April 20, 2017

The Honorable Kevin Brady
Chairman
House Committee on Ways & Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Brady:

We are writing to follow up on our meetings with your staff regarding "A Better Way" and whether farmers, ranchers, and service pass-through businesses should continue to be allowed to use the cash method of accounting. The Coalition to Preserve Cash Accounting (the Coalition) applauds your efforts to improve the nation's tax code to make it simpler, fairer and more efficient, strengthening the U.S. economy and creating jobs in the process. We appreciate the opportunity to provide these additional comments.

The Coalition is comprised of dozens of individual businesses and trade associations representing thousands of farmers, ranchers and service-provider pass-through entities across the United States that vary in line of business, size and description, but have in common that we rely on the use of cash accounting to simply and accurately record income and expenses. Pass-through entities account for more than 90 percent of all business entities in the United States. A substantial number of these businesses are service providers, farmers and ranchers that currently qualify to use cash accounting. These are businesses throughout America - farms, trucking, construction, engineers, architects, accountants, lawyers, dentists, doctors and other essential service providers - on which communities rely for jobs, health, infrastructure, and improved quality of life. These are not just a few big businesses and a few well-to-do owners. According to IRS data, there are over 2.5 million partnerships using the cash method of accounting, in addition to hundreds of thousands of Subchapter S corporations eligible to use the cash method.

<u>About the Cash Method of Accounting</u>

Under current law, there are two primary methods of accounting for tax purposes - cash and accrual. Under cash basis accounting, taxes are paid on cash actually collected and bills actually paid. Under accrual basis accounting, taxes are owed when the right to receive payment is fixed, even if that payment will not be received for several months or even several years; expenses are deductible even if they have not yet actually been paid.

The tax code permits farmers, ranchers, and service pass-through entities (with individuals as owners) of all sizes - including partnerships, Subchapter S corporations and personal service corporations - to use the cash method of accounting. Cash accounting is the foundation upon which they have built their businesses, allowing them to simply and accurately report their income and expenses, and manage their cash flows, for decades. Some recent tax reform proposals would require many of these businesses to switch to the accrual method of accounting to raise revenues for tax reform. Forcing such a switch would not only be an effective tax increase on the thousands upon thousands of individual owners that generate jobs and are integral to the vitality of local economies throughout our nation, but it would also increase recordkeeping and compliance costs due to the increased complexity of the accrual method. Because many businesses would have to borrow to bridge the cash-flow gap created by having to pay taxes on money they have not yet collected, they may incur even more cost with interest expense, a cost that would be exacerbated if interest expense is no longer deductible, as proposed under the Better Way blueprint.

Tax Reform Proposals and Cash Accounting

The Better Way tax reform plan moves toward a cash-flow, destination-based consumption tax. The cash-flow nature of the proposal suggests that the cash method of accounting would be integral and entirely consistent with the blueprint since it taxes "cash-in" and allows deductions for "cash-out," including full expensing of capital expenditures. While we understand that they are different proposals, the ABC Act, H.R. 4377, a cash-flow plan introduced by Rep. Nunes in the 114th Congress, *required* all businesses to use the cash method. However, the blueprint does not provide details regarding the use of the cash method, including whether all businesses would be required to use it, whether businesses currently allowed to use the method would continue to be allowed to do so, whether a hybrid method of cash and accrual would apply, or some other standard would be imposed.

The recent tax reform proposals that would require any business with average annual gross receipts greater than $10 million to use the accrual method of accounting were part of a plan to expand the use of cash accounting for the very smallest businesses in order to reduce their recordkeeping burdens. However, this expansion was paid for by forcing all other businesses currently using cash accounting to switch to accrual accounting. We do not oppose expanding the allowable use of cash accounting, but it is unfair and inconsistent with generally agreed upon tax reform principles to pay for good policy with bad policy that has no other justification than raising revenues. Further, there have been no allegations that the businesses negatively affected by the proposals are abusing the cash method of accounting.

We take the same position with respect to the blueprint. Farmers, ranchers and pass-through service providers that currently qualify to use the cash method of accounting should continue to be able to use cash accounting. Cash accounting is entirely consistent with the cash-flow, full expensing policies in the blueprint. It is also consistent with the intent of the blueprint to simplify the tax code, make it fairer, and level the playing field so that U.S. businesses are incentivized to stay in the U.S. and grow and prosper, together with their employees. Particularly for non-capital intensive service businesses where full expensing has minimal impact, the continued ability to use the cash method is vitally important. Further, it would be unfair to impose an effective tax increase on pass-through owners taxed at the individual level by repealing or imposing new restrictions on the cash method in order to pay for tax cuts for others.

