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CHAPTER 3

Size and Pattern of Income on Returns with Profit or Loss from Business and Professions

As a prelude to the discussion of the tax rates that have been applied to unincorporated enterprise income, it is necessary to have a detailed picture of the size distribution and pattern of net profits and losses reported under the headings of sole proprietorship and partnership. Business and professional profits and losses reported on personal tax returns exhibit peculiarities not found in other distributions of proprietors' income. The latter usually cover the total income of "proprietors," which includes only persons whose main occupation, or source of income, is proprietorship. In contrast, the present study covers all unincorporated enterprise income reported, regardless of its size in relation to the recipient's total income or occupational status. The result of this broad coverage is strikingly reflected in Table 17.

TABLE 17

CUMULATIVE PERCENTAGE DISTRIBUTION OF NET PROFITS AND NET LOSSES REPORTED BY SOLE PROPRIETORS AND PARTNERS, BY SIZE OF NET PROFIT AND LOSS, 1960

Size of Net Profit or Loss	RETURNS OF SOLE PROPRIETORS				RETURNS OF PARTNERS			
	With Net Profit		With Net Loss		With Net Profit		With Net Loss	
	Number	Amount[a]	Number	Amount[a]	Number	Amount[a]	Number	Amount[a]
Under 100	3.3	b	10.8	.3	4.3	b	16.7	.3
Under 500	17.5	1.3	41.5	5.7	15.7	.6	46.0	3.6
Under 1,000	32.7	4.5	63.0	15.5	25.7	1.8	63.6	9.2
Under 5,000	81.1	39.4	94.7	55.9	65.1	19.4	90.6	34.1
Under 10,000	93.0	62.6	98.1	69.9	83.4	40.0	95.6	48.2
Under 25,000	98.7	86.0	99.5	83.0	95.8	69.8	98.9	68.8
Under 50,000	99.8	96.1	99.9	90.7	99.2	87.9	99.6	78.1
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Total[c]	6,831	23,959	1,768	2,887	1,589	9,757	330	791

Source: The frequency distribution is based on Statistics of Income, 1960. The dollar distribution was estimated from this frequency distribution, using methods discussed in Appendix F. Absolute totals are from Statistics of Income, 1960.

[a]These percentages are of absolute totals given. To the extent that these totals differ from the sum of profits estimated, the difference was placed, as a residual, in the highest income class.

[b]Less than .05 per cent.

[c]Dollars in millions; frequencies in thousands.

Distribution by Size of Profit or Loss

A large number of returns show only "very small" [1] amounts of income from unincorporated enterprises. For 1960, one-third of the returns with net profit from sole proprietorship and one-fourth of those with net profit from partnership reported less than $1,000 net profit. Of course, very small amounts of net income from business for any given year do not necessarily mean very small business. Even the owner of a sizable enterprise may at times experience a small net profit or loss. Among returns with net loss, small amounts also predominate. On close to two-thirds of these returns, for both sole proprietors and partners, net losses were less than $1,000 (Table 17).

Not unexpectedly, the major industrial source of the large number of returns with net profit or loss below $1,000 is the farm sector.[2] It is possible that many of the returns, with net profit below $1,000, both farm and nonfarm, are filed by persons whose enterprise is merely a secondary source of income to them. A comparison of estimated mean ratios of net profit to total income (AGI) by returns with net profit under $1,000 and returns with net profit of $1,000 and over for 1960 appears to corroborate this:[3]

	Net Profit	
	Under $1,000	Over $1,000
Sole Proprietors	.15	.74
Partners	.06	.66

By this test, unincorporated enterprise appears more likely to be a secondary source of income for returns with less than $1,000 net profit than for returns with net profit exceeding $1,000. The wider relative spread in the means for partners than for sole proprietors conforms to

[1] Use of the term "very small" is deliberate since the term "small business," as commonly employed, is by no means limited to persons who derive incomes as small as $1,000, or even $10,000, from independent enterprise.

[2] See *Statistics of Income, U.S. Business Tax Returns, 1960-61* (Preliminary), Table 3, where a breakdown by industry and size of net profit is presented. For 1960, of the sole proprietorships with net profit under $1,000, 45 per cent were in agriculture, forestry, and fisheries. Of those with net loss, 55 per cent were in that industrial category. The frequencies cited are for number of businesses rather than number of returns filed as in Table 17. Distributions by number of businesses and number of returns are roughly comparable but not identical because an individual's return showing income from sole proprietorship may cover more than one business. In distributions having the individual as their focus, such a return is counted once; in distributions focusing on the business establishment, it counts as more than one frequency.

[3] The ratios were estimated from a cross tabulation of frequencies by size of net profit and size of adjusted gross income presented in *Statistics of Income, Individual Income Tax Returns, 1960,* Table 8. For each group of frequencies (some 200 in number) total net profit and AGI were estimated, and the ratio of net profit to AGI was computed from these estimates.

one's expectation that the above test applies to partners even more than to sole proprietors.

An alternative explanation might be found in year-to-year variability of income. The tax return with a low net profit for the year may be that of a full-time entrepreneur whose business income fluctuates widely, but whose stable secondary source of income (e.g., interest) will cause him to have a low ratio of net profit to total income for the year. Variability of business income would cause the reverse to hold true for returns with large net profits. Of course, only to the extent that unincorporated enterprise income fluctuates more widely than other income sources, can year-to-year variability be a cause of lower ratios of net profit to total income on returns with low net profits. It is doubtful that income variability alone can explain the wide difference observed in the ratios of net profit to total income.

In conclusion, it should be observed that while returns with net profits below $1,000 account for a very large proportion of the number of unincorporated enterprise returns, they account for only a small fraction of net profits reported on them: 5 per cent of the total for sole proprietors and 2 per cent for partners.

Relation of Income from Business or Profession to Total Income of Proprietors

In Table 18 unincorporated enterprise income is grouped by size of proprietors' total income (AGI) rather than by its own size as in the preceding section. We find that throughout the income scale, income from unincorporated enterprise tends to be substantially supplemented by income from other sources. On returns of proprietors, reported adjusted gross income for 1960 amounted to nearly $63 billion, which was almost evenly divided between net income from their enterprises and other sources. For none of the groups shown in the table, except that with negative income, did the business and professional component approach as much as two-thirds of income reported.[4] The extent to which unincor-

[4] In addition to our estimates of AGI of proprietors, the Internal Revenue Service has tabulated for some years (and published in *Statistics of Income*) the AGI reported on returns with self-employment tax (dollars in billions):

	On Returns with Self-Employment Tax (reported)	*On Returns with Business or Professional Income over $400* (estimated)
1956	37.3	43.9
1958	37.6	43.9

A large part of the discrepancy in the figures is explained by (a) the exemption of physicians from self-employment tax, and (b) the fact that self-employment tax was only incurred when wages and salaries subject to the tax and reported on the same return were less than $4,200. Working in the opposite direction, however, is the optional inclusion of ministers, members of religious orders, and Christian Science practitioners, in self-employment tax.

TABLE 18

DISTRIBUTION OF BUSINESS AND PROFESSIONAL INCOME AND AGI OF PROPRIETORS, BY INCOME GROUPS, 1960
(dollars in millions)

Adjusted Gross Income (thousand dollars)	Business and Professional: Net Profits (1)	Net Losses (2)	Net Income (Col. 1 minus Col. 2) (3)	Estimated AGI (4)	Col. 3 ÷ Col. 4 (5)
Negative AGI	84	1,321	-1,237	-958	129.1
0 - 2	1,805	355	1,450	2,495	58.1
2 - 3	1,849	265	1,584	3,010	52.6
3 - 5	4,507	411	4,096	8,342	49.1
5 - 10	8,306	540	7,766	18,339	42.3
10 - 25[a]	9,734	324	9,410	16,834	55.9
25 - 50	4,934	150	4,785	8,047	59.5
50 - 100	1,894	122	1,773	3,931	45.1
100 - 500	571	159	412	2,136	19.3
500 and over	33	34	b	632	-.1
Total	33,716	3,679	30,038	62,810	47.8

Source: Statistics of Income, 1960. AGI estimates were obtained by multiplying average AGI for all returns in each AGI class by the number of returns reporting business and professional income. The frequencies used were corrected for double counting of returns reporting both sole proprietorship and partnership income by reducing them by the 1959 fraction of returns in each income group showing both income sources (shown in column 8 of Table 33).

[a]Includes all nontaxable returns with AGI of $10,000 or more.

[b]Less than $500,000.

porated enterprise income is supplemented (or even exceeded) by other sources increases with the size of income reported by sole proprietors and partners. Business and professional income was nearly three-fifths of the total reported in the 0–$2,000 AGI group, but less than one-fifth of the total on returns with AGI exceeding $100,000.

