

¹⁰² Cf. Shuldiner & Shakow, *supra* note 42, at 693 (identifying the effect with respect to investment interest expense and gambling losses for taxpayers subject to the three-percent rule of section 68).

¹⁰³ I.R.C. §§ 163(a), (d) (2004).

According to IRS Statistics of Income for tax year 2000, of those taxpayers who itemize, the AGI group with the largest absolute number of returns claiming a deduction for investment interest was the group with AGI between \$100,000 and \$200,000. IRS Statistics of Income for Tax Year 2000, tbl.2.1, available at <http://www.irs.gov/taxstats/article/0,,id=96586,00.html> [hereinafter 2000 IRS Statistics of Income]. The largest absolute dollar amount was claimed by those taxpayers itemizing deductions with AGI of \$10,000,000 or more; the second largest absolute dollar amount was claimed by those in the \$200,000 to \$500,000 AGI group. *See id.* 12.6% of returns of taxpayers who itemized and had AGI of \$100,000 or more claimed an investment interest deduction. The aggregate investment interest expense claimed by that group was approximately \$19,624,386,000, about .74% of that group's aggregate AGI. Of course,

issues, both relating to investments that accrue unrealized appreciation. One issue raised in the legislative history is the possibility that a taxpayer can deduct investment interest at ordinary income rates but pay tax on any gain on the investment at preferential capital gains rates.¹⁰⁴ In addition, in that scenario, the deduction is current and any income is realized later. Thus, section 163(d) eliminates “[m]ismeasurement (at least that attributable to leverage) arising from unrealized appreciation of investment assets”¹⁰⁵ For example, assume that a taxpayer with a salary of \$100,000 per year borrows \$500,000 to purchase investments and will pay \$40,000 of interest on the investment for the year. If the investment produces no current return,¹⁰⁶ allowing a deduction would enable the taxpayer to reduce his taxable income by \$40,000, arguably a mismatching of income and expenses.¹⁰⁷

The effect of the limitation is to place a cap on the investment interest that an individual taxpayer may deduct.¹⁰⁸ No similar limitation exists with respect to

these figures do not reflect investment interest that was paid but not claimed as a deduction because it was disallowed by Code section 163(d).

¹⁰⁴ H.R. REP. NO. 91-413, pt. 1, at 72 (1969).

¹⁰⁵ Cecily W. Rock & Daniel N. Shaviro, *Passive Losses and the Improvement of Net Income Measurement*, 7 VA. TAX REV. 1, 49 (1987); see also Lawrence Zelenak, *When Good Preferences Go Bad: A Critical Analysis of the Anti-Tax Shelter Provisions of the Tax Reform Act of 1986*, 67 TEX. L. REV. 499, 562 (1989) (“The preference concerned in cases to which section 163(d) applies will usually be the deferral of tax on unrealized appreciation.”); H.R. REP. NO. 91-413, pt. 1, at 72 (1969).

¹⁰⁶ Any appreciation will be taxed when and if eventually realized. At that point, the investment interest will become deductible. See I.R.C. §§ 163(d)(2), (4)(B)(ii) (2004); Daniel N. Shaviro, *Selective Limitations on Tax Benefits*, 56 U. CHI. L. REV. 1189, 1196 (1989) (“Since unrealized appreciation is mostly deferred rather than excluded (in the case of appreciated stock, it would be taxed upon the sale of the stock at a gain), disallowed deductions are carried forward, rather than permanently denied.”).

¹⁰⁷ Of course, the same could be said with respect to business interest. In addition, the law effectively treats a wage earner worse than someone with unrelated income from capital:

By permitting the interest deduction to the extent of investment income, it discriminates against the taxpayer who has only earned income out of which to pay his interest expense. The abuse [of deducting interest expense from ordinary income and subsequently paying tax on gain at capital gains rates] is the same in either case, though under the bill the individual with earned income, but not a person receiving dividends or other investment income, might lose his interest deduction.

STAFF OF SENATE COMM. ON FINANCE, 91ST CONG., STATEMENT OF THE HONORABLE EDWIN S. COHEN 42 (Comm. Print 1969).

¹⁰⁸ This “basketing” approach is a technique that the Code sometimes uses to limit the deductibility of expenses from nonbusiness activities. See *supra* text accompanying notes 10, 34. Another example is that business expenses and losses are fully deductible under Code sections 162 and 165, but if an individual’s activity is determined not to be engaged in for profit within the meaning of section 183, the taxpayer may deduct expenses connected with

leveraged investment in an active business. The following example illustrates the effect of this difference: Alice and Bob, both of whom are unmarried, each earn \$150,000 of salary income in 2003. Alice borrows \$200,000 to start a business on the side. Bob borrows \$200,000 to buy stock. Assume that each taxpayer pays \$20,000 in interest expense for the year. Assume further that neither the business nor the investment produces any return for the year. Alice may deduct the \$20,000 of interest above the line while Bob may not deduct any of it. On these facts, Alice will owe \$28,962 in federal income tax for 2003 and Bob will owe \$34,630.32, a difference of \$5,668.32.¹⁰⁹

Of course, if the investment (or another investment¹¹⁰) produced some income (say, \$3,000), Bob theoretically could deduct that amount of his investment interest expense. However, the theoretically deductible amount (here, \$3,000) is an itemized deduction, and, as discussed above,¹¹¹ those deductions, in the aggregate, are traded off against the standard deduction.¹¹² Thus, on these facts, even as a single taxpayer (entitled to a standard deduction half that of a married couple), Bob will be better off taking the standard deduction, unless he has other itemized deductions as well.¹¹³

B. Restrictions on the Deductibility of Investment Losses

The Code imposes restrictions on investment-related losses as well as expenses. One of these restrictions is the limitation on capital losses,¹¹⁴ which

that activity only if they are otherwise deductible under a Code section other than section 162 or 212, or to the extent of income from the activity. I.R.C. §§ 183(a), (b), (c) (2004).

¹⁰⁹ The driving force behind the difference is disallowance of the \$20,000 deduction with respect to Bob. On these facts, that disallowance results in the partial phase-out of Bob's personal exemption (given his higher AGI). It does not result in taxation of a portion of Bob's taxable income at a higher marginal rate than the rate applicable to Alice's last dollar of income, but it could on slightly different facts.

¹¹⁰ See *supra* note 103.

¹¹¹ See *supra* text accompanying note 41.

¹¹² See I.R.C. §§ 62, 67(a), (b)(1) (2004).

¹¹³ The standard deduction for 2003 for an unmarried taxpayer was \$4,750. See Rev. Proc. 2002-70, 2002-2 C.B. 845, 848 § 3.09(1) (providing inflation-adjusted standard deduction for unmarried individual for 2003). The relevant amount of other itemized deductions is the amount remaining after application of the two-percent floor to any miscellaneous itemized deductions and the application of the overall limitation on itemized deductions. See *supra* text accompanying notes 48–71.

¹¹⁴ See I.R.C. § 1211(b) (2004). Corporations may deduct capital losses only from capital gains, I.R.C. § 1211(a), but do not benefit from a capital gains preference, see I.R.C. § 11 (2004) (regular corporate tax rates, with top rate at 35%), I.R.C. § 1201(a)(2) (2004) (35% rate applicable to net capital gain).

may be viewed as the flip-side of the well-known capital gains preference.¹¹⁵ Capital losses are deductible only to the extent of a taxpayer's capital gains plus, in the case of an individual taxpayer, up to \$3,000 of ordinary income.¹¹⁶ Individuals' disallowed capital losses are carried forward for possible deduction in a later year.¹¹⁷ No similar disallowance provision exists for ordinary losses. Thus, although the capital gains preference provides a tax benefit to appreciated

¹¹⁵ See I.R.C. § 1(h) (2004). One justification for the capital gains preference is the notion that because the federal income tax system does not index basis for inflation or otherwise exclude from taxation the portion of "gain" actually due to inflation, realized capital gain may not actually reflect economic gain, in whole or in part. The longer the asset is held, the larger the amount of inflation embodied in the return on eventual disposition of the asset, though the longer the asset is held, the greater the economic benefits of deferral. See Joseph Isenbergh, *The End of Income Taxation*, 45 TAX L. REV. 283, 321 (1995) ("[T]he [pre-1986] capital gains preference . . . offset to a degree the undeniable effect of inflation in enlarging nominal gains from sales of capital assets beyond their real value."). That is probably not the reason the capital gains preference initially was enacted. See William D. Popkin, *The Deep Structure of Capital Gains*, 33 CASE W. RES. 153, 159, 161 (1983). In addition, that justification is undermined by the relatively short holding period required for application of the capital gains preference—it need only be a year and a day. See I.R.C. § 1(h) (2004) (applying maximum capital gains rate to net capital gain), I.R.C. § 1222 (2004) (defining net capital gain and its component parts). However, assets held for a shorter term before realization bear more of the effects of inflation than those held for the longer term because a shorter holding period lessens the benefit of deferral.

In general, gains held for a shorter period of time are taxed at rates that exceed the ordinary tax rate. This is because the inclusion of inflationary gains in the tax base more than offsets the deferral advantage. On the other hand, gains held for a longer period of time are taxed at a rate below the ordinary tax rate as the deferral advantage exceeds the effect of taxing inflationary gains. The crossover point depends on the share of the total gain that is inflation, and on the real rate of return on capital.

Jane G. Gravelle & Lawrence B. Lindsey, *Capital Gains*, 38 TAX NOTES 397, 399–400 (1988).

¹¹⁶ I.R.C. § 1211(b) (2004). Ordinary income is essentially income that is not capital in character. See I.R.C. § 64 (2004). Ordinary loss is loss from the sale or exchange of an asset other than a capital asset. I.R.C. § 65 (2004).

The Bush administration proposed increasing the \$3,000 amount to \$8,250. See H.R. 1619, 107th Cong., 2d Sess. (2002) (making that change and adding an inflation adjustment provision); *Ways and Means Approves Bill to Increase Capital Loss Deduction Limitation to \$8,250*, 196 DAILY TAX REP. GG-1 (2002).

The capital loss rules are coordinated with the net operating loss rules as follows: "In the case of a taxpayer other than a corporation . . . the amount deductible on account of losses from sales or exchanges of capital assets shall not exceed the amount includable on account of gains from sales or exchanges of capital assets . . ." I.R.C. § 172(d)(2)(A) (2004). Thus, the net operating loss computation for an individual does not include net capital losses.

¹¹⁷ I.R.C. § 1212(b)(1) (2004).

property that is sold, the capital loss disallowance rules provide a significant disadvantage for capital assets sold at a loss.¹¹⁸

A principal justification for imposing a limitation on the deduction of capital losses include the taxpayer's ability to time the recognition of gains and losses: "If a taxpayer owns two stocks, one having appreciated by \$1 million and the other having declined by \$1 million in value, the provision prevents him from deducting a loss of \$1 million by selling the loss stock while retaining the appreciated stock."¹¹⁹ Another justification is the cost to the treasury of allowing a rate reduction on the income side but no rate limitation on the deduction side.¹²⁰

¹¹⁸ The combination of favorable treatment for investment gains and unfavorable treatment of investment losses may seem ambiguous as to whether the capital gains rules encourage or discourage investment. In fact, it is possible that the rules encourage some divestment. First, the rules may encourage taxpayers disposing of some investments to dispose of others because the treatment of capital gains and losses is linked. Because an individual taxpayer with recognized capital losses in a particular year can deduct as much as his capital gains plus up to \$3,000 of ordinary income, I.R.C. § 1211(b) (2004), a taxpayer with large capital losses has an incentive to dispose of capital assets with unrealized gains in the same year so as to take advantage of capital losses that exceed \$3,000. By contrast, a taxpayer with \$3,000 or less in capital losses has an incentive to hold off on recognizing the gains until a later year because the losses will be deductible from ordinary income. Gains recognized in the later year will in turn benefit from the capital gains preference if the assets were held for more than a year and they are not offset by recognized losses.

Conversely, a taxpayer with recognized gains in a taxable year has an incentive to dispose of capital assets with unrealized losses in order to shelter the gains. This is particularly true because, although individuals may carry disallowed losses forward to subsequent tax years, they may not carry them back to earlier years and the taxed gains may not be carried forward to be reduced by losses that occur in later years. *See* I.R.C. § 1212(b) (2004). The encouragement of additional divestment by a taxpayer who has decided to recognize certain capital gains or losses may seem to be a matter of timing in that assets not sold in one year would instead be sold in another year. In many instances that may well be the case. However, given the current incentive to hold appreciated assets until death, *see* I.R.C. § 102(a) (2004) (exclusion from gross income at death), I.R.C. § 1014(a)(1) (2004) (fair market value basis for property received by reason of death), some of those assets might never have been sold absent the link between capital gains and losses.

¹¹⁹ Shaviro, *supra* note 106, at 1196; *see also* H.R. REP. NO. 94-658, at 339 ("Because taxpayers have discretion over when they realize their capital gains and losses, unlimited deductibility of net capital losses against ordinary income would encourage investors to realize their capital losses immediately to gain the benefit of the deduction against ordinary income but to defer realization of their capital gains.").

¹²⁰ *See* H.R. REP. NO. 67-1388 (1923). The report states:

[T]o-day the taxpayer pays a maximum tax of 12½ per cent on gains derived from the sale of capital assets, but is allowed to deduct in full from his taxable income his net losses resulting from the sale of capital assets during the taxable year. The injustice to the Government is too obvious to require much comment. . . . The Government can collect

Because investment property generally constitutes a capital asset, the capital loss rules apply to investment property with recognized losses. By contrast, many business assets are “quasi-capital” assets that in effect can benefit from the capital gains preference without being burdened by the limitation on capital losses.¹²¹ The Code initially defines as capital assets “property held by the taxpayer (whether or not connected with his trade or business),” with several important exceptions.¹²² The exceptions from the capital asset definition encompass many items connected to trade or business activity, such as inventory,¹²³ real or depreciable property used in the taxpayer’s trade or business,¹²⁴ and accounts receivable acquired in the ordinary course of business.¹²⁵

Thus, real property and depreciable property used in the taxpayer’s trade or business do not constitute capital assets under Code section 1221. However, if these types of property are held for more than a year, they constitute “quasi-capital assets” under section 1231.¹²⁶ Under section 1231, if, in a particular taxable year, the gains from these assets for any taxable year exceed losses from these assets, the gains and losses are treated as long-term capital gains and

but 12½ per cent of a gain, but it is compelled to lighten the burden of the taxpayer to the extent of 58 per cent of the losses.

Id. at 2; see also Michelle Amopol Cecil, *Toward Adding Further Complexity to the Internal Revenue Code: A New Paradigm for the Deductibility of Capital Losses*, 1999 U. ILL. L. REV. 1083, 1119–26 (1999); Alvin C. Warren, Jr., *The Deductibility by Individuals of Capital Losses Under the Federal Income Tax*, 40 U. CHI. L. REV. 291, 304 (1973). This apparently was not a relevant justification for the 1986 Congress; Larry Zelenak has pointed out that the fact “[t]hat the 1986 Act retained the capital loss limitation despite the Act’s repeal of the 60% capital gains deduction demonstrates that Congress did not intend the capital loss limitation to serve as a rough offset for the favorable tax rate formerly applied to capital gains.” Zelenak, *supra* note 105, at 567 (footnote omitted).

¹²¹ See I.R.C. § 1231 (2004); see also *infra* text accompanying note 126.

¹²² I.R.C. § 1221(a) (2004). Personal use property is not generally excluded, so it benefits from the capital gains preference. For example, gain on the sale of a personal residence is taxed at favorable capital gains rates, to the extent it is taxable at all after the application of Code section 121, which excludes most gain on the sale of the taxpayer’s principal residence if certain criteria are met. I.R.C. § 121 (2004). The limitation on the deductibility of capital losses generally does not affect personal use property because losses on the sale of such property generally are not deductible. See I.R.C. §§ 165(a), (c) (2004).

¹²³ I.R.C. § 1221(a)(1). Inventory, the goods sold by a business, reflect the day-to-day earnings that are typical of ordinary income.

¹²⁴ I.R.C. § 1221(a)(2). As discussed below, the treatment of real property and depreciable property used in a trade or business is determined by Code section 1231. See *infra* text accompanying note 126.

¹²⁵ I.R.C. § 1221(a)(4). Accounts receivable reflect debt arising in the ordinary course of business, essentially substitutes for ordinary income.

¹²⁶ See I.R.C. § 1231(b)(1) (2004).

losses.¹²⁷ If the losses equal or exceed the gains, then both the gains and losses are treated as ordinary.¹²⁸ Therefore, disposition of depreciable or real trade or business assets held for more than one year is rewarded with a win-win rule that does not apply to investment assets: The character of gains is capital and of losses is ordinary, except with respect to the recapture of depreciation.¹²⁹

For noncorporate taxpayers, investment losses are disadvantaged vis-à-vis trade or business losses with respect to characterization as net operating losses (losses that can be carried to other tax years¹³⁰), as well. Net operating losses include all trade or business losses, but nonbusiness losses (typically investment losses because most personal losses are disallowed by Code section 165(c)) are allowed only to the extent of the taxpayer's gross income from nonbusiness activity.¹³¹ This "basketing" precludes a taxpayer from carrying a net investment loss to a prior or subsequent year (other than a capital loss subject to the capital loss carryover rules).¹³²

The passive activity loss rules also apply this basketing approach; taxpayers cannot avoid the deduction-side limitations on investments by investing passively in another's active business.¹³³ Under the passive activity loss rules, if the taxpayer invests in trade or business or income-producing activities¹³⁴ in which he does not "materially participate" (other than portfolio investment¹³⁵), and/or

¹²⁷ See I.R.C. § 1231(a)(1).

¹²⁸ See I.R.C. § 1231(a)(2).

¹²⁹ See I.R.C. §§ 1245, 1250 (2004). In general, because depreciation deductions reduce ordinary income, these Code sections treat as ordinary income the amount of gain that is attributable to prior depreciation.

¹³⁰ Under current law, taxpayers generally can carry net operating losses back two years and forward 20 years. I.R.C. § 172(b)(1)(A) (2004).

¹³¹ I.R.C. §§ 172(c), (d)(4).

¹³² The legislative history of this provision is not clear why it includes this restriction. The House Report states, in part: "In the case of a taxpayer other than a corporation, allowable deductions not attributable to a trade or business regularly carried on by the taxpayer are allowed only to the extent of the gross income not derived from the trade or business." H.R. REP. NO. 76-855, at 17 (1939) (discussing section 122, an antecedent provision). This makes the tax treatment sound comparable to the current treatment in Code section 183 of activities not engaged in for profit.

¹³³ "No activities are subject to both [the] limitations [on investment interest and on passive activity losses], and, in general, activities that are conducted by individuals for profit, other than those in which the taxpayer materially participates, are subject to one of the two rules." Rock & Shaviro, *supra* note 105, at 49 n.161 (citing Conf. Rep., *supra* note 12, at 153, reprinted in 1986 U.S. Code Cong. & Admin. News at 4241).

¹³⁴ See I.R.C. § 469(c)(6) (2004).

