BUSINESS AND PROFESSIONAL INCOME UNDER THE PERSONAL INCOME TAX

CHAPTER 1

Introduction and Summary

Purpose of the Study

THIS study is intended to summarize and interpret some of the extensive information on income and tax liabilities attributable to the proprietors of unincorporated businesses and professions. Such information has been published for many years in the Treasury Department's annual *Statistics of Income.* The adjustments of business and professional proprietors to a world complicated by a number of income taxes, and indeed their economic behavior in general, have long constituted an uncharted area of empirical knowledge. Proprietors at all times stand at the crossroads of the three taxes which compose our income tax system: the personal income tax, the corporate income tax, and the capital gains tax.

As long as an enterprise is unincorporated, all the proprietor's income from it, whether formally distributed or not, is taxed under the individual income tax as part of his total income. If the enterprise is incorporated, any salary which a proprietor may be paid for his services, and any interest on funds which he may lend to the enterprise, continue to be taxable under the individual income tax. But the remainder of the enterprise's income, which consists of a return on equity capital supplied by the owners and a pure profit residual, is defined as corporate profit by the tax law and subject to corporation income tax. Moreover, distributions to the owners (stockholders) out of these corporate profits are also subject to the individual income tax.[1] Whether the tax position of an enterprise is more favorable when operating as a corporation than under a sole proprietor or partnership depends on the size of total income of the enterprise, the amount of income distributed to the owners, and the size of total income of the owners themselves.

Enterprise income may, under some circumstances, be taxed as a capital gain at long-term capital gains rates. In recent years, these have been one-half of ordinary individual rates or 25 per cent, whichever is lower. The capital gains rates are not intended to apply to entrepreneurial income. Yet the difference between them and ordinary individual rates constitutes an obvious inducement to find ways of converting

[1] The first $100 of corporate dividends ($200 when husband and wife own stock jointly and file joint returns) is at present exempt from individual income tax. For a detailed treatment of this subject, and the impact on stockholders of corporate and individual tax combined, see Daniel M. Holland, *The Income-Tax Burden on Stockholders,* Princeton University Press for National Bureau of Economic Research, 1960.

ordinary income into long-term gains, though how much influence this possibility actually exerts is difficult to determine.

In what follows, we shall deal only with the part of business and professional income subject to individual income tax rates. Three broad questions concern us.

First, to what extent is sole proprietor and partnership income covered on tax returns? The answer to this question has a bearing on the discussion of the effective rate of tax on this income, which is dealt with later in Chapter 5. To obtain a correct picture of the tax rate imposed on business and professional income, the extent to which the amounts reported on tax returns are representative of actual income must be taken into account. Chapter 2 is largely devoted to this problem.

Secondly, the size and pattern of income reported on the returns with sole proprietor and partnership income is the subject of analysis. We seek to know the quantitative importance of other income types, such as wages and salaries, dividends, etc., on the returns of sole proprietors and partners. The presence of other income permits loss offsets in the current year. Differences in the distribution by income groups of reported net losses and reported net profits are examined, in some detail, in Chapter 3. The specific problem of business loss offsets under the individual income tax is subjected to scrutiny in Chapter 4.

Thirdly, the final broad topic dealt with is the measurement of tax liability attributable to business and professional income. Here, annual effective and marginal rates are presented, enabling us to compare tax rates on unincorporated enterprise with the previously well-known tax rates on corporate enterprise and capital gains.

Profit and Loss Concept in Tax Statistics

Income from unincorporated business and profession appears in the tax return statistics as "profit or loss of sole proprietors from business or profession" (including farming), or as "profit or loss from partnership." It does not necessarily constitute income of persons who are primarily, or even significantly, self-employed proprietors. Both the occasional counseling fees of a college professor and the income of an unincorporated manufacturing establishment whose owner has no other occupation are likely to appear in the same schedule of the tax return. The terms profit and loss as used in these statistics are more inclusive than either the economic or the popular meaning usually attached to them.

