

Testimony of

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“Cash Accounting: A Simpler Method for Small Firms?”

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Chairman Rice, Ranking Member Chu and Members of the Subcommittee, thank you for the opportunity to testify on the need to simplify the tax reporting requirements on small businesses by means of adopting simpler methods of tax accounting.

My name is Don Williamson and I am a professor of taxation at American University's Kogod School of Business where for the past thirty years I have been the Director of the School's Masters in Taxation degree program. The MST program at American University offers graduate courses in federal taxation to CPAs, experienced accountants, attorneys and others who wish to expand their knowledge of our nation's tax law. Our course offerings not only include traditional classes in subject areas such as the taxation of corporations and partnerships, international taxation and tax policy but also more specialized areas of the tax law such as accounting periods and methods which is the topic of this hearing today. As part of my responsibilities at American University, I am the Executive Director of the Kogod Tax Center which conducts nonpartisan research on tax issues affecting small business and entrepreneurs. For the past 25 years, I have had my own tax preparation and planning practice for small businesses in Falls Church, Virginia.

The Kogod Tax Center has previously testified before the House Small Business Committee on the most burdensome tax problems faced by small businesses. Today I would like to focus my remarks on one area in the Internal Revenue Code that can easily be changed

to substantially reduce the record keeping and tax compliance burdens on small businesses namely, liberalizing the law to permit more small businesses to adopt the cash method of accounting rather than being required to use the more burdensome accrual method.

My testimony will describe and highlight the burden placed upon small businesses when the Internal Revenue Code requires them to be on the accrual method of accounting. However, even where the law permits a small business to use the simpler cash method of accounting, the general requirement to maintain inventory records creates burdens that may only influence by only a few months the timing of a small business's taxable income. Therefore, we urge Congress to not only expand the number of businesses eligible to use the cash method of accounting but to also enact a "simplified" cash method of accounting for small businesses that would further reduce unnecessary record keeping and compliance burdens. We believe such simplification will neither adversely affect the accuracy of tax returns nor impact the ability of the IRS to collect tax.

I. Cash Method vs. Accrual Methods of Accounting

Before describing our proposal for a simplified cash method, I would like to explain, for the benefit of the members of the subcommittee who may not be familiar with tax accounting rules, the two major tax accounting methods used by businesses, i.e. the cash

method and the accrual method. I believe this explanation will highlight why for small businesses the accrual method is more burdensome than the cash method; and demonstrates that while the accrual method may in some cases more accurately measure economic net income, why the complexity and cost of any additional precision is unnecessary and ultimately provides no greater tax revenue for the IRS.

Once a business adopts a tax year, and for most small businesses this will be the calendar year, it must adopt an accounting method which will determine the time at which the business recognizes an item of income or may deduct an expense. It is important to note that a business's accounting method only affects the timing of when a business reports income or deductions on a tax return. The accounting method a business uses does not determine whether an item of income is taxable or an expense deductible and does not affect the total income and deductions a business will recognize over its lifetime.

Publicly traded corporations and many large businesses generate financial statements for the SEC or commercial banks based on generally accepted accounting principles (GAAP). Small businesses usually do not keep their books and records in accordance with GAAP, almost always relying upon their tax returns to provide lenders and owners with sufficient information to determine the success and credit worthiness of the business.

Under the Internal Revenue Code a small business is only required to choose an accounting method that “clearly reflects income” and apply that method consistently from year to year. Consistent with this requirement, most small businesses adopt the cash method of accounting unless the law requires them to use the accrual method.

A. Cash Method

A business adopting the cash method of accounting recognizes income when it receives actual payment for the goods or services sold, regardless of when the business sells the good or performs the service. Similarly, a cash method business is entitled to a deduction on its tax return only when payment for an ordinary and necessary business expense is actually made. However, even cash method businesses may not deduct certain types of payments when made. For example, a cash expenditure that creates an asset of the business with a useful life of more than one year but rather must “capitalize” the cost and depreciate (deduct) the cost over a prescribed “recovery period” in which the tax law presumes the asset will be consumed in the business. There are other types of cash payments subject to similar treatment. Thus, even the cash method adopts certain principles of the accrual method described below resulting in a mismatch of the time an expenditure is made and the time at which it can be deducted.

