

This PDF is a selection from an out-of-print volume from the National Bureau of Economic Research

Volume Title: Business and Professional Income Under the Personal Income Tax

Volume Author/Editor: C. Harry Kahn

Volume Publisher: Princeton University Press

Volume ISBN: 0-691-04107-5

Volume URL: <http://www.nber.org/books/kahn64-1>

Publication Date: 1964

Chapter Title: Introductory pages to "Business and Professional Income Under the Personal Income Tax"

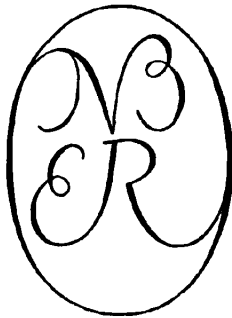
Chapter Author: C. Harry Kahn

Chapter URL: <http://www.nber.org/chapters/c0757>

Chapter pages in book: (p. -15 - -1)

Business
and Professional Income
Under the
Personal Income Tax

C. HARRY KAHN



A STUDY BY THE
NATIONAL BUREAU OF ECONOMIC RESEARCH, NEW YORK

PUBLISHED BY
PRINCETON UNIVERSITY PRESS
1964

Copyright © 1964 by National Bureau of Economic Research
All Rights Reserved
L.C. Card 62-21104

Printed in the United States of America

**BUSINESS AND PROFESSIONAL INCOME
UNDER THE PERSONAL INCOME TAX**

NATIONAL BUREAU OF ECONOMIC RESEARCH

Fiscal Studies

1. *Fiscal Planning for Total War*
William Leonard Crum, John F. Fennelly, and Lawrence H. Seltzer
2. *Taxable and Business Income*
Dan Throop Smith and J. Keith Butters
3. *The Nature and Tax Treatment of Capital Gains and Losses*
Lawrence H. Seltzer
4. *Federal Grants and the Business Cycle*
James A. Maxwell
5. *The Income-Tax Burden on Stockholders*
Daniel M. Holland
6. *Personal Deductions in the Federal Income Tax*
C. Harry Kahn
7. *Dividends Under the Income Tax*
Daniel M. Holland
8. *Business and Professional Income Under the
Personal Income Tax*
C. Harry Kahn

To My Parents

NATIONAL BUREAU OF ECONOMIC RESEARCH
1964

OFFICERS

Albert J. Hettinger, Jr., *Chairman*
Arthur F. Burns, *President*
Frank W. Fetter, *Vice-President*
Donald B. Woodward, *Treasurer*
Solomon Fabricant, *Director of Research*
Geoffrey H. Moore, *Associate Director of Research*
Hal B. Lary, *Associate Director of Research*
William J. Carson, *Executive Director*

DIRECTORS AT LARGE

Robert B. Anderson, *New York City*
Wallace J. Campbell, *Nationwide Insurance*
Erwin D. Canham, *Christian Science Monitor*
Solomon Fabricant, *New York University*
Marion B. Folsom, *Eastman Kodak Company*
Crawford H. Greenewalt, *E. I. du Pont de Nemours & Company*
Gabriel Hauge, *Manufacturers Hanover Trust Company*
A. J. Hayes, *International Association of Machinists*
Albert J. Hettinger, Jr., *Lazard Frères and Company*
Nicholas Kelley, *Kelley Drye Newhall Maginnes & Warren*
H. W. Laidler, *League for Industrial Democracy*
Charles G. Mortimer, *General Foods Corporation*
George B. Roberts, *Larchmont, New York*
Harry Scherman, *Book-of-the-Month Club*
Boris Shishkin, *American Federation of Labor and Congress of Industrial Organizations*
George Soule, *South Kent, Connecticut*
Joseph H. Willits, *Langhorne, Pennsylvania*
Donald B. Woodward, *A. W. Jones and Company*

DIRECTORS BY UNIVERSITY APPOINTMENT

V. W. Bladen, *Toronto*
Francis M. Boddy, *Minnesota*
Arthur F. Burns, *Columbia*
Lester V. Chandler, *Princeton*
Melvin G. de Chazeau, *Cornell*
Frank W. Fetter, *Northwestern*
R. A. Gordon, *California*
Harold M. Groves, *Wisconsin*
Gottfried Haberler, *Harvard*
Maurice W. Lee, *North Carolina*
Lloyd G. Reynolds, *Yale*
Paul A. Samuelson, *Massachusetts Institute of Technology*
Theodore W. Schultz, *Chicago*
Willis J. Winn, *Pennsylvania*

