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: The Treatment of Losses

Chapter Author: C. Harry Kahn

Chapter URL: http://www.nber.org/chapters/c0763

Chapter pages in book: (p. 85 - 97)

CHAPTER 4

The Treatment of Losses

IN EVERYDAY DISCOURSE a business loss is defined as negative net income from business. Such usage is meaningful as long as allowance for all cost elements is made in the definition of income. When allowance is not made, as often occurs in accounting practice[1] and income tax definitions of business income, a true loss may exist long before income from business becomes negative. After explicit allowance for an owner-manager's salary and return on his capital, we might find a loss where the tax return now shows a profit. Business losses as reported on tax returns are therefore understated.

However, in terms of tax treatment this understatement has little practical significance since it is a taxpayer's total income, that is, the sum of negative and positive components, that determines his tax liability. An economically correct definition of business profit would merely lower an individual's business income and raise his other income (salary, interest, etc.) commensurately; his total income would not be affected.[2]

To what extent do losses then present us with a problem that requires separate mention? Are losses not merely an extreme aspect of income variability, which is present whenever a person's income declines?

We are interested in the tax experience of losses, first, because of the widely held belief that the federal Treasury shares in profits but not in losses. This arises naturally from the fact that the income tax does not, with some exceptions, allow averaging of income over time. Therefore, a person whose loss results in negative over-all income may find the Treasury not sharing his loss as it shares his profit. If, on the other hand, a loss is offset against positive other income, it is no longer different from

[1] Many self-employed proprietors do, of course, make some imputation for the value of their services in the business. For instance, it is reported from the 1951 Survey of Consumer Finances that "11 of 13 interviews with entrepreneurs who clearly state that they had a business loss show positive total business income—withdrawals exceeding the stated loss" (Klein and Margolis, *Review of Economics and Statistics,* February 1954, p. 44). This finding does not prove, however, that most proprietors consider their services a business cost; it merely suggests that of those reporting losses, many do so after some imputation.

[2] For example, assume an individual proprietor whose business ends a given year with a $1,000 loss, without allowance for implicit costs such as the use of his capital and labor. If his income from other sources was $4,000, his total income for the year was accordingly $3,000. If he paid himself $10,000 for the services of his capital and labor, his business loss would mount to $11,000 instead of $1,000. But his total income would remain unchanged:

Income from other sources	4,000
Business income	−11,000
Amount imputed for services and capital supplied by owner	10,000
Total	3,000

any other decline in income, though the latter may not have the same label attached to it. The peculiarity of loss treatment is then the peculiarity of the treatment of income fluctuations in general; this, in turn, arises from the absence of averaging and the existence of progressive tax rates. The only way in which tax treatment of losses may thus differ from that of other income declines is in the absence of any offset against positive income. We inquire into the extent of this bias.

The second reason for our interest in the amount and distribution of net losses is to obtain some indirect information on income variability. It would be preferable, of course, to have data for an identical group of taxpayers over an extended period of time. This would show year-to-year income fluctuations for each taxpayer and hence the varying rates at which the Treasury actually participates in increases and decreases in income. In the absence of such a sample, the statistics on annual net profit and net loss furnish us with some insight into income variability (see the discussion of average effective and marginal rates in the next chapter).

The Extent of Loss Offset

In Table 18, both net profits and net losses from unincorporated enterprises were shown separately by income groups. As indicated in that table, most of the aggregate net loss was reported on returns with positive total income. This was evidently because individuals reporting net losses from sole proprietorship or partnership had significant amounts of income from other sources. The figures for 1960 in Table 18 may be summarized as follows:

Net loss reported on returns with positive AGI	\$2.36 billion
Net loss reported on returns with negative AGI	\$1.32 billion

Of close to \$3.7 billion net losses reported, almost \$2.4 billion must be considered offset by other income simply because it was reported on returns which, after taking the net loss from unincorporated enterprise into account, had nevertheless positive total income. An estimated \$0.57 billion of even the \$1.32 billion net loss reported on returns with negative incomes was offset by positive income from other sources.[3] This

[3] In addition to \$1,321 million net losses from unincorporated enterprises reported by individuals on returns with negative AGI, \$875 million positive income (including net long-term capital gains at 100 per cent) was also reported in this income group. If we prorate this positive income to the sole proprietors and partners in the group, an offset of \$569 million against the reported net losses results. The error in estimating the offset through simple prorating is likely to be small, for of the 435,000 returns with negative AGI, some 373,000 had also net loss from sole proprietorship or partnership.