In addition to the cross-sectional decline of business and professional income relative to total income of proprietors, we also find that a decline has occurred over time. In Table 19, estimates of total adjusted gross income reported on returns of sole proprietors and partners are shown for selected years, 1939–60. There has been a pronounced downward trend in the proportion of proprietors' income derived from independent enterprise. For sole proprietors the business and professional component declined from two-thirds to less than one-half between 1945 and 1960. For partners the decline was even greater.

TABLE 19

BUSINESS AND PROFESSIONAL NET INCOME AND AGI REPORTED ON RETURNS WITH BUSINESS AND PROFESSIONAL INCOME OR LOSS, 1939-60
(dollars in millions)

	Sole Proprietors			Partners		
	Estimated AGI (1)	Net Income (2)	Col. 2 ÷ Col. 1 (per cent) (3)	Estimated AGI (4)	Net Income (5)	Col. 5 ÷ Col. 4 (per cent) (6)
1939	3,868	2,480	64.1		n.a.	
1941	9,651	6,226	64.5		n.a.	
1945	17,845	11,943	66.9	10,537	7,060	67.0
1947	22,978	15,341	66.8	12,528	7,953	63.5
1949	22,599	14,231	63.0	13,557	7,474	55.1
1951	29,559	16,466	55.7	15,406	8,412	54.6
1953	30,213	16,664	55.2	13,167	8,287	54.6
1954	33,014	16,926	51.3	16,099	8,526	53.0
1955	36,325	18,430	50.7	18,168	9,024	49.7
1956	42,425	21,285	50.2	18,327	8,852	48.3
1957	40,173	20,339	50.6	19,253	9,359	48.6
1958	41,301	20,674	50.1	19,459	9,232	47.4
1959	45,389	21,431	47.2	21,688	9,563	44.1
1960	46,156	21,072	45.7	21,514	8,966	41.7

Source: Statistics of Income. AGI was estimated by assuming average AGI for returns with entrepreneurial income to be the same as AGI for all returns in a given income group.

Note: AGI figures shown in this table for 1960 add to a greater total than that shown in Table 18 because some returns show income from both sole proprietor and partnership. Fiduciary returns are excluded from this table for all years.

There are a number of possible reasons for this trend. The cross-sectional decline of unincorporated enterprise relative to other sources, when moving upwards along the income scale (Table 18), could be responsible for the decline over time. This appears to be only a partial explanation of the downward trend when we examine the cross-sectional pattern for five selected years (Tables 20 and 21). It is true that for both sole proprietors (Table 20) and partners (Table 21), independent enterprise declines in relative importance as a source with rising total income in every one of the five years shown. But in the range in which the bulk of the income reported by proprietors has been concentrated, the relative decline of unincorporated enterprise income has not been so large as to explain the sharp decline from 1945 to 1960, which we noted above.

For 1945, when the bulk of sole proprietors' adjusted gross income was reported in the 0–$25,000 income range, the part which originated in sole proprietorship varied from 65 to 75 per cent of the total (Table 20).

TABLE 20

SOLE PROPRIETORSHIP NET INCOME[a] AND ESTIMATE OF AGI REPORTED ON RETURNS OF SOLE PROPRIETORS, BY INCOME GROUPS, SELECTED YEARS, 1939-60

Adjusted Gross Income Class (thousand dollars)	Adjusted Gross Income (million dollars) (1)	Net Income	
		Amount (million dollars) (2)	Percentage of AGI (3)
	1939[b]		
Negative AGI	-65	-108	166.0
0 - 2, 2 - 3, 3 - 5	2,019	1,572	77.9
5 - 10	871	576	66.1
10 - 25	578	322	55.7
25 - 50	218	85	38.9
50 - 100	117	29	24.8
100 - 500	86	6	7.2
500 and over	45	-2	-3.6
Total	3,868	2,480	64.1
	1945		
Negative AGI	-248	-279	112.4
0 - 2	3,186	2,386	74.9
2 - 3	2,772	1,809	65.2
3 - 5	3,627	2,387	65.8
5 - 10	3,278	2,419	73.8
10 - 25	2,993	2,112	70.6
25 - 50	1,159	705	60.9
50 - 100	578	279	48.2
100 - 500	384	117	30.4
500 and over	116	8	7.0
Total	17,845	11,943	66.9
	1953		
Negative AGI	-923	-910	98.6
0 - 2	2,690	1,728	64.2
2 - 3	3,094	1,976	63.9
3 - 5	6,838	3,687	53.9
5 - 10	8,126	4,287	52.8
10 - 25[c]	4,928	3,224	65.4
25 - 50[c]	3,583	2,164	60.4
50 - 100	1,032	420	40.7
100 - 500	633	89	14.1
500 and over	211	-2	-1.2
Total	30,213	16,664	55.2

(continued)

TABLE 20 (concluded)

Adjusted Gross Income Class (thousand dollars)	Adjusted Gross Income (million dollars) (1)	Net Income Amount (million dollars) (2)	Net Income Percentage of AGI (3)
	1955		
Negative AGI	-757	-839	110.8
0 - 2	2,903	1,896	65.3
2 - 3	3,183	1,911	60.0
3 - 5	7,174	3,542	49.0
5 - 10	10,043	4,573	45.5
10 - 25	7,801	4,886	62.6
25 - 50	3,358	1,877	55.9
50 - 100	1,394	535	38.4
100 - 500	884	59	6.7
500 and over	342	-10	-2.9
Total	36,326	18,430	50.7
	1960		
Negative AGI	-862	-1,006	116.7
0 - 2	2,295	1,314	57.3
2 - 3	2,714	1,437	52.9
3 - 5	7,321	3,421	46.7
5 - 10	14,989	5,949	39.7
10 - 25[d]	11,654	6,329	54.3
25 - 50	4,786	2,822	59.0
50 - 100	1,964	794	40.4
100 - 500	958	26	2.7
500 and over	337	-14	-4.2
Total	46,156	21,072	45.7

Source: Statistics of Income.

[a]Sole proprietorship net profits minus net losses.

[b]For 1939, returns are classified by size of statutory net income.

[c]For 1953, the class limit is $20,000 instead of $25,000.

[d]Includes all nontaxables with AGI of $10,000 and over.

For 1960, the bulk of sole proprietors' income was reported in the 0–$50,000 range, and in it, sole proprietorship income constituted between 40 and 59 per cent of the total. A similar trend is evident for net income from partnership. Both in 1945 and 1960, reported adjusted gross income of partners was heavily concentrated in the $3,000–$100,000 income range. In that group, the proportion of AGI derived from partnership varied between 63 and 70 per cent for 1945, and between 37

TABLE 21

PARTNERSHIP NET INCOME[a] AND ESTIMATE OF AGI REPORTED ON RETURNS OF PARTNERS, BY INCOME GROUPS, SELECTED YEARS, 1939-60

Adjusted Gross Income Class (thousand dollars)	Adjusted Gross Income (million dollars) (1)	Net Income: Amount (million dollars) (2)	Net Income: Percentage of AGI (3)
	1939[b]		
Negative AGI	-10	-18	171.6
0 - 2, 2 - 3, 3 - 5	n.a.	372	n.a.
5 - 10	521	309	59.3
10 - 25	548	300	54.6
25 - 50	282	133	47.3
50 - 100	169	70	41.5
100 - 500	106	27	25.9
500 and over	25	1	3.6
Total	n.a.	1,195	n.a.
	1945		
Negative AGI	-31	-50	159.7
0 - 2	481	346	71.9
2 - 3	671	423	63.0
3 - 5	1,230	777	63.2
5 - 10	1,884	1,302	69.1
10 - 25	2,812	1,968	70.0
25 - 50	1,708	1,190	69.7
50 - 100	1,047	711	67.9
100 - 500	641	361	56.4
500 and over	94	32	33.7
Total	10,537	7,060	67.0
	1953		
Negative AGI	-179	-230	128.8
0 - 2	405	293	72.4
2 - 3	543	359	66.0
3 - 5	1,637	989	60.4
5 - 10	3,262	1,873	57.4
10 - 25[c]	3,076	1,867	60.7
25 - 50[c]	3,666	2,056	56.1
50 - 100	1,523	732	48.1
100 - 500	995	343	34.5
500 and over	238	6	2.7
Total	15,167	8,287	54.6

(continued)

TABLE 21 (concluded)

Adjusted Gross Income Class (thousand dollars)	Adjusted Gross Income (million dollars) (1)	Net Income Amount (million dollars) (2)	Net Income Percentage of AGI (3)
		1955	
Negative AGI	-117	-177	150.4
0 - 2	329	197	60.0
2 - 3	531	328	61.8
3 - 5	1,578	960	60.8
5 - 10	3,611	1,951	54.0
10 - 25	5,019	2,784	55.5
25 - 50	3,419	1,714	50.1
50 - 100	1,954	838	42.9
100 - 500	1,429	401	28.1
500 and over	416	27	6.6
Total	18,168	9,024	49.7
		1960	
Negative AGI	-141	-231	163.2
0 - 2	243	136	56.0
2 - 3	348	147	42.4
3 - 5	1,246	675	54.2
5 - 10	4,065	1,817	44.7
10 - 25[d]	6,672	3,080	46.2
25 - 50	4,431	1,963	44.3
50 - 100	2,617	978	37.4
100 - 500	1,578	386	24.5
500 and over	456	14	3.0
Total	21,514	8,966	41.7

Source: Statistics of Income.

