Committee on Ways and Means
United States House of Representatives
Tax Reform Working Group on Small Business and Pass-Through Entities

Comments of Kogod Tax Center
American University Kogod School of Business
Washington, District of Columbia

Professor David Kautter
Managing Director, Kogod Tax Center

Professor Donald Williamson
Executive Director, Kogod Tax Center

Working Group Chair Buchanan, Vice Chair Schwartz and Members of the Ways and Means Committee, thank you for the opportunity to submit comments on how to reform the federal tax code with respect to small businesses and pass-through entities.

The Kogod Tax Center is a tax research institute located at American University's Kogod School of Business that promotes balanced, nonpartisan research on tax matters. Our efforts focus principally on tax matters affecting small businesses, entrepreneurs and middle-income taxpayers. We develop and analyze potential solutions to tax-related problems faced by these three groups of taxpayers and promote public dialogue about these and other critical tax issues.

Our comments are focused on two proposals that we believe will substantially simplify the tax rules for small businesses, allow them to more easily comply with their tax reporting and compliance obligations, assure that they are treated fairly with respect to the rate at which their earnings are taxed and, most importantly, allow small businesses to spend more of their time and resources growing their business and adding jobs and less on tax compliance. These two proposals are:

1. A truly simplified cash method of accounting for small business, and

2. A comprehensive, integrated business tax rate structure applicable to all businesses regardless of the legal form in which they choose to conduct business.

First Proposal: Simplified Cash Method of Accounting for Small Business

The importance of small businesses to the United States economy is self evident. Over half of all employed Americans work in small businesses, which account for 98 percent of all U.S. employers. It is estimated that over the past 15 years, almost two out of every three new jobs created in the economy have been created by small businesses.

The National Taxpayer Advocate has found that the single most pressing problem encountered by taxpayers, including small businesses, is the complexity of the Internal Revenue Code. The National Taxpayer Advocate estimates that each year small businesses spend approximately 2.5 billion hours complying with tax filing requirements, the equivalent of 1.25 million full-time jobs. More than 70 percent of all unincorporated businesses (which tend to be small businesses) use paid tax return preparers and spend more than $16 billion for professional advice and compliance assistance from attorneys and accountants. While this complexity has spawned full employment for tax professionals, our economy cannot prosper when small businesses are diverting valuable time and such a substantial portion of their limited resources to unproductive behavior. The tax complexity that small businesses have to endure is an inevitable drag on the economy.

We believe that the simplified cash method of accounting (SCM) proposed below would substantially reduce time-consuming, expensive administrative burdens on both small businesses and the IRS. It would foster an overall economic climate that would unleash significant small business resources to be devoted to more productive, job- creating activities. We also believe that taxing the earnings of small businesses under a single, integrated business tax rate schedule would further simplify the tax law and treat small businesses fairly while facilitating the growth of small businesses.

Background of Simplified Cash Method

As early as 2001, the IRS granted administrative relief from the accrual method of accounting for businesses with less than $1 million of gross receipts. It later expanded that relief to $10 million of gross receipts for taxpayers not barred from using the cash method under the rules of section 448. In 2005, the Bush administration called for additional simplification to permit the cash method of accounting for all small businesses.

In 2007 Treasury released a report discussing the benefits and mechanics of a simplified reporting method for small businesses, and more recently, in 2010, the President's Economic Recovery Advisory Board (the Bowles-Simpson commission) reaffirmed the benefits of the simplified method offered in that report. Those studies concluded that simplifying the reporting of income and expenses on tax returns of small businesses would permit the reallocation of resources to more productive purposes, thereby stimulating job growth.

Current Cash Method of Accounting

While the cash method of accounting is seen by small businesses as simpler than the accrual method or its various hybrids, this does not mean it is simple. Substantial complexity still exists both in determining income and deductible expenses under current law. Our proposal for a simplified cash method of accounting would simplify both elements of computing taxable income, the determination of income and the computation of deductions.

Determination of Income

With respect to income, three judicial doctrines currently render the cash method of accounting unnecessarily complex. Under the doctrine of constructive receipt, a cash basis taxpayer must recognize income even when cash has not been reduced to a taxpayer's physical possession but is merely available to the taxpayer at his discretion. Under the cash equivalent doctrine, the mere receipt of a promise results in recognizable income if the promise is convertible to cash before it matures, in which case the fair market value (that is, cash equivalent) of the obligation is recognized at the time of receipt of the promise. Similarly, under the economic benefit doctrine, a cash basis taxpayer must immediately recognize income on the receipt of property whenever the taxpayer's right to the property is absolute, even if not immediately assignable.

