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HEARING ON CASH VERSUS ACCRUAL: THE POLICY IMPLICATIONS OF THE GROWING INABILITY OF SMALL BUSINESSES TO USE SIMPLE TAX ACCOUNTING

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

ONE HUNDRED SIXTH CONGRESS

SECOND SESSION

WASHINGTON, DC, APRIL 5, 2000

Serial No. 106–49

Printed for the use of the Committee on Small Business

U.S. GOVERNMENT PRINTING OFFICE
65–508 WASHINGTON : 2000

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CONTENTS

	Page
Hearing held on April 5, 2000	1

WITNESSES

Mikrut, Joseph M., Tax Legislative Counsel, United States Department of the Treasury, Washington DC	5
Mieras, Shane, Project Manager, Mid-Ceitling and Drywall, Rockford, Michigan	28
Wulkopf, David E., CPA, Treasurer, Beckner Painting Midwest, Inc., St. Louis, Missouri	30
Harris, Roger, President, Padgett Business Services, Athens, Georgia	33
Olson, Pamela F., Chair-Elect, Section of Taxation, American Bar Association	34
Satagaj, John S., Managing Partner, London and Satagaj, Washington, DC	36
Schneier, Abraham L., Partner, McKevitt & Schneier, Washington, DC	40

APPENDIX

Opening statements:	
Talent, Hon. James	50
Velazquez, Hon. Nydia	53
Manzullo, Hon. Donald A	55
Tubb-Jones, Hon. Stephanie	56
Prepared statements:	
Mikrut, Joseph M	61
Mieras, Shane	68
Wulkopf, David E	73
Harris, Roger	77
Olson, Pamela F	82
Satagaj, John S	93
Schneier, Abraham L	103
Additional material:	
Written statement of American Dental Association	108
Written statement of the Associated General Contractors of America	113
Written statement of Anthony Shaker, President, Air Conditioning Contractors of America	116
Written statement of the Plumbing-Heating-Cooling Contractors-National Association	122

HEARING ON CASH VERSUS ACCRUAL: THE POLICY IMPLICATIONS OF THE GROWING INABILITY OF SMALL BUSINESSES TO USE SIMPLE TAX ACCOUNTING

WEDNESDAY, APRIL 5, 2000

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The Committee met, pursuant to call, at 10:00 a.m., in Room 2360 Rayburn House Office Building, Hon. James M. Talent, [Chairman of the committee] presiding.

Chairman TALENT [presiding]. We will now call the hearing to order. I want to welcome our witnesses here today and take a moment to thank, in particular, Mr. English and Mr. Manzullo and Mr. Sweeney of the Committee for their legislative efforts on the small business issues before us today.

It's easy for our eyes to glaze over when we hear the terms "cash versus accrual" or "installment method of accounting." These terms are the rules that govern and determine when, not if, small businesses and other taxpayers have to pay taxes on their income.

The cash method is a simple method of accounting allowed by the tax code that most closely mirrors the way many small businesses operate. It allows them to pay taxes on income in the year that they actually receive the income. This is, at best, a brief deferral of tax, not any special exemption or waiver.

In contrast, forcing small businesses, including small contractors and service providers and, especially including small contractors and service providers, to switch to the accrual method of accounting means that they have to pay now and collect later on their accounts receivable. In reality, most small entities are willing to forego deductions to use simple accounting and have used the cash method consistently for years, if not for decades. An example is Beckner Painting, a constituent of mine who will testify later today, who has used cash accounting consistently since 1965.

Accounting issues have become increasingly important and controversial because of the underlying implications of recent Treasury proposals and consequent IRS enforcement activities that are hurting small businesses. We will explore these policy implications and the pending regulatory guidance that the Treasury Department plans to issue on who must use accrual accounting.

Unfortunately, the Treasury Department's recent policy statements and proposals demonstrate an increasingly aggressive position designed to deny American small business taxpayers the abil-

ity to use simple and lawful tax accounting, including the installment method repeal successfully advocated into law by the Treasury Department last year.

Similarly, the Treasury Department has announced it will soon issue guidance regarding the rules related to the cash and accrual methods of accounting. Specifically, the Department intends to issue guidance regarding when merchandise used by a taxpayer requires the use of inventories and, thus, the accrual method of accounting. The Treasury's plans, therefore, are critical in determining whether small businesses will find real relief or increasing controversy in their ability to use simple accounting in paying their taxes.

When testifying here today and moving forward on any regulations, I urge the Department to keep in mind that tax policy is distinct from financial accounting. Many important considerations, including fairness and simplicity, outweigh the need, if any, for mathematically precise matching of income and expenses for tax collection purposes.

Moreover, what you may consider in your accounting changes inside the Beltway harshly affect the lifeblood of small contractors and service providers, their cash flow. Having to pay taxes on income small entrepreneurs have not received strangles their cash flow and their businesses. Accordingly, the use of Treasury and IRS resources to litigate and audit small business contractors and service providers who regularly use cash accounting seems both cost ineffective and unreasonable.

Congress has made great strides in the last few years to provide tax relief for small businesses and to reform the Internal Revenue Service. I may say this Committee has been at the forefront of those efforts. The Committee appreciates the new direction the Commissioner is obviously taking the IRS in its responsiveness to the small business community. I hope any new policies, regulations, or legislation that the Treasury Department proposes and the Congress considers will make this important job easier.

In this regard, I want to make two more points. First of all, I appreciate Treasury's recognition of the damage last year's installment change is causing small business. I believe its policy position on installment sales is fundamentally flawed. I urge the Department to support H.R. 3594 to fully reverse last year's repeal of the installment method of accounting for accrual basis taxpayers.

This bill would restore the ability of small businesses to sell their businesses without losing between 5 to 20 percent of their value, 8.2 percent on average. In many cases, this value represents the small business person's life's work and retirement savings, which are now unexpectedly slashed.

Two, I urge the Treasury to support a proposed legislation to allow small businesses with gross receipt of $5 million or less to use the cash method of accounting without limitation. In the current law, Congress explicitly recognizes that allowing small business C corporations to use cash accounting outweighs any inherent distortions in the timing of their income and expenses. Setting a lower-than-$5 million threshold for other small businesses, including sole proprietors, partnerships, and S corporations makes no sense and would lead to additional and unnecessary complexity.

I'm happy now to recognize the distinguished gentlelady from New York for any comments that she may wish to make.

Ms. VELAZQUEZ. Thank you, Mr. Chairman. Over the past few years, America has experienced an unprecedented economic boom. And no one can deny the importance of small business in creating this growth and supporting our communities. Our nation's entrepreneurs provide jobs and represent the major tax base for our schools and roads, embodying the spirit of entrepreneurship that has made this country great.

However, too often small businesses lack the capital they need to grow or they don't have the money at the end of the day to make being their own boss a reward. One reason for this is that our tax system often creates road blocks for our nation's small businesses.

Today's hearing is a continuation of what I believe is one of the most important roles that this Committee plays to educate the rest of Congress about the tax challenges facing our nation's small businesses.

I would like to commend the Chairman for bringing before this Committee an issue essential to small businesses, the issue of tax simplification and specifically the cash versus accrual methods of accounting.

With no two small businesses facing the exact set of issues, the sides on this debate are clear. Many small businesses argue that the accrual method is too complicated and requires many small businesses to retain an accountant, tax expert, or hire a full-time employee who is skilled enough to use this accounting method.

I believe that there is one component of this debate that the Committee specifically has a responsibility to highlight, because it is a perfect example of the rule of unintended consequences, that is the repeal of the installment method of accounting, a variation of cash accounting.

The issue arose last year when Congress passed the Work Incentives Improvement Act. This legislation has many vital tax provisions, like the R&D tax credit, work opportunities tax credit, and alternative minimum tax credit, all significant provisions. As an offset to pay for this, the installment method was done away with.

The result was to force most small businesses to use the accrual method. Unfortunately, this change created more problems than it solved. Forcing small businesses to use the accrual method placed an especially disproportionate burden on those small business owners attempting to sell their businesses.

Unlike the installment method that allowed the owners to pay the taxes as the payment was received, the accrual method forces them to be liable for the full amount immediately, even if they only have partial or no payments. This has created an unintended burden on the business owner and a disincentive for business sales.

I am pleased Congress recognized this and corrected it through the repeal of the prohibition on the installment method.

Clearly, given this chain of events, we need to do much more educating our colleagues about the tax challenges facing small business owners. We need to continue to push for a tax system that is progressive but does not place the disproportionate burden on small business.

One again, I would like to thank the Chairman for holding today's hearing. Creating a fair and equitable tax structure for our nation's small businesses is crucial to their long-term success. At the same time, we must work to ensure that, by solving one problem, we do not create a more serious problem elsewhere. I look forward to hearing the testimony of today's witnesses and I thank the Chairman again for his hard work on this issue.

[Ms. Velazquez's statement may be found in appendix.]

Chairman TALENT. All right. Before we get to our first panel, and while it's our practice for only the ranking member and I to have opening statements, in this case, Mr. Manzullo, who does chair the Tax Subcommittee wanted to make a brief opening statement, so I'll allow him to do it.

Mr. MANZULLO. Thank you, Mr. Chairman. I commend you for holding this hearing today. As Chairman of the Tax Subcommittee, I realize this issue is perceived by some as being very dry, but it's really a matter of life and death for thousands of small businesses which have to sell some product associated with their services or at least use a product associated with their services.

I first became aware of this issue in 1996 when a dentist in the district that I represent became an IRS, "test case," forcing him to move from the cash method of accounting to the accrual method. This changeover required him to pay cash on income he had not even received. Medical professionals have no problem paying taxes on what they collect on their billings, but they object to paying taxes on outstanding invoices, particularly unpaid bills. This is another illustration of the IRS trying to collect taxes early.

In 1998, I offered legislation to give physicians and dentists the choice to remain with the cash method of accounting. It was reintroduced as H.R. 1004 in this Congress. I ask unanimous consent that the Chairman include in the hearing record a written statement of the American Dental Association on this issue.

[American Dental Association's statement may be found in appendix.]

Mr. MANZULLO. Over the past few years, I've learned that this issue impacts more than the small business community, such as landscapers, building contractors, and plumbers. That's why I'm proud to be a cosponsor of your bill, Mr. Chairman, that would allow any small business with gross receipts of up to $5 million the choice to remain with the cash method of accounting.

I could not have said it better than Judge Power when she reached a decision by the U.S. tax court. She said the IRS, "abused its discretion when it required the contractor to change from the cash method to the accrual method of accounting." I was pleased to have a few conversations with Commissioner Charles Rossotti. I observed he was sympathetic to the plight of small business owners on this issue.

I understand from previous testimony, the Treasury Department announced that small business owners with gross receipts of $1 million or less will be free to use the cash method of accounting. Mr. Chairman, it's a good step in the right direction, but I trust, after this hearing, that the new administration policy will be more in the direction of Chairman Talent's bill.

Chairman TALENT. I thank the gentleman. And the gentlelady from Ohio has sought recognition. I'm happy to recognize her.

Ms. TUBBS JONES. Mr. Chairman, thank you. I was seeking unanimous consent to have an opening statement on this issue submitted for the record.

Chairman TALENT. I thank the gentlelady and, without objection.

And without objection, any member who wishes to submit an opening statement, it will be entered into the record.

And I truly thank the members for their interest in this issue which is vital to small business. And we'll just introduce the first panel and we have one witness on the panel, Mr. Joseph M. Mikrut, who is the tax legislative counsel for the United States Department of the Treasury. Mr. Mikrut, it's your first time before the Committee. We're pleased to have you and thank you for coming in. You can give us your statement.

STATEMENT OF JOSEPH M. MIKRUT, TAX LEGISLATIVE COUNSEL, UNITED STATES DEPARTMENT OF THE TREASURY, WASHINGTON, D.C.

Mr. MIKRUT. Thank you, Mr. Chairman. Mr. Chairman, Ranking Member Velazquez, distinguished members of the Committee, thank you for inviting me today.

I appreciate not only talking about this issue, but at the Treasury we have come to understand the importance of tax issues for the small business community and we hope this will be a continuing dialogue to discuss these matters with the Committee.

I especially appreciate the opportunity to discuss with you today the important topic of the proper method of accounting as applied to any small business. Indeed, the choice and use of a method of accounting is one of the most fundamental aspects in determining a taxpayers' tax liability and these matters, although some may have described them as dry and uninteresting, are matters of great concern to the taxpayer.

This morning, I would like to focus on four main topics. One, I would like to discuss with you the current law and rules regarding the choice of accounting method; two, the tax policy rationale of such rules; three, the administrative guidance that we and the IRS are developing in this area; and four, recent developments with respect to the installment method.

Items of taxable income and deduction generally are taken into account by a taxpayer in a taxable year based on the taxpayer's method of accounting. Code section 446 requires that the selected method clearly reflect the taxpayer's income and grants the Secretary of the Treasury broad discretion in determining whether a method of accounting clearly reflects such income. Once a method is established by the taxpayer, the taxpayer must continue to use that method until he secures the consent of the Secretary to change.

Permissible methods of accounting include the cash receipts and disbursements method, known as cash method, accrual methods, or any other method or combination of methods permitted under Treasury regulations.

In general, there are two main methods, those being the cash method and the accrual methods. The cash method is the method

under which most individuals operate. The cash method of accounting generally requires an item to be included in income when actually or constructively received and permits a deduction for when the expense is paid.

In contrast, an accrual method of accounting generally requires that an item be included in income when all events have occurred that give rise to that income, in other words, when the event occurs that gives rise to the income. And similarly, a deduction is allowed to the accrual-method taxpayer when all of the events have occurred that give rise to the liability that gives rise to such expenditure.

Certain restrictions are imposed on the use of the cash method. Long-standing Treasury regulations provide that, in order to clearly reflect income, taxpayers that are required to keep inventories for a particular trade or business must use an accrual method of accounting. Inventory accounting is required whenever merchandise is a significant income-producing factor. Therefore, a taxpayer who is required to keep inventories is also required to use an accrual method of accounting. Exceptions are provided for farmers, even though such taxpayers generally are engaged in the production and sale of merchandise.

In addition, certain statutory provisions restrict the use of the cash method of accounting. Section 448 enacted by Congress in 1986 requires that C corporations and partnerships that have C corporate partners and have more than $5 million of average annual gross receipts may not use the cash method of accounting. An exception is provided for certain qualified professional service corporations that are owned by the employees.

Legislative history of the 1986 Act makes it clear that taxpayers that are not specifically, quote, "prohibited from using the cash method of accounting," for example, taxpayers with less than $5 million gross receipts, are not automatically eligible to use the cash method. On the contrary, legislative history clearly states that these taxpayers remain subject to other requirements, that their methods of accounting clearly reflect income, and that an accrual method must continue to be used by sellers of inventories.

The tax policy rationale underlying the use of an accrual method of accounting is relatively straightforward. Accrual methods of accounting, when compared to the cash method, are acknowledged to better reflect economic income and comport to generally accepted accounting principles for financial accounting purposes.

The clear reflection of income standard is demonstrated by the matching principle. Under the matching principle, gross receipts from sales must be matched with related costs of goods sold. In order to achieve such a matching of cost to revenue, it is necessary to keep an inventory account reflecting the cost of goods available for the sale so that these costs are not automatically deducted when paid, but are deferred until the year when the merchandise is sold.

Further, the taxpayer must report income under an accrual method to ensure that the income from the sale, like the related inventory costs, are reflected and matched with the year's sales. Treasury regulations issued in 1918 and have been continued in

force ever since, have contained these requirements. Their validity has been upheld by the Congress and the courts several times.

However, as you mentioned in your opening statement, Mr. Chairman, there are several factors that may override a tax policy rationale for the use of an accrual method. The relative simplicity of the cash method justifies its use by small, less sophisticated, taxpayers where an accrual method may be burdensome. In addition, the cash method addresses the liquidity concerns of small businesses in that it provides for payment of tax at the time that the taxpayer is most likely to have the cash and ability to pay the tax.

Although long-standing Treasury regulations require that inventories and accrual methods of accounting are required in order to clearly reflect income when merchandise is an income-producing factor, uncertainty exists as to when a taxpayer, and particularly a taxpayer that provides both goods and services, is selling merchandise and when the sale of merchandise is an income-producing factor. In addition, several small, unsophisticated, taxpayers that do not use an accrual method of accounting for financial accounting have complained that the requirement to account for inventories and to use an accrual method is burdensome.

As you mentioned, Mr. Chairman, we intend to publish administrative guidance that will address these concerns. Specifically, we will issue an exception for the use of the cash method of accounting when the average gross receipts of the taxpayer are less than $1 million.

We believe such a rule is justified in that these taxpayers with less than $1 million in gross receipts are generally less sophisticated, less likely to use an accrual method of accounting for other purposes, and that the results of using a cash versus an accrual method of accounting will not vary very much. In addition, the resources of the IRS will be saved by not having to examine the returns of these taxpayers.

We believe that this $1 million threshold will cover the majority of small business. In 1997, the most recent year for which we have data, approximately 78 percent of all C corporations, 85 percent of all S corporations, and approximately 95 percent of all partnerships and sole proprietorships had gross receipts of less than $1 million. I would point out that this data that I just gave you is on a non-aggregated level, so that if one taxpayer engaged in multiple businesses, there would be some double accounting.

Finally, Mr. Chairman, I would like to discuss with you the installment method of accounting. The installment method of accounting provides an exception to the general rules regarding accrual and cash methods, by allowing the taxpayer to defer the recognition of income from the disposition of certain property until payment is received.

Under the installment method, a taxpayer recognizes the gain resulting from a disposition of property proportionately as payments are received on an installment note. As such, the installment method more closely resembles the cash method. It is primarily for this reason that the Administration proposed and the Congress passed, as part of the Ticket to Work and Work Incentives Improvement Act of 1999, to limit the use of the installment method to cash method taxpayers.

After the 1999 Act was passed by Congress, small business groups began to express concerns that the repeal of the installment method for accrual method taxpayers negatively impacted the sales of small businesses. It is clear that the extent of the impact of the provision on the sales of small businesses was unforeseen by policymakers and potentially affected taxpayers and their advisors during the legislative process.

Treasury's Office of Tax Policy has met several times with interested industry groups, including the NFIB, NAM, AICPA, Small Business Legislative Council, and the U.S. Chamber of Commerce, and listened to their concerns about the effect of this recent legislative change. These groups have requested clarification on the effect of the installment sales provision on particular transactions. We intend to issue such guidance in the near-term.

In addition, these groups have expressed a need for an exception for small businesses. We believe that a $1 million exception—that we believe is a much broader approach that would deal not only with the cash versus accrual method of accounting, but also with the installment sales provision—will provide much of this relief. However, we understand and we believe that to go further will require legislation.

Overall, we believe the policy underlying the installment sales provision enacted in 1999 is appropriate. The installment method is inconsistent with an accrual method of accounting. Indeed, Congress has several times cut back the use of the installment method, most significantly in 1986 and 1987, when it disallowed the use of the installment method for sales of inventory.

We now understand, however, that the legislation passed last year has imposed financial burdens on small businesses that may override this basic tax policy concern. As such, we are eager to work with Congress to provide a legislative solution to alleviate this unforeseen impact of the provision.

Any legislative response should be targeted to address the legitimate concerns of affected taxpayers. For example, to address the liquidity concerns facing sellers of small businesses, we would suggest continued use of the installment method, perhaps with an interest charge, as provided under present law, for a certain defined class of small businesses, regardless of the sellers' method of accounting. There are other proposed solutions that we would be happy to work with Congress to address.

Mr. Chairman, this concludes my prepared remarks. I ask my entire written record be submitted for the record. We look forward to working with Congress in developing legislative proposals in these and other areas. And I'd be happy to respond to any of your questions.

[Mr. Mikrut's statement may be found in appendix.]

Chairman TALENT. I'm going to withhold my questions. But, thank you, Mr. Mikrut. I'm going to withhold my questions for now and defer to the gentlelady from New York for questions.

Ms. VELAZQUEZ. Thank you, Mr. Chairman. Mr. Mikrut, many of the small businesses, the small business advocates I hear from, talk about the $5 million exception for businesses that want to use the cash method of accounting. Yet it is my understanding that the IRS does not interpret the law as containing a specific $5 million

exception. I would like for you to shed some light on this issue. From the Treasury Department's interpretation of the current law, is there a $5 million exception for businesses who want to use the cash method?

Mr. MIKRUT. Ms. Velazquez, I've heard the same comment. In 1986, Congress enacted section 448 and what section 448 says is that if a C corporation, which is a separate corporate taxpayer, or a partnership that has a C corporation as a partner, has gross receipts in excess of $5 million, that entity must use an accrual method of accounting. Some have interpreted that to mean that if you're under $5 million in gross receipts, that you may use the cash method of accounting or you are no longer subject to requirements to use an accrual method of accounting.

However, when one looks at the legislative history to the 1986 Act, and this is contained in the House report of the Act, the Senate report to the Act, the Conference report to the Act, as well as the General Explanation prepared by the Joint Committee on Taxation with respect to section 448, it is clear that Congress only meant to affect taxpayers with gross receipts in excess of $5 million. And they made it very clear that an exclusion did not apply if taxpayers were subject to then-current law.

And Congress recognized at that time that then-current law, pursuant, again, to Treasury regulations that had been issued since 1918, provide that if merchandise is an income-producing factor in a trade or business, that that trade or business must use an accrual method of accounting.

So I think that the current state of the law, as provided in Treasury regulations and based on legislative history, is that corporate taxpayers in excess of $5 million must use an accrual method of accounting and all other taxpayers must use a method of accounting that clearly reflects their income and if merchandise is a significant portion of that trade or business, then an accrual method is required.

Ms. VELAZQUEZ. Do all the principals within the administration support the $1 million threshold for small businesses who wish to use the installment method?

Mr. MIKRUT. Yes, we do. Again, we have been trying to develop, in the last several years, several safe harbors and exceptions to be used with respect to small businesses in order to alleviate their tax compliance concerns.

I think it is generally agreed that taxpayers with gross receipts of $1 million or less, and this is average annual gross receipts, so that as an averaging concept so if you have over $1 million one year, you're not automatically off, that those taxpayers have particular needs that may override general tax policy concerns. And their compliance needs may mandate that they should be eligible to use the cash method of accounting in certain instances.

Ms. VELAZQUEZ. How, then, do you reconcile this $1 million threshold with the $5 million threshold under current law for use of the cash method?

Mr. MIKRUT. That's a very good question, Ms. Velazquez. Current law in section 446 requires that a taxpayer's method of accounting must clearly reflect income. And that we think that taxpayers that have gross receipts up to $1 million, that the results that they

would obtain in using a cash method, versus an accrual method, are very similar. So the use of the cash method for those taxpayers, in many instances, will clearly reflect their income.

Once you get to taxpayers that have greater gross receipts, approaching $5 million, it is less clear that the use of a cash method, particularly when they hold inventories, will clearly reflect their income. And, therefore, if Congress wanted to change that result, there should be a legislative change.

We think the tax policy considerations are such that the clear reflection of income standard is very important and that I think Congress should go carefully in considering such legislation. We do recognize, however, that it will create greater simplicity. The Administration is concerned with the complexities of tax compliance. In 1997, for instance, we proposed and Congress enacted a provision that took businesses with less than $5 million of gross receipts off of the corporate AMT and that provided considerable simplicity.

However, with respect to the overall method of accounting, one has to wonder if many of these businesses use an accrual method for other purposes: for purposes of reporting to their shareholders, to their owners, for purposes of applying for bank loans. It is often the case that a financial institution will ask them what their accounts receivables are, what their accounts payables are, and what their inventory accounts are. So, again, to the extent that tax conformity is an issue, perhaps for taxpayers that use accrual methods for other purposes, it is appropriate to use them for tax purposes as well.

Ms. VELAZQUEZ. You spoke before about the fact that you will be issuing guidance to all qualified small businesses with annual gross receipts of $1 million who continue to use the installment method. Can you tell me if the Treasury Department or IRS consult with representatives from the small business community prior to developing the rules?

Mr. MIKRUT. Yes. Both last summer and last fall, the IRS and Treasury had joint meetings with representatives of the small business community to discuss the cash versus accrual issues. In addition to IRSAC, which is an IRS advisory committee—a group of practitioners and advisors that advise the Commissioner—we discussed this issue with them several times, and we discussed the use of the installment with the small business community several times. And all of these discussions went into our calculation in trying to develop guidance in these areas.

Ms. VELAZQUEZ. Can you tell me the specific concerns by the small business groups when you met them?

Mr. MIKRUT. Well, I think their specific questions are contained in my testimony: the relative simplicity of the cash method of accounting, and their liquidity concerns. These are the ones that arise the most.

Ms. VELAZQUEZ. And what about the $1 million?

Mr. MIKRUT. We have not had specific comments on that yet. We have not yet published the guidance. We're also looking if we can develop anything else in this area. We'd like to come up with a complete package. But we would expect that, as soon as we publish this package, this will go through the normal process of notices and

proposed rulemaking so we will take any comments that they have into consideration.

Ms. VELAZQUEZ. And you would tell me that the guidance that you will be issuing will reflect the concerns that have been raised?

Mr. MIKRUT. I believe the $1 million threshold will address many of the concerns. As I mentioned in my testimony, the great majority of these businesses are under the $1 million threshold.

Ms. VELAZQUEZ. Mr. Chairman, I'll have some other questions, but I'll make them later. Thank you.

Chairman TALENT. Thank the gentlelady. I'll follow in line and then defer to other members.

Let me go back to the legislative history of section 448, which was passed in 1986. First of all, Mr. Mikrut, the Act of 1986 was supposed to be a tax simplification Act. I mean, that was the thrust of it, wasn't it?

Mr. MIKRUT. Yes, there were several simplification provisions in the Act.

Chairman TALENT. Congress was interested in simplifying taxes. Now, whether they actually did that or not is something we can all argue about, but I mean that was—I remember watching at the time and it was a big bipartisan deal and it supposed to simplify taxes.

You made a point that the legislative history, I think you said, clearly reflects that you still have the authority to impose the accrual method on small businesses. I'm going to take you through the legislative history and particularly a part that I think takes that authority away from you. And for the convenience of the members, can we distribute this page that I'm going to be working from? Make sure Mr. Mikrut has a copy of it also.

Because I'm going to work through this and just what seems logical to me. I'm trying to put myself in the shoes of our predecessors and maybe somebody—I don't know if anybody here was here then or not. I don't think so.

This is Congress' explanation of what it was trying to do with section 448. And what section 448 says, for the members who have not looked at it, is that it, on its face, appears to say that C corporations above $5 million in receipts can't use the accrual method unless it's a farming operation or a personal service operation like a lawyer or a doctor or something like that.

And on its face when I read it, I thought it was intended to say that a C corporation below $5 million could automatically use the cash method, at least if they had been using it in the past. Now the Treasury believes that what I think and I believe Congress intended as an extra measure of freedom and simplicity and certainty for taxpayers was actually a prohibition. Mr. Mikrut, and I don't want to put words in his mouth, is saying, no, what Congress was trying to do was prohibit taxpayers with above that amount using it, not make it clear that taxpayers with below that amount could use it. See?

So let's look at the legislative history and the reasons for the change. If you look at the bottom of the first column, that paragraph there, and I won't read all of that, basically, it's a statement of Congress and an understanding that the cash method of accounting may not technically reflect a perfect match of income and ex-

penses. And Congress is saying we understand that the accrual method might technically match this better and so, from the strict accounting principle, yes, we're conceding to the Treasury that this might be better from that standpoint.

Then look under the exceptions point. On the other hand, and remember this is a tax simplification bill, "the Congress also recognizes that the cash method generally is a simpler method of accounting and that simplicity justifies its continued use by certain types of taxpayers and for certain types of activities." That Congress believes—look at this next sentence. I draw your attention of the members to this—"that Congress believes that small businesses should be allowed to continue to use the cash method of accounting in order to avoid the higher costs of compliance which will result if they are forced to change from the cash method."

A pretty clear statement from Congress saying yes, we understand, Treasury, that in the policy role of Treasury among the big eight accounting firms, this maybe doesn't fit, but we're not representing you all only; we're also representing the small businesses. And, for simplicity's sake, at least if they've been using it, they should be allowed to continue to use the cash method. Okay? And that's what it appears to say.

Now you were saying, no, it doesn't say that. Tell me why I'm wrong in saying that. Why?

Mr. MIKRUT. Well, I don't believe you are wrong, Chairman Talent, because it says that for taxpayers that have used the cash method of accounting, nothing in this Act changes that. That if they were properly using it before and if they're under $5 million, they can continue to use it.