DIRECTORS BY APPOINTMENT OF OTHER ORGANIZATIONS

Percival F. Brundage, *American Institute of Certified Public Accountants*
Nathaniel Goldfinger, *American Federation of Labor and Congress of Industrial Organizations*
Harold G. Halcrow, *American Farm Economic Association*
Murray Shields, *American Management Association*
Willard L. Thorp, *American Economic Association*
W. Allen Wallis, *American Statistical Association*
Harold F. Williamson, *Economic History Association*
Theodore O. Yntema, *Committee for Economic Development*

DIRECTORS EMERITI

Shepard Morgan, *Norfolk, Connecticut*
N. I. Stone, *New York City*
Jacob Viner, *Princeton, New Jersey*

RESEARCH STAFF

Moses Abramovitz	Solomon Fabricant	C. Harry Kahn	G. Warren Nutter
Gary S. Becker	Albert Fishlow	Irving B. Kravis	Richard T. Selden
William H. Brown, Jr.	Milton Friedman	Hal B. Lary	Lawrence H. Seltzer
Gerhard Bry	Victor R. Fuchs	Robert E. Lipsey	Robert P. Shay
Arthur F. Burns	H. G. Georgiadis	Ruth P. Mack	George J. Stigler
Phillip Cagan	Raymond W. Goldsmith	Jacob Mincer	Norman B. Ture
Joseph W. Conard	Challis A. Hall, Jr.	Ilse Mintz	Herbert B. Woolley
Frank G. Dickinson	Daniel M. Holland	Geoffrey H. Moore	Victor Zarnowitz
James S. Earley	Thor Hultgren	Roger F. Murray	
Richard A. Easterlin	F. Thomas Juster	Ralph L. Nelson	

RELATION OF THE DIRECTORS TO THE WORK AND PUBLICATIONS
OF THE NATIONAL BUREAU OF ECONOMIC RESEARCH

1. The object of the National Bureau of Economic Research is to ascertain and to present to the public important economic facts and their interpretation in a scientific and impartial manner. The Board of Directors is charged with the responsibility of ensuring that the work of the National Bureau is carried on in strict conformity with this object.

2. To this end the Board of Directors shall appoint one or more Directors of Research.

3. The Director or Directors of Research shall submit to the members of the Board, or to its Executive Committee, for their formal adoption, all specific proposals concerning researches to be instituted.

4. No report shall be published until the Director or Directors of Research shall have submitted to the Board a summary drawing attention to the character of the data and their utilization in the report, the nature and treatment of the problems involved, the main conclusions, and such other information as in their opinion would serve to determine the suitability of the report for publication in accordance with the principles of the National Bureau.

5. A copy of any manuscript proposed for publication shall also be submitted to each member of the Board. For each manuscript to be so submitted a special committee shall be appointed by the President, or at his designation by the Executive Director, consisting of three Directors selected as nearly as may be one from each general division of the Board. The names of the special manuscript committee shall be stated to each Director when the summary and report described in paragraph (4) are sent to him. It shall be the duty of each member of the committee to read the manuscript. If each member of the special committee signifies his approval within thirty days, the manuscript may be published. If each member of the special committee has not signified his approval within thirty days of the transmittal of the report and manuscript, the Director of Research shall then notify each member of the Board, requesting approval or disapproval of publication, and thirty additional days shall be granted for this purpose. The manuscript shall then not be published unless at least a majority of the entire Board and a two-thirds majority of those members of the Board who shall have voted on the proposal within the time fixed for the receipt of votes on the publication proposed shall have approved.

6. No manuscript may be published, though approved by each member of the special committee, until forty-five days have elapsed from the transmittal of the summary and report. The interval is allowed for the receipt of any memorandum of dissent or reservation, together with a brief statement of his reasons, that any member may wish to express; and such memorandum of dissent or reservation shall be published with the manuscript if he so desires. Publication does not, however, imply that each member of the Board has read the manuscript, or that either members of the Board in general, or of the special committee, have passed upon its validity in every detail.