TABLE 35

NET OPERATING LOSS CARRYFORWARD DEDUCTIONS AND ESTIMATED NET OPERATING LOSSES FROM UNINCORPORATED ENTERPRISES ON RETURNS WITH NEGATIVE AGI, 1943-61
(dollars in millions; frequencies in thousands)

	Net Operating Loss Carryforward		Net Operating Loss on Returns with Negative Income			Carryforward as Percentage of		Number of Carryforward Returns as Percentage of Number with Net Loss and Negative Income for Preceding Year
	Amount (1)	Number of Returns (2)	Amount (3)	Weighted Average Amount for Years from Which Loss Carried Forward[a] (4)	Frequency of Sole Proprietor or Partnership Net Loss (5)	Preceding Year's Loss (1) ÷ (3) (6)	Average Loss for Years from Which Carried (1) ÷ (4) (7)	(2) ÷ (5) (8)
1943[b]			153.5		n.a.			
1944[b]			219.9		150.7			
1945[b]	80.5	n.a.	225.9	197.8	147.3	36.6	40.7	n.a.
1948			665.6		285.9			
1949			812.5		365.1			
1950			742.6		307.0			
1951	105.2[c]	30.6[c]	736.1	751.6	293.7	14.2	14.0	10.0
1952	134.6[c]	30.0[c]	745.6	748.9	334.3	18.3	18.0	10.2
1953	202.3[c]	38.2[c]	993.9	742.4	372.5	27.1	27.2	11.4
1954	145.0[c]	34.8[c]	879.3	876.9	397.7	14.6	16.5	9.3
1955			827.2		399.8			
1956			785.5		365.0			
1957			735.7		358.0			
1958			717.1		316.1			
1959			913.7		382.7			
1960	165.6[c]	13.9[c]	751.2	829.0	373.5	18.1	20.0	3.6
1961	91.9[c]	15.1[c]	n.a.	789.0	358.4	12.2	11.6	4.0

leaves $0.75 billion of net losses not offset against current-year positive income.

Such net losses are, subject to certain restrictions, eligible for so-called loss carryover. A net operating loss (as distinct from a capital loss) may be offset against the positive income of preceding years (referred to as carryback), and after the carryback possibilities have been exhausted, it may be offset against positive income in future years (referred to as carryforward). At present, a three-year carryback and a five-year carryforward are allowed. Statistics have been published only for 1945, 1951–54, and 1960–61, and then only for the carryforward portion. The total loss carryforwards reported for these years, and their relation to preceding years' estimated net operating losses for returns with negative total income, are shown in Table 35. On the basis of a projection of the 1960–61 level of reported loss carryforwards, an estimated $0.11 billion of the $0.75 billion not offset against other income in that year is carried

NOTES TO TABLE 35

Note: Number of years allowed for loss carryover.

Income Year	Loss Carryback	Loss Carryforward
1942-47	2 Years	2 Years
1948-49	2 Years	3 Years
1950-53	1 Year	5 Years
1954-57	2 Years	3 Years
1958-63	3 Years	5 Years

Source: Cols. 1, 2, and 5 as tabulated in Statistics of Income. Col. 3 estimated by subtracting from reported net losses of sole proprietors and partners with negative AGI a prorated amount of positive income.

