STATEMENT OF

WILLIAM C. HUBBARD

PRESIDENT-ELECT OF THE AMERICAN BAR ASSOCIATION

submitted to the

SUBCOMMITTEE ON ECONOMIC GROWTH, TAX AND CAPITAL ACCESS

of the

COMMITTEE ON SMALL BUSINESS

of the

UNITED STATES HOUSE OF REPRESENTATIVES

concerning

“CASH ACCOUNTING: A SIMPLER METHOD FOR SMALL FIRMS?”

July 10, 2014
Mr. Chairman and Members of the Subcommittee:

My name is William Hubbard, and I am the President-Elect of the American Bar Association (“ABA”) and a partner at Nelson Mullins Riley & Scarborough LLP in Columbia, South Carolina, where I practice in the area of business litigation. On behalf of the ABA, which has almost 400,000 members, thank you for the opportunity to express our views regarding the advantages of the traditional cash method of accounting utilized by most law firms, as well as our concerns over draft legislation prepared by House Ways & Means Committee Chairman Dave Camp (R-MI) that would substantially limit the continued use of cash accounting. We request that this statement be made part of the hearing record.

The proposed legislation, contained in Section 3301 of Chairman Camp’s draft “Tax Reform Act of 2014,” would impose substantial new financial burdens and hardships on many law firms and other types of personal service businesses throughout the country by fundamentally changing the manner in which they must pay their taxes.1 In particular, the provision would require all law firms and other personal service businesses with annual gross receipts over $10 million to switch from the traditional cash receipts and disbursement method of accounting to the much more complex accrual method of accounting. As a result, many small and medium sized businesses—including many thousands of law firms, accounting firms, medical firms, and other professional service providers—would be forced to pay taxes on income long before it is actually received.

Although we commend Chairman Camp and the Ways & Means Committee staff for their 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 3301 of his bill 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.

While the ABA has expressed its views on many different policy issues during the 113th Congress, this particular issue has become one of the most important issues to our members—and many state and local bars throughout the country\(^2\)—because of the serious negative effects that the proposed legislation would have on practicing lawyers, their law firms, and their clients. In addition, many other leading associations and other entities have expressed serious concerns regarding this and other proposals to impose substantial new limits on the use of cash accounting.\(^3\) Therefore, the ABA appreciates this Subcommittee’s efforts to highlight the benefits of cash accounting and the very serious effects that mandatory accrual accounting would have on law firms and many other types of small and medium sized businesses throughout the nation.

**Advantages of the Cash Method of Accounting**

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-

\(^2\) At least 21 state and local bars have expressed opposition to the mandatory accrual accounting legislation, including those in Delaware, Illinois, Maine, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Mississippi, Nebraska, New Jersey, North Carolina, Ohio, Oregon, Pennsylvania, South Carolina, Tennessee, and Wisconsin. A complete list of the national, specialty, state and local bars opposing the proposal and other resources on this issue are available at: [http://www.americanbar.org/advocacy/governmental_legislative_work/priorities_policy/independence_of_the_legal_profession/mandatory-accrual-accounting-for-law-firms.html](http://www.americanbar.org/advocacy/governmental_legislative_work/priorities_policy/independence_of_the_legal_profession/mandatory-accrual-accounting-for-law-firms.html).

\(^3\) The ABA has been working in close cooperation with a broad and diverse coalition of organizations including the American Institute of CPAs, American Council of Engineering Companies, American Dental Association, American Farm Bureau Federation, American Institute of Architects, American Association for Justice, Americans for Tax Reform, and over 50 law firms, accounting firms, and other entities in an effort to raise awareness of the proposed mandatory accrual accounting legislation and its unintended harmful consequences.
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.

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 Tax Code.

In addition to promoting simplicity, the cash method of accounting also 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 measure of its true income. While accounts receivable clearly are important in determining the overall financial condition of the business and assessing its future prospects, they do not accurately reflect what is available for the business’ owners to spend (or their present ability to pay taxes on their income). If the tax rules are changed to disconnect cash collections from how income is taxed, the very business model upon which many law firms and other personal service businesses operate will be turned on its head.

**Mandatory Accrual Accounting for Personal Service Businesses Would Be a Major Change to Current Law and Would Increase, Not Decrease, the Complexity of the Tax Code**

Section 3301 of Chairman Camp’s draft legislation would dramatically change current law
by raising the gross receipts cap to $10 million while eliminating the existing exemption for law
firms and other personal service businesses and for other partnerships and S corporations.
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 Chairman Camp’s proposal 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 of accounting.