[a]Partnership net income minus net losses.

[b]For 1939, returns are classified by size of statutory net income.

[c]For 1953, the class limit is $20,000 instead of $25,000.

[d]Includes all nontaxable with AGI of $10,000 and over.

and 54 per cent for 1960. Clearly the declining share of business and professional income in the total income reported by proprietors is not merely the result of their movement over time into higher income groups; that is, not the outcome of a mere movement along a curve but rather of a drop in the curve itself. The fact that the trend is observable for both sole proprietors and partners seems to rule out as the sole cause the relative decline of farm income in the postwar years. For farmers, the decline in the relative share of entrepreneurial income may have been especially pronounced.[5] But since they are, as we have seen, mainly sole proprietors, the relative decline of farm income cannot explain the decline of partnership income as a component of partners' AGI.

For both sole proprietors and partners the decline in entrepreneurial income relative to total income is very sharp at the top of the income pyramid. For sole proprietors in the $100,000–$500,000 AGI group, only 7 per cent of their income in 1955 and 3 per cent in 1960 was from their independent enterprises. The highest ratio on record for this group was 30 per cent for 1945.[6] For those reporting incomes over $500,000, the business and professional component was negative for all years except 1945. A similar, but less extreme pattern is revealed for partners.

We have so far viewed business and professional income as the algebraic sum of the net profits reported by some taxpayers and the net losses reported by others. It is therefore possible that the decline relative to total income of proprietors which has been observed—over time, and to some extent upwards over the income scale—is the result of a rise in net losses relative to net profits. We consider this possibility next.

PROFITS AND LOSSES IN RELATION TO TOTAL INCOME OF PROPRIETORS

In Tables 22 and 23 unincorporated enterprise income and AGI are shown separately for returns with net profit and returns with net loss by size of AGI. Two years, 1945 and 1960, were selected for close examination but data for other years may be found in Appendix G.

For both sole proprietors and partners the tendency for the share of entrepreneurial income to fall with rising income persists when net profit returns alone are viewed. For 1960, net profits fell from 82 to 70 per cent of AGI of sole proprietors over the 0–$50,000 income range. An even sharper drop may be observed for partners: from 86 to 55 per cent.

Net losses, not unexpectedly, trace a similar pattern: they decline sharply relative to the AGI of which they are reported as a negative component. For sole proprietors reporting the very highest incomes, that is, on returns with AGI over $500,000, the net losses reported by some exceed in absolute amount the net profits reported by others for most years. This was reflected in the negative incomes from sole proprietorship in four of the five years shown in Table 20. Thus, while the

[5] See Jacob Schiffman, "Multiple Jobholders in May 1962," *Monthly Labor Review,* May 1963, p. 517, and Bureau of the Census, "Multiple Jobholding: July 1958," *Current Population Reports,* Series P-50, No. 88, Table 1.

[6] This most probably reflects the brief period during World War II when, because of the excess profits tax, some businesses changed from corporate to unincorporated form.

TABLE 22

SOLE PROPRIETORSHIP INCOME AND ESTIMATED AGI, BY RETURNS WITH NET PROFIT AND NET LOSS AND BY INCOME GROUPS, 1945 AND 1960
(dollars in millions)

AGI Class (thousand dollars)	Returns with Sole Proprietorship Net Profits			Returns with Sole Proprietorship Net Losses		
	AGI (1)	Net Profits (2)	Col. 2 ÷ Col. 1[a] (3)	AGI (4)	Net Losses (5)	Col. 5 ÷ Col. 4[a] (6)
			1960			
Negative AGI	-41	53	-129.6	-821	1,059	129.0
0 - 2	1,987	1,625	81.8	308	311	-100.9
2 - 3	2,264	1,635	72.2	450	198	-44.1
3 - 5	5,839	3,777	64.7	1,482	356	-24.0
5 - 10	11,983	6,383	53.3	3,006	434	-14.4
10 - 25	10,135	6,550	64.6	1,519	221	-14.5
25 - 50	4,173	2,911	69.8	613	89	-14.5
50 - 100	1,486	876	59.0	478	82	-17.2
100 - 500	418	140	33.6	541	115	-21.2
500 and over	78	8	9.8	259	22	-8.4
Total	38,321	23,959	62.5	7,836	2,887	-36.8
			1945			
Negative AGI	-11	11	-106.3	-237	290	122.4
0 - 2	2,960	2,503	84.6	226	118	-52.0
2 - 3	2,533	1,855	73.2	239	46	-19.3
3 - 5	3,381	2,429	71.8	246	41	-16.7
5 - 10	3,092	2,457	79.4	186	38	-20.6
10 - 25	2,747	2,159	78.6	246	46	-18.9
25 - 50	981	732	74.6	178	26	-14.8
50 - 100	425	296	69.6	153	17	-11.1
100 - 500	216	131	60.9	169	14	-8.6
500 and over	31	11	35.0	84	3	-3.5
Total	16,356	12,583	76.9	1,489	640	-43.0

Source: Statistics of Income.

[a]Percentages computed from unrounded figures.

decline of business and professional income relative to AGI of proprietors cannot be ascribed to the rising ratio of net loss to net profit over the income scale, it was nevertheless reinforced by it.

In Tables 24 and 25, total reported net profits and net losses and total estimated AGI on returns with net profits and net losses, respectively, are shown for selected years of the period 1939–60. These tables sum

TABLE 23

PARTNERSHIP INCOME AND ESTIMATED AGI, BY RETURNS WITH NET PROFIT AND NET LOSS AND BY INCOME GROUPS, 1945 AND 1960
(dollars in millions)

AGI Class (thousand dollars)	Returns with Partnership Net Profits			Returns with Partnership Net Losses		
	AGI (1)	Net Profits (2)	Col. 2 ÷ Col. 1[a] (3)	AGI (4)	Net Losses (5)	Col. 5 ÷ Col. 4[a] (6)
			1960			
Negative AGI	-26	31	-120.9	-116	262	226.4
0 - 2	210	180	85.6	33	44	-132.1
2 - 3	301	214	70.9	46	66	-143.5
3 - 5	1,061	730	68.8	185	55	-29.6
5 - 10	3,438	1,923	55.9	627	106	-16.9
10 - 25	5,691	3,184	56.0	981	104	-10.6
25 - 50	3,706	2,024	54.6	726	60	-8.3
50 - 100	2,116	1,018	48.1	501	39	-7.8
100 - 500	1,091	430	39.4	487	44	-9.1
500 and over	199	26	12.9	258	12	-4.6
Total	17,786	9,757	54.9	3,728	791	-21.2
			1945			
Negative AGI	-6	13	-203.9	-25	62	252.3
0 - 2	449	366	75.0	33	20	-62.2
2 - 3	620	431	69.6	52	8	-16.2
3 - 5	1,162	786	67.6	68	9	-13.4
5 - 10	1,798	1,316	73.2	86	14	-16.0
10 - 25	2,681	1,985	74.0	131	17	-12.6
25 - 50	1,626	1,199	73.7	82	9	-11.0
50 - 100	983	716	72.8	63	6	-8.9
100 - 500	571	365	63.8	69	3	-4.9
500 and over	69	32	46.7	25	b	-1.7
Total	9,953	7,209	72.4	584	149	-25.5

Source: Statistics of Income.

[a]Percentages computed from unrounded figures.

[b]Less than $1 million.

up the two conclusions which one may draw from the discussion thus far in this section:

1. Unincorporated enterprise income has become increasingly reported together with income from one or more other sources. This is reflected in the fact that both net profits and net losses have declined over time relative to the incomes of which they are components. The nature of this supplementation will be discussed below.

2. The fact that income from business and profession has been increasingly supplemented with other income has given rise to increased loss offsets under the income tax. Net losses which might not have been reported, or indeed not acquired, at one level of income diversification, make their appearance at another level when there is enough income from other sources to offset losses.

One might ask whether a decline in the profitability of independent enterprises could not explain the falling share of business and professional income in the total income of proprietors. But if this were the case, not only would we observe a fall in net profits as a component of proprietors' AGI, but also a rise in the ratio of net losses to AGI on returns with losses. As we have seen in Tables 24 and 25, this has not been the case. Between 1945 and 1960, net losses reported by sole proprietors declined from 43 to 37 per cent of estimated AGI of these proprietors; those reported by partners from 26 to 21 per cent.

