REPEAL OF THE INSTALLMENT METHOD OF ACCOUNTING FOR ACCRUAL BASIS TAXPAYERS

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

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REPEAL OF THE INSTALLMENT METHOD OF ACCOUNTING FOR ACCRUAL BASIS TAXPAYERS

TUESDAY, FEBRUARY 29, 2000

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC.

The Subcommittee met, pursuant to call, at 1:04 p.m. in room 1100, Longworth House Office Building, Hon. Amo Houghton (Chairman of the Committee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE
February 16, 2000
No. OV–15

Contact: (202) 225–7601

Houghton Announces Hearing to Review the Repeal of the Installment Method of Accounting for Accrual Basis Taxpayers

Congressman Amo Houghton (R–NY), Chairman, Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing to review last year's repeal of the installment method of accounting for accrual basis taxpayers. The hearing will take place on Tuesday, February 29, 2000, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 1:00 p.m.

Oral testimony at this hearing will be from invited witnesses only. Invited witnesses include the U.S. Department of the Treasury, organizations representing small businesses, and tax experts. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

The accrual method of accounting generally requires that taxpayers recognize income in the year in which the right to receive the income occurs, regardless of whether the taxpayer actually receives the cash in that year. The installment method of accounting allows an accrual basis taxpayer to defer recognition of income until the taxpayer actually receives payment.

Repeal of the installment method for accrual basis taxpayers was included in the Ticket to Work and Work Incentives Improvement Act of 1999, which was signed into law on December 17, 1999 (Public Law 106–170).

Since the repeal of the installment method for accrual basis taxpayers, concerns have been raised regarding the unanticipated effects on small businesses. The repeal has caused hardships for the owners of small businesses when they try to sell the business by accelerating when taxes must be paid or by lowering the amount offered by potential buyers.

In announcing the hearing, Chairman Houghton stated: "It appears that last year's repeal of the installment method for accrual basis taxpayers has had unintended consequences for small businesses. We need to take another look at this and first see what the Administration can do to straighten it out, and then look to see what, if anything, Congress can do to help."

FOCUS OF THE HEARING:

The focus of the hearing is to review the effects of the repeal of the installment method of accounting on small business owners and to discuss possible regulatory and legislative solutions.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit six (6) single-spaced copies of their statement, along with an IBM compatible 3.5-inch diskette in WordPerfect or MS Word format, with their name, address, and hearing date noted on a label, by the *close of business*, Tuesday, March 14 , 2000, to A.L. Singleton, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Oversight office, room 1136 Longworth House Office Building, by close of business the day before the hearing.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be submitted on an IBM compatible 3.5-inch diskette in WordPerfect 5.1 format, typed in single space and may not exceed a total of 10 pages including attachments. Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, company, address, telephone and fax numbers where the witness or the designated representative may be reached. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press, and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are available on the World Wide Web at 'http://www.house.gov.ways__means/'.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman HOUGHTON. Good afternoon. We are here to discuss the installment method of accounting for accrual basis taxpayers. We are here to discuss this particular issue. I know the topic may sound a little dry, but I assure you that I have heard from many small businesses that its repeal has created real hardships to small business owners around the country.

The accrual method of accounting, as many of you know, generally requires that taxpayers recognize income in the year in which the right to receive income occurs, regardless of when the

taxpayer actually receives cash. The installment method allows an accrual basis taxpayer to defer recognition of income in some cases until the taxpayer actually receives payment. The repeal of the installment method has caused hardships when owners try to sell their small businesses by speeding up when taxes must be paid or by lowering the amount offered by potential buyers.

The repeal of the installment method was first proposed by the administration last February in the fiscal year 2000 budget. The repeal was included in the tax bill the Committee passed last June. And it was finally included in the Ticket to Work and Incentives to Work Improvement Act that was signed into law in December. I don't believe the administration or Members of this Committee or small business trade groups realized last year how far reaching this proposal was.

So today marks the first step to correct the unintended consequences. I want to thank Secretary Summers and his staff—particularly Joe Mikrut—for working so quickly to draft guidance to resolve some of the problems that the repeal of this provision has caused. I am interested in hearing what they have come up with.

I am also pleased that our colleagues, Wally Herger, John Sweeney, John Tanner, and Jerry Kleczka have joined us. They responded quickly by introducing legislation to repeal the repeal, and it is my hope that we can act soon to fix this problem that has caused so many businessowners—such as the two witnesses we have here today—so much concern.

Chairman HOUGHTON. Now I am pleased to yield to our distinguished ranking Democrat, Mr. William Coyne.

Mr. COYNE. Thank you, Mr. Chairman, and thank you for holding this hearing.

In recent months, the Ways and Means Oversight Subcommittee has received complaints from the small business community about the recent repeal of the installment method of accounting for accrual basis taxpayers. The new law appears to have had unexpected consequences for many small businesses throughout the country.

This repeal provision was enacted into law as part of the Ticket to Work and Incentives Act of 1999. Currently the Department of the Treasury is finalizing regulations to implement the new rules.

I applaud the Subcommittee chairman, Chairman Houghton, for scheduling today's hearing. Testimony form the Department of the Treasury, National Federation of Independent Businesses, U.S. Chamber of Commerce, and the American Bar Association will provide us with an analysis of what, if anything, needs to be done in providing regulatory guidance or statutory change.

Also I would like to welcome to our hearing two former Ways and Means Oversight Subcommittee members, Congressman Jerry Kleczka of Wisconsin and Congressman John Tanner of Tennessee. They have both introduced legislation this year to repeal the installment method provisions of the 1999 act and return to prior law. I understand we will be hearing from them for an opening statement. Is that correct, Mr. Chairman?

Chairman HOUGHTON. Yes.

Mr. COYNE. So Jerry and John will make their case for their legislation in their opening statement.

Thank you.

Chairman HOUGHTON. Thank you very much.

Mr. Herger, would you like to make a statement?

Mr. HERGER. Thank you, Mr. Chairman.

I would like to begin by thanking you for scheduling this hearing to discuss an issue which has been of great concern to myself and literally hundreds of thousands of small business owners throughout the United States, a repeal of the use of installment sales for accrual method taxpayers.