7. A copy of this resolution shall, unless otherwise determined by the Board, be printed in each copy of every National Bureau book.

(Resolution adopted October 25, 1926, as revised February 6, 1933 and February 24, 1941)

CONTENTS

ACKNOWLEDGMENTS	xvii
FOREWORD by Solomon Fabricant	xix
1. INTRODUCTION AND SUMMARY	3
Purpose of the Study	3
Profit and Loss Concept in Tax Statistics	4
Nature and Limitations of the Data	6
Summary of Findings	7
2. SOURCES AND COVERAGE OF BUSINESS AND PROFESSIONAL INCOME ON TAX RETURNS	15
Sources of Sole Proprietor and Partnership Income	15
Relation to Total Income	17
Coverage on Tax Returns	25
Effect on Coverage of Income Below Filing Requirement	38
Comparisons with Other Studies	41
Coverage by Size of Income Reported	45
3. SIZE AND PATTERN OF INCOME ON RETURNS WITH PROFIT OR LOSS FROM BUSINESS AND PROFESSIONS	51
Distribution by Size of Profit or Loss	52
Relation of Income from Business and Profession to Total Income of Proprietors	53
Conversion of Unincorporated Enterprise Profits into Other Income	64
Effect on Business Organization of Tax Treatment of Pension Plan Contributions	77
Pattern of Income on Returns with Profit or Loss from Business or Profession	79
4. THE TREATMENT OF LOSSES	84
The Extent of Loss Offset	85
Provisions for Loss Carryover Deductions	90
The Conceptual Relation Between Loss Carryover Deductions and Net Losses on Returns with Negative Income	95
5. TAX LIABILITY ON UNINCORPORATED BUSINESS AND PROFESSIONS	97
Effective Tax Rate on Business and Professional Income	98
Marginal Tax Rate by Sole Proprietor and Partnership Profit and Loss	120
Significance of Annual Mean Tax Rates for Aggregate Net Profits and Losses	124

CONTENTS

APPENDIXES

A. Tabulation of Sole Proprietor and Partnership Income by Size of Income and Type of Industry: Explanation of Difference	131
B. Derivation of the Estimates for Farm and Nonfarm Unincorporated Enterprise Income	134
C. Derivation of Estimates of Total Wages and Salaries and AGI	149
D. Estimates Based on 1948 ACP Data	153
E. Patterns of Income on Returns Which Have Unincorporated Enterprise Income as Well as Income from Wages, Interest, Dividends, or Rents and Royalties, 1955 and 1959	155
F. Derivation of Tables 43 Through 46	160
G. Amounts and Frequencies of Reported Net Profits and Net Losses; Estimated Tax Liability Attributable to, and Estimated AGI on Returns with, Net Profit and Net Loss, by Sole Proprietors and Partners, Selected Years, 1939-60	166
H. Computation of Mean Effective and Marginal Tax Rates	179
I. Note on Estimate of Net Operating Loss Deduction	182
INDEX	187

TABLES

1. Adjusted Gross Income and Its Components as Reported on Tax Returns, 1960	15
2. Industrial Distribution of AGI from Unincorporated Business and Professions Reported on Tax Returns, 1960	16
3. Unincorporated Business and Professional Income as a Component of Total Personal Income and Adjusted Gross Income, 1929-60	18
4. Unincorporated Business and Professions, Wages and Salaries, and Property as Sources of Income Reported on All Returns, 1918-60	20
5. Total Number of Tax Returns Related to Number with Sole Proprietor and Partnership Income, 1937-60	24
6. Business and Professional Income Reported on Tax Returns Related to Estimated Total, 1929-60	27
7. Total Wages and Salaries, Dividends, and Interest Receipts Reported on Tax Returns Compared with Estimated Total, 1936-60	29
8. Income from Unincorporated Enterprise Reported on Tax Returns as Percentage of Estimated Total, by Farm and Nonfarm, 1939-60	30
9. Average Farm Income from Farm Enterprise as Reported on Tax Returns and as Estimated, 1939-60	33
10. Number of Farm Businesses Accounted for on Individual Tax Returns, 1939-60	34
11. Income from Wages and Salaries and Nonfarm Business and Professions: Average Amount Per Recipient and Percentage Reported on Tax Returns, 1939-60	37
12. Number of Persons with Business and Professional Income Less Than \$500, Less Than \$1000, and Total: Tax-Return and Census Data, 1954, 1956, and 1960	40
13. Estimated Increase in Gross Receipts and in Net Profit Less Loss After Audit of 1949 Tax Returns for Sole Proprietors, by Farm and Nonfarm Income	42
14. Number of Sole Proprietor Returns with Tax Error, by Income Groups, 1948	46
15. Tax Change Disclosable by Audit on Returns of Sole Proprietors, by Income Groups, 1948	47
16. Estimated Increase in Disposable AGI Due to Underreporting on Returns of Sole Proprietors with Tax Error, by Income Groups, 1948	48
17. Cumulative Percentage Distribution of Net Profits and Net Losses Reported by Sole Proprietors and Partners, by Size of Net Profit and Loss, 1960	51
18. Distribution of Business and Professional Income and AGI of Proprietors, by Income Groups, 1960	54

