AMERICAN UNIVERSITY
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March 22, 2012

Committee on Ways and Means
U.S House of Representatives
Hearing on Treatment of Closely – Held Businesses in the Context of Tax Reform

Good Afternoon:
I am submitting a testimony in support of your efforts to reform the tax code for closely held businesses. To more efficiently administer the tax law and reduce the overall burden and cost of complying with the law, I propose a simplification of the cash method of accounting already generally used by most small businesses. The simplification calls for the recognition of income and deductions only when cash is received or expenses are actually paid. I believe the simplification will not reduce revenue to the government and will increase the level of compliance from small businesses and entrepreneurs.

Please do not hesitate to contact me if you have any questions.

Your consideration of my testimony is greatly appreciated.

Sincerely,
David J. Kautter

Enclosure: Testimony

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Statement for the record of
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American University Kogod School of Business
Washington, District of Columbia

Committee on Ways and Means
U.S. House of Representatives

Hearing on
Treatment of Closely-Held Businesses in the Context of Tax Reform
March 13, 2012

Chairman Camp, Ranking Member Levin and Members of the Committee, thank you for the opportunity to submit written comments on tax reform pertaining to the treatment of small businesses.

I have been a tax professional for over 35 years. For most of that time, I advised clients on tax matters as a partner with a Big Four accounting firm. I also served as tax counsel to former Senate Finance Committee member John Danforth, and I have remained closely involved in the tax policy process over the entire course of my career.

I am writing to you today to support your efforts to reform the tax code for closely held businesses in the hopes of growing and creating jobs. Reducing the complexity of the current

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tax law pertaining to small businesses would allow small business owners to spend more time creating jobs and less time filling out forms. As the United States continues to struggle with a persistently high unemployment rate, the need for small businesses to create new jobs is self-evident.

According to the Small Business Administration, over half of all employed Americans work for small businesses which account for 98 percent of all U.S. employers. Additionally, small businesses account for nearly 45 percent of the total private sector payroll. In 2010, small businesses accounted for 75 percent of all new jobs created in America.[1] Small businesses are a critical source of economic growth and new jobs which is why U.S. tax policies must encourage these businesses to reinvest their profits in a manner that will foster job growth.

One may question whether tax reform can create jobs, but it cannot be denied that the time and resources consumed by tax compliance foster neither economic growth in the small business community nor efficient tax administration. In fact, the Taxpayer Advocate has labeled the complexity of the Internal Revenue Code the 'most serious problem' taxpayers, including small businesses, encounter. Despite continual calls for simplification, there have been no fewer than 4,428 amendments to the Code over the last 10 years. The Taxpayer Advocate estimates that each year small businesses spend approximately 2.5 billion hours complying with tax filing requirements, the equivalent of 1,250,000 full-time jobs. In addition, over 70 percent

[1]Small Business Administration, "The Role of Small Business in Economic Development of the United States: From the End of the Korean War to the Present," 2010, at p. 6.

of all unincorporated businesses use paid tax preparers and spend over $16 billion for professional advice and compliance assistance from attorneys and accountants.[2] While this complexity has spawned full employment for tax professionals, our economy cannot prosper when businesses, especially small businesses, are diverting valuable time and resources to unproductive behavior that is an inevitable drag on the economy.

Any reform that reduces the time and cost of complying with tax filings will enable small businesses to use their resources in more productive ways. In addition, making tax compliance more understandable will serve to change the public's perception that the Code is unfair and replete with "loopholes" only understood by sophisticated tax professionals. In short, we believe that simplifying the tax code will increase taxpayer compliance, ease the burden of tax administration, raise government revenue and ultimately reduce the tax gap.

Our view is that one of the most effective ways to reduce the current tax compliance burden on small business is to dramatically simplify the manner in which they compute their income subject to tax. The rules governing the computation of taxable income are not only unduly complex, they are unnecessarily burdensome. Put simply, we propose an alternative method for small businesses to maintain their tax books and records and compute their taxable income: The Simplified Cash Method of Accounting ("SCM"). The SCM would enable small businesses to focus their efforts on growth rather than filling out tax forms. It would also

[2] See, Taxpayer Advocates Service 2010 Annual Report to Congress - Volume -1, pp. 3-5.

reduce time consuming and expensive administrative burdens upon the IRS and foster an overall economic climate that would unleash resources that can be devoted to more productive, job creating activities.