Because these judicial theories require cash basis taxpayers to recognize income and pay tax when they have not received cash, they impose a severe cash flow problem on small businesses which is unnecessary. Most small businesses do not have the resources to defer the receipt of cash. Nor do they have the time or resources to engage in sophisticated tax planning that would manipulate the timing of income. Cash flow is the lifeblood of small businesses. Requiring a small business to divert available cash to the payment of taxes prior to the receipt of cash income is not only a matter of complexity, it is a practice that inhibits the ability of small businesses to grow. While we understand the basis for applying these judicial tax doctrines to small businesses, we believe the benefits obtained by the federal government are minimal since small businesses would most certainly receive the cash shortly after constructive receipt, economic benefit, or a cash equivalent arises. While applying these concepts offer comfort to tax theorists, small businesses must pay next month's bills, and the acceleration of any income under these theories amounts to taxation only a few months before cash is received but at a cost of substantial complexity and, in some cases, economic hardship.

Accounting for Expenses

As challenging as the judicial doctrines for measuring income for small businesses can be, they pale in comparison to the challenges and complexity encountered by small businesses when computing deductible expenses. Generally, the cash method permits a deduction for ordinary and necessary business expenses only when actual payment is made. Thus, a promise to pay is not deductible until the payment is actually made, even though a check delivered or mailed is deductible at the time of delivery or mailing.

Although there can be confusion surrounding when and if a payment has been made, the real difficulty small businesses confront when computing allowable deductions under the current cash method of accounting involves four exceptions to the general rule that a deduction is permitted when payment is made. These are the rules governing (1) prepayments, (2) depreciation, (3) inventory, and (4) capitalization.

Prepayments for property or services are not deductible if the goods or services are provided more than one year after the prepayment. For inventory, the costs of its acquisition or production are deducted only when the inventory to which the costs are matched is sold. Similarly, property with a useful life of more than one year is generally subject to depreciation, requiring its deduction be spread over recovery periods ranging from three to 39 years. Costs exceeding $5,000 associated with creating a new business are not deducted when paid but amortized over 15 years.

These few examples demonstrate that the current cash method of accounting is too often based not on cash receipts and disbursements, but rather on principles that attempt to match costs with income similar to the accrual method. For small businesses that have no government regulators to whom financial statements must be submitted and have no banks or other creditors in need of profit and loss determinations that conform to the rules of generally accepted accounting principles, tax rules based on the accrual method serve no practical purpose when economic success and taxable income can simply be measured on cash receipts and expenditures — that is, cash flow.

Proposed Revision of Cash Method

We believe that small businesses would be better served by a cash method of accounting that more clearly reflects the cash flow of a small business from which taxes could be paid. We propose that the computation of taxable income under the cash method of accounting be reduced to the following formula:

Cash Receipts *Less*: Cash Expenses including expenses for : • Inventory • Prepayments • Materials/Supplies • Depreciable Property
Taxable Income

In short, derivation of taxable income would be based solely on amounts actually received or paid during the tax year. This could be done by simply examining the taxpayer's checkbook for when checks were cut and deposits made. Under this simplified cash method of accounting (SCM), income would consist only of cash, property, or services received during the tax year without regard to imputed income under the constructive receipt, cash equivalence, or economic benefit doctrines. While determining and valuing the receipt of in-kind goods and services would need to continue, small businesses would otherwise be able to arrive at their income by adding up their bank deposits for the year. Any timing advantage to taxpayers from not being subject to the three judicial doctrines mentioned above would be minimal given that small businesses cannot, as a practical matter, defer recognition of cash by more than a few months without creating severe cash flow problems for the payment of their own bills. The complexity of the judicial doctrines does not warrant their application to small businesses.

The SCM offers even greater simplification for the determination of deductible expenses. Under the SCM, all current expenditures, including those for the acquisition or production of inventory, would be deducted when paid. Although a technical violation of the matching principle of accounting, allowing for the immediate deduction of the cost of inventory simplifies small business recordkeeping at relatively little cost to the government. For a small business to stay in business, inventory paid for and deducted in one year likely will be sold no later than the next year to ensure sufficient cash flow for business operations. Also, permitting the expensing of inventory before its sale recognizes the hard fact that IRS audits reveal more than 50 percent of cost of goods sold calculations by small businesses are incorrect under current law. That is not likely to change unless small businesses divert even more valuable but limited resources to the maintenance of better tax books and records. Further, the latest capitalization rules issued by the IRS make the inventory rules look downright modest. The likelihood that small businesses will get these capitalization calculations right without spending substantial resources on professional help is remote at best. With respect to prepayments, small businesses simply do not have the resources to prepay expenses in an effort to manipulate their tax liability.

Permitting the immediate expensing of depreciable property simply continues 100 percent bonus depreciation for property acquired in 2011 and expands on the section 179 expense allowance rules currently available for small businesses.

While we understand that a dollar limitation on how much depreciable property or how much inventory can be expensed in a single year may be necessary, from a simplification point of view limitations tend to add complexity. For one thing, they result in taxpayers maintaining two sets of calculations, one for expenses below the threshold and one for expenses above. For another, taxpayers may end up spend time and effort focused on managing the timing of purchases from year to year to stay below the threshold. Neither of these types of behavior does anything to create jobs or grow businesses.

