



New York State Bar Association

One Elk Street, Albany, New York 12207 • 518/463-3200 • <http://www.nysba.org>

TAX SECTION

2001-2002 Executive Committee

ROBERT A. JACOBS

Chair
Milbank Tweed Hadley & McCloy LLP
1 Chase Manhattan Plaza
New York, NY 10005
212/530-5664

SAMUEL J. DIMON

First Vice-Chair
212/450-4037

ANDREW N. BERG

Second Vice-Chair
212/909-6288

LEWIS R. STEINBERG

Secretary
212/474-1656

COMMITTEE CHAIRS:

Bankruptcy and Operating Losses

Lawrence M. Garrett

Stuart J. Goldring

Capitalization and Cost Recovery

Joel Scharstein

Alan J. Tarr

Character, Gains & Losses

Michael S. Farber

Paul R. Wysocki

CLE and Pro Bono

James A. Locke

David R. Sicular

Compliance, Practice & Procedure

Robert S. Fink

Arnold Y. Kapiloff

Consolidated Returns

Deborah L. Paul

Jonathan Kushner

Corporations

Jodi Schwartz

Diana L. Wollman

Employee Benefits

David A. Pratt

Andrew W. Stumpf

Estates and Trusts

Mildred Kalik

Carlyn S. McCaffrey

Financial Instruments

Erika W. Nijenhuis

David M. Schizer

Financial Intermediaries

Elizabeth A. Smith

Andrew P. Solomon

Foreign Activities of U.S.

Taxpayers

Kimberly S. Blanchard

Peter H. Blessing

Individuals

Sherry S. Kraus

Lisa A. Levy

Multistate Tax Issues

Robert E. Brown

Paul R. Comeau

New York City Taxes

Robert J. Levinsohn

William B. Randolph

New York State Franchise and

Income Taxes

Maria T. Jones

Arthur R. Rosen

New York State Sales and Misc.

Hollis L. Hyans

Steven U. Teitelbaum

Partnerships

William B. Brannan

Patrick C. Gallagher

Pass-Through Entities

Janet Beth Korins

Robert T. Smith

Real Property

Eliot Pisem

Lary S. Wolf

Reorganizations

Kathleen L. Ferrell

Dale L. Ponikvar

Tax Accounting

Yaron Z. Reich

Marc L. Silberberg

Tax Exempt Bonds

Linda L. D'Onofrio

John T. Lutz

Tax Exempt Entities

Dickson G. Brown

Michelle P. Scott

Tax Policy

M. Carr Ferguson

David S. Miller

U.S. Activities of Foreign

Taxpayers

Stuart E. Leblang

Emily McMahon

MEMBERS-AT-LARGE OF EXECUTIVE COMMITTEE

Linda McKissack Beale

Katherine M. Bristol

Peter v. Z. Cobb

Gary M. Friedman

Karen Griffith Gilbreath

Alyse Grossman

David P. Hariton

Kenneth H. Heitner

Sherwin Kamin

Barbara T. Kaplan

Charles I. Kingson

Donald C. Lubick

James Ross MacDonald

David W. Mayo

Charles Morgan

David H. Schnabel

Dana L. Trier

Shlomo Twerski

Eugene L. Vogel

Gordon Warnke

David E. Watts

Victor Zonana

April 27, 2001

The Honorable William M. Thomas
Chairman
House Ways & Means Committee
United States House of Representatives
2208 Rayburn House Office Building
Washington, D.C. 20515

The Honorable Charles E. Grassley
Chairman
Senate Finance Committee
United States Senate
135 Hart Senate Office Building
Washington, D.C. 20510

Dear Chairman Thomas and Chairman Grassley:

I write on behalf of the Tax Section of the New York State Bar Association to comment on the Cash Accounting for Small Business Act of 2001 (H.R. 656), introduced in the House of Representatives by Representative Wally Herger on February 14, 2001, and the matching bill (S. 336), introduced in the Senate by Senator Christopher Bond. This legislation proposes to simplify the tax accounting for qualifying taxpayers with average annual gross receipts of \$5 million or less (as adjusted for inflation). Qualifying taxpayers would no longer be required to use the accrual method and the inventory method of tax accounting, but instead would be eligible to use the cash method, as modified by the proposed legislation.