I would point to a statement that I believe——

Chairman TALENT. Now you use the word "properly." Congress didn't say, "if they'd been properly using it." Congress says, "Even if it's improper, according to technical accounting." That was the whole lead-up. Congress was saying, look, we recognize that sometimes, according to technical accounting principles and technically matching this and that and the other thing, it might not be proper. On the other hand, Congress is saying it's our decision to overrule those that say if they'd been using it, they can continue to use it, even though it's not proper.

Mr. MIKRUT. I don't believe, Mr. Talent, that section 448 stands for the proposition that taxpayers that were using an improper method of accounting could continue to do so. In fact, I think I would turn the page, which isn't here, but somewhere else in the technical explanation, it says that under prior and present law, taxpayers for whom the production, purchase, or sale of merchandise is a material income-producing factor are required to keep inventories and to use an accrual method of accounting with respect to inventory items.

So I can reconcile those two statements. And the reconciliation is that certain taxpayers have traditionally been able to use the cash method of accounting and nothing in the 1986 Act disturbs that. And that, in addition, certain taxpayers have been required to use an accrual method of accounting and nothing in the 1986 Act disturbs that.

So the question, then, is which taxpayers have traditionally been required to use accrual methods of accounting and which are allowed to use the cash method of accounting? And this, again, harkens back to the regulations that have been in force since 1918 that say that if merchandise is an income-producing factor, such taxpayers must use an accrual method of accounting.

Chairman TALENT. No. What you're saying, in essence, is that the sentence, "The Congress believes that small businesses should be allowed to continue to use the cash method of accounting or to avoid the higher cost of compliance," that the term "should be allowed" is not strong enough to overrule the other evidence in the legislative history which you cite. I would say there's a conflict there.

Mr. MIKRUT. No, I think they're reconcilable. Again, I look at the word "continue," which suggests to me that if they were allowed to use it before, nothing in the 1986 Act says that they cannot continue to use it. The question is: were they allowed to use it before? And I think the legislation makes it clear that the regulations that were then in force will continue to be in force—that if merchandise is an income-producing factor, Congress recognizes an accrual method is appropriate and required and did not change that area as well.

Chairman TALENT. Now the next sentence says, "Congress believes that farming businesses, other than farming tax shelters and certain corporate farming businesses required to use an accrual method under the law, should be able to continue to use the cash method in order to avoid the complexity." Same language: "should be able to continue to use the cash method."

And then it says, "Finally, the Congress believes that individuals, whatever the size of activities," and this is, by the way, I think the reason why we didn't mention S corps, because S corps report as individuals. So I think Congress is saying, look, C corps are covered by the first paragraph here. And then S corps, S corps individuals, should be able to continue, okay? Whatever the size of their activities, should be able to continue to use the cash method.

Is Treasury taking the position that you can force the accrual method on farming operations?

Mr. MIKRUT. No, we are not.

Chairman TALENT. Okay.

Mr. MIKRUT. I think it is the long-standing policy that farmers are allowed to use the cash method of accounting unless they are subject to section 447 which requires the use of the corporate form——

Chairman TALENT. You're not going after personal services corporations either, right?

Mr. MIKRUT. No, they're not.

Chairman TALENT. No changes. Because what you're doing in the last three years is new. Now it may not be that—it's a new application—you're saying it's a new application of an old policy, but as far as small business is concerned and as far as the Congress in 1986 would have been concerned, this is new. What you're doing is new.

Now I guess the question I've got for you is if that language is not adequate to make clear that Congress intended small busi-

nesses to be able to use the cash method if they had been using it, even if it's not proper, under your thinking, okay, then why haven't you been able to go after the farming businesses now or personal services corporations? Because we used the same language in the legislative history with regard to all three and this was a tax simplification bill.

You have read out the juxtaposition that Congress put in here. We recognized that, yes, it may not be proper, okay, but we want to allow it anyway. And now you're saying we only intended to allow it when it was proper.

Mr. MIKRUT. I think what the legislative history indicates is that whether a cash or accrual method was allowable was once determined under regulations since 1918. Congress decided to overturn those regulations for corporations with gross receipts over $5 million, but preserved the regulations for all other taxpayers.

And I think the interpretations——

Chairman TALENT. I know what you're saying. You said, in fact, Congress intended by this Act to restrict what you had been doing, to pull back from cash accounting. What you're saying, basically, is that your regulations had been generous in certain instances as regards C corporations and big ones and this offended the Congress, so Congress is now pulling back and is restricting taxpayers.

And I think you've turned it on its head. This is clearly intended to provide some greater measure of freedom and simplicity to some set of taxpayers, the small ones, which Congress went ahead and defined as $5 million; now you're trying to redefine as $1 million.

And you're reasserting exactly the same considerations Congress considered and rejected. It said we understand that you all, you know, the very smart people like you and accountants who understand all this stuff, it may not fit your world precisely, but we're going to let small business people do it anyway.

And I don't know how much more clear we could have made it. Certainly your statement is at odds with this, your statement that it's clear Congress didn't intend to permit this is an overstatement.

Mr. MIKRUT. I don't think so, Mr. Talent, no. Because, again, I look at the words "continue to use" and I believe it was congressional recognition of when the two methods were appropriate under the existing law.

Chairman TALENT. Well, and I'm not on the Ways and Means Committee. And that's what's frustrating because you think you do something here and then you turn around and you find out you didn't do it.

I'll recognize Ms. Kelly. And then, on our side it's Mr. Sweeney and Mr. Manzullo. And then on the Democratic Ms. Christian-Christiensen, Ms. McCarthy, Mr. Pascrell. And then the rest of them are gone. Okay.

Mrs. KELLY. Thank you, Mr. Chairman. Mr. Mitrut, I am looking at what you're offering here and talked about. From the standpoint of having been a small business owner, as a small business owner, one of the most important things I could do for my business was help it to grow.

And when I looked at the $1 million cap that you have, I know full well that it's the small businesses that are driving the economy and you know this. This is driving the good, solid economy of the

United States right now. The increase in the economy and the increasing number of jobs is being caused by the ability of the small businesses to grow.

If you cap this at $1 million, I don't see why that doesn't act as a chill factor on the small businesses. Because what you then do is kick the small business, $1 million is small business, when you kick them in having them file in the same manner that some large corporation does, you're costing them a lot of money. And what you do is you cut into their profitability because they have to hire somebody, then, to fill out an additional packet. It's an additional, basically, acts as an additional tax burden on them.

I want you to defend against what I just said. Because I don't see that in anything you've said in your statement.

Mr. MIKRUT. Mrs. Kelly, I may have been unclear in my oral statement. What the $1 million, as you said, cap is meant to be is relief. What we are saying is that, notwithstanding Treasury regulations and notwithstanding what may be in the legislative history, if a taxpayer is under $1 million in gross receipts and even if they generally maintain inventories and if merchandise is an income-producing factor, the IRS will not question the use of a cash method of accounting.

In other words, the $1 million is a safe harbor. We are not changing the law with respect to taxpayers over $1 million or requiring them to use an accrual method of accounting. We're saying for those taxpayers that are under $1 million of average annual gross receipts, we will not question the use of the cash method with respect to their operations.

Mrs. KELLY. Mr. Mikrut, what's your statutory authority for the $1 million?

Mr. MIKRUT. I think there are areas where—the Commissioner has general discretion. His discretion is generally embodied in 446 that requires a clear reflection of income. There is a——

Mrs. KELLY. I'm sorry, sir, but I do not believe that the Commissioner's discretion allows the Commissioner to create law. A cap of $1 million, arbitrarily, pulled out of the air, is essentially creating law and flies in the face of exactly what the Chairman was talking about.

Mr. MIKRUT. Yes, but the $1 million is a safe harbor. If the Congress believes that the Commissioner doesn't have that authority, doesn't have the authority to provide that safe harbor and has to repeal the $1 million, that will force certain small businesses that maintain inventories to use an accrual method of accounting. That is something that we're hoping to avoid, both for purposes of taxpayer compliance and IRS administrative concerns.

There has been developed in the case law what is known as the SIR test which is Substantial Identity of Results test. And, basically, what the SIR test says is that if you compare your accrual method to a cash method and get relatively the same answer, that the Commissioner shouldn't change that taxpayer's method of accounting. And we think taxpayers that have less than $1 million of gross receipts generally will qualify for the SIR test without having to go through all the calculations to make that determination.

So, again, the $1 million is a safe harbor. It is, we think, a significant liberalization of law and not a tightener.

Mrs. KELLY. The test you're talking about only applies if you've got inventory, if I understand. I'm sitting here with the tax code sitting in front of me and I read it last night. And I want to tell you, it's really good bedtime reading. But it seems to me, from the court decisions that I've read, there seems to be confusion about inventory that I don't see any clarity and I don't understand what you mean by simplicity and I don't understand how you call this a safe harbor since it seems to me nobody really knows, right now, what the courts and you are calling inventory.

Mr. MIKRUT. I think that, Mrs. Kelly, that's why, with the $1 million test as it is, you don't have to make those inquiries. You don't have to make a determination of what is inventory, what is merchandise, when is it an income-producing factor. As long as you're under the $1 million threshold, the taxpayer can choose his method of accounting.

Mrs. KELLY. But a lot of small businesses don't have inventory. My husband and three of my kids are in businesses that don't qualify for inventory. But my husband's business, for instance, would be over your gap. And so all of a sudden you kick my husband and two of my kids into a situation where you are arbitrarily changing the law and I really think that you're making law here in a way that—I'm very concerned about the way you're interpreting section 448 (b) and (c). Because, depending on how you interpret that, I think you could allow that $5 million and not bring it back down to $1 million. And that's really what I'm getting at.

Mr. MIKRUT. I'm sorry, Mrs. Kelly, but let me be clear. Just as we believe that the 1986 Act provision requiring corporations with more than $5 million gross receipts to use the accrual method, had no negative inference to taxpayers under that, our $1 million cap, so that if taxpayers are under the $1 million they can use the cash method, it will not have a negative inference to say that if you're over $1 million, you must use an accrual method of accounting.

We think present law will continue to apply in those cases and that determination is made under current law and current regulations.

Mrs. KELLY. Mr. Chairman, I'm going to yield back the balance of my time. I still feel I've got a lot of questions here, but I don't want to belabor the issue right now. I am going to submit some questions to you and I want some real answers because I still don't feel that you're doing anything with this except making law. And I think that's the right of Congress.

Chairman TALENT. I thank the gentlelady. Ms. Christian-Christensen's next.

Ms. CHRISTIAN-CHRISTENSEN. Thank you, Mr. Chairman. One of the next panelists, I believe it's Ms. Olson, in her testimony is going to say something to the effect that merchandise is still an unfair term because it's not clearly defined and it keeps changing and that should justify raising that ceiling.

Was the fact that merchandise is still an unclearly defined item that is changing currently, was that something that was considered when the ceiling was set and do you think it could justify changing the ceiling?

Mr. MIKRUT. I believe that that was one of the main considerations. Just the general simplicity of cash versus accrual would

probably be important enough to liberalize the use of the cash method. I would agree that recent case law has made it less clear when something is or is not merchandise.

And we are continuing to look at trying to provide additional safe harbors through some guidance in that specific area. And, again, we would hope to try to address all of these as a combined package of items so not only would we use a $1 million liberalization, but also try to provide more specific guidance in the merchandise area.

Ms. CHRISTIAN-CHRISTENSEN. And you mentioned also and you mentioned it again just now that you are considering additional exceptions and safe harbors that would allow the use of the cash method. What would some of those be?

Mr. MIKRUT. Again, this would be, in determining what is merchandise and in determining when merchandise is significant. If we could provide certain safe harbors so that taxpayers meet those safe harbors, they wouldn't have to go through any further analysis. I think that would be welcome relief. And that's what we're trying to help along.

Ms. CHRISTIAN-CHRISTENSEN. Thank you, Mr. Mikrut. I yield back the balance of my time.

Chairman TALENT. I thank the gentlelady. We have on the second panel an expert from the ABA who will be happy to clarify this for us, I'm sure. And will do it, by the way, for nothing, whereas if she was being hired to do it, it would cost hundreds of dollars per hour, so it's one of the advantages we have as Members of Congress.

I'll recognize the gentleman from Illinois, Mr. Manzullo.

Mr. MANZULLO. Thank you very much. I would have a request, Mr. Mikrut, that you remain present when this panel testifies. Could you do that?

Mr. MIKRUT. Unfortunately, Mr. Manzullo, there is a markup in the Ways and Means Committee this afternoon and I'll have to be on hand.

Mr. MANZULLO. But this is 11:00.

Mr. MIKRUT. Well, okay, I really can't.

Mr. MANZULLO. I would like you to stay here. I think you need to hear what these people are saying. I think you need to hear about a lady from Rockford, Michigan, whose small company got fined $80,000 in penalties and interest based upon the fact of the confusion at IRS as to whether or not she's on the cash method of accounting. You need to hear these stories.

The purpose of this hearing is so IRS hears the clear message that you are hurting the little people in America. Do you understand that?

Mr. MIKRUT. We have met several times, Mr. Manzullo, as I mentioned——

Mr. MANZULLO. Can you change your afternoon so you can stay here?

Mr. MIKRUT. I do not believe I can reschedule the Ways and Means Committee.

Mr. MANZULLO. What time is that hearing?

Mr. MIKRUT. It's at 1:30.

Mr. MANZULLO. What do you have to do before that?

Mr. MIKRUT. I have to sit in for the Assistant Secretary of Tax Policy who was supposed to attend the mark-up. And I'll be sitting in for him at the desk. So I have to review the statutory language, the revenue forecasts, and prepare for the questions that may come up at the hearing, at the markup.

Mr. MANZULLO. What really bothers me is the cavalier attitude of the IRS in all of this and you reflect it. I have thousands of small businesses in the congressional district that I represent. Small people. Some earning under $1 million a year who have been terrorized by the IRS in this cash versus accrual business. And you readily admit, don't you, Mr. Mikrut, that there's confusion as to whether or not something is inventory or merchandise. Didn't you say that?

Mr. MIKRUT. Yes.

Mr. MANZULLO. Would the IRS consider a regulation, waiving any interest or penalties on a company that has been audited which, in good faith, operated on a cash basis which you say should have operated on an accrual one? Wouldn't that be fair?

Mr. MIKRUT. Mr. Manzullo, I think that the proposal we put forth addresses that specific concern so that if you were, again, as you said, less than $1 million, this would become a non-issue and you will be able to use whatever accounting method you are allowed to use.

Mr. MANZULLO. What about over $1 million, though? $1 million to $5 million?

Mr. MIKRUT. Again, I think, looking at the authority that we do have——

Mr. MANZULLO. Do you have the authority to waive any fines or interest on people who have in good faith and grossing between $1 million and $5 million who are forced to go from a cash method to an accrual basis based upon an IRS audit? Do you have the authority to waive the interest and penalties?

Mr. MIKRUT. We have the authority to waive penalties, but Congress has restricted the ability to waive interest.

Mr. MANZULLO. Thank you. Would you be in favor of Congress restricting the ability to collect interest in a situation like that?

Mr. MIKRUT. It's funny that you mention it, because the markup this afternoon is on the interest and penalty provisions of the Internal Revenue Code. And when one looks at interest, there is a distinction between interest and penalties and it is appropriate that penalties be waived for reasonable cause. And, quite frankly, more penalties are waived than imposed.

With respect to interest, however, interest is a function of time, value, and money. So, to the extent that a court, for instance, determines that a taxpayer's liability is higher than it is, it seems appropriate to charge interest to that taxpayer, to treat him as fairly as a taxpayer that was——

Mr. MANZULLO. That's really fair. She's going to testify it's cost her $100,000 in interest because of the confusion of the IRS whether or not her business should be based on the cash or the accrual system. And you are sitting here justifying the imposition of interest in that situation. Is that correct?

Mr. MIKRUT. What I'm saying is that there is no ability for the IRS currently to waive interest in that situation.

Mr. MANZULLO. Would you take a position that IRS should be able to waive the interest if Congress gave you that authority?

Mr. MIKRUT. I think each case, with respect to the interest/penalty provisions, stand on their own. The IRS has——

Mr. MANZULLO. Let me reiterate this. You've got a business here between $1 million and $5 million dollars. These people are strictly honest. Books are open. They've done nothing wrong. All of a sudden, they get audited by the IRS that says, oh, by the way, you should be on the accrual method and not the cash method. You never cheated on your taxes and no one's saying you did anything wrong. And we're going to impose $80,000 in fines plus $100,000 in interest.

And you can sit there and you can justify the imposition of that interest? That's what you just did.

Mr. MIKRUT. Well, Mr. Manzullo, not knowing the other facts than those you just said——

Mr. MANZULLO. That's the facts. That's all you need to know. That's what's going on here nationwide. When I met with Commissioner Rossotti on this issue, I told him this dentist was a test case to put all dentists on the accrual system because the little bit of gold that they may use and some of the dentures that they may use. And it's part of a nationwide pattern because now the IRS is test-casing MDs throughout the nation, trying to force everybody to go on the accrual system.

I'm saying here today that this is your mission to put as many people on the accrual system as possible to collect as much money upfront as possible and, sir, that is bringing terror into small businesses. And I would suggest that you, if you issue more regulations and issue more guidelines, all you have to do is say, look, we're just going to back off. We're going to make a recommendation that anything under $5 million, we're going to leave the small business people alone.

Do you realize how much easier that would make life in America for the hundreds of thousands of small business people?

Mr. MIKRUT. I think in developing our proposal at $1 million, we did take that into account. Again, I believe the $1 million threshold takes care of the bulk of them.

Mr. MANZULLO. When you met with the small business groups when you formulated the last policy, you mentioned that, which groups were those?

Mr. MIKRUT. I believe the last time we met was, again, it was on the installment sales provision which was the last time we did meet. It was the NFIB, it was Chamber of Commerce, the AICPA——

Mr. MANZULLO. Did you contact the Journal of Small Businessmen?

Mr. MIKRUT. No, we did not.

Mr. MANZULLO. You didn't. The dentist in my State that you forced to go on the accrual system is earning under $1 million. So the IRS, and I want you to listen very closely, the IRS is forcing small business people earning under $1 million to go on the accrual system. I want you to take that back to headquarters. Thank you.

Chairman TALENT. I thank the gentleman. Let me state for the record, because it's just confusing, I don't know that in my opening

statement or the gentlelady's we laid out maybe as well as we should have why this makes a practical difference to small business people.

If you're, say, an asphalt contractor, you've probably been using the cash method of accounting, which means that you report income as you actually receive it, not at the time when you're entitled to receive it. And what the Department is now saying, as I understand it, is that if the asphalt you use is more than 15 percent of your receipts in a given year, then that's merchandise or inventory so that you are required to report your income as if you were a store, as if you were a 7–11 or a Walgreen's or something. Which means that you have to report the income when you're entitled to receive it.

Now, this makes a difference when an account receivable is acquired in a different year than the cash is actually received. So, if you're entitled to payment on December 1st but you don't get it until January 15, then under the cash method you report that income in the following year; in the accrual method you report it in the previous year. That doesn't matter so much if it's only applied prospectively in that sense.

But this is the point Mr. Manzullo was making. They come in and audit and then they go back a few years and say, "Oh, you reported income in 1998 that you should have—or 1999 that you should have reported in 1998. So, you owed it for 1998." Even that is not so bad, but in the interest in penalties then add up to tens and tens of thousands of dollars.

The other problem is if you report—then those businesses are forced to treat that as individual rate, and the accrual method is a harder method from an accounting standpoint. It is more expensive, it is more complex, particularly since it doesn't really fit the inventory thing. And, so it is just another hassle.

And, Mr. Mikrut, we are still searching here for some overriding policy reason that is advanced through some reason of equity or something other than what accountants learn about matching income with expenditures that requires doing this to these people. Again, if this was some kind of fraud or quasi-fraud that you needed to—this was a preventative method, you know, we're going to make certain they don't run. But nobody's—you're not claiming that, are you, that these are people trying to get out of it?

[Mr. Mikrut shakes head no.]

Chairman TALENT. So, it comes down to some fairly technical things about—for the record, the witness shook his head saying no on that; he is not saying it is a fraud. So, what is the reason to put these people through all of this?

Mr. MIKRUT. I think, again, the statutory impetus behind methods of accounting are under section 446. Section 446 requires that the method of accounting clearly reflect income. There are certain instances where the use of the cash method of accounting will clearly reflect the income of the taxpayer. However, financial accounting literature, which has been developed well before tax accounting rules, generally acknowledge that an accrual method of accounting better reflects income, particularly where inventories and merchandise are involved, and I think that has been the evolution of the law, again, since the very beginning of the income tax.

Chairman TALENT. I recognize Mr. Hinojosa for questions he may have.

Mr. HINOJOSA. Thank you, Mr. Chairman. I am going to refrain and ask my questions after I hear the second panel.

But before I do that, I do want to echo the same concerns that my friend, Mr. Manzullo, has voiced for the small business community. We are in the 21st century, and Mrs. Kelly also pointed out to you that the economy is as strong as it is because of so many small businesses stepping in and starting up new businesses and expanding them to create the jobs and give us the economic boom that they contribute to.

I hope that when this Committee finishes with this issue that we can come forth with a national policy that will make this a much more friendly environment for the small business firms, and that the IRS is cut down to size so that they will not be the big giant that oftentimes imposes their authority on small businesses and keeps them from doing their job.

So, again, I am going to wait until we finish with the second panel, Mr. Chairman, and ask the questions then.

Chairman TALENT. I will finish up with a couple of questions, one of them I alluded to. And, first of all, Mr. Mikrut, let me just say that one of the kind of joint objectives we have on the Committee is to prevent—oh, I am sorry, Mr. Bartlett. I didn't see you there, Roscoe, you are normally so much more vocal. I am sorry, Mr. Bartlett, let me recognize him.

Mr. BARTLETT. Thank you very much.

In another life I was a small business person. I ran a land development home construction company. At the end of the day when I liquidated my company, would I have paid any more or less total taxes regardless of whether I reported on an accrual basis or a cash basis?

Mr. MIKRUT. Mr. Bartlett, that would have depended on whether tax rates had changed over the course of your business.

Mr. BARTLETT. That is correct, but presuming that tax rates did not change, at the end of the day I would have paid exactly the same amount of taxes no matter which way I reported, correct?

Mr. MIKRUT. That is correct. What we are discussing here is a timing issue.

Mr. BARTLETT. Okay. I built spec homes and sold them. If at the end of the year I had five spec homes sitting there that I had not been able to sell and I had to use an accrual method of accounting, I would have to go borrow money to pay those taxes. I didn't have the money. Isn't it true that in the long run the taxpayer, the IRS, the totality of taxpayers will get as much money regardless of which accounting method is used? That is true, is it not?

Mr. MIKRUT. Yes.

Mr. BARTLETT. Then, why in God's Earth do we want to harass these small businesses? Because at the end of the day—you know, next year we are going to have as much trouble balancing our budget as we did this year. Why do you want to harass these small businesses when at the end of the day we are going to get exactly the same amount of money from them no matter which accounting method is used? Why do we want to harass them? I am having difficulty understanding this.

Mr. MIKRUT. Mr. Bartlett, that was one of the considerations again with the broad relief.

Mr. BARTLETT. But my question is, why do you want to harass them? At the end of the day you get exactly the same amount of money no matter which accounting method is used. Why do we want to harass them and increase their costs of doing business, which is what you are doing?

Mr. MIKRUT. Mr. Bartlett, in a case that you just hypothesized where you had five homes built but did not sell, would you have to pay taxes on that? The answer would be no, because you hadn't sold the homes yet. It is only in the case where you have sold the homes where you have to pay.

Mr. BARTLETT. But I improved the value of those homes. They are there. You could call them inventory.

Mr. MIKRUT. They would be inventory. We would not, though, however, require a market-to-market type system where the value that was in those homes would be subject to tax. We would not require taxation until the homes were actually sold and a realization had occurred. However, again, it is when the event occurs is at the crux of the issue of a cash versus accrual method of accounting.

Mr. BARTLETT. On several of those homes that I sold I held the mortgage. I didn't get that money except by little dribs and drabs over a 30-year period. If I was on an accrual method, then I would have to pay the tax on that total sale at the time of sale, wouldn't I?

Mr. MIKRUT. Whether you are on a cash or accrual method, if you took back paper, which you did in your case, it would be a constructive receipt, and you would have had to pay tax in either event, cash or accrual.

Mr. BARTLETT. How can I pay taxes on money I haven't gotten? If I sold all those and held the mortgages myself, I would obviously have no money with which to pay the taxes. But, again, my question is, why do we want to throttle the most important part of our economy, small businesses? At the end of the day your responsibility to the taxpayers is achieved—because exactly the same amount of money is extracted from these small businesses, whether you harass them or not. Now, why don't we just let them alone and use what accounting method they wish, realizing at the end of the day we get exactly the same amount of money from them?

Mr. MIKRUT. Mr. Bartlett, nothing we are proposing today or any other guidance would restrict use of the cash method of accounting. If anything——

Mr. BARTLETT. Well, then you need to sit through our next witnesses here. You really do need to sit through and see what is happening to them as a result of what you are now doing.

Mr. MIKRUT. Again, what we are now doing is trying to provide guidance, broad guidance, that would allow the use of the cash method to address some of the concerns we have raised.

Mr. BARTLETT. One of the witnesses will be a drywall contractor. I build houses. I know who drywall contractors are and what they do. He now owes you, you say, $80,000. It may be $100,000 when it is finished, because he chose to use the cash method rather than the accrual method of accounting. You found nothing else wrong with his books, nothing wrong with his books at all. Now, I don't

understand why we are doing this to small business. At the end of the day you get exactly the same amount of money from them no matter which method they use. Why don't we just let them alone?

Thank you, Mr. Chairman.

Chairman TALENT. Let me just inquire of a couple areas as we wrap this up for this panel, because we do have another panel waiting.

One of them is the $1 million figure in your proposed regulation. Now, Congress thought fit to use a $5 million figure as a cut-off, and whatever that cut-off was intended to signify, and I understand we disagree with that, clearly Congress intended a $5 million figure to be the cut-off between the small businesses for whom simplicity more likely would be allowed to override other concerns depending on how we interpret that. Congress felt the $5 million figure was good.

We have in the Small Business Act certain definitions of what a small business is, and it varies depending on the sector. I am not familiar with $1 million as a test in any statute of which I am aware. So, would you enlighten me and tell me where you got the $1 million figure?

Mr. MIKRUT. Again, looking at the $1 million, we looked at the number of taxpayers in existence, and again, $1 million covers the bulk of those. We also had an income test called a Substantially Identical Results Test, and we thought $1 million would comport with that. We also looked at taxpayers as they get larger, in excess of $1 million, often use the accrual method for financial accounting purposes, and we thought full tax conformity might be achieved in those cases.

Mr. MANZULLO. I don't believe that; I am sorry.

Chairman TALENT. Let us let the witness finish. I mean I understand that—a lot of this is, if I can say, is a cultural thing. I mean you develop your policy over at the Treasury, and it is important to have all these considerations in mind. And, of course, we are dealing, I think it is fair to say, on a more regular basis with the real people who are having to deal with this. So, Mr. Mikrut is trying to do what he thinks is right from his perspective also.

So, you go ahead and finish. If you have an additional question, Don, I will recognize you.

Mr. MIKRUT. And, finally, Mr. Manzullo, I do believe because it was Congress that put in the $5 million threshold for purposes of corporations required to use the accrual method of accounting, that this is something that would be best handled legislatively, and I understand you and other Members have bills, so this is something that is clearly, I believe, within the purview of Congress to provide a threshold as far as $5 million.

The $5 million threshold has been used in many instances. For instance, the Administration proposed, and the Congress passed, the $5 million exemption from the corporate AMT. So, I mean $5 million is——

Chairman TALENT. Well, why don't we just use $5 million. I mean $1 million—there is no reference point for getting $1 million, and it comes out thin air. And I will tell you, our experience has been, and I understand why you can't—typically, I will also say in defense of the witness because we have given you a hard time, we

don't tell people to come and be prepared to stay for the second panel. It would be nice if somebody from Treasury were here to listen. And I understand Ways and Means is the Committee you typically report to.

But Congress did use the $5 million. The $1 million comes out of no place, and our experience has been that people that you would just instinctively think of as small business people—do the old Justice Stuart test, we will know them when we see them—often have receipts above $1 million. I think both witnesses on the second panel who have really been hurt by this have receipts that are above $1 million.

