

UPDATE ON MANDATORY ACCRUAL ACCOUNTING FOR LAW FIRMS

Recently, Secretary of the Treasury, Steven Mnuchin broadly explained President Trump's tax reform proposals. Little has changed from the summer of 2016, when, then candidate Trump initially put forth substantially similar proposals. The key goals of the President's tax reform include simplifying the tax code and significantly reducing, both, the administrative and economic burdens on American businesses. These are clearly business-friendly objectives, however, as with all legislation, the devil is in the details.

Those in Congress charged with drafting tax legislation, the Senate Finance Committee and the House Ways and Means Committee, must weigh the costs of such significant changes in United States tax law and find the means to pay for such costs. One proposal being considered by the committee members would if enacted, have a significant impact on the way law firms, accounting firms and other personal service businesses operate and do business. That proposal would require such businesses with gross receipts more than \$10 million, annually, to use the accrual method of accounting to compute their tax liability.

Cash vs. Accrual

Currently, most small businesses and personal service businesses are permitted to use the cash receipts method of accounting for tax reporting purposes. The cash method requires taxpayers to recognize and pay tax on income when received. It is safe to say that those in the personal service business will contend that this method most closely matches how their business operates and allows them to better serve their clients.

Accrual method taxpayers, on the other hand, are required to include income in the tax year when all events have occurred to accrue the taxpayer's right to receive the income, and the amount can be determined with reasonable accuracy. When the taxpayer receives the income is not a factor in determining whether income accrues under this method. Therefore, significant income would likely be taxed far in advance of receipt. Besides the obvious cash flow burden this would create, accrual accounting (for both financial reporting and tax reporting purposes) is far more

complex than the cash method and therefore would also create additional administrative burdens and increased compliance costs

It is not entirely clear what the transition to the accrual method would look like if this proposal becomes law or how a business should treat work in progress. At the very least, the additional "phantom" income that a firm would be required to recognize in the first year of transition to accrual should be permitted to be spread over four years, consistent with Internal Revenue Code §481(a), however, some opposed to the legislation have lobbied to have this period extended to eight years considering the magnitude of this potential change.

Given that President Trump's proposals have never referred to this accrual method mandate, as well as it clearly contradicting the President's overall objectives regarding tax reform, one would think that this proposal would have a difficult time becoming law. Nevertheless, certain law makers continue to consider this proposal as a "viable option" to help bring the President's tax reform proposals closer to revenue neutrality. Many in the personal service business (including the American Bar Association) have written to law makers urging them to abandon this proposal, arguing that additional burdens will create financial hardships which will adversely affect their businesses, their clients, as well as how and when they provide service. This proposal is being considered a serious threat to small businesses and personal service businesses. We will be monitoring the situation closely as more details surrounding tax legislation materialize.



Evan is a Director in the Tax Services Group at Wiss with a broad and extensive tax background. With over 15 years of experience, Evan has been delivering high-quality tax services to a diverse group of businesses, focusing on corporate tax and pass-through entities. He advises businesses on the tax implications of complex domestic, state & local and international transactions. His expertise also extends to the impact of such transactions on financial statements and other issues encountered in a tax provision. Evan has represented clients before the Internal Revenue Service, as well as state tax authorities and assisted in guiding clients through the examination process.