FORMER CHAIRS OF SECTION:

Samuel Brodsky
Thomas C. Plowden-Wardlaw
Edwin M. Jones
Hon. Hugh R. Jones
Peter Miller
John E. Morrissey, Jr.
Charles E. Herning

Ralph O. Winger
Martin D. Ginsburg
Peter L. Faber
Hon. Renato Beghe
Alfred D. Youngwood
Gordon D. Henderson
David Sachs

J. Roger Mentz
Willard B. Taylor
Richard J. Hiegel
Dale S. Collinson
Richard G. Cohen
Donald Schapiro
Herbert L. Camp

William L. Burke
Arthur A. Feder
James M. Peaslee
John A. Corry
Peter C. Canellos
Michael L. Schler
Carolyn Joy Lee

Richard L. Reinhold
Richard O. Loengard
Steven C. Todrys
Harold R. Handler
Robert H. Scarborough

Do the Public Good • Volunteer for Pro Bono

Under existing law, while taxpayers with average gross receipts of \$5 million or less generally may use the cash method,¹ all taxpayers must use the inventory method and the accrual method of tax accounting whenever the production, purchase or sale of merchandise is an income-producing factor.² Thus, the principal changes to be effected by the proposed legislation are (i) to enable taxpayers with average gross receipts of \$5 million or less that maintain inventories to use the cash method and (ii) to index the \$5 million threshold for inflation.

The Tax Section supports tax simplification, for small businesses and for taxpayers in general, whenever simplification is consonant with good tax policy. Viewing the proposed legislation from this perspective, the cash method of accounting has the virtue of simplicity, which makes it particularly appropriate for small businesses that do not maintain accrual method books and records for non-tax purposes. However, the cash method does not produce as clear a reflection of income as does the accrual method, and it presents more opportunities for “gaming” the system by affording taxpayers greater flexibility in accelerating their deductions or deferring their income.

The Internal Revenue Service has already taken a step in the direction of tax simplification in this area by issuing a revenue procedure similar to the proposed legislation, albeit with a lower cutoff point. Revenue Procedure 2001-10, 2001-2 I.R.B. 272 (Jan. 8, 2001) exempts qualifying taxpayers with average annual gross receipts of \$1 million or less (compared with \$5 million or less under the proposed legislation) from using the accrual method and the inventory method.

By extending the cash method to taxpayers with average gross receipts of \$5 million or less, the proposed legislation greatly expands the universe of taxpayers eligible for this simplification measure, and limits the more complex accrual method to the largest business enterprises in the United States. The question of whether to draw the line at \$1 million, \$5 million, or some other point is a policy decision on which we do not express an opinion.

We note, however, that the policy arguments for simplification are strongest in the case of small businesses that do not

¹ Sections 446(c)(1) and 448(b)(3) of the Internal Revenue Code of 1986, as amended (the “Code”). Unless otherwise indicated, all section references are to the Code or the Treasury regulations thereunder.

² Treasury Regulation §§ 1.471-1 and 1.446-1(c)(2)(i).

prepare financial statements on an accrual basis for other purposes, such as for internal management or reporting to lenders or shareholders. While it may not be desirable to make the availability of the cash method explicitly contingent on the absence of accrual method financial statements, in considering the appropriate dollar cutoff point for the availability of the cash method, the likelihood that businesses at a specified level of average gross receipts would have accrual basis financial statements would appear to be relevant.

The Tax Section also requests that two points concerning the operation of the proposed legislation be clarified.

1. *Treatment of the cost of items that would otherwise be inventory.*

The proposed legislation treats property that otherwise would have been inventory as “a material or supply which is not incidental,” but the proposed legislation does not provide adequate guidance as to when the cost of that property will be deductible.

The concept of non-incidental materials and supplies is taken from Treasury Regulation § 1.162-3, which requires taxpayers carrying materials and supplies on hand other than incidental materials and supplies to deduct the cost of materials and supplies “only in the amount they are actually consumed and used in operation during the taxable year.” It is not clear how to apply this standard to materials and supplies used to produce merchandise for sale.

One possible approach is suggested by Revenue Procedure 2001-10, which treats property that otherwise would have been inventory as “materials and supplies that are not incidental,” but then explicitly provides that the “actually consumed and used” standard is satisfied in the year in which the taxpayer sells the merchandise or finished goods. Thus, the Revenue Procedure concludes, “under the cash method, the cost of such inventoriable items are deductible only in that year, or in the year in which the taxpayer actually pays for the inventoriable items, whichever is later.” The Revenue Procedure permits producers to “use any reasonable method of estimating the amount of raw materials in their year-end work-in-process and finished goods inventory to determine the amount of raw

materials that were used to produce finished goods that are sold during the tax year, provided that method is used consistently.”³

On the other hand, the body of case law and revenue rulings interpreting “actually consumed and used in operation” under Treasury Regulation § 1.162-3 in the context of non-incidental materials and supplies that are not inventory generally treats those materials and supplies as consumed and used at the point when they are inserted into the production process.⁴ This formulation suggests that their cost could be deducted under the proposed legislation at some point during the production process, although one might question whether such a rule would promote simplification.

