TAX REFORM

The President released a 25 page document outlining some general concepts for business tax reform. Some of it is good stuff, some of it not so good. “The President’s Framework For Business Tax Reform” (Framework) calls for a lower C Corporation top rate and proposes the elimination of some business “tax expenditures” to “pay” for the lower rate. The document says “The President’s Framework would eliminate dozens of different tax expenditures and fundamentally reform the business tax base to reduce distortions that hurt productivity and growth.” It does not specify what those “tax expenditures” (think credits and deductions) might be but the repeal of the Last In/First Out (LIFO) method of inventory accounting is used as an example. The problem with the unspecified tax expenditures is that some of them may be used by sole proprietorships, partnerships and S Corporations too and there is no rate relief for those pass-through entities, which make up the bulk of the small business community.

There are some good provisions in the Framework for domestic manufacturers (regardless of structure). The Domestic Production Activity Deduction (Internal Revenue Code (IRC) Section 199) is bumped up (see SBLC issue paper for explanation but basically it currently allows businesses to reduce their taxable income by nine percent for U.S. based activities). Unfortunately, the definition of manufacturing would be tightened up and, as a result, some small businesses would lose the ability to use DPAD.

For the non-C Corporation or non-manufacturing small business world, the President offers two helpful provisions: Allow small businesses to expense up to $1 million in investments and allow cash accounting on businesses with up to $10 million in gross receipts.

I am going to spend the rest of this article on the grain of salt that goes with the cash accounting proposal. The Framework says: “Allow cash accounting on businesses with up to $10 million in gross receipts. Small businesses with up to $5 million in gross receipts are currently allowed to use this simplified form of accounting. Under the President’s Framework, this threshold would increase to $10 million.”

An interesting three sentences. Is it a big deal or not? Well, let’s start the analysis this way. How many of you out there with less than $5 million are currently not using cash accounting for tax purposes? How many with receipts in excess of $5 million are using cash accounting. Yes, a good number are going to raise their hand for each question. How can that be? The $5 million number drives the accounting method decision for just a small number of taxpayers.

Don’t get me wrong. I think this is a great idea. Cash in, cash out. Tax me on that. My heavy dose of sarcasm is rooted in long experience with the tax code section limiting the use of cash accounting which has the $5 million number in it. If the proposal is to change that number to $10 million, the earth is not going to move for many of you. The reasons are these: the section is not quite that simple AND there are other sections of the tax code that overrule the cash accounting section. If you want to get rid of all those other sections for small businesses with $10 million or less in gross receipts, now we would be talking.

For starters, the IRC section says that for a C corporation, partnership which has a C corporation as a partner, or tax shelter, taxable income shall not be computed under the cash receipts.
and disbursements method of accounting.

So right there, if you are sole proprietorship, a partnership without a C corporation partner, or an S Corporation you are not subject to the prohibition so the $5 million or $10 million in that section does not matter. (Some of you are saying “wait a minute, I am an S Corporation (or sole proprietorship or partnership) and I am on accrual accounting, what’s up?” Hold on, I will get to that after I go through the section.)

Then the section provides some additional exceptions (which mean the businesses are allowed to use cash accounting) to that general rule of not being permitted to use cash accounting. The first two permit farming businesses and qualified personal service corporations* to use cash accounting.

The third additional exception is that the prohibition on cash accounting shall not apply to any corporation or partnership for any taxable year if such entity meets the $5,000,000 or less gross receipts test. Yes, ladies and gentlemen, the $5 million or less exemption is for non-farming or non-personal service corporation* C Corporations and partnerships. So changing $5 million to $10 million will help those C Corporation and partnerships. But not even all of them would be able to take advantage of the expanded exception, as I will explain shortly.

First I need to finish up with this IRC section. The * on the personal service corporation is that the section goes on to take away the exception to the not permitted to use cash accounting general rule for some personal service corporations. Yes, an exception to the exception which translates to: only some personal service corporations can use cash accounting. The only personal service corporations that are allowed to cash accounting are ones when substantially all of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting (notice that lawyers and accountants take care of their own 😊)

Okay back to why you may or may not be able to take advantage of the rules and exceptions of this current Code section (BTW, it is IRC Section 448).