Other Implications of Limiting Cash Accounting

In addition to the policy implications, there are many practical reasons why the cash method is the best method to accurately report income and expenses for farmers, ranchers and pass-through service providers:

> The accrual method would severely impair cash flow. Businesses could be forced into debt to finance their taxes, including accelerated estimated tax payments, on money they may never receive. Many cash businesses operate on very small profit margins, so

accelerating the recognition of income could be the difference between being liquid and illiquid, and succeeding or failing (with the resulting loss of jobs).

Under accrual accounting, a bad crop year could make a farm go under. For farmers and ranchers, cash accounting is crucial due to the number and enormity of up-front costs and the uncertainty of crop yields and market prices. A heavy rainfall, early freeze or sustained drought can devastate an agricultural community. Farmers and ranchers need the flexibility and simplicity of cash accounting to manage their tax burden by evening out annual revenues that can fluctuate greatly from one year to the next.

Immutable factors out of the control of businesses make it difficult to determine income. Many cash businesses have contracts with the government, which is known for long delays in making payments that already stretch their working capital. Billings to insurance companies and government agencies for medical services may be subject to new billing codes or be disputed or discounted. Service recipients, many of whom are private individuals, may decide to pay only in part or not at all, or force the provider into protracted collection. Structured settlements and alternative fee arrangements can result in substantial delays in collections, sometimes over several years; taxes owed in the year a matter is resolved could potentially exceed the cash actually collected.

Recordkeeping burdens under accrual accounting would escalate in cost, staff time and complexity. Cash accounting is simple - cash in/cash out. Accrual accounting is much more complex, requiring sophisticated analyses of when the right to collect income or to pay expenses is fixed and determinable, as well as the amounts involved. In order to comply with the more complex rules, businesses currently handling their own books and records may feel like they have no other choice than to hire outside help or buy expensive software.

Accrual accounting could have a social cost. Farmers, ranchers and service providers routinely donate their products and services to underserved and underprivileged individuals and families. An effective tax increase and increased administrative costs resulting from the use of accrual accounting could impede the ability of these businesses to provide these benefits to those in their communities.

Conclusions

These impacts are not about the size of a business or the amount of its gross receipts. Whether large or small, a business can have small profit margins, rely on slow-paying government contracts, generate business through deferred fee structures or be wiped out through the vagaries of the weather. Cash diverted toward interest expense, taxes and higher recordkeeping costs is capital unavailable for use in the actual business, including paying wages, buying capital assets or investing in growth.

Proposals to limit the use of cash accounting are counterproductive to agreed-upon principles of tax reform. Tax reform should strengthen our economy, foster job growth, enhance U.S. competitiveness, and promote fairness and simplicity in the tax code. Accrual accounting does not make the system simpler, but more complex. Increasing the debt load of American businesses runs contrary to objectives to move toward equity financing instead of debt financing and will raise the cost of capital, creating a drag on economic growth and job creation. Putting U.S. businesses in a weaker position will put them at further disadvantage compared to foreign competitors. It is simply unfair to ask American businesses and their individual owners to shoulder the financial burden for reforms by forcing them to pay taxes on income they have not yet collected where such changes will leave them in a substantially worse position than when they started.

As discussions on tax reform continue, the undersigned respectfully request that you take our concerns into consideration and not propose to change the ability to use cash accounting. We would be happy to discuss any of these items further. Please feel free to contact Mary Baker (mary.baker@klgates.com) or any of the signatories for additional information.

Thank you for your consideration of this important matter.

Sincerely,[1]

Americans for Tax Reform
American Council of Engineering Companies
American Farm Bureau Federation
The American Institute of Architects
American Medical Association
Farmers for Tax Fairness
Akin Gump Strauss Hauer & Feld LLP
Baker Donelson
Debevoise & Plimpton LLP
Dorsey & Whitney
Foley & Lardner LLP
Jackson Walker L.L.P.
K&L Gates LLP
K·Coe Isom, LLP
Kilpatrick Townsend & Stockton LLP
Lewis Roca Rothgerber Christie LLP
Littler Mendelson P.C.
Mitchell Silberberg & Knupp LLP
Morrison & Foerster LLP
Nelson Mullins Riley & Scarborough LLP
Ogletree, Deakins, Nash, Smoak & Stewart, P.C.
Perkins Coie LLP
Phillips Lytle LLP
Squire Patton Boggs (US) LLP
Steptoe & Johnson LLP
White & Case LLP

[1] Although not a signatory to this letter, the American Bar Association (ABA) is working closely with the Coalition and has expressed similar concerns regarding proposals to limit the ability of personal service businesses to use cash accounting. The ABA's most recent letters to the House Ways & Means and Senate Finance Committees are available here and here.