¹³⁵ Portfolio investment is covered by the limitation on investment interest discussed above. See *supra* notes 103-13 and accompanying text.

rental activities,¹³⁶ and losses from those activities exceed income from those activities for the year, the loss is disallowed and is deferred for possible use in the following year.¹³⁷ Material participation is defined in the Code as “involve[ment] in the operations of the activity on a basis which is—(A) regular, (B) continuous, and (C) substantial.”¹³⁸ The regulations contain a number of safe harbors, including 500 hours of participation in the activity during the year.¹³⁹

The passive activity loss provision is the one that effectively shut down the tax shelters of the 1970s and 1980s, at least in conjunction with earlier changes in the law.¹⁴⁰ Though there is no uniformly accepted definition of tax shelter,¹⁴¹ it is clear that passivity is not the key.¹⁴² However, one feature of many of the tax

Considered together, sections 469 and 163(d) constitute a “two basket” approach to tax shelter limitations. To ensure that section 163(d) does not overlap with the passive loss rules, it provides that investment income and expenses do not include “any income or expenses taken into account under section 469 in computing income or loss from a passive activity.” Investment interest also does not include any interest taken into account in computing passive activity income or loss under section 469. Passive activities—including interest expenses attributable to such activities—go into the section 469 basket, while investments and their related interest expenses go into the section 163(d) basket.

Zelenak, *supra* note 105, at 564 (footnotes omitted); *see also supra* note 133.

¹³⁶ There is an exception for the first \$25,000 of losses from rental real estate activities except that the \$25,000 is phased out for AGI between \$100,000 and \$150,000. *See* I.R.C. § 469(i) (2004).

¹³⁷ *See* I.R.C. § 469(a), (b). The taxpayer will be able to use the loss (or credit) the following year only if the activity produces net income the following year. Deferral is disadvantageous because of the time value of money.

¹³⁸ I.R.C. § 469(h)(1).

¹³⁹ *See* Treas. Reg. § 1.469-5T(a) (as amended in 1996).

¹⁴⁰ *See* Shaviro, *supra* note 90, at 859. They were part of the Tax Reform Act of 1986. *See* Pub. L. No. 99-514, § 501(a), 100 Stat. 2085, 2233 (1986).

¹⁴¹ Johnson, *supra* note 90, at 879 (“There is no consensus definition of a ‘tax shelter’ in the law or legal literature.”). One good definition is “a transaction designed to give deductions in an amount large enough to reduce . . . taxes in a sum greater than the net consideration or cost . . . of the entire operation.” *Id.* at 883 (*quoting* Emmons v. Commissioner, 31 T.C. 26, 31 (1958)).

¹⁴² Johnson, *supra* note 90, at 880–81; Mona Hymel, *Tax Policy and the Passive Loss Rules: Is Anybody Listening?* 40 ARIZ. L. REV. 615, 616 (1998) (“Many question the appropriateness of the passive loss rules in the attack on abusive tax shelters.”). Professor Johnson laments:

The trouble with the 1986 act is that nobody seems to have known what a tax shelter was. The definition used in section 469, “passive activity,” is a terrible diagnosis. There is nothing wrong with being active, nothing wrong with passive, and nothing wrong with combining the two. If some kid comes up to me and says, “What’s a tax shelter?,” I cannot tell him it is a passive activity.

Johnson, *supra* note 90, at 880–81.

shelters in which lawyers, doctors, and others with high income participated, is that they did not participate in any business conducted by the shelter.¹⁴³ This unifying feature presented a “silver bullet” to stop these activities.¹⁴⁴

Because the passive activity loss rules make no distinction between legitimate investments and purported investments made to generate artificial tax losses, they also impose a tax burden on unprofitable but genuine investments.¹⁴⁵ For example, assume that a married taxpayer with a salary of \$300,000 per year decides to invest in a bakery conducted through a partnership.¹⁴⁶ Assume that the bakery is a legitimate business that will be run by the partners. Assume further that the taxpayer invests \$200,000 of cash and that the partnership has a net loss of \$250,000 for the year, of which \$100,000 is properly allocable to the taxpayer. If the bakery is operated solely by other partners, the taxpayer will be unable to deduct the loss. However, if the taxpayer “materially participates” in the operation of the bakery, the \$100,000 will constitute a trade or business loss, deductible above the line. On the facts (assuming that the taxpayer’s spouse has no earnings), that will make a difference of \$34,449.36 in the taxpayer’s tax liability for 2003.¹⁴⁷

¹⁴³ Cf. Johnson, *supra* note 90, at 881. Professor Johnson argues:

One plausible theory is that section 469 is, at its core, protectionist legislation, trying to keep the bad accounting as the exclusive privilege of insiders. Only the insiders get the artificial losses. You need to be a real real estate man to get the nonreal real estate tax losses. You have to have manure on your boots to get the cow-pod farm tax losses.

Id. (footnote omitted).

¹⁴⁴ See Lawrence Zelenak, *Business Purpose, Economic Substance, and Corporate Tax Shelters: Codifying Anti-Avoidance Doctrines and Controlling Corporate Tax Shelters*, 54 SMU L. REV. 177, 191 (2001).

¹⁴⁵ Arguably, this is exactly the purpose of section 469. That is, section 469 does not address the question of whether the activity in question is a sham. A sham should not be respected for tax purposes, so section 469 will not apply to it. See DODGE, FLEMING & GEIER, FEDERAL INCOME TAX: DOCTRINE, STRUCTURE AND POLICY 873, 876 (3d ed. 2004). Section 469 simply ensures that losses from “passive” activities are not deducted from “active” income, such as salary. However, that begs the question of why active income should be segregated from passive deductions. The Haig-Simons norm does not call for such segregation. See *supra* note 7 and accompanying text. However, arguably, allowing early deduction of losses from an investment activity (while deferring income) would provide consumption tax treatment by effectively exempting part of the return on the investment from tax. See Teacher’s Manual to DODGE, FLEMING & GEIER, FEDERAL INCOME TAX: DOCTRINE, STRUCTURE AND POLICY ch. 30, at 9 (3d ed. 2004).

¹⁴⁶ The example assumes that the taxpayer’s spouse has no income.

¹⁴⁷ Deductibility of the \$100,000 loss results in a \$42,297.50 federal income tax liability. Non-deductibility results in federal income tax liability of \$76,746.86. A large part of the differential reflects the tax benefit of the \$100,000 deduction. The remainder is due to a partial

For individuals, the deductibility of bad debt losses also hinges on whether or not the debt had a business connection. All taxpayers can deduct business bad debts that are wholly worthless and can deduct the worthless portion of a partially worthless business bad debt.¹⁴⁸ By contrast, noncorporate taxpayers can deduct “nonbusiness” bad debts only if they are wholly worthless, and then only as short-term capital losses.¹⁴⁹ In part, the treatment of nonbusiness bad debts reflects Congress’s concern for personal debts, especially those of dubious legitimacy.¹⁵⁰

With respect to investment bad debts, treating the debt as a short-term capital loss keeps the character of the loss comparable to that of a worthless security¹⁵¹ and to the sale or exchange of an investment asset.¹⁵² However, this tax treatment contrasts with that applicable to business bad debts; they are deductible from ordinary income.¹⁵³ Thus, for example, an employee who makes a \$50,000 loan to his employer (which may be a corporation), to protect his employment, may deduct it above the line if it becomes worthless and similarly may deduct a portion of it if only that portion is worthless. By contrast, a stockholder who makes a \$50,000 loan to the corporation in which he owns stock will have a

phase-out of personal exemptions resulting from the additional \$100,000 of adjusted gross income that results when the \$100,000 loss is not deductible.

¹⁴⁸ I.R.C. § 166(a) (2004).

¹⁴⁹ I.R.C. § 166(d). Nonbusiness bad debts include both investment bad debts and personal bad debts. Thus, in this instance, the Code makes a personal loss deductible (though as a relatively disfavored type of loss) and groups investments with personal activities.

¹⁵⁰ See H.R. REP. NO. 77-2333, at 45.

An example of a nonbusiness bad debt would be an unrepaid loan to a friend or relative, while business bad debts arise in the course of the taxpayer’s trade or business. This liberal allowance for nonbusiness bad debts has suffered considerable abuse through taxpayers making loans which they do not expect to be repaid.

Id.

¹⁵¹ See I.R.C. § 165(g) (2004).

¹⁵² A taxpayer holding a worthless debt cannot sell or exchange the debt precisely because it is worthless.

[The] plan [for nonbusiness losses] was suited to put nonbusiness investments in the form of loans on a footing with other nonbusiness investments. The proposal originated with the Treasury Department, whose spokesman championed it as a means “to insure a fairer reflection of taxable income,” and the House Ways and Means Committee Report stated that the objective was “to remove existing inequities and to improve the procedure through which bad-debt deductions are taken.”

Putnam v. Commissioner, 352 U.S. 82, 91–92 (1956) (footnotes omitted) (*quoting* Hearings Before House Committee on Ways and Means on Revenue Revision of 1942, 77th Cong., 2d Sess. 90; H.R. Rep. No. 2333, 77th Cong., 2d Sess. 44).

¹⁵³ See I.R.C. § 166(a); United States v. Genes, 405 U.S. 93, 95–96 (1972).

capital loss and not until total worthlessness of the debt.¹⁵⁴ If it becomes totally worthless and the shareholder has no capital gains (or none that are not absorbed by other capital losses), at most \$3,000 of the bad debt will be deductible for that year.¹⁵⁵ The nonbusiness nature of nonbusiness bad debts also restricts the usefulness of these losses under the net operating loss rules.¹⁵⁶

This Part of the Article has shown that the Code contains numerous limitations on the deductibility of investment expenses and losses, each of which has its own justification or rationale. Taken together, however, the picture that emerges consists of systematic deduction-side restrictions on individuals' investment activities but not on their business activities. The next Part demonstrates that the comparatively liberal deductibility of business losses reduces the risk of individuals' business activity. In effect, as discussed in Part IV, the Code implicitly subsidizes entrepreneurship by individuals, particularly high-income individuals.

III. SHARING RISK OF LOSS WITH THE FEDERAL GOVERNMENT

A person with capital to invest naturally seeks to maximize the financial return on the investment. In a world with taxes, the investor should focus on the post-tax return. In general, it is fair to assume that investments that are riskier need to provide higher expected returns to attract investors.¹⁵⁷ Each investor has a certain tolerance for risk, and risk-averse investors consider not only the overall

¹⁵⁴ In this respect, unlike with respect to expenses to produce the respective income, employees are treated better than investors, rather than equally disfavored. See I.R.C. §§ 62, 67 (2004); see also *supra* note 40.

¹⁵⁵ See I.R.C. § 1211 (2004).

¹⁵⁶ See I.R.C. § 172(d)(4) (2004); *Genesee*, 405 U.S. at 96; see also *supra* notes 131–32 and accompanying text.

¹⁵⁷ In other words, investors demand higher returns to invest in riskier assets, all else being equal.

Among finance theorists, the term “risk” refers to fluctuations or variations in returns, including both unusual gains and unusual losses. . . . Because . . . market (or beta) risk cannot be diversified away, risk-averse investors should demand a risk premium in the form of higher expected returns before they will be willing to hold stocks with a high degree of beta risk. Indeed, the CAPM [Capital Asset Pricing Model] predicts that the relationship between beta risk and returns should be linear: a stock with twice the market's level of beta risk must offer twice the market's expected return.

Lynn A. Stout, *Corporate Finance: How Efficient Markets Undervalue Stocks: CAPM and ECMH under Conditions of Uncertainty and Disagreement*, 19 CARDOZO L. REV. 475, 481 n.23 (1997) (citing RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 173–83 (5th ed. 1996)).

expected return but also the risk of loss.¹⁵⁸ The risk of loss must also be assessed on a post-tax basis because the loss ultimately borne by the investor is the portion remaining after any tax benefit is applied.

“Because losses are fully deductible under a normative income tax, an investor can tolerate greater risk in a world with an income tax while maintaining the same exposure she would have had in a tax-free world. This is because the investor and the government share the risk of loss”¹⁵⁹ In other words, assuming that losses are fully deductible, the investor will actually bear only the portion of the loss that remains after application of the tax rate on the loss side.

For example, if an investor would bear a \$1,000 loss before taxes but the loss is fully deductible for federal income tax purposes and the applicable tax rate is thirty percent, the investor will bear only \$700 of the loss, with the federal government bearing the other \$300.¹⁶⁰ Accordingly, if losses are deductible, the investor can invest more than he would in a world without taxes, without increasing his risk of loss. Assuming a thirty percent tax rate, the investor could bear a pre-tax loss of \$1,428.57; after tax, this loss would amount to only \$1,000.¹⁶¹ In other words, the imposition of a thirty percent flat tax with fully deductible losses increased by 42.86% the amount the investor could risk.¹⁶²

As the above example shows, an income tax that allows the deductibility of losses should increase risk-taking. Consider the model that Evsey Domar and Richard Musgrave developed.¹⁶³ It demonstrated that, given certain assumptions,¹⁶⁴ including an assumption that the return on investments

¹⁵⁸ For example, a risk-averse investor would prefer a guaranteed return of \$100 to a 50% chance of a \$300 return and a 50% chance of a \$100 loss, even though the expected value of the latter is \$100 (\$150 - \$50), so that the bets are, in theory, equivalent. See Lawrence Blume & Daniel L. Rubinfeld, *Compensation for Takings: An Economic Analysis*, 72 CAL. L. REV. 569, 585 (1984); cf. Cunningham, *supra* note 2, at 30–31 (“The precise amount of risk that an investor is willing to bear is a personal matter and is inextricably related to the amount an investor is willing to lose if the investment does badly.”).

¹⁵⁹ Cunningham, *supra* note 2, at 31.

¹⁶⁰ In the general case, “the government bears the percentage of the loss equal to the tax rate t and the investor bears the balance, $(1 - t)$.” *Id.*

¹⁶¹ See *id.* (“[I]f an investor were willing to invest \$1,000 in a risky venture in a world without taxes, she should be willing to invest $\$1,000/(1 - t)$ in that venture in a world with a normative proportional income tax.”). In the example in the text, \$1,000 divided by .7 is \$1,428.57.

¹⁶² The investment increased by \$428.57, which is 42.857% of \$1,000.

¹⁶³ See Domar & Musgrave, *supra* note 2.

¹⁶⁴ In addition to full loss offsets and a normative income tax, the assumptions include (1) proportional (and unchanging) taxation rather than progressive taxation; (2) constant marginal returns to investment; (3) costless borrowing, because an investor who was already fully invested in the risky asset would nonetheless have to invest more in that asset to replicate the pre-tax expected return, necessitating borrowing; (4) zero or at least low transactions costs for

compensates only for risk,¹⁶⁵ investors will invest more in riskier investments in the presence of an income tax than in its absence.¹⁶⁶

For example, assume that an investor in a no-tax world has \$200 to invest. Also assume that the riskless rate of return on investment is zero.¹⁶⁷ Assume that Asset A is a riskless asset and Asset B is a risky asset that has a 50% chance of

portfolio shifts; (5) infinite and infinitely divisible investment possibilities; and (6) no inflation. See Terrence R. Chorvat, *Apologia for the Double Taxation of Corporate Income*, 38 WAKE FOREST L. REV. 239, 260 (2003); Cunningham, *supra* note 2, at 35–36; Bankman & Griffith, *supra* note 2, at 397. The model also implicitly assumes unlimited availability of borrowed funds. These assumptions are necessary for the investor to replicate the pre-tax situation but are not necessary for the general point, relied on in this Article, that full loss offsets reduce an investor's risk. The "basic conclusion that proportional taxation with loss offsets encourages risk-taking is now widely accepted by economists." Warren, *supra* note 120, at 298–99 n.29 (1973); cf. Cecil, *supra* note 120, at 1107 ("It is generally agreed that permitting the deductibility of capital losses is necessary if the government is attempting to induce taxpayers to invest in risky undertakings.").

¹⁶⁵ In other words, the basic model assumes that the riskless rate of return on investment is zero. Cf. Chorvat, *supra* note 164, at 261 (assuming zero riskless rate of return); Alvin C. Warren, Jr., *How Much Capital Income Taxed Under an Income Tax is Exempt Under a Cash Flow Tax?*, 52 TAX L. REV. 1, 7 (1996) (assuming 2% return on riskless investment); Cunningham, *supra* note 2, at 32 (assuming .6% return on riskless investment). Professor Warren demonstrated that, under the assumptions discussed in the text, including full loss offsets, an income tax will impose a tax on the riskless rate of return on the entire portfolio, even after portfolio adjustments. See Warren, *supra*, at 8–9.

Return on investment may be conceived of as payment for a combination of inflation, deferred consumption, and risk. Cf. Fried, *supra* note 6, at 985 ("Investment returns include three components: an inflation premium, the real, riskless rate of interest, and positive or negative returns to risk.").

¹⁶⁶ See, e.g., Cunningham, *supra* note 2, at 41; Bankman & Griffith, *supra* note 2, at 378; Domar & Musgrave, *supra* note 2.

¹⁶⁷ See *supra* note 166. The payment for deferred consumption is very low, less than one percent, but inflation is not that low. See John K. McNulty, *Flat Tax, Consumption Tax, Consumption-Type Income Tax Proposals in the United States: A Tax Policy Discussion of Fundamental Tax Reform*, 88 CAL. L. REV. 2095, 2164 (2000) ("Importantly, some revealing empirical studies have shown that the real riskless rate of return in the U.S. from 1926–1989 has been very low, as low as 0.5%. In contrast, the annual inflationary rate of return, or premium, has been about 3.1%." (footnote omitted)). Professor Cunningham explains:

Since a normative income tax is indexed for inflation, r is the *real* risk-free rate of return, an amount that has averaged .6% per year over the last 70 years. Under an unindexed income tax, however, r is the *nominal* risk-free rate of return, an amount that includes inflation, which has averaged 3.7% over the same period of time. This suggests that the real tax burden imposed on capital income over this period of time would have been on average over six times greater under an unindexed income tax than it would have been under a normative income tax. Furthermore, the magnitude of the burden imposed by an unindexed income tax is primarily a function of inflation, not real income.

Cunningham, *supra* note 2, at 41 (footnotes omitted).

providing a positive 30% return over a one-year period and a 50% chance of returning a 10% loss over that period. Assume further that in the no-tax world, a particular investor would choose to invest \$100 in Asset A and \$100 in Asset B; this allocation reflects the amount of risk that particular investor is willing to bear. Given a \$100 investment in Asset B, the expected return over a one-year period on an investment in Asset B will be \$10, as illustrated in the chart below:¹⁶⁸

Expected Return After One Year of Investment in Asset B

GAIN (50% PROBABILITY)	LOSS (50% PROBABILITY)	NET EXPECTED RETURN
30% = \$30	10% = \$10	\$10 ¹⁶⁹

The investor therefore should have a total of \$210 at year's end: the \$100 invested in Asset A, the \$100 invested in Asset B, and the \$10 return on Asset B.

