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**WRITTEN STATEMENT
OF THE
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS**

**For the Record of the
July 10, 2014 Hearing
of the**

UNITED STATES HOUSE OF REPRESENTATIVES

COMMITTEE ON SMALL BUSINESS

SUBCOMMITTEE ON ECONOMIC GROWTH, TAX AND CAPITAL ACCESS

on

CASH ACCOUNTING: A SIMPLER METHOD FOR SMALL FIRMS?

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Introduction

The AICPA commends Chairman Rice, Ranking Member Chu, and the Subcommittee on Economic Growth, Tax and Capital Access for examining cash accounting, its utilization by small businesses, and whether the current policies should be changed to allow small firms more flexibility in choice of accounting methods.

We wholly support the expansion of the number of taxpayers that may use the cash method of accounting. The cash method of accounting is simpler in application, has fewer compliance costs, and does not require taxpayers to pay tax before receiving the income being taxed. For these same reasons, we are extremely concerned with, and oppose, any limitations on the use of the cash method for small and service businesses, including those businesses whose income is taxed directly on their owners' individual returns, such as S corporations and partnerships. Requiring these businesses to switch to the accrual method upon reaching a gross receipts threshold would unnecessarily discourage small business growth.

The AICPA is the world's largest member association representing the accounting profession, with more than 394,000 members in 128 countries and a 125-year heritage of serving the public interest. Our members advise clients on Federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

Background

1. General Rules

In general, a taxpayer may use any method of accounting that clearly reflects income (including the cash method) unless the taxpayer is required by the Internal Revenue Code or Income Tax

AICPA Written Statement for the Record
U.S. House of Representatives, Committee on Small Business
Subcommittee on Economic Growth, Tax and Capital Access
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Regulations to use a specific method of accounting (e.g., the accrual method of accounting, the percentage of completion method for long-term contracts, etc.).¹

For example, the following taxpayers are generally permitted to use the cash method of accounting:

1. Sole proprietors;²
2. Pass-through entities (e.g., partnerships and S corporations);³
3. Entities that engage in a farming business;⁴
4. Entities that primarily perform services by their owners;⁵ and
5. Entities that satisfy a \$5 million gross receipts test (and do not maintain inventory).⁶

Currently, the Internal Revenue Code and Income Tax Regulations require certain taxpayers to adopt a specific method of accounting (e.g., the accrual method of accounting, the percentage of completion method for long-term contracts, etc.). For example, C corporations (as well as partnerships that have a C corporation as a partner) and tax shelters are not allowed to use the cash method of accounting (subject to exceptions),⁷ and a taxpayer must also generally use the accrual method of accounting if the taxpayer purchases, produces, or sells merchandise.⁸

On the other hand, the Internal Revenue Service (IRS), by administrative action, has allowed certain “small” taxpayers (e.g., qualifying taxpayers⁹ and qualifying small business taxpayers¹⁰) to use the cash method even if inventories are maintained.

In other words, most types of entities (e.g., sole proprietorships, partnerships, and S corporations) may use the cash basis method of accounting regardless of whether they maintain inventory, if they have average annual gross receipts of less than \$10 million. As mentioned above, this threshold is lowered to \$5 million for C corporations.

In general, a taxpayer who changes its accounting method (e.g., from the cash method to the accrual method) is required to compute an adjustment (section 481(a) adjustment) to prevent items of income or expense from being duplicated or entirely omitted from the taxpayer’s taxable income. If the accounting method change is made with the permission of the Commissioner and results in a

¹ See section 446(c).

² See section 446(c).

³ See section 446(c).

⁴ See limitation, however, under section 447.

⁵ See section 448(b).

⁶ See section 448(b)(3).

⁷ See section 448(a) and 448(b)(3).

⁸ See Treas. Reg. § 1.446-1(c)(2)(i).

⁹ According to Rev. Proc. 2001-10, a qualifying taxpayer is an entity with average annual gross receipts for each prior tax year ending on or after December 17, 1998, of \$1 million or less.

