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# Cash Versus Accrual Accounting: Tax Policy Considerations

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## Summary

Two methods of accounting are generally available to businesses: cash basis and accrual basis accounting. Under cash basis accounting, revenue and expenses are recognized and recorded when cash is actually paid or received. Under accrual basis accounting, revenue is recorded when it is earned and expenses are reported when they are incurred, regardless of when payment is actually made or received. On the one hand, the cash basis method is simpler and arguably less administratively burdensome on businesses. On the other hand, cash accounting may result in a less accurate measure of economic income and allow for a deferral of tax liability. The Joint Committee on Taxation (JCT) considers cash accounting a departure from “normal income tax law” and thus classifies it as a tax expenditure.

Current tax law requires that most companies with average gross receipts in excess of \$5 million use the accrual basis of accounting. Some companies are allowed to use either the cash or accrual basis methods of accounting for tax purposes. Examples of companies that may be excepted from using accrual basis tax accounting regardless of total average gross receipts include sole proprietors and certain qualified Personal Service Corporations (PSCs) in such fields as health, law, engineering, accounting, performing arts, and consulting firms, as well as farms that are not corporations or do not have a corporate partner.

Some Members of Congress and the Administration have put forth proposals that would expand the number of firms allowed to use cash accounting by increasing the average gross receipts limit test. The Tax Reform Act of 2014 (H.R. 1) introduced in the 113<sup>th</sup> Congress would have expanded cash accounting by increasing the average gross receipts limit test to \$10 million, but it would have also restricted the use of cash accounting for certain other firms. Although allowed to use cash accounting under current law, certain partnerships, subchapter S corporations, and PSCs with average gross receipts in excess of \$10 million would not have been allowed to use cash accounting under the provisions of H.R. 1. Also introduced in the 113<sup>th</sup> Congress, the Small Business Accounting and Tax Simplification Act (H.R. 947), Start-up Jobs and Innovation Act (S. 1658), and Small Business Tax Certainty and Growth Act (S. 1085) would have all allowed certain firms with average gross receipts of \$10 million or less to use cash accounting. Similarly, S. 341 introduced in the 114<sup>th</sup> Congress would raise the average gross receipts test limit to \$10 million. The President’s FY2016 budget proposal also calls for expansion of cash accounting by changing the threshold from \$5 million to \$25 million.

This report provides a brief explanation of cash and accrual accounting. It then examines the legislative history surrounding the Tax Reform Act of 1986 (P.L. 99-514), which set most of the current policies related to cash accounting for tax purposes. It also discusses recent policy proposals to change accounting requirements for tax purposes. The report concludes by discussing a number of policy considerations Congress may find useful.

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## Introduction

Businesses must have a reliable means of maintaining their accounting records to manage their operations and determine tax liabilities. The two methods of accounting that businesses can use for this purpose are respectively known as cash and accrual basis of accounting. Under cash basis accounting, revenue and expenses generally are recognized and recorded when cash is actually paid or received. Under accrual basis accounting, revenue is recorded when it is earned and expenses are reported when they are incurred, regardless of when payments are actually made or received. Although the cash basis method is simpler and perhaps less administratively burdensome, it may result in a less accurate measure of economic income and allow for a deferral of tax liability. The Joint Committee on Taxation (JCT) considers cash accounting a departure from “normal income tax law.” Thus, the ability to use cash accounting for the purposes of determining tax liability is considered a tax expenditure by the JCT.<sup>1</sup> The JCT estimates the five-year revenue loss associated with cash basis accounting to be \$10.9 billion between FY2014 and FY2018.<sup>2</sup>

Legislation has been proposed that would change the tax accounting requirements for businesses. The changes would affect federal tax revenues and the businesses’ tax liabilities. Similar discussions on cash and accrual accounting were held prior to the enactment of the Tax Reform Act of 1986 (TRA86; P.L. 99-514). This report provides a brief explanation of cash and accrual accounting, and it reviews relevant legislative history surrounding TRA86. The report then explores the effects of the tax policy if cash basis of accounting is expanded for certain businesses and limited for others.