Just 3 weeks ago, Congressman Tanner, Congressman Sweeney, and I introduced legislation entitled The Installment Tax Correction Act. This legislation will correct the damage being done to small businesses across America by modifying the tax law to once again allow accrual method businesses to make use of the installment sales. It is a testament to the importance of this issue that our legislation has already garnered the support of a majority of the taxwriting Ways and Means Committee members.

Our legislation does not break any new ground, it simply restores a type of business transaction which has been in use for more than 80 years. Since 1918, accrual businesses have been using the installment sales method because this method adjusts the payments of taxes to the demands of the marketplace. In contrast, a repeal of the installment sales is forcing small business owners who sell their businesses to pay taxes on income they have not yet received and may not receive for several years. In many cases, these sales are falling through or being put on hold.

Is this good tax policy? I think we can all agree it is not.

I was pleased by the Treasury Secretary's admission that installment sales repeal is having an effect more broad than what was originally intended. I look forward to hearing how Treasury intends to assist us in fixing this problem.

Let us commit here today to correct this situation as quickly and completely as possible on behalf of America's small businessmen and businesswomen.

Thank you.

Chairman HOUGHTON. Thank you very much, Mr. Herger.

Mr. Kleczka.

Mr. KLECZKA. Thank you, Mr. Chairman.

Mr. Chairman, I have a statement that I would ask unanimous consent to be made a part of the record.

Chairman HOUGHTON. Without objection, your prepared statement will appear in the record.

Mr. KLECZKA. Thus I won't have to repeat all that has been said by yourself and the other members.

I want to join my colleagues in supporting legislation to reinstate the installment method of accounting. I don't believe Congress really understood the ramifications when we passed the repeal last year. When we were talking about the Ticket to Work and Work Incentives Improvement Act, we were looking at dollars to pay for the act and I think we moved in haste by repealing the installment method.

I have also been contacted by many small business people and tax preparers who are relating some of the ramifications. I think through either passage of my bill, which is H.R. 3568, or the

Herger Bill, I think Congress should reinstate the installment method. Clearly, it is having its effect. It was not the intent of this congressman to provide a hardship for small business people who are trying to sell or buy a business and having to pay the tax before the bulk of the receipts are received.

Mr. Chairman, thank you for inviting me to participate in your Subcommittee's hearing today. I did serve on the Oversight Subcommittee for a couple of sessions. Had I known that you were going to be chairman, I would not have left.

[The opening statement follows:]

Opening Statement of Hon. Jerry Kleczka, a Representative in Congress from the State of Wisconsin

Mr. Chairman and members of the Subcommittee, it is with pleasure that I come before you to testify on behalf of legislation I introduced to reinstate the installment method of accounting for accrual basis taxpayers.

As we all know, H.R. 1180, the Ticket to Work and Work Incentives Improvement Act was passed by Congress last year. Although H.R. 1180 contained many important provisions, it repealed the installment method of accounting for most accrual basis taxpayers. This change of law affected all transactions occurring after December 17, 1999.

Prior to the passage of H.R. 1180, many business owners who sold their operations would pay taxes on the profits from the sale over the period in which they received payments. However, by repealing the installment method of accounting, business owners are now faced with the prospect of paying all the capital gains taxes owed from the sale immediately. In other words, taxpayers will be paying taxes on money they will not receive for many years in the future.

The intention behind repealing the installment method of accounting was to crack down on large corporations deferring taxes for extended periods. Instead of addressing a tax avoidance scheme, H.R. 1180 eliminated a perfectly legitimate method of financing sales transactions for small business owners. Clearly, Congress did not consider the full ramifications of this change in law.

Shortly after its enactment, I began hearing from my constituents and tax preparers expressing concern over the repeal of the installment method of accounting. To their surprise and dismay, many small business owners have found themselves facing an enormous tax bill if they decide to sell their business' assets.

It is estimated that more than 250,000 small businesses will be adversely affected by the repeal of the installment method of accounting. Many sales that were not finalized by December 17, 1999 have fallen apart and countless others will never occur. According to the *Wall Street Journal*, "While global merger megadeals done by pin-striped investment bankers get most of the publicity, in fact, most corporate marriages in the U.S. are tiny, involving deals valued between $500,000 and $2 million."

Furthermore, those who are looking to purchase additional assets in order to expand their operations will now find it more difficult to find a potential seller. As a result, the value of small businesses could be reduced by as much as 20 percent.

I understand the Department of Treasury is developing regulations to clarify the new law. While I welcome the Administration's participation in this important issue, I am concerned that the rule will not address the concerns raised by the small business community.

Because of the consequences of repealing the installment sales method of accounting, I introduced H.R. 3568. My legislation would reinstate the installment sales method for all transactions occurring after December 17, 1999. This would have the effect of continuing the tax treatment of installment sales that existed prior to the enactment of the Work Incentives Improvement Act last year.

Mr. Chairman, I believe the broad, bipartisan interest that this hearing has attracted underscores the importance of passing legislation to reinstate the installment method of sales. As the first member of the House of Representatives to introduce legislation on this issue, I look forward to working with my colleagues, the Administration, and all other interested parties to bring about a rapid enactment of this important legislation.

Chairman HOUGHTON. You are very generous. Welcome back. Thank you very much.

Mr. Tanner, do you have something equally as nice to say?

[Laughter.]

Mr. TANNER. I can think about something, yes, sir. I always brag on the chairman.

[Laughter.]

Mr. TANNER. I also have a statement, Mr. Chairman.

Seriously, I do want to say thanks to both of you for bringing this timely hearing to pass. I used to be on the Armed Services Committee before I came to this one, and this seems to be the collateral damage from a tomahawk missile attack.

[Laughter.]

Mr. TANNER. There was a reason Treasury proposed and Congress accepted the proposal last year. In fact, we passed it twice in this Committee and in the House. But this is collateral damage from what was an abuse. I am glad Treasury has recognized this and we are going to work together to get it fixed.

It is a pleasure to work with you, Mr. Chairman.