If a flat 30% tax were imposed on returns to investment (and losses could be fully deducted),¹⁷⁰ because the \$10 expected return would bear a \$3 tax, the investor would expect to have only \$207 (\$100 + \$107) if he made the same investments.¹⁷¹ Only if the investor were to receive \$210 after tax—a \$10 return—would he be in the same economic position as before the tax was imposed. In other words, given the tax on the risky asset, the investor's expected pre-tax return would have to be \$14.29 in order to amount to \$10 after tax.¹⁷²

To obtain a \$14.29 return, the investor will have to invest more in Asset B, the risky asset. In other words, the investor will need to shift some of the \$200 from Asset A into Asset B. Investing \$57.10 in Asset A and \$142.90 in Asset B will produce the desired pre-tax return of \$14.29¹⁷³ (\$10 after tax),¹⁷⁴ recreating the investor's pre-tax situation.

¹⁶⁸ The expected value of the \$100 at year's end will be \$65 + \$45, or \$110.

¹⁶⁹ $\$30 * .5 + <\$10> * .5 = \$10$.

¹⁷⁰ The model requires that losses be refunded by the government to the taxpayer if the taxpayer lacks other income against which to offset them. See Domar & Musgrave, *supra* note 2.

¹⁷¹ The \$107 expected return on Asset B is the \$100 invested plus the \$7 remaining after the 30% tax on the \$10 return. It is also the net of a 50% probability of a \$30 return subject to the 30% tax (which would leave \$121) and a 50% probability of \$10 loss, which if fully deductible, leaves only a \$7 loss (which would leave \$93). Thus, the expected post-tax return of \$7 depends on the assumption that losses are fully deductible (and in fact refundable if the investor has no other income against which to offset them).

¹⁷² $\$14.29 - (.3 * \$14.29) = \$10$.

¹⁷³ $\$142.29 * .10 = \14.29 .

It might appear that the investment shift has increased the investor's risk; after all, the investor has increased his investment in the risky asset, Asset B. However, Domar and Musgrave showed that the risk of loss of amounts invested in Asset B has decreased proportionately with the tax.¹⁷⁵ That is, if the government imposes a 30% tax with full loss offsets, the government bears 30% of any losses. In effect, the government has become a partner in the investor's wager.¹⁷⁶

The fact that the investor has not increased his risk can be illustrated mathematically. Recall that Asset B provides a 50% probability of a 30% gain and a 50% probability of a 10% loss and that, in the world with a flat 30% tax, the investor will invest \$142.90 in Asset B. The following chart shows the expected gains and losses in the no-tax and flat tax worlds:

Amount Invested in Asset B to Equalize Returns in No-Tax and Flat Tax Worlds

WORLD	AMOUNT INVESTED	GAIN (30%)	LOSS (10%)
No-Tax	\$100	\$30	\$10
30% Flat Tax	\$142.90	\$42.87 (\$30 after tax)	\$14.29 (\$10 after tax)

Thus, not only is the expected return the same, but the expected after-tax gain and loss are the same. In other words, after taxes, the investor does not have a 50% chance of losing \$14.29 but instead has a 50% chance of losing \$10, just as he did in the no-tax world. This example illustrates the critical nature of the model's assumption that losses are fully deductible. If some or all of the \$14.29 loss were not deductible, then the investor would not be in the same situation that he was pre-tax, and the additional investment in Asset B would have increased his risk of loss compared to his risk in the no-tax world.¹⁷⁷

¹⁷⁴ See *supra* note 171.

Of course, the replication of pre-tax return through shifting more into the risky asset assumes that the individual was not invested entirely in the risky asset before the tax was imposed.

¹⁷⁵ See Domar & Musgrave, *supra* note 2.

¹⁷⁶ Cunningham, *supra* note 2, at 31; McNulty, *supra* note 167, at 2165.

¹⁷⁷ Note that if the riskless rate of return is not zero, the investor will bear a tax equal to the tax on the riskless rate of return applied to the entire portfolio. For example, as Professor Alvin Warren has demonstrated, if the tax rate is thirty percent, the riskless rate of return is two percent, then the tax on a \$100 portfolio will be sixty cents. See Warren, *supra* note 165, at 8;

Under the Domar-Musgrave analysis, not only does taxation increase investment in relatively risky assets, it increases investment in assets that bear more tax.¹⁷⁸ What is critical to that result, in addition to full loss offsets, is that the higher tax rate is applicable on the deduction side, not just the income

see also Chorvat, *supra* note 164, at 266 & n.180 (using \$200 portfolio, 30% tax rate and .5% riskless rate of return and arriving at \$0.30 of tax, $\$200 * .005 * .3$). In addition, Professor Noël Cunningham has shown that, given the model's assumption that investors borrow in order to replicate their pre-tax return, the tax burden that an investor bears increases with that investor's cost to borrow. Cunningham, *supra* note 2, at 37. This essentially results in a regressive tax on wealth, given the likelihood that wealthier persons face lower borrowing costs. *Id.* He treats the interest as deductible, as is generally the case under current law. In the example he uses, the investor would choose to replicate the pre-tax, pre-interest rate of return. The investor in his example bears \$10 of tax even after the increased investment—effectively the after-tax interest cost of that investor (he uses a \$15 interest cost and a 33 1/3 percent tax rate). *See id.* at 37–38. The investor could of course increase his investment further, to address the increased borrowing cost. Although the investor could thereby obtain his pre-tax return, he would nonetheless bear the (after-tax) cost of increased borrowing—a form of implicit tax. *See* MYRON S. SCHOLES & MARK A. WOLFSON, TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH 83–102 (1992).

¹⁷⁸ For example, if the tax enacted were 40% rather than 30%, the investor in the example in the text accompanying notes 168–75 would have to obtain a pre-tax return of \$16.66 in order to yield the same post-tax return of \$10. This would require an investment of \$166.60 in Asset B, rather than \$142.90, as illustrated in the chart below:

Amount Invested in Asset B for \$10 After-Tax Expected Return After One Year, in No-Tax, Flat 30% Tax and Flat 40% Tax Worlds

WORLD	AMOUNT INVESTED	EXPECTED RETURN (10%)
No-Tax	\$100	\$10
30% Flat Tax	\$142.90	\$14.29 (\$10 after tax)
40% Flat Tax	\$166.60	\$16.66 (\$10 after tax)

The same result would be obtained if the investor instead held a portfolio of three assets, one riskless asset and two otherwise identical risky assets, one bearing a 30% tax and one bearing a 40% tax. *See* Chorvat, *supra* note 164, at 265.

These counter-intuitive results may be more understandable if considered from the perspective that, in effect, increasing the rate of tax on the return on an asset requires greater investment to achieve the same after-tax return. As indicated above, increased investment in the asset is rational because the risk of loss decreases proportionately with the tax. *See supra* text accompanying notes 174–76.

side.¹⁷⁹ Imagine, for example, that, in a thirty percent flat tax world, the tax on income increases to forty percent while the tax rate applicable to deductions remains thirty percent,¹⁸⁰ and compare that with the reverse situation (income taxed at thirty percent rate but deductions allowed at a forty percent rate). Compare the amounts that would need to be invested in those situations in order to keep the amount of the loss at \$10:

Amount Invested in Asset B for \$10 After-Tax Loss on
Losing Investment After One Year, in No-Tax, Flat 30% Tax,
Flat 40%, and Variable 30%/40% Tax Worlds

WORLD	AMOUNT INVESTED	GAIN (30%)	LOSS (10%)
No-Tax	\$100	\$30	\$10
30% Flat Tax	\$142.90	\$42.87 (\$30 after tax)	\$14.29 (\$10 after tax)
40% Flat Tax	\$166.60	\$49.38 (\$30 after tax)	\$16.66 (\$10 after tax)
40% Tax on Income, 30% on Losses	\$142.90	\$42.87 (\$25.72 after tax)	\$14.29 (\$10 after tax)
30% Tax on Income, 40% on Losses	\$166.60	\$49.38 (\$34.98 after tax)	\$16.66 (\$10 after tax)

¹⁷⁹ Cf. Bankman & Griffith, *supra* note 2, at 402 (stating, in context of a tax system with no loss offsets, “an income tax without symmetrical treatment of gains and losses, or a tax applied to those who are unable to adjust their investment portfolios, reduces the utility, or surplus, of risk-takers in much the same way that taxation of interest reduces the utility or surplus of savers.”).

¹⁸⁰ This could be done by nominally applying the same rate but disallowing twenty-five percent of all deductions. In other words, for example, only \$75 of \$100 of otherwise available deductions would be allowed. Forty percent of \$75 is \$30, so it is as if all \$100 of deductions were allowed but the rate applied were only thirty percent.

This chart shows several things. First, in order to keep the loss in the loss scenario at no more than \$10 after tax, the amount invested under a tax with different tax rates on income and deductions must be based on the tax rate applied to deductions, not income. Second, increasing the rate applicable to losses allows increased investment in that asset without greater risk of loss, but increasing the rate applicable to income does not; the amount invested when the rate on income is forty percent is no more than when it was thirty percent. The reason for this is that if more were invested, the amount the investor could lose would increase, increasing the after-tax riskiness of the investment.¹⁸¹

The chart also shows that the effect of maintaining the amount the investor stands to lose at \$10 after tax despite the application of different rates to the loss side and the gain side means that the amount the investor stands to gain, after tax, will vary from the amount that it was in the worlds in which there was only one rate. The chart above showed that in the world of a forty percent tax on income and a thirty percent tax on losses, the investor stood to gain \$25.72 after tax from a successful investment, rather than \$30. In the world of a thirty percent tax on income, and a forty percent tax on losses, the investor stood to gain \$34.98 after tax, rather than \$30.

This, in turn, means that the expected return in the forty percent tax on income/thirty percent tax on losses world is lower than \$10 after tax and the expected return in the thirty percent tax on income/forty percent tax on losses world is higher than \$10 after tax. The chart below illustrates this:

¹⁸¹ The following chart shows that if the investor were risk-neutral, and were only concerned about expected after-tax return, the investor would invest more if the tax on income were higher but the after-tax amount the investor could lose if the investment turned out to be a loser (which has a fifty percent probability) increases above \$10.

Amount Invested in Asset B for \$10 After-Tax Expected Return After One Year, in Variable 30%/40% Tax Worlds

WORLD	AMOUNT INVESTED	GAIN (30%)	LOSS (10%)	EXPECTED RETURN
30% Tax on Income, 40% on Losses	\$133.33	\$39.99 (\$28 after tax)	\$13.33 (\$8 after tax)	\$10 (after tax)
40% Tax on Income, 30% on Losses	\$181.81	\$54.54 (\$32.72 after tax)	\$18.18 (\$12.72 after tax)	\$10 (after tax)

Expected After-Tax Return on Above Investments After One Year,
in No-Tax, Flat 30% Tax, Flat 40%, and Variable 30%/40% Tax Worlds,
Assuming \$10 After-Tax Loss in Loss Scenario

WORLD	AMOUNT INVESTED	EXPECTED RETURN
No-Tax	\$100	\$10
30% Flat Tax	\$142.90	\$10 after tax
40% Flat Tax	\$166.60	\$10 after tax
40% Tax on Income, 30% on Losses	\$142.90	\$7.86 after tax
30% Tax on Income, 40% on Losses	\$166.60	\$12.49 after tax

The chart above depicts the intuitive result that the effect of increasing the tax on income is to lower the investor's return if he keeps risk of loss the same and the effect of increasing the tax rate applicable to losses is to raise the investor's return if he maintains the same risk of loss.

Although the model that allows investors to replicate pre-tax return is essentially a special case because of the additional limiting assumptions it requires,¹⁸² it, like the general point that deductibility of losses decreases an investor's risk, hinges critically on the allowance of loss deductions. An income tax without loss offsets will reduce investors' gains from successful risky investments, but will not reduce their losses from unsuccessful investments. In certain cases, the combination of taxable gains and nonrefundable losses will reduce the expected return of risky assets below the return of safe assets, causing all investors to purchase riskless assets. In other cases, where the expected return from risky assets remains above that of the riskless assets, the tax simply will make risky investments less attractive.¹⁸³

Thus, the liberal deductibility of net losses from active businesses cushions the risk of those investments. By contrast, the numerous limitations on the deductibility of individuals' net investment losses, discussed above,¹⁸⁴ provide no such cushion. As discussed below, this disparity in effect provides an implicit subsidy for individuals' investments in their own business activities.

¹⁸² See *supra* note 164.

¹⁸³ Bankman & Griffith, *supra* note 2, at 401.

¹⁸⁴ See *supra* text accompanying notes 114–56.

IV. THE ENTREPRENEURSHIP SUBSIDY

Part II demonstrated that individuals' investment losses face important limits on deductibility that their business losses do not.¹⁸⁵ The discussion in Part III showed that, given certain assumptions and the presence of an income tax, the ability to deduct losses with respect to an activity effectively shifts part of the risk of that activity to the government. Several conclusions flow from this analysis. First, the full loss offsets assumption behind Domar-Musgrave is systematically violated with respect to individuals' investments. Thus, it is unrealistic to think that individuals functionally can eliminate the tax burden on investment capital through portfolio shifts, or even shift substantial risk to the federal government, absent the significant additional limiting assumption that, each year, the portfolio contains significant income from investments of the right character. By contrast, proprietors of active businesses can obtain the equivalent of full loss offsets or nearly full loss offsets if they have other income from any source or even net income in some years and net losses in others.

Consider the following examples. First, assume that a taxpayer, Ann, has \$100,000 in income, all from employment. She also has \$50,000 in capital to invest. Assume that her deductible expenses from the \$50,000 investment exceed her income in the first year by \$10,000 (for simplicity, assume that there are no capital losses). If Ann invests in a wholly owned business, the \$10,000 will be fully deductible from her employment income, above the line, effectively affording her full loss offsets from the activity. By contrast, if these were investment expenses, Ann would have to basket any interest-related income and expense first and then only be able to deduct the remaining investment expenses below the line and subject to the two-percent floor. This would disallow part of the loss, effectively applying a lower tax rate to the \$10,000 of losses than the rate applied to her last dollars of income (of course, if at least \$10,000 of the \$100,000 of income were from other investments, Ann generally would be able to deduct the investment expenses from that income.).

It is not unrealistic to imagine a taxpayer with employment income who also starts a business on the side. "[Internal Revenue] Service data indicates that only 50% of sole proprietors report more than 50% of their income from self-

¹⁸⁵ One commentator has stated:

For many years, the United States has had a love affair with small business. Americans may shop in megamalls and Super Wal-Marts, but they admire and respect the entrepreneurial spirit embodied in the many small businesses that increasingly drive our economy. The passion and concern the public has for small businesses, particularly entrepreneurs, is unparalleled.

Melissa A. Peters, *The Little Guy Myth: The Fair Act's Victimization of Small Business*, 42 WM. & MARY L. REV. 1925, 1925 (2001).

employment.”¹⁸⁶ In addition, if Ann were married, her overall tax picture would differ somewhat compared to if she were single, but the fundamental point would not change.¹⁸⁷ That is, if the \$100,000 of employment income were not Ann’s but Ben’s, Ann’s husband, and Ann invested the \$50,000 of capital, resulting in a \$10,000 net loss, the loss would be deductible from Ben’s employment income on the couple’s joint return if the loss was business-related but not if it was investment-related.

These examples may suggest that the Code in effect baskets investment income with investment losses and business income with business losses. However, the latter is not true. Business expenses and losses are deductible from income regardless of the source of the income.¹⁸⁸ It may seem as if a taxpayer with primarily investment income would therefore be indifferent between business expenses and losses and investment expenses and losses. However, that is not the case with respect to volatile investments.

For example, what if Ann has investments that produce current income when they are successful, but they produce income in some years but not others? Assume that in Year 1, Ann has \$100,000 of income; in Year 2, a \$50,000 loss; in Year 3, \$100,000 of income; in Year 4, a \$50,000 loss, and so on. What if Ann takes \$50,000 of capital and invests it in a new investment in Year 4, and, just as in the prior examples,¹⁸⁹ the otherwise deductible expenses of that investment exceed her income from that investment by \$10,000? If the capital is invested passively, Ann simply must bear the full weight of a \$10,000 loss. However, if the capital were invested in a business, Ann could carry back the \$10,000 to Year 3 and obtain a refund of some of the tax she had paid with respect to that year. Therefore, once again, Ann can achieve the equivalent of full loss offsets only by placing her capital in an active business, not an investment activity.¹⁹⁰

¹⁸⁶ See John W. Lee, *A Populist Political Perspective of the Business Tax Entities Universe: “Hey the Stars Might Lie But the Numbers Never Do,”* 78 TEX. L. REV. 885, 962 n.404 (2000) (citing GENERAL ACCOUNTING OFFICE, GAO/GGD-99-76, TAXPAYERS FACE MANY LAYERS OF REQUIREMENTS 4 n.5 (1999)). Of course, many of the individuals filing a Schedule C may be reporting work performed as an independent contractor to supplement low wages. See *id.* at 962 (quoting Oversight on Impact of Complexity in the Tax Code on Individual Taxpayers and Small Business: Hearing Before House Ways & Means Subcomm., 105th Cong., 2d Sess. 7–8 (1998) (statement of Steve Bafundo, C.P.A.)).

¹⁸⁷ As a married taxpayer, Ann would be more likely not to deduct any of the investment expenses because the standard deduction for married taxpayers filing jointly was \$9,500 in 2003; it was half that (\$4,750) for unmarried taxpayers. See *supra* note 44 and accompanying text.

¹⁸⁸ See *supra* note 33 and accompanying text.

¹⁸⁹ See *supra* text accompanying notes 185–87.

¹⁹⁰ This example does not apply the limitation on capital losses, see I.R.C. § 1211 (2004). Individuals can carry forward unused capital losses. See I.R.C. § 1212(b) (2004). Making the extreme assumption that, in this example, all of the \$100,000 gains and \$50,000 losses are

Thus, for individual taxpayers, the Code in effect provides a subsidy for business activity that it does not provide for investments.¹⁹¹ This particular subsidy generally is implicit in the Code's distinct approach to individuals' losses and expenses from passive investments as opposed to business activities.¹⁹²

capital, Ann could carry over her Year 4 \$50,000 loss into Year 5 (or \$47,000, if Ann had \$3,000 of other income, *see* I.R.C. § 1211(b)(1)). However, the \$10,000 net investment loss in Year 4 could not be carried forward under section 1212 because, in the example, it arises out of investment expenses in excess of investment income; it is not a capital loss.

¹⁹¹ Of course, an individual who conducts a business as a sole proprietor will owe self-employment tax, a tax not applicable to passive investment. *See* I.R.C. §§ 1401, 1402 (2004); *see also supra* note 16. It is the presence of labor that gives rise to that tax. However, passive investment involves only the allocation of the individual's capital, not his labor, and active business involves both. To compare the overall tax treatment of the passive investor with that of the business owner, the allocation of the passive investor's labor must also be considered. If the passive investor is employed by another, he (and his employer) will pay employment tax comparable to the self-employment tax. *See supra* note 16.