Our observations suggest that greater income diversification rather than a decline in the fortunes of unincorporated business lies behind the

TABLE 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

	Net Profit (1)	Net Loss (2)	AGI on Returns with Net Profit (3)	AGI on Returns with Net Loss (4)	Col. 1 ÷ Col. 3 (per cent) (5)	Col. 2 ÷ Col. 4 (per cent) (6)
1939	2,712[a]	223[a]	3,332	536	81.4	-41.6
1941	6,475[a]	228[a]	8,862	799	73.1	-28.5
1945	12,583	640	16,356	1,489	76.9	-43.0
1947	16,381	1,039	21,125	1,853	77.5	-56.1
1949	15,630	1,399	20,445	2,154	76.4	-64.9
1951	18,163	1,697	25,943	3,616	70.0	-46.9
1953	18,678	2,014	26,418	3,795	70.7	-53.1
1954	19,235	2,309	28,129	4,885	68.4	-47.3
1955	20,597	2,167	30,950	5,376	66.5	-40.3
1956	23,662	2,377	36,011	6,414	65.7	-37.1
1957	22,526	2,187	34,418	5,756	65.4	-38.0
1958	22,890	2,216	35,199	6,102	65.0	-36.3
1959	24,323	2,892	38,267	7,122	63.6	-40.6
1960	23,959	2,887	38,321	7,836	62.5	-36.8

Source: Statistics of Income.

[a]Includes taxable fiduciary returns with net income.

TABLE 25

TOTAL REPORTED NET PROFIT AND NET LOSS FROM PARTNERSHIP AS PERCENTAGE OF ESTIMATED AGI ON RETURNS OF PARTNERS, SELECTED YEARS, 1945-60

	Net Profit (1)	Net Loss (2)	AGI on Returns with Net Profit (3)	AGI on Returns with Net Loss (4)	Col. 1 ÷ Col. 3 (per cent) (5)	Col. 2 ÷ Col. 4 (per cent) (6)
1945	7,209	149	9,953	584	72.4	-25.5
1947	8,249	295	11,727	800	70.3	-36.9
1949	7,912	438	12,244	1,314	64.6	-33.3
1951	8,871	459	13,873	1,533	63.9	-29.9
1953	8,803	516	13,601	1,566	64.7	-33.0
1954	9,004	478	14,320	1,778	62.9	-26.9
1955	9,553	529	15,910	2,259	60.0	-23.4
1956	9,393	541	15,868	2,459	59.2	-22.0
1957	9,964	605	16,664	2,592	59.8	-23.3
1958	9,810	578	16,662	2,796	58.9	-20.7
1959	10,220	657	18,261	3,427	56.0	-19.2
1960	9,757	791	17,786	3,728	54.9	-21.2

Source: Statistics of Income.

[a]Includes taxable fiduciary returns with net income.

trends observed. As a consequence, the likelihood that losses as well as profits are shared by society through the income tax appears to have risen.

Conversion of Unincorporated Enterprise Profits into Other Income

The decline in the ratio of total reported unincorporated enterprise income to AGI of proprietors over time may be explained by increased amounts of income from other sources. In contrast, the sharp cross-sectional decline in this ratio, when moving above $50,000 in the income scale, requires further explanation. It will be recalled that the cross-sectional decline of the ratio of business and professional to total income of sole proprietors was found to be so sharp as to turn negative for the group with AGI over $500,000 in four of the five years selected in Table 20. Not only did net losses for the group exceed net profits in dollar amounts, but the frequency of returns with net loss also exceeded that of returns with net profit for sole proprietors reporting AGI over $100,000 and for

TABLE 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

Adjusted Gross Income (thousand dollars)	1955 Returns with		1960 Returns with	
	Net Profit	Net Loss	Net Profit	Net Loss
		SOLE PROPRIETORSHIP		
Negative AGI	12,549	351,226	16,303	327,383
0 - 2	2,299,420	319,644	1,854,380	309,934
2 - 3	1,110,584	169,273	908,161	179,823
3 - 5	1,486,357	346,185	1,477,772	370,660
5 - 10[a]	1,240,297	247,617	1,719,163	441,735
10 - 25	481,791	52,547	705,168	109,045
25 - 50	87,167	13,661	125,074	18,381
50 - 100	15,691	5,312	22,593	7,267
100 - 500	2,523	2,954	2,734	3,087
500 and over	56	243	79	229
Total	6,736,435	1,508,662	6,831,427	1,767,544
		PARTNERSHIP		
Negative AGI	7,898	48,552	10,247	46,113
0 - 2	255,968	42,245	185,588	33,711
2 - 3	185,285	26,363	120,587	18,697
3 - 5	350,716	47,845	264,504	45,082
5 - 10	461,849	53,390	480,355	87,515
10 - 25[b]	302,788	31,746	377,550	66,228
25 - 50	90,979	10,320	111,065	21,752
50 - 100	25,108	4,330	32,167	7,620
100 - 500	6,780	2,121	6,920	2,740
500 and over	199	190	200	224
Total	1,687,570	267,102	1,589,183	329,682

Source: Statistics of Income.

[a]Includes all nontaxable returns with AGI of $5,000.

[b]Includes all nontaxable returns with AGI of $10,000 or more.

partners reporting over $500,000 (Table 26).[7]

While it is not improbable for annual losses to exceed annual gains for some income groups, we do not expect to find it year after year in the upper reaches of the income distribution. The occurrence of a business loss imparts a downward bias to a person's income: for that year it

[7] For sole proprietors, the number of net loss returns has exceeded net profit returns in the group reporting income over $500,000 for every year since 1937; in the group reporting incomes between $100,000 and $500,000, in every year except one since 1952 and in the period 1937–40. For partners, the ratios of loss to profit frequencies have been less extreme, and only since 1953 have loss frequencies begun to outnumber profit frequencies in the highest income groups.

may place him in a lower income group. In the same sense, a business profit imparts an upward bias: the higher the profit, the higher of course a proprietor's total income for that year. For these obvious reasons we expect loss returns to be concentrated at low levels of income and profit returns at higher levels. To find that business and professional net losses outweigh net profits at high income levels is certainly contrary to our expectation.

The net profit and loss pattern which one might expect is found in the distribution of net capital gains and losses. In Table 27 such a distribution is shown for 1960 alongside that for unincorporated enterprise net profit and loss. The differences are striking. Net capital gains in the highest AGI groups were $1,047 million and losses only $4 million. In contrast, unincorporated enterprise net profits were $33 million and losses $34 million.

The question arises as to why the distribution for net capital gains and losses conforms to one's reasonable expectations while that for unincorporated enterprise profit and losses does not. From the mere size of

TABLE 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
(million dollars)

Adjusted Gross Income (thousand dollars)	Business and Professional		Capital[a]		AGI on Tax Returns
	Net Profit (1)	Net Losses (2)	Net Gains (3)	Net Losses (4)	(5)
Negative AGI	84	1,321	376	155	-1,091
0 - 2	1,805	355	445	205	14,546
2 - 3	1,849	265	407	160	17,333
3 - 5	4,507	411	757	274	54,915
5 - 10	8,306	540	1,673	556	140,032
10 - 25[b]	9,734	324	2,481	711	63,496
25 - 50	4,934	150	1,482	247	14,710
50 - 100	1,894	122	1,285	90	6,648
100 - 500	571	159	1,794	40	3,808
500 and over	33	34	1,047	4	1,070
Total	33,716	3,679	11,747	2,441	315,466

Source: Statistics of Income.

[a]Excluding gain or loss from sale of other property and after carryover. Both gains and losses are included at 100 per cent before net long-term capital gains deduction and statutory limitations on loss deduction.

[b]Includes all nontaxable returns with $10,000 or more AGI.

capital gains reported at the top of the tax return distribution one might conclude that most of the returns in that group for a given year are swept into it because of their capital gains. Other income types are therefore reported on these returns only incidentally. But this reasoning cannot explain why those who are "swept" into the topmost group have a disproportionately high unincorporated business loss experience.

