RESOLVED, that the American Bar Association opposes Section 212 of the House Ways and Means Committee’s “Tax Reform Act of 2013” discussion draft bill, and any other similar proposed legislation, regulations, or other governmental measures, which would require law firms and other personal service businesses that now compute taxable income on the cash receipts and disbursements method of accounting to convert to the accrual method of accounting.
REPORT

I. INTRODUCTION

In March 2013, Rep. Dave Camp (R-MI), Chairman of the House Ways and Means Committee, released a draft small business tax reform bill as part of the Committee’s broader effort on comprehensive tax reform and simplification. Among other things, Section 212 of the draft bill would require all partnerships, S corporations, personal service corporations and other pass-through entities with annual gross receipts over $10 million to use the accrual method of accounting rather than the traditional cash receipts and disbursements method of accounting. This change would sacrifice simplicity by disallowing the use of the cash method while increasing compliance costs and corresponding risks of manipulation. Moreover, it would be inequitable and cause substantial hardship to personal service businesses—including many law firms, accounting firms, architectural and engineering firms, and many other small businesses—by requiring them to pay tax on income that they have not yet received and may never receive. While the timing is uncertain, Chairman Camp is expected to formally introduce a comprehensive tax reform bill as early as mid- to late November of this year. Once the bill is introduced, it could start to move quickly as part of a revenue-raising tax reform package that is linked to larger budget and debt discussions. To ensure that the concerns set forth in this report are adequately considered during the legislative process, the ABA should adopt the proposed resolution as soon as possible so that the ABA can express its opposition to the bill in a timely manner.

II. SECTION 212 WOULD CREATE UNNECESSARY COMPLEXITY IN THE TAX LAW AND INCREASED COMPLIANCE COSTS FOR PERSONAL SERVICE BUSINESSES

Under current law, businesses are permitted to use the simple, straightforward cash receipts and disbursement 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 natural persons (i.e., individuals) or the entity’s 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 partnerships, limited liability companies, or subchapter S corporations, and farmers are exempt from the revenue cap and can use the cash method of accounting irrespective of their annual revenues, unless they have inventory.

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2 Certain aspects of this proposal are based on H.R. 947, which was introduced on March 5, 2013, by Representatives Aaron Schock (R-IL) and Mike Thompson (D-CA).
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 provision 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 exists and expenses are recorded when they are fixed, determinable and economically performed.

Although Section 212, if adopted, would allow certain small business taxpayers who have annual gross receipts in the $5 million to $10 million range to switch to, and thereby enjoy the benefits of, a cash method of accounting (a concept that the American Bar Association does not oppose), the proposal as written 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 onto 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—on a cash basis. From a compliance perspective, simplicity is important 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 in mitigating compliance costs—which already are significant—and in improving compliance with the Code. Conversely, the accrual method is complicated. The increased complexity inevitably will increase the costs of compliance for these businesses as separate sets of records will be needed to reflect the accrual accounting. Inherent in the increased complexity is the increased risk of instances where there is non-compliance with the Code. The proposal also could foster complicated and economically inefficient tax planning. Many partnerships and S corporations, at base, are designed to allow multiple owners to achieve the same flow-through of taxes as sole proprietors. Therefore, by disallowing the cash method, the ability to achieve this outcome would effectively be eliminated.

III. SECTION 212 IS INEQUITABLE AND WOULD ADVERSELY AFFECT ALL PERSONAL SERVICE BUSINESSES AND THOSE WHO RETAIN THEM, INCLUDING MANY LAW FIRMS AND THEIR CLIENTS

If enacted into law, Section 212 would be inequitable and would adversely affect all personal service businesses that currently use the cash method of accounting, including many law firms and their clients, in several different 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, Section 212, if enacted, would create significant economic distortions on 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 in the firm 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 services during a particular year are taxed on the income actually received that year. If, however, such firms were required to switch to the accrual method, then partners in one year will be taxed on income even though they 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 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 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, like 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 requirements that generally prohibit them from forming a law firm partnership with a non-lawyer or allowing a non-lawyer to own any interest in a law firm partnership. 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 non-lawyer investors. Therefore, forcing these law firms to pay tax on income that has not yet been received and which may never be received could place a major strain on lawyers’ ability to properly capitalize and operate their firms.