Here’s a biggie: If you have to use inventory accounting, say goodbye to cash accounting. There is this section (Section 471): “Whenever in the opinion of the Secretary of Treasury the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.”

Well, as you might imagine, since the beginning of time, the Secretaries of Treasury have basically been of the same mind about inventory accounting: “Do it.” The regulations under a different section (Section 446) then require “that a taxpayer use an accrual method of accounting with regard to purchases and sales of merchandise whenever Section 471 requires the taxpayer to account for inventories.”

(You may remember SBLC was instrumental in getting Revenue Procedure 2000-22 published. It provided some relief from the inventory leads to accrual accounting requirement. “This revenue procedure provides that the Commissioner of Internal Revenue will exercise his discretion to except a qualifying taxpayer with average annual gross receipts of $1,000,000 or less from the requirements to account for inventories and to use an accrual method of accounting for purchases and sales of merchandise.” It was updated and improved by Revenue Procedure 2001-10.)

Then there is Section 263A, a nasty legacy of the 1986 Tax Reform Act: “Nondeductibility of certain direct and indirect costs: In general In the case of any property to which this section applies, any costs described below in the case of property which is inventory in the hands of the taxpayer, shall be included in inventory costs, and in the case of any other property, shall be capitalized.”

It messes up cash accounting when you have to do that.

Then there is Section 460 that applies to some of you: “In the case of any long-term contract, the taxable income from such contract shall be determined under the percentage of completion method.”

Even some of the farmers who appear to have a get-out-of-accrual-accounting card in Section 448 actually are slammed back into it by Section 447: “Method of Accounting for Corporations
Engaged in Farming,” which as you probably have guessed, requires accrual accounting for some of them.

Finally, believe it or not, there is a Revenue Procedure, 2002-28, that does allow some industries, with gross receipts of $10 million or less, that have materials and supplies they provide/sell with the service to use cash accounting if they are not prevented by section 448 and other sections from using cash accounting, to use cash accounting if the only thing stopping them from doing so is the requirement to inventory those non-incidental materials and supplies. (Brutal sentence isn’t it? But it makes sense to us tax lawyers. If you are in construction, you know about 2002-28. PS Another victory that SBLC had a hand in.)

Well you get the idea. The net practical impact will be modest.

When it comes to changing $5 million to $10 million will it make a big difference? In the words of Agent Maxwell Smart, “not exactly.” The outline of the President’s tax reform proposal does not provide any clue as to what is intended by the three sentences. We will be working to find out. And rooting for the broadest interpretation (i.e. do more than just changing the $5 million number to $10 million in IRC Section 448), then you still care about LIFO repeal. IF my wildest dreams came true and it allowed any business with $10 million or less in gross receipts to be on true tax cash accounting, then you would not care about LIFO repeal – except for transition rules.

Determining what method of inventory accounting is used is a separate step in the tax accounting process, so it does not drive the determination of whether you are on cash or accrual.

There are several methods including the LIFO and the First In/First Out.

Generally speaking, LIFO is considered a favorable method during times of inflation. The reason is that the cost of the last good put into your inventory is the “highest” so your profit (aka taxable income) is lower.

What is happening during that time is you are deferring the use of the cost of the “cheapest” good in your inventory.

Now imagine you are a family owned business that for the last forty years has been successful and profitable. You keep selling and replacing inventory and generally inflation has resulted in the higher cost of the last good put into inventory being used for tax purposes.

You end up with large LIFO reserves or “pools” on your books that represent the costs of the cheaper goods that you have never used in the tax accounting. What this means is you have a lot of deferred taxable income.

When you repeal LIFO that deferred taxable income is now taxable. Under existing law and rules, if you “voluntarily” convert, there is a transition rule that allows you to spread out the liability generally over four years when you switch accounting methods.

Any time there is a chance of taking away what the opponents brand a “loophole,” the Plan B of the lobbyists charged with preserving the “loophole” is to secure a looonnng transition rule to soften the big tax liability blow.

Those of us with memories of the Tax Reform Act of 1986 know that one of the sub plots of the debate was the intense lobbying for transition rules because that law was the biggest closer of “loopholes” in decades.

I might add that for some, unfortunately, the LIFO reserve liability issue might not be as big as it once was. During times with net operating losses, there is an opportunity to reduce those reserves through tax planning.