TABLES

19. Business and Professional Net Income and AGI Reported on Returns with Business and Professional Income or Loss, 1939-60	55
20. Sole Proprietorship Net Income and Estimate of AGI Reported on Returns of Sole Proprietors; by Income Groups, Selected Years, 1939-60	56
21. Partnership Net Income and Estimate of AGI Reported on Returns of Partners, by Income Groups, Selected Years, 1939-60	58
22. Sole Proprietorship Income and Estimated AGI, by Returns with Net Profit and Net Loss and by Income Groups, 1945 and 1960	61
23. Partnership Income and Estimated AGI, by Returns with Net Profit and Net Loss and by Income Groups, 1945 and 1960	62
24. Total Reported Net Profit and Net Loss from Sole Proprietorship as Percentage of Estimated AGI on Returns of Sole Proprietors, Selected Years, 1939-60	63
25. Total Reported Net Profit and Net Loss from Partnership as Percentage of Estimated AGI on Returns of Partners, Selected Years, 1945-60	64
26. Number of Returns Reporting Net Profit or Net Loss from Sole Proprietorship and Partnership, by Net Profit and Net Loss and by Income Groups, 1955 and 1960	65
27. Business and Professional Net Profits and Losses and Realized Net Gains and Losses from Sale of Capital Assets Reported on All Returns, by Income Groups, 1960	66
28. Number of Corporations and Unincorporated Enterprises Electing Optional Tax Treatment as Percentage of Total Number, 1957-60	69
29. Number and Net Income of Corporations Electing to Be Taxed as Partnerships, by Net Profit and Loss, 1958-60	70
30. Net Profit, Net Loss, and Depreciation of Real Estate Operators and Lessors Reporting as Sole Proprietors and Partnerships, 1958-60	71
31. Mining Net Profit and Loss, Depreciation, and Depletion, Reported for Sole Proprietors, Partnerships, and Corporations, 1953-60	74
32. Sole Proprietorship Net Income: Total and Four Selected Industries, by Income Groups, 1960	77
33. Number of Returns with Unincorporated Enterprise Profit or Loss as Percentage of All Returns Filed, 1955 and 1959	80
34. Relative Frequency of Returns with Unincorporated Enterprise Profit or Loss and Income from Other Sources, 1955 and 1959	82
35. Net Operating Loss Carryforward Deductions and Estimated Net Operating Losses from Unincorporated Enterprises on Returns with Negative AGI, 1943-61	86