## Cash and Accrual Accounting

Accounting is the process by which businesses, nonprofits, and government entities record and report their financial transactions. Properly accounting for the timing of income and expenses allows for more accurate predictions of cash flows and better business and investor decisions. Accurate accounting also allows taxpayers and tax authorities to correctly determine a taxpayer’s income tax liability. Financial regulators employ certain accounting standards as well to help gauge the financial health of firms. Although a discussion of financial accounting standards and policy considerations is beyond the scope of this report, it is worthwhile mentioning that financial accounting or “accounting per books” may differ in various ways from accounting for tax purposes.

Businesses generally use one of two accounting methods for calculating their federal tax liabilities. Under the cash basis method of accounting, income and expenses generally are recorded only when payments are actually received or paid. In contrast, under the accrual method

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<sup>1</sup> The Treasury Department differs from the Joint Committee on Taxation (JCT) with respect to how it identifies tax expenditures, and it does not consider cash basis accounting to be a tax expenditure. The Treasury considers the cash method to be normal income tax law for some businesses, whereas the JCT considers accrual accounting to be the normal income tax law, according to *Federal Tax Expenditures for Fiscal Years 2012-2017*, JCS-1-13, February 1, 2013, p. 21, <https://www.jct.gov/publications.html?func=startdown&id=4503>.

<sup>2</sup> U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2014-2018*, committee print, 113<sup>th</sup> Cong., 2<sup>nd</sup> sess., August 5, 2014, JCX-97-14 (Washington, DC: GPO, 2014).

of accounting, income and expenses are recorded when a transaction occurs, regardless of when payments are actually received or paid.<sup>3</sup>

An example may assist in better understanding the difference between cash and accrual accounting. Consider a nail supply company that sells \$1,000 worth of nails to a roofing company in August, but the roofing company does not make payment until January of the following tax year. Using the cash accounting method, the nail supply company would record \$0 in revenue for that sale in August of Year 1 and \$1,000 in revenues in January of Year 2, when the payment is actually received. Alternatively, if the nail supply company used the accrual method of accounting, it would record \$1,000 in revenue in August of Year 1 and no revenue for that sale in January of Year 2. The nail supply company would treat any business expenses in the same manner as revenues depending on the accounting method used.

The accrual method more accurately measures a business's income during a given accounting period. The reason is that the accrual method captures all revenues actually earned during a given period, even if the cash has not actually been received. Similarly, the accrual method also captures all expenses generated in the production of revenue in a given period. The accrual method thus most accurately measures a firm's economic income in the sense that all profits or losses are accounted for when an economic event occurs, regardless of whether they are actually realized. It is this feature of the accrual method of accounting that leads it to be the baseline accounting method underlying the "normal income structure" used by the JCT.<sup>4</sup> Departures from the accrual method in computing tax liability, such as the cash basis method, are therefore considered tax expenditures by the JCT.<sup>5</sup>

On the one hand, the cash method of accounting is simpler. Allowing small business taxpayers to file taxes using cash accounting reduces the cost of record keeping for these businesses. In addition, some businesses, particularly smaller ones, may find the cash method beneficial when they are cash or credit constrained and would have trouble meeting their tax obligations under the accrual method. For example, a company may be waiting to receive payment for goods or services provided to a customer. Even if the payment is not expected to arrive until the following year, under the accrual method, the company would be required to incorporate it in its taxable income calculation for the current year. This, in turn, could result in a tax liability that the company may not yet have the cash resources to pay (because they are awaiting a customer's payment). The cash basis method allows the pending payment to be accounted for in the tax year in which it is received.

On the other hand, the cash method of accounting might lead to mismatching of income and related expenses to maximize tax deferral and avoidance. Under the cash method, a business could maximize tax deferral by strategically timing when income and expenses are recorded. For

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<sup>3</sup> For more information, see CRS Report R43811, *Cash Versus Accrual Basis of Accounting: An Introduction*, by (name redacted).

<sup>4</sup> For a broader discussion of what the JCT defines as a "normal income structure," see U.S. Congress, Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, JCS-10-87, Washington, DC, May 4, 1987, <http://www.jct.gov/jcs-10-87.pdf>.