Under the "simplified cash method" of accounting ("SCM") computation of taxable income would be reduced to the following formula:

Cash Receipts

Less: Cash Expenses including:

- 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 by means of examining the taxpayer's checkbook for when checks were written and deposits made.

With respect to gross income, under SCM gross income would consist only of cash, property or services received during the taxable year without regard to imputed income under the constructive receipt, cash equivalence or economic benefit doctrines Although determining and valuing the receipt of in-kind goods and services will continue to be an issue, small

businesses will otherwise be able to calculate income by adding up their bank deposits for the year. Any timing advantage afforded to taxpayers from not being subject to the judicial doctrines mentioned above will 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 with regard to the payment of their own bills. The complexity of the judicial doctrines mentioned above does not warrant their application to small businesses.

With respect to tax expenses, there are four areas that create most of the complexity for small businesses: Inventory, prepayments, material/supplies, and depreciable property. We would propose that all expenditures for inventory, prepayments, materials/supplies and depreciable property be deductible when paid. All current expenditures, including those for the acquisition and/or construction of inventory, would be deducted when paid. While a technical violation of the matching principle of accounting, allowing for the immediate deduction of the cost of inventory simplifies a 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 will likely be sold no later than the next year to ensure sufficient cash flow for the business to continue in operation. The same holds true for prepayments. The vast majority of small businesses do not have the financial wherewithal to prepay expenses at all, let alone make substantial prepayments.

Permitting the immediate expensing of depreciable property simply continues 100% bonus depreciation for property acquired in 2011 and expands upon the §179 expense allowance currently available for small businesses. It may be appropriate to put some sort of

limitation on the ability of small businesses to immediately deduct otherwise depreciable property, such as certain very long lived property. But, as a general principle, we would advocate allowing small businesses to immediately deduct amounts they spend for otherwise depreciable property. Finally, exempting small businesses from the extensive proposed rules relating to whether an expense should be capitalized or deducted naturally follows if small businesses are allowed to immediately expense depreciable property. As discussed below, thresholds or limitations should be established to limit SCM to only small businesses similar to those currently described in §448 or §179.

Thresholds or limitations should be established to limit SCM to only small businesses similar to those currently described in §448 or §179. Under current law, only sole proprietorships, S corporations, qualified personal service corporations, C corporations with gross receipts of not more than $5 million and partnerships with no partner being a C corporation with gross receipts over $5 million may currently use the cash method. We would propose applying these same limitations for the SCM. If these limitations were used, approximately 99 percent of all business taxpayers accounting for over 12 percent of all business gross receipts will qualify for the proposed SCM accounting method. Alternatively, if the gross receipt dollar limits for SCM's adoption were set at $5,000,000 or $10,000,000 for all taxpayers almost the same 99 percent level of qualification would be reached. The small decrease (.4 %) would be primarily attributable to sole proprietorships, S corporations and qualified personal service corporations whose gross receipts exceed the $5,000,000 or $10,000,000 threshold. Regardless of whether a $5,000,000 or $10,000,000 gross receipt

dollar limitation is utilized, the percentage of business gross receipts subject to SCM would increase to around 16 percent.

Because most businesses will qualify for SCM and its reduced tax compliance burdens, taxpayers will be more able to maintain their own accounting records and prepare their own returns reducing the need for costly tax professionals who currently prepare over 70 percent of all business returns. Such a reduction in the reliance on tax accountants and lawyers will foster a better appreciation by average Americans that the tax law is not benefitting only special interests but is, in fact, attempting to measure each taxpayer's true economic income. In short, SCM will offer better compliance at lower cost to both taxpayers and the government with minimal, if any, loss of tax revenue.

Background on the Kogod Tax Center

The Kogod Tax Center is a tax research institute located at American University's Kogod School of Business. The Center promotes balanced, nonpartisan research on tax law, the challenges of tax compliance and planning, and the implications of tax reform.

Our efforts focus principally on tax issues affecting small businesses, entrepreneurs, and middle-income taxpayers. We develop and analyze potential solutions to selected tax-related

problems faced by these three sectors of the economy promote public dialogue to inform taxpayers, policymakers, academics, the press, and tax practitioners about critical tax issues.

We appreciate your taking our concerns on behalf of small businesses into account. Please do not hesitate to contact me if you have any questions.

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