The "idle rich" is a fairly small class. With respect to under age 65 heads of households, only about five percent of the top one percent of wealth holders were not in the labor force in 1983 and 1992 (not working part-time, full-time, "unemployed," or retired). Edward N. Wolff, *Who Are the Rich? A Demographic Profile of High-Income and High-Wealth Americans* in DOES ATLAS SHRUG? THE ECONOMIC CONSEQUENCES OF TAXING THE RICH (Joel Slemrod ed., 2000) at 81 tbl.3.3 (5.4% in 1983 and 3.6% in 1992, based on Survey of Consumer Finances Data). "Clearly many inheritors enjoy working and making more money. They are not, by and large, unproductive." Jesse Dukeminier & James E. Krier, *The Rise of the Perpetual Trust*, 50 UCLA L. REV. 1303, 1325 (2003) (footnote omitted). *See also id.* at 1323 ("[O]f the total income in the United States, income from capital (including inherited wealth) declined from 55 percent in the 1920s, to 35 percent in the 1950s–1960s, to 15 percent in the 1990s. Hardworking entrepreneurs have steadily replaced coupon clippers.") (footnote omitted).

¹⁹² Entrepreneurship is favored by the tax system in more direct ways, as well. For example, Code section 1202 provides a fifty-percent exclusion for gain on certain small business stock, including stock in a "specialized small business investment company," which is an organization that provides "a source of equity capital for incorporated and unincorporated small-business concerns, in such manner and under such terms as the small business investment company may fix in accordance with the regulations of the Administration," 15 U.S.C. § 684(a). I.R.C. § 1202 (2004); *see also infra* text accompanying notes 351–56. The American Jobs Creation Act of 2004, enacted in October of 2004, contains a number of provisions that benefit small businesses. *See* Pub. L. 108–357, §§ 201–51 ("Business Tax Incentives" title), 331–41 (subtitle entitled "Incentives for Small Manufacturers"), 118 Stat. 1418 (2004).

Entrepreneurship also is subsidized by the federal government outside of the tax system. *See, e.g.*, 15 U.S.C. § 631 (2004) ("It is the declared policy of the Congress that the Government should aid, counsel, assist, and protect, insofar as is possible, the interests of small-business concerns in order to preserve free competitive enterprise, to insure that a fair proportion of the total purchases and contracts or subcontracts for property and services for the Government (including but not limited to contracts or subcontracts for maintenance, repair, and construction) be placed with small-business enterprises, to insure that a fair proportion of the total sales of Government property be made to such enterprises . . ."). The mission of the

How, then, does federal income tax law define the distinction between the “business” activities that experience the subsidy and the “investment” activities that do not?

A. *The Role of Labor in the Business/Investment Distinction*

Despite the Code’s systematic distinction between business and investment activities, discussed above,¹⁹³ it does not contain a definition of “trade or business” applicable to the many provisions in which that phrase is used.¹⁹⁴ However, the phrase has been defined judicially in the context of specific provisions.¹⁹⁵ An early case, *Deputy v. Dupont*,¹⁹⁶ provides background and is analogous, though not directly on point.

In that case, the Supreme Court distinguished between the business of E.I. du Pont de Nemours and Company (Dupont) and the taxpayer, an individual who was a sixteen-percent shareholder of Dupont. The taxpayer had paid \$647,711.56 in connection with assisting Dupont in providing company stock to nine new executives of Dupont.¹⁹⁷ The IRS argued that the taxpayer’s “activities in

Small Business Administration, established by Congress, is to “[m]aintain and strengthen the nation’s economy by aiding, counseling, assisting and protecting the interests of small businesses and by helping families and businesses recover from national disasters.” <http://www.sba.gov/aboutsba/index.html>. Professors David Weisbach and Jacob Nussim argue that the question of whether to provide a particular benefit through the tax system or through direct expenditures should be a question of how to organize government rather than one of tax policy. See DAVID A. WEISBACH & JACOB NUSSIM, THE INTEGRATION OF TAX AND SPENDING PROGRAMS (John M. Olin Program in Law & Econ., Working Paper No. 194 2d Series, 2003), available at http://papers.ssm.com/sol3/delivery.cfm/SSRN_ID442063_code030909570.pdf?abstractid=442063.

¹⁹³ See *supra* text accompanying notes 39–156.

¹⁹⁴ See *Commissioner v. Groetzinger*, 480 U.S. 23 (1987).

The phrase ‘trade or business’ . . . is common in the Code, for it appears in over 50 sections and 800 subsections and in hundreds of places in proposed and final income tax regulations. . . . Despite this, the Code has never contained a definition of the words ‘trade or business’ for general application, and no regulation has been issued expounding its meaning for all purposes.” (footnote omitted).

Id. at 27; see also *Snow v. Commissioner*, 416 U.S. 500, 503 (1974) (“The words ‘trade or business’ appear . . . in about 60 different sections of the 1954 Act. Those other sections are not helpful here”) (footnote omitted).

¹⁹⁵ See, e.g., *Commissioner v. Groetzinger*, 480 U.S. 23 (1987) (gambling losses for purposes of AMT); *Snow v. Commissioner*, 416 U.S. 500, 503 (1974) (experimental expenditures); *Higgins v. Commissioner*, 312 U.S. 212 (1941) (expenses of producing income).

¹⁹⁶ 308 U.S. 488 (1940).

¹⁹⁷ *Id.* at 489–92.

connection with conserving and enhancing his estate did not constitute a 'trade or business' within the meaning" of the relevant Code section,¹⁹⁸ which allowed the deduction of "'ordinary and necessary expenses paid or incurred during the taxable year in carrying on'" a trade or business.¹⁹⁹ The Court held for the government, on the grounds that the expenditures related not to the taxpayer's business but to that of the corporation²⁰⁰ and they were not "ordinary" expenditures even if they were connected to a business of the taxpayer.²⁰¹ Although the majority did not define the phrase "trade or business" in *Dupont*, Justice Frankfurter, in a brief but well-known concurrence, stated, "carrying on any trade or business,' within the contemplation of § 23(a), involves holding one's self out to others as engaged in the selling of goods or services."²⁰²

Higgins v. Commissioner,²⁰³ which presented the issue squarely, arose after *Dupont*. Mr. Higgins, who had investments totaling \$35,000,000 in real estate, bonds and stocks,²⁰⁴ apparently worked every day²⁰⁵ overseeing his investments with the assistance of several employees.²⁰⁶ Like the taxpayer in *Dupont*, Higgins claimed that his expenses—which consisted of salaries and other expenditures—were deductible under Code section 23(a), the predecessor of section 162.²⁰⁷ In denying the deductions, the Court stated:

The petitioner merely kept records and collected interest and dividends from his securities, through managerial attention for his investments. No matter how large the estate or how continuous or extended the work required may be, such facts are not sufficient as a matter of law to permit the courts to reverse the decision of the Board [of Tax Appeals]. Its conclusion is adequately supported by this

¹⁹⁸ *Id.* at 493.

¹⁹⁹ *Id.* at 489–90 (quoting Code section 23(a)).

²⁰⁰ *Id.* at 493–94.

²⁰¹ *Id.* at 494–95.

²⁰² *Dupont*, 308 U.S. at 499 (Frankfurter, J., concurring). Code section 23(a)(1) is the predecessor of Code section 162(a). *See, e.g.*, *Lettie Pate Whitehead Found., Inc. v. United States*, 606 F.2d 534, 537 n.3 (5th Cir. 1979).

²⁰³ 312 U.S. 212 (1941).

²⁰⁴ *Higgins v. Commissioner*, 39 B.T.A. 1005, 1006 (1939), *aff'd*, 111 F.2d 795 (2d Cir. 1940), *aff'd*, 312 U.S. 212 (1941).

²⁰⁵ *Id.* at 1007 ("Upon receipt of a letter [Mr. Higgins] would usually either cable or radio, being a prolific user of the cable and radio. He was in touch with his New York office by letter or cable almost daily.").

²⁰⁶ *Higgins*, 312 U.S. at 213–14.

²⁰⁷ *See supra* note 33.

record, and rests upon a conception of carrying on business similar to that expressed by this Court for an antecedent section.²⁰⁸

Although the holding apparently turned on the standard of review, implying that if the Board of Tax Appeals had held for Mr. Higgins, the Supreme Court might have upheld that decision, the Court's ruling is still good law—investment activities, no matter how extensive, cannot constitute a trade or business for purposes of section 162.²⁰⁹ Thus, a modern-day Mr. Higgins would face the limitations on miscellaneous itemized deductions discussed above,²¹⁰ with respect to the salaries he pays his employees, the rent for office space, and the like.

Higgins did not define the phrase “trade or business” but *Commissioner v. Groetzinger*,²¹¹ a more recent decision, came closer to doing so with respect to the context of the provision in issue in that case.²¹² *Groetzinger* involved a full-time gambler who gambled only for his own account.²¹³ He apparently gambled approximately \$70,000 in 1978, ending the year with a net loss of about \$2,000.²¹⁴ The IRS asserted that he was subject to alternative minimum tax under the law in effect in the year in question, which could be reduced by deductions attributable to a trade or business but not by other deductions.²¹⁵ Thus, Groetzinger argued that his gambling activities constituted a trade or business.

In *Groetzinger*, the Court first rejected the test that Justice Frankfurter had used in his concurrence in *Dupont*, referring to it as a “gloss” and an

²⁰⁸ *Higgins*, 312 U.S. at 218 (footnote omitted). The Board of Tax Appeals was the predecessor of the current United States Tax Court. See Leandra Lederman, “Civilizing Tax Procedure: Applying General Federal Learning to Statutory Notices of Deficiency,” 30 U.C. DAVIS L. REV. 183, 191 n.36 (1996).

²⁰⁹ See *Commissioner v. Groetzinger*, 480 U.S. 23, 31 (1987) (“expenses incident to caring for one’s own investments, even though that endeavor is full time, are not deductible as paid or incurred in carrying on a trade or business”). Nonetheless, being a “trader”—essentially buying and selling securities in one’s account with great frequency, rather than relying primarily on passive returns—can constitute a trade or business. See *infra* note 221 and accompanying text.

²¹⁰ See *supra* text accompanying notes 48–65.

²¹¹ *Groetzinger*, 480 U.S. at 31.

²¹² *Id.* at 27 n.8.

²¹³ *Id.* at 24. In other words, Groetzinger did not place bets for others, sell tips, or act as a bookie. *Id.* If he had, those facts would have supported characterization of his activities as a trade or business under Justice’s Frankfurter’s concurrence in *Deputy v. Dupont*. See *supra* text accompanying note 201.

²¹⁴ *Groetzinger*, 480 U.S. at 25 (“In 1978, he [Groetzinger] had gross winnings of \$70,000, but he bet \$72,032; he thus realized a net gambling loss for the year of \$2,032.”).

²¹⁵ *Id.*

“adumbration,” and noting that it had never been adopted by a majority of the Supreme Court.²¹⁶ The Court also stated,

[w]e accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer’s primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify.²¹⁷

This statement does not seem to contrast the gambling activity of Mr. Groetzinger and the investment activity of Mr. Higgins. Did Higgins not pursue his activity in good faith, with regularity, and, if not full-time, nearly so? He also employed others to assist him.²¹⁸ It “was not a hobby or a passing fancy.”²¹⁹ In addition, unlike Groetzinger, Higgins actually profited from his efforts.²²⁰ The fact of profit alone should warrant a deduction under the Haig-Simons norm.²²¹

Nonetheless, the Court made clear that it saw a distinction from *Higgins* that warranted a deduction in *Groetzinger*:

We do not overrule or cut back on the Court’s holding in *Higgins* when we conclude that if one’s gambling activity is pursued full time, in good faith, and with regularity, to the production of income for a livelihood, and is not a mere hobby, it is a trade or business within the meaning of the statutes with which we are here concerned.²²²

To square Higgins with Groetzinger, the focus must be on the “active” or “passive” nature²²³ of the taxpayer’s earnings.²²⁴ In Higgins, the Court noted

²¹⁶ *Id.* at 31–32.

²¹⁷ *Id.* at 35.

²¹⁸ *Higgins*, 39 B.T.A. at 1006.

²¹⁹ *Groetzinger*, 480 U.S. at 36.

²²⁰ Higgins had a \$35,000,000 portfolio that generated \$380,394 of gross income in 1932. *Higgins*, 39 B.T.A. at 1011.

²²¹ *See supra* note 7.

²²² *Groetzinger*, 480 U.S. at 35.

²²³ *See, e.g.*, Mayer v. United States, 32 Fed. Cl. 149, 156 (1994) (“To claim a trade or business deduction, the taxpayer must himself perform the activity characterizing the ‘trade or business.’”); Levin v. United States, 597 F.2d 760, 765 (Ct. Cl. 1979) (taxpayer “passively accumulating earnings” or “merely overseeing one’s accounts” is not engaged in trade or business of trading stocks).

²²⁴ *Cf. Snell v. Commissioner*, 97 F.2d 891, 892 (5th Cir. 1938) (“The word [business], notwithstanding disguise in spelling and pronunciation, means busyness; it implies that one is kept more or less busy, that the activity is an occupation.”).

Both *Higgins* and *Groetzinger* involved taxpayers caught by a glitch in the Code that was subsequently fixed by Congress, in Groetzinger’s case prior to his litigation but for later tax years, and for Higgins after his litigation but retroactively. As discussed in the text, Higgins lost

that Higgins “did not participate directly or indirectly in the management of the corporations in which he held stock or bonds.”²²⁵ Similarly, in another case, *United States v. Generes*,²²⁶ which involved a bad debt that required characterization as a business or nonbusiness debt,²²⁷ the Supreme Court stated:

In tax jargon, Generes’ status as a shareholder was a nonbusiness interest. It was capital in nature and it was composed initially of tax-paid dollars. Its rewards were expectative and would flow, not from personal effort, but from investment earnings and appreciation. On the other hand, Generes’ status as an employee was a business interest. Its nature centered in personal effort and labor, and salary for that endeavor would be received.²²⁸

in the Supreme Court while Groetzinger won. It is interesting to note the Board of Tax Appeals’ characterization of Mr. Higgins:

The petitioner has not been in the United States since 1921, having been in Europe, particularly in France, during that time. He had no business whatever in France or Europe, and in the taxable years reported no income from foreign corporations. He lived there as a matter of choice because he liked to live there for his own pleasure and for his health. He has a seagoing yacht.

Higgins, 39 B.T.A. at 1009. It was completely irrelevant to the issue in *Higgins* that Mr. Higgins happened to own a yacht in addition to his \$35,000,000 portfolio of stocks and bonds. Why mention it if not to portray Mr. Higgins as someone who did not need government protection of his earnings?

²²⁵ *Higgins*, 312 U.S. at 214; *cf.* *Medchem, Inc. v. Commissioner of Internal Revenue*, 116 T.C. 308 (2001). In *Medchem*, the Tax Court stated:

[W]e believe that Congress promulgated the ‘active conduct of a trade or business’ requirement of section 936(a) intending to prevent a domestic corporate taxpayer from availing itself of the possessions tax credit unless it established and regularly operated an employment-producing, profit-motivated business activity in a U.S. possession. We also believe that Congress expected the taxpayer to participate meaningfully in the management and operation of that activity and to invest significantly in that activity, the expected result of which would be to strengthen the economy of the possession where the activity was located.

Id. at 336.

²²⁶ 405 U.S. 93 (1972).

²²⁷ See I.R.C. § 165(c) (2004); *see also supra* text accompanying notes 148–56.

²²⁸ *Generes*, 405 U.S. at 100–01; *see also* *Smartt v. Commissioner*, T.C. Memo. 1993-65.

In *Smartt*, the Tax Court stated:

Returns from investing—as a shareholder—are “expectative”; they result from appreciation and earnings on the investment rather than from personal effort or labor. . . . On the other hand, one’s role or status as an employee is a business interest. Its typical nature is the exertion of effort and labor in exchange for a salary.

Id.

In that regard, an older case stated:

A person of property, who devotes his time to the active management of it and also to active participation in the management of the companies in which his property is invested, and who maintains an office for that purpose where he spends a substantial part of his time, is carrying on business within the meaning of this statute. . . . The line comes between those who take the position of passive investors, doing only what is necessary from an investment point of view, and those who associate themselves actively in the enterprises in which they are financially interested and devote a substantial part of their time to that work as a matter of business. . . .²²⁹

As this suggests, the focus is also on the taxpayer's own labor. Higgins had several employees, and employment constitutes a trade or business,²³⁰ but their activities were not imputed to him. As another example, the Court of Federal Claims has stated:

The arguably more fundamental reason for determining that plaintiff is not entitled to treatment as a "trader" [which would constitute a trade or business] . . . is simply that plaintiff is not a trader because he, personally, did not engage in (or direct) the "trading" of stocks, or the transactions related to the stocks at issue, regardless of how long they were held. In fact, there is no evidence that he personally ever engaged in a single trading transaction.²³¹

As this quotation may suggest, one odd effect of the distinction between earnings from labor and earnings from investment is that, although holding stocks, bonds, or real estate for their dividends, interest, and rents does not constitute a trade or business under *Higgins*, under case law distinguishing *Higgins*, the investor who buys and sells with great frequency, turning over the

²²⁹ *Foss v. Commissioner*, 75 F.2d 326, 327–28 (1st Cir. 1935); see also *Washburn v. Commissioner*, 51 F.2d 949, 953 (8th Cir. 1931) ("A party may have investments in corporate stock, have no particular occupation, and live on the return of his investments. That would not constitute business under the statute in question. He may, however, take such an active part in the management of the enterprise in which he has investments as to amount to the carrying on of a business."). These holdings are in line with *Dupont*, 308 U.S. at 488, discussed above. See *supra* text accompanying notes 195–201.

²³⁰ See *Groetzinger*, 480 U.S. at 28.