Since unincorporated enterprises are usually owner-managed, the sole proprietor and partnership profit and loss data, as tabulated from tax returns, include what may be considered payments to the proprietors for their labor services, as well as interest and a risk premium for capital supplied by them.[2] Therefore it would be more precise to say that only what remains after these implicit income items have been deducted constitutes pure profit (or loss).[3]

With the available statistics, it was not feasible to isolate the profit component from the rest of unincorporated enterprise income. Yet if one were to compare the average effective tax rate on profit under the personal income tax to that under the corporation income tax, the profit concept now used in the personal tax would have to be narrowed. All payments for services and contractual interest on capital supplied by equity owners are excluded in the computation of corporate profits. However, the return on equity capital is included in the corporate profit concept, which gives the latter an intermediate position between the all-inclusive breadth of unincorporated business profits for income tax purposes and the pure profits of economic theory.[4]

The lack of a statistical division of income from unincorporated enterprises into its several components—wages, return on capital, allowance for risk, and profit—has, however, no influence on individual tax liabilities. Even if the separation were always effected, and some of what appears under current practice as net profit were converted into net loss, an individual's tax liability would not thereby be altered. What would be altered is the relative frequency and amount of net profit and net loss reported for a given income group: present practice leads to overstatement of the former and understatement of the latter.

The United States national income accounts also do not divide income from unincorporated business and professions into its capital and labor services components, but break it down by very broad industrial groups:

[2] Since 1954, partnership net profit or loss is reported on partnership information returns (1065) after deducting payments to partners for services, or for the use of capital, to the extent that such payments are contractual, that is, determined without regard to the income of the partnership. Thus, a net loss may be reported on the partnership return although a salary was paid to one or more partners. But *Statistics of Income* for individual returns continues to include such payments in an individual's distributive share of partnership net profit or loss.

[3] When thus defined, profits (losses) are the results of unforeseen events, disequilibria, and monopoly power. To the extent that profits are a residual amount of income resulting from lack of foresight into an uncertain future, they are as likely to be positive as negative. For an extended discussion of the economic meaning of profit, see Frank H. Knight, "Profit" in *Readings in the Theory of Income Distribution,* William Fellner and Bernard F. Haley, eds., Philadelphia, 1946, pp. 533–546.

[4] Annual dividend payments of corporations might be excluded as a rough approximation of return on owners' investment, bringing us a step closer to an accounting concept of pure profits.

business, independent professional practice, and farming. The unincorporated business category is heavily weighted with retail and wholesale trade, construction, and services such as hotels and laundries. The independent professional group includes mainly physicians, dentists, lawyers, accountants, and engineers. The farm group comprises the income of unincorporated farm operators.

Thus, because the income reported comprises more than profit or loss in the economic sense, and because the primary occupation of individuals included on tax returns as proprietors is not always entrepreneurial, the single common denominator of what is reported in the sole proprietor and partnership schedules is income resulting from unincorporated business and professions. Some other terms, widely used elsewhere, might have served nearly as well. Most of this income might also be termed self-employment income; but this does not apply well to the income of partners who are not active in the enterprise. In that case, most of the income is property income, and the term, income from unincorporated proprietorship suggests itself. But here again the occasional independent consulting work of professional persons, where labor is more important than proprietorship, would be poorly defined.

Nature and Limitations of the Data

Data on unincorporated business and professional income have been tabulated by the Internal Revenue Service in two major forms: (1) annually for sole proprietor and partnership profit and loss by size of adjusted gross income (AGI), and (2) for selected years by type of industry. Since the two tabulations are not based on identical sources, their totals are not the same. However, the differences are less than 5 per cent in most years.[5]

The income-size tabulations are available for 1918–60; however, two significant changes in method of tabulation disrupt the continuity of the series. (1) For the years 1918–29 only net profits were tabulated. The net losses reported on some returns were not offset by the net profits reported on others. This means that for this period the figures are only for returns which on balance show a net profit from sole proprietorship or partnership, although losses reported within these schedules, and exceeded by gains, are included. If losses exceeded gains, the net loss was tabulated with miscellaneous deductions. (2) Until 1943, all income-size distributions are by size of statutory net income; thereafter they are by size of

[5] See Appendix A for a comparison of the totals (Table A-1) from the two sources and a discussion of the difference.

AGI. The difference between the two concepts is personal deductions: AGI is net income before personal deductions; the old statutory net income was after personal deductions.