Chairman HOUGHTON. Thank you very much, Mr. Tanner.

Mr. Sweeney.

Mr. SWEENEY. Thank you, Mr. Chairman.

I, too, would like to commend you. And you know that I have often said privately and publicly great things about you because you are a real inspiration.

I want to commend the Committee. As a members of the Small Business Committee and as someone who represents a district where 90 percent of the local economy derives from small businesses, this is obviously a great concern. There are real human elements to the problem that we are going to try to correct here.

I will just give you one of them.

I have constituents—George and Dorothy Long of Lake George—who have worked all their lives building their business, which is a resort in beautiful Lake George. Unfortunately, they have had to reconsider their plans to retire and sell their business off because they are faced with three options based on the problem that exists here.

One is to take a loan out in order to pay for the capital gains tax. Two is to break the contract that they have signed already to conduct that sale and they would face a lawsuit. Or three is to suffer the consequences of nonpayment of taxes. So it put them in a very terrible position.

I will submit for the record a formal statement and I want to thank Mr. Herger and Mr. Tanner for their work on this effort and I look forward to the hearing.

[The opening statement follows:]

Opening Statement of Hon. John E. Sweeney, a Representative in Congress from the State of New York

Thank you, Mr. Chairman.

I commend you and your Subcommittee for your efforts to help small business and for holding a necessary and timely hearing.

It is imperative that we review the installment method of accounting for accrual basis taxpayers.

Thousands of small business sales have been inadvertently hurt by the inclusion of a provision in the tax extender bill, H.R. 1180, which prohibits the use of installment sales.

I applaud this Subcommittee for focusing its attention on a problem facing small businesses across the United States.

I appreciate the opportunity to participate in this Hearing.

As a Member of the Committee on Small Business, and a Representative of a Congressional District where 90% of the local economy is generated by small business transactions, I am particularly concerned with this topic.

I was shocked by the number of small business owners whose transactions were adversely impacted by the loss of installment sales.

For so many families, their only equity is entrenched in their family business.

Not only have I been contacted by many of my constituents, but my office has heard from small business owners throughout the United States, from Nova, Ohio to Lake George, New York to Clearwater, Florida.

It is sad to say, but we hear this same story and the same pleas for help over and over again.

Many small business owners signed sales contracts prior to the enactment of this provision and are now suffering the consequences of having to postpone their retirement plans.

These comments only scratch the surface of this growing problem.

Several months ago, Dorothy and George Long arranged for the sale of their resort in Lake George, New York, part of my district.

Unfortunately, they may have to reconsider their plans.

Mr. and Mrs. Long were relying on this sale to finance their retirement and are now faced with three options:

1.) take a loan out in order to pay for the capital gains tax, or

2.) break their contract and face a law suit, or

3.) suffer the consequences of non-payment of taxes.

It is terrible that small business, the engine of the local economy and the source of innovation throughout the country, is being hurt this way.

For example, this has happened to Richard Lohnes and his brother of Schaticoke, New York.

These gentlemen currently own an insurance agency in upstate New York, and after a lifetime of working, over

fifty years, they planned to finance their retirement by selling their business.

Sadly, they learned the tax bill for their sale exceeds the first year payment -a bill they cannot afford to pay.

Due to the loss of installment sales, these men and their families must consider temporarily postponing their retirements.

It is ironic that after more than fifty successful years in the insurance business, they cannot afford to recover their hard-earned equity.

We all know and agree this provision was unintentional, so we must work together to ensure small business sales are no longer depressed.

Thank you, for addressing this detrimental problem to small business across the United States.

I look forward to hearing this important testimony and working with this committee to restore the use of installment sales.

Thank you, Mr. Chairman.

Chairman HOUGHTON. Thank you very much, Mr. Sweeney.

I would now like to welcome and call on Mr. Joseph M. Mikrut, Tax Legislative Counsel, United States Department of the Treasury.

Mr. Mikrut.

STATEMENT OF JOSEPH MIKRUT, TAX LEGISLATIVE COUNSEL, U.S. DEPARTMENT OF THE TREASURY

Mr. MIKRUT. Thank you, Mr. Chairman.

Mr. Chairman, Mr. Coyne, Members of the Subcommittee, members of the Full Committee, we appreciate the opportunity to come before today to discuss the repeal of the installment method of ac-

counting. We especially appreciate your leadership, Mr. Chairman, in addressing this issue so soon after the Secretary made his statement before the Full Committee.

This afternoon I would like to quickly discuss where we are, potentially how we got here, what we see as the effect of the repeal of the installment method, and potentially where we should go from here, both administratively and legislatively.

As you mentioned in your opening statement, Mr. Chairman, there are essentially two types of taxpayers: Cash method taxpayers and accrual method taxpayers. The cash method taxpayer generally takes an item into account in income or as a deduction when he receives or pays the cash with respect to that item. In contrast, accrual method taxpayers generally take amounts into account when the event occurs that gives rise to the income or deduction.

The installment method of accounting is a different type of method altogether. The installment method provides an exception to these overall methods of accounting by allowing the taxpayer to defer the recognition of income from the disposition of certain property until payment is received. Under the installment method, a taxpayer recognizes gain resulting from the disposition of property proportionately as payments are received on the installment note. In this regard, the installment method more closely resembles the cash method of accounting.

Primarily for this reason, the Treasury Department and the administration last year proposed to repeal the installment method of accounting for accrual method taxpayers. In addition, the budget proposal also contained several rules dealing with the treatment of certain pledges and other items which are essentially cash equivalents and are not allowed under the use of the installment method of accounting.

Soon after the 1999 Act was passed by Congress, the small business community began to express concerns that the repeal of the installment method of accounting for accrual method taxpayers negatively impacted the sales of small businesses. In particular, small business groups have asserted that the use of the installment method to report the gain on the sale of business enabled the seller to get a higher price for its business and for a buyer to purchase a business for which bank financing may not be readily available.

As a result of the enactment of the installment sales provision, several small business groups have estimated that the reduction in the value of small businesses has exceeded 8 percent or more.