Third, the legislation 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.

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3 Rule 5.4(b) of the ABA Model Rule of Professional Conduct (“ABA Model Rules”) provides that “a lawyer shall not form a partnership with a nonlawyer if any of the activities of the partnership consist of the practice of law.” See also Charts Comparing Individual Professional Conduct Rules as Adopted or Proposed by States to ABA Model Rules, available at [http://www.americanbar.org/groups/professional_responsibility/policy.html](http://www.americanbar.org/groups/professional_responsibility/policy.html).

4 ABA Model Rule 5.4(d)(1) provides that “a lawyer shall not practice with or in the form of a professional corporation or association authorized to practice law for a profit, if…a nonlawyer owns any interest therein, except that a fiduciary representative of the estate of a lawyer may hold the stock or interest of the lawyer for a reasonable time during administration.” Similarly, in many states, accounting firms may not have any passive (i.e., investor) ownership and a majority of the owners must hold active CPA licenses.
IV. SECTION 212 IS CONTRARY TO LONGSTANDING ABA POLICIES

Over the past forty years, the ABA has been a staunch supporter of simplicity in the tax system. For example, in 1976, and again in 1985, the House of Delegates adopted policies advocating tax simplification through the adoption of a comprehensive and stable income tax base and accompanying rate reductions. More recently, in 2008, the ABA Section of Taxation released a statement of policy favoring tax simplicity, stability and transparency. As explained above, Section 212 of the draft legislation would create unnecessary complexity—not simplicity—in the Federal Tax Code, and therefore runs contrary to these longstanding ABA policies.

It should also be noted that the general premise of Section 212 and the substance of the proposal is not a new one. In 1985, the Reagan Administration proposed a comprehensive tax reform plan that, like the current House Ways and Means Committee draft bill, would have made the accrual method of accounting mandatory for law firms and other personal service businesses with annual gross receipts above a certain threshold. The ABA House of Delegates subsequently adopted policy in July 1985 expressly opposing the Reagan Administration’s proposal. In particular, ABA Resolution 300, which was sponsored by the ABA Section of Taxation and adopted unanimously by the House of Delegates, urged Congress to “…reject the Administration’s proposal to require many personal service businesses, which now compute taxable income on the cash basis, to convert to the accrual basis.” After the Association adopted that resolution, the President of the ABA then sent a letter to the Chairman of the House Ways and Means Committee urging him to oppose the Administration’s proposal, and that provision was ultimately omitted from the final tax reform bill approved by the Committee.

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6 See ABA Section of Taxation’s Statement of Policy Favoring Tax Simplicity, Stability, and Transparency, at http://www.americanbar.org/content/dam/aba/migrated/tax/nosearch/councilagenda/2008/08fall/1 6 1_1.authcheck dam.pdf.

7 President Reagan’s proposal would have required all personal service businesses with annual gross receipts of $5 million or more to use the accrual method of accounting, while the current House Ways and Means Committee draft bill would make the accrual method mandatory for all such businesses with annual gross receipts over $10 million. However, because $5 million in 1985 would have the same buying power as approximately $10.8 million in 2013 when adjusted for inflation, the two proposals were virtually identical in effect. See Bureau of Labor Statistics’ CPI Calculator, at http://data.bls.gov/cgi-bin/cpicalc.pl?cost1=5%2C000%2C000.&year1=1985&year2=2013.


Although the ABA’s 1985 policy is still relevant and would have been applicable to Section 212 of the House Ways and Means Committee draft bill, the ABA policy was automatically archived in August 1999. Therefore, pursuant to the ABA’s archiving policy, the 1985 resolution is “no longer considered to be current policy of the American Bar Association and shall not be expressed as such.”\textsuperscript{11} Although removing the policy from the archives and reactivating it was an option, it was decided that the best course was to request that the Board adopt a new updated policy.

