April 13, 2016

The Honorable Orrin G. Hatch
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

The Honorable Ron Wyden
Ranking Member
Committee on Finance
United States Senate
Washington, D.C. 20510

Re: Preserving Cash Accounting for Law Firms and Other Personal Service Businesses and Concerns Over Burdensome Mandatory Accrual Accounting Proposals

Gentlemen:

On behalf of the American Bar Association (“ABA”), which has over 400,000 members, I am writing to express our views regarding an important aspect of the tax reform legislation that your Committee and its tax reform working groups are in the process of developing. In particular, we strongly oppose those proposals—such as Section 51 of the Committee’s staff discussion draft bill to reform cost recovery and tax accounting rules prepared during the 113th Congress and other similar proposals now under consideration—that would require personal service businesses with annual gross receipts over $10 million to switch from the traditional cash receipts and disbursements method of accounting to the more complex and costly accrual method. These mandatory accrual accounting proposals are also strongly opposed by the Utah State Bar, Oregon State Bar, and over 30 other state, local, and specialty bars throughout the country.

Although we commend you and your colleagues 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 mandatory accrual accounting proposals like Section 51 would have the opposite effect and cause other negative unintended consequences. These far-reaching proposals would create unnecessary new 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 lawyers, law firms, and other personal service businesses by requiring them to pay tax on income long before it is actually received. Therefore, we urge you and your colleagues not to include these or any other similar mandatory accrual accounting proposals in the new tax reform legislation that is currently being developed.

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—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—are exempt from the revenue cap and can use the cash method of accounting regardless of their annual revenues, unless they have
inventory. Most other businesses are required to use the accrual method, in which income is recognized when the right to receive the income arises, not when the income is actually received.

Mandatory accrual accounting proposals like Section 51 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, other sole proprietorships and pass-through entities, and farmers. Although these proposals 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 proposals would significantly complicate tax compliance for a far greater number of small business taxpayers, including many solo practitioner lawyers, law firms, and other personal service businesses, by forcing them to use the accrual method.

Sole proprietors, 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.

If law firms and other personal service businesses are required to use the more complex accrual method of accounting, they would be forced to calculate and then pay taxes on multiple types of accrued income, including work in progress, other unbilled work, and accounts receivable (where the work has been performed and billed but payment has not yet been received). To meet these requirements, law firms and other affected businesses would need to keep much more detailed work and billing records and hire additional accounting and support staff. This would substantially raise compliance costs for many law firms and other personal service businesses while greatly increasing the risk of noncompliance with the tax code.

In addition to creating unnecessary complexity and compliance costs, these mandatory accrual accounting proposals would lead to economic distortions that would adversely affect all law firms and other personal service businesses that currently use the cash method of accounting and their clients in several ways.

First, the proposals would impose substantial new financial burdens on many thousands of personal service businesses throughout the country—including many law firms—by forcing them to pay taxes on income they have not yet received and may never receive. Requiring these businesses to pay taxes on this “phantom” income—and to borrow money or use their scarce capital to do so—would impose a serious financial burden and hardship on many of these firms. The legal profession would suffer even greater financial hardship than other professions because many lawyers are not paid by the clients until long after the work is performed.

Second, mandatory accrual accounting would adversely affect clients, interfere with the lawyer-client relationship, and reduce the availability of legal services. If law firms are required to pay taxes on accrued income they have not yet received, the resulting financial pressures could force many firms charging on a traditional hourly fee basis to collect their fees immediately after the legal
services are provided to the client or at least much sooner than they currently do. As a result, many clients could find it more difficult to afford legal counsel. In addition, many law firms would no longer be able to represent as many accident victims, start-up companies, or other clients on an alternative or flexible fee basis as they now do, and many firms would also have to reduce the amount of pro bono legal services they currently provide to their poorest clients.

Third, the proposals would constitute a major, unjustified tax increase on small businesses and discourage economic growth. The Joint Committee on Taxation estimated that the similar House proposal introduced in the last Congress, which closely parallels Section 51 of the Senate draft bill, would generate $23.6 billion in new taxes over ten years by forcing many thousands of small businesses to pay taxes on 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.

The proposals would also 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 costly accrual accounting requirement. For example, solo practitioner lawyers would be discouraged from entering into law firm partnerships—and 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 legal services, especially in today’s difficult economic environment.

For all of these reasons, as discussions on tax reform continue, we urge you and the Committee to preserve the ability of law firms and other personal service businesses to use the simple cash method of accounting and not to support any proposals that would require these businesses to switch to the more burdensome accrual method.

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,

Paulette Brown
President, American Bar Association

cc: Members of the Senate Finance Committee
    The Honorable Mark J. Mazur, Assistant Secretary of the Treasury for Tax Policy