<sup>5</sup> The Treasury Department differs from the JCT with respect to how it identifies tax expenditures, and it does not consider cash basis accounting to be a tax expenditure. The Treasury considers the cash method to be normal income tax law for some businesses, whereas the JCT considers accrual accounting to be the normal income tax law, according to *Federal Tax Expenditures for Fiscal Years 2012-2017*, JCS-1-13, February 1, 2013, p. 21, <https://www.jct.gov/publications.html?func=startdown&id=4503>.

example, during a tax period when expenses are lower, a firm could ask a customer to remit the payment the following tax period to reduce income and taxes on the profit in the current tax period. The converse is also possible; a firm could ask a customer to pay early if there were high expenses during the current tax period. By receiving the payment early, the firm is able to record higher income in the current period that is offset by the higher expenses, thus the firm is able to reduce the net tax liability in the subsequent tax period. Continuous management of income and expenses from one period to the next may not be as significant with small transactions but with larger transactions, it has the potential to significantly reduce tax liability. Mismatching of income and expenses is one of the many reasons the cash method of accounting is not considered in accordance with generally accepted accounting principles.<sup>6</sup>

## Legislative History

Before TRA86, taxpayers were allowed to use any method of accounting that clearly reflected income for tax purposes and that was regularly used for bookkeeping purposes. Taxpayers were required to maintain records to reconcile differences between financial and taxable income.<sup>7</sup> If the taxpayer used an accounting method that failed to clearly reflect income, the Secretary of the Treasury had authority to require the taxpayer to use a method that satisfied the statutory requirements. Accounting methods potentially available to taxpayers before TRA86 included the cash method, the accrual method, certain industry specific methods, and, with limitations, hybrid methods that combined several of these and other methods.

TRA86 changed the tax accounting rules governing what types of businesses could use the cash method of accounting. Congress recognized that the simpler cash method is easier for record keeping, entails less paperwork, and requires less computation to file taxes. As a result, TRA86 allowed most businesses with three-year average gross receipts of \$5 million or less to use the cash method of accounting.<sup>8</sup>

TRA86 also allowed certain businesses to continue to use the cash method of accounting regardless of whether their average gross receipts exceeded the \$5 million threshold. These businesses included (1) Personal Service Corporations (PSCs), such as law firms, doctors' offices, and consulting companies; (2) Subchapter S corporations; and (3) farm corporations subject to corporate income tax if their average gross receipts were not greater than \$1 million. In addition, partners of a partnership were taxed at the individual level on a cash basis.<sup>9</sup>

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<sup>6</sup> U.S. Congress, Joint Committee on Taxation *General Explanation of the Tax Reform Act of 1986*, JCS-10-87, Washington, DC, May 4, 1987, <http://www.jct.gov/jcs-10-87.pdf>. There are several reasons why cash accounting is not in accordance with generally accepted accounting principles (GAAP). First, the cash method does not require recording of receivables and accrued expenses in the period in which they are incurred. Second, financial reporting under GAAP accounting is standardized with specific set of rules and guidelines whereas financial reporting under the cash method does not have specific rules and guidelines. In addition, financial statements using cash accounting may not accurately report depreciation, inventory, prepaids, allowance for losses, and other assets and liabilities.

<sup>7</sup> Certain items are included for computing financial income that are not considered when determining taxable income. See, also, U.S. Congress, Joint Committee on Taxation, *Tax Reform Proposals: Accounting Issues*, JCS-39-85, Washington, DC, September 13, 1985, <https://www.jct.gov/publications.html?func=startdown&id=3394>.

<sup>8</sup> U.S. Congress, Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, JCS-10-87, Washington, DC, May 4, 1987, <http://www.jct.gov/jcs-10-87.pdf>.

<sup>9</sup> 26 U.S.C. §701.

### Personal Service Corporations

*Personal Service Corporations (PSCs)*—A PSC also can be identified as a qualified personal service corporation. A corporation is a qualified personal service corporation if it meets both of the following tests:

1. Substantially all of the corporation's activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.
2. At least 95% of the corporation's stock, by value, is owned, directly or indirectly, by employees performing the services listed above, retired employees who had performed such services, any estate of an employee or retiree described above, or any person who acquired the stock of the corporation as a result of the death of an employee or retiree (but only for the two-year period beginning on the date of the employee's or retiree's death).