²³¹ *Mayer v. United States*, 32 Fed. Cl. 149, 155 (1994) (emphasis omitted); cf. *Levin v. United States*, 220 Ct. Cl. 197, 205 (Ct. Cl. 1979) ("In contrast to the distant management of a portfolio portrayed in *Higgins*, judgments regarding purchases and sales were made directly by taxpayer, based on his personal investigation of the assets, operation and management of various corporations."); *Mayer v. Commissioner*, T.C. Memo. 1994-209 ("[W]e do not reach the issue of whether the mere fact that petitioners ceded full discretion over their accounts, and engaged in no trading in such accounts themselves, precludes them from being classified as 'traders.'").

contents of his portfolio often, is deemed to be in the trade or business of trading stock.²³² For example, in *Groetzinger*, the Supreme Court stated, in part, “we conclude . . . that . . . expenses incident to caring for one’s own investments, even though that endeavor is full time, are not deductible as paid or incurred in carrying on a trade or business . . . [but] that the opposite conclusion may follow for an active trader”²³³

The passive/active distinction is not solely judicial. A similar distinction is reflected in the earned income credit of Code section 32²³⁴ and the foreign earned income exclusion.²³⁵ For those purposes, “earned income” is generally defined to include wages, salaries, tips, and other employee compensation that constitute gross income for the taxable year, as well as net earnings from self-employment.²³⁶ Thus, no earned income credit is awarded with respect to dividends, interest, rents, and other earnings on “passive” investments. In fact, individuals with “excessive” passive investment income are not eligible to claim the earned income credit regardless of the amount of earned income they have.²³⁷

²³² See, e.g., *Moller v. United States*, 721 F.2d 810, 813 (Fed. Cir. 1983) (if “securities are bought and sold with reasonable frequency in an endeavor to catch the swings in the daily market movements and profit thereby on a short term basis,” that indicates that the taxpayer is engaged in the trade or business of trading stocks; if “securities are purchased to be held for capital appreciation and income, usually without regard to short-term developments that would influence the price of securities on the daily market,” the taxpayer is a mere investor); *Purvis v. Commissioner*, 530 F.2d 1332, 1334 (9th Cir. 1976); *Liang v. Commissioner*, 23 T.C. 1040, 1043 (1955) (“The distinction between an investment account and a trading account is that in the former, securities are purchased to be held for capital appreciation and income, usually without regard to short-term developments that would influence the price of the securities on the daily market. In a trading account, securities are bought and sold with reasonable frequency in an endeavor to catch the swings in the daily market movements and profit thereby . . .”). See also *Mayer*, 32 Fed. Cl. at 155 (1994) (“83.8% of [taxpayers’] investment income came from dividends, interest, and long-term appreciation (capital gains) and only the remainder (16.2%) was generated by ‘short-term’ trades (although not ‘short-term’ under the definition in *Moller*, since most of these securities were held more than thirty days)” so taxpayers were mere “investors”).

²³³ *Groetzinger*, 480 U.S. at 31 (citations omitted). Accordingly, a stock-owning taxpayer who forgoes much of the deferral afforded by the realization requirement, and perhaps the benefits of the capital gains preference (by selling stock after holding it only briefly) can benefit from the lifting of the deduction-side restrictions that apply to investors. See *supra* text accompanying notes 39–156 (discussing these restrictions).

²³⁴ See I.R.C. § 32 (2004) (providing refundable credit with respect to “earned income” of eligible low-income individuals).

²³⁵ See I.R.C. § 911 (2004) (excluding, up to a cap, “foreign earned income” of certain citizens and residents of the United States living abroad).

²³⁶ I.R.C. §§ 32(c)(2), 911(d)(2).

²³⁷ I.R.C. § 32(i). For this purpose, “investment income” includes “capital gain net income.” I.R.C. § 32(i)(2)(D). The investment income cap was \$2,600 for 2003. See Rev. Proc.

Similarly, and as indicated above, Code section 469, an anti-tax shelter provision, generally defers losses and credits from “passive activities” until there is income from the activity against which to offset them.²³⁸ For the most part,²³⁹ passive activities are trade or business or investment-type activities in which the taxpayer does not “materially participate.”²⁴⁰ Therefore, in order to avoid disallowance of losses and credits under this section, the taxpayer generally must “materially participate” in the activity.²⁴¹ Material participation is defined as “involve[ment] in the operations of the activity on a basis which is—(A) regular, (B) continuous, and (C) substantial.”²⁴² Implementing regulations provide a facts and circumstances test as well as a number of safe harbors that focus on the amount of time the taxpayer personally devotes to the activity.²⁴³

Thus, the primary distinction between business activity and investment activity is the element of labor. At a minimum, an active business requires the provision of labor.²⁴⁴ An income-oriented activity involving the provision of labor can constitute a trade or business regardless of whether capital accompanies the labor. However, as the discussion above demonstrated, an activity in which capital can produce earnings without accompanying labor—that is, an investment activity—does not constitute a trade or business.²⁴⁵

In effect, federal income tax law provides an incentive for a taxpayer with capital to combine labor with the capital, rather than investing it passively,²⁴⁶ so long as either the taxpayer or his spouse has other income from labor or the taxpayer’s other income is variable (giving rise to profit years and loss years).²⁴⁷

2002-70, 2002-2 C.B. 845, 848 § 3.06(2). This rule apparently serves as a means test, though it is both overbroad (for example, given the cap for 2003, a taxpayer selling a relatively low value item at a \$2,700 gain is disqualified) and underinclusive (otherwise eligible taxpayers with enormous wealth that does not yield current earnings qualify for the credit).

²³⁸ See *supra* text accompanying notes 133–37.

²³⁹ The term “passive activity” also includes most rental activities, regardless of the taxpayer’s level of participation. I.R.C. §§ 469(c)(2), (4) (2004).

²⁴⁰ I.R.C. § 469(c).

²⁴¹ I.R.C. § 469(c)(1).

²⁴² I.R.C. § 469(h)(1).

²⁴³ See Treas. Reg. § 1.469-5T(a) (as amended in 1996).

²⁴⁴ To constitute a trade or business, an activity must also have continuity and regularity and be engaged in for profit. *Groetzinger*, 480 U.S. at 35; see also *supra* text accompanying notes 210–16.

²⁴⁵ See *supra* text accompanying notes 193–232.

²⁴⁶ Code section 469 serves to deny full loss offsets to a taxpayer’s non-portfolio passive investment. See I.R.C. § 469 (2004); see also *supra* notes 133–37 and accompanying text.

²⁴⁷ If the taxpayer and/or his spouse have a substantial and steady stream of income from passive investments, then the taxpayer has no federal income tax incentive to put capital in active business rather than passive investment. In fact, in that case, the taxpayer might prefer to

This subsidy for actively run businesses arguably serves to level the playing field because entrepreneurship is riskier than investing in established ventures.²⁴⁸ The next section explores which subset of individual taxpayers benefit from this subsidy to the greatest extent.

B. *Who Benefits From the Subsidy?*

The discussion thus far has explored a subsidy for taxpayers with variable income or other labor income who combine labor and capital. In fact, this subsidy primarily benefits high-income taxpayers, for both tax and non-tax reasons. First, the higher the taxpayer's other income, the greater amount is available to use to offset losses. Second, as discussed below, higher-income taxpayers are more likely to have capital left after taking advantage of tax-favored investment opportunities. Third, the high-income also are most likely to have the resources to capitalize a start-up business, as well as to afford tax advice. In addition, as discussed in Section C, high-income individuals benefit most from the tax advantages afforded successful small businesses.

1. *Who are the Entrepreneurs?*

Taxpayers with the most income or wealth²⁴⁹ engage in entrepreneurial activity disproportionately.²⁵⁰ In 1995, 74.3% of the top 1% of taxpayers²⁵¹ (by

invest passively because of the relatively lower risk of established ventures compared to start-ups.

²⁴⁸ Of course, encouraging risk through tax incentives is not necessarily salutary. For an argument that "risk incentives are difficult to defend economically, except perhaps under limited circumstances and then only when making the most favorable assumptions," see Livingston, *supra* note 13, at 165. However, whether providing incentives for risk-taking is beneficial depends on whether there would be an optimal amount of risk-taking without incentives. Because individuals are ambiguity averse (they prefer risks with known probabilities to unknown risks), Chorvat, *supra* note 12, at 617 (citing DANIEL ELLSBERG, RISK, AMBIGUITY AND DECISION 131–50 (2001)), Professor Terry Chorvat argues that "[b]ecause entrepreneurial activity is subject to fairly ambiguous risks, in the absence of some incentive, the amount of entrepreneurial activity will be lower than the social optimum." *Id.* at 647 (citing Wen-Fang Liu, *Saving and Portfolio: Observable Implications with Knightian Uncertainty* (Univ. of Washington Working Paper, Apr. 2000) and Joram Mayshar, *Should Government Subsidize Risky Private Projects?*, 67 AM. ECON. REV. 20, 23 (1977)); see also Cullen & Gordon, *supra* note 15 (explaining that effect of spillover benefits of entrepreneurship may be that market incentives produce too little entrepreneurial activity).

²⁴⁹ As reported by Professor John Lee, the Congressional Research Service found in 1994 that "families that owned small businesses were found to have eighty percent more income and over five times the wealth of the average family." Lee, *supra* note 186, at 910 (citing Jane G. Gravelle, *Small Business Tax Subsidy Proposals*, 93 TAX NOTES TODAY 61–12, March 15, 1993).

income) owned interests in privately held businesses.²⁵² On average, those businesses comprised 41.4% of the taxpayer's net worth, and the single largest component of that net worth.²⁵³ For the period 1962 through 1995, 74.9% of that group owned interests in privately held businesses, while only 12.8% of the bottom 99% did.²⁵⁴ For the same period, on average, the net value of private businesses constituted 37.7% of the total net worth of the top 1% of taxpayers and only 14.8% of the total net worth of the bottom 99%.²⁵⁵

Entrepreneurs also make up a disproportionate percentage of the top of the population by income. One study found that, in 1989, entrepreneurs' ²⁵⁶percentage of the top 1% of the population by income was 56.3%, and of the 4% just below the top 1% was 26.7%.²⁵⁷ In addition, the average net worth of entrepreneurs in the top 1% was \$5,164,994, while the average net worth of non-entrepreneurs in that group was \$3,130,220.²⁵⁸

Income and wealth are likely to be correlated. See Jeffrey H. Kahn, *Personal Deductions—a Tax “Ideal” or Just Another “Deal”?*, 2002 L. REV. M.S.U.-D.C.L. 1, 22 n.70 (2002); EDWARD N. WOLFF, *RECENT TRENDS IN WEALTH OWNERSHIP, 1983–1998*, at 5–6 (Jerome Levy Econ. Inst., Working Paper No. 300, 2000) (“Wealth and income are strongly correlated. . . .”) (quoted in Deborah A. Geier, *Incremental Versus Fundamental Tax Reform and the Top One Percent*, 56 SMU L. REV. 99, 114 (2003)).

²⁵⁰ See, e.g., Cullen & Gordon, *supra* note 15, at 31 (Their data, which uses income reported on federal tax returns for a sample of taxpayers, suggest that “entrepreneurial activity is heavily concentrated among the top one percent of the population.”); EDWARD P. LAZEAR, *ENTREPRENEURSHIP*, 19 (Nat'l Bureau of Econ. Research, Working Paper No. 9109, Aug. 2002), available at <http://www.nber.org/papers/w9109> (Study of alumni of Stanford Graduate School of Business bore out prediction that the proportion of individuals who are entrepreneurs increases with income bracket and the income distribution of entrepreneurs has a “fatter upper tail.”).

²⁵¹ In the 1980s, the top one percent by net worth owned approximately a quarter or a third of all wealth, excluding defined benefit pensions. See John Laitner, *Inequality and Wealth Accumulation: Eliminating the Federal Estate and Gift Tax*, in *RETHINKING ESTATE AND GIFT TAXATION*, 272 tbl.6-3 (William G. Gale et al. eds. 2001) (data from 1983 Survey of Consumer Finances and 1989 Panel Study of Income Dynamics).

²⁵² CHRISTOPHER D. CARROLL, *PORTFOLIOS OF THE RICH*, Working Paper No. 7826, at 28 tbl.2 (Aug. 2000), available at <http://www.econ.jhu.edu/people/ccarroll/richportfolios.pdf>.

²⁵³ *Id.* at 29 tbl.3.

²⁵⁴ *Id.* at 28 tbl.2. Professor John Lee summarizes a variety of statistics on ownership of stock and ownership of business assets by stating “[t]he literature shows that the active owners of small corporations are, on the average, high income individuals” Lee, *supra* note 186, at 908.

²⁵⁵ Carroll, *supra* note 252, at 29 tbl.3.

²⁵⁶ The term “entrepreneur” was defined as a household owning one or more active businesses with a total market value of at least \$5,000. Gentry & Hubbard, *supra* note 12, at 4.

²⁵⁷ *Id.* at 46 tbl.1.

²⁵⁸ *Id.* at 47 tbl.2.

Similarly, of expected decedents for 1998, the share of total assets of those with life-insurance-augmented assets of \$10,000,000 and over attributable to active business was 49.4%, while the share of directly held public stock for that group was only 22.4%.²⁵⁹ For those with life-insurance-augmented assets of \$5,000,000 to \$10,000,000, the share attributable to active business drops to 5.2%, while the share of directly held public stock for that group is 41.2%.²⁶⁰ Overall, the 1998 mean and median income of those employed by another were \$40,500 and \$53,500, while the same figures for the self-employed were \$52,700 and \$109,000.²⁶¹ There is an even starker contrast in family net worth: The 1998 mean and median net worth of those employed by another were \$52,400 and \$168,900, while the same figures for the self-employed were \$248,100 and \$919,800, respectively.²⁶²

[O]nly 8.6 percent of households (in the 1989 cross-section of the Federal Reserve Board Survey of Consume Finances) . . . have active business assets of more than \$5,000, but . . . those households own about 40% of household wealth. Moreover, the higher one goes in the wealth distribution, the greater is the importance of business owners and business assets. Entrepreneurs own 68 percent of the net worth held by the top 1 percent of households in the wealth distribution.²⁶³

Thus, it appears that the richest individuals, measured either by income or wealth, disproportionately invest in active business rather than in publicly held companies, when compared to those in the strata below them. Of course, it is quite possible that for many individuals, it is the entrepreneurial activity that occasioned the high-income status, rather than the reverse, particularly because these figures consider only those who have high income (or wealth). In other words, these figures reflect survival bias in that they only look at entrepreneurs who have the threshold level of income (or wealth).²⁶⁴ However, it is interesting

²⁵⁹ See James M. Poterba & Scott Weisbrenner, *The Distributional Burden of Taxing Estates and Unrealized Capital Gains at Death*, in *RETHINKING ESTATE AND GIFT TAXATION*, *supra* note 251, at 440 tbl.10-8.

²⁶⁰ *Id.*

²⁶¹ See <http://www.federalreserve.gov/pubs/oss/oss2/98/bulltables98.txt>. at tbl.1.

²⁶² *Id.* at tbl.2.

²⁶³ Hubbard, *supra* note 15, at 456.

²⁶⁴ According to IRS data from tax returns, entrepreneurs seem to be doing well. The IRS found that the number of non-farm proprietorship returns increased by 1.9% from 1999 to 2000 and non-farm sole proprietor profits increased 3.3% for the 2000 tax year, a 2.4% increase in constant dollars. Michael Parisi & Brian Balkovic, *Sole Proprietorship Returns, 2000*, at 6, 7 at <http://www.irs.gov/pub/irs-soi/00spart.pdf>. Aggregate non-farm sole proprietor profits were \$214.7 billion. *Id.* at 6. Sole proprietorships with employees were included in the data. See *id.* at 9, figure D (15.2% of aggregate expenses were for salaries and wages).

to note that to the extent that the entrepreneurship occasioned the high-income status, then even those individuals subject to the highest marginal tax rates have on the whole done well by investing disproportionately in active business.

Statistics relating to the employment status and financial holdings of the top 1% of Americans before and after the Tax Reform Act of 1986 (TRA '86) suggest that tax incentives may play a role. TRA '86 increased the importance of labor to favorable deduction-side tax consequences by enacting the two-percent floor and the passive activity loss rules²⁶⁵ and by tightening the limitation on investment interest.²⁶⁶ It was also accompanied by pro-entrepreneurship rhetoric²⁶⁷ and contained concessions for small businesses.²⁶⁸

The Federal Reserve Board conducted surveys of Consumer Finances in 1983 and 1992.²⁶⁹ Those data cannot isolate the effect of the 1986 Act, but they

²⁶⁵ See *supra* notes 48, 134, and accompanying text.

²⁶⁶ The 1986 Act eliminated the \$10,000 (\$5,000 for married taxpayers filing separately) of investment interest that could be deducted without regard to investment income. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 511(a), 100 Stat. 2244 (1986). The 1986 Act also eliminated the capital gains preference, though that turned out to be temporary. See I.R.C. § 1(h) (2004).

²⁶⁷ See PRESIDENT RONALD REAGAN, REMARKS DURING TAX BILL SIGNING CEREMONY (Oct. 22, 1986), *reprinted in* 33 TAX NOTES 413, 413 (1986) ("When I sign this bill into law, America will have the lowest marginal tax rates and the most modern tax code among major industrialized nations, one that encourages risk-taking, innovation, and that old American spirit of enterprise. We'll be refueling the American growth economy with the kind of incentives that helped create record new businesses and nearly 11.7 million jobs in just 46 months. Fair and simpler for most Americans, this is a tax code designed to take us into a future of technological invention and economic achievement, one that will keep America competitive and growing into the 21st century."); see also Kornhauser, *supra* note 18, at 162.

The 1986 Act also lowered personal income tax rates, which has the effect of lowering the amount of risk transferred to the government, decreasing the incentive for entrepreneurship. See Cullen & Gordon, *supra* note 15, at 35-36.

²⁶⁸ See Wilson, *supra* note 18. Mr. Wilson remarks:

[N]otwithstanding [the] massive overhaul of the Code [in 1986], small business and its advocates were still able to extract special treatment from the lawmakers, primarily in the form of size tests that protected small firms from many of the TRA's [Tax Reform Act's] provisions. . . . In total, these provisions gave small businesses an advantage over their larger competitors. Although small business was caught by some TRA reforms, on balance small business was a big winner under tax reform legislation of the mid-1980s.

Id. at 56.

²⁶⁹ In looking at the 1983 and 1992 data, Edward Wolff asks, as one of six introductory questions, "with the substantial increase in inequality over this period, and especially with the record-high salaries recorded on Wall Street and among professional workers in general, has there been a shift in the composition of the rich away from the classic 'coupon clippers' toward entrepreneurs?" See Wolff, *supra* note 191, at 74. Wolff's discussion generally does not

are informative nonetheless. They show, for example, that in 1983 the portion of the top 1% by wealth that was self-employed was 38%, whereas in 1992, the portion of the top 1% by wealth (which may not consist of the same people as in 1983) that was self-employed was 69%²⁷⁰—an increase of thirty-one percentage points. In addition, between 1983 and 1992, the share of income of the top 1% by wealth from self-employment, partnerships, and unincorporated business increased from 27% to 40%.²⁷¹ The share held by this group of net business equity increased from 52.1% to 62.0% while their share of stocks and mutual funds fell from 57.5% to 50.1%.²⁷²

In addition, during that period:

the income statistics show a greater reliance on labor income than other forms of income among the very rich. Between 1983 and 1992, labor earnings (both wages and salary and self-employment income) as a share of the total income of the top wealth percentile jumped from 51% to 69%, and that of the top income percentile from 60% to 68%.²⁷³

Correspondingly, the rich relied less on income from capital in 1992 than in 1983; income from property, such as interest, dividends, capital gains, rents, and royalties, fell from 46% to 27% of the income of the top 1% by wealth and from 36% to 30% for the top 1% by income.²⁷⁴

Thus, these statistics suggest that taxes may play a role in the concentration of entrepreneurs among the highest-income individuals, although it is unlikely to be the only important factor.²⁷⁵ The next Section addresses the issue of why

connect changes in levels of entrepreneurship among the very rich with tax changes during that period. *See generally id.*

²⁷⁰ *Id.* at 82, 86. There was a corresponding drop in that group in the various categories that make up employment by others. *See id.*

²⁷¹ *Id.* at 109. Wolff points out that part of the increase may be due to the incentive created by the Tax Reform Act of 1986 for C corporations to elect to be taxed under Subchapter S; the data classify S corporations as unincorporated business. *Id.* at 110.