So, since that is what Congress used, and that is, as you mentioned just a minute ago, that is a test that is out there for a number of different things, for simplicity's sake, if we don't overrule this, you may want to consider the $5 million. And if the point is to make this simple and consistent, that, seems to me, would be better. The $1 million comes out of no place. I mean there is no statutory reference to a $1 million figure, is there?

Mr. MIKRUT. No, there isn't. Again, the statutory reference is to a clear reflection of income. We thought that taxpayers under $1 million, whether they use cash or accrual, their income would be clearly reflected in either event.

Chairman TALENT. Yes, and of course, just I will say for the record, it is something for Congress to deal with, and it is my position that that is exactly what Congress did in 1986, and your interpretation of it is incorrect, but I understand we have a difference of opinion there.

Let us go to the installment method issue, which I don't think we have had many questions on, and is of even greater, I think, immediate and urgent importance in the small business community. You recognize we have a problem out there with small businesses not being sold that we want to be sold from a policy standpoint because of this installment change. You recognize there is a problem, don't you?

Mr. MIKRUT. Yes.

Chairman TALENT. And the Department recognizes that. And I will tell you that I had a—after we do this, it is quite embarrassing, because this is something Congress did, and I smiled when I read my opening statement, because my staff was kind enough to say that the Department recommended this and got us to do this. But Congress did it, and we should have caught it, I think, and not done it last year as a revenue raiser. A fellow came up to me, and he has got a classic thing. He has got a plumbing wholesale business. He wants to sell it, and he can't now. Because you recognize that very often small business people sell to other small business people, right? If you want to say yes, you——

Mr. MIKRUT. Yes, I'm sorry.

Chairman TALENT. Okay. And the purchaser is not able to get a bank loan financing to buy the whole business all at once; you understand?

Mr. MIKRUT. Yes, sir.

Chairman TALENT. And, so therefore they pay in installment notes, or notes with the installment payments to the original owner; you understand that? In essence, the owner finances it and

gets a stream of payments over time. And the record will show the witness is nodding for all this. I am going to start asking some other questions like, aren't we right about all these things? [Laughter.]

And, so the effect of the law Congress passed is to make people pay taxes on the whole amount of the sale when they have only received a fraction, like 10 percent. That is the problem, right?

Mr. MIKRUT. That is the problem.

Chairman TALENT. And I just suggest to you that here there is no reason even in accounting principles to do this, because just because you are an accrual taxpayer in an ongoing business, we want to match income and expenses. When you are selling the business and shutting it down, from your perspective, there is no reason, is there, from an accounting standpoint to require that you treat the whole amount as paid even though only a downpayment has been paid. Even from an accounting standpoint that is not necessary, is it?

Mr. MIKRUT. Mr. Talent, I think the effects of the repeal of the installment method for accrual method taxpayers upon small business was unforeseen, and I think that is something that is appropriate for us, and working on that is something where I think the legislation is very clear, that we need them simply——

Chairman TALENT. Well, I agree. This is not something where you have discretion, but—and if this is above your pay grade, just tell me—but can't the Department just come out in favor of repealing this?

Mr. MIKRUT. I think we, too, believe that the installment method is very much like a cash method. It should be restricted to cash method taxpayers. However, we do believe that that overriding tax policy—that type of tax policy concern can be overridden by the concerns of small businesses. We think there are going to be concerns, as you mentioned. Liquidity concerns override tax policy concern, so we look forward to working with you to develop something to take small businesses out of last year's bill.

Chairman TALENT. Was that a yes?

Mr. MIKRUT. That is a long yes.

Chairman TALENT. A long yes, very good. Well, with that in the record—and I will just say that I can't believe that if I had Secretary Summers here or if the head of the administration, the President, were favoring us with an appearance here that he would not say yes. I mean this is just this unintended negative hit on people, accrual and other kinds of taxpayers. I mean these are people who have accrued, they have done all this. They are not involved in all the rest of this stuff, and all they want to do is sell their business, and they have to treat large amounts of—they get large amounts of tax bills, and they don't have the money. I don't have to tell you it is quite embarrassing to go home in a town hall meetings and other meetings, Kiwana or rotary meetings, and have these people come up to you and have to say we didn't foresee this. Can you tell me why—and Congress shares in this—why we didn't foresee this? I mean to me it would seem to me to be obvious.

Mr. MIKRUT. It is hard for me to prove the negative, Mr. Talent.

Chairman TALENT. Yes. Well, you all have pushed this, and I just think we have—when did this get in, in the Conference Com-

mittee? The House didn't do this, did it? Well, the Senate did this; that explains a lot. [Laughter.]

All right. Don, did you have a further question you wanted to ask?

Mr. MANZULLO. I have a follow-up question. You stated, Mr. Mikrut, that one of the policy reasons underlying the use of the accrual methods is that a small business person will sign for a loan, and the loan application provision will rely on the accrual method. You said that.

Mr. MIKRUT. I believe what I said, Mr. Manzullo, was that one of the policy considerations on whether to pick a cash or accrual method of accounting is simplicity, and to the extent that a taxpayer is not using an accrual method for other purposes, it would seem that simplicity would indicate they should that tax method for tax purposes as well. But to the extent that they perhaps are using an accrual method for other purposes——

Mr. MANZULLO. What are these other purposes?

Mr. MIKRUT. Financial accounting purposes, reporting to shareholders, reporting to creditors.

Mr. MANZULLO. Do you have actual proof of that?

Mr. MIKRUT. Well, I do not get involved with an individual taxpayer applying for a loan, but, yes, I have——

Mr. MANZULLO. I mean do you have actual proof of what you just said?

Mr. MIKRUT. Yes, there are instances where creditors will ask for supplemental statements with respect to the accrual method of accounting.

Mr. MANZULLO. Creditors.

Mr. MIKRUT. Yes.

Mr. MANZULLO. Well, what has this got to do with the small business person? Do you think he determines the questions that are asked of him by his creditors?

Mr. MIKRUT. No, Mr. Manzullo. I was just stating that there are instances where the accrual method is used for purposes other than tax purposes.

Mr. MANZULLO. State that again for me.

Mr. MIKRUT. The accrual method is generally accepted—comports with generally accepted accounting principles. It is generally used to report the financial results of a business.

Mr. MANZULLO. Wait a second. Financial results? Now, this is a business under $5 million.

Mr. MIKRUT. I believe the accrual method is used and inventory methods are used for businesses under $5 million, yes.

Mr. MANZULLO. This is for a widely held corporation.

Mr. MIKRUT. They are mandated for widely held corporations.

Mr. MANZULLO. There are a lot of widely held corporations that have assets, sales under $5 million. There are just millions of them across this country, would you agree?

Mr. MIKRUT. No, I would not.

Mr. MANZULLO. Yes. Well, that is the whole point. So, what you have done is you have taken a few isolated occasions where someone may have used the method other than the cash method, and you penalize that small business person. That is what you have just done.

Mr. MIKRUT. Well, Mr. Manzullo, I was simply suggesting that there are instances where full book and income tax conformity are appropriate, and accounting methods are one of those instances. And that can be done on a case-by-case basis, not——

Mr. MANZULLO. But you said that as a matter of policy. You said one of the reasons that you want to impose an accrual system is that many of these businesses use an accrual system for purposes other than filing their income tax returns. You made that statement.

Mr. MIKRUT. The statement I made was that an accrual method of accounting, if it is used for book purposes, does not require any additional complexity for a small business, at least not for tax purposes.

Mr. MANZULLO. I want you to refer to a document in writing with your name on it the number of companies in this country that are using a cash method of accounting to the IRS, at the same time using an accrual method of reporting anything else to their shareholders. Do you have any idea how many there are across the nation?

Mr. MIKRUT. I can provide you with information as to how many taxpayers are using the cash method or the accrual method for tax purposes, but that does not necessarily then tell us for financial——

Mr. MANZULLO. You don't have the answer to my questions, and you have just made a very bold statement that a policy reason for using the accrual method is that people on the cash basis are out there using the accrual methods for something else, and you have no proof. You have none.

Mr. MIKRUT. Mr. Manzullo, I do not believe that is what I said.

Mr. MANZULLO. I know what you said. I want you to furnish a letter to my Subcommittee on Taxation and put—write this down—down the number of small businesses in this country that have receipts under $5 million, gross receipts under $5 million, that are on the cash method, and then the number that are on the accrual method. And those that are on the cash method, how many outside activities they are doing including whatever you mentioned that they are using the accrual method of taxation.

Chairman TALENT. If the gentleman will yield. I think it is a fruitful line of questioning. We have another panel. So, what I would ask the gentleman, encourage him to do is to file in his Subcommittee, and maybe I am sure Mr. Mikrut would be pleased to come back and appear before——

Mr. MANZULLO. I will have you meet my Subcommittee along with the drywall man, along with the tax lady from the ABA.

Chairman TALENT. And then follow that up, and I would encourage the gentleman to do it. And this is something that the Committee is going to pressure on, both without and within the Congress.

Mr. Mikrut, thank you for coming and for your patience, and we will look forward to working with you in the future.

And I will adjourn the first panel and ask the witnesses for the second panel to come forward.

[Recess.]

What I am going to ask the witnesses to do is to summarize your testimony if your written testimony is of any length. And that is not because we are not interested but really because we are, and members are going to want to ask questions and have plenty of time for that. So, I imagine the questioning here may be a little bit less adversarial than it was in the last panel.

Our first witness today is Mr. Shane Mieras, a project manager for Mid-Ceilings and Drywall in Rockford, Michigan, who is here on behalf of the Associated Builders and Contractors.

Mr. Mieras.

STATEMENT OF SHANE MIERAS, PROJECT MANAGER, MID-CEILINGS AND DRYWALL, ROCKFORD, MICHIGAN, ON BEHALF OF THE ASSOCIATED BUILDERS AND CONTRACTORS, WASHINGTON, DC

Mr. MIERAS. Good morning, Mr. Chairman, and members of the Committee. My name is Shane Mieras, and I am co-owner of Mid-Michigan Ceilings and Drywall, located in Rockford, Michigan. Associated Builders and Contractors is a national trade association representing more than 22,000 contractors, subcontractors, material suppliers, and related firms from across the country including all specialties in the construction industry. ABC has 82 chapters across the country.

Chairman TALENT. Shane, if you put the microphone a little closer to you, it would be better.

Mr. MIERAS. Mid-Michigan Ceilings and Drywall has been a member of ABC for approximately three years. We would like to thank Chairman Talent and House Small Business Committee members for hosting this hearing today.

Mid-Michigan Ceilings and Drywall is a small commercial drywall company that was established in 1990. I currently employ 22 people. I came to Washington today to testify on my real-life experience of currently being audited by the Internal Revenue Service based on my company's use of the cash method of accounting. As many of you know, the cash basis method allows deductions for expenses to be taken in the year paid and reporting of income in the year the cash is received.

Approximately two years ago, the IRS called on Mid-Michigan Ceilings and Drywall and initiated an audit for tax years 1996 and 1997. Our sales at the time of audit were only $1.7 million. We have always kept our books on the cash basis, because it is a simple and easy method of accounting. There is really no need to hire outside professional accountants when using this method. My business never had any intention of converting to the more complex and time-consuming accrual method, because we are such a small company.

In October 1998, the IRS informed us that we owed approximately $80,000 in interest and underpayments as a result of using the cash method of accounting. Our case is in the final stages of appeal, and I have been advised that the final assessment could be as high as $100,000.

At Mid-Michigan Ceilings and Drywall we keep a clean set of books. No other tax problems were identified during the audit other than the fact that we were using the cash method of accounting.

The IRS' reason for this assessment on Mid-Michigan Ceilings and Drywall is because they feel we are merchandisers. We disagree. We are not merchandisers. We install commercial drywall and have never sold drywall to the public without installing the drywall. The IRS concedes that we do not have inventory on hand. However, that is not good enough to refute the IRS' use of the merchandise argument.

What is troubling is that the IRS can force small businesses to change from a legal, simple accounting method to the accrual method. Mid-Michigan Ceilings and Drywall is a small business and pays taxes on cash we collect minus expenses paid. By forcing us to the accrual accounting method, we will now incur an added expense of having to hire professionals to maintain our books. Speaking of professional help, we have also hired a tax attorney to fight this unfair assessment by the IRS. This has resulted in approximately $5,000 in legal fees to date, in addition to the assessment made by the IRS.

Of course the obvious problem now for my company is determining how we are going to pay the IRS. Since this money is not available to us through the business, we will have to seek a bank loan to pay the assessed taxes, penalties, and interest. The bank interest payments alone will cost us between $10,000 and $15,000 per year. A $100,000 tax burden is a huge sum of money to a small business such as ours. This huge arbitrary assessment by the IRS will definitely hurt my company's growth potential and limit my ability to hire new employees.

A couple of goals we have set up for year 2000 are now in jeopardy. We need to purchase new work trucks, and new equipment such as scaffolding and tools. Most importantly, we would like to build our own building so we can expand the business, and hopefully hire more employees. This tax burden imposed by the IRS will take away money that we could use for growing the business. Our bank also is withholding a line of credit to the tune of $50,000 until the final outcome of this case is determined.

We all know that business investment is what is driving this economy right now. We will be forced to sit on the sidelines due to lack of capital because of this unfair tax assessment. Lastly, this tax payment will make it harder for us to improve our wages and benefits to our employees and is also forcing us to rethink charitable giving until our financial solvency is determined.

I understand that any corporate business that does over $5 million has to use accrual accounting. Someday at Mid-Michigan Ceilings and Drywall we hope to reach $5 million threshold and will plan on converting to the accrual method at that time. Right now it is unfair to treat Mid-Michigan Ceilings and Drywall any differently from other small businesses by converting us to big business accounting.

The IRS' position on which businesses should be using the cash method or accrual accounting is not based on any specific section of the Internal Revenue Code, but on a series of court cases successfully litigated by the service. Hence, the IRS is not enforcing the law, they are making it. Congress should amend the Internal Revenue Code to clarify that small businesses can keep using the

cash method of accounting even if the IRS argues that they have inventory or merchandise as a material income-producing factor.

Two legislative proposals before Congress would permit small contractors like Mid-Michigan Ceilings and Drywall to continue to use the cash method of accounting without fear of audit, penalties, and interest. H.R. 2273, introduced by Small Business Committee Chairman Talent and Ways and Means Committee member, Phil English, and S. 2246, introduced by Senate Small Business Committee Chairman Christopher Bond and Senate Finance Committee member, Charles Grassley, have both been endorsed by the ABC National Tax Committee and would provide relief to small businesses like Mid-Michigan Ceilings and Drywall.

Mid-Michigan Ceilings and Drywall joins ABC in urging members of the Committee to advance these proposals in the next tax bill considered by Congress. Small businesses are the backbone of the economy and our country's economic engine. We urge you to enact this legislation into law to ensure that small contractors can operate their businesses without living in fear of the IRS.

I would like to thank Chairman Talent and the Committee members for allowing me to present Mid-Michigan Ceilings and Drywall's concerns regarding this important issue. I stand ready to answer any questions the Committee may have.

[Mr. Mieras' statement may be found in appendix.]

Chairman TALENT. Thank you, Mr. Mieras. If you pay the whole $80,000, you at least have the pleasure of knowing you kept the Federal Government open for a nanosecond.

Mr. Dave Wulkopf, who is a CPA and the treasurer of Beckner Painting, where he began working as a painter in 1986, continued working the summers until 1992, and now handles all tax and accounting issues. And you were promoted to treasurer in 1993. Appreciate your coming here, David.

We'll go ahead with this. We haven't had the second bell yet, have we? I don't think so. Go ahead, and we may have to recess this in the middle of your testimony, but go ahead, please, David.

STATEMENT OF DAVID E. WULKOPF, CPA, TREASURER, BECKNER PAINTING MIDWEST, INC., ST. LOUIS, MO

Mr. WULKOPF. Okay. My father is actually the owner of the company. I am the treasurer.

Chairman TALENT. Go ahead.

Mr. WULKOPF. Beckner Painting was founded—we are a small painting company located in St. Louis, Missouri. The primary focus of our work is interior and exterior apartment painting. We also do some limited residential and commercial work. We employ up to 80 people in the summers and as few as 15 during the winter months as the workload slows down.

Since the company was founded over 30 years ago, we pay our taxes on the cash basis of accounting, as permitted by section 446 of the Internal Revenue Code. The company has annual revenues of $2 million to $3 million, and we do not maintain inventories. Therefore, at least we thought the company qualified as a small business, as defined by section 448, and we thought we were permitted to use the cash method of accounting.

In 1995, we were the subject of a random audit of our 1992 Federal income tax return. The IRS did not find any changes that needed to be made as a result of this audit. Then again in September of 1998 we were notified that we were going to be audited on our 1996 Federal income tax return. Once again, there were no changes that needed to be made with the exception of this cash basis issue that is before us today.

The reasoning behind the proposed changes is kind of a stretch. Even though we provide a service and do not sell anything directly to the public, because our material cost, such as the paint, is more than 15 percent of our revenues, the IRS claims that we have merchandise which is an inventoriable item. Since we have an inventoriable item we are required to use the accrual method of accounting even though we do not carry any physical inventory.

The reason for the change can be masked in a number of different ways, but the bottom line is obvious. The motive behind the Treasury Department policy is to speed up the collection of tax revenues and to collect the tax on the accounts receivable. If we had accounts payable that were higher than our accounts receivable, we would not be in a position of having to defend ourselves from this proposed change.

It is understandable that the Treasury Department would want to expedite the collection of tax revenues, but it seems no thought is given to how unfair this policy is to small businesses.

Chairman TALENT. Well, David, what they basically did was they took an enactment, section 448, which was intended to make clear that businesses like yours could use the cash method if you had intended to do it, interpreted it as saying that you can only use the cash method when they would otherwise have said you could use the cash method anyway, and then changed their interpretation of when you could use the cash method so as to substantially restrict it and treat people who are not in the business of merchandising or do not have an inventory as if they do. So, they interpreted the law and are trying to make it consistent with their practices, and then they changed their practices in order to go back and fleece you out of, what, $200,000?

Mr. WULKOPF. Yes.

Chairman TALENT. That is a good days work. Go ahead.

Mr. WULKOPF. Under this new policy, accelerating the collection of tax revenues is done at the expense of small businesses who have been allowed to report on a cash basis for years. These companies are currently being selected for audit and forced to change accounting methods. This change in accounting methods causes an enormous tax liability that is a result of years of cash basis reporting to come due. Most small business do not have large sums of cash available to pay taxes on money that is not yet received.

The effects of this proposed change would be devastating to Beckner Painting. We operate in a very competitive industry, and cash flow is always a concern. There are numerous sole proprietors in the painting industry that operate with little overhead and can undercut the prices of established companies like Beckner Painting. As an established company we do offer higher quality work and tend to be more reliable, but if our prices get too high many

customers will switch to these sole proprietors in order to save some money.

Therefore, we must constantly keep our costs down and our cash flow is usually tight. There is rarely a payroll period that goes by that we are not concerned about having cash needed to make the payroll. With the minimum wage increasing seemingly everyday, this cash flow gets even tighter. In addition, the company has to continually repair and replace painting equipment, like power washers, sprayers, ladders, trailers, and vehicles, and these costs further limit cash flow.

Should the IRS succeed in making us change our method of accounting, the amount of tax due is well beyond the cash we have on hand. Therefore, we would be required to borrow money to pay the tax. Not only is forcing the company to borrow money to pay tax fundamentally unfair, but it would put us in a very vulnerable position. The amount of money we would need to borrow, close to $200,000, would max out our borrowing resources and put us a bad year away from bankruptcy.

The primary unfairness of this new policy is that we have paid our taxes on a cash basis since the company was founded. We were not even asked to change during the 1992 audit. Then in 1996, when our receivables had grown, we were told that we needed to change accounting methods. The difference between paying our taxes on a cash basis versus an accrual method is minimal year by year, but it is the one-time hit of the change that is damaging.

Our case has not yet been resolved. It has been going on for more than a year and a half now, and the time and money spent on trying to defend the case has put a serious strain on our resources. We have spent countless hours examining invoices, preparing schedules, and researching position guidelines. We are afraid to invest in any new equipment, because we may need the money to try to pay the tax resulting from the proposed change.

Beckner Painting has grown from a small summer hobby to a successful small business. Being a small business it is hard enough to comply with the seemingly endless stream of Federal, State, local, and industry regulations. Policies like this makes it even more difficult. Small businesses face many unique challenges in defending themselves from policies such as this. It is not only unfair, but it could jeopardize our continued existence. That is why we are here to support Congressman Talent's bill, H.R. 2273.

[Mr. Wulkopf's statement may be found in appendix.]

Chairman TALENT. All right. I have to thank you, David. I have to recess the hearing now, because I have got to go vote, but as soon as I think Mr. Sweeney gets back we will just have him reopen the hearing, and then you all can begin testifying so we can expedite this.

I recess the hearing.

[Recess.]

Mr. MANZULLO [presiding]. We are reconvening the hearing. The next witness is Roger Harris, who is president of Padgett Business Services in Athens, Georgia.

Mr. Harris.

STATEMENT OF ROGER HARRIS, PRESIDENT, PADGETT BUSINESS SERVICES, ATHENS, GA

Mr. HARRIS. Thank you, Congressman Manzullo. It is a pleasure to be here and to have the opportunity to speak to the Committee about cash versus accrual and the installment sale. As you mentioned, my name is Roger Harris of Padgett Business Services, and we have been providing accounting and tax services to small business for over 30 years. I have been involved in that for over 25 years. We have about 15,000 businesses that we represent, and the topic of this hearing has become of great importance to our clients.

I don't think we can have any discussion about this topic without reiterating what has been said before. What we are talking about here is nothing but an issue of timing. Income and expenses will always get reported under any method of accounting. And I think we also have heard this morning that there is no debate about the fact that the cash method is a much simpler method of accounting. Therefore, it seems strange to me that there is any argument that when all we are talking about is timing, why are we not looking for a way to have a broad definition of business that can use the simplest method of accounting as opposed to trying to find a way to narrow the definition.

I think the problem we face today in most taxation is complexity, and yet we are hearing arguments that we should make things more complicated for some unknown reason when taxes are not really the issue. It is just the timing of paying the tax. We became aware of the difficulties in this area when we, through our foundation, did a survey of our client base to look at the effect that the current regulations would have, which is based on the 30-year old Wilkinson-Beane case, and we found many cases where people would be forced to change their method of accounting if the current regulations were continued to be enforced. That has a short-term cost, as you may have heard here, in taxes, interest, and penalties, but it also has a greater long-term cost in the complicated accounting procedures that must go on forever.

Another thing I find interesting that we have not heard here today in any of the testimony up to this point is that changing from cash to accrual can also produce a refund. It is very possible that the change can have an effect that lowers income. I would challenge anyone here—if the IRS and Treasury are so concerned about the accurate reflection of income, produce the number of cases where they forced a change that produced a refund. I think you will find very few, if any, of those cases.

So, I am not sure that the reflection of income is the real issue. I am also amazed when I listen to the inside the Beltway explanation from Treasury that a clear reflection of income requires our clients to pay tax on money they don't have yet. I don't think they will understand that logic.

I also have to refer directly to—Mr. Manzullo, you asked a question about two sets of record, one for lending institutions, one for the business, and the answer related to the fact that this is done to report to the shareholders. I think that shows a clear lack of understanding in Treasury about how small business operates. In most small businesses, all the shareholders live in the same house. It doesn't require a separate set of statements to explain how the

business is doing. They live it, and they breathe it. And I know in our client base it is extremely rare that we produce a second set of records for a bank. Small business operates a lot of different ways, and they don't have to produce two sets of records except in very rare occasions.

I want to change the subject a minute to the installment sale, because, clearly, this was something that when the rule changed in December, created a real ripple effect through our offices and small businesses in terms of how serious an effect this change could have. As everyone, I think, recognizes on this Committee, people sell their business as part of their retirement. And it is very difficult to find someone who will pay cash for a small business. Financing over a number of years is almost a necessity.

But in the meetings when I hear Treasury state that since you are using the accrual method of accounting, the only accurate way to bill your business is to report all the income up-front in the year of sale. I don't understand why they don't understand that selling an inventory item off the shelf and waiting 30 days for a payment is nothing like selling their business and waiting 10 years to get paid. I think the only real fix to this serious problem is the repeal of the installment sale bill that was passed, and go back to something that had worked extremely well for a number of years.

I see my time is about up. I realize I deviated completely from what I had written, but I welcome any questions that you many have. Thank you.

[Mr. Harris' statement may be found in appendix.]

Mr. MANZULLO. Thank you very much.

Our next witness is Pamela Olson, who is the Chair-elect of the Section of Taxation of the American Bar Association. She is also partner in the Washington law firm of Skadden and Aarps.

Ms. Olson.

STATEMENT OF PAMELA F. OLSON, CHAIR-ELECT, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

Ms. OLSON. Good morning. Thank you. I appreciate the opportunity to be here.

My name is Pam Olson, and I am Chair-elect of the ABA Section of Taxation. I am testifying today on behalf of the Section of Taxation. I have another tax expert with me. Her name is Helen Hubbard. She is the immediate past-Chair of our Tax Accounting Committee and was a principal drafter of our testimony.

We appreciate the opportunity to appear before the Committee today to address issues causing both considerable complexity for small business and continuing controversy between small businesses and the IRS. Our prepared statement addresses both the use of the cash method of accounting by small business and the repeal of the installment method of accounting.

Since the House has passed legislation retroactively reinstating the installment method, I am going to limit my remarks this morning to small business use of the cash method of accounting, but I would be happy to respond to questions on either topic.

Over the past year, the Tax Section has testified twice on simplification of the tax law. In February, we joined with the AICPA Tax Division and TEI in releasing a list of proposed simplification

items. Permitting the use of the cash method of accounting for small business, which we would define as those with gross receipts of $5 million or less, was included in our testimony and on our February list of proposed simplification items.

The Treasury Department recently announced that it intended to issue guidance permitting businesses with gross receipts of $1 million or less to use the cash method of accounting. We applaud the Treasury Department for taking this step, but we do not believe $1 million in gross receipts provides sufficient relief from the complexity the accrual method of accounting creates. So, we would go further than they have gone.

Requiring small businesses to use the accrual method of accounting subjects them to complex rules and recordkeeping, substantially increases the cost of compliance for these taxpayers, and creates cash flow problems. The characterization of a taxpayer's income as income from the purchase, production, or sale of merchandise requires that the taxpayer use the accrual method, which increases income for the year of change by the excess of the taxpayer's accounts receivable over its accounts payable, and follow the inventory accounting rules, which defer deduction of the cost of merchandise on hand. If a change to the inventory and accrual methods is required on audit, small businesses are likely to face substantial adjustments attributable to the deferral of deductions and acceleration of income, plus, as we have heard this morning, interest and, in many cases, penalties.

Generally, the permissibility of the cash method varies depending on the type of entity, the business and activities of the taxpayer and the gross receipts of the taxpayer. Current law requires businesses that purchase, sell, or produce merchandise to apply the inventory accounting rules and use the accrual method of accounting. Although taxpayers and the Service have spent considerable resources contesting whether particular items constitute merchandise, the issue has never been consistently resolved.

For example, last week, in a case that was noted earlier this morning, the tax court in a deeply divided opinion held that concrete used by a construction contractor was not merchandise. This result may have appeared obvious to the IRS following the Tax Court's decision, we noted in our prepared statement, but it was not in fact obvious to them. It was also not obvious to the six judges of the Tax Court who dissented in two separate dissenting opinions. If the Tax Court cannot agree on whether a particular item constitutes merchandise, imagine how difficult it is for small businesses to make this determination.

This problem will only increase with the growth of the new economy. For example, is electronic information inventory or is the business providing a service? If the business is providing a service, are its materials supplies or are they merchandise?

There are other complications. Under the regulations, any taxpayer receiving any income from the production, purchase, or sale of merchandise must use the accrual method of accounting for its purchases and sales unless the Commissioner determines that another method of reporting will clearly reflect income. But the courts have compared the cost of merchandise with the taxpayer's total

gross receipts in determining whether merchandise is an income-producing factor.

The decisions suggest that de minimis inventory purchases do not necessarily make merchandise an income-producing factor. While this provides relief for some taxpayers, it also adds additional complexity and is a source of controversy between companies and the IRS trying to figure out whether or not they fit in that category. The result of all of this is some businesses cannot easily determine if they have merchandise inventory that requires them to keep inventories and consequently whether they must use the accrual method of accounting.