[a]Amounts shown are the weighted average of the figures in col. 3 for the following years (the numbers in parentheses are the weights attached to the net loss of the year shown):

1945: 1943 (.5), 1944 (1).
1951: 1948 (.25), 1949 (.5), 1950 (1).
1952: 1949 (.25), 1950 (.5), 1951 (1).
1953: 1950 (.25), 1951 (.5), 1952 (1).
1954: 1950 (.12), 1951 (.25), 1952 (.5), 1953 (1).
1960: 1955 (.06), 1956 (.12), 1957 (.25), 1958 (.5), 1959 (1).
1961: 1956 (.06), 1957 (.12), 1958 (.25), 1959 (.5), 1960 (1).

[b]Data for 1943-45 are for sole proprietors only.

[c]For 1952-54 and 1960-61 the net operating loss carryforward includes an undetermined amount of carryover of casualty loss on nonbusiness property.

Positive income reported on returns with negative AGI was prorated on the basis of frequencies with net loss from unincorporated enterprise as a percentage of the total frequency in the group. The prorated share of net long-term capital gain was included at 100 per cent to correspond with the requirement that the net operating loss must be computed before the 50 per cent net long-term capital gains deduction. For detail, see Appendix I.

forward against future income. Net losses reported for 1960 may thus be accounted for in this manner:

Total net loss reported	$3.68 billion
Offset on returns with positive total income	2.36
Offset on returns with negative total income	
Against positive components (estimated)	0.57
Loss carryforward (estimated)	0.11
Loss carryback	n.a.
Net loss carried back or not offset	$0.64 billion

At most, one-sixth of reported net losses were not offset against positive income. How much of the $0.64 billion which we failed to account for was carried back against preceding years' income cannot be estimated with the information now at hand. A carryback requires the filing of an amended return and therefore does not appear on regular tax returns from which the *Statistics of Income* information is drawn. Yet a net operating loss must be carried back first, and only the amounts not offset in this manner can be carried forward. Carrybacks may therefore be substantial, depending largely on the degree of income variability experienced by the relevant group of taxpayers.

No mention has yet been made of losses which were offset by gains reported in the same schedule of the tax return. For a given taxpayer, no loss is shown if that from one business he owns is offset by the gain from one or more others. The net losses shown are those of taxpayers whose loss from one business exceeds the gain from others they may own. There is consequently some understatement of loss offsets on this account.

It is evident from the figures presented that all but a small proportion of the total losses from unincorporated enterprises are taken into account in computing taxable income. To the extent that this is so, losses are treated more symmetrically with profits than is frequently assumed,[4] and the adverse effect of the income tax on the disposition to assume risks may not be as great as it first appears. However, since our discussion of loss offsets has so far been confined to the aggregate of reported

[4] Henry C. Simons' view of loss treatment is representative of widely held opinion on this subject. "Our tax laws are crude, niggardly, and patently unfair in their treatment of losses... The possibility of deducting losses would largely counterbalance the prospective tax on speculative gains, except for persons and enterprises whose small resources prohibit diversification of investments." (See *Personal Income Taxation,* Chicago, 1938, p. 21.) Simons' impressions of a quarter century ago may be more valid for capital losses for which offsets are largely limited to the amount of capital gains. For operating losses his generalization, as we have seen, appears less valid.

net losses, the finding that a large proportion has been offset in recent years may not apply equally to all taxpayers. For instance, taxpayers who devote full time to their enterprise and have little or no income from other sources may find it much harder to obtain loss offsets under current provisions than taxpayers whose independent enterprise is a part-time activity and who obtain, therefore, a large proportion of their income elsewhere. A business loss will result in over-all negative income for those without other income whereas it may not for those with diverse sources. Therefore, one would expect to find "other income" less frequently on returns with negative total income than on returns higher up in the distribution of annual income.[5]

This expectation is confirmed in Tables 33 and 34, where we observed the patterns of income on returns with unincorporated enterprise profit or loss. The negative income group has a somewhat above-average frequency of returns with more than one business, but is below average with respect to the number reporting wages and salaries, dividends, and interest. The percentage of returns with income from unincorporated enterprise and specified other sources is reproduced below:

	Sole Proprietor and Partnership Profit or Loss		*Wages and Salaries*		*Dividends*	*Interest*	*Rents and Royalties*
	1955	1959	1955	1959	1955	1955	1959
Negative AGI	5.3	4.7	22.0	23.2	6.1	11.3	17.0
Total	3.8	3.8	43.6	46.3	10.7	19.0	19.0

These frequencies suggest that losses leading to negative income are relatively more likely for persons with few or no income sources besides unincorporated enterprise. The same, however, does not seem to hold for taxpayers with more than one enterprise[6]: negative income occurs with greater frequency among taxpayers who are both partners and sole proprietors than among those who are only one or the other. It is possible, though our data are not sufficient to establish it, that persons

[5] Whereas this expectation seems reasonable and may at first sight appear obvious, it assumes a random distribution of losses. A different pattern is conceivable. If the taxpayers who engaged in risky enterprises were also the ones with other income sources, whereas those without other sources were engaged in relatively riskless businesses, the negative income group could show a higher average frequency of income sources per return than some positive income groups.

[6] As noted in the preceding chapter, the frequencies presented are actually only for the number of returns with both sole proprietorship and partnership profit or loss. Multiple business ownership is thereby understated since only one frequency is recorded when a taxpayer has more than one business in the same category, e.g. sole proprietorship.

strongly inclined to independent enterprise (as we may assume those who are both partners and sole proprietors to be) are also engaged in more risky ventures than single-enterprise persons.

It is evident that the provisions extending loss offsets over a number of years are of greater importance for taxpayers whose major, or sole, source of income is from unincorporated enterprise than for those with other income sources. If the trend (noted in Chapter 3) toward an ever-rising share of income from other sources in the total income of proprietors continues, the need for loss offsets extending over long periods will of course correspondingly decrease. In the meantime, the adequacy of loss carryovers is still an important question.

Provisions for Loss Carryover Deductions

The history of loss carryover provisions is largely one of varying combinations of loss carryback and carryforward periods. Through most of the 1940's the carryback period was two years and the carryforward period at first two and later three years. In 1950 the emphasis was shifted from carryback to carryforward. The former was reduced to one year, the latter increased to five. While the length of the carryforward period has remained the same since then, the carryback has been lengthened twice: in 1954 to two years, and again in 1958 to three years. The principle of operation of the carryover system has remained the same throughout. A net loss not fully offset in the current year must, after appropriate adjustments, first be carried back to the earliest year possible, and then to each successive year until fully offset. A business loss incurred in 1950, for example, had to be offset in the following sequence:

Offset year	2	1	3	4	5	6	7
Calendar year	1949	1950	1951	1952	1953	1954	1955

Under the provisions in force during the four years 1950–53, a business loss thus had a potential offset period of seven years. Over a seven-year period, an occasional operating loss, even if six times as large as a taxpayer's usual positive income (ignoring signs), can in principle be fully offset. In addition, losses over a succession of years can be offset, as long as their numerical value is not far out of line with the taxpayer's usual positive income. Under the law applicable to the 1950–53 period, operating losses for six successive years, if numerically the same as positive income in other years, could in principle be offset over a twelve-year period:

Year	Income	Year	Income
1949	+	1955	–
1950	–	1956	+
1951	–	1957	+
1952	–	1958	+
1953	–	1959	+
1954	–	1960	+

In the above example, an extreme case of course, the taxpayer's 1950 net operating loss could be carried back to 1949; the loss for 1951 five years forward to 1956; that for 1952 forward to 1957, and so forth until 1960.

