

Preserve the cash method of accounting

Proposed limits promise broad, deep adverse effects | September 2013

A proposal contained in House Ways and Means Committee Chair Dave Camp's (R-MI) small business tax reform discussion draft (*Proposed Tax Reform Act of 2013, Title II — Tax Reform for Businesses*) would limit the cash method of accounting to businesses with gross receipts of less than \$10 million, affecting companies across all geographic boundaries and industries. The dynamic pass-through businesses described below employ millions of people and would be adversely affected by this proposal. Those businesses rely on the cash method because it's simple, it's accurate in measuring actual economic gain, and it's intuitive so it doesn't require specialized personnel to administer it.

| Adverse effect across industries | |
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| <ul style="list-style-type: none">• Trucking• Farmers• Janitorial services• Engineers• Doctors/dentists | <ul style="list-style-type: none">• HR and benefits services• Payroll services• Security services• Factory turnaround businesses• Construction |

Affected industries

Trucking

Trucking businesses vary greatly in size. Some are small, local businesses doing a few million dollars in business per year, while others are larger, doing business well into the hundreds of millions of dollars annually. For the industry as a whole, however, margins are tight, fuel costs are rising, and attracting new generations of truckers is difficult. Forcing a change to the accrual method would result in even tighter margins, lowering the already-modest wages of truckers and increasing freight costs for consumers. Under the accrual method, trucking companies would be forced to recognize income when services are performed rather than when they receive payment — and in some cases, payment isn't received until weeks or months after the services are performed. Furthermore, businesses would have to expend thousands of dollars in computer, legal and accounting fees to convert their systems to an accrual-based method.

Farmers

The farming industry in the U.S. is quite diverse, and the Internal Revenue Code's definition of a "farming business" is broad, encompassing all variety of crop and animal farming. Under current law, farming businesses organized as pass-through entities can utilize the cash method of accounting, which represents a simpler, more accurate method of recordkeeping. For example, some farms' income is dictated by government price schedules, which often lag by one month. For those farms, accurately booking income in the month in which their goods are shipped would be impossible, because the price to be paid is yet to be determined. Small- to medium-sized farming businesses — many of which are family owned — face significant challenges, including unpredictable weather, fluctuating commodity prices, greater competition from large conglomerates that continue to consolidate the industry, and foreign farming companies. If forced to adopt the accrual method, the cost of compliance would cut into these farmers' already-thin profit margins.

Janitorial services

Like many industries, janitorial services are slowly rebounding from the economic downturn during which many businesses and households cut back. As consumers find that they have more disposable income, they're again investing in those services. The industry itself is highly diversified, with more than 800,000 businesses employing more than 1.7 million people. Contract janitorial and custodial services companies are often regional pass-throughs.

Engineers

Thousands of engineering firms in the U.S. concentrate on a variety of specialties, from chemical to civil engineering. These businesses — often organized as pass-throughs — employ hundreds of thousands of people, including land surveyors, architects, lab technicians, scientists and other specialists, and countless administrative staff. They design and help maintain our infrastructure and create new, innovative technologies.

Doctors and dentists

Many doctors and dentists in private practice operate in partnerships and would be affected by a forced accounting method change. Medical and dental care is expensive, and a small practice of two to three providers could easily have gross receipts of \$10 million or more in a single year. That income is offset by payroll, rents, insurance and the cost of purchasing and maintaining high-cost equipment. Under the accrual system, income would have to be recognized at the time of service, but insurance payments would be received much later. Providers might then bill for procedures in advance — placing the burden of up-front payment on patients, who then must seek a refund from their insurer. Worse still, a shift to the accrual method may incentivize some providers to accept only patients whose ability to pay is not in doubt.

Human resources and benefits services

The nearly 250,000 human resources and benefits services providers in the U.S. are locally owned and assist businesses that lack their own internal administrative staffs. A third-party human resources firm works closely with a business's principals to determine their needs and help them comply with labor laws, health insurance rules, occupational safety laws and other regulations governing incoming, current and outgoing employees. Many of these businesses are organized as pass-through entities.

Payroll services

Much like third-party human resources and benefits services providers, payroll services firms assist small businesses with their payroll obligations. In addition to processing paychecks, they properly withhold taxes, remit those taxes to the IRS on time, and issue annual tax forms. Payroll services firms range in size, but many are businesses organized as pass-through entities, with one or several principals owning the business and doing the work, and with minimal support staff.

Security services

A decade of terror threats, mass shootings and increased property crime driven by a down economy has security firm services more in demand. The market for security services is diverse, with more than 39,000 businesses nationwide, many of which are organized as pass-throughs. These businesses offer a range of services, including surveillance, alarm systems, theft deterrent systems, and physically present security guards. Supplying security guards is labor intensive and mandates high insurance costs, which translates to tight margins for smaller security businesses that already face stiff competition from large, integrated security firms.

Factory turnaround businesses

Nearly all manufacturing facilities shut down operations for a brief period during the year. To ensure that manufacturers can efficiently operate during their “up” time, while operations are shut down a “turnaround” services provider inspects, recalibrates and performs general maintenance on machinery and equipment. The work performed by these companies is essential, as billions of dollars of manufactured goods depend on their thorough inspection and maintenance services. Turnaround businesses are typically organized as pass-throughs.

Construction

Construction — public or private — drives the U.S. economy. The industry employs hundreds of thousands of people — millions more when accounting for land surveyors, architects, engineers, demolition crews, plumbers, electricians and other affiliated professionals. Federal, state and local governments will face significant construction costs as infrastructure ages, breaks down and needs to be replaced. Forcing the industry to adopt the accrual method would hinder its comeback after the financial crisis, devastating many construction businesses and restricting economic growth when America can ill afford it.

Automobile financing

The automobile financing industry, which provides loans to individuals and small businesses, has been hit hard in the last few years as credit has been tight, unemployment has stayed high, and demand has dropped. Potential customers are holding on to older vehicles, and debtors have defaulted at higher than historically average rates. Analysts expect the next few years to be better, but while many of these financing operations carry a large corporate name, they are often independently owned small businesses organized as pass-throughs.

Deep impact on local businesses

Many businesses organized as pass-throughs — like partnerships and S corporations — would be adversely impacted by an accounting method change from cash to accrual. These dynamic businesses cut across nearly all U.S. geographies and industries, including transportation, engineering, health care, agriculture, real estate, professional services, repair and maintenance, and finance. Many of these companies are local, small- to medium-sized businesses that are the driving force of economic expansion and job growth. Requiring a shift to the more complicated accrual method would slow growth and create administrative burdens.

Forced adoption of an accounting method that’s complex and counterintuitive to many small business owners would — in year one alone — require them to:

- pay accountants to put the new accounting method in place,
- update and adjust their software systems in order to comply,
- possibly retrain their finance and accounting staff,
- pay tax on the accelerated income generated from an accrual-based system, and
- begin to recognize the “phantom” income necessitated by the change in accounting method.

That’s just in the first year. Phantom income would continue to be recognized for an additional three years, and business growth would trigger additional taxes so long as the taxpayer is required to remain on the accrual method. At first glance, \$10 million in gross receipts may appear to be a considerable amount of money. But gross receipts are not the same as profits. Many businesses have tight operating margins, with low take-home profit after having paid for high operating costs — equipment, leases, payroll and other expenses. Imposing an unnecessary tax burden on those business owners — many of whom would have to make “true-up” payments to come into compliance with an accrual-based method — would likely result, at best, in economic losses and, at worst, layoffs and loss of the business.