²⁷² *Id.* at 87, 88 tbl.3.4, 91 tbl.3.5. Although the absolute increase in the value of net business assets was large, from \$1.232 trillion in 1983 to \$2.5332 trillion in 1992 (unadjusted for inflation), the percentage increase was small. *Id.* A comparison of the holdings of the top one percent in 1983 and 1992 reveals that the percentage of their gross assets in net business equity increased slightly from 32.1% to 32.6% while the percentage of their gross assets in stock fell from 17% to 12.1%. *See id.* at 88 tbl.3.4, 91 tbl.3.5.

²⁷³ *Id.* at 109. There was nonetheless a reduction in “labor-force effort” by the very rich, reflecting a shift to part-time work among the top one percent by income and both a shift to part-time work and retirement among the top one percent by wealth. *Id.*

²⁷⁴ *Id.* at 110.

²⁷⁵ High-income individuals may also be better able to bear the risks of entrepreneurship because of decreasing absolute risk aversion. In other words, a higher-income individual is

high-income taxpayers benefit disproportionately from the federal income tax subsidy of business activities.

2. *Why Do High-Income Individuals Benefit Most?*

There are a number of reasons why high-income taxpayers benefit most from the entrepreneurship tax subsidy.²⁷⁶ First, high-income taxpayers benefit from the greatest risk-shifting under the federal income tax because they face higher marginal rates in a progressive income tax system. For example, in general, a taxpayer who has a top marginal rate of 30% shifts 30% of the risk of loss to the government, whereas a taxpayer with a top marginal rate of 15% shifts only 15% of the risk to the government.²⁷⁷

Second, high-income taxpayers obtain the greatest benefits of the income-splitting made possible by incorporating a successful business, discussed below.²⁷⁸ In addition, as discussed below, there are estate tax benefits to owning active business. Only very wealthy individuals need be concerned about estate tax liability; the estate tax only applies to fewer than two percent of estates each year.²⁷⁹

High-income taxpayers are also disproportionately affected by the restrictions on itemized deductions, discussed above,²⁸⁰ that affect investment expenses but not business expenses.²⁸¹ IRS 2000 Statistics of Income data show that over 90% of individuals with AGI of \$100,000 or more itemized their deductions, whereas only about 28% of individuals with AGI under \$100,000 did.²⁸² In addition, because of the AGI threshold provided in section 68, the

more able to bear the risk of losing an investment of, say \$50,000, than a lower-income individual is.

²⁷⁶ On a practical level, they are more able to afford tax and financial advice.

²⁷⁷ See *supra* text accompanying notes 158–61, illustrating the shifting of risk.

²⁷⁸ See *infra* text accompanying notes 326–37.

²⁷⁹ See Lee Anne Fennell, *Death, Taxes, and Cognition*, 81 N.C. L. REV. 567, 593–94 & n.99 (2003).

²⁸⁰ See *supra* text accompanying notes 39–102.

²⁸¹ Additionally, 12.6% of returns of taxpayers who itemized and had AGI of \$100,000 or more claimed an investment interest deduction. See 2000 IRS Statistics of Income, *supra* note 103, at tbl.2.1; see also *supra* note 103. It is not clear how many taxpayers incurred investment interest but did not deduct it because they had no investment income.

²⁸² There were 117,372,120 returns showing AGI under \$100,000, not including those with zero AGI. 84,640,562 of those took the standard deduction, which is 72.11%. There were 10,855,026 returns showing AGI of \$100,000 or more. Of those, 1,029,964 took the standard deduction, which is 9.49%. All calculations done by the author, based on 2000 IRS Statistics of Income, *supra* note 103, at tbl.1.2. The latter statistic is consistent with the 1994 data Professors Shuldiner and Shakow analyzed. See Shuldiner & Shakow, *supra* note 42, at 683 tbl.4; see also *supra* note 42.

overall limitation on itemized deductions affects all high-income individuals who itemize. Professors Shuldiner and Shakow found that in 1994, 1% of all itemizing returns with AGI between \$55,000 and \$100,000 were affected by the overall limitation on itemized deductions whereas 69.7% of those itemizing with AGI between \$100,000 and \$200,000 were affected and all of those itemizing with AGI over \$200,000 were affected.²⁸³ Furthermore, some high-income taxpayers take the standard deduction and the data suggest section 68 as the most likely reason.²⁸⁴ Additionally, a disproportionate percentage of high-income taxpayers pay AMT²⁸⁵ and miscellaneous itemized deductions are entirely disallowed under the AMT.²⁸⁶

Lower-income individuals who itemize are more frequently affected by the two-percent floor on miscellaneous itemized deductions. A quarter of returns itemizing deductions and showing AGI under \$100,000 are affected by the two-percent floor, whereas 19.35% of returns itemizing deductions and with AGI of \$100,000 to \$500,000 are affected. Only 11.86% of taxpayers with AGI over \$1 million dollars who itemize deductions are so affected. *See* 2000 IRS Statistics of Income, *supra* note 103, at tbl.2.1 (calculations performed by the author). These figures suggest that itemized deductions do not rise proportionately with income, which turns out to be the case. *See* 2000 IRS Statistics of Income, *supra* note 103, at tbl.1.2. In fact, with respect to some AGI groupings, as AGI increases, aggregate itemized deductions decrease (such as between the \$50,000 to \$75,000 and \$75,000 to \$100,000 AGI groups and the \$500,000 to \$1 million and \$1 million to \$1.5 million AGI groups).

Of course, higher-income taxpayers affected by the two-percent floor lose many more dollars of deductions, given that the lost deductions are two percent of AGI. *See* 2000 IRS Statistics of Income, *supra* note 103, at tbl.2.1. In addition, a number of high-income individuals pay AMT, and miscellaneous itemized deductions are completely disallowed under the AMT. *See supra* notes 57–65 and accompanying text.

²⁸³ 2000 IRS Statistics of Income, *supra* note 103, at 682 tbl.3. IRS Statistics of Income for tax year 2000 show that virtually all taxpayers with AGI of \$200,000 and up who itemized deductions were affected by section 68. *See* 2000 IRS Statistics of Income, *supra* note 103, at tbl.2.1.

²⁸⁴ Shuldiner & Shakow, *supra* note 42, at 683 (pointing out that, in the 1994 data they present, the percentage of taxpayers taking the standard deduction is greater for those with AGI over \$500,000 than it is for those with AGI under \$500,000). For 2000, 8.72% of taxpayers with AGI between \$500,000 and \$1 million took the standard deduction, whereas 10.53% of taxpayers with AGI between \$1 million and \$1.5 million did. *Id.* The percentages decline from there: 8.71% of taxpayers with AGI between \$1.5 million and \$2 million took the standard deduction; 7.60% of taxpayers with AGI between \$2 million and \$5 million did; 5.47% of taxpayers with AGI between \$5 million and \$10 million; and 2.92% of taxpayers with AGI over \$10 million did. 2000 IRS Statistics of Income, *supra* note 103, at tbl.1.2 (calculations performed by the author).

²⁸⁵ Overall, 45% of individuals' year 2000 returns paid AMT. 2000 IRS Statistics of Income, *supra* note 103, at tbl.1.2 (percentage calculated by the author). By contrast, 9.03% of taxpayers with over \$100,000 of AGI paid AMT and 17.99% of taxpayers with over \$200,000 of AGI paid AMT. *Id.* (percentages calculated by the author). More specifically, 5.8% of taxpayers with AGI between \$100,000 and \$200,000 paid AMT. *Id.* (percentage calculated by the author). 18.79% of taxpayers with AGI between \$200,000 and \$500,000 paid AMT. *Id.*

Although middle-income taxpayers may have a similar, if smaller, federal income tax incentive to combine their labor and capital into active business, in fact the Code tends to channel their capital to other investments. That is, taxpayers have tax incentives to make significant investments in owner-occupied housing, retirement vehicles, and whole life insurance,²⁸⁷ and middle-income taxpayers likely have little capital to invest after taking advantage of these tax-favored investments.

With respect to owner-occupied housing, the Code provides several important benefits, although living arrangements fall in the category of personal, not profit-seeking, activities.²⁸⁸ First, although other personal interest generally is not deductible, home mortgage interest on debt of up to a maximum of \$1,100,000 is deductible with respect to a first and second residence.²⁸⁹ Second, state and local real property taxes are deductible.²⁹⁰ Third, gain of up to \$500,000 on the sale of a principal residence is excludible from gross income if certain requirements are met.²⁹¹ Taxpayers may take advantage of this provision as often as once every two years.²⁹² Fourth, the Code does not tax the imputed income from home ownership. That is, although a taxpayer who puts \$100,000 in a bank or in stock pays tax on the earnings²⁹³ and cannot deduct rent paid for housing,²⁹⁴ the taxpayer who puts the \$100,000 in a home in which he lives pays no tax on the imputed rental value.²⁹⁵ These provisions provide a substantial incentive for a taxpayer to invest in a home.²⁹⁶

(percentage calculated by the author). 15.86% of taxpayers with AGI between \$500,000 and \$1 million paid AMT. *Id.* (percentage calculated by the author). 13.70% of taxpayers with AGI between \$1 million and \$1.5 million paid AMT. *Id.* (percentage calculated by the author).

²⁸⁶ See I.R.C. § 56(b)(1)(A)(i) (2004); see also *supra* text accompanying notes 57–65.

²⁸⁷ See *infra* text accompanying notes 287–304.

²⁸⁸ See I.R.C. § 262 (2004) (denying deduction for “personal, living, or family expenses.”); see also *supra* text accompanying notes 27–32 (discussing Code’s distinction between personal and profit-seeking activities).

²⁸⁹ I.R.C. §§ 163(a), (h)(3) (2004).

²⁹⁰ I.R.C. § 164(a)(2) (2004).

²⁹¹ I.R.C. § 121 (2004). The \$500,000 cap applies to qualifying married taxpayers filing a joint return. See I.R.C. § 121(b)(2)(A). Otherwise, the limit is \$250,000. See I.R.C. § 121(b)(1).

²⁹² I.R.C. §§ 121(a), (b)(3).

²⁹³ See I.R.C. §§ 61(a)(4), (7) (2004).

²⁹⁴ Treas. Reg. § 1.262-1(b)(3) (1987).

²⁹⁵ The Code does not tax the imputed income from other assets, either, but the home is often a family’s most valuable asset. In addition, other assets are not favored by the other tax incentives that encourage home ownership.

²⁹⁶ Although the home is a personal use asset, it has significant investment aspects. See Myron C. Grauer, *A Case for Congressional Facilitation of a Collaborative Model of Statutory Interpretation in the Tax Area: Lessons to be Learned from the Corn Products and Arkansas Best Cases and the Historical Development of the Statutory Definition of “Capital Asset(s)”*,

With respect to retirement, the Code provides incentives for a variety of different types of plans, many of which are employment-based. Employment-based defined contribution plans²⁹⁷ allow for an exclusion from gross income of both employer and employee contributions, up to a maximum of \$40,000 per year.²⁹⁸ In general, individual retirement accounts (IRAs) allow a tax deduction for contributions of up to \$3,000 for the 2003 tax year,²⁹⁹ this amount is scheduled to increase to \$5,000 for the 2008 tax year.³⁰⁰

Tax-deductible IRAs provide more benefit to individuals who do not participate in employer-sponsored plans than to those who do; the maximum deductible amount is rapidly phased out for an individual who is an active participant in a pension plan, or whose spouse is an active participant.³⁰¹ A taxpayer may not deduct an IRA contribution that exceeds "compensation,"³⁰² which is defined as the sum of "earned income"³⁰³ and alimony received.³⁰⁴

84 KY. L.J. 1, 42 (1995-96) ("Many persons view their residences . . . as investments.") (footnotes omitted). That is, many taxpayers hope to make a profit from their home (or from a series of different homes that they own over a period of time), perhaps to use that profit to help support their retirement. See F.H. Buckley, *The Debtor as Victim*, 87 CORNELL L. REV. 1078, 1082 (2002) ("[H]ouses are often an individual's largest asset and his most important private source of retirement savings. . . . On retirement, the debtor will ordinarily cash in the house by trading down to a smaller house, using the proceeds of the sale as a nest egg.") (footnote omitted). Alternatively, some senior citizens obtain a "reverse mortgage." See Jean Reilly, *Reverse Mortgages: Backing into the Future*, 5 ELDER L.J. 17, 18 (1997).

²⁹⁷ Code section 414 defines the term "defined contribution plan" as "a plan which provides for an individual account for each participant and for benefits based solely on the amount contributed to the participant's account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participant's account." I.R.C. § 414(i) (2004). It defines the term "defined benefit plan" as "any plan which is not a defined contribution plan." I.R.C. § 414(j). For defined benefit plans, the maximum allowable benefit is \$160,000 per year. I.R.C. § 415(b)(1) (2004).

²⁹⁸ I.R.C. §§ 415(c)(1), (2). The maximum also cannot exceed 100% of the individual's compensation. I.R.C. § 415(c)(1)(B).

These plans also apply to self-employed individuals. See I.R.C. §§ 401(c)(1), 415(c)(3)(B) (2004).

²⁹⁹ See I.R.C. § 219(b)(5)(A) (2004). That amount is increased for individuals over age 50. See I.R.C. § 219(b)(5)(B). For 2003, the amount of the increase was \$500. *Id.*

³⁰⁰ I.R.C. § 219(b)(5)(A). The amount will be adjusted for inflation after 2008. Additional contributions of \$500 or \$1,000 are allowed for individuals age 50 and older. I.R.C. § 219(b)(5)(B).

³⁰¹ See I.R.C. § 219(g).

³⁰² I.R.C. §§ 219(b)(1)(B), (c) (considering spouse's compensation in certain situations). IRAs in a sense shelter earnings from labor but, under the Cary Brown thesis, the economic effect is to exempt the return on capital from taxation. See Johnson, *supra* note 3 at 1022. Thus, the net effect of an IRA is to shelter from taxation the income on capital earned from the income from labor, given that contributions cannot exceed compensation.

³⁰³ This term is defined in I.R.C. § 401(c)(2) (2004).

With respect to life insurance, the Code generally does not tax life insurance proceeds payable “by reason of the death of the insured,”³⁰⁵ regardless of the source of the payments—premiums for term insurance, additional premiums for “whole life” insurance, and even the earnings on those additional premiums. In addition, the “inside build-up” of a whole life policy is not taxed as it is earned. Therefore, inside build-up paid out at death is never taxed.

Taxpayers, including middle-income taxpayers, do take advantage of these provisions. In 1998, 66.2% of families owned their primary residence.³⁰⁶ Of families with net worth in the second quartile from the bottom, 67.2% did, and those residences had a median value of \$60,000.³⁰⁷ In the top two quartiles, over 90% owned their primary residence.³⁰⁸ The median value of residences owned by taxpayers in the second quartile from the top was \$95,000.³⁰⁹

The percentage of families with income of \$50,000 to \$99,999 in 1998 dollars that owned retirement accounts was 73.5%, and the average value of those accounts was \$31,000.³¹⁰ For families with income of \$100,000 or more in 1998 dollars, the percentage owning retirement accounts was 88.6%, and those accounts had a median value of \$93,000.³¹¹ Of families with net worth in the second quartile, 44.2% owned a retirement account (with a median value of \$8,100); in the third quartile, 56.4% did (with a median value of \$28,000); and in the 75th to 89.9th percentiles, 71.9% did (with a median value of \$59,800).³¹²

³⁰⁴ I.R.C. §§ 219(a), (b)(1), (f)(1) (2004).

³⁰⁵ I.R.C. § 101(a)(1) (2004).

³⁰⁶ Board of Governors of the Federal Reserve System, Division of Research and Statistics, *Recent Changes in U.S. Family Finances: Results from the 1998 Survey of Consumer Finances*, 86 FED. RESERVE BULL. 1, 17 tbl.8B (2000) [hereinafter *1998 Survey*]. In 1998, of families with net worth in the bottom quartile, 14.1% owned their primary residence, which had a median value of \$40,000. *Id.*

³⁰⁷ *Id.* In 1998, 71% of families with income of \$50,000 to \$99,999 in 1998 dollars had home-secured debt. U.S. DEP'T OF COMMERCE, BUREAU OF THE CENSUS, STATISTICAL ABSTRACTS OF THE UNITED STATES: THE NATIONAL DATA BOOK 727 tbl.1169 (121st ed. 2001) [hereinafter 2001 ABSTRACTS]. For families with income of \$100,000 or more in 1998 dollars, the percentage with home-secured debt was 73.4. *Id.* Thus, approximately three-quarters of families with income of \$50,000 and up had homes subject to a mortgage. A similar proportion owned retirement funds. See *infra* notes 310–12 and accompanying text.

³⁰⁸ *1998 Survey, supra* note 306, at 17 tbl.8B.

³⁰⁹ *Id.* For families with a net worth in the 75th to 89.9th percentiles, the median value of the principal residence was \$140,000. *Id.* For families in the top 10% by net worth, the median value was \$250,000. *Id.*

³¹⁰ See 2001 ABSTRACTS, *supra* note 307, at 726 tbl.1167.

³¹¹ *Id.*

³¹² *1998 Survey, supra* note 306, at 11 tbl.5B. In the top 10% of families by net worth, 80.2% owned retirement accounts, with a median value of \$125,000. *Id.*

Overall, on average, in 1998, retirement accounts constituted 27.5% of families' financial assets, the single largest percentage.³¹³

The percentage of families with income of \$50,000 to \$99,999 in 1998 dollars that owned life insurance was 39.8%, and the median cash value of those policies was \$9,500.³¹⁴ For families with income of \$100,000 or more in 1998 dollars, the percentage owning life insurance was 50.1%, and the median cash value of those policies was \$18,000.³¹⁵ In 1998, on average, the cash value of life insurance constituted 6.4% of a family's financial assets.³¹⁶

Thus, middle-income taxpayers on the whole typically will have little capital that they cannot shelter in retirement vehicles, owner-occupied housing, and life insurance. By contrast, high-income taxpayers typically will have assets that exceed the caps of these provisions. High-income taxpayers own a disproportionate amount of capital when compared to middle and low-income taxpayers.³¹⁷

High-income taxpayers may take advantage of the tax benefits of home ownership, including the mortgage interest subsidy on two residences.³¹⁸ Additional homes or loans in excess of \$1,100,000 will not benefit from that subsidy. The alternative minimum tax may also apply to eliminate any deduction for home mortgage interest.³¹⁹ In addition, gains exceeding \$250,000 on the sale of a principal residence (\$500,000 for married taxpayers filing jointly) and gains

³¹³ *Id.* at 8 tbl.4. Stocks were next at 22.7%.

³¹⁴ 2001 ABSTRACTS, *supra* note 307, at 726 tbl.1167; 1998 Survey, *supra* note 306, at 11 tbl.5B.