A third possible approach is suggested by statements made by Senator Bond in the Congressional Record concurrent with his introduction of S. 336, which could be construed as permitting qualifying taxpayers under the proposed legislation to deduct the cost of non-incidental materials and supplies at the time they are purchased and paid for. While this approach may be simplest, it may result in the greatest income distortion. Moreover, this approach appears to be inconsistent with the treatment of non-incidental materials and supplies under Treasury Regulation § 1.162-3.

In any event, assuming the Treasury Regulation’s rule for the treatment of non-incidental materials and supplies will be the relevant standard under the proposed legislation, it seems clear that retailers, wholesalers and other distributors that purchase and resell merchandise without performing production or manufacturing functions in respect thereof would not be eligible to deduct the cost of that merchandise when payment is made. Rather, these taxpayers will still be required to keep track of their inventories of merchandise, although (consistent with Revenue Procedure 2001-10) presumably they would be permitted to estimate their inventories under any reasonable method instead of having to comply with a specific inventory method under § 471.

³ Rev. Proc. 2001-10, § 4.02.

⁴ See *Hillsboro National Bank v. Comm’r*, 460 U.S. 370 (1983); *RACMP Enterprises v. Comm’r*, 114 T.C. 211 (2000); *Osteopathic Medical Oncology and Hematology, P.C. v. Comm’r*, 113 T.C. 376 (1999); *Galeridge Construction, Inc. v. Comm’r*, 73 T.C.M. 2838 (1997); *Rojas v. Comm’r*, 90 T.C. 1090 (1988); Rev. Rul. 98-25, 1998-1 CB 998; Rev. Rul. 78-382, 1978-2 CB 111; Rev. Rul. 75-491, 1975-2 CB 19; Rev. Rul. 75-407, 1975-2 CB 196; Rev. Rul. 73-357, 1973-2 CB 40; Rev. Rul. 69-200, 1969-1 CB 60.

As there seems to be some potential for confusion in this regard, we recommend that the legislation or committee reports clarify the correct timing of deductions for the cost of items that would otherwise be inventory.

2. *Treatment of accounts receivable.*

The proposed legislation contains no explicit provision concerning the timing of the recognition of income from accounts receivable. The treatment of accounts receivable should be clarified.

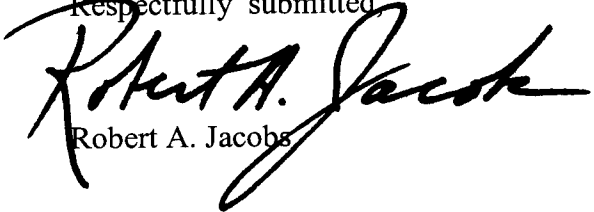
Under current law, both cash method taxpayers and accrual method taxpayers generally recognize gain on a sale at the time the sale takes place.⁵ The installment sale provisions under § 453 are the principal exception, but under § 453(l), installment sale reporting is not available to merchants who regularly sell property of the same type (“dealers”). Thus, in the absence of another available exception, even under the proposed legislation, dealers would be required to report the full amount of gain at the time of sale, rather than upon receipt of payment under a receivable.

Revenue Procedure 2001-10 allows qualifying taxpayers that use the cash method not to include amounts in income attributable to open accounts receivable (*i.e.*, receivables due in 120 days or less) until those amounts are actually or constructively received. Because the proposed legislation makes no specific provision for accounts receivable, it is not clear whether and under what circumstances qualifying taxpayers may be able to defer income attributable to sales of property that give rise to accounts receivable.

* * *

⁵ Section 1001(c).

Please let us know if we can be of further assistance in consideration of the issues addressed in this letter.

Respectfully submitted

Robert A. Jacobs

Enclosure

cc: The Honorable Charles B. Rangel
The Honorable Wally Herger
The Honorable Max Baucus
The Honorable Paul H. O'Neill
The Honorable Charles O. Rossotti
The Honorable Mark A. Weinberger
Pamela F. Olsen, Esq.
Lindy L. Paull, Esq.
James D. Clark, Esq.
John Buckley, Esq.
Mark Prater, Esq.
Russell W. Sullivan, Esq.
Cary Pugh, Esq.
Joseph M. Mikrut, Esq.
John Parcell, Esq.
Richard W. Skillman, Esq.
Lon B. Smith, Esq.
Philip J. Levine, Esq.
William Alexander, Esq.
Ms. Jennifer Brittenham
Mr. Robert Wells
Ms. Rebecca McCracken
Ms. Lee Sheppard
Mr. Tom Herman

NY2:#4411097v1