The industrial breakdowns have been tabulated since 1939, at two-year intervals, for sole proprietors. For partnerships, industrial breakdowns are also available beginning with 1939, but at irregular intervals, and tabulated from partnership information returns rather than individual tax returns. Whereas an individual's reported share in partnership income is tabulated in the income-size distribution, in the industrial distribution, partnership net income is tabulated because the partnership is the reporting unit. It is therefore possible that amounts reported on partnership information returns were not reported on individual returns whenever a partner's income was too low to require his filing a return.

Summary of Findings

INCOME FROM BUSINESS AND PROFESSIONS REPORTED ON TAX RETURNS

Income from unincorporated business and professions has, for recent years, constituted one-tenth of total income reported on tax returns. For 1960, sole proprietors reported net income of $21 billion and partners $9 billion. Together they accounted for $30 billion of the total adjusted gross income of $316 billion reported. Nearly three-fourths of their reported net income (profits minus losses) was from three industry groups: agriculture, trade, and services. The rest is largely accounted for by the construction industry and by the finance, insurance, and real estate groups.

Comparison with Total Income from Business and Professions

The $30 billion income reported is, however, not the total amount actually earned from this source. According to the best available estimates for the years 1956–60 (Tables 6 and 8) the reported total was approximately 70 per cent of the actual income from unincorporated enterprise.[6] Part of the discrepancy between the reported and estimated totals is owing to the receipt of unincorporated enterprise income by persons not required to file tax returns. Most of the discrepancy, however, does not seem to be explained by such persons (Table 12). The greater part must be explained by taxpayers' errors in reporting income, and possibly

[6] The estimates of total income from unincorporated enterprise were obtained by adjusting Department of Agriculture and Department of Commerce figures to make them compatible with tax return tabulations.

insufficient reconciliation between the tax return data, on the one hand, and the Commerce and Agriculture Department estimates, on the other.

Comparison with Total Income Reported by Sole Proprietors and Partners

As explained above, income from unincorporated enterprise includes that of persons for whom it is a secondary, or minor, source. This is strikingly reflected in the comparison of income from unincorporated enterprise and estimated total income reported on the returns of proprietors. The $21.4 billion net income from sole proprietorship reported for 1960 constituted less than half the estimated total income reported on returns with income from that source. For returns with partnership net income the results were even more extreme. Between 1947 and 1960, income from sole proprietorship declined from 67 per cent to 46 per cent of the total income reported by such proprietors; income from partnership declined from 64 per cent of the total income of partners to only 42 per cent.

A small part of the decline over time in the ratio of unincorporated enterprise income to total income of proprietors may be explained by the cross-sectional decline in the ratio when moving up the income scale; but most of it is not. For 1960, the ratio by income-size groups for sole proprietors was as follows:

Total Income (AGI) in Thousands of Dollars	Sole Proprietorship Net Income as Percentage of AGI
Negative income	117
0–2	57
2–3	53
3–5	47
5–10	40
10–25	54
25–50	59
50–100	40
100–500	3
500 and over	–4
Total	46

The decline is very sharp from negative income to the first positive income class; but in the 0-to-$50,000 range, in which the bulk of sole proprietors' income is located (see Table 20), we find no decline. Apparently the declining share of unincorporated enterprise in proprietors' total income is mainly the result of a trend toward more income from other than entrepreneurial sources at any given level of income.

A consequence of the declining proportion of income from unincorporated enterprise has been more government sharing in the losses as well as the profits of proprietors, for with increased income diversification, proprietors increasingly have had other income against which to offset losses. This is reflected in the increasing proportion of net losses reported on returns with positive total income:

	Net Losses Reported for Sole Proprietorships On Returns with:			*Net Losses Reported for Partnerships On Returns with:*		
	Negative Total Income (1)	Positive Total Income (2)	(2) ÷ (1) (3)	Negative Total Income (4)	Positive Total Income (5)	(5) ÷ (4) (6)
1947	520	519	1.0	143	152	1.1
1960	1,059	1,828	1.7	262	529	2.0

The sharp relative decline in income from independent enterprise near the top of the income pyramid, observed in the income-size breakdown shown above, reflects in part a rise of reported net losses relative to net profits at income levels above $50,000. In this one respect, returns in the highest income group resemble those in the very lowest. It is apparent that we are witnessing the results of taxpayers' adjustments to income taxation. A taxpayer subject to high-bracket rates may find it to his advantage to operate an enterprise as an unincorporated business as long as the latter results in net losses, as is frequently the case with young but promising ventures and in particular areas such as oil and gas exploration (Table 31). But for the same reason that losses may make operation in unincorporated form attractive, profits may make it unattractive. The individual now becomes subject to a tax motive either to convert his enterprise into corporate form, where lower tax rates may apply, or to sell his enterprise, thereby capitalizing anticipated profits so as to be taxed at the lower long-term capital gains rates.

