

"(2) EARNED INCOME.—The term 'earned income' means the net earnings from self-employment (as defined in section 1402(a)), but such net earnings shall be determined—

"(A) only with respect to a trade or business in which personal services of the taxpayer are a material income-producing factor.

"(B) without regard to paragraphs (4) and (5) of section 1402(c),

"(C) in the case of any individual who is treated as an employee under sections 3121(d)(3) (A), (C), or (D), without regard to paragraph (2) of section 1402(c), and

"(D) without regard to items which are not included in gross income for purposes of this chapter, and the deductions properly allocable to or chargeable against such items.

For purposes of this paragraph, section 1402, as in effect for a taxable year ending on December 31, 1962, shall be treated as having been in effect for all taxable years ending before such date."

SEC. 3. The amendments made by this Act shall apply with respect to taxable years beginning after December 31, 1965.

I. SUMMARY

Your committee's bill provides for the repeal of two limitations on the deduction from gross income a self-employed individual may take with respect to contributions on his own behalf to a retirement plan. First, the bill repeals the provision which limits the *deduction* to 50 percent of the contribution. However, your committee has retained the provision restricting the *contribution* for self-employed persons to the lesser of 10 percent of earned income or \$2,500. Second, the bill also permits a self-employed individual to include in earned income all of his net profits when his income is earned from a business in which both the performance of personal services and capital are material income-producing factors. However, in such cases the personal services of the self-employed person involved must be material income-producing factors.

The provisions of H.R. 10 are to be effective for taxable years beginning after December 31, 1965.

II. BACKGROUND AND REASONS FOR THE BILL

Under present law, self-employed individuals may establish retirement plans and may deduct from their gross incomes contributions made to these plans. Employees with more than 3 years of service must be covered, and contributions on their behalf are fully deductible.

The self-employed individual may deduct from his gross income 50 percent of the contribution on his own behalf, but the contribution is limited to the smaller of 10 percent of his earned income or \$2,500. Accordingly, the maximum deduction allowed to a self-employed person with respect to his own contribution is \$1,250.

Earned income for this purpose is defined as the income received from the performance of personal services. When capital, as well as personal services, is a material factor in the production of the income, earned income may not exceed 30 percent of the net profits from the business (except that where an individual renders personal services on a substantially full-time basis, this 30-percent rule cannot reduce the net profits considered as earned income below \$2,500).

The Self-Employed Individuals Tax Retirement Act of 1962 was enacted in order to give self-employed individuals an opportunity to defer tax on a portion of their income set aside for retirement purposes