TABLES

36. Number of Returns with Negative AGI and Net Loss from Either Sole Proprietorship or Partnership, by Size of Net Loss, 1954 and 1960	93
37. Tax Liability Attributable to Unincorporated Business and Professional Income, Employment, and Property Income Under the Personal Income Tax, 1918-60	99
38. Effective Tax Rate on Unincorporated Business and Professional Income and All Other Income Reported on Tax Returns, 1929-60	101
39. Estimated Mean Effective Tax Rate on Unincorporated Business and Professional Income, Reported and Estimated Total, 1929-60	102
40. Effective Tax Rates on Unincorporated Business and Professional Net Income Reported on Tax Returns, by Income Groups, Selected Years, 1939-60	105
41. Effective Tax Rates on Unincorporated Enterprise Net Income Reported on Tax Returns Adjusted for Income Reporting Errors, by Income Groups, Selected Years, 1949-60	109
42. Mean Effective Tax Rate on Profits and Losses, by Sole Proprietor and Partnership, 1952-60	110
43. Estimated Percentage of Returns on Which Reported Sole Proprietorship Net Profit Is Less Than, or Exceeds, Stated Percentage of Income, by Income Groups, 1960	114
44. Estimated Net Profit Reported on Returns with Sole Proprietorship Net Profit Less Than, or Exceeding, Stated Percentage of Income, by Income Groups, 1960	116
45. Estimated Net Profit and AGI Reported on Returns for Which Net Profit from Sole Proprietorship Was Over 50 Per Cent of AGI, by Income Groups, 1960	117
46. Estimated Effective Profit Tax Rate of Returns with Sole Proprietorship Profit Greater Than 10 Per Cent, and Greater Than 50 Per Cent, of AGI, 1958 and 1960	118
47. Estimated Effective Tax Rate on Net Income from Sole Proprietorship, by Farms, Professions, and Business, 1960	119
48. Mean Marginal Tax Rate on Profits and Losses, by Sole Proprietor and Partnership, 1952-60	121
49. Amounts of Unincorporated Enterprise Net Profit and Net Loss and Marginal Tax Rate, by Income Groups, 1957 and 1960	122

APPENDIX TABLES

A-1 Unincorporated Enterprise Income Reported on Tax Returns, by Income-Size and Industrial Tabulations, 1939-60	132
--	-----

TABLES

B-1	Net Income and Net Loss from Sole Proprietorship and Partnership, by Farm and Nonfarm Enterprises, as Reported on Business Tax Returns, Selected Years, 1939-60	135
B-2	Estimates of Farm Operators' Net Money Income (Agriculture Department), Adjusted for Comparability with Tax Return Concepts, Selected Years, 1939-60	140
B-3	Estimates of Nonfarm (Commerce Department) and Total Unincorporated Enterprise Income, Adjusted for Comparability with Tax Return Concepts, 1939-60	144
C-1	Adjustment of Wage and Salary Disbursements (Commerce Department Estimates) for Comparability with Amounts Reported on Tax Returns, Selected Years, 1939-60	149
C-2	Adjustment of Personal Income Estimate (Commerce Department) to Obtain Estimate of Total Adjusted Gross Income, 1960	150
C-3	Estimated Adjusted Gross Income on Tax Returns, 1918-43	152
E-1	Number of Returns with Unincorporated Enterprise Profit or Loss and Income from Wages and Salaries, Dividends, or Interest, 1955	156
E-2	Number of Returns with Unincorporated Enterprise Profit or Loss and Income from Wages and Salaries and/or Rents and Royalties, 1959	158
F-1	Estimated Number of Returns with Reported Net Profit from Sole Proprietorship Less Than, or Exceeding, Stated Percentage of Income, by Income Groups, 1960	160
F-2	Estimated Net Profit on Returns with Net Profit from Sole Proprietorship Less Than, or Exceeding, Stated Percentage of AGI, by Income Groups, 1960	162
F-3	Estimated Mean Effective Tax Rate on Net Profits for Returns with Sole Proprietorship Net Profit Greater Than 10 Per Cent and Greater Than 50 Per Cent of AGI, 1960	164
F-4	Estimated Mean Effective Tax Rate Weighted by Frequencies on All Returns with Sole Proprietorship Net Profit and on Returns with Sole Proprietorship Net Profit Greater Than 10 Per Cent and Greater Than 50 Per Cent of AGI, by Income Groups, 1960	165
G-1	Amounts and Frequencies of Reported Net Profits and Net Losses; Estimated Tax Liability Attributed to, and Estimated AGI on, Returns with Net Profit and Net Loss, by Sole Proprietors and Partners, Selected Years, 1939-60	167
I-1	Computation of Net Operating Loss Estimate for 1952 and 1959	183
I-2	Distribution of Net Operating Loss Carryforward Deduction, by Income Groups, Selected Years, 1951-61	185

TABLES

CHARTS

1. Business and Professional Income, Wages and Salaries, and Property Income Reported on All Tax Returns, 1918-60	23
2. Business and Professional Income and Wages and Salaries as Percentage of Adjusted Gross Income, 1929-60	26
F-1 Formulas for Estimating Frequencies for a Fraction of a Class Interval	161