I would like to clarify two things with respect to the installment sales provision that was proposed by the administration and passed by Congress just this last year.

First of all, the installment sales provision is applicable to all accrual method taxpayers and is not limited to only small businesses. In addition, I believe certain press reports may have overstated the effect of the repeal of the installment method. Again, the installment method is still available for cash method taxpayers.

As indicated by the legislative history to the provision, the sale of stock of an accrual method business by a cash method taxpayer will continue to qualify for the installment method. Similarly the sale of an interest in an accrual method partnership by a cash

method taxpayer will also continue to be eligible for the installment reporting. On the other hand, the effect of the legislation is that sales of assets of an accrual method corporation or partnership will no longer qualify for installment reporting.

These different tax treatments add to the tension that already exists between buyers and sellers with respect to the decision to sell assets or stock. Buyers generally want to purchase assets in order to avoid contingent liabilities associated with the stock and to obtain an asset basis step-up to fair market value.

On the other hand, sellers typically want to sell stock in order to avoid two levels of tax, To obtain favorable capital gain treatment, and to transfer contingent liabilities associated with the stock.

Treasury's Office of Tax Policy has met several times with interested industry groups, including the NFIB, NAM, AICPA, the Small Business Legislative Council, and the U.S. Chamber of Commerce and listened to the concerns on the effects of the repeal of the installment sale on small businesses. These groups have requested clarification of the effect of the installment sales provision on particular transactions.

As indicated by Secretary Summers, we intend to issue such guidance in the near future that will address the availability of the installment method for the most common business disposition transactions. In addition, in analyzing the situation further, we will issue broader guidance that should alleviate the effect of the legislation on small businesses regardless of the entity's form, as well as provide additional tax accounting relief.

As the installment sales legislation as enacted by Congress only applies to accrual method taxpayers, the threshold issue is: Which taxpayers must use the accrual method and which taxpayers are allowed to use the cash method? As indicated in our most recent Treasury and IRS priority guidance plan, we intend to issue guidance addressing the requirements to account for inventories, and as a result, to use the accrual method. Part of this guidance generally will allow a qualified taxpayer with average annual gross receipts of $1 million or less to use the cash method and thus the installment method of accounting.

Let me point out and be clear that this is a significant change that will change not only the availability of the installment method, but the use of the cash method as well for all small taxpayers meeting the requirements. The details for qualifying for this exception and the procedures to automatically change to the cash method of accounting will be provided in guidance that should be published in the near future.

We believe that it is important to provide this guidance quickly. However, we understand that the guidance may not provide redress for all taxpayers. Consequently, providing relief for additional transactions may require legislation.

Overall, we believe the policy of repealing the installment method of accounting for accrual method taxpayers was sound, that the accrual method and the installment method are somewhat inconsistent. However, as exhibited by the comments we have received, we now understand that the legislation has imposed financial burdens on small businesses that override this basic tax policy con-

cern. As such, we are eager to work with the Congress to develop a legislative solution to alleviate this unforeseen impact on small businesses.

We believe that any legislative response should be targeted to address the legitimate concerns of affected taxpayers. To address the liquidity problems often brought up by sellers of small businesses—traditionally businesses with less than $5 million in gross receipts—use of the installment method should be allowed, perhaps with an interest charge as provided under present law, regardless of the seller's method of accounting. If there are other concerns regarding different treatments for different types of entities—for example, partnerships or subchapter S corporations—legislation can address these concerns as well.

Mr. Chairman, this concludes my prepared remarks. We look forward to working with you, Mr. Chairman, Mr. Coyne, and Members of the Subcommittee and Full Committee in addressing these concerns and we will keep you informed of our proposed administrative actions.

[The prepared statement follows:]

Statement of Joseph Mikrut, Tax Legislative Counsel, U.S. Department of the Treasury

Mr. Chairman, Ranking Member Coyne, and distinguished Members of the Subcommittee:

I appreciate the opportunity today to discuss with you the repeal of the installment method of accounting for accrual method taxpayers, which was originally proposed in the Administration's Fiscal Year 2000 budget and was enacted by section 536 of the Ticket to Work and Work Incentives Improvement Act of 1999, effective for sales or other dispositions occurring on or after December 17, 1999.

BACKGROUND

Items of income and loss generally are taken into account by a taxpayer in a taxable year based on the taxpayer's method of accounting. The cash receipts and disbursements method of accounting (cash method) generally requires an item to be included in income when actually or constructively received. In contrast, an accrual method of accounting items generally requires an item to be included in income when all events have occurred that fix the right to its receipt and its amount can be determined with reasonable accuracy. Accrual methods of accounting, when compared to the cash method, generally are acknowledged to better reflect economic income and comport to generally accepted accounting principles. Present law places several restrictions on the use of the cash method for income tax purposes.

The installment method of accounting provides an exception to these general recognition principles by allowing a taxpayer to defer recognition of income from the disposition of certain property until payment is received. Under the installment method, a taxpayer recognizes the gain resulting from the disposition of property proportionately as payments are received on the installment note. Payments taken into account for this purpose generally include cash, marketable securities, and evidences of indebtedness that are payable upon demand or are readily tradable.

The use of installment reporting was originally permitted by Treasury regulations in 1918 for dealers and subsequently sanctioned by Congress in 1926 for dealers and nondealers, subject to certain conditions. As explained by the Supreme Court in *South Texas Lumber Co*, 333 U.S. 496 (1948), the installment method of reporting was enacted to relieve taxpayers who adopted it from having to pay income tax in the year of sale based on the full amount of anticipated profits when in fact they had received in cash only a small portion of the sales price. However, beginning with the Tax Reform Act of 1986 (1986 Act), the availability of the installment method has been restricted and the benefits derived from its use have been substantially reduced. For example, use of the installment method was denied for revolving credit sales and sales of certain publicly traded property by the 1986 Act and for dealer dispositions of real or personal property, with exceptions for farming property, timeshares and residential lots, by the Revenue Act of 1987 (1987 Act). In addition, the 1987 Act significantly limited the benefits of using the installment meth-

od by imposing interest charges on the deferred tax liability attributable to certain installment obligations and by treating pledges of certain installment obligations as payment, thereby triggering the recognition of income.

