



December 5, 2013

The Honorable Max Baucus, Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Orrin G. Hatch, Ranking Member
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

RE: Continued Availability of Cash Method of Accounting

Dear Chairman Baucus and Ranking Member Hatch:

As Congress moves forward on tax reform this year, the American Institute of Certified Public Accountants (AICPA) offers our comments on the cash method of accounting proposal in Chairman Baucus' Discussion Draft on Cost Recovery and Accounting ("Proposal").

The AICPA commends Chairman Baucus and the Senate Finance Committee on your continued efforts to simplify the Internal Revenue Code (IRC or "Code") and your responsiveness to taxpayer concerns that the Code as written is currently too complex. We have consistently supported tax reform simplification efforts because we are convinced such actions will significantly reduce taxpayers' compliance costs, encourage voluntary compliance through an understanding of the rules, and facilitate enforcement actions.

We 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 certain limitations included in the Proposal. We believe that Congress should not further restrict the use of the long-standing cash method of accounting for the thousands of U.S. businesses that rely on it.

Limitation on Use of Cash Method of Accounting (Section 51)

Generally, Section 51 of the Proposal provides that the cash method of accounting is only available for taxpayers including natural persons (i.e., sole proprietors) who meet the gross receipts test. A taxpayer satisfies 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 eliminates exceptions that currently exist for all natural persons, certain pass-through entities (i.e., partnerships and S corporations), farmers, and personal service corporations. Under current law, these businesses are permitted to use the cash basis method of accounting, regardless of their gross receipts, unless they have inventory.

The AICPA opposes the proposed limitation on the use of the cash method by natural persons, pass-through entities, personal service corporations, and farmers.

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. Under the accrual method, income is recognized when the right to receive the income exists, and expenses are recorded when they are fixed, determinable and economically performed (i.e., all-events test). All-events tests are more complex, do not track the financial accounting concepts of the accrual method, and increase costs of compliance. Given that the cash method remains a far simpler method of accounting, we believe that simplicity justifies its continued use by natural persons, certain pass-through entities, personal service corporations, and farmers, regardless of their gross receipts.

The AICPA urges you to consider the financial burden that the Proposal, if enacted, would place on businesses. For example, it would require partners and shareholders of pass-through entities to annually pay tax on income they have not yet received since they would need to recognize accounts receivable and work-in-progress (WIP) in income without a significant ability to manage accounts payable. The accumulated prior year amounts are reported in the initial year when the change in accounting method is reported. Even under current law, which allows taxpayers to pay the tax associated with such change over four years, this substantial increase in taxes will place a significant financial burden on businesses. It is also important to note that the increase in taxes is not limited to the first four years. In a growing economy, the acceleration of income would continue every year.

In order to cover this accelerated need to pay taxes, some businesses would be forced to make cash distributions to their owners from other sources, 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 their ability to pay. We believe either scenario would result in an unjustifiable burden.

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 obtaining any passive (investor) ownership and a majority of the owners must hold active CPA licenses. We believe that similar restrictions also exist for firms engaged in the practice of law. As a result, many accounting and law firms must raise capital solely by the individual professionals, who together own the firm, and cannot raise capital from outside investors. Because of these limitations, 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.

The AICPA believes the Proposal would also discourage natural business growth because exceeding \$10 million in annual receipts would trigger an accounting change. In other words, a

business' inability to use the cash method of accounting would create an artificial obstacle to the acquisition of or merger with another service firm.

Finally, we ask you to consider the potential negative impact the Proposal could have on our capital markets. By virtue of their education, training and skill-set, CPA firm partners have a variety of career options. By mandating the use of accrual accounting by partnerships, Congress is essentially penalizing those individuals solely for being part of a partnership. It could have the unintended consequence of driving many of these individuals out of accounting firms. Thinning the ranks of those individuals who perform public company audits could weaken investor confidence in our capital markets.

AICPA's Position

The AICPA opposes any limitation on the use of the cash method of accounting on natural persons, pass-through entities, personal service corporations, and farmers. These businesses are located across the U.S. and comprise nearly all industries, including agriculture, finance, health care, personal services, professional services (e.g., attorneys, CPAs, engineers, architects, doctors and dentists), real estate, repair and maintenance, retail, and transportation. These types of companies are some of the most dynamic American businesses and are part of the driving force behind economic expansion and job growth. The Proposal would require these companies to change to the accrual method, force their owners to pay tax before they have the cash to pay it, and add to the complexity and cost of compliance for these businesses.

The AICPA believes tax reform should promote simplicity and economic growth but should *not* create unnecessary administrative and financial burdens on taxpayers or impede the productive capacity of the economy. Simplicity is important both to improve the compliance process and to enable taxpayers to better understand the tax consequences of transactions in which they engage in or plan to engage. However, we believe Section 51 of the Proposal, as drafted, would impose undue burdens on many of these taxpayers by requiring significant additional planning to prepare for, and comply with, the new requirements. In summary, the AICPA strongly opposes the limitation on the use of the cash method of accounting for both natural and non-natural taxpayers as drafted. The AICPA proposes an expansion of the eligible taxpayers to include qualifying pass-through entities and natural persons regardless of their gross receipts.

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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.

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The AICPA appreciates the opportunity to provide comments as part of the tax reform process. If you have any questions or would like to discuss our comments, please contact me at (304) 522-2553 or jporter@portercpa.com; or you may contact Chris Hesse, Chair, AICPA Small Business Tax Reform Task Force, at (612) 397-3071, or Chris.Hesse@CLAconnect.com; or Melissa Labant, AICPA Director – Tax Advocacy & Professional Standards, at (202) 434-9234, or mlabant@aicpa.org.

Sincerely,

A handwritten signature in black ink, appearing to read "Jeffrey A. Porter". The signature is fluid and cursive, with the first name "Jeffrey" being the most prominent.

Jeffrey A. Porter, CPA
Chair, Tax Executive Committee

cc: Members of the Senate Committee on Finance
The Honorable Mark Mazur, Assistant Secretary for Tax Policy, Treasury Department
Mr. Daniel I. Werfel, Acting Commissioner, IRS
The Honorable William J. Wilkins, Chief Counsel, IRS