TAX REFORM SENATE STYLE

Last week, Senator Max Baucus (D-MT), Chairman of the Senate Finance Committee, released drafts of some proposed revisions to the tax code. The one that caught our eye is entitled “Cost Recovery and Accounting.”

Let’s start with the good news. As Ways and Means Chairman Dave Camp (R-MI) proposed in his draft, Senator Baucus would permit all small businesses with gross receipts of $10 million or less to use cash basis accounting. You may recall, while we were enthusiastic about Chairman Camp’s draft, one of the shortcomings we quickly identified was that unless you eliminate inventory accounting, the cash basis accounting does not reduce administrative burdens and complexity for significant segments of the small business taxpayer community. The good news is that Senator Baucus has embraced our concern and proposed elimination of the inventory accounting requirement for those businesses with $10 million or less in gross receipts. We are optimistic we can get somewhere with this because Chairman Camp is clearly sympathetic to the concern.

The direct expensing allowance found in Internal Revenue Code Section 179 has always been one of our priorities. Aside from the cash flow benefits, it too is a simplification measure. Under Section 179, a business can write off a certain amount of investment in new equipment and machinery. The business is limited to a cap on total investments. If the cap is exceeded, the business cannot use Section 179 and must use depreciation methods. (We currently have a temporary allowance and cap of $500,000 and $2,000,000 respectively. And as we have reported numerous times, these will revert to $25,000 and $200,000, respectively, in 2014.)

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Senator Baucus has proposed considerably higher amounts, which should more than cover the needs of most small businesses. For years beginning after 2014, the maximum amount that may be expensed is increased to $1,000,000, phasing out for qualifying property exceeding $2,000,000, with both thresholds indexed for inflation. Again, we believe Chairman Camp is sympathetic and we think we can close the gap upward.

Another of Senator Baucus’s proposals is to all businesses such as manufacturers with $10 million or less in gross receipts, not just resellers would be exempt from the uniform capitalization rules of Section 263A.

The rules for expensing start-up expenditures and organizational costs are consolidated into a single rule. The combined amount that can be immediately expensed is increased from $5,000 to $10,000, phased out for expenses in excess of $60,000. Chairman Camp had proposed this as well.

There are some not so good portions of the draft.

One huge downside is that only half of advertising expenses may be deducted immediately. The remaining 50 percent must be capitalized and amortized ratably over 5 years. This is mitigated by the fact the direct expensing allowance definition would be expanded to include the portion of the advertising that has to be
capitalized as one of the items that is eligible for inclusion in the direct expensing allowance.

The draft eliminates Last In, First Out inventory accounting. This is mitigated by the no inventory provision for business with $10 million or less in gross receipts. If you do not have inventory accounting, the method of valuation is a moot point.

The draft eliminates the Research and Development credit but those expenses, which would have to be capitalized, would also be included in the definition of qualified property eligible for the direct expensing allowance.

The draft changes the depreciation system and there are going to be winners and losers for those that purchase capital assets. The proposal creates “pools” of depreciable assets instead of depreciating each asset separately. The administrative burden would be reduced but some assets are going to be in pools that are depreciated over a longer period than they are now, and some are going into pools with a shorter write off period. Again, for small businesses buying such assets, the impact should be minimal because they will most likely use the direct expensing allowance to expense everything they acquire in a year.

Even with all the items thrown into the direct expensing allowance, most small businesses should be well within the $1 million expensing allowance. Nevertheless, changes such as no longer allowing a 100 percent deduction for advertising will be difficult to swallow.

As we all know, the timetable for reform has slipped into next year. The challenge with many of these proposals is finding offsetting revenue. The no inventory rule and direct expensing in excess of $500,000 are expensive. However, a cash basis system with no inventory accounting and with essentially everything else being direct expensed would be true simplification.

As to the proposed $10 million ceiling on cash accounting, the $10 million number has been a remarkably consistent benchmark over decades that has withstood the test of time. It continues to ensure the vast number of small businesses will never have to worry about a transition from cash to accrual. A recent study by the Office of Advocacy for Small Business, using the most recent Internal Revenue Service Statistics of Income data, affirmed that tenet and the report indicates that 28.6 million business returns out of 32 million are under the threshold:

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<tr>
<th>Number of Business Returns by Entity Type, 2010</th>
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<tr>
<td><strong>Entity Type</strong></td>
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<tr>
<td>C Corporations</td>
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<tr>
<td>S Corporations</td>
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<tr>
<td>Partnerships (including LLCs)</td>
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<tr>
<td>Non-Farm Sole Proprietorships</td>
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<td><strong>Total Businesses (excluding farms)</strong></td>
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Happy Thanksgiving to you!