Beginning with 1954, Congress extended the carryback period to two years (starting with the earlier year), so that the loss for any one year could now be offset over an eight-year span, and a succession of losses could in principle be averaged over a fourteen-year period. Seven poor years could be offset against seven good years, a provision that would have been adequate to Egypt's feast and famine sequence in the days of Joseph. Beginning with 1958, Congress extended the carryback period once more by an additional year, so that at present, any year's net loss can be offset against taxable income over a nine-year period.[7]

To what extent have these provisions resulted in loss offsets? As already indicated, there is only scant information on the adequacy of loss carryovers. For the seven years for which we have data on loss carryforwards (Table 35), the amounts carried forward to any one year have varied from $80 million for 1945 (sole proprietors only) to $202 million for 1953. In the latter figure (as well as those for other years from 1952 on) an undetermined, but probably small,[8] amount of nonbusiness casualty-loss carryforwards are also included. The 1945 deduction is the result of losses carried forward from two preceding years; the 1951–53 deductions derive from losses of three preceding years; that for 1954,

[7] These recent moves toward greater loss offsets are in contrast to an earlier history of very small carryovers. In the 1920's (1921–29), net operating losses could be carried forward two years, but not back. Beginning with 1930, the carryforward was reduced to one year, but even this modest allowance was shortlived. For 1932–38 no carryover provisions existed. Beginning with 1939, a carryforward of two years was once more available. In 1942 a carryback of two years was added. Changes in the carryover allowance made thereafter are shown in the note to Table 35.

[8] Nonbusiness casualty losses tabulated for 1960 on tax returns with AGI less than $1,000 were only $2.6 million. The carryover from this source, although it could arise from returns with positive as well as negative AGI, does not appear to have been significant compared with business losses.

four preceding years; and those for 1960–61, five preceding years. When viewed in relation to a weighted average of the preceding years' losses, the 1945 carryforward deduction was 41 per cent; those for 1951–54, between 14 and 27 per cent; and those for 1960–61, 20 and 12 per cent, of estimated prior year net operating losses on returns with negative income.

In view of the single-year carryback in the early 1950's, the fraction of net operating losses carried forward (about 19 per cent) appears modest. Taxpayers must either have been unable to make use of the carryforward provision for lack of positive income in the years following the loss year, or the then prevailing carryback must have been ample to absorb most of their net operating losses. The above-average frequency in the negative income group of returns which have both sole proprietor and partnership income, noted above, suggests a high income variability. In other words, prior-year income for this group may have been high enough to allow the offset of a large part of net operating loss through carryback. The average unincorporated enterprise net loss on returns with negative income in the early 1950's was somewhat over $3,000, against which various positive income items had to be offset before the loss could be carried to other years. The average loss available for carryback (net operating loss) may thus have been, very roughly, in the neighborhood of $2,500. Table 36 shows a distribution of returns with negative income by size of net loss reported. It shows that for half of the sole proprietor returns, the net loss in 1954 was less than $1,500; and for half of the partner returns, it was less than $2,000. Three-fourths of the returns showed net losses below $3,000 and $5,000, respectively. The concentration of net losses in the small net-loss size groups is greater than the concentration of net profits in the corresponding profit groups.

The loss carryforward figures in Table 35 show little relation between the length of the carryforward period and the proportion of preceding years' operating losses offset. The deductions for 1954, although carried forward from four preceding years, are relatively no greater than those for 1951–53, which are carried forward from only three preceding years each. In addition, some of the loss-years entering the 1951–53 deductions had a two-year carryback, whereas the loss-years entering the 1954 deductions had only a one-year carryback.[9] The

[9] For a derivation of the carryback and carryforward periods affecting the deductions of a given year, see the notes to Table 35.

TABLE 36

NUMBER OF RETURNS WITH NEGATIVE AGI AND NET LOSS FROM EITHER SOLE PROPRIETORSHIP OR PARTNERSHIP, BY SIZE OF NET LOSS, 1954 AND 1960