We have several recommendations in our prepared statement. I would just note that we do recommend that small business be allowed to use the cash method. We also recommend that small businesses not be required to keep inventories and not be subject to the rules of section 1.162–3 of the regulations that defer the deduction of supplies.

We believe the adoption of these proposals would achieve considerable simplification for small businesses and eliminate the considerable controversy that currently exists between taxpayers and the Service regarding inventory accounting and the use of the accrual method of accounting.

We appreciate your interest in this matter. We would be pleased to answer your questions and to work with the staff.

[Ms. Olson's statement may be found in appendix.]

Mr. MANZULLO. Thank you very much. Our next witness is John Satagaj?

Mr. SATAGAJ. Satagaj. I have been a witness for the last 20 years, and no one has gotten it right, Mr. Congressman.

Mr. MANZULLO. Well, try Manzullo. I was 14 before I could pronounce it myself.

Mr. SATAGAJ. That is right. My wife kept her maiden name, 25 years.

Mr. MANZULLO. Okay. All right, that is good. Anyway, John Satagaj is the managing—you have got a name like Talent that is very easy. Do you want to introduce the next witness?

[Laughter.]

Would you like to pronounce—why don't you pronounce his last name.

John Satagaj is the managing partner from London and Satagaj in Washington, on behalf of the Small Business Legislative Council.

Mr. Satagaj.

STATEMENT OF JOHN S. SATAGAJ, MANAGING PARTNER, LONDON AND SATAGAJ, WASHINGTON, D.C., ON BEHALF OF THE SMALL BUSINESS LEGISLATIVE COUNCIL

Mr. SATAGAJ. Thank you very much.

Mr. MANZULLO. Thank you.

Mr. SATAGAJ. Mr. Chairman—see that is how you get around it. I am happy to be here. As you noted, I am John Satagaj, president of the Small Business Legislative Council, and also a tax lawyer. Unlike Skadden and Aarps, our firm is London and Satagaj, and

we are the two partners. So, we are on the other end of the size spectrum of a tax law practice.

I want to address a couple of specific issues that we talked about here today rather than what is in my statement. Pam just mentioned a moment ago about one tax case that was recently decided and the precedent that was set in that case, all regarding this whole issue of the inventory.

There has actually been three cases recently on this. There was a case in November in the medical field, there was this case that involved the concrete construction company, and there was another one the day after. The concrete case was released on Thursday; there was another case reported on Friday of a sand and gravel hauler that came out in favor of the IRS. The first two decisions were in favor of the taxpayer; the third one was in favor of the IRS. The court is split, each half feels very strongly a different way. It does illustrates that you can't fix this by the regulations, the administrative process, or letting this go through the courts, because it just is an unresolvable issue. That is why we have asked Congress to set the bright line, make the decision, and say this is the way it is going to be. We are kidding ourselves if we think we are ever going to resolve this through the courts.

Interestingly enough, and it brings me to my second point, in all three of those cases, guess the size of the taxpayer. Between $1 million and $5 million. All three of them are in that area. And that brings me to the point about the $1 million. First of all, we never heard a clear explanation today of how you can do this administratively at $1 million—and you went along this line of questioning—but not do it for $5 million. And the truth of the matter is when you put the faces on these businesses such as we got right next to us, these businesses between $1 million and $5 million, a very important part of the small business constituency.

The administration talked percentages, the number of businesses that would be exempt under $1 million. There are a million, business taxpayers, between a $1 million and $5 million—a million taxpayers. That is a lot of taxpayers. But more importantly, not only are those, just by their numbers, important, those are the ones you see in the Kiwanas, the rotary, the local chamber, the ones who are creating the jobs in your communities. Those are the ones who are going to be in this no-man's land between $1 million and $5 million.

There are another 750,000 with between $500,000 and $1 million in receipts. Those are all the businesses that Ms. Kelly was talking about who will look and say, "Do I grow my business?" Seven hundred and fifty thousand taxpayers with gross receipts between $500,000 and $1 million. So, you have got a million seven hundred fifty thousand, and those are the small businesses that you see in your district.

Chairman TALENT [presiding]. Let me jump in, John, because I am going to have to leave, and I wanted to ask the witnesses—and you will have a chance to give your statement too, and you can answer this too—is my reading—in your judgment, is my reading of section 448 correct, that Congress already tried to address this? Ms. Olson, if you would like to jump in on this too. I mean what is——

Mr. SATAGAJ. Abe and I were here in 1986. Unfortunately, the bad news, we have been representing small business a long time, and I would say your reading is what we believe to have happened. But it also illustrates how we can argue this thing till the cows come home, and they are never going to concede the point and why we need your legislation. Because we will debate this forever. We believe, like you, that is what it was, but there is no sense in beating them over the head.

Chairman TALENT. Well, I am going to talk to Mr. La Falce who was here and I am sure he took an interest in this issue and would be able to give us his opinion.

Ms. Olson, do you have an opinion on what section 448 is intended to do, and don't hesitate to——

Ms. OLSON. I must admit that I actually think that section 448 was intended as a revenue raiser; in other words, that it was supposed to provide clarity as to when people had to be on the accrual method as opposed to permission. So, I am afraid I sort of fall into Treasury's view on that.

Chairman TALENT. Sure, that is all right. I recognize that there are other points of view, although I am kind of looking at it less from a legal stand as if I were there at the time. And I am reading that language and I am thinking the sensible thing would have been to establish these bright line tests, and also there is some language in there that just is not consistent really with believing that it was intended to restrict the ability of taxpayers rather than free taxpayers.

Abe, do you have a comment?

Mr. SCHNEIER. Mr. Chairman, I happened to bring my tax reform and a conference report, and as you were reading this morning, it is a section from the Conference Committee report: The House bill generally provides that the cash method of accounting may not be used by any C corporation, by any partnership that as a C corporation was a part of any tax exempt trust. Exceptions are made for foreign businesses, qualified personal service corporations, and entities with average annual gross receipts of $5 million or less for all prior taxable years. I didn't think it had to get much clearer than that.

Chairman TALENT. Yes, and this was a point I tried to make. The same language is used with regard to the farmers and the personal service corporations as is used with regard to C corporations under $5 million. So, if the service is correct, or the Department is correct, it didn't provide any extra rights to C corporations under $5 million, then it certainly did not provide any extra certain rights or certain safe harbors to the farmers or personal service corporations, which means they can go after farming operations next under that theory. But they haven't done it. They are starting to go after the personal service corporations like the dentists.

So, maybe that is their view, but, clearly, I would say—knowing how this Congress typically feels about agricultural operations, I don't think—you know, when we need to find a safe harbor for the farmers, by heaven, we provide the safe harbor for the farmers. And I read all three of those the same. And, so let us just get rid of this issue. And I understand how they get into the corporations—Mr. Harris, do you have——

Mr. HARRIS. Yes, I think you can also look at the repeal of the installment sale provision. I remember when it first passed and everybody ran around and said, "How could you do this to small business?" The common answer we were given was that if your revenues were under $5 million, you are case basis, therefore you are exempt. So, when it is convenient, I think that is a good definition to use.

And that would be why counsel over at Ways and Means would have felt this would not have a big impact on small business. If they are assuming that everybody under $5 million is cash basis that would explain, why they felt it would not have a big impact, and I don't have any gripes about the Ways and Means staff, they are not telling us something they didn't believe. And that would explain it, wouldn't it. Because they are thinking if you are under $5 million, you are reporting on the cash basis anyway, so the installment repeal doesn't apply to you.

Mr. SATAGAJ. The important thing I think about the law is what you talked about regarding the interest and the penalties. Aside from how we interpreted it all and whether they meant that or not, look at all the taxpayers that have been following that rule as the way of doing business. Literally hundreds of thousands of small businesses continued on the cash accounting since 1986, and now they get whacked. They get hit with the interest and the penalties. So, even aside from our interpretation, just look at the practical impact on those businesses since 1986 that have continued with that type of tax accounting.

Chairman TALENT. Yes, you guys can jump in if you want. Abe, I guess we will let you give your statement at some point, and I want to hear what you have to say. I think we all understand the issues pretty well, and I think we understand what we need to do with regard to both issues.

Mr. SATAGAJ. Do you want me to continue finishing up my statement.

Chairman TALENT. Oh, I am sorry. Yes, John, you can.

Mr. SATAGAJ. Okay. I will be quick.

I just want to make a couple of other points. We just talked about the audit. I want to talk about the installment sale method briefly, because there has been continuing confusion. It was mentioned again here today why don't we use this $1 million test also for use of the installment sale method. This is mixing apples and oranges. When you sell the business you are talking about the sales of assets. What we are talking about in their debate on cash accounting is gross receipts in a year. There is no way to compare these two things, and in fact to the case of installment sales of the business even the $5 million limit doesn't make sense.

I prefer repealing the installment repeal outright. But if I was going to do something I would look at IRC section 1202 where there is a definition, for venture capital purposes, of small business: the limit is $50 million, based on assets. If you are going to do limit asset sales, let us use a definition based on assets. That would make more sense than $1 million or $5 million. Repealing the darn thing would be best.

Chairman TALENT. By the way, can this raise any revenue? I don't think it is going to raise revenue, is it, because people just aren't going to sell or they are going to find some other way to sell.

Mr. SATAGAJ. You are going to structure around it. We all know the advice we start giving to folks when this happens. It is not the best way. You are losing some money or you are going to lose a little bit of a premium.

Final thing I wanted to bring up is I did sit in on a couple of meetings at the IRS about cash accounting, not the installment method repeal. This has gotten blurred here. I can tell you when the idea of $1 million was brought up, we said there is no way this makes any sense. We believe you must go with the $5 million limit. It makes the most sense for many reasons. We believe they should have done so in 1986 and perhaps drafted a little more clearly.

And that concludes my statement, Mr. Chairman.

[Mr. Satagaj's may be found in appendix.]

Chairman TALENT. Abe, we will go on to you.

STATEMENT OF ABRAHAM L. SCHNEIER, PARTNER, MCKEVITT & SCHNEIER, WASHINGTON, D.C., ON BEHALF OF THE NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. SCHNEIER. Thank you, Mr. Chairman.

Mr. Chairman, my name is Abraham Schneier. I am a partner in the firm of McKevitt & Schneier, and I am a consultant on tax issues to the National Federation of Independent Business. On behalf of the 600,000 members of the NFIB I appreciate the opportunity to present the views of small business owners on this short subject of the cash method of accounting.

I would like to address a couple of points that were made earlier. First of all, in terms of Mr. Mikrut claiming that 97 percent of all small businesses fell into the category of $1 million or less, the problem with Treasury statistics of income is they are highly aggregated. The real measure includes many part-time businesses and many businesses that have no employees. If you really look at the number of small businesses that have employees, you come up with a population closer to six million in total, and of that population I think we would find that the numbers would diverge quite a bit from that $1 million threshold.

The $5 million number was clearly what we thought we achieved in 1986. It was clearly the intention of the proposals that took place during the committee. I was as distressed as anybody to find out later on that, well, the provision did not mean exactly what we thought it meant.

In terms of how the regulations are being pursued, the IRS has, obviously, an enforcement issue involved here, and I think that the biggest point we can make is that enforcement would be assisted by a clearer line. The last thing the IRS can afford right now is to have a lot of agents who are just focusing on these very small accounting method issues. They really need to be focusing their resources in areas that are more productive in terms of policy issues and their impact on small business.

This approach does not gain the IRS, it doesn't gain the Federal Treasury anything. As we have said several times here today, we are talking about timing shift, whether the inventory is deductible

in 1999 or 2000. The typical small business owner in these circumstances clearly believe that cash flow is their biggest problem, day-to-day, week-to-week operations. He is looking to pay his rent; he is looking to pay his employees; he is looking to pay for supplies; he is looking to pay for the needed costs of running his business. Cash flow is where he goes.

The accrual method of accounting puts him in a very difficult position, especially as you get to the end of fiscal years where you have artificial numbers coming into play, creating an artificially high tax situation. We believe, as you do, that the $5 million threshold really should be where the line should be drawn and that the rules, as they apply to businesses under $5 million, should be much clearer than they are right now. The efforts in terms of trying to define when a business actually has inventory, whether or not to impose percentages of gross profit as some kind of a line of demarcation really would help specific industries, but I think we need to really sort of clarify it across the board for all small businesses.

I would be happy to answer any other questions. We have covered so much ground. And I want to compliment the members of the Committee for an excellent discourse on this issue, which can be pretty complex, and, frankly, I haven't heard as good a discussion on the Ways and Means Committee.

[Mr. Schneier's statement may be found in appendix.]

Chairman TALENT. All right, I will recognize the gentlelady from New York, and thank her for her patience.

Ms. VELAQUEZ. Sure. Thank you, Mr. Chairman.

Mr. Harris, in your testimony you indicate that the $1 million gross receipts threshold, which is being proposed by Treasury, is inadequate to prevent hardship to small businesses, and that even a $5 million threshold may not be suitable in some cases. What standard would you propose or recommend?

Mr. HARRIS. Well, certainly, there has to be a reality check of what is reasonable, but revenue is not always the best way to determine the size of the business. That, in large part, has to do with what it is that you sell—the smaller the item, the smaller the price. I think total assets could be used, it could even be a combination of things: Assets of under a certain amount, sales of under a certain amount. You meet one of two tests.

And I think the danger is that we try to find a very simple solution to a very complex issue of what is a small business, and I really don't know where $1 million came from. That just came out of nowhere. I guess if I was going to be stuck with a revenue number, I would use $5 million, because there is already some precedent. But I think we should look for a real definition of how to define a small business, and I think assets may be better in some cases, as I mentioned in my testimony, that an insurance agency could have $25,000 worth of assets and one employee and do over $1 million in revenue, and that is not a large business under any definition. So, I would like to see a definition that truly defines small business and doesn't eliminate a true small business.

Ms. VELAQUEZ. Thank you.

Mr. Schneier, with regard to installment sales, do you believe it necessary to repeal the restriction on the use of installment method

as proposed in H.R. 3594 or would you support trying to find some sensible middle ground? For example, can we say that businesses with gross sales of less than $5 million should be allowed to choose whether they can use the installment method?

Mr. SCHNEIER. Given the confusion that this provision has sort of engendered, I believe that repeal really is the way to go. The $5 million threshold only creates, I think, an additional barrier for some businesses in terms of understanding where they are going to be when they go and sell their business. The issue for most businesses is who can I sell to? And I can only sell to another small business owner who is going to pay me over a period of time.

You don't want to create a situation where the small business owner is going to be taxed on income he has yet to receive, and I think the $5 million threshold really doesn't achieve that for a large number of small businesses who would not fall into that category.

Ms. VELAQUEZ. Thank you.

Mr. Satagaj.

Mr. SATAGAJ. Satagaj.

Ms. VELAQUEZ. Thank you. Is it a problem with regard to the cash versus accrual accounting method and now an issue that primarily affects businesses which do not have large inventories of goods for sale or is it broader?

Mr. SATAGAJ. Well, it certainly affects a lot of folks in that it goes beyond the people who commonly think if they have goods, because when you get into, for example, the osteopathic case I mentioned earlier, the one in the fall, or a veterinarian who is giving a shot to an animal and the IRS considers the material in the needle as merchandise. Never in their wildest mind would they think that that material is at issue here. It would have never occurred to them. So, the answer is it is much broader than just folks who would normally think of themselves as selling merchandise.

Ms. VELAZQUEZ. If Congress were to legislate in this area, are there competitive implications where our decisions might either tip or level the playing field in a particular field of owners?

Mr. SATAGAJ. That is a good question. The answer is probably no in that this is a timing issue primarily, not competition vis a vis another business. This has to do more with your personal survival. Abe talked about cash flow, and this is the ability of a particular taxpayer to be able to pay his/her taxes when he/she has to pay them. So, I don't know if it has a competitive advantage or disadvantage. It is more related to the direct survivability of that particular firm.

Ms. VELAZQUEZ. Thank you.

Ms. Olson, as a tax expert, are there cases where you would recommend to small business clients that they use the accrual accounting method instead of the cash method? And can you give specific examples of where the use of the accrual method might be beneficial to a small business?

Ms. OLSON. Quite frankly, no, I cannot think of a situation when I would recommend that a small business use the accrual method of accounting.

I also want to note that there were questions about companies keeping books for financial purposes that would be kept on the ac-

crual basis versus the cash basis. And I just want to note that for financial accounting purposes there are very different rules that apply to how you accrue your income and expenses versus what the tax rules are. And so just because a company may be keeping some financial books and records on the accrual basis for purposes of showing a bank or whatever wouldn't necessarily mean that those books and records would be the books and records that they would need in order to properly prepare their tax returns on the accrual basis.

So, the answer to your question is no, and I also wanted to add that other highlight.

Ms. VELAZQUEZ. I want to address resolve the non-taxed costs associated with the small business using the accrual method of accounting as opposed to cash method. From your experience, is the average small business equipped to handle the necessary paperwork that goes with it?

Ms. OLSON. I think the answer is no. Most small businesses are not equipped to either do the accrual accounting or to keep the inventory accounting or to keep the supply accounting that might be required by the section 162 regulations. And that is why we recommended that small businesses be allowed to use the cash method and to not keep inventories and to not inventory supplies as well.

In addition to the costs of doing so, the controversy costs have to be taken into account, because to the extent that you end up at some point fighting with the IRS about whether or not you have to do it, you also obviously significantly increase the cost to small business.

One other point I want to note is that with regard to the question about section 448 and what Congress thought they were doing in 1986, the IRS' administrative practice doesn't always stay constant; in fact, it probably generally doesn't stay constant. So some of the things that I think are going on today that have excited the gentlemen at the table with me probably weren't happening in 1986, because I don't think the IRS at that point in time was aggressively pursuing dentists or veterinarians or contractors.

So while Congress may have done one thing in 1986, they might not have appreciated what the IRS might do with those rules subsequently, and so we may end up with different results today were Congress to look at what is happening today in IRS administration rather than what was happening in 1986.

Ms. VELAZQUEZ. Can you tell me if a small business is forced to seek assistance from a tax lawyer or a CPA to comply with the accrual basis accounting requirements, what other kinds of additional expense would that person incur?

Ms. OLSON. I wonder whether this gentleman might not be in a better position to answer that question than I am.

Mr. HARRIS. Are you talking about the direct cost of the service that they would incur versus the——

Ms. VELAZQUEZ. Yes.

Mr. HARRIS. Certainly, the size of the business would have a lot to do with it, but I think it is very unlikely that a small business owner is going to understand accrual accounting well enough to do most of what is needed. Maybe they can do some basic internal rec-

ordkeeping. But, clearly, at the end of the year and on a regular basis they are going to have to solicit an outside firm to make all the proper adjustments and end up with statements that they don't understand, because they understand the in and out of money, the money in the checkbook. And when all of a sudden you bring them a set of financial statements that have no bearing whatsoever to their money in their bank account, they wonder what they just paid for.

Ms. VELAZQUEZ. Mr. Olson, can you tell us what will be the average payment if a person has to seek a tax expert or a tax lawyer or a CPA to comply?

Ms. OLSON. Yes, to prepare the return? I am not sure—again, we probably should have had somebody here from the AICPA to try to answer that question, but I would guess that the fee is going to be something between—for a very small business, something between $5,000 and $10,000, probably closer to the high end of that. And that is probably a minimum kind of number. It might in fact be considerably more than that.

Ms. VELAZQUEZ. Thank you. Thank you very much.

If the person is doing the work, using the cash method, how much it would be instead of the accrual?

Ms. OLSON. So, it is the difference between keeping it—I mean I think that to a certain extent there is probably not a real big difference in the cash method versus the accrual method. The additional work is probably going to be attributable to the recordkeeping that that taxpayer had to do him or herself in order to make sure that they have all of the additional information.

So, what you are probably talking about is, as opposed to somebody who, as he mentioned, can pretty much look at their checkbook and say, okay, it is December 31, this is my balance, therefore, this is my taxable income for the year. Instead you have got to keep all the records on the accounts payable and the accounts receivable and perhaps inventory, perhaps supplies, and factor those in as adjustments to what you see as the balance in your checkbook. So, I think it is going to be more of a burden on the taxpayer, him or herself, to keep records as opposed to the additional cost for the accounting.

Mr. HARRIS. Yes, I would just like to second that, and say I think the real cost is during the year internally as opposed to the actual preparation of a document or tax return at the end of the year. And the only way I think you would see a substantial increase there is when people have not done a good job during the year, and now it is left to the firm to come in at the end of the year and correct all the mistakes. But I think the real cost is during the year as opposed to at the end of the year.

Mr. SATAGAJ. I might make one point on this. One of the great ironies is you can have what I call phantom inventory. You can actually begin and end the year with no inventory and have the internal responsibility in the course of the year because the IRS says even if you have zero liability you still have to do this during the course of the year. So, you can be incurring this cost, the internal cost, of maintaining inventory. Mr. Bartlett was talking about his five houses. You could clean your inventory out. You could have zero houses at the beginning of the year, zero at the end of the

year, but go through the year and still be required by the IRS to be on inventory accounting. So, you still get to go through that whole game for zero at the end of the year.

Ms. VELAZQUEZ. Thank you.

Chairman TALENT. Dave, did you want to respond to that same question? Here is a guy, grew your family business and became a CPA, and now you are going to law school to fight the IRS.

Mr. WULKOPF. I was just going to say——

Chairman TALENT. Especially with a name like David.

Mr. WULKOPF. For a cash basis taxpayer, it is just like paying your individual taxes. A person who can do their taxes regularly can probably do the cash—their business taxes on a cash basis. But when you have to convert to an accrual basis where you have to report prepayment of expenses, accrued vacations, and you have to accrue expenses and payables and receivables, it gets a little complicated, and the average taxpayer probably could not, and that is when you are going to have to hire the outside counsel which is going to cost at least $5,000 to $10,000.

Chairman TALENT. That would be during the course of the year to keep those records——

Mr. WULKOPF. You could have a firm come in on a quarterly basis or monthly basis and help you out, but if you convert it at the year end, that is a $5,000 to $10,000 expense every year that you have to incur just to report. And like we said all along, there is no difference in the amount of tax that is going to be paid. This is all a timing difference.

Chairman TALENT. I want to ask a question of Ms. Olson, but before I do that, Dave, I am sorry that I missed your testimony. I was running off to exercise my constitutional obligation to vote on that particular rule that we had. My understanding is that the IRS has come against—this is your family painting company?

Mr. WULKOPF. Correct.

Chairman TALENT. And how many employees do you have?

Mr. WULKOPF. During the summers, we can get up to around 80, 90 painters, but in the winter months it is pretty lean, probably around 15, maybe 20.

Chairman TALENT. And they want $200,000?

Mr. WULKOPF. Correct.

Chairman TALENT. Including interest?

Mr. WULKOPF. They have said that they know it is a gray area, so——

Chairman TALENT. Have they waived penalties?

Mr. WULKOPF. They waived the penalties, but they are not going to waive the interest.

Chairman TALENT. So, they can't waive the interest.

Mr. WULKOPF. Correct.

Chairman TALENT. Because of the United States Congress. I would be interested in knowing if somebody could research the amount of penalties and interest that the IRS has collected from attacking cash payers that it forced to go from the cash basis to the accrual basis. Does anybody have any idea how much—just on this table here, Shane, it is $100,000 for you; David, it is $200,000, and, Shane, I have referred to you as the drywall man, forgive me—but you have 22 employees.

Mr. MIERAS. That is correct.

Chairman TALENT. And, David, you have normally 15, blossom up to 80 with the college painter signs and everything. That is $300,000, and you guys are little. But I would be interested in finding out how much is out there, and maybe that is what the IRS is trying to do. Where they make the money is not on the cash versus the accrual basis but on screwing the taxpayer with the interest and the penalties.

Mr. WULKOPF. And it is the one-time hit. I mean they have let us report on a cash basis for years and your accounts receivable continue to grow, and then all of sudden they want the tax in one lump sum payment, which is close to $200,000, which obviously most small businesses don't have that kind of money laying around.

Chairman TALENT. Don't keep that on hand.

Pam, my question here is—could you expand on the tax section simplification recommendation to allow small businesses at or below $5 million to use cash method even if they use merchandise or inventory? This is Mr. Talent still. Do you understand my question?

Ms. OLSON. Yes. Well, for purposes of simplifying the law, which is something that the ABA Tax Section has tried hard to be an advocate for, for a number of years, and we are making a big push again now, because we really think that people have become just overwhelmed by the complexity in the law, we think that the value to small business of being able to essentially look at that business checkbook on December 31 and know what their taxable income is for purposes of figuring out how to pay their taxes is the right way to go. Now, granted, they will have to go through and segregate things for purposes of putting them on the tax return, but we really think that is the right way to go.

And we also think that inventory accounting is too complicated, that most small businesses just don't keep adequate records in order to properly do that. We think that the questions that have been raised over the last few years, in particular about whether or not things that might be called supplies in fact are merchandise and therefore require inventories, could be taken care of by eliminating the requirement that small businesses keep inventories.

And then the final piece is the regulations under section 162, which would defer deductions for supplies. We think that similarly should be addressed, because you don't want to end up with the IRS reversing course from saying, "well, it is merchandise, and therefore you have to keep inventories, and since you have to keep inventories, you have to be on the accrual method of accounting", to saying, "well, okay, but we still got you on the supplies, because really these things aren't merchandise. Now we think they are supplies, and so since they are supplies you can't deduct them under section 162".

There is obviously some possibility for people to play games in this area, but we, frankly, don't think that the possibility is significant, because there are too many costs. If you are on the cash basis, you have to shell out the cash in order to buy the inventory. You have to defer getting the payment. We don't think that people are going to incur over $1 in expense in order to save 35 cents in

taxes. We just don't think that is going to happen. So we really think you could achieve significant simplification for small business by going this way.

Chairman TALENT. I appreciate that.

Let me ask you a question about our friend, the dentists. There is really no one from the IRS here. No one has been here from the IRS that knew anything today or answered any questions except of trying to come up with these different explanations as to what Congress intended. But do you feel that if a dentist is forced to go on the accrual system that this is going to make him less willing to do pro bono cases? I mean people that come in that he ordinarily would do as charity, they are going to say, hey, your services are done. You are entitled to be paid, and whether or not you get paid for a person who is indigent that is totally irrelevant.

Mr. SATAGAJ. Interestingly, if you apply the textbook, you would end up with a liability in certain cases, I suppose an offsetting deduction later on for a charitable contribution of some kind.

Chairman TALENT. But you can't use your service, render it as a charitable contribution, obviously.

Mr. SATAGAJ. Right, and there would be no way to do it, therefore it would be ridiculous.

Chairman TALENT. When I practiced law years ago, probably 20 to 30 percent of my practice was pro bono. I mean these were just very unfortunate people who lived literally across the track. They couldn't afford an attorney, and if I had to report my income based upon the value of my services to them as finalized, that would make me less willing to do it. But I think this a real hit on professionals that want to help out the people that are faced with real problems in society.

Mr. HARRIS. I think the real danger there if people are going to be required to report their income when they provide the services, there are people who could come into the dentist office and say, "Look, I need this work, but I can't pay you today," the dentist won't accept them, because they are going to have to report the income even though they did not get any payment. They are only going to be able to accept people who either have insurance that will provide full payment or people that have the capability to provide full payment. It is going to discourage the dentists ability to work with people that need time to pay for the dentist services. I think that the real danger is that these people will find it very difficult to go out and have services provided, because they don't have the ability to pay for it up-front.

Mr. SATAGAJ. There is an interesting point here with this also in the African trade bill. There is a provision about eliminating the ability of accrual taxpayers to write off based on experience some bad debts. And when we talk about pro bono, we are essentially talking about what would be a bad debt. Right now, in the current tax law, if you are on accrual, you do have a cash-like provision that allows you to write off a certain amount of bad debts based on what your experience is. The provision in the African trade bill eliminates that for many folks.

So, now here is the kicker: If we move all these taxpayers that are currently taxpayers in the $1 million to $5 million range, from cash to accrual, not only do they go on accrual, they find out that

they have lost the ability which you had in the past to adjust for that bad debt. So, you have double whammy, as if it were, because with cash bad debts don't matter from a tax standpoint.

