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

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

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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.

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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.

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

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).

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).
do not establish a “safe harbor,” but nevertheless suggest that de minimis inventory purchases do not necessarily make merchandise an income-producing factor.  

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. 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.  

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.

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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).
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 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


\(^{12}\) 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).


\(^{17}\) *Osteopathic Medical Oncology & Hematology, P.C. v. Commissioner*, 113 T.C. No. 26 (1999).
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.\(^\text{18}\)

**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.

**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

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.
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.\textsuperscript{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.

\textit{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.

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

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\(^{20}\) 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).
• 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.

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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.