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Simplified Cash Method Keeps Taxes Simple

Owning your own business is about doing the one thing you love to do, and 99 other things you dislike but must do, according to Roger Harris, president and chief operating officer of Padgett Business Services.

"For most small business owners, at the top of that list of things they dislike are taxes and tax compliance," he told the House Small Business Committee at a hearing titled "Small Business Tax Reform: Growth through Simplicity."

Wednesday's hearing was particularly timely given the recent sluggish-to-non-existent job growth. Whether operated as sole proprietorships, partnerships or S corporations, small businesses continue to be the driving force for economic growth and job creation in the American economy, and have generated 65 percent of net new jobs over the past 17 years, according to the Small Business Administration.

The first witness at the hearing was House Ways and Means Committee chairman Dave Camp, R-Mich., who noted that he was the first Ways and Means Committee chairman to testify before the Small Business Committee since former chairman Al Ullman, D-Ore., did in 1979.

"It was nearly that long ago that Congress reformed the Tax Code," he observed. "Instead of making the Tax Code better, Congress has spent the last 27 years adding special provisions, making the code less effective and less efficient. That is something we must correct, especially for America's small businesses and their workers."

Camp cited a discussion draft he released last month designed to simplify tax compliance for small businesses. Core provisions in the draft would spur investment in equipment needed to grow business operations by providing permanent expensing of investments and property under Code Section 179; simplify tax and accounting practices by expanding the use of the simpler cash accounting method to businesses with gross receipts of $10 million or less; provide relief for start-up and organizational costs by establishing a unified deduction for these expenses; and make tax compliance easier for partners and S corporation shareholders by reordering and simplifying the due dates of tax returns for partners and S corporations.

Elaborating on the Camp plan, Harris proposed a Simplified Cash Method of accounting for small businesses based on the business checking account.

"For most entrepreneurs, the business checking account is the focal point for their bookkeeping," he told the committee. "It is how they measure cash flow and profits, and to a great extent is the basis for their tax accounting as well. First working with President Bush's Advisory Panel on Federal Tax Reform and most recently with David Kautter, professor of taxation and executive director of the Kogod Tax Center at American University, we have developed a legislative tax reform proposal—the Simplified Cash Method—that we believe would provide significant simplification, improve cash flow, encourage entrepreneurship and improve compliance foe the nation's millions of small businesses," he said.

Under the proposal:

- Qualifying taxpayers electing to use the simplified Cash Method would be required to have a dedicated small business checking account (or accounts) associated with a single EIN.
- All cash receipts and disbursements must pass through the dedicated account;
- Taxable income is based solely on amounts actually received;
- Deductions would be allowed when made for cash disbursements for inventory, prepayments, capital assets and depreciable assets;
- Payments made for leasehold improvements would be deducted as cash disbursements are made. All other real property rules would be governed under current law.
- Banks would report annual gross cash receipts and disbursements to the IRS, and IRS forms would provide a means on the tax return to reconcile any cash flows that are not income or a deductible disbursement.

Harris explained that the Simplified Cash Method would have the advantage of making the business checking account the "books" for the small business.

"A tax practitioner would rely almost solely on it for preparing the tax return," he said. "The IRS would have the same information to decide on which businesses to audit or contact. The tax return would provide the flexibility for the taxpayer to explain differences between what is reported to the IRS and what is on the tax return."

By contrast, today's rules require many small businesses to separately track and compute depreciation, amortization, inventory, capital expenditures and other items, strictly for tax purposes, Harris noted. "On the flip side, the IRS receives only parts of the information necessary for selecting taxpayers for compliance actions," he said. "We believe that both sides win from this proposal."

With the continuing talk about tax reform, it seems likely that some of these ideas will be in play when lawmakers get serious about simplifying the Code. And this idea sounds like a good one.