***Van Kalker v. Commissioner, 76 T. C. 610 (1981)***

Capital is a material income-producing factor in a business when it is significantly used in generating income, such as through inventory or equipment, even if personal services are also crucial.

**Summary**

In Van Kalker v. Commissioner, the Tax Court ruled that capital was a material income-producing factor in the petitioner's ornamental iron business, affecting the application of the 50-percent maximum tax rate. John Van Kalker, operating as Van's Ornamental Iron Co. , argued that his $196,046 net profit from 1978 was solely personal service income, but the IRS contended capital was significant due to the use of inventory and equipment. The court agreed with the IRS, noting the substantial use of capital in purchasing materials and maintaining equipment, which materially contributed to the business's income, thus limiting the portion of income eligible for the lower tax rate to 30 percent.

**Facts**

John E. Van Kalker, Jr. , operated Van's Ornamental Iron Co. from a structure adjacent to his home, fabricating and installing custom iron railings, fences, gates, and arches. In 1978, his business employed six or seven people, used two metal cutters, four welders, handmade tools, and maintained a stock of iron rods and bars. Van Kalker reported a net profit of $196,046 for that year, claiming it as personal service income to qualify for the 50-percent maximum tax rate. The IRS, however, determined that capital was a material income-producing factor in his business, limiting the income subject to the maximum tax rate to 30 percent of the net profit.

**Procedural History**

The IRS issued a notice of deficiency to Van Kalker for $14,578 in 1978 Federal income tax, asserting that capital was a material factor in his business. Van Kalker petitioned the Tax Court, which reviewed the case and ultimately sided with the IRS, holding that capital was material in the production of his business income.

**Issue(s)**

1. Whether capital was a material income-producing factor in Van Kalker's ornamental iron business under section 1348 of the Internal Revenue Code of 1954?

**Holding**

1. Yes, because the use of capital in purchasing raw materials and maintaining equipment was significant to the production of the business's income, as reflected by the substantial investment in inventory and equipment used in the fabrication process.

 

## Court's Reasoning

The court applied section 1348 and its regulations to determine whether capital was a material income-producing factor. It noted that capital is material if a substantial portion of gross income is attributable to its use, such as through inventory or equipment. The court found that Van Kalker's business involved significant capital use in purchasing raw materials ($113,010 in 1978) and maintaining equipment ($46,721 adjusted basis). The court emphasized that it is the use of capital, not merely its possession, that is crucial, citing Fuller & Smith v. Routzahn and Lewis v. Commissioner. It distinguished this case from others where capital was not material, such as Bruno v. Commissioner, where the business was primarily service-based. The court also addressed Van Kalker's argument that he could have operated without maintaining an inventory, but found this irrelevant since his income was derived from selling manufactured products rather than services. The court concluded that even though Van Kalker's personal services were vital, capital was also a material factor in generating income, thus limiting the portion of income eligible for the 50-percent maximum tax rate to 30 percent.

## Practical Implications

This decision clarifies that businesses relying on capital to produce income, even if personal services are also significant, must consider capital as a material income-producing factor under section 1348. It affects how self-employed individuals and small business owners categorize their income for tax purposes, particularly when determining eligibility for lower tax rates. The ruling underscores the importance of evaluating the actual use of capital in business operations, not just its presence. Subsequent legislative changes removed the 30-percent limitation post-1978, but this case remains relevant for understanding the interplay between capital and personal services in income generation. Legal practitioners should advise clients on the materiality of capital in their business models, especially in manufacturing or product-based businesses, to ensure proper tax treatment of their income.