1. Judicial Doctrines of Income

In addition to requirements to capitalize certain expenditures there are several other technical requirements for a business computing taxable income under the cash method that are unnecessarily complex. Under the judicial doctrine of “constructive” receipt, a cash basis taxpayer must recognize income even when cash has not come into the physical possession of the business but is merely available to the business at its discretion. Similarly, the mere receipt of a promise results in recognizable income under the cash method if the promise is convertible to cash before it matures, in which case the fair market value (that is, the “cash equivalent”) of the obligation is recognized at the time of receipt of the promise. Finally, under the “economic benefit” doctrine, a cash method business must immediately recognize income on the receipt of property whenever the business’s right to the property is absolute, even if not immediately assignable and even though it cannot be immediately converted to cash.

Such judicial theories that require a business using the cash method to pay tax on income deemed received prior to the receipt of cash unnecessarily imposes a severe cash flow problem on small businesses - a problem that creates only a marginal timing benefit to the IRS, since small businesses would most certainly receive the cash shortly after constructive receipt, economic benefit, or a cash equivalent arises. While these concepts offer comfort

to theorists, small businesses must pay next month's bills, and the acceleration of any taxable income before the receipt of cash under these theories requires small businesses to use their operating cash to pay tax on amounts they have not yet received instead of using that cash to run their businesses.

2. Accounting for Expenses

An even more challenging problem encountered by small businesses using the cash method of accounting is the compliance costs and complexity associated with computing deductible expenses. Generally, the cash method permits a deduction for ordinary and necessary business expenses when actual payment is made. Thus, a promise to pay is not deductible until payment is actually made.

Although there may be confusion surrounding when and if a payment has been made, small businesses confront even greater difficulties when computing allowable deductions under the cash method because of four exceptions to the general rule that a deduction is permitted when payment is made, i.e. prepayments, depreciation, inventory and capitalization of some expenses. Prepayments for property or services are not deductible if the goods or services are provided more than one year after the prepayment. Costs exceeding \$5,000 associated with creating a new business are not deducted when paid but amortized over 15

years. For inventory, the costs of its acquisition or production are deducted only when the inventory is sold. Similarly, property with a useful life of more than one year is generally subject to depreciation, requiring its deduction be spread over recovery periods ranging from three to 39 years.

These examples demonstrate that the current cash method of accounting is too often not based upon cash receipts and disbursements, but rather on principles that attempt to match costs with income similar to the accrual method. For small businesses that have no government regulators to whom financial statements must be submitted and have no banks or other creditors in need of profit and loss determinations that conform to the rules of GAAP, tax rules based on the accrual method serve no practical purpose when economic success and taxable income can simply be measured on cash receipts and expenditures - that is, cash flow. In short, while the current cash method is substantially simpler than the accrual method, certain refinements to the current rules could make the cash method even simpler and more easily enable allow small businesses to comply with tax record keeping and reporting requirements without the loss of accuracy on their tax returns.

B. Accrual Method

The other major accounting method, the accrual method, attempts to determine the time at which “all events” occur that give rise to the right to income and the amount of that income can be determined with reasonable accuracy. Similarly, an expense may be deducted when the obligation to pay an expense is fixed, the amount of that obligation can be determined with reasonable accuracy and economic performance has occurred. Thus, businesses must report income on their tax returns when earned and may deduct expenses when incurred without regard to the receipt or payment of cash.

