

II. REMOVAL OF LIMITATION ON COMPUTING EARNED INCOME

A. Description of amendment

This amendment would increase the amount which self-employed individuals in businesses involving both capital and services may contribute on their own behalf to qualified pension or profit-sharing plans. The 10-percent limitation on the amount a self-employed individual may contribute to a qualified pension or profit-sharing plan is applied against his "earned income." Section 401(c)(2) of the Internal Revenue Code presently defines the "earned income" of a self-employed individual for pension plan purposes to mean his net earnings from self-employment (as defined in section 1402(a)) to the extent that such net earnings constitute earned income (as defined in section 911(b)). The amendment would revise this definition of "earned income" to mean a self-employed individual's net earnings from self-employment without regard to what part of such net earnings constitutes earned income under section 911(b). The amendment would apply to taxable years beginning after December 31, 1965.

The amendment would primarily concern self-employed individuals who are engaged in a trade or business in which both personal services and capital are material income-producing factors. At present, section 911(b) provides that such a self-employed individual may not treat more than 30 percent of the net profits from his trade or business as "earned income." Under a special provision, the 30-percent limitation does not operate, however, to reduce a self-employed individual's earned income below \$2,500 for pension plan purposes. The amendment would have the effect of removing this 30-percent limitation with the result that a self-employed individual could treat the entire net profits from his trade or business as earned income for purposes of computing the amount he may contribute to a qualified pension or profit-sharing plan.

B. Treasury position

The Treasury Department is opposed to the amendment in this form.

Where both capital and personal services are material income-producing factors in a trade or business, it logically follows that a portion of the net profits from that trade or business represents a return on the individual's investment in the business. Historically, the primary purpose for the special tax provisions applying to pension and profit-sharing plans has been to permit individuals to defer tax on part of their wages or personal service income until after retirement. It would be inconsistent with this to permit self-employed individuals to contribute and take tax deductions with respect to amounts which represent a return on their investment rather than compensation for personal services. Moreover, such a provision would give self-employed people a decided tax advantage over corporate employees who cannot take their investment income into account under pension