In recent years, provisions in the tax law have permitted small businesses, to choose to a limited extent between being taxed as corporations or unincorporated enterprises without being required to change their legal form of organization.

With the "Technical Amendments Acts of 1958," corporations with not more than ten shareholders, and subject to certain other limitations, were given the option to elect taxation at the shareholder level like partnerships, provided all shareholders consented. For the fiscal year 1960–61, some 90,000 corporations (or 8 per cent of the total), many of which were in retail and wholesale trade, elected to be taxed like partnerships. Sole proprietors and partnerships were given the option of being taxed as corporations in 1954, but only an insignificant number have elected to do so (Table 28). This striking difference is probably a reflection of the different income tax treatment accorded to pension plan contributions on behalf of employees and self-employed persons. Until 1963, the pension plan contributions of the latter were not deductible from business income whereas those of the former were, as long as they met certain requirements. Thus, provided other things remained equal, the corporate form of organization was advantageous.

Another, equally important reason for the sharp decline of unincorporated enterprise income in relation to total income of proprietors when ascending the income scale, is the occurrence of so-called hobby-losses. The gentleman's farm is the outstanding case in point. We find that for farm sole proprietors with total income (AGI) over $50,000 in 1960, farm net income is negative: reported losses exceed profits. Only the mining group showed equally extreme results in that respect (Table 32).

THE AMOUNT OF NET OPERATING LOSSES DEPENDENT ON CARRYOVERS

As we saw above, the greater part of net losses reported for 1960 was on returns with positive total income ($2.36 billion). Only $1.32 billion was reported on returns with negative income. These net losses may be offset against positive taxable income for other years to the extent that they can qualify as "net operating loss." The estimated total net operating loss for 1960 was $0.75 billion.

At present a net operating loss may be carried back against income of three preceding years and forward against income of five succeeding years. No data on the carryback portion are available. Loss carryforward figures have been published intermittently; most recently for 1960 and 1961. These figures suggest that currently no more than 10 to 20 per cent of net operating losses (largely losses reported on returns with negative total income) are carried forward to other years.

In the neighborhood of $0.64 billion of 1960 net operating losses must have depended on carryback or remained without offset. While this involves less than one-fifth of total net losses reported for 1960, it may nevertheless be that this low aggregate figure is not very representative. Taxpayers who are completely committed to their enterprises with respect to time and capital, and who may therefore have little income from other sources, may find it hard to obtain offsets for their losses.

Data on the frequency of selected income sources for business and professional proprietors reveal that those with negative income for a given year are below average in reporting wages and salaries, dividends, interest, and rental income, but above average in reporting income from both sole proprietorship and partnership (Table 34). For this group of entrepreneurs whose income appears less diversified than that of others, generous loss carryover provisions are of importance.

THE FRACTION OF NET PROFITS AND LOSSES SHARED BY THE INCOME TAX

While the theory underlying the income tax requires that persons be taxed by size of income, regardless of its functional composition, in practice tax liability may vary considerably with variations in income composition. The individual has for this reason some control over the amount of tax he pays on an income of given size. Many, for example, have a choice between operating their enterprise as an unincorporated business or as a corporation. A few have the opportunity of converting ordinary business income into a long-term capital gain, which is taxed at a lower rate.

By prorating each individual's tax liability among his various functional income components (making necessary adjustments for differences in treatment where they exist, e.g., capital gains and dividends), we obtain weighted average effective rates of tax for each. For all business and professional net income reported on taxable returns, the mean effective rate of tax liability for 1960 was nearly 17 per cent. When we include the amount of income reported on nontaxable returns, the mean effective rate drops to 16 per cent, and if we expand the denominator further to include business and professional income not reported on tax returns (but conceptually part of adjusted gross income), the mean rate drops to 11 per cent. Mean effective rates on all individual income other than unincorporated business and professional for 1960 were 13, 12, and 11 per cent respectively.