So, that is one of the ironies of this thing, how complex it is getting. Not only are we changing it here, but it will have that effect on that accrual provision in the African trade bill. We have the impact on the installments sales, so it is getting pretty complicated in terms of where we are driving these businesses and what they are willing to do, and I think the net result would be as you suggest, that you are going to look hard at whether you are going to provide any lenient terms for anybody that comes into your business, because you are going to say, "Wait a minute. I am an accrual taxpayer, and I can't write off the bad debt. Forget it, I am not providing service unless you can pay for it." So, I think you have got a good point.

Mr. MANZULLO. In the case of Shane with the drywall, someone would give you a call and say, "I need—" is it commercial or residential?

Mr. MIERAS. It is commercial.

Mr. MANZULLO. Commercial. They would say I want my building done. And you would keep no drywall on hand.

Mr. MIERAS. None.

Mr. MANZULLO. None whatsoever. You have no storage, because essentially you operate the business out of a home if you wanted to.

Mr. MIERAS. Yes, you could. We would call a supplier and they deliver the materials, and we place them.

Mr. MANZULLO. And does the supplier bill directly the cost of the drywall to the owner of the building?

Mr. MIERAS. No, that is billed to us.

Mr. MANZULLO. That would be billed to you. Would the situation be different if there had been a direct bill from the supplier to the owner of the building? Suppliers don't want to do that, because they want to get paid, of course, and they rely upon you. But would that have made any difference in the kind of value of that drywall as inventory? Anybody?

Mr. SATAGAJ. From the interpretation of the law, the issue is timeliness. You wouldn't have to include it in an inventory if it was truly billed directly to the consumer or the customer, because it wouldn't come into your inventory. But that means he doesn't take any title. Most of it is drop-shipped.

Mr. MANZULLO. Yes, you just show up.

Mr. SATAGAJ. And it shows up, and it is under the case law here that is considered taking title in that case. So, only if it went straight to the site and was billed directly to the owner of that building or whoever is building it, then it would not show up.

Mr. MANZULLO. But if it was billed directly to the contractor, then the contractor would have to show that as inventory, and it would be shift from the sub to the contractor.

Mr. SATAGAJ. Exactly, exactly.

Mr. MANZULLO. So, everybody gets screwed.

Mr. SATAGAJ. Right. It gets even worse. And, actually, under current circumstances that is a little bit of the problem, building down the process.

Mr. SCHNEIER. This also shows the importance of the regulatory process and how it affects the law, how the regulatory review process is so important to small business to be involved when the IRS is going to reinterpret a particular area, saying whether or not inventory is applied here or whether or not it should be applied in this particular circumstance. And the concern that we have had over the years of the fact that IRS has always exempted itself from the regulatory review process, claiming that they were simply interpreting the statute. Obviously these changes in interpretations have the effect of changing the law in many circumstances.

Mr. SATAGAJ. That is a commercial message for Congressman Talent bill stuck in the House. Let us move that one forward too.

Mr. MANZULLO. That is what we were discussing here. I am trying to think back as to when I practiced law from 1970 to 1992 when I was elected to the House of Representatives. And I represented a number of small business people. I am trying to look back at the qualitative and quantitative distinction as to what difference does it make if you have inventory on hand? I mean, it just sits there. We have problems back home—McHenry County is the fastest growing county in the State of Illinois; it is in my congressional district. And we do have lots of nurseries, and you nod your head.

Mr. SATAGAJ. One of my favorite clients, keep going.

Mr. MANZULLO. And there they are with their stock on which they have to pay taxes even though it is stuck in the ground growing for six months. Is that correct?

Mr. SATAGAJ. Well, they actually have a whole separate provision. I have been fighting that for 20 years. The IRS would like to shut that down as well. No inventory whether they are on cash or accrual. They are not required to inventory, because it is impossible to do it. So, they have a special exemption.

Mr. MANZULLO. Okay. Well, I would—if any of you has any questions that you would like me to convey in my official letterhead to the IRS witness, please contact Phil Eskeland from my staff or Ligia here, and I will be glad to work with Mr. Talent to formulate questions, not with regard to particular cases but perhaps general principles and answers that they have never given you. I would like to see how they would respond to a Member of Congress who asked that same question.

Did you have anything further?

Ms. VELAZQUEZ. No.

Mr. MANZULLO. Okay. Well, listen, we really appreciate your coming here, appreciate your sitting through the bells and our voting. Don't give up. You can tell that this really is a non-partisan movement in order to bring some resolution to this problem. I would encourage you to continue to stay in contact with your member of your House of Representatives and your two Senators to keep this issue hot and not to stagnate it.

This Committee is adjourned.

[Whereupon, at 12:50 p.m., the Committee was adjourned.]

OPENING STATEMENT
CHAIRMAN JIM TALENT
HOUSE SMALL BUSINESS COMMITTEE

"CASH VERSUS ACCRUAL: THE POLICY IMPLICATIONS OF THE GROWING INABILITY OF SMALL BUSINESSES TO USE SIMPLE ACCOUNTING"

April 5, 2000

I want to welcome our witnesses here today, and take a moment to thank Mr. English, Mr. Manzullo, and Mr. Sweeney of this Committee for their legislative efforts on the small business issues before us today.

Its not hard for our eyes to glaze over when we here the terms "cash versus accrual" or "installment method of accounting." Simply put, these terms and the rules that govern them determine when, not if, small businesses and other taxpayers have to pay taxes on their income. The cash method is a simple method of accounting allowed by the Tax Code that most closely mirrors the way small businesses operate. It allows them to pay taxes on income in the year that they actually receive the income. This is at best a brief deferral of tax, not any special exemption or waiver.

In contrast, forcing small businesses, including small contractors and service providers to switch to the accrual method of accounting, means that they have to pay now and collect later on their accounts receivable. In reality, most small entities are willing to forego deductions to use simple accounting and have used the cash method consistently for years if not decades. An example is Beckner Painting, a constituent of mine who will testify later today, who has used cash accounting consistently since 1965.

Accounting issues have become increasingly important and controversial because of the underlying policy of recent Treasury proposals, and consequent IRS enforcement activities, that are hurting small business. We will explore those policy implications, and the pending regulatory guidance that the Treasury Department plans to issue on who must use accrual accounting.

Unfortunately, the Treasury Department's recent policy statements and proposals demonstrate an increasingly aggressive position designed to deny American small business taxpayers the ability to use simple and lawful tax accounting – including the installment

method repeal successfully advocated into law by the Administration and the Treasury Department last year.

Similarly, the Treasury Department has announced it will soon issue guidance regarding the rules related to the cash and the accrual methods of accounting. Specifically, the Treasury Department intends to issue guidance regarding when "merchandise" used by a taxpayer requires the use of inventories and, thus, the accrual method of accounting. Treasury's plans, therefore, are critical in determining whether small businesses will find real relief or increasing controversy on their ability to use simple accounting in paying their taxes.

In testifying here today and in moving forward on any regulations, I urge the Treasury Department to keep in mind that tax policy is distinct from financial accounting. Many important policy considerations, including fairness and simplicity, outweigh the need (if any) for mathematically precise matching of income and expenses for tax collection purposes.

Moreover, what we may consider mere accounting changes "inside the belt way" harshly affect the "life-blood" of small contractors and service providers – their cash flow. Having to pay taxes on income small entrepreneurs have not received strangles their cash flow and their businesses. Accordingly, the use of Treasury and IRS resources to litigate and audit small builders, contractors, and service providers who regularly use cash accounting seems both cost ineffective and unreasonable.

Congress has made great strides in the last few years to provide tax relief for small business and to reform the Internal Revenue Service. Consequently, this Committee appreciates the new direction that Commissioner Rossotti is taking the IRS in its responsiveness to the small business community. Hopefully, any new policies, regulations, or legislation that the Treasury Department proposes and that Congress considers will make this important job easier.

In this regard, I want to make two primary points:

One, while I appreciate Treasury's recognition of the damage last year's installment change is causing small business, I believe its policy position on installment sales is fundamentally flawed. Consequently, I urge Treasury to support H.R. 3594 (included in the House-passed small business tax bill H.R. 3081) to fully reverse last year's repeal of the installment method of accounting for accrual basis taxpayers. This bill would

restore the ability of small businesses to sell their businesses without losing between 5 to 20 percent of their value (8.2 percent on average). In many cases, this value represents their life's work and retirement savings which are now unexpectedly slashed.

Two, I urge Treasury to support or propose legislation to allow small businesses with gross receipts of $5 million or less to use the cash method of accounting without limitation. Under current law, Congress explicitly recognizes that allowing small business C corporations to use cash accounting outweighs any inherent distortions in the timing of their income and expenses. Setting a lower than $5 million threshold for different small businesses, including sole proprietors, partnerships, and S corporations, makes no policy sense and would lead to additional and unnecessary complexity.

Forcing small businesses to pay lump-sum capital gains taxes on the sale of their businesses is wrong. Similarly, forcing small businesses – especially small contractors and service providers – to switch to the complex accrual and inventory methods of accounting means they have to pay now and collect later on income they have not received. For Treasury and the IRS to go back to prior years and collect back taxes, interest, and penalties on small businesses for using a lawful accounting method is simply unfair. We need to repeal the new installment sales tax completely. In addition, small business should be allowed to freely and consistently use the cash method of accounting.

JAMES M. TALENT, MISSOURI
CHAIRMAN

NYDIA M. VELÁZQUEZ, NEW YORK

Congress of the United States
House of Representatives
106th Congress
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-6315

Statement from The Honorable Nydia M. Velázquez
Hearing on Cash Method Versus Accrual Method
Tax Accounting for Small Businesses
April 5, 2000

Thank you Mr. Chairman. Over the past few years, America has experienced an unprecedented economic boom. And no one can deny the importance of small business in creating this growth and supporting our communities. Our nation's entrepreneurs provide jobs and represent the major tax base for our schools and roads–embodying the spirit of entrepreneurship that has made this country great.

However, too often small businesses lack the capital they need to grow, or they don't have the money at the end of the day to make being their own boss a reward. One reason for this is that our tax system often creates road blocks for our nation's small businesses.

Today's hearing is a continuation of what I believe is one of the most important roles that this Committee plays–to educate the rest of Congress about the tax challenges facing our nation's small businesses.

I would like to commend the Chairman for bringing before this Committee an issue essential to small businesses–the issue of tax simplification and specifically the cash vs. accrual methods of accounting.

With no two small businesses facing the exact set of issues, the sides on this debate are clear–many small businesses argue that the accrual method is too complicated and requires many small businesses to retain an accountant, tax expert, or hire a full-time employee who is skilled enough to use this accounting method.

I believe that there is one component of this debate that the Committee specifically has a responsibility to highlight, because it is a perfect example of the "rule of unintended consequences." That is the repeal of the installment method of accounting, a variation of cash accounting.

This issue arose last year when Congress passed the Work Incentives Improvement Act.

This legislation extended many vital tax provisions like the R&D tax credit, work opportunities tax credit, and alternative minimum tax credit– all significant provisions. As an offset to pay for this, the installment method was done away with.

The result was to force most small businesses to use the accrual method. Unfortunately, this change created more problems than it solved. Forcing small businesses to use the accrual method placed an especially disproportionate burden on those small business owners attempting to sell their businesses.

Unlike the installment method that allowed the owners to pay the taxes as the payment was received, the accrual method forces them to be liable for the full amount immediately even if they only have partial or no payments.This has created an unintended burden on the business owner and a disincentive for business sales.

I am pleased Congress recognized this and corrected it through the repeal of the prohibition on the installment method.

Clearly given this chain of events, we need to do much more educating our colleagues about the tax challenges facing small business owners. We need to continue to push for a tax system that is progressive but does not place the disproportionate burden on small business.

Once again, I would like to thank the Chairman for holding today's hearing. Creating a fair and equitable tax structure for our nation's small businesses is crucial to their long-term success. At the same time, we must work to ensure that by solving one problem, we do not create a more serious problem elsewhere. I look forward to hearing the testimony of today's witnesses, and I thank the Chairman again for his hard work on this issue.

REMARKS OF THE HONORABLE DONALD A. MANZULLO
BEFORE THE HOUSE SMALL BUSINESS COMMITTEE

"CASH VERSUS ACCRUAL: THE POLICY IMPLICATIONS OF THE GROWING INABILITY OF SMALL BUSINESSES TO USE SIMPLE TAX ACCOUNTING"

April 5, 2000 10:00AM in Room 2360 RHOB

Mr. Chairman, I commend you for holding this hearing today. As Chairman of the Tax Subcommittee, I know that this issue is perceived to be a very dry topic. But it is a matter of life and death for thousands of small businesses that sell some product associated with their services.

I first became aware of this issue in 1996 when a dentist in the northern Illinois district I represent became an Internal Revenue Service (IRS) "test case" to force him to move from the cash method of accounting to the accrual method. This dentist is a sole practitioner who had under $1million in gross receipts. This accounting change required my constituent to pay tax on income he had not even received yet! Medical professionals have no problem paying taxes on what they collect on their billings. But they object to paying taxes on outstanding invoices, particularly on unpaid bills! This is another illustration of the IRS trying to collect taxes early.

In 1998, I authored legislation to give physicians and dentists the choice to remain with the cash method of accounting. It was reintroduced as HR 1004 in this Congress. I ask unanimous consent, Mr. Chairman, to include in the hearing record the written statement of the American Dental Association on this issue.

Over the past few years, I have learned that this issue impacts more in the small business community, such as landscapers, building contractors, and plumbers. That's why I am proud to cosponsor your bill, Mr. Chairman, that would allow any small business with gross receipts of up to $5 million the choice to remain with the cash method of accounting.

I could not have said it better than Judge Parr in a recent decision by the U.S. Tax Court: the IRS "abused (its) discretion in requiring (the) contractor to change from cash method to accrual method of accounting." I am pleased that after a few conversations with IRS Commissioner Charles Rossotti, I observed that he is sympathetic to the plight of small business owners on this issue.

I understand that in previous testimony, the Treasury Department announced that small business owners with gross receipts of $1 million or less will be free to use the cash method of accounting. This is a good first step in the right direction. But I trust that after this hearing, we can move Administration policy more in the direction of Chairman Talent's bill.

Thank you Mr. Chairman for your leniency in allowing me to give this opening statement.

Statement

Issue I - Cash v. Accrual Accounting

Mr. Chairman, Ranking Member Velazquez, Colleagues and Invited Guests:

Numerous court cases around the country have demonstrated the ongoing uncertainty surrounding the cash versus accrual accounting methods. Congress should not leave the entire burden of this difficult matter to the Treasury Department or the courts to sort out.

Small businesses argue that the accrual method of accounting is too complicated and requires the dedication of too many resources for the purpose of record-keeping. The primary focus of this argument

is that businesses are, in effect, required to pay taxes with money that has not yet been received, and which may never be received.

On the other hand, the IRS has argued that accrual accounting more accurately reflects the economic realities of business.

The IRS's disregard of provisions that permit small businesses to utilize cash accounting systems often hurts businesses that are small and family-owned. We need to do a better job of balancing the competing interests of business and the government. These hearings will play a vital role in that process.

Issue 2 – Installment Sales

Mr. Chairman, Ranking Member Velazquez,

Colleagues and Invited Guests:

I have serious concerns about the Installment Sales Provision. In the House, we recognized the burden that the repeal of the Installment Method placed on small businesses. Notwithstanding the legislation the House passed, this hearing is important because we narrowly managed to avert a catastrophe for many closely-held businesses.

Large mergers get most of the attention when it comes to mergers and acquisitions. However, most mergers involve deals valued at $500,000 to $2,000,000. These businesses drive the American economy.

Before any legislation is enacted which affects small businesses, we must be mindful that many small businesses are family-owned and pass between family members. The installment sales provision reduced the value of many businesses and disrupted the sale of others when business owners learned that they would be responsible for paying tax on the entire amount of the sale in the first year. Based upon feedback from industry groups, it is clear that upwards of 200,000 closely held businesses could have been affected by this legislation, and in fact many deals were interrupted. In short, although the installment sales repeal raised revenue, it was bad

policy, and a mistake that the Congress should never repeat.

EMBARGOED UNTIL 10:00 A.M. EDT
Text as Prepared for Delivery
April 5, 2000

STATEMENT OF JOSEPH MIKRUT, TAX LEGISLATIVE COUNSEL BEFORE THE COMMITTEE ON SMALL BUSINESS

Mr. Chairman, Ranking Member Velazquez, and distinguished Members of the Committee:

I appreciate the opportunity today to discuss with you the cash receipts and disbursements and accrual methods of accounting, and the interaction of these methods with the installment method of accounting. We recognize and understand the importance of these issues to small businesses and look forward to working with Congress to address their concerns.

General principles

Items of taxable income and deduction generally are taken into account by a taxpayer in a taxable year based on the taxpayer's method of accounting pursuant to §446(a) of the Internal Revenue Code of 1986.[1] Under §446(c), permissible methods of accounting include the cash receipts and disbursements method (cash method), an accrual method, or any other method or combination of methods, such as the hybrid method, permitted under Treasury regulations. A taxpayer generally is entitled to adopt any one of these permissible methods for each separate trade or business. However, §446(b) requires that the selected method clearly reflect the taxpayer's income from such trade or business and grants the Secretary of the Treasury broad discretion to determine whether a method of accounting clearly reflects income. See *Thor Power Tool*, 439 U.S. 522 (1979), *Hansen*, 360 U.S. 446 (1959), Treas. Reg. §1.446-1(c)(2)(ii). A method of accounting that reflects the consistent application of generally accepted accounting principles ordinarily is considered to clearly reflect income. Once a method of accounting has been adopted, the taxpayer must secure the consent of the Secretary in accordance with §446(e) before changing that method.

LS-525

[1] Unless otherwise stated, all section references are to the Internal Revenue Code of 1986.

The cash method of accounting generally requires an item to be included in income when actually or constructively received and permits a deduction for an expense when paid. Treas. Reg. §1.446-1(c)(1)(i). In contrast, the principles of an accrual method of accounting generally require that an item be included in income when all events have occurred which fix the right to its receipt and its amount can be determined with reasonable accuracy. Similarly, a deduction is allowed to an accrual method taxpayer when all events have occurred which determine the fact of liability for payment, the amount of the liability can be determined with reasonable accuracy, and economic performance with respect to the liability has occurred. Treas. Reg. §1.446-1(c)(1)(ii).

The installment method of accounting provides an exception to these general recognition principles by allowing a taxpayer to defer recognition of income from the disposition of certain property until payment is received. Under the installment method, a taxpayer recognizes the gain resulting from the disposition of property proportionately as payments are received on the installment note. Payments taken into account for this purpose generally include cash, marketable securities, and evidences of indebtedness that are payable upon demand or are readily tradable.

Restrictions on use of the cash method

Long-standing Treasury regulations provide that, in order to clearly reflect income, taxpayers (other than farmers) that are required to use inventories for a particular trade or business generally must use an accrual method of accounting for their purchases and sales. Treas. Reg. §1.446-1(c)(2). A taxpayer is required to use inventories in any case in which the production, purchase, or sale of merchandise is an income-producing factor. Treas. Reg. §1.471-1. Any other permissible method (including the cash method) may be used to account for items of income and deduction other than purchases and sales in that trade or business or for other trades or businesses of the taxpayer. A farmer generally may use the cash method of accounting even though the farmer is engaged in the production and sale of merchandise.

In addition to the general requirement that a taxpayer's method of accounting must clearly reflect income, the Code places several specific restrictions on the use of the cash method for income tax purposes. Under §448, certain entities have been specifically prohibited from using the cash method since 1986. Those entities generally include a C corporation (other than a farming business and a qualified personal service corporation [2]) with average annual gross receipts over $5 million; a partnership (other than a farming business) which has a C corporation (other than a qualified personal service corporation) as a partner and average annual gross receipts over $5 million; or a tax shelter. Taxpayers that are not specifically prohibited from using the cash method under §448 are not automatically eligible to use the cash method. On the contrary, these taxpayers remain subject to the other requirements that a method of accounting

[2] A qualified personal service corporation generally is a corporation in which substantially all of the activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting and substantially all of the owners are employees and retired employees performing the services for the corporation in those fields.

must clearly reflect income and that an accrual method must be used for purchases and sales of inventories. As explained in the legislative history underlying §448 [3]:

> Present law requires the use of the accrual method in certain situations. First, if the production, purchase or sale of merchandise is an income-producing factor to the taxpayer, the taxpayer is required to use the accrual method of accounting and to keep inventories.
>
> ...
>
> The Committee bill does not change the rules of present law relating to what accounting methods clearly reflect income or the authority of the Secretary of the Treasury to require the use of an accounting method that clearly reflects income.

See also General Explanation of the Tax Reform Act of 1986, Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess. (May 4, 1987). [4] Consistent with the legislative history underlying §448, temporary Treas. Reg. §1.448-1T(c) provides that "nothing in §448 affects the ... requirement of §1.446-1(c)(2) that an accrual method be used with respect to the purchases and sales of inventory." Thus, for example, if the purchase, production or sale of merchandise is an income-producing factor in a taxpayer's business, the taxpayer generally must use an accrual method for its purchases and sales, regardless of whether the taxpayer has average annual gross receipts of less than $5 million.

Under §447, use of an accrual method also is required for a corporation engaged in the trade or business of farming (or a partnership engaged in the trade or business of farming that has a corporation as a partner) with gross receipts of more than $1 million in any taxable year beginning after December 31, 1975 ($25 million in any taxable year beginning after December 31, 1985 for certain family corporations).

Policy reasons underlying the use of accounting methods

Accrual methods of accounting, when compared to the cash method, are acknowledged to better reflect economic income and comport to generally accepted accounting principles. As explained in the Treasury Department's "Tax Reform for Fairness, Simplicity, and Economic Growth" (Treasury I), Vol. 2, p. 215-216 (1984):

> The cash method of accounting frequently fails to reflect the economic results of a taxpayer's business over a taxable year. The cash method simply reflects actual cash receipts and disbursements, which need not be related to economic income.

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[3] House of Representatives Ways and Means Committee Report, H.R. Rep. No. 426, 99th Cong., 1st Sess., Dec. 7, 1985. See also, Senate Finance Committee Report, S. Rep. No. 313, 99th Cong., 2nd Sess., May 29, 1986; House-Senate Conference Committee Report, H.R. Rep. No. 841, 99th Cong., 2nd Sess., Sept. 18, 1986.

[4] "Under prior and present law, taxpayers for whom the production, purchase or sale of merchandise is a material income-producing factor are required to keep inventories and to use an accrual method of accounting with respect to inventory items."

> Obligations to pay and rights to receive payment are disregarded under the cash method, even though they directly bear on whether the business has generated an economic profit or loss. Because of its inadequacies, the cash method of accounting is not considered to be in accord with generally accepted accounting principles and, therefore, is not permissible for financial accounting purposes.
> ...
> The cash method also produces mismatching of income and deductions where the taxpayer engages in transactions with parties that employ a different method of accounting. For example, an accrual method taxpayer may deduct certain liabilities as incurred, such as liabilities for certain services rendered, even though the service provider on the cash method may defer reporting income until cash payment is made.

These shortcomings of the cash method were specifically cited by Congress as the reasons for change in the legislative history to §448. [5]

In order to clearly reflect income, Treasury regulations since 1918 have required the use of inventories and an accrual method to properly match gross receipts from merchandise sales with the related cost of goods sold when the purchase, production or sale of merchandise is an income-producing factor. The rationale for these regulations has been recognized by Congress and the courts. For example, as explained by the court in *Knight-Ridder Newspapers*, 743 F.2d 781, 789-90 (11th Cir. 1984):

> The reasoning behind this regulatory scheme is straightforward. According to accounting wisdom, the income realized from the sale of merchandise is most clearly measured by matching the costs of that merchandise with the revenue derived from its sale. In order to achieve such a matching of revenue and cost, it is necessary to keep an inventory account reflecting the costs of merchandise, raw materials and manufacturing expenses. The costs are not deducted immediately when paid but are deferred until the year when the resulting merchandise is sold. To make the matching complete, the taxpayer must report income on the accrual method. That method helps to ensure that income from the sale (like the inventory costs) is reflected in the year of the sale.

Not only does the cash method fail to reflect economic income, the cash method is subject to manipulation that distorts taxable income. For example, cash method taxpayers may attempt to postpone the collection of income that they are otherwise entitled to receive or to prepay certain expenditures in order to yield a targeted taxable income. [6] Because of this concern,

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[5] See footnote 3, *supra*.

[6] However, to the extent such manipulation results in the failure of the cash method to clearly reflect the taxpayer's income, the Secretary may exercise his discretion under §446(b) to change the taxpayer to a method that does clearly reflect income.

Congress denied the use of the cash method to tax shelters in §448. General Explanation of the Tax Reform Act of 1986, Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess. (May 4, 1987).

Despite these defects, as noted in Treasury I and the legislative history to §448, the relative simplicity of the cash method justifies its use for tax purposes by smaller, less sophisticated businesses for which accrual accounting may be burdensome. In addition, the cash method is ingrained with certainty as to the actual realization of items of income and deduction. Finally, the cash method addresses liquidity concerns in that it provides for payment of tax at the time the taxpayer is most likely to have the ability to pay the tax.

Anticipated guidance regarding the cash method

Although long-standing Treasury regulations provide that inventories and, generally, an accrual method of accounting are required in order to clearly reflect income when merchandise is an income-producing factor in the taxpayer's business, uncertainty exists as to when a taxpayer, in particular a service provider, is selling merchandise and when the sale of merchandise is an income-producing factor. In addition, small, unsophisticated taxpayers that do not use an accrual method for any other purpose have complained that the requirement to account for inventories and to use an accrual method is burdensome. We intend to publish administrative guidance that would address these concerns.

For example, in recognition that inventory and accrual accounting may be burdensome to some taxpayers, we plan to issue guidance providing an administrative exception for small taxpayers. This small taxpayer exception would allow qualified taxpayers with average annual gross receipts of less than $1 million (with appropriate aggregation rules) to not keep inventories and to use the cash method. This exception will provide simplicity to small, unsophisticated taxpayers by exempting them from the complex inventory accounting rules and by not requiring them to compute their books and records on an accrual method. We believe this $1 million threshold should cover a majority of small businesses. In 1997 (the most recent year for which data is available), approximately 78 percent of all C corporations, 85 percent of all S corporations, 95 percent of all partnerships and 94 percent of all sole proprietorships had gross receipts of under $1 million (not considering aggregation rules). We are also considering additional exceptions and safe harbors that will allow the use of the cash method.

Use of the installment method of accounting

As part of the Ticket to Work and Work Incentives Improvement Act of 1999 (1999 Act), Congress repealed the use of the installment method of accounting for accrual method taxpayers effective for sales on or after December 17, 1999 (the installment sales provision). The installment sales provision was made applicable to all accrual method taxpayers, not just to small businesses. The provision applies to both casual sales of property and sales of businesses that would otherwise be reported on an accrual method.

After the 1999 Act was passed by Congress, small business groups began to express concerns that the repeal of the installment method for accrual method taxpayers negatively impacted the sales of small businesses. In particular, small business groups have asserted that the use of the installment method to report the gain on the sale of the business enabled a seller to get a higher price for its business and a buyer to purchase a business for which bank financing was not readily available.

Treasury's Office of Tax Policy has met several times with interested industry groups, including the National Federation of Independent Businesses, National Association of Manufacturers, American Institute of Certified Public Accountants, Small Business Legislative Council, and U.S. Chamber of Commerce, and listened to their concerns about the effect of this recent legislation on sales of small businesses. These groups also requested clarification of the effect of the installment sales provision on particular transactions. For example, they requested that we address the sales by cash method individuals of interests in accrual method businesses and the sales by such businesses of their assets.

We intend to issue guidance in the near future that will address the availability of the installment method for many common disposition transactions. In addition, we believe that the broader accounting method guidance described above (relating to the availability of the cash method) will alleviate the effect of the legislation on small businesses, regardless of the entity's form. However, providing the complete relief requested by small businesses will require legislation.

Overall, we believe the policy underlying the installment sales provision enacted in 1999 is appropriate. The installment method is inconsistent with an accrual method of accounting, which generally requires a taxpayer to pay tax on a realized gain, regardless of whether the taxpayer has received the related cash. However, the extent of the impact of the provision on the sales of small businesses apparently was unforseen by policymakers and potentially affected taxpayers and their advisors during the legislative process. We now understand that the legislation has imposed financial burdens on small businesses that override the basic tax policy concern. As such, we are eager to work with Congress to provide a legislative solution to alleviate this unforseen impact of the provision.

