

Tax Reform Act of 2014 to include a provision with significant impact to Service Firms

Background:

On February 26th Dave Camp (R-MI), the chairman of the House Ways and Means Committee, released the latest effort to revamp the U.S. Tax code. While the discussion draft contains multiple provisions, one provision that is a particular concern for service firms is the mandate for businesses with gross receipts over \$10 million to convert from the cash basis of accounting to the accrual basis of accounting for income tax purposes.

The proposal to mandate a change in accounting methods for service firms was introduced last year by Senator Baucus (D-MT), the then Senate Finance Committee chairman. The Baucus proposal had gained some traction as it was circulating among legislators on Capitol Hill. However, when it was announced that Senator Baucus would leave his Senate Finance Committee position to become the Ambassador to China, industry professionals and their respective professional organizations, such as the American Bar Association, were waiting to see if tax reform would lose momentum and if the proposed change to the accrual basis of accounting in particular would survive in subsequent drafts. Now that the Tax Reform Act of 2014 has been released, we know that this provision is alive and well.

The Issue:

Currently, most service firms, including law firms, use the cash basis of accounting to recognize income and expenses for income tax purposes. Under the cash basis method, firms record income when payment is actually received, i.e. cash is collected and recognize expenses when they are paid vs. when they are incurred. This method more appropriately matches the cash flow realities of service firms, especially law firms as cash is often collected long after services have been rendered. Income taxes are paid after cash has been collected thus mitigating strains on cash flow.

The proposed change to the accrual basis of accounting records income when it is earned vs. when collected and recognizes expenses when incurred vs. paid resulting in a potential strain on cash flow. The conversion from cash to accrual method for income tax purposes would generate a front-loaded income tax liability that would require payment prior to the collection of cash for services rendered. This problem can be further exacerbated for law firms that provide services on a contingent fee basis.

Potential Implications:

As a result and given the potential strain on cash flow, firms and partners could be forced to borrow to fund tax liabilities until revenues are collected. Additionally, the overall capital structure of service firms may need to be evaluated to help ensure financial stability. Partnership agreements would need to be revised to address capital contributions, the timing of cash distributions, partner retirements and new partner capital requirements. The accrual basis of accounting could also complicate internal accounting efforts and would involve more subjectivity with regard to income recognition and income allocations among partners.

The recently released Tax Reform Act of 2014 proposes that the accrual mandate shall apply to taxable years beginning after December 31, 2014. Impacted taxpayers may elect to include the resulting increase in 2015 taxable income over a four-year period starting with its first tax year beginning after December 31, 2018 as follows:

- 10 percent included in 2019;
- 15 percent in 2020;
- 25 percent in 2021;
- 50 percent in 2022.

At the election of the taxpayer, the four-year inclusion of the adjustment could also begin prior to 2019. Timing issues will result and will require firms to keep track of tax payments for 2019 through 2022 related to income earned in prior years. Further adding to this complexity will be partner retirements and new partner admissions.

Concluding comments and recommendations:

The change to the accrual basis of accounting for service firms has been met with significant opposition by various service professional organizations and impacted firms. The American Institute of Certified Public Accountants (AICPA), the American Bar Association (ABA), and organizations representing other service firm industries including architects and engineers have all issued statements voicing their concerns over the last several months. Since the initial release of this proposal by former Senate Finance Committee chairman, Senator Baucus, lobbying efforts and conversations have continued with members of the House and Senate. Notwithstanding this effort, Camp's latest draft of proposed tax legislation still included this provision.

Tax Alert

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On one end of the spectrum, it appears that comprehensive tax reform seems highly unlikely in the near future, and this accrual mandate would need to be, in its current format, part of comprehensive tax reform. On the other hand, the government is always considering attractive sources of revenue, and the more traction a specific provision such as this one gains, the more likely it is to be carved out as a separate proposal.

We will continue to monitor developments with regards to this proposal and the actions of the House Ways & Means Committee. We are communicating with the AICPA and other industry organizations and will keep you informed. HCVT recommends that impacted professionals in the service firm industry continue to reach out to policy makers. We also suggest that you support your respective professional associations to voice opposition to this proposal.

If you would like to know more about the potential impact of this proposal to your firm, please contact Hans Gustafsson at (626) 463-7213 or hans.gustafsson@hcv.com