¹⁰ According to Rev. Proc. 2002-28, a qualifying small business taxpayer is an entity with average annual gross receipts for each prior tax year ending on or after December 31, 2000, of more than \$1 million but not more than \$10 million, and is not otherwise prohibited from using the cash method under section 448(a).

positive section 481(a) adjustment (increase in income), the adjustment is included in taxable income ratably over four taxable years. Whereas, a negative section 481(a) adjustment (decrease in income) is taken into account entirely in the year of change.¹¹

2. *Recent Proposals*

On February 21, 2014, House Ways and Means Committee Chairman Dave Camp released the [Tax Reform Act of 2014](#), which provides that the cash method of accounting is available for natural persons (in other words, “individuals”) and any other taxpayer who meets the gross receipts test and is otherwise eligible to use the cash method. Under the proposal, a taxpayer would satisfy the gross receipts test if the taxpayer’s average annual gross receipts for a three taxable-year period are \$10 million or less. The proposal effectively would require certain pass-through entities (e.g., partnerships and S corporations) and personal service corporations with average annual gross receipts in excess of \$10 million to use the accrual method of accounting. The proposal also would provide that a positive section 481(a) adjustment from an accounting change from the cash method to the accrual method is accounted over a four-year stepped period within eight years.

On November 21, 2013, the former Senate Finance Committee Chairman Max Baucus released the [2013 Cost Recovery and Accounting Staff Discussion Legislative Language](#), which provides that the cash method of accounting is only available by taxpayers who meet the gross receipts test and are otherwise eligible to use the cash method. Under the proposal, a taxpayer would satisfy the gross receipts test if the taxpayer’s average annual gross receipts for a three taxable-year period are \$10 million or less. The proposal effectively would require certain individuals, farmers, pass-through entities (e.g., partnerships and S corporations), and personal service corporations with average annual gross receipts in excess of \$10 million to use the accrual method of accounting. However, the proposal would permit a taxpayer to use the cash basis method of accounting, if the gross receipts threshold is satisfied, regardless of whether it maintains inventory.

In summary, if enacted, these proposals would both expand and limit the availability of the cash method of accounting for small businesses by increasing the gross receipts threshold from \$5 to \$10 million and requiring pass-through entities and personal service corporations with average annual gross receipts in excess of \$10 million to use the accrual method of accounting.

Analysis

Increased burden in adopting the accrual method of accounting

The AICPA believes that requiring small and service businesses, including those businesses whose income is taxed directly on their owners’ individual returns, such as S corporations and partnerships, to adopt and use the accrual method of accounting imposes complexities and increases burden.

¹¹ See Section 481(a); Rev. Proc. 97-27, 1997-1 C.B. 680.

Under the cash method, income is recognized when it is actually or constructively received, and expenses are recorded when paid. These are straightforward and easily applied tests. Therefore, determining taxable income using the cash method is much simpler in application. Thus, many small businesses, including the service industry, prefer using the cash method of accounting.

Under the accrual method, income is recognized when the right to receive the income is fixed and the amount is determinable with reasonable accuracy,¹² and expenses are deductible when they are fixed, determinable, and economically performed¹³ (e.g., the “all-events test”). These tests require analysis that is more complex than under the cash method. For example, under the accrual method, a taxpayer must determine the fact and amount of liability and determine if the property or service to which the accrual relates is actually provided or used. Therefore, determining taxable income under the accrual method is far more difficult in application, resulting in increases in the cost of compliance compared with the cash method. Thus, many small businesses oppose any requirement that the accrual method of accounting be used.

Given that the cash method remains a far simpler method of accounting, the AICPA believes that simplicity justifies its continued use by non-natural persons (e.g., pass-through entities and personal service corporations), regardless of their gross receipts.

Discouraging business growth

The AICPA believes that limiting the use of the cash method of accounting by businesses (e.g., sole proprietors, farmers, and pass-through entities) would discourage their natural business growth.

Every business hopes to grow. Businesses may grow organically, or by combining with similar businesses. As a result, although many businesses start out as a sole proprietorship, most eventually convert to a pass-through entity (e.g., general partnerships, limited liability partnerships, limited liability companies, and S corporations) to join forces and expand their operations.

Under Chairman Camp’s proposal, many pass-through entities would need to change to the accrual method of accounting once their average annual gross receipts exceeded a \$10 million threshold, inhibiting both organic growth and growth through combination. For example, assume a sole proprietor is currently operating a successful business with more than \$10 million of gross receipts. If the sole proprietor rewards an employee by making the employee a partner in the business, the business is no longer operating as a natural person (sole proprietor) and therefore, would be ineligible to continue to use the cash basis method of accounting – providing a disincentive to expand the business.