V. CONCLUSION

The mandatory accrual accounting provisions contained in Section 212 of the House Ways and Means Committee’s discussion draft bill would create unnecessary complexity in the tax law, increased compliance costs, and significant new financial burdens and hardships on many law firms and other personal service businesses throughout the country by requiring them to pay tax on income not yet received and which may never be received. Although the ABA successfully spoke out against—and helped to defeat—a similar proposal back in the mid-1980s, the ABA must update its policy so that it can effectively weigh in on the current legislation. Because the legislation could start to advance as early as this fall, the Board should promptly adopt this new resolution opposing Section 212 and any other similar proposed legislation, regulations, or other governmental measures which would require law firms and other personal service businesses that now compute taxable income on the cash receipts and disbursements method to convert to the accrual method of accounting.

Respectfully submitted,

Dixie L. Johnson
Chair, ABA Section of Business Law
October 2013

\textsuperscript{11} See ABA Resolution 400 on archiving, item 29, adopted by the House of Delegates in August 1999, available at 
1. **Summary of Resolution(s).**

The Resolution expresses the Association’s opposition to Section 212 of the House Ways and Means Committee’s “Tax Reform Act of 2013” discussion draft bill, which would require all law firms and other partnerships, S corporations, personal service corporations and other pass-through entities with annual gross receipts over $10 million to use the accrual method of accounting rather than the traditional cash receipts and disbursements method of accounting. This change would sacrifice simplicity by disallowing the use of the cash method; increase compliance costs and corresponding risks of manipulation; and cause substantial hardship to many law firms and other personal service businesses by requiring them to pay tax on income that they have not yet received and may never receive. The Resolution also expresses the ABA’s opposition to other similar proposed legislation, regulations, or other governmental measures, which would require law firms and other personal service businesses that now compute taxable income on the cash receipts and disbursements method of accounting to convert to the accrual method of accounting.

2. **Approval by Submitting Entity.**

The Resolution was approved by the ABA Section of Business Law Council on October 28, 2013.

3. **Has this or a similar resolution been submitted to the House or Board previously?**

Yes. See response to Question 4 below.

4. **What existing Association policies are relevant to this Resolution and how would they be affected by its adoption?**

The Resolution is very similar to previous ABA Resolution 300, adopted by the House of Delegates in July 1985 and then archived in August 1999, which urged Congress to reject a proposal by the Reagan Administration “…to require many personal service businesses, which now compute taxable income on the cash basis, to convert to the accrual basis.” Unfortunately, the ABA is unable to speak out against Section 212 of the current draft bill based on its 1985 resolution because the ABA’s archiving policy provides that archived resolutions are “no longer considered to be current policy of the American Bar Association and shall not be expressed as such.” Although removing the policy from the archives and reactivating it was an option, it was decided that the best course was to request that the Board adopt a new updated policy.
5. **What urgency exists which requires action at this meeting of the Board?**

House Ways and Means Committee Chairman Dave Camp (R-MI) released his discussion draft small business tax reform bill in March 2013 as part of the Committee’s broader effort on comprehensive tax reform and simplification. While the exact timing for future action on the legislation is uncertain, Chairman Camp is expected to formally introduce a comprehensive tax reform bill containing language similar to Section 212 as early as mid- to late November of this year. Once the new bill is introduced, it could start to move quickly as part of a revenue-raising tax reform package that is linked to larger budget and debt discussions. Therefore, it is important that the Board adopt the proposed Resolution at its next meeting on November 14-15 so that the ABA will be able to express its concerns regarding Section 212 (or other similar provisions in the new revised bill) while the legislation is still pending in the House Ways and Means Committee. If the ABA must wait until the next meeting of the House of Delegates in February 2014, the bill may be further along in the legislative process. In that event, it could be more difficult or impossible for the ABA to fully participate in this important policy debate in the House of Representatives and perhaps in the Senate as well.

6. **Status of Legislation.** (If applicable)

See response to Question 5 above.

