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Before the U.S. House of Representatives Committee on Small Business, Subcommittee on Economic Growth, Tax and Capital Access
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Thank you, Chairman Rice, Ranking Member Chu, and members of the Subcommittee, for asking me to testify today. I am an enrolled agent (EA) and President-Elect of the National Association of Enrolled Agents (NAEA), which represents the interests of over 46,000 enrolled agents across the country. The enrolled agent license is the highest credential granted by the Department of Treasury. EAs are the only tax practitioners who are directly approved by the Department of Treasury for competency and ethical behavior.

I am also a sole proprietor. My practice is primarily focused on individuals and on small businesses of less than $500,000 gross revenues—what I refer to as “microbusinesses.” Today I share with you my perspectives as both a tax practitioner and a small business owner. While I am testifying as an officer of NAEA, the opinions I express in this testimony are mine alone.

Over the years, it has become clear to me that the business checking account is the focal point for most small business bookkeeping. Small businesses use the business checking account to measure cash flow and profits, and to a great extent it is the basis for their tax accounting as well. As a result, any change to the tax law that requires small business owners to move away from simple checkbook accounting, or cash basis accounting, has two negative effects:

1. Increased complexity: Other methods of accounting, for example accrual or hybrid, create complexity by forcing small businesses to track certain expenses and capital outlays separately from their basic income and expense ledgers. For less sophisticated taxpayers, these separate accounting systems can be counter-intuitive and create expensive paperwork requirements.

2. Restricted cash flow: Small businesses are commonly undercapitalized, which results in severe cash flow problems when they make payments but are unable to expense them for tax purposes in the same calendar year. A common complaint I hear in my practice is, “How do I owe taxes when I do not have any cash in my business checking account?”

As Congress begins reforming the tax code, I urge you to keep in mind how essential cash basis accounting is to startup businesses, especially micro businesses. I believe Congress can do more to help them. Both Chairman Camp and former Senator Baucus’s proposals are good first steps, but I strongly recommend that Congress go even further. I have several recommendations:

First, increase expensing under section 179. Because Congress has not enacted legislation to extend expired tax provisions, expensing of capital purchases is currently limited to $25,000. This is a big drop from the $500,000 deduction that was available for the last several years under the provisions that expired. Also, the purchase limit for section 179 property has dropped to $200,000. This, again, is a big drop from the $2,000,000 total purchase limit of the past several years. I have a client in the medical field who is a sole proprietor (single member LLC) and planning to purchase a $100,000 piece of equipment this year. With the current rules, she will not be able to take the whole $100,000 amount as a section 179 expense. Given her situation, she needs to pay estimated taxes to account for the limited expenses she can take this year. However, if she were able to take a section 179 expense on the whole purchase, her tax liability and thus estimated tax payments would be much less. You can see the tax planning challenges we face when taxpayers do not know in advance which provisions might or might not be extended. I urge Congress to increase the section 179 expensing to at least $250,000 and to increase the total purchase limit to at least $1,000,000. Section 179 is essential to creating a true cash basis system for small businesses.

Second, remove uniform capitalization rules for small businesses. The uniform capitalization rules, which were enacted as part of the Tax Reform Act of 1986, require certain direct and indirect costs allocable to real or tangible personal property produced by the taxpayer to be included in either inventory or capitalized into the basis of such property, as applicable. I recommend that Congress consider removing this rule for small businesses and allow them simply to expense these costs.

Third, allow small businesses to use pure cash accounting even if they have inventory. In general, taxpayers must account for inventories if the production, purchase, or sale of merchandise is material to the production of income.

In those circumstances in which a taxpayer is required to account for inventory, the taxpayer must maintain inventory records to determine the cost of goods sold during the taxable period. Cost of goods sold generally is determined by adding the taxpayer's inventory at the beginning of the period to the purchases made during the period and subtracting from that sum the taxpayer's inventory at the end of the period. I recommend that Congress allow small businesses to use pure cash accounting for their operations, even if they have inventory.

Fourth, allow small businesses to expense leasehold improvements. While the current list of tax extenders provides some relief from depreciating improvements to leased property over 39 years, I urge Congress to allow these outlays to be expensed, under either section 179 or its own specific tax code section. For example, under the currently expired provisions, leasehold improvements were allowed fifteen-year treatment for qualified property. This treatment covers qualified leasehold improvements, retail improvements, and restaurant property. I represent a small business owner that leased part of a building to create a performing arts theatre. He made $300,000 worth of leasehold improvements to the building. Sadly, he did this before consulting anyone and thought he would be able to write off the whole $300,000 in one year since he spent it in that year. Being able to expense these costs in the year spent or at the very least to depreciate the $300,000 over 15 years would be much more palatable and better for his cash flow than depreciating it over 39 years.

Fifth, allow small businesses to deduct all start-up and organizational expenses. A taxpayer may elect to expense up to $5,000 of start-up expenditures in the tax year in which the active trade or business begins. A corporation or a partnership may elect to expense up to $5,000 of organizational expenditures in the taxable year in which the active trade or business begins. I urge Congress to allow all of these costs to be expensed for small businesses. When one of my clients starts a business, he or she inevitably asks, “I spent much more money on the business than I received in income. How can I still owe taxes?” I try to explain that some of the expenses cannot be written off in the year they are expended, even though the client is on a cash accounting system. As you can imagine, this does not go over well for microbusinesses.

Sixth and finally, increase the limit on repairs and improvements. Under rules created by the IRS, smaller businesses that lack an applicable financial statement, such as my microbusinesses, may expense amounts paid for property costing less than $500 rather than depreciating the property over several years. Taxpayers elect this new provision annually by including a statement on the tax return. In addition, taxpayers must have in place appropriate and documented business procedures. Although the idea is a good one, taxpayers must do a lot of paperwork for a small benefit. I would recommend a rule that allowed small businesses to expense these costs in the year made.

I had a client with several rental properties document his intentions to use this new regulation, but his question to me was, “When I buy a washer for the rental unit this year for $600, I cannot take advantage of this new regulation and will have to depreciate it anyway, right? What good is it to have the ‘under $500’ threshold?” I had to agree with him. He would see more benefits from this regulation if he could expense his $600 washing machine purchase or his $1,000 dryer purchase.

Based on my experience as a small business owner and as a tax practitioner, I believe the above recommendations would substantially simplify operations, ease paperwork burdens, and improve cash flow for many businesses.

In closing, I would like to draw the Subcommittee’s attention to the recommendations of President George W. Bush’s Advisory Panel of Federal Tax Reform:

> The Panel recommends that most small businesses file taxes the same way they pay their bills – with their checkbook. Under the Panel’s options, most small businesses would report income as cash receipts minus cash business expenses. This rule reduces compliance costs by relieving small businesses from keeping a second (or sometimes even a third) set of books for tax reasons and allowing them to use records they already keep for their businesses.

President Bush's panel of experts clearly saw the advantage of simplification and the importance of cash flow for small business owners.

Thank you for your time and attention.