Any legislative response should be targeted to address the legitimate concerns of affected taxpayers. To address the liquidity problems facing sellers of small businesses (e.g., businesses with less than $5 million in gross receipts), use of the installment method could be allowed (perhaps with an interest charge), regardless of the seller's method of accounting. If there is concern that different types of flow-through entities are treated differently (because sales of partnerships may be structured to allow the buyer to obtain a stepped-up basis and the seller to use the installment method while sales of S corporations allow either the buyer to obtain a stepped-up basis or the seller to use the installment method), special rules could be provided to level the playing field. In addition, legislation also could clarify the treatment of sole proprietorships and address other issues related to the use of deferred payments. Finally, any legislative solution should promote simplification and administrability.

Conclusion

This concludes my prepared remarks. We look forward to working with the Congress in developing any legislative proposals deemed appropriate, and we will keep you informed of our proposed administrative actions. I would be pleased to respond to your questions.

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Statement of Associated Builders and Contractors

Shane Mieras
Mid-Michigan Ceilings and Drywall, Rockford, MI

On
Use of the Cash Method of Accounting by Small Businesses

Before the
House Small Business Committee

April 5, 2000

Speaking for the Merit Shop

1300 North Seventeenth Street
Rosslyn, Virginia 22209
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Good morning, Mr. Chairman and members of the Committee. My name is Shane Mieras and I am co-owner of Mid-Michigan Ceilings and Drywall, located in Rockford, Michigan. Associated Builders and Contractors (ABC) is a national trade association representing more than 23,000 contractors, subcontractors, material suppliers and related firms from across the country including all specialties in the construction industry. ABC has 82 chapters across the country. Mid-Michigan Ceilings and Drywall has been a member of ABC for approximately three years. We would like to thank Chairman Talent and House Small Business Committee members for hosting this hearing today.

Mid-Michigan Ceilings and Drywall is a small commercial drywall company that was established in 1990. I currently employ 22 people. I came to Washington today to testify on my real-life experience of currently being audited by the Internal Revenue Service (IRS) based on my company's use of the cash method of accounting. As many of you know, the cash basis method allows deductions for expenses to be taken in the year paid and reporting of income in the year the cash is received. Approximately two years ago the IRS called on Mid-Michigan Ceilings and Drywall and initiated an audit for tax years 1996 and 1997. Our sales at the time of audit were only $1.7 million. We have always kept our books on the cash basis because it is a simple and easy method of accounting. There is really no need to hire outside professional accountants when using the cash method. My business never had any intention of converting to the more complex and time-consuming accrual method because we are such a small company.

In October 1998, the IRS informed us that we owed approximately $80,000 in interest and underpayments as a result of using the cash method of accounting. Our case is in the final stages of appeal, and I have been advised that the final assessment could be as high as $100,000.

At Mid-Michigan Ceilings and Drywall, we keep a clean set of books--no other tax problems were identified during the audit, other than the fact that we were using the cash method of accounting. The IRS' reason for this assessment on Mid-Michigan Ceilings and Drywall is because they feel we are "merchandisers." We disagree. We are not "merchandisers"--we install commercial drywall, and have never sold drywall to the public without installing the drywall. The IRS concedes that we do not have inventory on hand. However, that is not good enough to refute the IRS' use of the "merchandise" argument.

What is troubling is that the IRS can force small businesses to change from a legal, simple accounting method (cash) to the accrual method. Mid-Michigan Ceilings and Drywall is a small business and pays taxes on cash we collect minus expenses paid. By forcing us to the accrual accounting method we will now incur an added expense of having to hire professionals to maintain our books. Speaking of professional help, we have also hired a tax attorney to fight this unfair assessment by the IRS. This has resulted in approximately $5,000 in legal fees to date, in addition to the assessment made by the IRS.

Of course the obvious problem for my company now is determining how we are going to pay the IRS. Since this money is not available to us through the business, we will have to seek a bank loan to pay the assessed taxes, penalties and interest. The bank interest payments alone will cost us between $10,000 to $15,000 per year. A $100,000 tax burden is a huge sum of money to a small business such as ours. This huge arbitrary assessment by the IRS will definitely hurt my company's growth potential and limit my ability to hire new employees.

A couple of goals we have set up for 2000 are now in jeopardy. We need to purchase new work trucks, and new equipment such as scaffolding and tools. Most importantly, we would like to build our own building so we can expand the business, and hopefully hire more

employees. This tax burden imposed by the IRS will take away money that we could use for growing the business. Our bank is also withholding a line of credit to the tune of $50,000 until the final outcome of the case is determined. We all know that business investment is what is driving this economy right now--we will be forced to sit on the sidelines due to lack of capital because of this unfair tax assessment. Lastly, this tax payment will make it harder for us to improve our wages and benefits to our employees, and is also forcing us to rethink charitable giving until our financial solvency is determined.

I understand that any corporate business that does over $5 million has to use accrual accounting. Someday at Mid-Michigan Ceilings and Drywall we hope to reach the $5 million threshold and will plan on converting to the accrual method at that time. Right now it is unfair to treat Mid-Michigan Ceilings and Drywall any differently from other small businesses by converting us to big business accounting.

Legislative Solutions

The IRS' position on which businesses should be using the cash method or accrual accounting is not based on any specific section of the Internal Revenue Code, but on a series of court cases successfully litigated by the Service. Hence, the IRS is not enforcing the law--they are making it. Congress should amend the Internal Revenue Code to clarify that small businesses can keep using the cash method of accounting, even if the IRS argues that they have inventory or merchandise as a material income-producing factor.

- Two legislative proposals before Congress would permit small contractors like Mid-Michigan Ceilings and Drywall to continue to use the cash method of accounting without fear of audit, penalties, and interest.

- H.R. 2273, introduced by House Small Business Committee Chairman Talent (R-MO) and Ways and Means Committee Member Phil English (R-PA), and S. 2246, introduced by Senate Small Business Committee Chairman Christopher Bond (R-MO) and Senate Finance Committee Member Charles Grassley (R-IA), have both been endorsed by the ABC National Tax Committee and would provide relief to small businesses like Mid-Michigan Ceilings and Drywall.

The ABC National Tax Committee is supportive of (and has endorsed) both cash accounting bills, though it continues to encourage Congress to raise the threshold of businesses covered to those with annual gross receipts of $10 million or less, or link the threshold to the Consumer Price Index.

Mid-Michigan Ceilings and Drywall joins ABC in urging members of the Committee to advance these proposals in the next tax bill considered by Congress. Small businesses are the backbone of the economy and our country's economic engine--we urge you to enact this legislation into law to ensure that small contractors can operate their business without living in fear of the IRS.

I would like to thank Chairman Talent and the Committee members for allowing me to present Mid-Michigan Ceilings and Drywall's concerns regarding this important issue. I stand ready to answer any questions the Committee may have.

David Wulkopf
Beckner Painting Midwest, Inc.
Testimony in Support of H.R. 2273
Wednesday, April 4, 2000

PERSONAL BACKGROUND

I am the Treasurer of Beckner Painting Midwest. I am in charge of overseeing the financial side of the business on a part-time basis. My responsibilities include preparation of monthly financial statements, monthly bank reconciliations, and handling any tax-related matters. I also work for a regional CPA firm on a part-time basis where I specialize in tax. In addition to my work with these two companies, I attend St. Louis University Law School in the evenings.

I began working for Beckner Painting when I was a junior in high school. I painted every summer until I graduated from college. After earning a B.S. in Accounting from the University of Missouri - Columbia, I began handling Beckner Painting's financial matters. I set up a computerized accounting system and trained my Aunt and the Company secretary on how to enter invoices and pay the bills, etc. I then went into public accounting at Boyd, Franz & Stephans, a local CPA firm. After almost two years there, I moved to Kerber, Eck & Braeckel LLP where I continue to work as a tax accountant today.

COMPANY BACKGROUND

Beckner Painting Midwest was founded in the 1960's. My father and some of his college friends began painting houses in their neighborhood to earn extra money for school. They continued this work every summer throughout college. Upon graduation, my father went on to earn his MBA and eventually took a job with the Frisco Railroad Company. Dave Beckner continued with the painting business he and his friends began in college.

During the mid-80's, Frisco Railroad merged with Burlington Northern and my father was asked to relocate to St. Paul, Minnesota. Rather than uproot the family, my father returned to work at Beckner Painting as Vice-President. At the time, Beckner Painting was doing work in Florida as well as the Midwest. In 1986, my father mortgaged everything he and my grandparents had and purchased Beckner Painting Midwest from Dave Beckner, who then moved to Florida and established Beckner Painting Southeast.

Today, Beckner Painting Midwest remains a small painting company in St. Louis, Missouri. The primary focus of our work is interior and exterior apartment painting. We also do some limited residential and commercial work. Beckner Painting employs up to eighty people in the summers and as few as fifteen during the winter months as the workload slows down.

THE PROPOSED CHANGE IN ACCOUNTING METHOD

Since Beckner Painting was founded over 30 years ago, we have paid our taxes on the cash basis of accounting as permitted by §446 of the Internal Revenue Code. The company has annual revenues of $2 - $3 million and does not maintain inventories. Therefore, the company qualifies as a small business as defined by § 448 and is permitted to use the cash method of accounting.

In 1995, Beckner Painting was subject to a random audit of their 1992 federal income tax return. The IRS did not find any changes that needed to be made as a result of this audit. In September of 1998, the IRS notified us that they were going to audit our 1996 federal income tax return. Once again, they found no changes with the exception of the cash basis issue before us today.

The reasoning behind the proposed change is a stretch. Because our material costs are more than 15% of our revenues, the IRS claims that we have "merchandise" which is an inventoriable item. And since we have an "inventoriable" item, we are required to use the accrual method of accounting even though we do not carry any physical inventory.

The reason for the change can be masked in a number of different ways, but the bottom line is obvious. The motive behind the Treasury Department policy is to speed up the collection of tax revenues. They want the tax on the Accounts Receivable one-year sooner. If we had Accounts Payable that were higher than our Accounts Receivable, we would not be in the position of having to defend ourselves from this proposed change. It is understandable that the Treasury Department would want to expedite the collection of tax revenues, but it seems that no thought is given to how unfair this policy is to small businesses.

Under this new policy, accelerating the collection of tax revenues is done at the expense of small businesses who have been allowed to report on a cash basis for years. These companies are arbitrarily being selected for audit and forced to change accounting methods. This change in accounting methods causes an enormous tax liability that is the result of years of cash basis reporting to become due. Most small businesses do not have large sums of money available to pay taxes on money they have not yet received.

EFFECTS OF THE CHANGE

The effects of this proposed change would be devastating to Beckner Painting. We operate in a very competitive industry and cash flow is always a concern. There are numerous independent contractors in the painting industry that operate with little overhead and can undercut the prices of established companies like Beckner Painting. As an established company, not only do we offer a higher quality of work than many of our independent competitors, but we are also more reliable. However, if our prices get too high, many customers will switch to an independent contractor in order to save money.

Beckner Painting offers our customers advantages over these independent contractors, but at the same time, we must keep our prices down in order to remain competitive. Consequently, our costs must be closely monitored and cash flow is usually tight. There is rarely a pay period that goes by that we are not concerned about having the cash needed to make the payroll. With the minimum wage increasing seemingly every day, this cash flow gets even tighter. In addition, the Company has to continually repair and replace painting equipment like powerwashers, sprayers, ladders, trailers and vehicles. These costs further limit cash flow.

Should the IRS succeed in making us change our method of accounting, the amount of tax due is well beyond the cash we have on hand. Therefore we would be required to borrow money to pay

the tax. Not only is forcing a company to borrow money to pay tax fundamentally unfair, but it would put us in a very vulnerable position. The amount of money we would need to borrow would max out our borrowing resources and put us one bad year away from bankruptcy.

The primary unfairness of this new policy is that we have paid our taxes on a cash basis since the company was founded. We were not even asked to change during the 1992 audit. Then, in 1996, when our receivables had grown we were told that we needed to change accounting methods. The difference between paying our taxes on a cash basis vs. an accrual basis is minimal year by year. It is the one-time hit of the change that is damaging.

Our case has not yet been resolved. It has been going on for more than a year and a half now. The time and money spent on trying to defend this case has put a serious strain on our resources. We have spent countless hours examining invoices, preparing schedules, and researching the position of the IRS. We are afraid to invest in new equipment because we may need the money to try to pay the tax resulting from the proposed change.

Beckner Painting Midwest has grown from a summer hobby to a successful small business. As a small business, it is hard enough to comply with the seemingly endless stream of federal, state, local and industry regulations. A policy like this makes it even more difficult. Small businesses' face many unique challenges and defending themselves from policies such as this is not only unfair, but it could jeopardize their continued existence. That is why we support Congressman Talent's bill H.R. 2273.

WRITTEN STATEMENT

OF

ROGER HARRIS, PRESIDENT

PADGETT BUSINESS SERVICES

BEFORE THE

COMMITTEE ON SMALL BUSINESS

U.S. HOUSE OF REPRESENTATIVES

ON

"THE ABILITY OF SMALL BUSINESS TO USE THE CASH AND DISBURSEMENTS METHOD OF ACCOUNTING"

WASHINGTON, D.C. APRIL 5, 2000

Padgett Business Services
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Athens, GA 30606
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Testimony of
Roger Harris
Before The
House Committee on Small Business
April 5, 2000

Chairman Talent and distinguished Members of the Committee, I am pleased to offer my testimony today on the ability of small business to use the cash method of accounting. This is an issue that has been a problem for many small business owners and practitioners for a number of years. It would be wholly beneficial to quickly determine a clear understanding of when the cash method of accounting may be used in small businesses. .

My name is Roger Harris, and I am President of Padgett Business Services. Padgett Business Services has been providing accounting and tax services to small businesses for over thirty years. We currently have over 275 offices providing service to more than 15,000 small businesses across the United States; in fact we have an office in every State represented on this Committee. We provide complete accounting services to all our clients. Part of those services includes monthly visits to each of our clients' place of business. These visits allow us to discuss issues with every owner that can potentially affect their business. It is quite common to have discussions with these business owners about their method of accounting. I also am currently a member of the Internal Revenue Service Advisory Council and am immediate past chairman of the National Society of Accountants Federal Taxation Committee. However, today I am speaking only in my individual capacity and on behalf of Padgett Business Services. Neither Padgett nor I has received a federal grant during the preceding two years.

I cannot begin any discussion about accounting methods without making a few key points. First, using either the cash method or accrual method of accounting does not alter the amount of income reported by a taxpayer. The only difference between the two accounting methods is when income and expenses are reported, not how much is reported. Secondly, we all are aware that all taxpayers, not just business owners, complain about the complexity they face in paying their taxes. Therefore, it would appear that when there is no change in how much income is to be reported, no matter which accounting method is used, we should search for ways to allow as many people as possible to utilize the simplest way to report their income.

As a basis for my comments, I would like to share with the Committee the results of a recent survey our Foundation conducted of Padgett clients relating to the cash vs. accrual accounting method issue. The survey was predicated on apparent increased enforcement activity by the Internal Revenue Services (IRS) requiring that small business entities change their accounting method from cash to accrual. In so doing, a decision issued in the Wilkenson-Beane case on January 12, 1970 is being used. We wanted to determine the potential effect such enforcement activity could have on small businesses. I think the

results are meaningful to this hearing. We received responses from 96 of our offices, and found that almost 1,100 clients – all small businesses – could be subject to a change of accounting method if the IRS continues using the Wilkenson-Beane decision. Such decision provides that merchandise is an income-producing factor where the cost of merchandise purchased by a business was 15 % or greater than the entity's gross receipts for that year. If a small business were to meet that test, it could not use the cash method of accounting and must change its accounting method. Our study also found that a change of accounting method would mean small businesses would face significant costs both in the short and long term. For example, some responders to our survey reported they had been audited by the IRS and were required to change their accounting method as a result of the audit. In each of these situations, additional tax was assessed along with interest and penalties. The additional tax assessed was tax that would have been paid under the cash method as well. Consequently, the only real additional revenues were the interest and penalty charges collected.Greater business expenses would be incurred for the costs of using the accrual accounting method. We concluded that if the IRS continues to use this 30-year-old test to determine a business' method of accounting, it could be a substantial problem to small businesses throughout the nation. Internal Revenue Commissioner Rossotti is working diligently to change the image of the IRS. Rules and policies that work against this effort will not make his job any easier.

The Treasury Department has recently indicated that it intends to issue guidance allowing the use of the cash method of accounting by businesses with gross receipts $1 million or less. While this is an improvement on the 15% test, I do not feel it goes far enough. I am not clear as to how they arrived at the $1 million threshold. Currently, certain businesses with gross receipts of over $5 million are not permitted to use the cash method. If gross receipts are going to be the determining factor, then why use $1 million instead of $5 million? The simplest answer may be one that denies small business owners the relief they need; thus, we should actively search for other solutions. I also question if revenues are the only or best way to define a small business. There are several other ways in which a small business could be defined for purposes of use of the cash method of accounting. They include total amount of assets the business owns, the number of full time employees, and sales totals. Why should a business with one full time employee, with assets of less than $50,000, be required to use the accrual method simply because it has receipts of more than $1 million? I do not believe any of us would describe the business in my example as a large business.

One concern that has been raised about allowing more businesses to use the cash method of accounting relates to the reporting of inventory. This concern could be valid because some retailers may carry large inventories they would not be required to report if allowed to use the cash method. However, we should not bundle the requirement to report inventory with the inability to use the cash method of accounting. The reporting of a year-end inventory should not preclude a business from using the cash method of accounting. There ought to be a determination of when the reporting of a year end inventory is material for the accurate calculation of income. That determination should be required for any business, regardless of the accounting method. Most businesses must report a year-end inventory to other agencies for such things as their local personal

property taxes. Requiring them to report an inventory on their tax return would not add further complications. If a requirement to report an inventory did not eliminate the ability to use cash method accounting, I hope the Treasury definition of a business that may use the cash method of accounting will be expanded. The benefits gained by not having to account for outstanding accounts receivable or payable would not be material to most small businesses. For many of our clients, the two numbers are not significantly different and therefore would not have a weighty effect on their net income. Many small business owners are unable to pay their bills until their customers have paid their accounts. I would also remind you that, ultimately, the recognition of income and expenses caused by these events are just a timing issue.

Another issue of great concern to this Committee and small business owners across the country is the recent repeal of the installment sale option for accrual basis taxpayers. This repeal has created more calls to our offices than any tax law change in recent years. While I advocate the repeal of this law, we must do everything possible to minimize its effect until a repeal does occur. An expanded definition of a cash-basis taxpayer would help until full repeal occurs. This is another reason why I feel the $1 million threshold for use of the cash method is much too low. Again, I applaud the Treasury for recognizing the problem this repeal has caused; however, its solution does not go far enough. In the final analysis, even raising the gross receipts limit on using the cash method of accounting to $5 million may not be adequate. I urge everyone on the Committee to support the full repeal of this provision until a reasonable determination of who can use the installment sale provision is determined.

As mentioned earlier, we should always seek simpler ways for taxpayers to report their income and pay their taxes. This is yet another potent argument for a more favorable definition of a business allowed to use cash method accounting. All business owners understand the tenet that money received is income, and money spent is an expense. However, many small business owners do not understand accrual accounting. They also find difficulty in understanding how it is justifiable to be forced to pay tax on money not yet received. They would happily give up the benefit of deducting expenses on bills they have yet to pay if they are not required to report income they have yet to receive. The amount of complexity and record keeping required of a small business to comply with the accrual method can be extremely time consuming and costly to most small business owners. These owners do not understand such things as prepaid expenses, when income must be recognized, and when expenses may be deducted. It is for that reason the most common question asked to us by our accrual basis taxpayers is: "If I made that much money, why doesn't my bank balance show it?" I believe it would be most beneficial if this Committee would continue to push for a more liberal definition of a business permitted to use the cash method of accounting.

In summary, to many it would seem that the method of accounting used by a business is a minor issue to the business owner. However, as we see it, it can be one of the most important decisions businesses can make. This decision today affects when they report income, when they report expenses, when they pay their taxes, if they carry an inventory, and how they may or may not sell their business. Despite the importance of this decision,

many business people are uninformed about the effect their decision may ultimately have. And worse, as our study showed, the majority have made a decision that today could cause them problems with the IRS. We also are aware that, if given the choice, most small business owners would prefer to use the cash method of accounting because it is easier, more equitable, and still sends the Treasury the taxes due. I commend this Committee for working to provide more small business owners access to this simpler way of paying their taxes. We all share in the belief that there is a great amount of work to be completed in order to simplify our tax code. In reality, we are a long way from curing all the inherent problems in the current tax code, but this is a significant step in the right direction.

Again Mr. Chairman, on behalf of Padgett Business Services and small business, I thank you for the opportunity to speak to your Committee. I look forward to answering any questions you may have.

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STATEMENT

of

PAMELA F. OLSON

on behalf of the

AMERICAN BAR ASSOCIATION SECTION OF TAXATION

before the

HOUSE COMMITTEE ON SMALL BUSINESS

of the

U.S. HOUSE OF REPRESENTATIVES

on the subject of the

SMALL BUSINESS USE OF THE CASH METHOD OF ACCOUNTING
and REPEAL OF INSTALLMENT METHOD OF ACCOUNTING

April 5, 2000

STATEMENT of PAMELA F. OLSON
on behalf of the
AMERICAN BAR ASSOCIATION SECTION OF TAXATION
before the
HOUSE COMMITTEE ON SMALL BUSINESS
of the
U.S. HOUSE OF REPRESENTATIVES
on the subject of
SMALL BUSINESS USE OF THE CASH METHOD OF ACCOUNTING
and REPEAL OF INSTALLMENT METHOD OF ACCOUNTING

April 5, 2000

My name is Pamela F. Olson. I appear before you today in my capacity as Chair-Elect of the American Bar Association Section of Taxation. This testimony is presented on behalf of the Section of Taxation. It has not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, accordingly, should not be construed as representing the policy of the Association.

The Section of Taxation is pleased to appear before the Committee today to address an issue that causes both considerable complexity for small businesses and continuing controversy between small businesses and the Internal Revenue Service. Approximately a year ago, the Section of Taxation testified before the House Ways and Means Oversight Subcommittee and the Senate Finance Committee on simplification of the Internal Revenue Code. Our testimony included a number of recommendations important to the small business community, including a recommendation that small businesses be permitted to use the cash method of accounting. On February 25, 2000, the Section of Taxation, the AICPA Tax Division, and Tax Executives Institute released identical simplification proposals that again recommended small businesses be permitted to use the cash method of accounting. We are pleased the Committee has chosen to address this issue. As Paul Sax, the Chair of the Section of Taxation, stated when we released our simplification proposals on February 25:

"The ABA Section of Taxation strongly believes that major simplification of the tax laws should be viewed as an urgent and continuing priority on the part of the Congress....

"Concern about the critical need for simplification is not limited to tax professionals. In his most recent report to the Congress, the National Taxpayer Advocate confirms that complexity of the tax law 'continues to be the most serious and burdensome problem facing America's taxpayers.' His concerns were echoed by others at the Senate Finance Committee's IRS Oversight Hearing on February 2, 2000. The heavy burden of complexity affects the entire spectrum of taxpayers, from low-income individuals to multi-billion dollar corporations. It also impedes greatly the continuing efforts of the Internal Revenue Service to better administer and enforce the nation's tax laws."

As you are aware, following a proposal set forth in President Clinton's Fiscal Year 2000 Budget Proposal, Congress repealed the installment method of tax accounting for accrual method taxpayers in the Tax Relief Act of 1999 (Title V, Subtitle C, Section 536), enacted as part of the "Ticket to Work and Work Incentives Improvement Act of 1999" (H.R. 1180). The repeal of installment sales treatment for accrual method taxpayers adversely affects businesses attempting to sell business assets because they are taxed immediately even when payments are received years later. Immediate taxation of business sellers, and its chilling effect on the marketplace, simply does not represent sound tax policy. For these and other reasons that we have previously outlined[1] and reiterate briefly below, we respectfully request that Congress reenact prior law which, for over eighty years, has permitted accrual method taxpayers to sell business assets for installment payments and report the gain in the year cash is actually received.

In response to concerns expressed about the repeal of the installment method, the Treasury Department announced that it intended to issue guidance permitting businesses with gross receipts of $1 million or less to use the cash method of accounting.[2] Although we applaud the Treasury Department for taking this step, we do not believe it resolves the concerns caused by the repeal of installment sales reporting and we do not believe $1 million in gross receipts provides sufficient relief from the complexity the accrual method of accounting creates. Current law requires businesses that purchase, sell, or produce merchandise to apply the inventory accounting rules and use the accrual method of accounting. Although taxpayers and the Service have spent considerable resources contesting whether particular items constitute merchandise, the issue has never been consistently resolved. The result is some businesses cannot easily determine if they have merchandise inventory that requires them to use the accrual method of accounting. Additional issues continue to arise as taxpayers provide new products and services. Considerable simplification could be achieved by allowing small businesses with gross receipts of $5 million or less to elect to use the cash method of accounting even if the purchase, production, or sale of merchandise is an income-producing factor. Further

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[1] Letter from Paul J. Sax, Chair, ABA Section of Taxation to Senator William V. Roth, Jr., Chairman, Senate Committee on Finance (February 24, 2000) (on repeal of installment method of accounting).

Letter from Paul J. Sax, Chair, ABA Section of Taxation to Congressman Bill Archer, Chairman, House Committee on Ways and Means (February 24, 2000) (on repeal of installment method of accounting).

Repeal of the Installment Method of Accounting for Accrual Basis Taxpayers: Hearings Before the Subcomm. on Oversight of the House Comm. on Ways and Means, 106th Cong, 2d Sess. (February 29, 2000) (statement of Pamela F. Olson, Chair-Elect, ABA Section of Taxation).

[2] *Repeal of the Installment Method of Accounting for Accrual Basis Taxpayers: Hearings Before the Subcomm. on Oversight of the House Comm. on Ways and Means,* 106th Cong, 2d Sess. (February 29, (statement of Joseph M. Mikrut, Tax Legislative Counsel, U.S. Department of Treasury). The Service included this guidance project on its 2000 business plan which was released on March 21, 2000.

simplification could be achieved by allowing these small businesses to elect not to maintain inventories.

Small Business Use of Cash Method of Accounting

Background

A brief review of the history of the cash method of accounting provides an important framework for the current discussion. Generally, the availability of the cash method varies depending on the type of entity, the business and activities of the taxpayer, and the gross receipts of the taxpayer.[3]

If the production, purchase, or sale of merchandise is not an income-producing factor:

- an individual, an S corporation, or a partnership that does not have a C corporation as a partner may use the cash method; and
- a C corporation or a partnership that has a C corporation as a partner may use the cash method if it (i) is engaged in a farming business, (ii) is a personal service corporation, or (iii) has average annual gross receipts over the prior three-year period of $5 million or less.[4]

The regulations provide that "inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor."[5] The regulations also state that "[i]n any case in which it is necessary to use an inventory the accrual method of accounting must be used with regard to purchases and sales" unless the Commissioner determines that the use of another method will clearly reflect income.[6] Thus, under the regulations, *any* taxpayer receiving *any* income from the production, purchase, or sale of merchandise must use the accrual method of accounting for its purchases and sales unless the Commissioner determines the use of another method will clearly reflect income.

[3] A tax shelter may not use the cash method of accounting. I.R.C. § 448(a)(3). No change should be made in this rule. The discussion that follows relates only to non-tax shelters.

[4] I.R.C. § 448.

[5] Treas. Reg. § 1.471-1.

[6] Treas. Reg. § 1.446-1(c)(2).

In determining whether merchandise is an income-producing factor, courts have compared the cost of merchandise with the taxpayer's total gross receipts.[7] The decisions do not establish a "safe harbor," but nevertheless suggest that de minimis inventory purchases do not necessarily make merchandise an income-producing factor.[8]

The characterization of a taxpayer's income as income from the purchase, production or sale of merchandise requires that the taxpayer (i) use the accrual method, which increases income for the year of change by the excess of the taxpayer's accounts receivable over its accounts payable, and (ii) follow the inventory accounting rules, which defer deduction of the cost of merchandise on hand. In the litigated cases, the accrual method adjustment generally is far more significant than the inventory adjustment.