Size of Loss from Stated Source (dollars)	Number of 1954 Returns with No AGI and Sole Proprietorship Loss	Number of 1954 Returns with No AGI and Partnership Loss	Number of 1960 Returns with No AGI and Sole Proprietorship Loss	Number of 1960 Returns with No AGI and Partnership Loss
Under 100	17,579	2,495	19,090	1,711
100 - 200	17,444	2,543	19,247	1,306
200 - 300	20,960	989[a]	15,102	1,843
300 - 400	19,047	3,505	14,229	1,537
400 - 500	16,950	1,017[a]	15,094	1,336
500 - 1,000	61,871	6,059	56,673	7,732
1,000 - 1,500	43,434	5,136	39,813	4,644
1,500 - 2,000	25,492	5,088	28,699	2,938
2,000 - 2,500	22,968	2,092	18,648	2,903
2,500 - 3,000	16,585	2,551	14,432	3,103
3,000 - 4,000	23,158	2,565	20,792	2,476
4,000 - 5,000	18,753	a	13,728	2,405
5,000 - 10,000	24,876	7,208	31,753	5,749
10,000 - 25,000	16,214	3,911	15,226	5,147
25,000 - 50,000	3,307	1,620[a]	4,022	908[a]
50,000 - 100,000	1,142[a]	a	517	375
100,000 or more	26[a]	a	318[a]	
Total	349,806	47,903	327,383	46,113

Source: Statistics of Income.

[a]Sampling variability of more than 100 per cent. For some of these groups the frequencies could not be separately obtained.

sixth and seventh years of loss offsets possible under the 1950–53 provisions may have had little relevance for most persons with net operating loss. By the same token, the eighth and ninth year under the loss offset provisions in force since 1958 may have had slight significance for most.

The figures for 1960 and 1961 bear this out, at least in part. The relative frequency of returns with carryforward declined from over 9 per cent for 1954 to less than 4 per cent for 1960–61 (column 8 of Table 35). But the total amount of carryforward did not decline relative to the amount of net losses reported in prior years. A possible explanation for this increase in the average size of carryforward deductions is the inclusion, since 1958, in the net operating loss deduction of losses from the sale of small business corporation stock and small business investment company stock as well as taxpayers' pro rata share in the losses of corporations electing to be taxed as partnerships. These losses may, on average, be larger than those of sole proprietors and partners.

It is thus possible—though with the information now at our disposal, it is no more than a speculation—that a sizable proportion of net operating losses were offset through carryback. Carryforwards appear to be used primarily by taxpayers with relatively large losses, a supposition supported by a comparison of columns 6 and 8 of Table 35. It shows that even the average carryforward is larger than the average net loss reported on returns with negative income in the preceding year. This follows from the observation that the relative share of loss carryforward returns is greater on a dollar basis (col. 6) than on a frequency basis (col. 8).[10] That those with carryforwards have large losses is not as obvious as it might seem at first, when one considers that loss carryforward is as much a matter of income variability as it is a matter of size of loss. Even very small losses would have to be carried forward if there were no income against which to carry them back.

The probable increase in carrybacks has one distinct advantage. The tax refunds associated with loss carryovers are speeded up and tend to take place shortly after the net operating loss is established. The greater

[10] The number of returns with net loss and negative income in the preceding year, used in computing column 8 of Table 35, is somewhat larger than the number of returns with net operating loss. It is the latter figure we actually desire; the former constitutes a mere proxy. Some overstatement of the desired frequencies results because (a) some returns may have both sole proprietor and partnership net loss and are therefore counted as two frequencies instead of only one; (b) not every return with net loss from unincorporated business and negative AGI has also a net operating loss after the required adjustments are made. However, neither of these overstatements are large enough to alter any conclusions based on the percentage shown in column 8 of Table 35.

the reliance on the carryback provision, the more effective as an automatic stabilizer the individual income tax is likely to be. A carryback calls for tax rebates in the loss year, whereas a carryforward postpones rebates, possibly into prosperity years. The extension of the carryback period has thus probably contributed somewhat to the stabilizing effectiveness of the income tax.[11]

The Conceptual Relation Between Loss Carryover Deductions and Net Losses on Returns with Negative Income