Source: 26 U.S.C. §269A(b).

For more detailed discussion of different business types, see CRS Report R43104, *A Brief Overview of Business Types and Their Tax Treatment*, by (name redacted).

TRA86 also excluded certain businesses from using the cash method based on the legal structure of the business. As a general rule, the following businesses were prohibited from using the cash method: (1) Subchapter C corporations with average gross receipts over \$5 million; (2) partnerships that had a subchapter C corporation with average gross receipts over \$5 million as a partner; (3) tax shelters;<sup>10</sup> and (4) businesses that had average gross receipts in excess of \$1 million that carried inventory.

In the year following enactment of TRA86, Congress passed the Omnibus Reconciliation Act of 1987 (P.L. 100-203), which raised the average gross receipts test for family farm corporations from \$1 million to \$25 million. Family farm corporations with average gross receipts in excess of \$25 million were required to use the accrual method of accounting.

## Recent Legislative Proposals

The proposals to change the method of accounting for tax purposes predate the 1986 tax reform and continue to be a policy consideration for Congress and the executive branch. For example, the 1984 Treasury report on tax reform contained proposals on changes to method of accounting.<sup>11</sup> Since TRA86, there have been other proposals to modify the tax code as it relates to cash accounting. Over the last decade, at least three executive branch reports have addressed the allowable methods of accounting for tax purposes.<sup>12</sup> In general, all three reports emphasized the ease of recordkeeping and lower costs of compliance for small businesses. The reports

<sup>10</sup> 26 C.F.R. §301.6111-1T.

<sup>11</sup> Department of the Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth*, Washington, DC, November 27, 1984, p. 128, <http://www.treasury.gov/resource-center/tax-policy/Documents/tres84v1All.pdf>.

<sup>12</sup> See, President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System*, Washington, DC, November 2005, <http://govinfo.library.unt.edu/taxreformpanel/final-report/>; Department of the Treasury, Office of Tax Policy, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21<sup>st</sup> Century*, Washington, DC, December 20, 2007, <http://www.treasury.gov/resource-center/tax-policy/Documents/Approaches-to-Improve-Business-Tax-Competitiveness-12-20-2007.pdf>; The President's Economic Recovery Advisory Board, *The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation*, Washington, DC, August 2010, [https://www.whitehouse.gov/sites/default/files/microsites/PERAB\\_Tax\\_Reform\\_Report.pdf](https://www.whitehouse.gov/sites/default/files/microsites/PERAB_Tax_Reform_Report.pdf).



recommended expanding the use of cash accounting by small businesses when they file their taxes because cash accounting corresponds with how they pay their bills.

Recent proposals to change the allowable methods of accounting have focused on three general options. The first would expand the use of cash accounting for small businesses. Several bills introduced in the 113<sup>th</sup> Congress, including the Small Business Accounting and Tax Simplification Act (H.R. 947), the Start-up Jobs and Innovation Act (S. 1658), and the Small Business Tax Certainty and Growth Act (S. 1085), would have expanded the use of cash basis accounting by raising the average gross receipts limit to \$10 million from \$5 million.<sup>13</sup> Similar legislation was introduced in the 112<sup>th</sup> Congress, the Small Business Tax Simplification Act (H.R. 4643).

The second option, from the 113<sup>th</sup> Congress, the Tax Reform Act of 2014 (H.R. 1), would have changed the cash method of accounting for businesses in two ways. First, similar to the bills previously discussed, it would have expanded the use of the cash method for qualified businesses by raising the average gross receipts threshold from \$5 million to \$10 million. Second, unlike the previous bills discussed, H.R. 1 would have restricted cash accounting for some businesses. It would have required certain partnerships, S corporations, and PSCs that currently use the cash method to use the accrual method if their average gross receipts exceed \$10 million. The JCT estimated that the changes would have increased revenue by \$23.6 billion over 10 years.<sup>14</sup> One aspect of the revenue gain is the one-time income adjustments from the cash to accrual method transition. The other aspect of the gain, however, is likely transitory as the proposal would not change taxes due, just the timing.