The accrual method and its “all events” test creates substantial complexity in an effort to better identify the financial success or failure of a business. This complexity calls for small businesses, whose every day well being centers upon its cash position, to determine its financial well-being in a manner that adds no value to its success. From the perspective of the IRS, while the timing of income and expense reported under the accrual method may provide some acceleration of tax upon income that must be recognized before any cash is received, such acceleration is clearly unfair if the cash is never received, and may only accelerate tax collection by no more than one year if the cash is subsequently receive shortly after the accrual.

The complexity of the accrual method is illustrated by prepayments. In the case of prepaid rent or interest received, income must be reported immediately upon receipt even if “all events” entitling the business to the income have not occurred. Similarly, where goods or services have not been delivered but cash payment has been received, the general rule under the accrual method that delays reporting the cash receipts on the business’s tax return until “all events” have occurred, i.e. the goods are delivered or services performed, is disregarded. Thus, in the case of prepayments a business otherwise on the accrual method finds itself using the cash method for prepayments. Not an easy concept for a small business owner to understand.

Another complexity of the accrual method is the necessity to account for bad debts when a business reports as income an account receivable for which it never receives actual payment. Each year businesses on the accrual method must determine which previously reported receivables are uncollectible and claim them as tax deductions. This can be a time consuming, confusing and expensive process. Businesses using the cash method do not deduct bad debts because they do not include receivables in taxable income.

Finally, even when a business on the accrual method meets the “all events” test with respect to an expense, a deduction may be claimed only when “economic performance” occurs. Therefore, in the case of receiving goods and/or services from another party, the

business may deduct the obligation to pay the other party only as the goods or services are received regardless of when the business pays for the goods or services, subject to an exception permitting deduction in the year of prepayment if the other party provides the goods or services within three and one-half months of the next taxable year. Again, not such an easy concept for small businesses to understand.

The above illustrations of some of the complexity required by the accrual method of accounting demonstrates that in the case of small businesses the technical accuracy resulting from these rules offers no practical benefit to the business in measuring its economic performance, and over the life cycle of the business, offers no additional tax revenue to the government.

II. Tax Accounting for Inventories

Regardless of whether a business is on the cash or accrual method of accounting, if inventory is a material income producing factor, the business must account for gross profit, i.e. sales minus cost of goods sold, using the accrual method, even if they have adopted the cash method as their overall accounting method. Thus, a business cannot deduct the cost of the inventory (finished goods) to the extent it has not sold the product by the end of the business's taxable year. Businesses selling inventory must maintain records documenting

their cost of unsold, finished goods, partially finished goods and “raw” materials on hand that will be used in the future to manufacture or produce inventory. In addition, inventory cost accounting principles call for the deduction of indirect costs (overhead) associated with manufacturing or producing the inventory only when the inventory is sold.

In determining its cost of inventory, a business must adopt an inventory costing method, i.e. the first-in, first-out (FIFO) method, the last-in, last-out (LIFO) method or the specific identification method. The FIFO and LIFO methods relieve businesses of the need to keep track of the cost of each item its sells, but where the items are unique or relatively high-cost, low volume products (e.g., jewelry, antiques, cars, etc.) the specific identification method is used.

As an exception to the requirement to maintain inventory accounts, the IRS (not the Internal Revenue Code) permits a cash method business to use the cash method to account for their gross profit from the sale of inventory if the business’s average annual gross receipts for the three year period prior to the current year do not exceed \$10,000,000 and the business’s primary activity is to provide services to customers but also offers a product for sale incidental to the performance of services. Thus, a veterinarian using the cash method of accounting need not use the accrual method to account for the sale of medicines or other goods associated with the business of caring for animals because such sales are incidental

to the veterinarian's professional practices. But when the average gross receipts of the business exceeds \$10,000,000, businesses must not only account for inventory using the accrual method, but also must apply certain "uniform cost capitalization" (UNICAP) rules that require an allocation to inventory of an array of indirect costs beyond those ordinarily associated with producing goods. Thus, under the UNICAP rules, a business must add to the cost of inventory a portion of compensation paid to employees who may not be involved in producing the inventory but may merely indirectly support the production process.