³¹⁵ 2001 ABSTRACTS, *supra* note 307, at 726 tbl.1167; 1998 Survey, *supra* note 306, at 11 tbl.5B.

³¹⁶ 1998 Survey, *supra* note 306, at 8 tbl.4.

³¹⁷ See *infra* note 323 and accompanying text. For families with income of \$100,000 or more in 1998 dollars, the percentage that directly owned stocks was 56.6% (median value of \$55,000), the percentage owning savings bonds was 32.3% (median value of \$1,500), the percentage owning mutual funds was 44.8% (median value of \$65,000), and the percentage owning retirement accounts was 88.6% (median value of \$93,000). 2001 ABSTRACTS, *supra* note 307, at 726 tbl.1167.

In 1998, of families with a net worth in the top 10%, 58.9% owned stock directly (with a median value of \$85,000), 33.1% owned savings bonds (with a median value of \$2,000), 46.4% owned mutual funds (with a median value of \$107,000), and 82.9% owned retirement accounts (with a median value of \$125,000). 1998 Survey, *supra* note 306, at 11 tbl.5B. In addition, 16.9% of these families owned other bonds (with a median value of \$100,000).

³¹⁸ See I.R.C. §§ 163(a), (h)(3), (4)(A) (2004). In 1995, 96% of the top 1% of taxpayers by income owned their principal residence. Carroll, *supra* note 252, at 28 tbl.2.

³¹⁹ I.R.C. § 56(b)(1)(C) (2004). The alternative minimum tax generally will apply at relatively higher levels of income coupled with relatively high deductions of the type disfavored by the tax (which include investment expenses and unreimbursed employee business expenses).

on the sale of other residences will be taxed just like any other sale of a capital asset.³²⁰ High-income taxpayers also may shelter as much income as middle-income taxpayers in qualified retirement plans but high-income taxpayers will have additional income that exceeds the limits of those vehicles.

Thus, it is high-income taxpayers who likely more frequently have the choice to live off the return from a diversified portfolio of investments like Mr. Higgins,³²¹ invest in someone else's small business, as in the bakery example discussed above,³²² participate in a trade or business by working for others, or start a business. By contrast, low-income taxpayers tend to have small amounts of capital to invest.³²³ They also have more limited borrowing prospects, and, when they do borrow, it is more costly.³²⁴

³²⁰ See I.R.C. § 1(h) (2004) (defining capital gains preference), I.R.C. § 121 (2004) (defining exclusion for certain gains on sales of principal residences), I.R.C. § 1221 (2004) (defining capital asset), I.R.C. § 1222 (2004) (defining other terms relating to capital gains and losses).

³²¹ *Higgins v. Commissioner*, 111 F.2d 795, 796 (2d Cir. 1940), *aff'd*, 312 U.S. 212 (1940); see also *supra* text accompanying notes 202–09.

³²² See *supra* text accompanying notes 146–47.

³²³ For families with income under \$10,000 in 1998 dollars, the percentage that owned stocks was 3.8% (median value of \$14,000), the percentage owning savings bonds was 3.5% (median value of \$1,800), the percentage owning mutual funds was 1.9% (median value of \$6,000), and the percentage owning retirement accounts was 6.4% (median value of \$7,500). For families with income of \$10,000 to \$24,999 in 1998 dollars, the percentage that owned stocks was 7.2% (median value of \$10,000), the percentage owning bonds was 10.2% (median value of \$1,000), the percentage owning mutual funds was 7.6% (median value of \$26,000), and the percentage owning retirement accounts was 25.4% (median value of \$8,000). See 2001 ABSTRACTS, *supra* note 307, at 726 tbl.1167. The term “family” refers to a group of individuals residing in a single household, except that it includes one-person units. See *id.* at 726.

In 1998, of the bottom quartile of families (by net worth), 3.1% owned stocks directly (with a median value of \$700); 7% owned savings bonds (with a median value of \$200); 2.1% owned mutual funds (with a median value of \$1,500); and the percentage of those that owned retirement accounts was 18.4% (with a median value of \$2,000). 1998 Survey, *supra* note 306, at 11 tbl.5B.

The 1998 Survey of Consumer Finances sampled 4,309 families. 1998 Survey, *supra* note 306, at 2. The sample included 2,927 households with net worth of less than \$500,000 and one of more than \$500 million, which was the amount necessary to be listed in the *Forbes* 400 richest Americans for that year. See James M. Poterba & Scott Weisbrenner, *The Distributional Burden of Taxing Estates and Unrealized Capital Gains at Death*, in *RETHINKING ESTATE AND GIFT TAXATION*, *supra* note 251, at 427–28 (2001).

³²⁴ See Todd J. Zywicki, *The Economics of Credit Cards*, 3 CHAP. L. REV. 79, 99 (2000) (“It is unfortunate that lower-income Americans do not have access to home equity loans and other forms of debt provided at low interest rates. Those seeking access to credit confront a variety of alternatives that all appear unattractive when compared to the options available to middle-class borrowers.”).

It is therefore not surprising, given the incentive structure of the federal income tax, that, as the statistics above showed,³²⁵ the highest-income taxpayers tend to have much of their wealth invested in their own active businesses. Non-tax factors such as diversification of risk and a desire for liquidity support the fact that even these individuals do not invest all of their capital in privately held businesses.

C. *The Taxation of a Profitable Business Venture*

The discussion above showed that the federal income tax subsidy for active business primarily benefits high-income individuals. It might seem that if the start-up venture is successful, a high-income taxpayer would be disproportionately burdened with high taxation because of the progressive nature of the tax rates. Although this is true in theory, in fact, a high-income individual can use a variety of techniques to lower taxation on the up side.³²⁶

The key to most of the tax-saving techniques is the option an entrepreneur has of incorporating the business, which is valuable for a successful business.³²⁷ First, if used for a business, the corporate form can benefit individual taxpayers

For families with income of less than \$10,000 in 1998 dollars, the percentage with any debt was 41.7%, and the median indebtedness was \$4,100. For families with income of \$10,000 to \$24,999 in 1998 dollars, the percentage with any debt was 63.7 and the median indebtedness was \$8,000. For both groups, credit card balances and installment debt were the most frequent sources of debt but most of the debt amounts were attributable to home-secured debt. See 2001 ABSTRACTS, *supra* note 307, at 727 tbl.1169.

In 1998, for the lowest quartile of taxpayers by net worth, the median indebtedness of those families with debt was \$8,400. This contrasts with median indebtedness of \$28,400 for those families with debt in the next highest quartile, and \$46,200 median indebtedness for those families with debt in the quartile that is the second from the top. *1998 Survey, supra* note 306, at 21 tbl.11B.

³²⁵ Of course, the tax system may not be the only reason for this allocation. See Carroll, *supra* note 252, at 2–4.

³²⁶ The average tax rate paid by the top one percent of households (by income) in selected years between 1963 and 1995 ranged between approximately twenty and twenty-five percent. Carroll, *supra* note 252, at 27 tbl.1. This percent has not varied much over time because the decline in top marginal rates was accompanied by clamping down on tax shelters. *Id.* at 5.

³²⁷ See Cullen & Gordon, *supra* note 15, at 2. Until 2003, this option was not tax-saving for the successful passive investor because the undistributed income of “personal holding companies” was taxed at the top marginal rate applicable to single individuals. See I.R.C. § 541 (2002). Under a 2003 amendment, the applicable tax rate is 15%, see I.R.C. § 541 (2004), which is the same as the 15% maximum rate applicable to most dividends and adjusted net capital gain received by individuals. See I.R.C. §§ 1(h)(1)(C), (11) (2004). The amendment to section 541 is scheduled to sunset at the end of 2008, as is the 15% rate in I.R.C. § 1(h). See Pub. L. 108-27, § 303, 117 Stat. 752, 764 (2003).

through income splitting (two or more trips up the graduated rate brackets).³²⁸ Professor Joseph Isenbergh describes how this worked under pre-1986 law, which provided graduated tax rates for the first \$100,000 of corporate income:³²⁹

The basic idea was for the shareholders of the corporation, if they were also directly engaged in its operations, to leave a substantial balance of its income in the corporation as retained earnings after the deduction of their salaries. The result was two separate trips through the rate brackets for the two separate components of the earnings in the year they arose. The gains left in the corporation as retained earnings would be exposed to additional taxation upon their subsequent distribution to the shareholders, but with the advantage of delay in taxation at the shareholder level. Furthermore, a sale of the shares or a liquidation of the corporation permitted the value of the retained earnings to be captured by shareholders as benignly taxed capital gains. And finally, the shares receive a stepped-up tax basis upon the death of their individual owners, which permits a sale at fair market value at no income tax cost. From one generation to the next, therefore, deferral of shareholder-level tax on retained earnings becomes forgiveness.³³⁰

Current law taxes the first \$50,000 of a corporation's taxable income at 15%,³³¹ the next \$25,000 at 25%,³³² the amount between \$75,000 and \$10 million at 34%,³³³ and the remainder at 35%,³³⁴ subject to surtaxes for taxable income in excess of \$100,000 that eventually impose a flat rate of 35%.³³⁵ The

³²⁸ Repeated trips generally are precluded by Code section 1561. See I.R.C. § 1561 (2004) (defining limitations on certain multiple tax benefits in the case of certain controlled corporations), I.R.C. § 1563(a) (2004) (defining controlled group of corporations).

³²⁹ Isenbergh, *supra* note 115, at 300 n.69 (citing then-current version of I.R.C. § 11(b)).

³³⁰ *Id.* at 300–301 (footnotes omitted).

³³¹ I.R.C. § 11(b)(1)(A) (2004). As Professor Lee points out, this is the same rate applicable to the working poor. See Lee, *supra* note 186, at 909. Of course, under current law, there is a 10 percent marginal rate applicable to individuals. I.R.C. § 1(i)(1) (2004).

³³² I.R.C. § 11(b)(1)(B). This is currently the marginal rate applicable to middle-income taxpayers (between \$28,400 and \$68,800 in taxable income for an unmarried individual in 2003). See I.R.C. § 1(i)(2); Rev. Proc. 2002-70, 2002-2 C.B. 845, 846 § 3.01 tbl.3; *cf.* Lee, *supra* note 186, at 909.

³³³ I.R.C. § 11(b)(1)(C).

³³⁴ I.R.C. § 11(b)(1)(D).

³³⁵ See I.R.C. § 11(b)(1). The American Jobs Creation Act of 2004, enacted just as this Article was going to press in October of 2004, provides a deduction for “domestic production activities.” American Jobs Creation Act of 2004, Pub. L. 108-357 § 102, 118 Stat. 1418 (2004). The deduction, once it is fully phased in, and assuming the requirements and limitations of the section are met, will amount to 9 percent of the lesser of (1) “the qualified production activities income of the taxpayer for the taxable year” or (2) in the case of a corporation, the taxpayer’s taxable income for the taxable year (computed without regard to the deduction itself). See *id.*; I.R.C. § 199(a) (2004). The 9 percent deduction is equivalent to a rate cut of approximately 3 percentage

top marginal rate applicable to income of individuals is also 35%,³³⁶ but an individual nonetheless benefits from shifting income to a corporation because of progressivity. In effect, the use of a corporation allows another trip up the graduated rate brackets.

Professor John Lee has pointed out that sixty-one percent of C corporations report no income or a loss for tax purposes,³³⁷ thirty-seven percent “report, on the average, about \$40,000, which is taxable at fifteen %”³³⁸ while a whopping “eighty percent of their owners are taxable at the higher individual income brackets”³³⁹ These high-income individuals can benefit from another trip

points. See Committee on Ways and Means, *Summary of Conference Report on H.R. 4520, The American Jobs Creation Act of 2004*, available at <http://waysandmeans.house.gov/media/pdf/hr4520/hr4250confreptshortsummary.pdf>.

Immediately prior to 1986, section 11(b) read as follows:

The amount of the tax imposed by subsection (a) shall be the sum of—

- (1) 15% (16% for taxable years beginning in 1982) of so much of the taxable income as does not exceed \$25,000;
- (2) 18% (19% for taxable years beginning in 1982) of so much of the taxable income as exceeds \$25,000 but does not exceed \$50,000;
- (3) 30% of so much of the taxable income as exceeds \$50,000 but does not exceed \$75,000;
- (4) 40% of so much of the taxable income as exceeds \$75,000 but does not exceed \$100,000; plus
- (5) 46% of so much of the taxable income as exceeds \$100,000.

In the case of a corporation with taxable income in excess of \$1,000,000 for any taxable year, the amount of tax determined under the preceding sentence for such taxable year shall be increased by the lesser of (A) 5 percent of such excess, or (B) \$20,250.

I.R.C. § 11(b) (1985).

³³⁶ See I.R.C. § 1(i)(2) (2004). Under current law, the brackets above the zero bracket are 10%, 15%, 25%, 28%, 33%, and 35%. See I.R.C. §§ 1(i)(1)(A), (2). Of course, employment taxes raise the rate effectively applied to wages and salaries. See Lee, *supra* note 186, at 888 (referring to then-existing “forty-five percent federal income and wage taxes combined.”).

There was even more incentive for individuals to use the income-splitting technique described in the text when the top individual rate was much higher. Before changes in 1986, the top marginal federal income tax rate applicable to individuals was fifty percent. See I.R.C. § 1 (1985).

³³⁷ Lee, *supra* note 186, at 906 (citing Joint Comm. on Taxation Staff, *Impact on Small Business of Replacing the Federal Income Tax*, 96 TNT 81-16 at 5 n.8 (1996)) [hereinafter Joint Comm. on Taxation Staff].

³³⁸ *Id.* at 887; see also *id.* at 906.

³³⁹ *Id.* Those brackets ranged from 31 to 39.6% at the time. *Id.* Professor Lee argued in 1986:

through a 15% bracket by shifting up to \$50,000 of taxable income to the corporation.³⁴⁰

Note also that the owner/entrepreneur can manipulate the amount subject to corporate versus individual taxation by controlling the pay-out of profits as salary. Salary payments are deductible to the corporation,³⁴¹ and therefore reduce the corporation's taxable income.³⁴² However, salary is taxable to the individual at individual rates and subject to employment taxes (most, but not all, of which are capped at modest levels of income).³⁴³ Thus, in most cases, aggregate taxation of the corporation and the entrepreneur will be lowered by failing to pay out substantial amounts of profits as salary.³⁴⁴

[T]he tax law has tried to limit the available opportunities to shift reported earnings into the corporate tax base. Opportunities for this kind of income shifting, however, do remain. At one extreme, consider the situation of a small, family-owned corporation. The family has virtually full flexibility to shift income between the personal corporate tax bases. Although it can still pay itself wages, it can easily retain profits within the firm instead. Retaining earnings implies extra corporate taxable income and less personal taxable income in the short term, though it probably implies larger realized capital gains when and if the firm is sold.³⁴⁵

Even if the closely held corporation is taxed on its earnings, the ridiculously low graduated bottom corporate rates in comparison with the entrepreneur's usually high bracket on any additional income coupled with the opportunity to invest the business' net profits after minimal or no taxation in capital or section 1231 assets (e.g., plant and land) erode most of the credibility to the frequently raised argument that, absent the *General Utilities* exemption for long-term capital and section 1231 assets, the entrepreneur who incorporated her or his farm or corner drugstore would be worse off than if he or she had operated as a sole proprietor or in a partnership.

John W. Lee, *Capital Gains Exception to the House's General Utilities Repeal: Further Indigestions from Overly Processed Corn Products*, 30 TAX NOTES 1375, 1377 n.39 (1986).

³⁴⁰ See Lee, *supra* note 186, at 910.

³⁴¹ See I.R.C. § 162(a)(1) (2004).

³⁴² See I.R.C. § 11(a) (2004).

³⁴³ See *infra* note 349.

³⁴⁴ See Lee, *supra* note 186, at 888.

³⁴⁵ Roger H. Gordon & Joel Slemrod, *Are "Real" Responses to Taxes Simply Income Shifting Between Corporate and Personal Tax Bases?* in DOES ATLAS SHRUG?: THE ECONOMIC CONSEQUENCES OF TAXING THE RICH 240, 243 (Joel Slemrod ed., 2000).

If a corporation with untaxed profits is sold to an individual, then, economically, the price should reflect the tax liability of the undistributed dividends, a form of implicit tax. That tax will be lower than it would have been before Congress lowered the maximum tax rate on most dividends to fifteen percent. I.R.C. § 1(h)(1) (2004) (taxing adjusted net capital gain at rates of five percent and fifteen percent), I.R.C. § 1(h)(11) (defining "net capital gain" to include

The entrepreneur also can avoid the double taxation for which the corporate form is notorious by failing to pay dividends,³⁴⁶ though that double taxation is mitigated by the recent enactment of a 15% top rate on most dividends.³⁴⁷ Professor Lee has calculated that:

the splitting of business income between (1) compensation to shareholder-employees taxed at higher individual income graduated rates and (2) profits left in the private C Corporation taxed at the lowest graduated corporate rates amounted, for 1993, to an annual tax expenditure or subsidy of \$3 to \$4 billion as to . . . 750,000 profitable small income, mostly private C Corporations.³⁴⁸

A pass-through entity, such as a partnership or limited liability corporation, will not accomplish a lowering of the federal income tax liability on profits. The idea is to leave most or all of the profits in the corporation, subjecting them to only to corporate-level taxation. A growing corporation can justify retaining earnings, thereby avoiding not only the tax on dividends but also the imposition of the accumulated earnings tax,³⁴⁹ a corporate-level penalty tax. This technique also minimizes self-employment taxes because self-employment taxes are imposed on salary, not on retained earnings or dividends.³⁵⁰

“qualified dividend income”); *see supra* text accompanying notes 22–23. If the corporation is sold to another corporation, there should be no implicit tax because a corporate parent effectively benefits from the exclusion of dividends through the dividends-received deduction. *See* I.R.C. §§ 243(a)(3), (b) (2004) (allowing a one hundred percent deduction for dividends received from a corporation in which it owns at least eighty percent of the shares, by vote and by value).

As Professor Lee points out, the entrepreneur completely avoids double taxation if he dies holding the stock. *See Lee, supra* note 186, at 887–88; I.R.C. § 1014 (2004) (scheduled to terminate at the end of 2009, I.R.C. § 1014(f), and reappear in 2011, when the Economic Growth and Tax Relief Reconciliation Act of 2001 sunsets, *see* Pub. L. 107-16, §§ 901(a)(1), (b), 115 Stat. 38, 150 (2001)). Of course, holding on to the stock until death requires bearing the costs of illiquidity.

³⁴⁶ *See Lee, supra* note 186, at 887–88.

³⁴⁷ *See* I.R.C. § 1(h)(1)(B) (five percent rate—declining to zero percent in 2008—applies to the amount of “adjusted net capital gain” that would otherwise be taxed at rates below twenty-five percent), I.R.C. § 1(h)(1)(C) (fifteen percent rate applies to remaining adjusted net capital gain), I.R.C. § 1(h)(3) (defining adjusted net capital gain to include qualified dividend income). These provisions are scheduled to sunset at the end of 2008. *See* Jobs and Growth Tax Relief Reconciliation Act of 2003, 108 Pub. L. 27, §§ 301–303, 117 Stat. 752, 764 (2003).

