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January 13, 2014

The Honorable Dave Camp  
Chairman  
Committee on Ways and Means  
U.S. House of Representatives  
Washington, D.C. 20515

The Honorable Sander M. Levin  
Ranking Member  
Committee on Ways and Means  
U.S. House of Representatives  
Washington, D.C. 20515

Re: Provisions in the Discussion Draft “Tax Reform Act of 2013” Requiring Law Firms and Other Personal Service Businesses to Pay Taxes Using the Accrual Method of Accounting

Gentlemen:

On behalf of the American Bar Association (“ABA”), which has almost 400,000 members, I write to express our concerns regarding provisions in Section 212 of the Committee’s discussion draft “Tax Reform Act of 2013” that would require all law firms and other personal service businesses with annual gross receipts over \$10 million to use the accrual method of accounting (“accrual method”) rather than the traditional cash receipts and disbursement method of accounting (“cash method”).

Although we commend you for your efforts to craft legislation aimed at simplifying the tax laws—an objective that the ABA and its Section of Taxation have long supported—we are concerned that Section 212 would have the opposite effect and cause other negative unintended consequences. This far-reaching provision would create unnecessary complexity in the tax law by disallowing the use of the cash method; increase compliance costs and corresponding risk of manipulation; and cause substantial hardship to many law firms and other personal service businesses by requiring them to pay tax on income they have not yet received and may never receive. Therefore, we urge you and your Committee to remove this provision from the overall draft legislation.

Under current law, businesses are permitted to use the simple, straightforward cash method of accounting—in which income is not recognized until cash or other payment is actually received and expenses are not taken into account until they are actually paid—if they are individuals or pass-through entities (e.g., partnerships or subchapter S corporations), or their average annual gross receipts for a three year period are \$5 million or less. In addition, all personal service businesses—including those engaged in the fields of law, accounting, engineering, architecture, health, actuarial science, performing arts, or consulting—whether organized as sole proprietorships, partnerships, limited liability companies, or S corporations, are exempt from the revenue cap and can use the cash method of accounting irrespective of their annual revenues, unless they have inventory.

Section 212 of the draft legislation would dramatically change current law by raising the gross receipts cap to \$10 million while eliminating the existing exemption for personal service businesses, other partnerships and S corporations, and farmers. Therefore, if this proposal is enacted into law,

all law firms and other personal service businesses with annual gross receipts over \$10 million would be required to use the accrual method of accounting, in which income is recognized when the right to receive the income is present and expenses are recorded when they are fixed, determinable and economically performed, both aspects of which present complications.

Although Section 212 would allow certain small business taxpayers with annual gross receipts in the \$5 million to \$10 million range to switch to—and thereby enjoy the benefits of—the cash method of accounting (a concept that the ABA does not oppose), the proposal would significantly complicate tax compliance for a far greater number of small business taxpayers, including many law firms and other personal service businesses, by forcing them to use the accrual method.

Partnerships, S corporations, personal service corporations and other pass-through entities favor the cash method because it is simple and generally correlates with the manner in which these business owners operate their businesses—i.e, on a cash basis. Simplicity is important from a compliance perspective because it enables taxpayers to better understand the tax consequences of transactions in which they engage or plan to engage. In this regard, simplicity helps to mitigate compliance costs—which already are significant—and to improve compliance with the Code. The increased complexity associated with the accrual method will raise compliance costs for many law firms and other personal service businesses—as separate sets of records will be needed to reflect the accrual accounting—while greatly increasing the risk of noncompliance with the Code.

In addition to creating unnecessary complexity and compliance costs, Section 212 would lead to economic distortions that would adversely affect all personal service businesses that currently use the cash method of accounting and those who retain them, including many law firms and their clients, in several ways.

First, the proposal would place a new financial burden on millions of personal service businesses throughout the country—including many law firms—by requiring them to pay tax on income not yet received and which may never be received. As a result, the proposal would create significant economic distortions in terms of how many personal service businesses are organized and operate.

For example, most law firms are organized as partnerships owned by lawyers who have elected to join together in practice. In many firms, particularly larger firms, the partners change from year to year as older lawyers retire, younger lawyers are promoted, and other lawyers migrate to or from other firms. As an economic matter, firms that operate on the cash method are able to ensure that the partners who were present in the firm and performing legal services are taxed on the income actually received that year. However, if such firms were forced to switch to the accrual method, then partners will be taxed on income that their firms accrue on paper in the current year even though the partners may not be around when the clients pay their bills (if the bills are ever paid). For new partners and retiring partners alike, the economics will be changed dramatically.

The existing cash method of accounting produces a sound and fair result because it properly recognizes that the cash a business actually receives in return for the services it provides—not the business' accounts receivable—is the proper reflection of its true income and its ability to pay taxes on that income. While accounts receivable clearly are important to determining the financial

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condition of a business and assessing its future prospects, they do not accurately reflect its current spendable income or its present ability to pay taxes on that income.

Second, for professional service providers that practice in regulated professions, such as lawyers, the proposal would impose greater financial hardships on their firms than may be felt by other types of small and medium sized businesses because many of these professionals are subject to special rules that significantly limit their ability to raise capital. For example, lawyers must comply with state court ethics rules that generally prohibit them from forming a law firm partnership with a nonlawyer or allowing a nonlawyer to own any interest in the law firm. As a result, many law firms must be capitalized solely by the individual lawyers who together own those firms and they are unable to raise equity capital from outside nonlawyer investors. Therefore, forcing these law firms to pay tax on income that has not yet been received and that may never be received could place a major strain on lawyers' ability to properly capitalize and operate their firms.

Third, the proposal would discourage individual professional service providers from joining with other providers to create or expand a firm, even if it made economic sense and would benefit their clients, because it could trigger the accrual accounting requirement in the bill. For example, solo practitioner lawyers would be discouraged from entering into law firm partnerships—and many existing law firms would be discouraged from growing or expanding—because once a firm exceeds \$10 million in annual gross receipts, it would be required to switch from cash to accrual accounting, thereby accelerating its tax payments. Sound tax policy should encourage—not discourage—the growth of small businesses, including those providing personal services such as law firms, especially in today's difficult economic environment.

In sum, the mandatory accrual accounting provisions in Section 212 of the draft bill would create unnecessary complexity in the tax law, increased compliance costs, and significant new financial burdens and hardships for many law firms and other personal service businesses throughout the country by requiring them to pay tax on income not yet received and that may never be received. To avoid these harmful unintended consequences, the ABA urges you and the Committee to remove Section 212 from the draft bill or from any tax reform bill that may be approved by the Committee.

Thank you for considering the ABA's views on this important issue. If you have any questions regarding our position, please contact ABA Governmental Affairs Director Thomas Susman at (202) 662-1765 or Associate Governmental Affairs Director Larson Frisby at (202) 662-1098.

Sincerely,

A handwritten signature in cursive script that reads "James R. Silkenat". The signature is written in dark ink and is positioned above the typed name and title.

James R. Silkenat  
President, American Bar Association

cc: Members of the House Ways and Means Committee