It is possible that these results reflect a number of tax-law influences on the conduct of business, all of which tend to operate in the same direction. One of the explanations for the rising loss ratios at high income levels may be the conversion of would-be unincorporated business net profits into statutory long-term capital gains. A taxpayer subject to a high marginal tax rate will find it to his advantage to report his losses as ordinary negative personal income, which can be offset against other income in full, but to convert profits whenever possible into long-term capital gains, which are subject to a 25 per cent maximum effective rate limitation.[8] The simultaneous occurrence of long-term gains and unincorporated business losses on high income tax returns seems to support the explanation offered. For instance, on tax returns with AGI over $500,000, we find the following reporting frequencies:[9]

	Total	*With Net Capital Gain*	*With Sole Proprietor and/or Partnership*	
			Net Profit or Loss	Net Loss
1959	982	856	614	387
1960	1,018	882	584	361

These figures show that for 1960, at least 448, or 77 per cent, of the 584 returns with unincorporated enterprise income reported also net capital gain; at least 225, or nearly two-thirds of the 361 with net loss from unincorporated enterprise reported net capital gain. These are only minima based on the conservative, indeed extreme, assumption that the

[8] Net long-term capital gains are included in adjusted gross income at only 50 per cent of their value and subject to a maximum effective rate of 50 per cent. Hence, even for taxpayers subject to the lowest marginal rates, the conversion of business profits into net long-term capital gains is advantageous. But once a taxpayer's marginal tax rate exceeds 50 per cent, the relative gap widens between his rate on a long-term capital gain and that on a business profit.

[9] The frequencies for the group total and net capital gains are as tabulated in *Statistics of Income*. Those shown for sole proprietorship and partnership are corrected for estimated overlap, since the tabulated frequencies are given for sole proprietorship and partnership separately. Uncorrected frequencies for 1960 are 732 for sole proprietor and partnership profit or loss; 453 for those with only loss. The figures were reduced by the 1959 per cent of returns reporting both sole proprietor and partnership profit or loss (see column 8, Table 29).

number of returns with business and professional income or capital gain (or both) is equal to the number for the class. If we assume that the incidence of the two types of income within the income group is entirely random (i.e., zero correlation between business net loss and capital gain), then 313 of the 361 returns with unincorporated enterprise loss, or 87 per cent, had also net capital gain.[10]

The fact that entrepreneurial losses and net capital gains are frequently associated on high-income tax returns does not, of course, prove that some of these capital gains are in fact the capitalization of unincorporated enterprise profits. But there are a number of reasons for this hypothesis. High-bracket taxpayers have a strong inducement, in the absence of other factors, to conduct promising, but deficit-incurring, ventures in unincorporated form because a large part of current loss is offset by the consequent reduction in the individual's tax liability. The loss is shared by the Treasury at the individual's highest bracket rate. But the opposite occurs as soon as the venture begins to show the expected profits: for the same reason that losses make operation in unincorporated form attractive, profits make it unattractive. The individual becomes subject to a tax motive to convert either the expected *future* profits into a capital gain, or to convert his business into corporate form. In the one case, the proprietor's capitalized future profits become subject to the lower long-term capital gains rates; in the other, he avoids the personal income tax (but of course not the corporate tax) on earnings retained in the business.

In recent times the tax law has contained explicit recognition of the varying advantages in organizing as a corporation or unincorporated business. Under the 1954 Code, unincorporated businesses were granted the option to be taxed as corporations provided there were no more than 50 partners (in case of a partnership). Since 1958, corporations with no more than ten shareholders, and subject to certain other limitations,[11] have been permitted to elect partnership treatment under the income tax. Provided all shareholders consent, their profits are taxed at the shareholder level without loss of the benefits of incorporation. Whereas a corporation can at any time revoke its election to be taxed as a partnership, it cannot subsequently renew it for a period of five years.

The extent to which businesses have been able, and desirous, of electing optional tax treatment is shown in Table 28. Corporations have

[10] The figure was obtained as follows: $\frac{882}{1{,}018} \cdot 361 = 313$.

[11] For detail, see Internal Revenue Service, *Tax Guide for Small Business,* Publication No. 334, 1961 ed., pp. 125–129.

TABLE 28

NUMBER OF CORPORATIONS AND UNINCORPORATED ENTERPRISES ELECTING OPTIONAL TAX TREATMENT AS PERCENTAGE OF TOTAL NUMBER, 1957-60

	Total Number		Number Electing Optional Tax: Corporations		Number Electing Optional Tax: Unincorporated Businesses	
	Corporations (1)	Unincorporated Businesses (2)	Number (3)	Per Cent of Total (4)	Number (5)	Per Cent of Total (6)
1957-58	940,147	9,708,292			200	a
1958-59	990,381	9,753,551	43,945	4.4	560	a
1959-60	1,074,128	10,091,755	71,140	6.6	445	a
1960-61	1,140,575	10,030,545	90,221	7.9	n.a.	n.a.

Source: U.S. Treasury Department, Statistics of Income, U.S. Business Tax Returns.

[a]Less than 0.1 per cent.

clearly made the greater use of the option: for 1960–61, 8 per cent of corporations compared to less than 0.1 per cent of unincorporated businesses have chosen optional treatment.[12] The data suggest that small businesses use the option largely to carry losses directly to the individual; few in order to have profits taxed at the corporate level. For the corporations electing to be taxed as partnerships, 38 per cent had a net loss for 1960–61 (Table 29).[13]

In addition to these general considerations, a few special situations tend to create a bias among high-income taxpayers in favor of net losses from unincorporated enterprise. Partnerships (or syndicates) are often formed for the purpose of owning and operating depreciable real estate. Because physical assets are by far the most important input for the real estate industry, to the extent that depreciation for tax purposes proceeds at a faster rate than actual depreciation, tax accounting net income may for many years be greatly reduced or nonexistent. Writing of private investment in rental housing, Louis Winnick concludes that "the combi-

[12] Even if only partnerships are included in the denominator for unincorporated businesses, the number electing to be taxed as corporations is less than 0.5 per cent.

[13] However, this relative loss frequency is no greater than for corporations not electing optional treatment, after the data are standardized for asset size. For corporations with a similar asset-size distribution, but filing regular corporation tax returns, the percentage reporting net loss was: 39.2 in 1958–59; 38.7 in 1959–60; and 43.5 in 1960–61. For 1959–61, the relative loss frequency is greater for corporations using the regular return than for those choosing partnership treatment. For a possible explanation of this surprising result, see the hypothesis advanced in footnote 31 below.

TABLE 29

NUMBER AND NET INCOME OF CORPORATIONS ELECTING TO BE TAXED AS PARTNERSHIPS, BY NET PROFIT AND LOSS, 1958-60

	Number with			Amount (million dollars) of	
	Net Profit (1)	Net Loss (2)	Net Loss as Percentage of Total (3)	Net Profit (4)	Net Loss (5)
1958-59	25,203	18,742	42.6	287.9	199.0
1959-60	46,037	25,103	35.3	605.3	210.1
1960-61	56,123	34,098	37.8	678.5	296.0

Source: U.S. Business Tax Returns.

nation of mortgage interest and depreciation allowance on real estate improvements seems to be sufficient, in most cases, to wipe out the tax liability entirely or else to reduce it to relatively insignificant amounts."[14]

In such situations, operating a real estate venture in unincorporated form may be preferable, although the corporate form offers advantages which frequently outweigh any tax considerations.[15] In the early years of a venture the combination of mortgage interest and depreciation is particularly high relative to gross income. As mortgage interest and, possibly, depreciation[16] decline, and as taxable income from the venture rises, the owners become subject to a tax motive to sell the property and to realize a long-term capital gain in consequence. In this case accumulated past taxable income is converted into a capital gain. The bias toward so-called tax losses is confirmed by the relation of net losses to net profits reported for sole proprietors and partnerships classified as real estate operators and lessors (Table 30). This relation differs markedly

[14] *Rental Housing: Opportunities for Private Investment,* New York, 1958, p. 145. Because of its size relative to true net income, and a depreciation rate allowed by the Treasury that is faster than actual, this item has occupied a crucial position for many real estate investors for whom "depreciation is not considered an expense, even if it is so regarded by the Treasury, but a tax-free income." *Ibid.,* p. 151.

[15] *Ibid.,* p. 153. "While depreciation may yield the investor a tax-free cash surplus, the transfer of this cash from the corporation to his own bank account exposes the typical investor to a high personal income tax liability. This would not be the case if the apartment property were held by an individual proprietorship or partnership . . ." For further discussion of the same points, see W. J. Casey, *Tax Shelter in Real Estate,* New York, 1957.

[16] Where the taxpayer elects a form of accelerated depreciation, as permitted under the 1954 Tax Code, depreciation deductions as well as interest deductions for a given real estate improvement decline. However, accelerated depreciation is restricted to original owners, and further, according to Winnick, "many investors in FHA projects with 90 per cent mortgages are quite content to use straight-line depreciation." See Winnick, *Rental Housing,* p. 147.