¹² See section 451.

¹³ See section 461.

Similarly, if two firms (each with \$5.5 million gross receipts) intend to combine to share resources and expertise and better serve their clients, the combined firm would exceed the proposed threshold and be subject to the mandatory use of the accrual method of accounting – again, creating a disincentive to gain efficiencies through combination. In other words, a business’s inability to use the cash method of accounting would create an artificial obstacle to joint ventures or the joining of two or more owners or businesses.

In addition, limiting the use of the cash method of accounting would slow down (even stop) business growth. As noted above, requiring businesses to adopt the accrual method would increase the cost of compliance. This increase would force these businesses to stop hiring and planning for future expansions. In other words, instead of these businesses focusing on their growth (e.g., hiring more employees, expanding to new markets), they would be required to shift their resources to comply with the requirement.

Small businesses play a key role to the economic growth in the United States. According to the [Small Business Administration](#), small businesses “accounted for 63 percent of the net new jobs created between 1993 and mid-2013 (or 14.3 million of the 22.9 million net new jobs).” The AICPA believes that small businesses need a sound tax policy and business environment that promotes simplicity and economic growth. The cash method of accounting provides simplification and allows small businesses to focus on their expansion and growth.

Financial burden on individual owners of service businesses

The AICPA believes that limiting the use of the cash method of accounting for service businesses and pass-through businesses would impose an undue financial burden on their individual owners.

These businesses should not be required to use the accrual method of accounting. Such a requirement would accelerate the taxable income of many professional service firm owners (e.g., CPAs, attorneys, engineers), resulting in an increased tax liability on earnings they have not yet received. In order to pay this accelerated tax, some businesses would be forced to make cash distributions to their owners from other sources (e.g., new loans, reduction in workforce, slowing growth initiatives, etc.), potentially threatening their operations due to a tightening of cash flow. Other businesses would force their owners to deal with the financial burden regardless of the individuals’ ability to pay.

Additionally, the acceleration of income may result in the only reason that a partner is taxed at a higher marginal tax rate. Under the current U.S. tax system, income is taxed at progressively higher rates.¹⁴ For example, the top marginal rate of 39.6 percent applies to taxable income over \$400,000 for a partner filing as a single person. Thus, the acceleration of income of a partner could be taxed at the highest marginal rate that would otherwise be taxed at a lower rate (e.g., 35, 33, 28, 25, 15, or 10 percent). In addition to paying the highest tax rate, the partner could lose some of the benefit of

¹⁴ [IRS 2013 Form 1040 Instructions](#), page 101.

itemizing certain deductions. For example, itemized deductions (e.g., mortgage interest deduction, charitable deduction) of a partner with an adjusted gross income of \$250,000 would be reduced by the lesser of 3 percent of the excess of adjusted gross income (AGI) over \$250,000 or 80 percent of the itemized deduction.¹⁵ Thus, the partner is likely to have a higher overall tax liability with the acceleration of income.

For those professional service firms that are subject to state regulations limiting ownership to individuals who actively participate in the business, the potential hardship created by restricting use of the cash method by pass-through entities would increase significantly. For example, in many states, a firm engaged in the practice of accountancy is specifically prohibited from allowing any passive (investor) ownership and a majority of the owners must hold active CPA licenses. As a result, many accounting firms must raise capital solely by the individual professionals who together own the firm; they cannot raise capital from outside investors. As a result, an acceleration of tax on income that has not actually been collected in cash would place a strain on the ability of such professional owner-operators to properly capitalize and maintain capital in their firms.

We believe that a transition from the cash to the accrual method imposes undue financial burden and would have a negative impact on both a new owner's ability to finance entrance into a partnership and a firm's ability to grow either independently or through merging with another firm.

Conclusion

The AICPA supports expansion of the number of taxpayers who may use the cash method of accounting. As we have discussed, the cash method of accounting is simpler in application, has fewer compliance costs, and does not require taxpayers to pay tax before receiving the cash.

However, we strongly believe that Congress should not restrict the use of the long-standing cash method of accounting for the thousands of U.S. businesses that rely on it. We have confidence that forcing more businesses to use the accrual method of accounting for tax purposes would increase their administrative burden, discourage business growth in the U.S. economy, and unnecessarily impose financial hardship on cash-strapped businesses.

¹⁵ See section 68(a).