The third proposed option would also expand cash accounting but to a higher threshold. The President's FY2016 budget contains such a proposal. Specifically, the Administration proposes to increase the three-year average gross receipts limit to \$25 million.<sup>15</sup> The President's budget proposal differs from the congressional proposals by increasing the average gross receipts limit to \$25 million instead of \$10 million. The budget proposal also states that more than 99% of all businesses would be able to pay taxes based on the simpler cash method if the limit were increased to \$25 million. The JCT estimates the President's proposed expansion of cash basis of accounting will result in 10-year revenue loss of \$24.9 billion between FY2015 and FY2025.<sup>16</sup>

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<sup>13</sup> H.R. 4840 in the 108<sup>th</sup> Congress and H.R. 2 in the 110<sup>th</sup> Congress would have changed the tax law for small businesses. Both proposals contained provisions that would require the average gross limit test to be inflation adjusted. H.R. 2 would have also raised the average gross limit test threshold to \$10 million.

<sup>14</sup> U.S. Congress, Joint Committee on Taxation, *Estimated Revenue Effects of the Tax Reform Act of 2014*, JCX-20-14, Washington, DC, February 26, 2014, p. 7, <https://www.jct.gov/publications.html?func=startdown&id=4562>.

<sup>15</sup> This report assumes that the intent of the President's FY2016 budget document was for a three-year average gross receipts limit. The budget does not specifically state that it is a three-year average gross receipts limit, rather it specifies "gross receipts of less than \$25 million." Office of Management and Budget, *Fiscal Year 2016 Budget of the U.S. Government*, Washington, DC, February 2, 2016, p. 57, <https://www.whitehouse.gov/omb/budget/Overview>.

<sup>16</sup> U.S. Congress, Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal*, 114<sup>th</sup> Cong., 1<sup>st</sup> sess., March 6, 2015, JCX-50-15 (Washington, DC: GPO, 2015), p. 3.



## Policy Considerations

Policy issues surrounding the use of cash versus accrual accounting involve the tradeoff between accurately capturing the economic activity of businesses to determine tax liability and the potential administrative burden placed on businesses as the result of increased recordkeeping. If Congress chooses to change the allowable methods of accounting for businesses, the availability of cash accounting could be expanded or restricted.<sup>17</sup> One general option is to expand the number of businesses allowed to use cash accounting by either including all businesses regardless of legal structure or increasing the average gross receipts threshold. Alternatively, another general option is to either eliminate cash accounting for all businesses or restrict the use of cash accounting for certain types of businesses.

Each of these policy considerations would have a direct effect on certain types of businesses. This section first discusses different ways of allowing more businesses to use cash accounting and then options that would eliminate or restrict cash accounting.

### Allow All Small Businesses to Use Cash Accounting

Providing targeted assistance to small businesses requires first a definition of “small business.” Eligibility for small business preferences often relies on asset, receipt, or employment size metrics or legal structure.<sup>18</sup> Some of the size standards in the tax code use employment or receipts, similar to the U.S. Small Business Administration’s (SBA) size standards for most industries. The small business cash accounting tax preference generally uses a receipt-based test, but it also explicitly excludes certain businesses based on legal structure in addition to the receipt-based test. For example, businesses that carry inventory with average gross receipts over \$1 million may not use cash accounting, although the majority of businesses that carry inventory would be viewed as “small” under most common measures of firm size.<sup>19</sup>

Cash accounting more closely aligns with how small businesses maintain their records and might provide a better picture of companies’ cash flows than accrual accounting. Whether these small businesses are C corporations, sole proprietorships, or partnerships, they are often more sensitive to cash flow considerations than are large businesses. Allowing all businesses to file tax returns under the cash method with average gross receipts not exceeding a predetermined threshold

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<sup>17</sup> According to tax law (26 U.S.C. §481), when a business chooses to change the method of accounting for tax purposes, it must determine income for the taxable year preceding the change under the old method. The income for the year of change and subsequent years must be determined under the new method. When the change in method of accounting is adopted, the business must also take into account items that might be duplicated or omitted because of the change.