TABLE 30

NET PROFIT, NET LOSS, AND DEPRECIATION OF REAL ESTATE OPERATORS AND LESSORS REPORTING AS SOLE PROPRIETORS AND PARTNERSHIPS, 1958-60
(million dollars)

				Depreciation on Returns with		
	Net Profit (1)	Net Loss (2)	Net Profit Less Loss (3)	Net Profit (4)	Net Loss (5)	Total (6)
			1958			
Sole proprietors	113.2	53.7	59.5	46.6	42.4	89.0
			1959			
Sole proprietors	176.6	51.2	125.5	50.7	33.8	84.5
			1960			
Sole proprietors	152.2	47.4	104.9	n.a.	n.a.	78.7
Partnerships[a]	515.0	156.1	358.9	262.3	170.6	433.0

Source: Statistics of Income: Selected Financial Data, 1958-59, 1959-60, 1960-61.

[a]Partnership net income and loss are after payments to partners are added back. For payments to partners, see U.S. Business Tax Returns, 1960-1961, p. 70.

from that reported for the rest of unincorporated enterprises whose reported losses are much smaller in relation to net profits (Tables 24 and 25).

Another special situation which may give rise to some asymmetry in tax treatment is individual participation in mineral exploration, especially oil exploration. Aspects of this type of enterprise have been widely discussed and need not be gone into in detail here.[17] It may suffice to note that a large proportion of exploration and development costs (referred to in the Tax Code as intangible costs)[18] incurred in the search for oil can be written off currently. These include the cost of surveys, exploratory drilling, labor, power, materials, etc. In addition, salvageable equip-

[17] See, for instance, the papers in Joint Committee on the Economic Report, *Federal Tax Policy for Economic Growth and Stability,* Washington, 1955, pp. 419–493, especially that by Arnold C. Harberger, "Taxation of Mineral Industries;" the Committee on Ways and Means, *Tax Revision Compendium,* Washington, 1959, vol. 2, pp. 933–1060, especially the paper by Peter O. Steiner, "Percentage Depletion and Resource Allocation;" and an exhibit on "Comparative Tax Benefits in Investment in Oil Property and in Depreciable Facilities," by Senator Paul H. Douglas in *Congressional Record,* June 18, 1960, p. 13291.

[18] *Internal Revenue Code of 1954,* Sec. 263 (c).

ment used is depreciated at ordinary rates. Each search is in effect a separate venture, and as long as an individual has other income, the cost of an unsuccessful search is for the most part written off and treated as a loss on the tax return. On the other hand, if a venture is successful, in addition to deducting intangible development costs in the year incurred and depreciation deductions for equipment, it is permissible to make a depletion deduction from taxable income of 27.5 per cent of the gross value of the output of the property, but not to exceed 50 per cent of net income attributable to it. As an alternative to producing oil from his discovery, the individual may sell it after a six-month interval and pay a capital gains tax limited to 25 per cent of the gain.

To the extent that high-income investors engage in oil ventures in unincorporated form,[19] there is thus ample reason for the pattern of net losses and profits displayed in Table 27. Some confirmation that mining ventures have contributed to the pattern observed can be obtained from industry breakdowns of unincorporated enterprise tax returns for six selected years in the period 1953–60 (Table 31). For these years, net losses for unincorporated mining enterprises, most of which were engaged in oil and gas production, were nearly as great as net profits. Indeed, for 1953, 1958, and 1960, net losses exceeded net profits in the mining sector. This situation was very different from the aggregate for unincorporated enterprises whose net profits for 1960 were over nine times as large as net losses (Table 27). For the corporate mining sector (included in Table 31 for comparison), the allowance of depletion also reduced the ratio of net profit to loss, but this ratio was nevertheless much higher for corporations than for unincorporated business. Apparently, we are observing the result of a bias in favor of reporting the less successful ventures in the unincorporated enterprise category and the more successful ones as long-term capital gains.[20]

[19] Much of the exploration for oil in the United States has been carried out by individuals in recent times. In a paper by Paul Haber, "Writeoffs, Cost Depletion, and Percentage Depletion—An Appraisal" (inserted into the *Congressional Record,* June 18, 1960, pp. 13292–13293, by Senator Paul H. Douglas), it is asserted that "at least 40,000 wells a year, out of a total of 55,000, are drilled by individual taxpayers and only 15,000 are drilled by major oil companies . . . ."

[20] In contrast to the annual net profit-net loss relation for mining ventures observable in Table 31, the following relation is found in the sale of natural resources which are reported as long-term capital assets (assets held longer than six months) on individual tax returns for 1959:

Gross sales	$382
Long-term capital gains	276
Long-term capital losses	13

The above figures are from the Treasury's special study *Sales of Capital Assets Reported on Individual Income Tax Returns for 1959* (*Statistics of Income, 1959,* Supplemental Report), Table 2. The

In addition to the possible capitalization by individuals of future, and in some cases past, net income through sale of the enterprise to a corporation or other individuals, the observed bias may also be the result of conversion of unincorporated businesses into corporations. When an operation becomes profitable (in the tax-law sense), an individual has a tax motive to convert it into a corporation, for he is then able to avoid the personal income tax on the earnings retained in the business. If the accumulation of retained earnings in the business is desired, and possible,[21] there may be a tax motive against making the takeover by a corporation the occasion for realizing capital gains. The individual will then avoid capital gains tax until the stock in the corporation itself is sold; and if death intervenes, the tax will be avoided forever.[22]

The above analysis may also shed light on a problem raised by Irwin Friend and Irving Kravis.[23] They note that, according to survey data, the unincorporated enterprise sector has a high marginal propensity to save and accounts for a major share of personal saving; and that "unincorporated nonfarm enterprises have played a significant role in capital formation."[24] In other words, a large proportion of proprietors' savings is offset by investment in inventories, plant, and equipment. Yet Friend and Kravis also note that, according to aggregate data, the annual changes in equity of proprietors in unincorporated business enterprises have grown surprisingly little. In the postwar period (1946–54), changes in net physical investment of unincorporated businesses were found to be 24 per cent of personal saving, whereas the net increase in unincorporated business equity was only 3 per cent of personal saving.[25]

The authors pose the question "Can this conflict be reconciled?" and consider the possibility that conceptual differences between the various estimates might account for the apparent paradox. The savings data used in the Friend-Kravis study are for the most part survey estimates of both

"natural resources" category used in the capital assets study includes the sale of timber and timber royalties; oil and mineral rights and leases; oil well ventures; coal royalties; and production payments in oil and minerals. The figures for sole proprietorship and partnership income do not include timber or forestry operations and the data are to that extent not entirely comparable.

[21] That is, if there are suitable opportunities to invest retained earnings through the corporation so as not to incur the penalty tax on undistributed earnings provided for in Section 102 of the Code.

[22] The Code provides that if property is exchanged solely for stock of a corporation, which is controlled by the transferor, no gain or loss is to be recognized at the time of the exchange. See *Internal Revenue Code of 1954,* Sec. 351.

[23] "Entrepreneurial Income, Saving, and Investment" *American Economic Review,* June 1957, pp. 269–301.

[24] *Ibid.,* pp. 282–283.

[25] *Ibid.,* p. 281.

TABLE 31
MINING NET PROFIT AND LOSS, DEPRECIATION, AND DEPLETION, REPORTED FOR SOLE PROPRIETORS, PARTNERSHIPS, AND CORPORATIONS, 1953-60
(million dollars)

	Net Profit (1)	Net Loss (2)	Depreciation (3)	Depletion (4)
			1953	
Sole proprietors	87	96	n.a.	n.a.
Partnerships	353	411	82	77
Corporations	1,101	156	443	743
			1956	
Sole proprietors	209	182	185	190
Partnerships[a]	157	144	94	84
Corporations	1,470	303	593	845
			1957	
Sole proprietors	167	134	85	86
Partnerships[a]	182	89	146	105
Corporations	1,287	338	665	882
			1958	
Sole proprietors	109	105	144	200
Partnerships[a]	140	168	107	81
Corporations	1,190	358	645	797
			1959	
Sole proprietors	105	110	94	71
Partnerships[a]	122	84	91	68
Corporations	1,152	479	678	n.a.
			1960	
Sole proprietors	116	219	134	202
Partnerships	127	152	104	98
Corporations	1,260	521	720	893

Source: The following supplements to Statistics of Income were used: U.S. Business Tax Returns; Corporation Income Tax Returns; Partnership Returns, 1953; Business Indicators, Sole Proprietorships Partnerships, Corporations, 1956-57; and Selected Financial Data for the four most recent years in the table.