The Code specifically permits a taxpayer to use a combination of accounting methods.[9] The Service, however, generally seeks to require the use of the accrual method for all of a taxpayer's income and expenses if the taxpayer provides to the same customers both services and something that is, in the view of the Service, merchandise.[10]

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[7] *See, e.g., Thompson Electric v. Commissioner*, T.C. Memo 1995-292 ("[i]f the cost of material a taxpayer uses to provide a service is substantial compared to its receipts, the material is a substantial income-producing factor even if the taxpayer does not mark up the prices charged to its customers for the material"); *Wilkinson-Beane, Inc. v. Commissioner*, 420 F.2d 352 (1st Cir. 1970) (caskets were income-producing factor for funeral service provider; cost of caskets was 14.7% of taxpayer's cash-basis gross receipts).

[8] *See* Treas. Reg. § 1.446-1(c)(2)(ii) ("Commissioner may authorize a taxpayer to continue the use of a method of accounting consistently used by the taxpayer, even though not specifically authorized by the regulations in this part, if, in the opinion of the Commissioner, income is clearly reflected by the use of such method"); *see also Ansley-Sheppard-Burgess Co. v. Commissioner*, 104 T.C. 367 (1995) ("taxpayer that is required to use the inventory method of accounting must meet the substantial-identity-of-results test [by showing that continued use of cash method would produce substantially identical results to use of accrual method] in order to show that the Commissioner's determination requiring a change in its method of accounting was an abuse of discretion. [Service's] contention that we must apply the substantial-identity-of-results test in cases where the taxpayer is not required to maintain an inventory is without support in the case law."); Tech Adv. Mem. 98-08-003 (Nov. 3, 1997) (landscape contractor's merchandise purchases were 3-6% of its annual gross receipts; use of accrual method not required); Tech. Adv. Mem. 97-23-006 (Feb. 7, 1997) (medical clinic's total merchandise and supply purchases were 8% of its annual gross receipts; use of accrual method not required).

[9] *See* I.R.C. § 446(c)(4) (combination of cash, accrual, and other methods permitted for single trade or business) and § 446(d) (taxpayer engaged in more than one trade or business may use different method of accounting for each trade or business).

[10] *See, e.g., Hospital Corporation of America v. Commissioner*, T.C. Memo 1996-105 (court rejected Service's assertion that hospitals should use accrual method of accounting stating the "hybrid method is a permissible method under the regulations and . . . it clearly reflects the taxable income of the hospitals"); Tech. Adv. Mem. 9408003 (Nov. 10, 1993) (Service required use of accrual method for sales of food supplements and merchandise and providing of services under weight reduction contracts).

It should be noted that, in many cases, section 1.162-3 of the regulations would defer deduction of the cost of items on hand even if the items were materials and supplies and not merchandise. Specifically, section 1.162-3 provides that a taxpayer with materials and supplies on hand may deduct only the cost of the materials and supplies actually consumed unless (i) the materials and supplies are incidental, (ii) the taxpayer keeps no record of consumption, (iii) the taxpayer does not take physical inventories at the beginning and end of the year, and (iv) deduction of the cost of all materials and supplies clearly reflects income. The presence of a materials or supplies inventory does not affect the taxpayer's eligibility to use the cash method of accounting.

Given that the Service could permit a combination of accounting methods and that it could defer the deduction of costs of materials and supplies wherever appropriate under section 1.162-3 of the regulations, it appears the Service pursues merchandise characterization in order to bootstrap the requirement to use the accrual method. For example, in a recent Tax Court decision involving a medical clinic using chemotherapy drugs in the process of providing medical services to patients, the Service sought inventory treatment for $31,887 of the drugs and use of the accrual method for $148,557 of year-end accounts receivable.[11] Were deferring the deduction of the cost of the drugs the Service's objective, it could have accomplished the same result under section 1.162-3 of the regulations without requiring the taxpayer to use the accrual method. Apparently, the Service did not argue this point, however, even as an alternative to its primary position. In addition, characterization of materials as merchandise may require that a taxpayer use the accrual method even if the taxpayer has no inventory on hand, as the Service successfully contended in a case involving a roofing contractor who only purchased materials as needed for particular jobs.[12]

Although taxpayers and the Service have spent considerable resources contesting whether particular items constitute merchandise, the distinction between merchandise and materials or supplies remains unclear. Examples of recent issues that have arisen as to whether a taxpayer was selling merchandise include: (1) flowers, plants, mulch, seeds, and ice melt provided by a lawn care maintenance business (the Service concluded the items were merchandise, but could be treated as supplies because amounts were de minimis);[13] (2) drugs, anesthetics, crowns, bridges, and dentures provided by a dentist (the Service concluded that the items were merchandise, but that amounts were de

[11] *See, Osteopathic Medical Oncology & Hematology, P.C. v. Commissioner*, 113 T.C. No. 26 (1999).

[12] *See, J. P. Sheahan Associates Inc. v. Commissioner*, T.C. Memo. 1992-239 (taxpayer with no inventory on hand at year-end nevertheless required to use accrual method; "the regulations speak in terms of 'every case in which the production, purchase, or sale of merchandise is an income-producing factor.' This is the foundation for the determination by respondent, pursuant to section 471, that inventories should be used; the fact that such use may produce a zero or minimal year-end inventory is irrelevant.").

[13] Tech. Adv. Mem. 98-08-003 (Nov. 3, 1997) (lawn care maintenance service's merchandise purchases were 3-6% of its annual gross receipts; use of accrual method not required).

minimis);[14] (3) emulsified asphalt provided by an asphalt paving contractor (the Tax Court ruled that the emulsified asphalt was not merchandise due to its ephemeral nature);[15] (4) electricity produced and delivered by the taxpayer (the Service ruled that electricity is merchandise rather than a service);[16] and (5) chemotherapy drugs administered by a medical clinic (the Tax Court ruled that the drugs were not inventory).[17] These rulings and decisions illustrate the difficulties of determining if an item is merchandise. If businesses cannot easily determine if they have merchandise inventory, they cannot determine if they must use the accrual method of accounting.

Many small businesses continue to use the cash method even though the production, purchase, or sale of merchandise is an income-producing factor. Small businesses often do not maintain inventory records and may have only minimal books and records. Requiring small businesses to compute year-end inventory balances and use the accrual method of accounting subjects them to complex rules and record-keeping and substantially increases the costs of tax compliance for these taxpayers. Moreover, if a change to the inventory and accrual methods is required on audit, small businesses face substantial adjustments attributable to the deferral of deductions and acceleration of income, plus interest and, in many cases, penalties, that they simply do not have the ability to fund.[18]

Proposals

Accrual method. Considerable simplification could be achieved by amending sections 446 and 448 to allow small businesses to elect to use the cash method of accounting even when the purchase, production, or sale of merchandise is an income-producing factor. We understand the Treasury Department plans to issue guidance that generally will allow a qualified taxpayer with average annual gross receipts of $1 million or less to use the cash method. We suggest that utilization of the $5 million gross receipts test already included in section 448 to identify small businesses eligible for this election would provide simplification for more taxpayers, minimize the confusion likely to result from different dollar thresholds, and reduce controversy that is similarly likely to result from applying different dollar thresholds for different types of businesses. A gross receipts threshold at least equal to the threshold provided for service businesses in section 448 is appropriate because the profit margin often is lower for businesses selling merchandise than for businesses providing services.

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[14] Tech. Adv. Mem. 98-48-001 (July 16, 1998) (percentage of gross receipts not specified; use of accrual method not required).

[15] *Galedrige Construction Inc. v. Commissioner,* T.C. Memo 1997-240; *Jim Turin & Sons, Inc. v. Commissioner,* T.C. Memo 1998-223.

[16] Tech. Adv. Mem. 95-27-003 (Feb. 15, 1995).

[17] *Osteopathic Medical Oncology & Hematology, P.C. v. Commissioner,* 113 T.C. No. 26 (1999).

[18] For example, in *J. P. Sheahan Associates Inc. v. Commissioner*, T.C. Memo. 1992-239, the taxpayer was assessed a substantial understatement of tax penalty.

Inventory accounting. Further simplification could be achieved by amending section 471 to allow small businesses with gross receipts of $5 million or less to elect not to maintain inventories even if the purchase, production, or sale of merchandise is an income-producing factor. Although allowing a small business to deduct in the current year the cost of goods to be sold in a future year would result in some mismatch of income and expense, we believe the mismatch would be minimal for the simple reason that small businesses generally cannot afford to maintain large quantities of inventories. Although we expect there will be concern expressed over the possibilities for abuse such a proposal entails, we do not believe this should be a significant concern because we do not believe it will result in small businesses purchasing additional inventory to manipulate taxable income. Inventory purchases entail carrying costs and risks of ownership. The result is that small businesses seeking to manipulate taxable income would incur in excess of $1.00 in costs to save 35 cents in tax. We do not believe most small businesses will adopt such a course of conduct. In addition, case law provides that sham inventory purchases or purchases not for use in the ordinary course of a taxpayer's business are to be disregarded.[19] Thus, the courts have made it clear that the Service can address abusive situations.

If small businesses are allowed to elect not to maintain inventories, such businesses should also be permitted to elect to deduct materials and supplies as purchased to avoid the complexity and controversy likely to result from assertions that amounts previously viewed as merchandise must be capitalized as materials and supplies under section 1.162-3 of the regulations.

While small businesses that predominantly provide services have been involved in many of the litigated cases regarding the definition of merchandise, other small businesses with gross receipts of $5 million or less that do not primarily perform services may have relatively more significant inventory levels. Our proposal would allow these small businesses to elect not to maintain inventories as well. We believe this approach achieves maximum simplification. Should the Committee find this approach unacceptable, a different test should be developed to determine whether inventories must be maintained by taxpayers with gross receipts of $5 million or less. For example, rather than requiring inventories only if gross receipts exceed $5 million, inventories could be required if the taxpayer's total purchases of merchandise, materials, and supplies during the year exceeded a stated percentage, perhaps twenty percent, of its total gross receipts. Alternatively, inventories could be required if the taxpayer either (i) keeps a record of consumption or (ii) takes physical inventories. These alternatives, while more complicated than a $5 million gross receipts test, would nevertheless represent substantial simplification for many taxpayers

[19] *See, e.g., United States v. Ingredient Technology Corp.*, 698 F.2d 88 (2d Cir. 1983); Rev. Rul. 79-188, 1979-1 C.B. 191.

Automatic change procedures. Transition rules often provide for automatic accounting method changes for affected taxpayers in the first year a new statutory provision is effective. For small businesses that may not become aware of a change in law as quickly as larger taxpayers, simplification would be increased by providing for or encouraging the Service to provide automatic change procedures not only for the initial year, but also for subsequent years.

Repeal of Installment Method of Accounting

We turn now to the repeal of the installment method of accounting. We appreciate that the House Ways and Means Committee has passed legislation retroactively reinstating the installment method. For the reasons set forth below, we urge its prompt passage.

Background: The Eighty-Year History of Installment Sales

First set forth in Treasury regulations promulgated in 1918, Congress codified the installment method of tax reporting in section 212(d) of the 1926 Revenue Act. The sound policies underlying the installment method are to relieve taxpayers from paying tax on anticipated gains in the year of sale when they received only a small portion of the sales price, and to eliminate the need to value installment obligations. Although Congress has revised and limited the use and benefit of the installment method over the past eighty years, the policies prompting its enactment remain equally sound today.

Reason For Repeal

We understand there was essentially one reason cited in support of repealing the installment method for accrual method taxpayers – the installment method is somewhat inconsistent with the accrual method because, by allowing deferral of recognition, the annual economic results of an accrual method taxpayer's business are not properly reflected. This reason fails to withstand careful analysis and is insufficient to overturn eighty years of consistently applied tax policy. Section 1001 of the Code, which governs recognition of income associated with sales of property, makes no distinction between sales made by cash and accrual method taxpayers, providing only that the amount realized from a sale or other disposition equals the sum of money received plus the fair market value of other property received.[20] The installment method is an exception that permits a taxpayer to report gain from the sale of capital assets in the year payment is actually received. However, the installment exception essentially applies only to nonrecurring dispositions of business assets. While a taxpayer should be expected to pay taxes on ordinary profits earned from business operations, the nonrecurring sale of a capital asset falls into an entirely different category. The imposition of immediate

[20] The Service has successfully argued that cash method principles are not relevant in determining gain recognized on sales of property. *See Warren Jones Co. v. Commissioner*, 524 F.2d 788 (9th Cir. 1975).

taxation on the anticipated gain from the disposition of a business or substantial capital asset, such as real estate, places an unexpected and unfair burden on the business seller.

Market Effect of Repeal on Business Sales -- Liquidity, Price and Deals That Will Not Be Done

Since 1918, the installment sales method has been an important rule in our Federal income tax system, because it adjusted the payment of taxes to the demands of the marketplace. Repeal of the installment method alters those demands and likely will adversely affect all parties to potential transactions:

- The seller, faced with a significant tax liability, will be less willing to finance the sale, and will demand a sizable cash down payment. This will force the small business purchaser to attempt to obtain third-party financing, likely at a higher rate, and/or increase the amount paid in cash up front.

- The seller will be more reluctant to enter into contingent or "earn out" agreements based on future performance of the assets sold which will tend to depress the price paid by the small business purchaser.

- Sellers agreeing to contingent or "earn out" provisions will be faced with increased complexity and controversy with the IRS with respect to valuation of such contingent amounts, or the application of the "open transaction" doctrine, which defers taxation on the contingent piece until actual payments are received.

- Cash basis shareholders or partners will attempt to structure business transfers as stock or partnership interest sales in order to use the installment method. As pointed out in the 1999 legislative history, buyers generally want to purchase assets and will refuse to assume, directly or indirectly, the contingent liabilities inherent in the acquisition of the entity itself.

For the reasons stated above, as well as others, repeal of the installment method has increased the tension between buyers and sellers, often with adverse and unintended results. We are aware of a number of transactions that have been canceled since December 1999 due to the change in the law.

The Treasury Department's Proposal

The Treasury Department proposes to mitigate the adverse effects of the installment method repeal by reducing the number of taxpayers subject to the accrual method of accounting. Although the Treasury Department's proposal will eliminate the effect of the repeal for taxpayers with gross receipts of $1 million or less, this is a very limited subset of the taxpayers adversely affected by the repeal of the installment method of accounting. It will not eliminate the chilling effect the repeal has had on the marketplace, because the

repeal will nevertheless remain in effect for a large number of taxpayers and will affect a large number of transactions. Moreover, for these taxpayers, the Treasury Department's proposal will not eliminate the increased complexity and burden of paying taxes on amounts from contingent or "earn out" sales that are only estimated and might never be received. Even if the threshold for utilization of the cash method by taxpayers selling merchandise is increased to $5 million as we have suggested, we continue to believe the only appropriate approach with respect to installment sales is to reverse the repeal of the installment method for accrual basis taxpayers.

* * *

We appreciate your interest in these matters. The Section would be pleased to work with the Committee and its staff on these important issues, as well as other tax issues of significance to small businesses.

TESTIMONY OF

JOHN S. SATAGAJ

PRESIDENT AND GENERAL COUNSEL

SMALL BUSINES LEGISLATIVE COUNCIL

BEFORE THE COMMITTEE ON SMALL BUSINESS

UNITED STATES HOUSE OF REPRESENTATIVES

ON APRIL 5, 2000

ON THE SUBJECT OF SMALL BUSINESS TAX ACCOUNTING

On behalf of the Small Business Legislative Council (SBLC), I am here today to offer our strong support for Chairman Talent's legislation, H.R. 2273, to restore common sense to the rules of tax accounting. The United States Department of Treasury appears determined to extract every last tax penny from small business, even if it costs the taxpayer and the government two dollars to get that penny. We are speaking, of course, of Treasury's effort to force small businesses to switch from cash basis to accrual basis tax accounting.

My name is John S. Satagaj, and I am the President and General Counsel of SBLC, and have served in that capacity since 1985. Since it is relevant to today's hearing, I should also note I am also a partner in the law firm of London and Satagaj, I do have an LLM in taxation and among my areas of expertise is working with small businesses on understanding the enforcement of tax accounting law by the IRS.

It is time to recognize that textbook tax accounting and the realities of day-to-day small business cash management are not always going to be a perfect match. To many small business owners, tax accounting simply means they record cash receipts when they come in and the cash they pay when they write a check for a business expense. The difference is income, which is subject to taxes. In its simplest form, this is known as the "cash receipts and disbursements" method of accounting—or the "cash method" for short. It is easy to understand, it is simple to undertake in daily business operations, and for the vast majority of small enterprises, it matches their income with the related expenses in a given year.

The IRS contends that a small business should report its income when all events have occurred to establish the business' right to receive the income and the amount can reasonably be determined. Similar principles are applied to determine when a business may recognize an expense. This method of accounting is known as "accrual accounting." The reality of accrual

accounting for a small business is that it may be deemed to have income well before the cash is actually received and an expense long after the cash is actually paid. As a result, accrual accounting can create taxable income for a small business that has yet to receive the cash necessary to pay the taxes.

We are here today because the Internal Revenue Code does not set forth an affirmative rule on the use of cash accounting. Like many issues under the Internal Revenue Code, you find the answer by working backwards. Most determinations of which tax accounting method a taxpayer must use begin with Internal Revenue Code (IRC) Section 448. (Other IRC sections such as IRC Sections 447 and 460 may also come into play, but that is a story for another day.)

As a general rule, IRC Section 448 requires corporations to use the accrual method of accounting. There are three basic exceptions. There is one for farming and another for certain qualified personal service corporations. There is a third exception for corporations with less than $5 million in gross receipts. But, as it turns out, the small business exception may not quite be the exception we thought it was.

The Department of Treasury is in the early stages of a new effort to force small business service providers using the cash method to convert to accrual accounting. As we understand it, it is the Department's position that IRC Section 448 does not necessarily guarantee a small business the right to use cash accounting, rather, the Treasury asserts, IRC Section 448 only prevents large corporations from using cash accounting. It is the Department's position that if it can otherwise require a small business taxpayer to be on accrual accounting, it may do so, notwithstanding IRC Section 448. While we believe the intent of Congress at the time of enactment of the $5 million gross receipts test in IRC Section 448 was to allow small businesses

to use cash accounting regardless of circumstances, the actual language of the section can be read to support the Treasury's views.

The principal "other reason" for imposing accrual accounting can be found in complex and vague rules regarding inventory accounting responsibilities. Using IRC Sections 446 and 471 and relying on the case of *Wilkinson-Beane* 1970 (420 F.2d 352) and its progeny, the IRS has imposed inventory accounting and accrual accounting requirements on small service providers. The IRS arrives at this conclusion by employing a two-step analysis. The first step takes place under IRC Section 471, which gives the IRS broad authority to impose inventory requirements. Under the regulations, inventories are required if the "production, purchase or sale of merchandise is an income producing factor." Both what is "merchandise" and when is it "an income producing factor" have been the source of long-standing disputes. Some of the cases involving IRC Section 471 are based on the presence of what I call "phantom" inventory, such as the plant material a landscape contractor picks up the day of a job or the flooring an installer has drop shipped from the manufacturer directly to a customer's site. Other cases involve an analysis of what constitutes "merchandise" as opposed to when the items are subordinate to the provision of the service, such as the drugs administered by a veterinarian to an animal. For many service provider taxpayers, merchandise is acquired on an "as needed" basis. As a result, the actual tax liability on a year-to-year basis for inventory changes is negligible. The imposition of the inventory accounting requirement does create significant new responsibilities. Whatever type of IRC Section 471 situation is involved, it ultimately comes down to a conclusion by the IRS that the "sale" of the items is an income producing factor and inventory accounting is required.

Being a cynic, I believe Treasury's renewed interest in issuing new guidance in this area has to do with its recent batting average in the Tax Court. Just last Thursday, the court rendered

a decision in favor of the taxpayer under this IRC Section 471 analysis. The decision, *RACMP Enterprises, Inc. v. Commissioner* (114 T.C. No. 16) (No. 23954-97) released March 30, 2000, involves a concrete construction contractor. The IRS tried to argue the concrete was income producing merchandise under IRC 471. The tax court said, "No way." This comes on the heels of a second recent case, *Osteopathic Medical Oncology and Hematology P.C. v. Commissioner (*113 TC 26), which was decided on November 29, 1999 in favor of the taxpayer.

History tells us a couple of tax court wins are of small comfort to small business. Because of the unique way by which we litigate tax cases in this country, there are some limitations on the value of individual tax court decisions as precedent. Further, it takes time and resources to litigate, and the IRS will persist until it has truly been told to stop litigating these cases. In the trade association community we learned that lesson the hard way as the IRS pursued the recharacterization of royalty income from affinity programs for many years despite several losses. Most importantly, legislation is needed because we do believe the Department of Treasury is attempting to "improve" its litigation odds by regulatory guidance. If you have any doubt about the need for legislation to put this debate to rest, read the dissents in these two cases.

On cue, the Tax Court illustrated my point perfectly on March 31, 2000, last Friday. Just one day after the *RACMP* decision, a Tax Court Memorandum in a different case, was issued in favor of the IRS. In this case the taxpayer provided sand and gravel delivery. The judge distinguished the facts from the *RACMP* decision of just the day before. The most recent decision is *Von Euw & L.J. Nunes Trucking, Inc. v. Commissioner* (T.C. Memo 2000-114) (No. 17599-97), released March 31, 2000. It is unfair to ask small businesses to ride this roller-coaster.

If the IRS is able to establish an inventory requirement, the second step is for the IRS to then require the taxpayer to utilize accrual accounting under IRC Section 446, which allows the IRS to change the method of accounting to one that "clearly reflects income." I am personally not familiar with a case in which the IRS believed cash basis accounting "clearly reflected income." The regulations under IRC Section 446 specifically require a taxpayer to use accrual accounting if inventories must be maintained.

Putting aside the inventory issue, which, as an accrual accounting concept, in essence delays the ability of the taxpayer to deduct expenses already incurred, the other big issue in the cash versus accrual accounting debate is the timing of the tax liability for income. Under the tests applied for accrual accounting purposes, a small service provider can find itself paying taxes on income it has not yet received. The determination that income is "taxable" income under accrual accounting principles is based on an "all-events" test. Generally, income whether received, or just due or earned, on the basis of whichever of those events comes first, can meet this test. I don't need to tell you how difficult it is for small businesses to accept the notion they should pay taxes on income they do not "possess" yet. And from a practical standpoint, it can also be a significant cash flow burden.

I should note a separate issue that has nothing to do with the substantive interpretations but frankly, drives small businesses crazy. Many of these taxpayers are businesses that have been "in business" for many years, and the industry practice of cash basis accounting without merchandise inventory accounting, has existed for decades. Some of them have been audited previously by the IRS and, although the taxpayer used the same accounting method, the issue of proper accounting method was never raised.

Only now is the IRS attempting to force the inventory and accrual accounting methods on these truly small businesses. Many of these taxpayers believe it is unfair for the IRS to change its audit procedures, having approved the taxpayer's or similarly situated taxpayers' accounting procedures in the past. Unfortunately, unless Congress says otherwise, the courts have generally upheld the IRS' right to be inconsistent.

The conversion to accrual accounting has other consequences for small business service providers. At present, unless the Senate and President follow the House's lead to reverse the repeal of the installment method of accounting, any small business that converts will lose the right to use the installment sale method of accounting upon the sale of the business, if the taxpayer "takes back the note" and receives payments for a number of years.

In the pending African trade bill there is a "pay-for" which eliminates the ability of many accrual basis taxpayers to write off bad debts based on experience. It is not a big deal now for the small businesses currently on the cash basis because their income is only taken into account when actually received. For tax purposes, a bad debt is not an issue for a cash basis taxpayer. However, if they are converted to accrual accounting, small business service providers would incur a double whammy if the African trade bill passes as is. They would be forced to recognize income they have not yet received under the IRS' interpretation of IRC Sections 446 and 448. Then, stuck with accrual accounting, they would discover they had also lost the right to adjust for the proven impact of bad debts as a result of a legislative change to the experience method rule.

We believe Congress should correct two fundamental flaws in the current interpretation of tax accounting rules. First, IRC Sections 446 and 448 of the tax code should be revised so there is no doubt about the scope of IRC Section 448. The small business community has

believed from its adoption that IRC Section 448 should permit small business taxpayers with less than $5 million in annual gross receipts to use the cash method of accounting.

Second, Treasury is stretching the rubber band of logic to find the presence of "income producing" merchandise for the inventory triggering purposes of IRC Section 471 in the most unlikely of places. IRC Section 471 should be amended to indicate inventory accounting of merchandise is required only when it is a "substantial and material" income producing factor (for example, only when the cost of the merchandise constitutes 51 percent of the gross receipts).

It is important to recognize we are not talking about corporate tax shelters here. This is not about escaping tax liability. This is all about short-term timing. Frankly, most small businesses do not have the luxury of carrying accounts receivable for very long if they expect to survive. It all adds up to imposing a lot of work (or spending extra money on professional help) for the taxpayer and the government to recover relatively small amounts of tax liability sooner. The plain reality is that textbook tax accounting does not always match up with what makes practical sense.

While the actual decision went against the taxpayer, I find the following observations by one court about cash versus accrual accounting to be most perceptive:

> "The cash method – simple, plodding, elemental – stands firmly in the physical realm. It responds only through the physical senses, recognizing only the tangible flow of currency. Money is income when this raw beast actually feels the coins in primal paw; expenditures are made only when the beast can see that is has given the coins away…The accrual method, however, moves in a more ethereal, mystical realm. The visionary prophet, it recognizes the impact of the future on the present, and with grave foreboding or ecstatic anticipation,

announces the world to be. When it becomes sure enough of its prophecies, it actually conducts life as if the new age has already come to pass."

We urge you to stand in the physical realm of small businesses that must live in the world of the beast rather in the ethereal world of textbook tax accounting. There is adequate precedent for Congress to make a "mid-course" correction. On more than one occasion, Congress has acknowledged promoting the growth of small business is important enough that it should override textbook tax policy when the textbook policy does more harm than good. For example, IRC Section 179, the small business direct expensing provision, overrides textbook depreciation policy. We urge you to restore common sense to tax accounting.

As you know, the SBLC is a permanent, independent coalition of nearly 80 trade and professional associations that share a common commitment to the future of small business. Our members represent the interests of small businesses in such diverse economic sectors as manufacturing, retailing, distribution, professional and technical services, construction, transportation, tourism and agriculture. Our policies are developed through a consensus among our membership. Individual associations may express their own views. For your information, a list of our members is attached.

SMALL BUSINESS
LEGISLATIVE
COUNCIL

Members of the Small Business Legislative Council

ACIL
Air Conditioning Contractors of America
Alliance of Independent Store Owners and Professionals
American Association of Equine Practitioners
American Bus Association
American Consulting Engineers Council
American Machine Tool Distributors Association
American Moving and Storage Association
American Nursery and Landscape Association
American Road & Transportation Builders Association
American Society of Interior Designers
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American Subcontractors Association
Associated Landscape Contractors of America
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Association of Sales and Marketing Companies
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Automotive Service Association
Bowling Proprietors Association of America
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Florists' Transworld Delivery Association
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Independent Medical Distributors Association
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National Tooling and Machining Association
National Wood Flooring Association
Organization for the Promotion and Advancement of Small Telephone Companies
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Printing Industries of America, Inc.
Professional Lawn Care Association of America
Promotional Products Association International
The Retailer's Bakery Association
Saturation Mailers Coalition
Small Business Council of America, Inc.
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SMC Business Councils
Society of American Florists
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United Motorcoach Association
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STATEMENT OF

ABRAHAM SCHNEIER

REPRESENTING

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

SUBJECT: THE ABILITY OF SMALL BUSINESS TO USE THE CASH AND DISBURSEMENTS METHOD OF ACCOUNTING

BEFORE: THE HOUSE COMMITTEE ON SMALL BUSINESS

DATE: APRIL 5, 2000

Mr. Chairman:

Mr. Chairman, members of the Committee, my name is Abraham Schneier. I am a partner in the firm of McKevitt & Schneier, and I am a consultant on tax issues to the National Federation of Independent Business.

On behalf of the 600,000 members of the National Federation of Independent Business (NFIB), I appreciate the opportunity to present the views of small business owners on the subject of the Cash Method of Accounting. This issue has come to the forefront of small business tax concerns due to enactment of legislation last year to the limit the use of the installment method to taxpayers using the cash method of accounting.

BACKGROUND

The most difficult aspect of this issue is getting past the accounting jargon and putting the issue into plain English. At its core this issue starts with the Internal Revenue Code (IRC), and the tax laws requirement that," Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." (IRC Code Section 446(a))

Section c(1) of this section states that the cash receipts and disbursements method is a permissible method.