A final illustration of the complexity of the accrual method deals with the perceived abuse of an accrual method business accruing (deducting) an amount owed to a related party using the cash method. In this case the business using the accrual method may not deduct the amount owed to the related party until the amount is actually paid and recognized as taxable income by the cash method party. This issue frequently arises where a business employs the owner or a relative of an owner. Related parties, for this purpose, include family members and certain businesses owned by the same individual(s).

III. Comparison of Cash and Accrual Methods

As the above descriptions demonstrate, the primary advantages of the cash method over the accrual method are its clarity and flexibility in measuring income and expenses and

its less cumbersome bookkeeping and record keeping requirements. While the accrual method is generally considered a more accurate reflection of a business's financial condition, the price of this accuracy is mind numbing complexity and inevitably increased compliance and record keeping costs.

However, the Internal Revenue Code limits the adoption of the cash method to the following businesses: (1) sole proprietorships; (2) S corporations; (3) certain corporations engaged predominantly in the performance of services by their owners; (4) corporations with average gross receipts over the preceding three years of \$5,000,000; (5) partnerships with no corporate shareholder whose gross receipts exceed \$5,000,000; and (6) farms.

Suggestions for simplifying and liberalizing the use of the cash method were made by the Treasury Department in 2007, and by the Bowles-Simpson Commission in 2010. These studies concluded that simplifying the reporting of income and expenses on tax returns filed by small businesses would result in the reallocation of resources to more productive purposes, ultimately stimulating job growth. In addition, the IRS Taxpayer Advocate has consistently recommended simplifying accounting methods for small business as a way to ease compliance burdens and reduce tax administration.

IV. Simplified Cash Method of Accounting (“SCM”) - The “Checkbook” Method

Based on this brief description of the accounting methods available to small businesses and the observations of Treasury, IRS and independent tax reform studies, I believe that small businesses need and deserve legislative relief in measuring and reporting their taxable income and deductible expenses. In my view, the Internal Revenue Code should be amended to not only permit the adoption of the cash method by more small businesses, but also the adoption of a “simplified cash method of accounting” (“SCM”). This proposed simplification of the existing cash method of accounting will reduce time-consuming, expensive administrative burdens on small businesses in keeping records and reporting their income and expenses on their returns, thereby unleashing resources that will create more productive, job creating activities.

Besides reducing compliance costs the SCM will enable small businesses to better understand their tax returns, thereby reducing the general public’s cynicism that the Internal Revenue Code is replete with loopholes only accessible to businesses with resources to employ expensive tax professionals. In short, I believe that simplifying reporting on tax returns will increase compliance, ease the burden of tax administration, increase tax revenue and ultimately reduce the gap between what taxpayers should pay and what the IRS actually collects.

Under the SCM the computation of taxable income is reduced to the following formula:

Cash Receipts

Less: Cash Expenses including:

- Inventory
- Prepayments
- Materials/Supplies
- Depreciable Property

Taxable Income

In short, the derivation of taxable income is based solely on amounts actually received or paid during the tax year, by means of examining the business's checkbook for when checks were cut and deposits made. Under SCM, income consists only of cash, property or services received during the tax year without regard to imputed income under the constructive receipt, cash equivalence, or economic benefit doctrines. While determining and valuing the receipt of in-kind goods and services would continue to be a problem, small businesses would otherwise be able to arrive at their income by adding up their bank deposits for the year. Any timing advantage to businesses from not being subject to the judicial doctrines just mentioned would be minimal given that small businesses cannot, as a practical

matter, defer recognition of cash by more than a few months without creating severe cash flow problems for the payment of their own bills. The complexity of the judicial doctrines does not warrant their application to small businesses.