<sup>18</sup> The Small Business Act of 1953 (P.L. 83-163, as amended) empowered the Small Business Administration (SBA) to select the size standards that are used to determine eligibility for federal programs. Two considerations guide the agency in establishing size standards for all industries. First, the standards should vary to reflect differences among industries. Second, the federal programs subject to the standards, including those administered by the SBA, should enable affected small firms to improve their competitiveness within the domestic economy. See CRS Report RL32254, *Small Business Tax Benefits: Current Law and Main Arguments For and Against Them*, by (name redacted).

<sup>19</sup> Certain legal protections are afforded to a C corporation, including continuity of life, because it is recognized as a separate legal and taxpaying entity. A C corporation conducts business, realizes net income or loss, pays taxes, and distributes profits to shareholders. The profits of a C corporation are taxed at the corporate entity level unlike a pass through entity, and the dividends are taxed when distributed to the shareholders. The corporation does not get a tax deduction when it distributes dividends to shareholders. Shareholders cannot deduct any loss of the corporation.

would simplify record keeping. The House Small Business Subcommittee on Economic Growth and Tax and Capital Access held a hearing on this issue, “Cash Accounting: A Simpler Method for Small Firms?” One of the witnesses at this hearing, Prof. Williamson, testified that increasing the statutory gross receipts limit to \$10 million would benefit small businesses and the overall economy.<sup>20</sup>

There are other reasons why cash accounting may be a less burdensome accounting method for small businesses. Many small businesses, regardless of legal structure, are more likely to require payment upon delivery of goods or when services are performed than to sell these items on credit. Payment upon delivery or performance eliminates the need for tracking payments.<sup>21</sup> In addition, unlike publicly traded companies that are required to issue public financial statements under the accrual method, most small businesses have no need to release public financial statements under the accrual or the cash method.

As previously discussed, cash accounting is a departure from normal tax law according to the JCT, and thus, a tax expenditure. Cash accounting is a less accurate measure of economic income, as it does not require matching of income and expenses under the standard of “economic performance.” Acceleration or deferral of income and expenses under cash accounting might result in deferral of tax liability. The JCT estimates that allowing cash basis accounting results in foregone revenue of \$10.9 billion from FY2014 through FY2018.<sup>22</sup>

Cash accounting is one tax benefit for small businesses. Various other provisions in the tax code support small business. For example, small businesses organized as pass through entities are subject to a single layer of taxation. Small businesses organized as corporations benefit from a graduated corporate rate structure. In addition, the ability to expense certain otherwise depreciable assets is mainly targeted at small businesses and confers a tax deferral.<sup>23</sup> This is considered a tax preference because expensing allows for full and immediate depreciation while the associated asset may have a useful life of many years.<sup>24</sup> Thus, taxable income is reduced in the year the asset is expensed. Although taxable income will be higher in later years, the earlier deduction will allow the asset’s owner to benefit from the time-value of money and realize a higher after-tax return on investment.<sup>25</sup>

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<sup>20</sup> U.S. Congress, House Committee on Small Business, Subcommittee on Economic Growth, Tax and Capital Access, *Cash Accounting: Simpler Method for Small Firms?*, 113<sup>th</sup> Cong., 2<sup>nd</sup> sess., July 10, 2014 (Washington: GPO, 2014), <http://www.gpo.gov/fdsys/pkg/CHRG-113hrg88718/html/CHRG-113hrg88718.htm>.

<sup>21</sup> Marty Schmidt, “Single Entry System Explained,” *Building the Business Case Analysis*, January 9, 2015, <https://www.business-case-analysis.com/single-entry-accounting.html>.

<sup>22</sup> U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2014-2018*, committee print, 113<sup>th</sup> Cong., 2<sup>nd</sup> sess., August 5, 2014, JCX-97-14 (Washington, DC: GPO, 2014).