[a] After 1953, "payments to partners" became a deductible item on partnership information returns. Estimates of payments to partners were therefore added back to the ordinary income and loss data as tabulated. Total payments to partners for 1957-60 were tabulated in Selected Financial Data; only the total for 1956 was therefore estimated by us. However, no breakdown of this item between net income and net loss returns was available, and the division was therefore made on the assumption that payments to partners are divided between income and loss returns in proportion to gross receipts on such returns.

personal and business savings of businessmen; the data for changes in unincorporated business equity are based on Commerce estimates which cover business saving and capital transfers between personal and business accounts. The authors, noting that capital transfers between personal and business assets would have to be negative to help the reconciliation, feel that these differences "can at best account for only part of the difference between the survey and Commerce estimates." Their discussion suggests strongly that the disparity may be accounted for by weaknesses in the annual Commerce estimates of changes in unincorporated business equity.[26]

While an attempt at quantitative reconciliation of the findings from cross-sectional surveys and annual aggregates would be clearly outside the scope of the present study, it is nevertheless noteworthy that the tax-return data suggest that the "conflict" may indeed be largely a matter of capital transfers. Proprietors may at any moment of time invest most of their savings in their own businesses, and yet year-to-year data may show only small increases in unincorporated business equity. Such a development will occur if proprietors sell profitable businesses to corporations, or incorporate them on their own.[27] It will show up on asset account as a transfer from unincorporated business to personal holdings. Our data suggest that this may have taken place over time. To the extent that this explanation is valid, there is no conflict between the Commerce Department "equity" estimates and the survey findings.

[26] *Ibid.*, pp. 286–287.

[27] The number of sole proprietorships and partnerships that were converted into corporations during any one year appears to be very small in relation to the total number of unincorporated businesses. IRS tabulations of first-year corporation returns for 1946 and 1954 show the following:

	New Corporation Returns of Previously Unincorporated Enterprises		*Number of Unincorporated Enterprises in Preceding Year*		*Per Cent of Total Converted*	
	Total (1)	Nonfarm (2)	Total (3)	Nonfarm (4)	Total (5)	Nonfarm (6)
1946	22,473	22,232	6,316,522	3,520,331	0.36	0.63
1954	16,346	16,108	8,673,103	5,319,895	0.19	0.30

Source: Cols. 1 and 2: *Statistics of Income, Corporation Returns,* 1946 and 1954.
Source: Cols. 3 and 4: *Statistics of Income, Individual Returns,* 1945 and 1953, and *Partnership Returns* (Supplements), 1945 and 1953.

It is, however, difficult to conclude anything from frequencies alone in the present context. Even if small in number relative to the total, the businesses changing into corporations are likely to be among the largest and to control a disproportionate share of assets. Furthermore, even a small outmigration of firms may offset much of the increase in equity of all the remaining firms for the same period, since the former represents the cumulation of past years' increases in equity (a stock) whereas the latter is only the increase over that period (a flow).

Another set of situations, which operates to reduce the reported net-profit-to-loss ratio on tax returns, consists in attributing expenses to unincorporated enterprises which are actually unrelated to them. Individuals may pursue hobbies which are difficult to distinguish from enterprises conducted to produce income. The most frequently cited case in point is the so-called gentleman's farm. In this case the business aspect of the farm may be incidental to the consumption purpose which it has for its owner, and the loss at which it is operated is thus questionable within the usual business terms. Similar instances are the occasional antique or gift shop, which permits its owner to deduct the cost of travel as a business expense, and various resort enterprises, such as the operation of a ski-tow, which permit the mingling of business and pleasure.[28] A clue to the possible quantitative importance of hobby-losses among sole proprietors of farms and recreational enterprises can be obtained from a breakdown of net income for these industries by total income (AGI) of the proprietors. Such a tabulation became available for the first time for 1960. In Table 32 net income from farming, recreational services, mining, and real estate operation is shown by AGI groups. For the latter two, the figures shown are the algebraic sum of the net losses and net profits shown separately in Tables 30 and 31. No separate tabulation of net losses and net profits by size of AGI and industry groups are available. However, even the net income (net profits minus net losses) tabulations in Table 32 show conclusively that, for the four industry groups in question, net losses are highly concentrated at the upper extreme of the income scale. Net income originating in mining and farming turned negative from the $50,000 level on. The reasons why this may be so for mining have already been discussed. For farming it suggests the existence of a significant hobby-loss element at high income levels. Indeed, the hobby-loss farm appears to contribute a large part, though by no means all, of the explanation for the peculiar relation of unincorporated enterprise net income to AGI on tax returns when moving up along the income scale.

Probably more prevalent at low-income levels is the practice of some to ascribe a disproportionate part of professional or business expense to part-time self-employment. For example, an employed scientist may deduct from small or occasional consulting fees most of his professional expenses, such as the cost of journals and depreciation of professional

[28] The so-called hobby-loss provision of the Tax Code is intended to curb this practice. It applies to individuals whose expenses relating to an enterprise exceeds gross income therefrom by $50,000 or more in each of five consecutive years. See *Internal Revenue Code* of 1954, Sec. 270.

TABLE 32

SOLE PROPRIETORSHIP NET INCOME: TOTAL AND FOUR SELECTED INDUSTRIES, BY INCOME GROUPS, 1960
(million dollars)

AGI (thousand dollars)	All Industries (1)	Mining (2)	Real Estate Operators and Lessors (3)	Farms (4)	Recreational Services (5)	All Other (6)
Under 1	-714	-50	-12	-241	-8	-403
1 - 2	1,027	2	14	460	1	550
2 - 5	4,840	4	24	1,336	30	3,446
5 - 10	5,943	-17	36	808	32	5,084
10 - 20	5,058	12	23	333	30	4,660
20 - 50	4,113	10	18	96	20	3,970
50 - 150	813	-50	2	-23	4	880
150 - 500	1	-9	a	-22	-4	36
500 and over	-15	-6	a	-10	-2	3
Total	21,067[b]	-103	105	2,737	103	18,226

Source: Cols. 1-5: U.S. Treasury Department, U.S. Business Tax Returns, 1960-61, Table 6. Col. 6: col. 1 minus the sum of cols. 2-5.

[a]Less than 0.5 million (negative for the $500,000 and over group).

[b]This total differs by $5 million from that shown in Table 19 whose source is Statistics of Income, Individual Income Tax Returns, 1960.

library. He could not deduct such expenses at the same time as using the standard deduction if he were merely an employee.[29] The practice results in understatement of his independently obtained income, and indeed may result in a small business loss.

Effect on Business Organization of Tax Treatment of Pension Plan Contributions

The data presented earlier in this chapter are influenced by the treatment of employer contributions to pension funds. Subject to certain limitations, such contributions have in recent times been a deductible current expense to employers, the same as cash wage payments, and a form of deferred compensation to employees. The treatment as deferred compensation under the income tax means that beneficiaries are not taxed currently on either the employer contributions made on their behalf nor on the accumulated investment income of the fund, but only

[29] Occupational and professional expenses of employees may be deducted and are part of the so-called personal deductions on the individual return, Form 1040. For persons who itemize, it is therefore immaterial whether they include these expenses among their personal deductions or among their business deductions in the business schedule of the return. But for persons who take the standard deduction, an advantage arises from shifting occupational expenses into the business schedule.

at the time when payments are actually made to them. The effect of this deferral is a considerable lowering of tax liability over time. Owner-managers of corporations, because they are employees, have long been able to obtain substantial tax advantages through qualified pension plans.[30]

Until recently owner-employees of unincorporated enterprises have not had this opportunity. In order to obtain the same tax treatment with respect to retirement contributions as has been available to employees, self-employed persons had to incorporate their business or profession and pay themselves a salary. Many state laws were amended to enable professional persons to do so. This may have been an important consideration, in addition to the possibility of lower corporate tax rates, in causing some proprietors to incorporate. For some, as has been discussed earlier in the chapter, it has been possible to do both; namely to incorporate and, at the same time, to carry any income (loss) directly to the proprietors. This may also explain why few partnerships and sole proprietors, but a substantial number of corporations, choose optional tax treatment (see Table 28).[31]

Beginning with January 1, 1963, self-employment income has received some of the favorable tax treatment available for employment income.[32] One-half of the contributions to approved retirement plans up to 10 per cent of earned self-employment income, or $2,500 annually, whichever is lower, may be deducted. That is, the amount deducted cannot exceed $1,250, must be matched 100 per cent by nondeductible contributions to the plan, and the combined total cannot exceed 10 per cent of income. Any full-time employee with a minimum of three years of service must be included on a nondiscriminatory basis under the plan, and any contributions on his behalf must be vested immediately.

The new provisions concerning self-employment income thus appear, at least initially, less favorable than those for stockholder-employees of corporations. Many proprietors may therefore continue to find incorporation combined with the option to be taxed as a partnership more

[30] The term "qualified" in this context means that a plan has met all the requirements of the Internal Revenue Service in order to qualify for the desired tax treatment.

[31] It might also explain why the incidence of losses was found to be no greater among corporations electing optional partnership tax treatment than among corporations not electing (Table 29). It would mean that those electing to be taxed as a partnership incorporated mainly to obtain the more advantageous treatment of retirement contributions but otherwise found it advantageous to be taxed at individual, rather than corporate, tax rates.