For example, while law firms using the cash method of accounting simply pay taxes on the
income that they actually receive, law firms that are required to use the accrual method will be
forced to calculate and then pay taxes on multiple types of accrued income, including work in
progress and other unbilled work, accounts receivable (where the work has been done and billed but
not yet paid for), and accounts paid (where the work has been done, billed, and paid for).\(^4\) In order
to meet these requirements, law firms and other affected businesses will need to keep much more
detailed work and billing records and hire additional accounting and support staff. As a result, the
proposal would substantially raise compliance costs for many law firms and other personal service

\(^4\) For a detailed discussion of the specific effects that mandatory accrual accounting legislation would have on law firms,
see PwC’s Law Firm Services, \textit{Congressional Proposals Requiring Law Firms to Report Taxable Income on the
Accrual Method of Accounting} (December, 2013), available at: http://legaltimes.typepad.com/files/cash-to-accrual-
white-paper.pdf.
businesses while greatly increasing the risk of noncompliance with the Tax Code.

Other ABA Concerns Regarding the Legislation

In addition to creating unnecessary complexity and compliance costs, Chairman Camp’s proposal 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 impose substantial new financial burdens on many thousands of personal service businesses throughout the country—including many law firms—by requiring them to pay taxes on income they have not yet received and may never receive. Unlike the current law, where law firms and other personal service businesses need only pay taxes on income they have actually received, the proposal would require many of these firms to pay tax on “phantom income” that they have not yet received, including work in progress, other unbilled work, and accounts receivable. As a result, many firms would have to borrow money or use their scarce capital just to pay their accelerated tax obligations. In either event, the proposal would impose a serious financial burden and hardship on many of these firms.

Second, the proposal would cause the legal profession to suffer even greater financial hardships than other professions because many lawyers and law firms are not paid by their clients until long after the work is performed. Many types of lawyers—such as business lawyers working on complex transactions and litigators involved in lengthy trials or appeals—often are not paid until the end of the case or project, which can be years after the work is performed. This sets lawyers and law firms apart from many other types of professionals—such as doctors, dentists, and accountants—who typically work on a pay-as-you-go basis. Therefore, requiring personal service providers to pay taxes on income that has accrued but not yet been received will create special
hardships for many in the legal profession.

The proposal also would disproportionately affect professional service providers that practice in regulated professions, like lawyers, 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 mandatory accrual accounting proposal could adversely affect clients, interfere with the lawyer-client relationship, and reduce the availability of legal services in various ways. Under the traditional hourly billing model followed by many law firms, individual lawyers within the firm typically perform any necessary legal services for the client throughout the month and the firm then bills the client on a monthly (or quarterly, or some other periodic) basis. In other cases, law firms may agree to handle a client’s case on a contingency fee basis, in which a fee (typically a percentage of the total recovery, plus actual expenses) is only charged if the client prevails. In still other cases, a law firm may agree to represent a start-up company in return for an equity interest in

5 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.

6 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.
the new business instead of a traditional legal fee. Many law firms also agree to represent a certain number of indigent clients on a pro bono basis in which no fee of any kind is charged.

Unfortunately, if the proposed legislation is enacted and many law firms that currently use the cash method of accounting are forced to use the accrual method and pay taxes on income they have not yet received, the resulting financial pressures will force many firms charging on an hourly basis to collect their legal fees immediately after the legal services are provided to the clients (or at least much sooner than they currently do). In addition, many firms will no longer be able to represent as many accident victims, start-up companies, or other clients on a contingent fee basis as they currently do because the taxes on contingent fee income could become due once the court judgments or settlements become final, even if the firm does not actually collect the income for months or even years later. Perhaps worst of all, the serious cash flow and other financial pressures caused by the acceleration of their tax liabilities will force many firms to reduce the amount of free, pro bono legal services that they currently provide to the poor.

Finally, the ABA opposes the mandatory accrual accounting proposal because it would constitute a major tax increase on small and medium sized businesses and would discourage economic growth. According to the Joint Committee on Taxation, the accrual accounting mandate in Section 3301 of Chairman Camp’s bill would generate $23.6 billion in new taxes over ten years\(^7\) by requiring the affected businesses to pay taxes on phantom income up to a year or more before it is actually received (if it is ever received). Because this acceleration of a firm’s tax liability would be permanent and continue year after year, it would constitute a major permanent tax increase for the firm, when compared to the taxes the firm currently pays under the cash method, until the firm eventually dissolves, merges with another firm, or otherwise ceases to exist.

In addition, the proposal would discourage 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 and medium sized businesses, including those providing personal services such as law firms, especially in today’s difficult economic environment.

Conclusion

In sum, while the simple cash method of accounting more accurately reflects the true income of most businesses and offers many other advantages, mandatory accrual accounting proposals such as Section 3301 of the draft Tax Reform Act of 2014 would likely cause numerous harmful unintended consequences. These include unnecessary new complexity in the tax law, increased compliance costs, and significant new financial burdens and hardships for the many law firms and other personal service businesses throughout the country that will be required to pay tax on phantom income that has not yet been received and may never be received. In addition, the proposal would harm the economy and discourage growth, without providing any corresponding benefits.

To avoid these harmful results, the ABA urges you and your colleagues to protect the ability of personal service businesses to use the simple cash method of accounting and to oppose provisions like Section 3301 that would require many of these businesses to utilize the more complex and costly accrual method of accounting.

Thank you again for the opportunity to express the ABA’s views on this important issue.