<sup>23</sup> Section 179 of the Internal Revenue Code (26 U.S.C. §179) gives firms in all lines of business and all sizes the option, within certain limits, of expensing part or all of the cost of new and used qualified properties they acquire in the year when the assets are placed in service. For more information, see CRS Report RL31852, *The Section 179 and Bonus Depreciation Expensing Allowances: Current Law and Issues for the 114<sup>th</sup> Congress*, by (name redacted).

<sup>24</sup> 26 U.S.C. §57.

<sup>25</sup> There are also a number of other non-tax federal programs available that support small business. Small businesses also receive support through various programs administered by the SBA and other federal government agencies. As an example, the SBA provides loan guarantees and venture capital programs to enhance small business access to capital; contracting programs to increase small business opportunities in federal contracting; direct loan programs for businesses, homeowners, and renters to assist their recovery from natural disasters; and small business management and technical assistance training programs to assist business formation and expansion. See CRS Report R40985, *Small Business: Access to Capital and Job Creation*, by (name redacted).

## Increase the Average Gross Receipts Threshold

Another option is to increase the \$5 million average gross receipts threshold, while leaving all other current rules in place that exclude certain businesses from using the cash method. Over time, some businesses have been pushed over the \$5 million threshold since the enactment of TRA86 because it did not link the \$5 million threshold to inflation. Increasing the threshold would allow more small businesses to use the cash method, which would have similar effects to those of the previous proposal. As discussed above, some in Congress have proposed increasing the threshold to \$10 million, whereas the President's FY2016 budget proposal would raise the threshold to \$25 million.<sup>26</sup>

**Table 1** below illustrates the percentage and number of firms that would qualify to use cash accounting at \$10 million and \$50 million thresholds, by legal structure. Increasing the threshold would not generally affect pass through entities, such as S corporations, partnerships, and nonfarm sole proprietorships, because they are typically allowed to use cash accounting regardless of size. The data also shows that if the threshold were increased to either \$10 million (or \$50 million) that over 95% (98%) of C corporations would be permitted to use cash accounting. However, it is not possible to determine how much higher these percentages would be from the current \$5 million threshold because the data used in **Table 1** do not reflect the \$5 million threshold. According to **Table 1** increasing the threshold to \$10 million would allow 96% of C corporations to use cash accounting.<sup>27</sup>

**Table 1. Distribution of Firms by \$1 Million, \$10 Million, and \$50 Million Gross Receipts Threshold in 2012**

Types of Firms	C Corporations	S Corporations	Partnerships	Nonfarm Sole Proprietorships
Number of Firms	1,635,369	4,205,452	3,388,561	23,553,850
% of firms under \$1 million	77.75%	83.15%	93.01%	99.44%
% of firms under \$10 million	95.75%	97.81%	98.88%	99.98%
% of firms under \$50 million	98.81%	99.63%	99.73%	100% <sup>a</sup>

**Source:** CRS analysis of Internal Revenue Services' Statistics of Income as reported in U.S. Congress, Joint Committee on Taxation, *Choice of Business Entity: Present Law and Data Relating to C Corporations, Partnerships, and S Corporations*, committee print, prepared by Staff of the Joint Committee on Taxation, 114<sup>th</sup> Cong., 1<sup>st</sup> sess., April 10, 2015, JCX-71-15 (Washington: GPO, 2015), pp. 24-29.

a. The actual figure is 99.9987%

<sup>26</sup> Office of Management and Budget, *Fiscal Year 2016 Budget of the U.S. Government*, Washington, DC, February 2, 2016, p. 57, <https://www.whitehouse.gov/omb/budget/Overview>.

<sup>27</sup> When Congress considered TRA86, the Treasury Department estimated in 1985 that 8% (103,000) of all corporations, 1% (4,000) of all partnerships, and less than 1% (1,800) of all sole proprietorships would exceed the \$5 million threshold. U.S. Congress, Joint Committee on Taxation, *Tax Reform Proposals: Accounting Issues*, committee print, 99<sup>th</sup> Cong., 1<sup>st</sup> sess., September 13, 1985, JCS-39-85 (Washington: GPO, 1985), p.16.