ADMINISTRATION'S PROPOSAL AND SUBSEQUENT LEGISLATION

The Administration's Fiscal Year 2000 budget proposed to prohibit the use of the installment method to report income from an installment sale that would otherwise be reported on an accrual method of accounting (installment sales provision). The proposal did not change the use of the installment method by cash method taxpayers or the present-law exceptions regarding the availability of the installment method for sales of farming property, timeshares or residential lots. The Administration also proposed to eliminate certain inadequacies in the pledging rules by clarifying that put rights or other similar arrangements will receive the same treatment as pledges. The installment sales provision was proposed to be effective for sales or other dispositions occurring on or after the date of enactment.

As indicated in the General Explanations of the Administration's Fiscal Year 2000 Revenue Proposals, the installment sales provision was proposed because the use of the installment method is inconsistent with an accrual method of accounting and effectively allows an accrual method taxpayer to recognize income from the sale of certain property using the cash method. Consequently, the installment method fails to reflect the economic results of a taxpayer's business during the taxable year.

The policy reason underlying the installment method of accounting is to impose tax when the taxpayer has the wherewithal to pay the tax (i.e., when the taxpayer has received the cash). It was difficult to reconcile this policy reason, however, with an accrual method, which requires the payment of tax on trade or business receivables prior to the receipt of the related cash. Moreover, as a result of the repeal of the installment method for revolving credit sales, certain publicly traded property and dealer dispositions, the law already required taxpayers to include in income amounts that had not been collected. Allowing an exception for accrual method taxpayers for the disposition of certain property, but not for other property, created additional inconsistencies in the application of accounting methods.

The installment sales provision and the pledge rule clarification were enacted as part of the Ticket to Work and Work Incentives Improvement Act of 1999 (1999 Act), effective for sales or other dispositions occurring on or after December 17, 1999.

EFFECT OF THE LEGISLATIVE CHANGE

After the 1999 Act was passed by Congress, small businesses began to express concerns that the repeal of the installment method for accrual method taxpayers negatively impacted the sales of small businesses. In particular, small business groups have asserted that the use of the installment method to report the gain on the sale of the business enabled a seller to get a higher price for its business and a buyer to purchase a business for which bank financing was not readily available. As a result of the enactment of the installment sales provision, these small business groups have estimated that the sales price of some closely held businesses may be reduced by 8 percent or more.

The installment sales provision was made applicable to all accrual method taxpayers, not just to small businesses. The ability for an accrual method taxpayer to defer a realized gain until the related cash was received is inconsistent with an accrual method, regardless of the size of the taxpayer's business. The provision applies to both casual sales of property and sales of businesses that would otherwise be reported on an accrual method. However, the extent of the impact of the provision on the sales of small businesses apparently was unforeseen by policymakers and potentially affected taxpayers and their advisors during the legislative process.

The repeal of the installment method for accrual method taxpayers decreases the flexibility of structuring certain business dispositions, but does not totally eliminate the use of the installment method in such transactions. As indicated in the legislative history to the provision, the sale of stock of an accrual method business by a cash method taxpayer will continue to qualify for the installment method. Similarly, the sale of an interest in an accrual method partnership by a cash method taxpayer generally should continue to be eligible for installment reporting. On the other hand, sales of assets of an accrual method corporation or partnership will no longer qualify for installment reporting. These different tax results add to the tension that already exists between buyers and sellers with respect to the decision to sell assets or stock. Buyers generally want to purchase assets in order to avoid contingent liabilities associated with the stock and to obtain an asset basis "step-up" to fair market value. On the other hand, sellers typically want to sell stock in order to avoid

two levels of tax, to obtain favorable capital gain treatment, and to transfer contingent liabilities associated with the stock.

TREASURY'S RESPONSE

Treasury's Office of Tax Policy has met several times with interested industry groups, including the National Federation of Independent Businesses, National Association of Manufacturers, American Institute of Certified Public Accountants, Small Business Legislative Council, and U.S. Chamber of Commerce, and listened to their concerns about the effect of this recent legislation on sales of small businesses. These groups also requested clarification of the effect of the installment sales provision on particular transactions. For example, they requested that we address the sale by a cash method individual of an accrual method business conducted as a sole proprietorship; the continued viability of section 453(h), which allows a shareholder of a liquidating corporation to use the installment method to report the gain on the exchange of its stock for an installment obligation of the purchaser of the corporation's assets; and the effect of a section 338 election, under which a stock sale is deemed an asset sale for tax purposes, on a stock sale of an accrual method corporation by a cash method seller.

We intend to issue guidance in the near future that will address the availability of the installment method for most common disposition transactions. In addition, we will issue broader guidance that should alleviate the effect of the legislation on small businesses, regardless of the entity's form, as well as provide additional tax accounting relief. As the installment sales legislation applies to accrual method taxpayers, a threshold issue arises as to which taxpayers are required to use an accrual method, an issue that we have been aggressively studying in other contexts. As indicated on the most recent Treasury and IRS Priority Guidance Plan, we intend to issue guidance addressing the requirements to account for inventories and, as a result, to use an accrual method. Part of this planned guidance generally will allow a qualified taxpayer with average annual gross receipts of $1 million or less to use the cash method and, thus, the installment method. The details for qualifying for this exception and the procedures to automatically change to the cash method will be provided in guidance that should be published in the near future.

While we believe it is important to provide clear and timely guidance to clarify the effect of the installment sales provision on particular transactions and certain small businesses, we believe the law is clear that where an accrual method entity sells assets, or is deemed to sell assets, the installment method will no longer be available because the method of accounting of the entity controls the transaction. Consequently, providing relief for such transactions will require legislation.

Overall, we believe the policy underlying the legislation is appropriate. The installment method is inconsistent with an accrual method of accounting, which generally requires a taxpayer to pay tax on a realized gain, regardless of whether the taxpayer has received the related cash. However, we now understand that the legislation has imposed financial burdens on small businesses that override this basic tax policy concern. As such, we are eager to work with Congress to provide a legislative solution to alleviate this unforeseen impact of the installment sales provision.