As has been indicated, the connection between loss carryovers and the net losses reported on returns with negative adjusted gross income is only an approximate one. For the purpose of computing net operating loss (the amount which may be carried to other years), a taxpayer in essence computes the excess of allowable deductions over gross income. But some adjustments are required by law to restrict the carryover to specified income components. Thus, taxpayers with capital losses can only take them into account to the extent of capital gains.[12] The deduction from gross income of 50 per cent of the excess of net long-term capital gain over net short-term capital loss is also not allowed. These restrictions are intended to prevent the carryover of these deductions, which might otherwise, in effect, take place. For the same reason a taxpayer's personal exemptions cannot be taken into account when computing his net operating loss. Nonbusiness (personal) deductions may be taken to the extent of "nonbusiness income" only, which for this purpose is defined to exclude wages and salaries.[13]

These adjustments, which are intended to restrict carryovers in the main to business loss deductions and to exclude others, point up the fact that without a generalized carryover system, the carryover for sole proprietor and partnership losses is, in a sense, also limited. A proprietor with net loss from unincorporated enterprise is, in effect, required to offset his loss against any positive income he may have before taking any other deductions. Only if, and to the extent that, positive income is left, can he take the other deductions he is entitled to. To do otherwise would

[11] For a more detailed discussion of the advantages and disadvantages of carryforwards compared to carrybacks, see Morris Beck, "Carryover of Business Losses," *National Tax Journal,* March 1953, pp. 82–85. The statistical part of Beck's article deals only with corporate carryovers.

[12] But nonbusiness capital losses are deductible only to the extent of nonbusiness capital gains, even though the taxpayer may have an excess of business capital gains (i.e., gains from sale of property used in his business) over business capital losses. See Treasury Department, Internal Revenue Service, *Tax Guide for Small Business,* 1961 edition, pp. 64–66.

[13] *Ibid.,* p. 65.

amount to letting him carry over other deductions, such as capital losses,[14] personal exemptions, and personal deductions, which other taxpayers are not allowed to carry over to other years. For the sake of uniform treatment, the proprietor is thus required, in the process of deducting his business loss, to "waste" some deductions to which he was entitled.[15]

Thus, the finding that unincorporated enterprise losses are mostly offset is contradicted to some extent. However, our main purpose has been to examine the adequacy of operating loss offset provisions per se. If the offsets which we have shown are at times spurious, because they require the taxpayer to sacrifice other deductions he could have claimed, the fault lies not in inadequate operating loss provisions but rather in inadequate (or totally absent) carryover provisions for other deductions.[16]

True, a taxpayer may care little to which particular provision one ascribes the fact that the loss offset was in fact spurious—that to take one deduction he had to sacrifice another. But from the standpoint of causality there may be merit in stating that the losses of certain taxpayers were largely offset, but their personal exemptions were largely lost. To put the matter in this way suggests that to obtain more adequate loss offsets may not require a change in provisions regarding unincorporated enterprises, but a change in provisions regarding all taxpayers.

[14] Net capital losses can, under present law, be offset against income other than capital gains, only to the extent of $1,000 annually in the year when realized and for five succeeding years. No carryback is allowed.

[15] Vickrey, writing at a time when exemptions were still very high by present standards, proposed to continue the exclusion from carryforward of unused exemptions even in his very comprehensive averaging plan. See William Vickrey, "Averaging of Income for Income-Tax Purposes," reprinted in *Readings in the Economics of Taxation* (Musgrave and Shoup, eds.), Homewood, Ill., 1959, pp. 88–89.

[16] For a proposed remedy, see Joseph A. Pechman, "A Practical Averaging Proposal," *National Tax Journal,* September 1954. Pechman would replace the current requirement—that losses be offset against an individual's entire income for a year before they can be carried to the next year in the averaging period—with a provision allowing the averaging of a number of income (and loss) items over a five-year period. In effect, losses would thereby be credited at the highest bracket rates in each year of the five-year period. While this proposal would greatly mitigate the problem of unused exemptions and deductions, it does not entirely remove it, since in many cases some of the income so averaged may have been covered by exemptions.