Two general ways for determining a threshold adjustment could be implemented. First, Congress could choose to simply adjust the current \$5 million limit for inflation. If the limit had been adjusted for inflation since 1987, the threshold would be nearly \$10.7 million in 2015.<sup>28</sup> Congress could then index the threshold to inflation.<sup>29</sup> Two legislative proposals—H.R. 2 in the 110<sup>th</sup> Congress and H.R. 4840 in the 108<sup>th</sup> Congress—proposed indexing the \$5 million threshold to inflation.

Second, Congress could simply increase the threshold to a level deemed appropriate. For example, the President’s budget proposal for FY2016 would increase the cash accounting cutoff to \$25 million allowing, the Administrations argues, 99% of all businesses to pay taxes based on the simpler cash method in 2015.<sup>30</sup> As proposed, no inflation adjustment would occur. However, one option would be to combine the two methods, increasing the threshold and adjusting for inflation.

## Limit Cash Accounting or Require Accrual Accounting

Alternatively, Congress could eliminate cash accounting for all businesses or restrict the use of cash accounting for certain types of businesses based on legal structure. Excluding the cash method of accounting can be a tool for Congress to increase tax revenue and reduce the scope for tax planning and avoidance.

Eliminating cash accounting for all businesses would increase the administrative burden cost of compliance for many businesses. The accounting knowledge required to use the accrual basis may force business owners to hire accountants or the services of accounting firms, increasing the business’s expenses. Further, a business paying taxes under the accrual method may not have sufficient cash and may therefore be required to borrow to meet tax obligations. At the same time, it could be argued that a firm that continually required short-term financing to meet its tax liability is poorly managed rather than overly burdened by accounting standards.

The second approach is to require accrual accounting for all business types. One provision of the Tax Reform Act of 2014 (H.R. 1 in the 113<sup>th</sup> Congress) sought to require accrual accounting for certain partnerships, S corporations, PSCs, and other pass through entities with over \$10 million in average gross receipts that are currently exempt from accrual accounting requirements.<sup>31</sup> **Table 1** illustrates that 98% of S corporations and partnerships would qualify for the cash method with a \$10 million threshold. Economic theory generally provides no justification for taxing businesses differently based on their legal identity unless it can be shown that one form confers tax advantages that others do not share.

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<sup>28</sup> The 1986 \$5 million threshold inflation adjusted to 2015 is \$10,661,816, according to the Bureau of Labor and Statistics CPI Inflation Calculator, at [http://www.bls.gov/data/inflation\\_calculator.htm](http://www.bls.gov/data/inflation_calculator.htm).

<sup>29</sup> IHS Economics, *The U.S. Economy 30-Year Focus*, Third Quarter 2014, Washington, DC, 2014, p. 18, <https://www.ihs.com/>.

<sup>30</sup> Office of Management and Budget, *Fiscal Year 2016 Budget of the U.S. Government*, Washington, DC, February 2, 2016, p. 57, <https://www.whitehouse.gov/omb/budget/Overview>.

<sup>31</sup> A number of Members have publicly signaled that they would not support such a change. In August 2014, 46 Senators signed a letter stating their support for maintaining the cash method for businesses currently using it. In September 2014, 233 Representatives signed a similar letter.

If Congress were to eliminate cash accounting, or limit its use for certain firms, it could allow for tax deferral for affected firms with or without a penalty (e.g., accruing interest). Tax deferral allows taxpayers to delay their payments until a future date. A form of tax deferral currently offered by the Internal Revenue Service (IRS) is extended payment plans. There are two main types of extended payment plans, with certain limitations: (1) a payment extension for up to 120 days with interest and penalties and (2) an installment agreement. Although installment agreements are similar to the 120-day extensions, they offer a longer payment period and have their own specific caveats.<sup>32</sup>

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<sup>32</sup> Another option the Internal Revenue Service (IRS) offers taxpayers is Offer in Compromise (OIC), if an installment agreement will not work for the taxpayer. OIC is an agreement between the IRS and taxpayer, where the taxpayer agrees to pay the IRS a reduced amount. IRS, *Payment Plans, Installment Agreements*, Washington, DC, January 28, 2015, <http://www.irs.gov/Individuals/Payment-Plans-Installment-Agreements>.

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