Any legislative response should be targeted to address the legitimate concerns of affected taxpayers. To address the liquidity problems facing sellers of small businesses (e.g., businesses with less than $5 million in gross receipts), use of the installment method could be allowed (perhaps with an interest charge), regardless of the seller's method of accounting. If there is concern that different types of flow-through entities are treated differently (because sales of partnerships may be structured to allow the buyer to obtain a stepped-up basis and the seller to use the installment method while sales of S corporations allow either the buyer to obtain a stepped-up basis or the seller to use the installment method), special rules could be provided to level the playing field. In addition, legislation also could clarify the treatment of sole proprietorships and address other issues related to the use of deferred payments. Finally, any legislative solution should promote simplification and administrability.

This concludes my prepared remarks. We look forward to working with you, Mr. Chairman, Mr. Coyne, and members of the Subcommittee and full Committee in developing any legislative proposals deemed appropriate, and we will keep you informed of our proposed administrative actions. I would be pleased to respond to your questions.

Chairman HOUGHTON. Thank you very much, Mr. Mikrut.

I usually pass the questioning off to my associate here, but I would like to ask a general question.

As you probably know, I have been pretty interested in the tax simplification issue and the ramifications on people and all business, particularly small business. But it just seems to me that the repeal last year of this particular provision really sort of flipped on its side 80 years of tax policy, and also makes it much more difficult for small business to exist, particularly because it is a lot easier for legal action to be taken against these small businesses.

How do you feel about that?

Mr. MIKRUT. I think over the years, Mr. Chairman, Congress has slowly itself cut back on the use of the installment method with respect to accrual method taxpayers. For instance, it was no longer available to the sellers of goods, which had traditionally been accrual method taxpayers. Likewise, the installment method is not applicable when what you receive is publicly traded property primarily for liquidity concerns.

We take to heart, though, your call for simplification. And we do recognize that the repeal of the installment method for accrual taxpayers, including small businesses, will create complications in trying to structure transactions. I will point out, though, that in present law, use of the installment method with its concomitant interest charges is itself a bit of complexity. I am not here to suggest that we are saving taxpayers from that complexity by requiring them to pay their tax up front, but I will point out that any solution here ought to be both administrable by the IRS and readily applicable by taxpayers.

Chairman HOUGHTON. And it makes you wonder whether an almost complete repeal of the repeal isn't the only way to go.

Mr. MIKRUT. Again, Mr. Chairman, we believe from a policy standpoint that the use of the installment method is inconsistent with the use of the accrual method. In general, most taxpayers that use the accrual method are larger taxpayers who can probably more readily adapt to such complications. That is why we have suggested in our testimony that a more targeted direct carve-out for small businesses would be most appropriate.

Chairman HOUGHTON. Mr. Coyne, would you like to ask some questions?

Mr. COYNE. Thank you, Mr. Chairman.

Mr. Mikrut, you had testified that those in the million-dollar category or less that would be covered by your proposal would be about 30 million businesses. Is that correct?

Mr. MIKRUT. I can give you some better statistics than that, Mr. Coyne.

In looking at 1997 return data, of the 2.2 million subchapter C corporations, which generally are the larger corporations—some 78 percent of those would qualify for the million-dollar exception. With respect to the 2.4 million S corporations, 85 percent have gross receipts of under $1 million.

With respect to the 28 million partnerships and sole proprietorships, in excess of 95 percent of those entities have gross receipts

under $1 million. So we think providing the million-dollar exception, as we outlined for use of the cash method, will alleviate much of the concern small business has raised.

Mr. COYNE. Is it accurate to say that there are 33 million business taxpayers? Is that the figure?

Mr. MIKRUT. That is correct.

Mr. COYNE. Total?

Mr. MIKRUT. That is correct, according to 1997 return data.

Mr. COYNE. What types of small businesses in that 33 million figure and sales transactions would not be covered by the Treasury's guidance?

Mr. MIKRUT. I think it is approximately three million of those taxpayers, and those are primarily subchapter C corporations, which are in general the larger, more sophisticated taxpayers who generally use the accrual method for book treatment as well.

Mr. COYNE. Is there any additional legislation that you would suggest now? I know you are going to work with the Committee and the Committee is going to work with you in trying to come up with additional legislation, but is there anything you can touch on now? And could you let us know the major features of such legislation?

Mr. MIKRUT. Again, Mr. Coyne, the purpose of this hearing is to hear the direct concerns of small businesses and other affected taxpayers. We think any legislation should be crafted toward those concerns.

Traditionally, Congress has defined a small business as one that had less than $5 million of gross receipts. So in that regard, perhaps the use of the installment method for those taxpayers—those with less than $5 million in gross receipts—might be appropriate. To the extent that Congress would want to backstop that, there is under present law a requirement for some taxpayers to use an interest charge. Perhaps the interest charge could be applied to those taxpayers to make the government whole for any deferral of tax.

Mr. COYNE. Thank you.

Chairman HOUGHTON. Mr. Herger?

Mr. HERGER. Thank you, Mr. Chairman.

Mr. Mikrut, I want to begin by thanking you and the Treasury and expressing my appreciation for the effort you have been making to help us correct this very major problem. We have been hearing from literally thousands of small businesses throughout the United States. I have heard from many hundreds just from my own district. Having said that, we have just today seen your proposal. I am really waiting to hear more from the small business community as they begin looking at it to see if indeed it is able to address the full concerns that we have.

I do have one question. I think about a million—in this day and age we are talking about gross sales. Is that correct?

Mr. MIKRUT. Yes, Mr. Herger. Traditionally, Congress has used a gross receipts test to try to define a small business.

Mr. HERGER. My concern is that with small business, particularly today, you can get up to $1 million—particularly if you have a couple of McDonald's restaurants, for example. Maybe each business may not get over $1 million, but maybe several together may. If someone, say, had two or three McDonald's around town that he

had built up, and he was selling one of these for his retirement or whatever, would it be the aggregate of his several businesses, or just that one that he was selling?