³⁴⁸ *Lee, supra* note 186, at 888.

³⁴⁹ The accumulated earnings tax only taxes accumulations in excess of reasonable business needs. *See* I.R.C. §§ 531–537 (2004).

³⁵⁰ Employment taxes aggregate 15.3%. *See* I.R.C. § 1401(a) (2004) (defining the general self-employment tax as 12.4%), I.R.C. § 1401(b) (defining the hospital insurance tax for self-employed individuals as 2.9%). The self-employed bear the 15.3% directly, *see* I.R.C. § 1401, while employers and employees each bear half of the 15.3%, *see* I.R.C. §§ 3101, 3111 (2004).

The federal income tax cost of incorporating a closely held business is generally small. The Code facilitates the formation of closely held businesses by minimizing the tax burden of contributions of assets to corporations.³⁵¹ Under Code section 351, transferors of property who obtain eighty percent “control” of a corporation’s stock (by vote and by value) do not recognize realized gain except to the extent of their divestment (the receipt of property other than stock).³⁵²

The incorporation also can convert much of the entrepreneur’s profits from ordinary income to capital gain. That is, the entrepreneur will now own stock, a capital asset. An eventual sale of an ownership interest in the business will therefore likely be taxed at preferential capital gains rates.³⁵³ In addition, with respect to the gain on stock in a small business—already likely subject to the capital gains preference—Code section 1202 allows non-corporate taxpayers to exclude half of the gain on qualified small business stock³⁵⁴ held for more than

The bulk of the employment tax is capped based on a wage base of \$87,000 for 2003, but the 2.9% hospital insurance excise tax (generally referred to as the Medicare tax) is not capped. *See* I.R.C. §§ 3101(b), 3111(b), 3121 (providing cap for taxes imposed by sections 3101(a) and 3111(a)); Publication 15, *Employer’s Tax Guide (Including 2003 Wage Withholding and Advance Earned Income Credit Payment Tables)* (revised Jan. 2003) (2003 wage base), available at 2002 TNT 245–50. Because of the lack of a ceiling on the Medicare tax:

tax planners have spent considerable time and effort over the last five years developing strategies for recasting income that might be considered self-employment earnings as passive types of income that are excluded from the net earnings from self-employment base, and for restructuring the forms of organizations so that earnings may be distributed as dividends rather than compensation for services.

Dilley, *supra* note 16, at 81–82.

³⁵¹ Contributions to partnerships in exchange for partnership interests also are tax-free. I.R.C. § 721(a) (2004).

³⁵² I.R.C. §§ 351(a), (b) (2004).

³⁵³ *See* I.R.C. § 1(h) (2004). Section 1202 gain is taxed at a 28% rate. *See* I.R.C. §§ 1(h)(1)(E), (4)(A)(ii).

³⁵⁴ To constitute “qualified small business stock,” the stock must have been acquired by the taxpayer at its original issue, I.R.C. § 1202(c)(1) (2004), the corporation must conduct an active business or qualify as a specialized small business investment company, I.R.C. §§ 1202(c)(2), (e), and the aggregate gross receipts of the corporation immediately after the issuance of the stock cannot exceed \$50,000,000, I.R.C. § 1202(d), among other requirements. A “small business investment company” is an organization that provides “a source of equity capital for incorporated and unincorporated small-business concerns, in such manner and under such terms as the small business investment company may fix in accordance with the regulations of the Administration.” 15 U.S.C. § 684(a) (2004).

five years.³⁵⁵ This will result in a net tax rate on the profit of only fourteen percent.³⁵⁶

This provision applies to the sale of the business' stock and may thereby seem to encourage divestment. However, it should, in fact, encourage an entrepreneur to grow a business once it is incorporated, for three reasons. First, whether the corporation qualifies as a "small" business is determined by initial capital—information that is available at the time of the incorporation. Thus, incorporators can be fairly confident *ex ante* that these provisions will apply (and can plan so as to make them applicable).³⁵⁷ Measuring smallness on initial incorporation does not deter efforts aimed at corporate growth. Second, the fifty-percent exclusion on the gain side requires a five-year holding period, which deters quick divestment; this stands in contrast to the mere year and a day minimum holding period of the general capital gains preference.³⁵⁸ Third, because the exclusion is a percent of appreciation, every additional dollar of growth provides an additional potential tax benefit.³⁵⁹ The taxpayer therefore has an additional incentive to continue to grow the enterprise rather than to divest relatively early and invest the proceeds elsewhere.

One study found that entrepreneurship "is heavily concentrated in the top one percent of the population" and that if individual income tax rates were cut by five percentage points across the board, entrepreneurial activity would drop thirty percent overall, but most at the top.³⁶⁰ That study also found that if the lowest corporate tax rate were cut from fifteen percent to ten percent, "entrepreneurial activity [would] more than double[] . . . in each quantile, and in aggregate."³⁶¹ Part of the effect of such a reduction would be to allow taxpayers other than those in the highest brackets to benefit from income-shifting, so it is not

³⁵⁵ See I.R.C. § 1202. This provision applies only to C corporations. See I.R.C. §§ 1202(c)(1), (2)(A).

³⁵⁶ In addition, a noncorporate taxpayer can "roll over" the gain on qualified small business stock held for more than 6 months into another qualified small business by purchasing stock in the new qualified small business within 60 days of selling the old business and making an election. See I.R.C. § 1045 (2004).

Of course, a 14% rate no longer looks as favorable now that the general capital gains rate has decreased from 20% to 15%. Compare I.R.C. § 1(h)(1) (2002) with I.R.C. § 1(h)(1) (2003). However, it remains below the 15% rate a high-income individual experiences with respect to both capital gains and dividends.

³⁵⁷ Compliance with the active business requirements of section 1202 and 1244 cannot be determined *ex ante* but presumably can be controlled by the stockholders.

³⁵⁸ See I.R.C. § 1222 (2004).

³⁵⁹ Of course, with a low capital gains rate, that tax benefit is relatively small. See *supra* note 356.

³⁶⁰ Cullen & Gordon, *supra* note 15, at 31.

³⁶¹ *Id.* The quantiles are based on earnings ability and are grouped as follows: 0–70, 70–80, 80–90, 90–95, 95–99, 99–100. *Id.* at 50 tbl.3a.

surprising that this change would increase entrepreneurship even in the lower quantiles.

Of course, incorporation is itself a risk. What if the business ceases to be successful after it is incorporated?³⁶² Even then, the entrepreneur can deflect a significant portion of that risk to the federal government. First, the entrepreneur can make an election under Subchapter S so that the losses pass through.³⁶³ The corporation's losses will then generally be deductible from the other income of the entrepreneur (or his spouse),³⁶⁴ subject to any applicable restrictions.³⁶⁵ In 1996, approximately twenty-eight percent of S elections were made by C corporations.³⁶⁶

Second, if the entrepreneur chooses to exit the business by selling it, or if the stock becomes totally worthless,³⁶⁷ the usual restrictions on the deductibility of capital losses will not apply to the first \$50,000 of loss (\$100,000 in the case of married taxpayers filing jointly) per year with respect to the corporation's stock.³⁶⁸ Thus, the usual basketing of capital losses is eliminated for those amounts. This provision, unlike the gain-side provision, applies to S corporations as well as C corporations,³⁶⁹ so it can be used in conjunction with the Subchapter

³⁶² A corporation cannot simply be terminated without treating it as a taxable liquidation. See I.R.C. §§ 331, 336 (2004) (defining taxable liquidations). Of course, the business might not be liquidated but might be sold or acquired in a non-taxable merger or acquisition. See I.R.C. § 368 (2004) (defining reorganizations).

³⁶³ See I.R.C. §§ 1361, 1363(a) (2004). An empirical study of entrepreneurs' saving and investment decisions noted that, in their sample, forty-nine percent of the businesses were sole proprietorships, twenty-four percent were partnerships, fourteen percent were C corporations and eleven percent were S corporations. See Gentry & Hubbard, *supra* note 12, at 6.

³⁶⁴ The deduction of losses is limited to the shareholder's basis in stock and debt of the S corporation. I.R.C. §§ 1366(d)(1)(A), (B) (2004).

³⁶⁵ See I.R.C. §§ 1363(a), (b), 1366. The character of items passes through I.R.C. § 1366(b), so, for example, capital losses of the S corporation will be subject to the limitation on capital losses at the shareholder level. See I.R.C. § 1211(b) (2004).

³⁶⁶ Susan Wittman & Robert Grant, S Corporation Returns, 1996, 18 SOI BULL., No. 4, at 40, 40 (1999), *cited in* Lee, *supra* note 186, at 925 n.219. Professor Lee reports:

[Sixty-eight percent] of C to S conversions for 1987 reported positive income (almost two-thirds of the remaining C to S conversions reporting a loss in 1986 also reported a loss in 1987). This indicates that perhaps a third of C to S conversions are made in order to pass through operating losses otherwise trapped in a C Corporation.

Lee, *supra* note 186, at 924 (citing Susan M. Wittman & Amy Gill, S Corporation Elections After the Tax Reform Act of 1986, 17 SOI BULL., No. 4, at 82, 83 (1998)).

³⁶⁷ See I.R.C. §§ 165(g)(1), (2) (2004); Treas. Reg. § 1.1244(a)-1(a).

³⁶⁸ See I.R.C. § 1244 (2004).

³⁶⁹ See *id.*; Walter D. Schwidetzky, *Is it Time to Give the S Corporation a Proper Burial?*, 15 VA. TAX REV. 591, 609 n.74 (1996).

S election.³⁷⁰ Notice also that the value of the deduction will also reflect the entrepreneur's top marginal rate; it is not matched to the 14% rate applied to gain on the sale of a successful small business corporation.³⁷¹

Thus, not only does the federal income tax operate to deflect some of the risk of start-up business to the federal government, it also protects the successful (and well-advised) entrepreneur from harsh taxation of profits. The entrepreneur will not experience the higher taxation generally applied to labor, but instead will benefit from the lower taxation often accorded capital.³⁷²

In addition, if the entrepreneur dies holding a profitable business, the estate will benefit from more favorable treatment under the estate tax than if the estate's assets consisted of passive investments, presumably because of concerns that heirs might be forced to sell a family business in order to pay estate taxes. Estates with land used in a business can value it based on its business use³⁷³ even if the land would be worth more if put to another use, reducing the land's value for estate tax purposes by up to \$840,000 for 2003,³⁷⁴ if the land passes to a family member who continues to use the land in a trade or business.³⁷⁵ In addition, if the

³⁷⁰ However, increases in basis resulting from S corporation income will not increase basis for purposes of section 1244. See Treas. Reg. § 1.1244(d)-2(a); John R. Dorocak, *I.R.C. Section 1244: Current Issues—Advances to Failing Corporations, Guarantees of Third-Party Debt, Limited Liability Companies, and S Corporations*, 14 VA. TAX REV. 329 (1994).

³⁷¹ See *supra* note 355 and accompanying text.

³⁷² See *supra* note 1 and accompanying text. Scholars have sometimes argued that capital effectively is not taxed. See, e.g., Shaviro, *supra* note 2, at 652–53 (arguing that income tax on capital often approaches zero, or is at least “limited, relative to the tax planning, compliance and administration costs.”). However, a recent empirical study found that capital does bear tax. See Roger Gordon et al., *Do We Now Collect Any Revenue From Taxing Capital Income?* Nat'l Bureau of Econ. Research, Working Paper No. 9477 (Feb. 2003), available at <http://www.nber.org/papers/w9477>. Specifically, that study found that if new investment were allowed to be “expensed” immediately, that would cost the government approximately \$90.1 billion in federal income tax revenue from individuals for 1995. *Id.* at 6–12.

³⁷³ I.R.C. § 2032A (2004).

³⁷⁴ See Rev. Proc. 2002-70, 2002-2 C.B. 845, 849 § 3.23.

³⁷⁵ See I.R.C. §§ 2032A(b)(2), (c), (e)(1). Additional estate tax is imposed if, “within 10 years after the decedent's death and before the death of the qualified heir,” the heir ceases to use the land for a business use or disposes of the land. I.R.C. § 2032A(c)(1).

Until recently, the Code also allowed an elective estate tax deduction of up to \$675,000 for “qualified family-owned business interests,” I.R.C. § 2057(a) (2004), so long as the heir materially participated in the business after the decedent's death, see I.R.C. § 2057(f). Section 2057(f) provided for additional tax if the material participation requirement was not met for a period of 10 years following the decedent's death or until the heir's death, whichever came first. If the full deduction was claimed, the unified credit against the estate tax was reduced to \$625,000. See I.R.C. § 2057(a)(3)(A). The unified credit amounted to \$1 million for 2003. I.R.C. § 2010(c) (2004). If a smaller deduction was claimed, the \$625,000 was increased by the

value of the decedent's interest in a closely held business exceeds a thirty-five percent threshold, the estate can defer the payment of the portion of the estate tax liabilities attributable to the business³⁷⁶ for up to five years,³⁷⁷ paying only interest, annually,³⁷⁸ at a rate of two percent.³⁷⁹ After that, the estate can spread the payment of that portion of the tax over five more years.³⁸⁰

V. CONCLUSION

Although commentators sometimes discuss the federal income tax as if all profit-seeking activities are treated similarly, in fact, individuals' expenses and losses face limitations on deductibility that business expenses and losses do not face. Part II of this Article showed that, although each of the restrictions may be justified individually, together they form a pattern that systematically limits individuals' investment-related deductions.

These restrictions on deductions violate the "full loss offsets" assumption of the Domar-Musgrave model, discussed in Part III, under which an investor can increase investment in risky assets without actually increasing his risk (after taxes). As Part III of the Article showed, not only is the "full loss offsets" assumption critical, but, in the presence of a progressive rate system rather than the proportional (flat) tax system assumed by Domar and Musgrave, the critical rate is the marginal rate applied to deductions, not income.

Part IV showed that the distinction in federal tax law between individuals' business and investment activities is not the presence or absence of capital but rather the role of labor as a material income-producing factor. By requiring labor for an activity to constitute a "trade or business," the federal income tax system rewards individuals' industrious activity with significantly greater loss offsets—and therefore decreased risk—than is available for their "passive" earning activities.

difference up to the otherwise allowable amount. *See* I.R.C. § 2057(a)(3). The deduction terminated on December 31, 2003. *See* I.R.C. § 2057(j).

Richard Schmalbeck reports that "in 1997, fewer than 3,200 estates with gross assets of less than \$5 million, who had any assets categorized as 'closely-held stock,' had any net estate tax liability at all." Richard Schmalbeck, *Does the Death Tax Deserve the Death Penalty? An Overview of the Major Arguments for Repeal of Federal Wealth-Transfer Taxes*, 48 CLEV. ST. L. REV. 749, 768 (2000) (citing Barry Johnson & Jacob Mikow, *Federal Estate Tax Returns, 1995–1997*, 19 STAT. OF INCOME BULL. 102 (1999)).

³⁷⁶ *See* I.R.C. § 6166(a)(2) (2004).

³⁷⁷ *See* I.R.C. § 6166(a)(3).

³⁷⁸ I.R.C. § 6166(f)(1).

³⁷⁹ I.R.C. § 6601(j) (2004).

³⁸⁰ *See* I.R.C. §§ 6166(a)(1), (3).

The net effect of this systematic distinction in the Code is a subsidy for entrepreneurship for high-income individuals with capital and income from labor (which may be the spouse's income) or income that varies from year to year. The subsidy is most valuable for high-income individuals, in part because they are the ones who will likely have income to invest after taking full advantage of other tax-favored activities. High-income individuals almost obtain the largest benefit from deducting expenses and losses, because of the progressive nature of the federal income tax system. Similarly, high-income individuals obtain the greatest benefit from income splitting with a corporation if a start-up business becomes successful.

The tax subsidy for entrepreneurship explored in this Article is likely primarily accidental, given how it results from a combination of provisions that are scattered throughout the Code and limit deductions from investment activities rather than addressing business activities directly. However, the existence of the subsidy is not particularly surprising.

Historians have noted that a "small-business ideology has been present throughout American history"³⁸¹ and politicians recently have proposed small business incentive packages in the name of America's "entrepreneurial spirit."³⁸²

Americans love small business. Despite the notoriously high rate of early failure, every year hundreds of thousands of undaunted Americans launch small businesses. The folklore of the independent entrepreneur being the backbone of American self-reliance and work ethic is a more persuasive argument for favorable tax incentives than any reality-based economic consideration.³⁸³

Identifying the components of the tax subsidy, many of which are not initially obvious, buried as they are in limitations on deductions, is useful

³⁸¹ Wilson, *supra* note 18, at 31 (quoting *SMALL BUSINESS IN AMERICAN LIFE 2* (Stuart W. Bruchey ed., 1980)).

³⁸² *Id.* (quoting J. Andrew Hoerner, *Small Business Incentives: An Eight-Fold Path to Who Knows Where?*, 49 *TAX NOTES* 133, 133 (1990)).

³⁸³ Wilson, *supra* note 18, at 31, 64 (footnotes omitted). Professor Michael Livingston makes a related point:

It is a commonplace that Americans are becoming more risk averse, losing some of the adventurous spirit that characterized their ancestors. Yet the idea, if not always the reality, of risk taking retains its hold on popular imagination. Tax incentives are an expression of this ambivalence: They encourage risk taking while at the same time cushioning the relevant risks. Tax subsidies thus perform an incentive function, supporting investment in risky activities, but also a communication function, expressing the polity's approval of risk taking and providing at least a modest reward to risk takers.

Livingston, *supra* note 13, at 183. He adds, "[a]sking government to make us daring has the faint whiff of decadence: We demand symbolic affirmation of what we fear we no longer are." *Id.* at 231.

because it highlights possible side effects of changes in federal income tax law. For example, the recently enacted Jobs and Growth Tax Relief Reconciliation Act of 2003³⁸⁴ made a number of changes in federal income tax rates applicable to individuals that may have the unintended consequence of lowering the incentive for entrepreneurship: it lowered individual tax rates, which lowers the advantage of deductions and it lowered the tax rate on dividends, which may spur passive investment. It also lowered the general rate applicable to adjusted net capital gain to fifteen percent from twenty percent.³⁸⁵ That change may be ambiguous in its effect because capital gains rates may apply to both investment and business activity. However, the change all but eliminated any differential with the fourteen percent rate applicable to gain on certain sales of small business corporations.³⁸⁶ Thus, it will be interesting to see if there are observable differences in entrepreneurship trends following the 2003 legislation.

³⁸⁴ 108 Pub. L. 27, 117 Stat. 752 (2003).

³⁸⁵ See 108 Pub. L. 27 § 301(a)(2)(A), 117 Stat. 752 (2003); compare I.R.C. § 1(h)(1)(C) (2003) with I.R.C. § 1(h)(1)(C) (2002).

³⁸⁶ See I.R.C. § 1202 (2004); see also *supra* note 355 and accompanying text.