7. **Brief explanation regarding plans for implementation of the policy, if adopted by the Board.**

The ABA Governmental Affairs Office (GAO) would work closely with an informal ABA working group consisting of representatives of the Business Law and Taxation Sections, the Solo, Small Firm and General Practice Division and the Law Practice Division, and other interested ABA sections and divisions to prepare ABA policy letters to Congress expressing the ABA’s opposition to Section 212. GAO and various ABA working group members will also meet with key congressional staff to explain the ABA’s concerns over Section 212 in an effort to remove it from the final legislation. In addition, the ABA will continue to work with the American Institute of Certified Public Accountants (AICPA), which has already expressed strong opposition to Section 212, and will also reach out to state and local bars, law firms, and other potentially like-minded associations and stakeholders in a coordinated effort to oppose and defeat the legislation.

8. **Cost to the Association.** (Both direct and indirect costs)

None.

9. **Disclosure of Interest.** (If applicable)

Not applicable.
10. **Referrals.**

The proposed Resolution and Report has been sent to the Chairs and staff liaisons of each ABA Section, Division, Task Force, Standing and Special Committee, and Commission.

11. **Contact Name and Address Information.** (Prior to the meeting. Please include name, address, telephone number and e-mail address)

   Michael J. Scanlon  
   Gibson Dunn & Crutcher LLP  
   1050 Connecticut Avenue, NW, Suite 300  
   Washington, DC 20036  
   (202) 887-3668  
   mscanlon@gibsondunn.com

   R. Larson Frisby  
   Associate Director, Governmental Affairs Office  
   American Bar Association  
   1050 Connecticut Avenue, N.W., Suite 400  
   Washington, D.C. 20036  
   (202) 662-1098  
   larson.frisby@americanbar.org

12. **Contact Name and Address Information.** (Who will present the report to the Board? Please include name, address, telephone number, cell phone number and e-mail address.)

   Barbara Mendel Mayden  
   Young Mayden LLC  
   4414 Herbert Place, Suite 1000  
   Nashville, TN 37215-4544  
   (615) 823-7338  
   bmayden@youngmayden.com
EXECUTIVE SUMMARY

1. Summary of the Resolution

The Resolution expresses the Association’s opposition to Section 212 of the House Ways and Means Committee’s “Tax Reform Act of 2013” discussion draft bill, which would require all law firms and other partnerships, S corporations, personal service corporations and other pass-through entities with annual gross receipts over $10 million to use the accrual method of accounting rather than the traditional cash receipts and disbursements method of accounting. This change would sacrifice simplicity by disallowing the use of the cash method; increase compliance costs and corresponding risks of manipulation; and cause substantial hardship to many law firms and other personal service businesses by requiring them to pay tax on income that they have not yet received and may never receive. The Resolution also expresses the ABA’s opposition to other similar proposed legislation, regulations, or other governmental measures, which would require law firms and other personal service businesses that now compute taxable income on the cash receipts and disbursements method of accounting to convert to the accrual method of accounting.

2. Summary of the Issue that the Resolution Addresses

The Resolution addresses the issue of whether the ABA should continue to oppose legislation that would fundamentally change the manner in which law firms and other personal service businesses are taxed under federal law. In particular, the Resolution addresses the question of whether the ABA should adopt an updated version of its previous policy (ABA Resolution 300, adopted in 1985 and archived in 1999) opposing legislation that would require many law firms and other personal service businesses to use the accrual (instead of cash) method of accounting, which would require them to pay tax on income they have not yet received and may never receive.

3. Please Explain How the Proposed Policy Position will Address the Issue

If adopted, the Resolution would authorize the ABA to oppose Section 212 of the House Ways and Means Committee’s “Tax Reform Act of 2013” discussion draft bill, and any other similar proposed legislation, regulations, or other governmental measures, which would require law firms and other personal service businesses that now compute taxable income on the cash basis to convert to the accrual basis.

4. Summary of Minority Views

No minority views have been identified in opposition to this Resolution.