[32] See "Self-Employed Individual Tax Retirement Act of 1962" (P.L. 87-792).

favorable. It is, of course, too early for any of the effects of the new provisions to be reflected in the data available at the time of writing.

Pattern of Income on Returns With Profit or Loss From Business or Profession

Table 33 shows the relative frequency of returns with profit or loss from sole proprietorship or partnership, or both, for 1955 and 1959. These are the only recent years for which data are available in sufficient detail to make possible the elimination of double-counting of returns filed by persons who are both sole proprietors and partners. In every income group above the $10,000 level, more than one-third of the returns have profit or loss from unincorporated enterprise. Above the $100,000 level, the frequency is more than one-half. This is in sharp contrast to the relatively small, if any, net profits from that source reported for that income range, and is another indication that some of this entrepreneurship may be so in name only, or may be largely directed toward the accumulation of capital gains through sale of the enterprise.

We also see in Table 33 that the proportion of returns reporting profit or loss from both sole proprietorship and partnership rises continuously from the bottom of the income scale to the top, except for the group with negative income. Nearly one out of ten returns with business or professional income in the $10,000-$25,000 group was filed by a person who was both a sole proprietor and a partner. On returns with adjusted gross income of $100,000 and over, this proportion was greater than two in ten. For the total of returns in the two annual distributions, only four out of one hundred had both sole proprietor and partnership income. However, the relative frequency of multiple business returns is greater than that, since no account is taken of returns with income from more than one sole proprietorship or more than one partnership. The important aspect of this diversification is that it lowers the chance of unaveraged losses. The loss in one enterprise can be offset against the profit in another.

Such loss offsets are of course not dependent on multiple business ownership. As Table 34 shows, at least 57 per cent of returns with business and professional income for 1955 and 1959 also reported income from one or all of these other sources: wages, salaries, dividends, interest, rents, and royalties.[33] One-third of those with negative income and

[33] Hereafter referred to, for brevity, as "other sources." Capital gains or losses and the smaller income sources were omitted from the basic tabulation from which Table 34 is derived.

TABLE 33

NUMBER OF RETURNS WITH UNINCORPORATED ENTERPRISE PROFIT OR LOSS AS PERCENTAGE OF ALL RETURNS FILED, 1955 AND 1959
(in thousands)

		Number with Profit or Loss from			Percentage of Returns with Profit or Loss from			
Income Group (thousand dollars)	All Returns (1)	Sole Proprietorship (2)	Partnership (3)	Sole Proprietor and/or Partnership[a] (4)	Sole Proprietorship (2) ÷ (1) (5)	Partnership (3) ÷ (1) (6)	Sole Proprietor and/or Partnership (4) ÷ (1) (7)	Sole Proprietor and Partnership[b] (8)
				1955				
Negative AGI	432.0	363.8	56.4	399.2	84.2	13.1	92.4	5.3
0 - 2	15,691.1	2,619.1	298.2	2,872.2	16.7	1.9	18.3	1.6
2 - 3	8,428.7	1,279.9	211.6	1,457.0	15.2	2.5	17.3	2.4
3 - 5	16,673.6	1,832.5	398.6	2,158.8	11.0	2.4	12.9	3.3
5 - 10	14,461.5	1,487.9	515.2	1,912.6	10.3	3.6	13.2	4.7
10 - 25	2,153.0	534.3	334.5	791.2	24.8	15.5	36.7	9.8
25 - 50	311.0	100.8	101.3	177.2	32.4	32.6	57.0	14.1
50 - 100	77.6	21.0	29.4	43.6	27.1	38.0	56.3	15.6
100 - 500	20.8	5.5	8.9	11.9	26.3	42.7	57.0	21.0
500 and over	0.9	0.3	0.4	0.5	33.7	43.9	61.6	26.0
Total	58,250.2	8,245.1	1,954.7	9,824.2	14.2	3.4	16.9	3.8

(continued)

TABLE 33 (concluded)

Income Group (thousand dollars)	All Returns (1)	Number with Profit or Loss from: Sole Proprietorship (2)	Partnership (3)	Sole Proprietor and/or Partnership[a] (4)	Percentage of Returns with Profit or Loss from: Sole Proprietorship (2) ÷ (1) (5)	Partnership (3) ÷ (1) (6)	Sole Proprietor and/or Partnership (4) ÷ (1) (7)	Sole Proprietor and Partnership[b] (8)
				1959				
Negative AGI	433.1	355.0	51.9	388.6	82.0	12.0	89.7	4.7
0 - 2	14,315.2	2,273.7	232.6	3,702.3	15.9	1.6	17.3	1.7
2 - 3	7,128.2	1,105.6	153.7		15.5	2.2		
3 - 5	14,065.1	1,823.0	331.8	2,098.4	13.0	2.4	14.9	2.7
5 - 10	19,546.4	2,079.0	575.0	2,554.6	10.6	2.9	13.1	3.9
10 - 25	4,217.9	784.6	421.2	1,107.8	8.6	10.0	26.3	8.8
25 - 50	422.7	145.5	123.7	235.0	34.4	29.3	55.6	14.5
50 - 100	114.8	35.9	45.8	70.1	31.3	39.8	61.0	16.5
100 - 500	26.8	6.9	11.4	15.5	25.8	42.6	57.6	18.7
500 and over	1.0	.3	.5	.6	29.8	47.0	61.3	25.4
Total	60,271.3	8,609.7	1,947.8	10,172.9	14.3	3.2	16.9	3.8

Source: Statistics of Income, Individual Income Tax Returns, 1955 and 1959, Tables 6 and 8 respectively.

[a] Derived from Tables 6 and 8 in above source.

[b] Col. 2 plus col. 3 divided by col. 4 minus 1.

TABLE 34

RELATIVE FREQUENCY OF RETURNS WITH UNINCORPORATED ENTERPRISE PROFIT OR LOSS AND INCOME FROM OTHER SOURCES, 1955 AND 1959

Income Group (thousand dollars)	PERCENTAGE OF RETURNS WITH ENTERPRISE INCOME AND: Wages and Salaries 1955 (1)	Wages and Salaries 1959 (2)	Dividends 1955 (3)	Interest 1955 (4)	Rents and Royalties 1959 (5)	Income from Other Sources[a] 1955 (6)	Income from Other Sources[a] 1959 (7)
Negative AGI	22.0	23.2	6.1	11.3	17.0	32.9	36.0
0 - 2	27.2	31.2	3.7	10.1	14.7	36.8	41.9
2 - 3	42.6		4.8	13.4		53.3	
3 - 5	54.3	53.9	6.6	15.1	17.2	64.4	63.7
5 - 10	60.4	63.3	13.8	25.4	21.2	74.9	73.2
10 - 25	44.8	50.6	36.7	46.3	28.8	75.5	66.2
25 - 50	45.4	44.4	62.2	64.0	36.0	85.8	64.1
50 - 100	56.1	50.6	79.3	73.8	40.3	93.4	70.2
100 - 500	67.2	60.0	90.2	83.5	46.2	98.1	78.1
500 and over	71.1	88.1	97.4	89.4	58.0	99.5	88.1
Total	43.6	46.3	10.7	19.0	19.0	56.9	57.4

Source: See source to Table 33.

[a]For 1955, income from other sources means wages and salaries, dividends, and interest. For 1959 it means wages and salaries and rents and royalties.

nearly all those reporting adjusted gross income over $100,000 for 1955 had income from these sources in addition to that from unincorporated enterprise.[34] As the percentages show, for those reporting incomes below $10,000, the most frequent source of other income was wages and salaries; for those with higher income, dividends and interest were the most frequent other sources.

[34] These relative frequencies may be compared with data from the Survey of Consumer Finances for 1949–52, presented by L. R. Klein and J. Margolis in "Statistical Studies of Unincorporated Business," *Review of Economics and Statistics,* February 1954, p. 40. Klein and Margolis dealt with unincorporated business exclusive of farm operators, professionals, and self-employed artisans who have no employees "and little or no capital plant or equipment." They found that 62 per cent of the entrepreneurial spending units in their sample received money income outside the business; 52 per cent if the units are limited to those in which the owner himself receives outside income. From these figures we could expect a tax return sample to show a range of 52 to 62 per cent for outside income, and our figure for 1955 indeed falls into that range. But for receipt of income from dividends, interest, trust funds, or royalties, Klein and Margolis present us with a range of only 13 to 14 per cent. The large difference between this and our figure of 23 per cent for dividends and interest alone may be primarily the result of differences in concept between the tax return distributions and the Klein-Margolis sample. The latter excludes professional practitioners, a category which is included in the tax return distribution. This group is likely to have a high property income frequency which would explain the difference in the two studies.