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President

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April 6, 2015

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 350,000 members, I am writing in response to your invitation to stakeholders to express their views to the Committee’s tax reform working groups on how to improve the nation’s tax code. In particular, the ABA supports preserving the traditional cash receipts and disbursements method of accounting for law firms and other personal service businesses. Thus we unequivocally oppose proposals—such as Section 51 of last year’s Senate Finance Committee staff discussion draft bill to reform cost recovery and tax accounting rules—that would require all such entities with annual gross receipts over \$10 million to switch from the cash method of accounting to the more complex and costly accrual method. These proposals are also strongly opposed by the Utah State Bar, Oregon State Bar, and many other state and local bars throughout the country.

Although we commend you and the Committee 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 they have not yet received and may never receive. Therefore, we urge you and the Committee not to include these or similar proposals in the new tax reform legislation that would require personal service businesses to switch from the cash method of accounting to the accrual method.

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 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). 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 personal service businesses that currently use the cash method of accounting and those who retain them, including many lawyers, law firms, 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 requiring them to pay taxes on income they have not yet received and may never receive. Unlike current law, where these businesses need only pay taxes on income they have actually received, the proposals would force many of these firms to pay tax on “phantom income” that they have not yet received. Therefore, many firms would have to borrow money or use their scarce capital just to pay their accelerated tax obligations. The legal profession would suffer even greater financial hardships 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 would 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. In addition, many 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 would have to reduce the amount of pro bono legal services they currently provide to their poorest clients.

Third, the mandatory accrual accounting proposals would constitute a major, unjustified tax increase on small businesses and discourage economic growth. The Joint Committee on Taxation estimated that last year's House proposal, 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 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.

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 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 legal services, especially in today's difficult economic environment.

As discussions on tax reform continue, we urge you and the Committee to protect 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 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,



William C. Hubbard
President, American Bar Association

cc: The Honorable John Thune, Co-Chair, Business Income Tax Working Group,
Senate Finance Committee
The Honorable Benjamin Cardin, Co-Chair, Business Income Tax Working Group,
Senate Finance Committee
Members of the Senate Finance Committee
The Honorable Mark J. Mazur, Assistant Secretary of the Treasury for Tax Policy