The following chart contrasts the current cash method and the SCM proposal for the treatment of some common business expenditures.

Type of Expenses	Current Cash Method	Simplified Cash Method
Prepayment of expenses	Deductible when paid if prepayment does not exceed one year	Deductible when payment is made
Prepayment of interest	Deductible over period it covers	Deductible when payment is made
Inventory	Capitalized	Deductible when payment is made
Business start-up expenses	Deductible up to $5,000	Deductible when payment is made
Section 179, bonus depreciation, research and development expenditures	Immediately deductible	Deductible when payment is made
Bonus depreciation	Immediately deductible (only 2011)	Deductible when payment is made unless either (1) aggregate cost of depreciable assets exceeds certain dollar threshold or (2) asset is a "long-lived asset"
Materials, supplies, and improvements	Capitalized or deducted	Deductible when paid
Expenditures related to tax-exempt income	Nondeductible	Same as current law
Expenditures contrary to public policy	Bribes, kickbacks, fines, and penalties are nondeductible	Same as current law
Political contributions and lobby expenses	Nondeductible if lobbying or political campaigning is an integral part of the business	Same as current law

Eligibility for Simplified Cash Method

We believe that the appropriate level for allowing businesses to use the SCM is $10 million. At that level, over 99% of all small businesses would be eligible to use this new method of accounting.

Conclusion

Because most businesses would qualify for the SCM and its reduced tax compliance burdens, small businesses would be able to better maintain their own accounting records and prepare their own returns. This would reduce the need for costly tax professionals and free up more resources that could be put to work in adding jobs and growing business. We believe that the SCM would offer better compliance at lower cost both to taxpayers and the government, with little or no loss of tax revenue.

Second Proposal: Apply a Single Business Tax Rate Schedule to All Businesses Regardless Of Their Legal Form

The Potential Impact of Corporate Tax Reform

Many of the proposals for corporate tax reform rely on eliminating some business deductions, preferences, and credits to increase the amount of income subject to tax, i.e. broaden the tax base, and then apply a lower corporate tax rate to that broader income base. In some of the proposals, the base-broadening changes that would be made would apply to all businesses, including non-incorporated businesses, and the rate reductions would be made only in the corporate rate.

If corporate tax reform moves forward in this way, small businesses will end up with an increased tax burden when many are already struggling to stay afloat. This seems to make little sense if we are interested in enhancing the competitiveness of our economy.

We believe that the country would be better served if “corporate tax reform” is approached as “business tax reform”. As part of the process of broadening the tax base and lowering the corporate tax rate, we believe the time has come for Congress to consider a single tax rate schedule for all businesses no matter what legal form they use to conduct business. Given the importance of small businesses to our economy, it seems to make little sense that income earned by unincorporated businesses are subject to tax at the higher individual rates while income earned by corporations are taxed at lower corporate rates. This is especially the case since the calculation of “taxable income” for both types of taxpayers, i.e. the determination of income and the determination of which business deductions are allowable, are virtually identical. While it is true that corporate earnings are subject to tax both at the corporate level and the shareholder level (when distributed) and earnings of unincorporated businesses are taxed only once, there are well documented approaches that can be used to effectively resolve this matter. We do not believe that the rate at which earnings from these two types of businesses are taxed should play any role in trying to reconcile the two levels of corporate tax with the single level of tax on unincorporated businesses.

A single integrated business tax rate schedule could use graduated tax rates which are phased out as income rises similar to the current corporate tax rate schedule. This would be relatively simple to administer. Income from flowthroughs already appears on separate schedules on individual tax returns. Income from sole proprietorships is reported on Schedule C and income from both partnerships and S corporations is reported on Schedule E of the individual tax return (Form 1040). All that would be required would be for a taxpayer who is an owner of a flowthrough entity to add his or her income on those two schedules (C and E) together and subject the total to the ‘‘business tax rate schedule”. This would be no different in practice than how individuals who have qualifying dividend income and capital gains on schedules B and D compute their taxes today.

In short, we believe that what is needed is “business tax reform” not simply corporate tax reform. As part of the process of business tax reform, we would urge the Working Group and the Ways & Means Committee to consider a single tax rate schedule applicable to all business earnings regardless of the legal form of the business that produced the earnings. Such an approach would move us toward a more comprehensive system of business taxation—one that applies to all businesses equally across the board. If done right, it could ease compliance while increasing simplicity and fairness. And ultimately, that could provide small businesses with the relief they need in order to compete and thrive.

*   *   *

Thank you for allowing Kogod Tax Center to submit these comments for review by the Tax Reform Working Group on Small Business and Pass-Through Entities. We would be pleased to speak with any member of the Working Group, the full Committee, or staff to address questions you may have about our comments. We can be reached at:

Kogod Tax Center
4545 42nd Street NW, Suite 105
Washington, DC 20016

[redacted]