Mr. MIKRUT. Mr. Herger, we haven't put together all the details of the proposal, but if you look at current section 448, which provides the $5 million rule for required use of the accrual method, those rules use an aggregate concept and we would most likely try to apply those types of rules as well.

Mr. HERGER. So in other words, you would take the several businesses—you would add it all, not just the one he was selling? So that very well could put this individual in over the $1 million range.

Mr. MIKRUT. As Congress addressed this in 1986, you would not want to have a well-advised taxpayer start dividing his business into very small parts so that each one qualified for the $1 million or $5 million exception.

Mr. HERGER. And I can certainly understand that. But also just the nature—this is not uncommon at all. You have a small business man who may have a Burger King, and he may have two in the same small community. I represent a very large rural area and there are small towns. You could have one in each of the small towns. He hasn't divided this on purpose to get out of paying his taxes, that is just the nature of his small business.

Mr. MIKRUT. I understand, Mr. Herger. It is just very difficult to distinguish a tax-motivated transaction from a pure business-type transaction.

Mr. HERGER. The concern that has been expressed by several of the members—as well as Secretary Summers, I believe, in so many words—and I don't want to put words in his mouth—when he was before our Committee a few weeks ago he indicated that they were not aware of the incredible ramifications of what this was going to do. Certainly those of us as Members of Congress—as was mentioned by Congressman Kleczka a little earlier—were not aware of the ramifications this was going to have.

As we move forward with this, I would hope—and it would appear that maybe it doesn't take care of all these ramifications—I would certainly hope that perhaps the Treasury and the administration could support our legislation that would basically put it back like it was for 80 years and do away with it completely.

Do you have a comment on that?

Mr. MIKRUT. I also don't want to put words in the Secretary's mouth, but I think it is clear that what we are trying to address both administratively and with proposed legislation are the direct concerns of small businesses. At this point we don't believe that a complete repeal of the repeal is necessary to do that. Clearly, it would cover everything, but we think that a more limited approach using traditional means by which Congress has tried to define small business might be appropriate here. Of course, we are looking forward to the testimony from the other witnesses to see if that might be appropriate.

Mr. HERGER. Thank you.

Thank you, Mr. Chairman.

Chairman HOUGHTON. Thank you.

Mr. Kleczka.

Mr. KLECZKA. Thank you, Mr. Chairman.

I am still unclear as to Treasury's position on the legislation introduced by Mr. Herger and myself which would reinstate the repeal of the installment method.

Your proposal is to provide for continuing the cash method for businesses with gross receipts of $1 million or less. Current law is $5 million or less. Is it not?

Mr. MIKRUT. No, Mr. Kleczka. Present law is that if you are a subchapter C corporation or if you are a partnership that has a subchapter C corporation as a partner, and you have gross receipts in excess of $5 million, you must use the accrual method of accounting.

Mr. KLECZKA. So if you have $5 million or less you can use cash accounting?

Mr. MIKRUT. You can use cash accounting—and I think the legislative history to the 1986 act makes it clear—you can use cash accounting if you were otherwise eligible to use cash accounting. Regulations also dating back approximately 80 years have made it clear that where merchandise is a significant income-producing factor in a business, there is a requirement to keep inventories. And if there is a requirement to keep inventories, then there is a requirement to use an accrual method of accounting regardless of the amount of the gross receipts.

So traditionally dealers in goods, sellers of goods had to use an accrual method of accounting no matter what their gross receipts.

Mr. KLECZKA. But the statute at one point does talk about a $5 million gross for a small business. What would be wrong with Treasury using that same $5 million figure instead of the $1 million that you are proposing? What is the problem there?

Mr. MIKRUT. Again, it would be overturning approximately 80 years of regulations that have been in existence. We also believe that it would result in the improper measurement of income, that for sellers of goods or larger businesses it is more appropriate to use an accrual method of accounting. This is the method of accounting that is often required to be used for book purposes, to provide financial statements, to apply for bank loans. It provides a clearer reflection of income. It eliminates any timing ability for taxpayers to take in receipts or to make prepayments and receive deductions.

We think many of these concerns are not there when the level of gross receipts is small, $1 million. But once you reach the $5 million plateau, general tax policy and other considerations require the use of the accrual method of accounting.

Mr. KLECZKA. I guess we just disagree what that level should be.

We do have two pieces of legislation to introduce. What is Treasury's specific objection to the bills that are before the Committee, and how would you recommend they be changed to get Treasury's support?

Mr. MIKRUT. I believe the bills are important in that they try to address concerns that have been raised. But I think they address more than those concerns because I think they also address the use of the installment method of accounting by a Fortune 500—

Mr. KLECZKA. The bills repeal the repeal, so whatever was previously current law—

Mr. MIKRUT. That's right.

Mr. KLECZKA. How do you suggest we change the legislation to comply with the thinking of the Treasury Department?

Mr. MIKRUT. I think perhaps the most appropriate method would be to provide a small business exception. If you believe a small business should be $5 million in gross receipts as opposed to $1 million in gross receipts, that would be an appropriate cutoff. I think that is what Congress has traditionally tried to define a small business as.

Mr. KLECZKA. So the bills would be more acceptable with a level or definition of what type of business shall be applicable to the cash accounting, and that would be either $1 million or $5 million, but not higher than $5 million?

Mr. MIKRUT. That is correct.

Mr. KLECZKA. Thank you, Mr. Chairman.

Chairman HOUGHTON. Now I would just like to ask a question—sort of a peripheral question—but in terms of the installment method, which was established 80 years ago, it wasn't $1 million and it wasn't $5 million. What was it in 1920?

Mr. MIKRUT. There was no dollar threshold, Mr. Chairman.

Chairman HOUGHTON. When did the dollar figure come into effect?

Mr. MIKRUT. In 1986, Congress again provided that a subchapter C corporation with gross receipts over $5 million—except for certain professions—

Chairman HOUGHTON. So it was keyed in 1986 for the first time?

Mr. MIKRUT. Yes, and again in 1986 and 1987 Congress repealed the use of the installment method for dealers in goods, which were essentially accrual method taxpayers, but continued to allow the installment method for casual sales of property, for instance, land used in the business, maybe a division or subsidiary, something like that, but imposed an interest charge to the extent that the installment obligations exceeded $5 million. And that's where we were until last year.