The averages hide, of course, wide variations by size of income. For 1960, we observe these differences in effective rates on business and professional income by quintiles of tax returns ranked by size of total income (from Table 40):

Quintile Group	*Unincorporated Enterprise* Net Income (million dollars) (1)	Tax Liability (2)	Effective Tax Rate (2) ÷ (1) (3)
Lowest	−487	−13	2.7%
Second	2,473	117	4.7
Third	4,005	317	7.9
Fourth	5,523	576	10.4
Highest	18,524	3,783	20.4
Total	30,038	4,780	15.9

The effective rate on reported amounts varied from 3 per cent for the lowest quintile of returns to 20 per cent for the highest. The latter group, however, accounted for over 60 per cent of unincorporated enterprise net income reported for 1960.

The mean effective rate of 15.9 per cent for that year is a composite rate covering returns with net profit and returns with net loss and combining sole proprietors and partners. For the nine years 1952–60, separate means were computed for each (Table 42):

	Sole Proprietorship Net Profits	Net Losses	*Partnership* Net Profits	Net Losses
	(per cent)		(per cent)	
Taxable returns	15.5	17.9	20.5	23.6
All returns	13.5	8.4	19.7	12.4

The percentages shown express the mean rate at which net profits and net losses were "shared" by the Treasury. Partnership net profits and losses were shared at a higher rate than those for sole proprietors, reflecting the fact that the former were reported by persons with higher income, on average, than were the latter. The same explains why net losses on taxable returns are, on average, shared through the income tax at a higher rate than net profits. In this group, net losses are more concentrated in high-income groups than net profits, a finding which partly reflects our earlier observation that individuals have some discretion over the form in which they obtain their income, and therefore also over the amount of tax they pay on a given amount of business income.

When the averages are computed for net profits and losses reported on taxable and nontaxable returns, inclusion of the latter significantly lowers the effective rate at which net losses are shared. For sole proprietors the mean rate for total net profits is 13.5 per cent; that for net losses, only 8.4 per cent.

One of the difficulties encountered in this study has been lack of data enabling us to break up the distributions between farm and nonfarm proprietors, and between full-time and part-time self-employed persons. However, some limited estimates were possible. For two years, sole proprietors reporting net profits were classified according to the fraction of their total income obtained from business and profession (Table 46). Only a minor difference in effective rates between returns for which net profits were a large fraction of AGI and those for which they were a small fraction was found. For 1960 the mean effective tax rate for returns whose net profit constituted more than one-half of total income was 13.5 per cent, compared to 13.6 per cent for all returns. Estimates of effective rates by farm, business, and profession for all sole proprietors differed more widely. For farm sole proprietors the mean rate was 8.8; for the business group 13.3; and for independent professionals 19.9 per cent (Table 47). The business group, it should be noted, accounted for $12.8 billion of $21.1 billion net income reported by sole proprietors for 1960.

The mean effective rates tell us approximately what fraction of net profit and loss is absorbed by the federal government. They do not tell us the rate at which government shares at the margin, that is, what rate of tax is levied on additional profit or loss. To that end, mean marginal rates for 1952–60, analogous to the mean effective rates, were computed (Table 48):

	Sole Proprietorship		*Partnership*	
	Net Profits	Net Losses	Net Profits	Net Losses
	(per cent)		(per cent)	
Taxable returns	30.5	34.8	40.1	44.5
All returns	26.5	16.3	37.9	23.7

As before, the mean rate for net losses is higher than that for net profits on taxable returns, but not when mean marginal rates are computed for all returns. The weight assigned to the marginal tax rate of a given return is determined by the amount of net profit (or net loss) reported on it. Therefore, the mean marginal rates shown above are in effect those one would obtain if all net profits and net losses were to change by 1 per cent. If we wanted to know the mean marginal rate per one dollar of change of net profit (or net loss), the weight assigned to each return would have to be the same. The results for all returns for 1960 would be as follows:

	Sole Proprietorship	*Partnership*
Net profits	15.5	23.4
Net losses	14.9	21.8