The cash method should be familiar to most individuals as its basis is income received during the calendar year is taxable, and deductions actually paid during the year are deductible from income. Most individuals file their personal tax returns on the cash method, and it reflects income actually received as well as payments actually made during the same period. In addition the cash method allows the business owner to pay taxes on income actually received during the tax year.

To a small business this accounting method reflects another reality that all small businesses must deal with, cash flow. Profits in the short term are not as critical as the need to pay your rent, payroll, utilities, and other business expenses. Failure to have adequate cash flow would necessitate having a credit line result or using some type of debt to keep paying the bills.

To a small business owner, this method of accounting is the one that the typical small business owner is used to dealing with. Cash flow is the every day pressure that the small business owner must deal with. If you speak with any small business owner, the one figure he or she knows, is how much cash do I need this week to pay my expenses. This method of accounting is regularly used and more clearly reflects how the business is run than any other.

If a business is not eligible to use the cash method it typically must use the accrual method. Under the accrual method income is included for the taxable year when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. (Section 1.446-1-c-(ii), IRC Regulations).

Section C of these regulations states:

§1.446-1. General rule for methods of accounting
(C) No method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. The method used by the taxpayer in determining when income is to be accounted for will generally be acceptable if it accords with generally accepted accounting principles, is consistently used by the taxpayer from year to year, and is consistent with the Income Tax Regulations. For example, a taxpayer engaged in a manufacturing business may account for sales of the taxpayer's product when the goods are shipped, when the product is delivered or accepted, or when title to the goods passes to the customers, whether or not billed, depending on the method regularly employed in keeping the taxpayer's books.

Limitation on the use of the Cash Method Enacted In the Tax Reform Act of 1986.

In 1986 Congress enacted Section 448 of the Internal Revenue Code. This section was designed to limit the use of the cash method of accounting to eligible businesses with annual gross receipts of $5 million or less.

SEC. 448. LIMITATION ON USE OF CASH METHOD OF ACCOUNTING.
448(c) $5,000,000 GROSS RECEIPTS TEST.--

For purposes of this section--

448(c)(1) IN GENERAL.--A corporation or partnership meets the $5,000,000 gross receipts test of this subsection for any prior taxable year if the average annual gross receipts of such entity for the 3-taxable-year period ending with such prior taxable year does not exceed $5,000,000.

Use of the Installment Method on Business Sales

The installment method was modified in The Installment Sales Revision Act of 1980. The installment sales rules were streamlined but essentially left alone. The rules permit the owner selling a business to pay taxes as payments are received.

In many cases a small business owner is selling to another small business owner, and the main problem that individual has is lack of cash and credit. To permit the sale the owner will often take back installment notes that the new owner will pay out of the profits generated from the business, but this only works because the owner pays taxes when the payments are received.

In 1980 a limitation of $5 million was included so that if the value of installment notes exceeds that amount at the end of a year, the holder of the notes pays an interest charge to the IRS. The IRS is therefore left whole on large sales.

Who May Use the Cash Method of Accounting

The IRS has previously stated that the $5 million threshold under section 448 of the IRC is not a safe harbor and that businesses under $5 million in gross sales may also be required to be on the accrual method if they meet the rules for accounting for inventory. The IRS is making the claim that in some cases supplies used by a business may be inventory and that those businesses should move to the accrual method.

In recent testimony before the House Ways and Means Committee on the Installment Method issue, the Treasury Department stated that it plans to issue guidance that will allow a small business with $1 million or less in gross receipts, a safe harbor for the cash method. However, for businesses between $1 million and $4 million in gross sales volume, the accrual method should be used.

Since the repeal of the installment method relied on the accounting method employed by the taxpayer, the question of who must use which method of accounting is a major concern.

Impact on a Small Business of Changing to the Accrual Method

A small business moving to the accrual method must first alter the fundamental basis for maintaining its books and records. In nearly all circumstances this requires the business owner to spend money on accountants. As a result income is recognized when a sale is booked. At the same time expenses are recognized when all circumstances have been determined to fix the liability or when the bill is received. The result is that taxes must be paid on income before the income is received.

To a growing small business the accrual method may be preferable for a variety of reasons. In many cases banks require that financial statements be prepared on the accrual basis as the accrual basis conforms to generally accepted accounting principles. Wholesalers and retailers must use the accrual method because they buy and sell inventory and in these cases the accrual method more accurately reflects income.

However, small business owners who have inventory that is incidental (mostly supplies) and who use the cash method on a consistent basis, should be permitted to retain the cash method if they are below $5 million in gross sales.

Further restricting the cash method as an exercise in accounting purity merely sacrifices the good for the perfect. It will simply generate additional resentment against the tax code which most have concluded is far too complex, merely to achieve a limited objective. The cost to implement the accrual method will in effect be as a tax as most small businesses will have to pay for the necessary expertise. Finally, the accrual method will artificially increase taxes on a small business in one tax year, while reducing it in the next tax year. After all, the difference between the cash and accrual method is merely a timing shift with expenses not deductible in the current year usually deductible in the next year.

Conclusion

The 1986 Tax Reform Act specified a reasonable approach to this issue that the Treasury Department seems to want to ignore. The proposal for a $1 million safe harbor should be rejected as should any effort to increase the number of businesses forced to use the accrual method because they maintain incidental levels of supplies in their businesses.

The serious policy concerns small business owners have regarding this issue are being ignored by Treasury officials who view the elimination of the cash method as an enforcement concern for the IRS. If consistently applied, this accounting method is as fair and just as the accrual method, and the IRS would still have the ability to determine whether the business is engaging in transactions designed to avoid taxes. Section 269 of the IRC permits the IRS to act where transactions are engaged in order to avoid taxes.

The $5 million threshold should be a safe harbor that is both practical and enforceable.

In addition, the Installment Method Repeal enacted last year should itself be repealed. The issue of use of the installment method on sales of a business should be left as it is. Any business under $5 million should be allowed to use this method to clearly reflect the income when it is actually received by the business.

Thank you for your attention, and I would be happy to respond to any questions that any member of the committee might have at this point.

STATEMENT OF THE

AMERICAN DENTAL ASSOCIATION

SUBMITTED TO THE

COMMITTEE ON SMALL BUSINESS

U.S. HOUSE OF REPRESENTATIVES

ON

ACCOUNTING METHOD CHANGES

APRIL 5, 2000

Washington Office: 1111 14th Street NW Washington DC 20005 (202) 898-2400

On behalf of our approximately 144,000 members, the American Dental Association (ADA) is pleased to submit our comments to the House Small Business Committee regarding usage of the cash-based vs. accrual methods of accounting.

This issue is of particular importance to the ADA because of the Internal Revenue Service's (IRS) recent attempts in some areas to compel dentists who have used the cash-based accounting method for decades to change to the accrual method of accounting. Conversion to the accrual method will cost dentists a considerable amount of money and is both unfair and unwarranted.

The Association is working closely with Representative Donald Manzullo (R-IL) on H.R.1004, the "Accounting Fairness for Physicians and Dentists Act," that permits dentists and physicians to continue to use the cash-based method of accounting. Mr. Manzullo's efforts on behalf of dentists began in the last Congress and were in direct response to IRS audits of several dentists in which some in the agency asserted the dentists should be using the accrual method. Although these particular cases were satisfactorily resolved, the resolution is not a permanent fix for all dentists.

In addition, the Association strongly supports H.R. 2273 as introduced by Representative James Talent (R-MO). This bill provides small business relief by amending the tax code and clarifying that small businesses with annual gross revenues below $5 million are permitted to use the cash-based method of accounting.

Historically, dentists and many other service oriented small business owners have used the cash-based method of accounting where income is only taxable when payment for goods and services is actually received. In contrast, the accrual method requires that taxpayers recognize income at the time that services are rendered regardless of when or whether payment is received. This latter approach often results in taxpayers paying taxes on accounts receivable prior to receiving payment.

Dental Practice Problem

Under IRS regulations, retail businesses that purchase an inventory for later resale to customers are normally required to follow an accrual accounting system so that the revenues generated at the time of sale are recognized immediately, not when the actual payment is received. In the case of dental offices, the IRS has misapplied that concept. Because dental offices do not purchase inventory (like a retail merchant), most dental offices have employed cash-based accounting where the dentist only recognizes income when the payment is actually received and not normally at time of service.

Dentists do not maintain an inventory of "products" for resale to patients. The IRS apparently considered prosthetic replacements as "inventory", since they were, in some instances, "stored" in the dental office awaiting the patient's appointment to have the dentist complete the service. These custom appliances are fabricated for individual patients according to a prescription developed by the dentist for an individual patient. Dentists do not purchase and stock an inventory of crowns, bridges, dentures, etc. that are only adjusted and delivered to any patient walking in the door. No amount of adjustment

of "stock prosthetic inventory" can result in an acceptable prosthesis for an individual patient. The concept of inventory does not apply in dental treatment.

Federal Activity

During 1996, in an audit by the IRS, agents directly challenged an Illinois dentist for use of the cash-based method of accounting. The IRS asserted that the dentist had income-producing inventory, which required use of the accrual method of accounting. While in a subsequent technical advice memorandum (TAM) the service found that the dentist's use of the cash-based method was warranted, that decision was fact-based and only applicable to that particular case. In addition, the TAM provides insufficient guidance for other dentists and taxpayers because the service did not define the threshold at which merchandise becomes a significant enough income-producing factor to compel use of the accrual method.

This issue is of such complexity that the IRS is currently working to put together a broad-based guidance that will clarify for both taxpayers and agents when businesses must employ the accrual method or shift from the cash-based to the accrual method of accounting. At the heart of this guidance is clarification as to what constitutes merchandise for resale (inventory) and when it becomes an income producing factor that requires use of the inventory accrual method. Furthermore, the Treasury Department has recently stated that it will allow qualified taxpayers with average annual gross receipts of $1 million or less to use the cash-based method. Nevertheless, this threshold will not provide much relief for small businesses and appropriately needs to be increased. A

threshold of $5 million, such as that advocated in H.R. 2273, is a much more appropriate figure for small businesses.

Conclusion

At this time, the IRS has not made a final determination with respect to the appropriateness of accrual accounting for all dental offices and their forthcoming guidance may not solve dentistry's problem. Dentists should be allowed to use the cash-based method of accounting without fear of the IRS requiring that they shift to the accrual method upon audit. The ADA supports legislation providing for a permanent change in the IRS code to permit dentists to use the cash-based method of accounting if they elect to do so. Other small business owners may choose the method of accounting that best reflects the nature of their businesses.

The Association would like to thank Chairman Talent, Representative Manzullo, and the other members of this Committee for their efforts to highlight this very important issue. The ADA stands ready to work for passage of legislation that will clarify that dentists have the right to use the cash-based method of accounting.

Written Statement of

The Associated General Contractors of America

presented to the

House Small Business Committee

on

""Cash versus Accrual: The Policy Implications of the Growing Inability of Small Businesses to Use Simple Tax Accounting"

Hearing Date – April 5, 2000

The Associated General Contractors of America (AGC) is a national trade association of more than 33,000 firms, including 7,500 of America's leading general contracting firms. They are engaged in the construction of the nation's commercial buildings, shopping centers, factories, warehouses, highways, bridges, tunnels, airports, waterworks facilities, waste treatment facilities, dams, water conservation projects, defense facilities, multi-family housing projects and site preparation/utilities installation for housing development.

The Associated General Contractors of America
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Statement Submitted

on behalf of

The Associated General Contractors of America (AGC)

presented to the

House Small Business Committee

"Cash versus Accrual: The Policy Implications of the Growing Inability of Small Businesses to Use Simple Tax Accounting"

Hearing Date – April 5, 2000

The Associated General Contractors of America (AGC) is pleased to provide the House Small Business Committee on Oversight with this written statement in support of Chairman Jim Talent's efforts to protect small businesses using the cash method of accounting. AGC is the nation's largest and oldest construction trade association, founded in 1918. AGC represents more than 33,000 firms, including 7,500 of America's leading general contracting firms. AGC's general contractor members have more than 25,000 industry firms associated with them through a network of 101 AGC chapters. AGC member firms are engaged in the construction of the nation's commercial buildings, factories, warehouses, highways, bridges, airports, waterworks facilities, waste treatment facilities, dams, water conservation projects, defense facilities, multi-family housing projects, site preparation, and utilities installation for housing developments.

For small contractors, the cash method of accounting is the most practical method because it recognizes income and expenses when the cash is actually paid to the company or by the company. Under the accrual method, a company is required to pay taxes with money it doesn't have, which can be quite a burden for small contractors. The IRS has long favored the accrual method over the cash method, with little thought of small businesses that often find the accrual method a financial burden. The difference in a taxpayer's liability usually does not change based on the method of accounting utilized, rather the question is one of tax payment timing.

Although I.R.C. §448 places limitations on the use of the cash method of accounting, a specific exception is provided for entities with average annual gross receipts of $5 million or less for three previous taxable years. Accordingly, small contractors should be able to use the cash method of accounting. The IRS has largely ignored the $5 million exception for small contractors and has aggressively sought to enforce the accrual method. The IRS has done so by requiring contractors to inventory on-site supplies, because the IRS says that these supplies are an income-producing factor. Once the IRS requires an inventory to be kept, then a small contractor must switch to the accrual method and pay substantial back taxes, interest and possibly even penalties.

Over the past year, AGC has heard from several smaller general contractors who have been audited by an IRS agent who determined that the contractor should be on the accrual method of accounting. In one instance, the contractor was required to pay a total of $6,742 in back taxes, interest and an accountant's fees. For the years in question, this contractor was under the $5 million in annual revenue threshold and, in the view of her accountant, clearly entitled to use of the cash method. But the IRS' view was that the accrual method was required. Fortunately this contractor was able to find the resources to pay the tax assessment and move on. This was money, though, that could have been spent building a business but instead was spent to keep the IRS at bay.

Another contractor recently contacted AGC to tell us about his visit from the IRS. The IRS wants him to switch to accrual on the basis that the cost of his materials (including subcontractor materials) as a percentage of gross receipts is 15%. The contractor subsequently calculated, however, that the cost of his direct materials (excluding those of his subs) was only 5% of gross receipts. Nonetheless, the IRS is insisting that the contractor pay back taxes and interest. This case has not yet come to a resolution, but this contractor feels he has no chance but to comply with the heavy handed decision of the IRS. It is a shame that these two contractors who believed they were in full compliance with the tax code have been told they are violating the code and must pay back taxes and interest.

AGC strongly supports your bill, H.R. 2273, declaring that a taxpayer shall not be required to use an accrual method of accounting for any taxable year by reason of using merchandise or inventory, if the taxpayer's average annual gross receipts do not exceed $5 million. This bill recognizes what AGC believes was the intent of Congress in 1986 – to establish a "safe harbor" for small businesses under $5 million in annual revenue using the cash accounting method. While larger contractors can more readily afford an in-house accountant or outside tax advisor, a small contractor's cash flow can be severely squeezed by the added compliance costs of the accrual method. Small contractors are not seeking to evade taxes. They simply want to focus on growing their businesses and not live in fear of an IRS audit.

In sum, the IRS is attempting to ignore certain sections of the Internal Revenue Code which allow the cash method, thus giving the IRS the luxury of using the method of accounting that most aggressively accelerates revenue recognition. Regardless of what the Internal Revenue Code clearly states, the IRS has continued its assault on small contractors by administratively repealing the $5 million protective statute.

AGC strongly supports your bill, H.R. 2273, and your efforts to protect those contractors using the cash method of accounting. AGC greatly appreciates your leadership on reducing the tax burden on small businesses, and we look forward to working with you toward the passage of your legislation into law.

The Essential Partner
For Contractor Excellence

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Testimony for the Record

on

Small Business Use of the
Cash and Disbursement Method of Accounting

before the

House Committee on Small Business

submitted by

Anthony I. Shaker, President
Air Conditioning Contractors of America

April 5, 2000

Mr. Chairman and members of the committee. On behalf of the Air Conditioning Contractors of America (ACCA), I would like to thank the Committee for holding this hearing which is of vital importance to the future well being of the heating, ventilating, air conditioning and refrigeration (HVACR) industry. In addition to being President of the Air Conditioning Contractors of America, I am Chief Executive Officer of Boston-based BALCO, Inc., a specialist in energy and environmental systems.

Mr. Chairman, ACCA is the nation's premiere HVACR industry representative, with 68 state and local chapters across the country, and 9,000 members nationwide. We appreciate the opportunity to present the views of our small business owners regarding their growing inability to use the cash method of accounting. In the past year or so, this subject has become a contentious issue for many small business owners. We hope the Committee's efforts will help restore a measure of common sense to this aspect of the nation's tax code.

As you are aware, the Congressionally-allowed "cash receipts and disbursements" method of accounting, or the "cash method," has been used for decades by small businesses. It allows businesses to report income in the year cash is actually received and to report business expenses in the year incurred. The method is simple to understand and allows small businesses to minimize the amount of time spent on paperwork compared to the complex demands of the accrual method of accounting. It simultaneously avoids the expense of hiring outside services to maintain books, and it is an effective means to reconcile income and expenses in a particular calendar year. Most importantly, the cash method of accounting allows small businesses to maintain their vital cash flow channels -- an issue that is of particular concern to the small businessman who doesn't operate

under economies of scale and has fewer safeguards against the vagaries of the marketplace than do large corporations.

Regrettably, the ability of small businesses to continue taking advantage of this legal, straight-forward method of accounting has come under attack. In 1986, Congress enacted Section 448 of the Internal Revenue Code, a move designed to allow use of the cash method of accounting for businesses with gross receipts of $5 million or less. But, it appears that the Treasury Department has taken the position that Section 448 of the Internal Revenue Code does not guarantee a small business the right to use cash accounting. As you are well aware, the IRS, in recent years, has unilaterally forced many small businesses to abandon the practical cash method of accounting and to adopt the complicated accrual method. As a result, many small businesses have been billed for back taxes and interest, a hurdle many have difficulty handling. In response to public outcry, the Treasury Department recently announced that it will issue guidance allowing businesses with annual gross receipts of $1 million or less to continue using the cash method of accounting. While this is welcome news to those businesses qualifying under this allowance, ACCA believes this figure is an arbitrary designation which neither answers the needs of the small business community as a whole, nor adheres to the original intent of Congress which was quite clear in establishing the $5 million ceiling for eligibility in using the cash method.

ACCA believes the Treasury Department's determination needlessly burdens the small business owner by subjecting him to a complex and time-consuming accounting practice that has traditionally been reserved for large businesses. In addition to sapping precious resources, which could otherwise be used to grow the business, the accrual

method can place the small business owner in the untenable position of having to pay taxes on income that has yet to be collected, producing significant cash flow dilemmas in the process. This practice is fundamentally unfair, as it subjects law-abiding businesses that have been complying with both the spirit and letter of the law to pay back taxes, while removing from them a sensible method of accounting that has been used for decades. Further, the accrual method exists for the purpose of taxing income derived from the purchase, production, or sale of merchandise. ACCA's members are not merchandisers -- their income is derived solely from the installation and maintenance services they provide -- and they should not be taxed as if they are.

Looking at our nation's Byzantine tax code, it's easy to lose sight of the code's tremendous effect on the taxpayer. As such, allow me to put a human face on this matter. One of ACCA's members, David Baker, owner of Great Lakes Services, located in Kinross, Michigan, has firsthand experience with the IRS on this matter. Great Lakes Service is a $1 million company. The IRS decided to audit Mr. Kinross's books and paid him a visit. After examining his records, the IRS determined that he owed approximately $63,000 in underpayments for a two-year period, plus $6,000 interest, because the agency decided to tax him for all business logged on his books, even though he had yet to collect the revenue from a large portion of that recorded business. Having just come off a couple of particularly bad years, Mr. Kinross and his wife were forced to borrow money from a bank in order to pay taxes on income he had not yet received. No other problems were identified in his records, and the IRS did not claim Mr. Kinross's assessed liability was the result of any illegalities or negligent behavior on his part. Apparently, his only

"crime" was in using the cash method of accounting, as he and small business owners across the country had been doing for years.

Mr. Kinross has said that over the past year he has seriously questioned whether he should just close shop. The IRS's actions have had a crippling effect on his enterprise -- an impact from which he is still trying to recover. Having to service this new loan has disrupted his payroll schedule, has required him to lay off workers, and has delayed his plan to grow the business by purchasing new vehicles and equipment. He and his employees are driving trucks with over 200,000 miles on them, and with the IRS assessment, it is unlikely he will have the cash flow necessary to finance business improvements in the foreseeable future. In short, this unanticipated tax burden is compromising his company's as well as his family's future.

From the small business owner's perspective, the Treasury Department's policy is foolish at best, and ruinous at worst. But, the Treasury's policy makes little sense for the country either. Perhaps the most perplexing feature of the ardor with which the IRS has advanced its position is the fact that the level of tax revenue is unaffected by the accounting method ultimately used – it is simply a question of timing. Whether the cash method or the accrual method is used, the total amount of income reported by the taxpayer is unaltered -- the only difference between the two methods is *when* income and expenses are reported. Given that there is no discernible benefit for the national treasury or the public as a whole, it would seem difficult for the Treasury Department to justify the accrual method of accounting when such a practice is attended by the gravest of consequences for the small business owner.

Again, we at ACCA are deeply hopeful that a resolution which provides for simplification of requirements and protection of the small business community can be achieved. We strongly recommend that utilization of the $5 million gross receipts ceiling already established in Section 448 of the IRC be used to determine small business eligibility for using the cash method. This would seem an appropriate remedy, as this adheres to Congress' original intent, while expanding protection for those businesses most in need of shelter from arbitrary enforcement.

The Air Conditioning Contractors of America appreciates this opportunity to testify on this issue. Your role in addressing this critical issue, which may very well determine the continued viability of many of ACCA's members, as well as small businesses in other industries, deserves to be recognized. We at ACCA are pleased to do so, and thank you for your zeal in pursuing this miscarriage of justice.

Plumbing-Heating-Cooling Contractors–National Association

Pride In Our Past–Faith In Our Future

Statement of

The Plumbing-Heating-Cooling Contractors – National Association

on

Cash Versus Accrual: The Policy Implications of the Growing Inability of Small Businesses to Use Simple Tax Accounting

Before the

U.S. House of Representatives

Committee on Small Business

April 5, 2000

Introduction

The Plumbing-Heating-Cooling Contractors – National Association commends House Small Business Committee Chairman James Talent for addressing several accounting and tax collection problems confronting today's small businesses, chiefly the Internal Revenue Services' campaign to switch "cash" based taxpayers to the accrual method of accounting and the recent change in the installment method of accounting tax law that has severely restricted a small business' ability to sell the business.

PHCC – National Association, founded in 1883 to address the common concerns of the industry, is the oldest trade organization in the construction industry, and the largest in the plumbing-heating-cooling industry. PHCC's membership is composed of more than 4,000 contracting firms nationwide, including both union and open shop, and performing all types of work from residential and commercial to industrial and institutional. Whether serving as a subcontractor or a general contractor, our members engage in maintenance, remodeling, service and repair, and new construction in the following fields: air-conditioning, backflow prevention, heating (warm air and hydronics), plumbing, process piping, refrigeration, fire sprinklers, sheet metal, and ventilation.

Cash Versus Accrual Accounting Methods

The small business community has, for years, been operating under the belief that current tax law (Internal Revenue Code Section 448) provides an exemption for businesses with less than $5 million in gross receipts to use the cash-based method of accounting without

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exception. In the late 1990's, however, the IRS began interpreting the rule so that contractors were required to switch from the cash-based to the accrual method of accounting, even though many such firms had been on the cash method for decades and had been previously audited, and cleared, by the IRS. The small business community has been rudely awakened to the fact that IRS has its own interpretation of the law which is now forcing many small business owners to change accounting methods.

The two common accounting methods in question are the cash method and the accrual method. The cash method records income and expenses in the year they are actually made and received. If a contractor completes a job this year, but does not get paid until the following year, they would record their income for the year they had the money in their hands. The accrual method requires the owner to record (and pay tax) on income the year the owner has a right to collect that income, regardless of when the money was actually received.

In the end, contractors will generally pay the same amount using either accounting method. The difference is when the tax is paid. Contractors changing from cash to accrual pay more taxes during the year they change over, because they are now paying tax on income from projects that they have not yet collected on as well as on those projects they have collected on. Following the change to accrual accounting, smaller businesses will find it more difficult to manage their cash flow. Their income is taxed although they have not yet been paid. They will be paying taxes without the benefit of possessing the actual money to pay the tax.

IRS has ignored the Congressional intent which meant to provide small businesses a safe harbor of $5 million and they have pressed ahead in auditing small contractors and forcing them onto the accrual method. Such audits are promoted under the pretense that the contractor's cash accounting method does not "accurately reflect income," (IRC section 446(b)) because the contractor maintains an inventory or a certain amount of material has been provided in the services the contractor rendered. In either case, IRS believes the only way to properly track and report income is by using the accrual method.

Definition of Inventory

IRS does not view a business' inventory as a room full of items for sale. Rather, IRS considers the entries on a financial ledger that track the purchase and sale of material as inventory. Even though the furnaces and water heaters our contractors install may go directly from the warehouse to the homeowner and never touch their office or warehouse, in IRS's eyes that contractor still has an inventory. And if this inventory becomes an "income producing factor", then the contractor must use the accrual method of accounting. For other industries, such as veterinary medicine, IRS has not counted certain merchandise as a significant income producing factor if it accounts for less than 12% to 15% of the cost of the job or service. IRS is using a similar threshold when auditing inventory in the construction industry.

PHCC does not agree with the IRS definition or application of inventory. Because of the unique nature of the construction industry, it is quite common for contracting firms to have equipment, parts, and material directly shipped to a construction site. Contractors that manage their work in such an efficient manner should not then be penalized with excessive textbook accounting. Additionally, the current IRS threshold of 12% to 15% of material is too low and defies the

definition of significant. PHCC agrees with the legislative changes proposed in S. 2246, which would raise the merchandise threshold to over 50% before a taxpayer is required to use the accrual method of accounting. PHCC also agrees with the provisions in S. 2246 and H.R. 2273 that permit businesses with less than $5 million in gross receipts to use the cash method of accounting regardless of the circumstances.

PHCC – National Association is willing to furnish anecdotal stories of plumbing-heating-cooling contractors who have undergone audits and were required to switch from the cash method to the accrual method to Committee Members upon request.

Installment Sales Provisions
A second problem that has begun to plague the small business community is the recent repeal of the provision allowing small business owners who use the accrual method to use the installment sales method to report and pay tax on the sale of their business.

Often when a small business is sold, the payments for the business are spread out over several years and are not paid in one lump sum at the time of the sale. There are several reasons for this. Sometimes the new entrepreneur purchasing a business can only finance the sale over a period of time. This is especially true when a business is being passed on from one generation to the next generation in the family in an effort to avoid the destructive effects of the estate tax. Nor is it uncommon for a business owner to use the sale of their business as retirement income, spreading the payments over a decade or two and then simply retiring. Until December 1999, a taxpayer could negotiate a long-term payment plan for the sale of a business and use the "installment sales tax method" to pay tax on only the income as it is received each year.

In December 1999, Public Law 106-170, the Ticket to Work and Work Incentives Improvement Act, contained revenue offsets to pay for its provisions. One such offset was to repeal the installment sales method used in calculating the tax on the sale of a business. Now businesses must pay the full tax on the price of the business as soon as it is sold and ownership transferred, even though the previous owner has not yet received all of the money the business sold for and will not for several years.

Repeal of the installment method has frozen the sale of many small businesses. When faced with the likelihood of paying a large tax without the benefit of having all of the revenue that is being taxed, many small business owners have decided not to sell their business or are not considering sales to buyers who cannot pay the full cost up front.

In testimony before the House Committee on Ways and Means, the Treasury Department stated that their decision to repeal the installment sales provision was approved because it fit with certain accounting theories and because it was revenue offset. The Treasury testified that the installment sales provision was not a corporate loophole nor had the Treasury encountered problems with the administration and collection of taxes on installment sales. Since Treasury had admitted that there was no problem to begin with, PHCC believes that the federal government should not fix what is not broken. If there was no problem to begin with, then Congress should restore the installment method of accounting.

Conclusion
IRS and Treasury's fanatic devotion to textbook accounting practices necessitates Congressional action. A stream of auditing horror stories and numerous appeals to reason have done little to bring about a kinder, gentler IRS as it relates to small business accounting and taxation issues.

PHCC urges the House Small Business Committee, and all of Congress, to support legislation that emphasizes common sense and real-word accounting practices over the ivory-tower auditing standards of IRS and Treasury.