SCM offers even greater simplification for the determination of deductible expenses. Under SCM, all current expenditures, including those for the acquisition or construction of inventory, would be deducted when paid. Although a technical violation of GAAP's matching principle of accounting, GAAP is not a particularly useful concept in measuring the ability of a small business to pay tax, or even stay in business. More than one small business that had a profit under GAAP has failed because of cash flow problems. Allowing for the immediate deduction of the cost of inventory simplifies small business record keeping at relatively little cost to the government. For a small business to stay in business, inventory paid for and deducted in one year likely will be sold no later than the next year to ensure sufficient cash flow for business operations. Also, permitting the expensing of inventory before its sale recognizes the fact that by the IRS's own admission, small businesses are not following the rules for the computation of cost of goods sold, in that audits reveal more than 50 percent of cost of goods sold calculations are incorrect.

Finally, permitting the immediate expensing of depreciable property simply continues 100 percent bonus depreciation approach for acquired property with a useful life in excess of one year and the current section 179 expense allowance for purchased depreciable property. Thresholds and limitations similar to the present \$10,000,000 limitation for uniform capitalization rules and the current IRS allowance for the cash method may be adopted to restrict SCM to small businesses. Exhibit 1 compares the treatment of many items under the current cash and accrual methods with the SCM.

With a \$10 million threshold for the general adoption of the cash method coupled with an election to adopt the SCM, simplification would be available to approximately 99% of all businesses in the United States, thereby reducing the tax compliance burden for almost every person owning and operating a business in America.

IV. Conclusion

The cash method of accounting is undeniably simpler than the accrual method of accounting. Expanding the number of businesses eligible to use the cash method by substituting the current statutory limits on its use with a \$10 million gross receipts threshold would benefit not only small businesses but the overall economy.

In addition, codification of the SCM would reduce the tax record keeping and compliance burdens faced by small businesses even further and improve the ability of small businesses to maintain their own accounting records and prepare their own tax returns eliminating the need to retain expensive tax professionals. Such a reduction in the reliance on tax accountants and lawyers will foster a greater appreciation by average Americans that the tax law is not benefitting only special interests but is, in fact, attempting to measure a business's true economic net income. In short, I believe that a simplified cash method of accounting such as the SCM will improve tax compliance at lower cost to businesses with little or no loss of tax revenue.

Thank you for the opportunity to testify today. I welcome any questions from any Member of the Committee or its staff.

Exhibit 1: Comparison of Cash, Accrual and SCM Accounting Methods

Income or Expense Item	Cash Method	Accrual Method	SCM
Income recognition	Actually or constructively received.	Earned under the all-events test.	Actual receipt
Prepaid rental and interest income	Taxable on receipt.	Taxable on receipt.	Taxable on receipt
Prepaid income for services	Taxable on receipt.	Taxed when earned or in the following year of receipt if not earned by end of year of receipt.	Taxable on receipt
Prepaid income for goods	Taxable on receipt.	Taxed on receipt but deferral election allows taxation when earned.	Taxable on receipt
Deduction recognition	Deduct when paid.	Deduct under all-events test and economic performance test.	Deduct when paid
Expenditures for tangible assets with a useful life more than one year	Capitalize and apply cost recovery.	Same as cash method.	Deduct when paid
Prepaid business expenses	Immediately deductible unless contract period exceeds 12 months or extends beyond the end of the next taxable year.	Same as cash method but use economic	Deduct when paid.
Prepaid interest expenses	Not deductible until interest accrues.	Same as the cash method.	Deduct when paid.
Bad debt expense	Not deductible	Deduct under direct write-off method.	Not deductible
Inventory	Capitalize	Same as cash method.	Deduct when paid
Business start-up expenses	Deduction limited to \$5,000 then amortize	Same cash method.	Deduct when paid
Section 179	Deduction limited to \$500,000	Same as cash.	Deduct when paid
Materials, supplies, improvements	Capitalize or deduct	Same as each	Deduct when paid