Chairman HOUGHTON. Thank you very much.

Mr. Sweeney.

Mr. SWEENEY. Thank you, Mr. Chairman, and thank you, Mr. Mikrut, for all of your work and for issuing the guidance today.

It seems that, as the prior questioners honed in, that the difficulty we are going to have—as is usually the case when you are trying to define delineations that will provide benefits to some and not to others—the standard for defining what a small business is. That is really the crux of the disagreement. So I am going to try to hone in a little just to clarify in my mind how we can begin to develop those definitions.

Is it correct that the guidance that you have issued today will not help closely held businesses operating as corporations?

Mr. MIKRUT. I believe it would, Mr. Sweeney. We haven't issued the guidance yet. But again, as we began to examine this issue, the small business community pointed out several different type of transactions that the legislation affected and requested guidance with respect to those limited types of transactions. But the more we looked at it, we thought a more global solution was necessary

and that is why we came up with a $1 million threshold that would apply to all businesses.

And more importantly, this $1 million threshold for the use of the cash method is applicable not only for the installment sales but also for purposes of reporting day-to-day operations. That is why we think it is a significant development.

Mr. SWEENEY. So the type of business structure doesn't really matter?

Mr. MIKRUT. No, it does not.

Mr. SWEENEY. Would the $1 million exception apply regardless of inventories?

Mr. MIKRUT. That is correct.

Mr. SWEENEY. That seems to be a new approach. What is that based on? What precedent?

Mr. MIKRUT. Again, we think the cash method of accounting Congress reserved for less sophisticated taxpayers. One measure of determining sophistication is the level of gross receipts. Also in the law is a concept that as long as the accrual and the cash method give you substantially the same results, the cash method would otherwise be allowable. We think with respect to gross receipts of less than $1 million the results will not vary by that much between cash and accrual.

And finally, part of this is a very practical concern, Mr. Sweeney. As you know, there has been a lot of litigation or potential litigation in the area between cash and accrual methods of accounting. It is probably not an adequate use of IRS resources to look at businesses where gross receipts are relatively insignificant, less than $1 million.

Mr. SWEENEY. I think if there is going to be disagreement, it will be based on the sense that many of us have that—and it is true that when you are setting an arbitrary number to define something clearly you are going to have these difficulties—but I am concerned that the $1 million figure would limit the applicability and it may not cover all kinds of circumstances.

I noticed in your statement you recognized that we need to take approaches that would respond to those issues and concerns of the small business community.

I look forward to working with you.

Thank you, Mr. Chairman.

Chairman HOUGHTON. Thank you very much.

You cut off the cash method for a business at $5 million and kick into the accrual method, and yet the United States government which has a budget of $1.9 trillion is still on a cash basis.

Can you explain the difference?

Mr. MIKRUT. The rule that requires a taxpayer with $5 million of gross receipts to cut off from the cash to the accrual method is something that Congress enacted in 1986. I believe the rationale there was that the accrual method is generally the method that corporations use for book purposes. There was an attempt to conform book and tax treatment with respect to those types of entities.

I do not know why the Federal Government necessarily—nor am I a budget expert able to explain to you why—it uses the cash method for accounting.

Chairman HOUGHTON. I didn't really expect you to have that answer. [Laughter.]

Mr. Tanner.

Mr. TANNER. Thank you very much, Mr. Chairman.

I think this has been an interesting discussion. I think there is room for agreement here with everyone. I think we are talking about two different things. I don't know who would change their day-to-day accounting. We are talking about the sale of a business, which is a one-time event in the lifetime of a small business, not a year-to-year situation.

Number two, you stated that you were concerned that our bill addressed more than the problem. I am a little concerned that your solution is more narrow than the problem. So I think we have some work to do to see where we can work together to make the end result we all want come to fruition.

Thank you for your time, Mr. Chairman. I am going to have to go to another meeting, but I sincerely appreciate the invitation and the opportunity to speak. We will work with you and Treasury to see what we can come up with.

Chairman HOUGHTON. Thank you very much, John, for being with us.

Mr. Weller.

Mr. WELLER. Thank you, Mr. Chairman.

I missed the opening statements, but I do have an opening statement I would like to submit into the record.

Chairman HOUGHTON. Without objection, your prepared statement will appear in the record.

[The opening statement follows:]

Opening Statement of Hon. Jerry Weller, a Representative from the State of Illinois

We are here today to hear testimony about the inadvertent effect that a provision included in "The Tax Relief Extension Act of 1999" is having on small businesses. Section 536 of that Act modified the installment method of accounting and generally prohibited the use of the installment method of accounting for sales of property by taxpayers that use the accrual method of accounting. It appears that the impact of this Installment Sales provision goes well beyond anything hinted at in the President's Budget for 1999 which first introduced this repeal provision. While the provision appeared to target larger, accrual method businesses when they sold a particular asset or assets, its real effect will be to reduce the value of closely held businesses when they are sold in their entirety. These small business run the gamut -from dry cleaners and mom and pop convenience stores to insurance agencies and other small service providers.

I have already heard from many independent insurance agencies located in and around Joliet in my home district that this provision is crippling the value of their agencies that they have worked lifetimes to create. I believe that it is essential that we take corrective action immediately to ensure that small business owners like the independent insurance agents in my district do not suffer from such needless punishment. I hope that the hearing we are holding today will be the first step toward that goal.

Mr. WELLER. Mr. Chairman, first I want to thank you for conducting this hearing. This is an issue I have heard about from back home—folks who run dry cleaners, mom and pop convenience stores, and particularly some insurance agents. The other day they were looking for someone's head because they took a look at the impact of this provision in last year's law in the budget and have

come to the conclusion that it really has a big impact on the value of their agency. These are middle-class guys and gals that have worked very hard to build something they would like to pass on to their kids and they are already threatened by the estate tax, which can have an impact on passing that on to their children.

They now see that because of this change the value of this asset they would like to pass on to their kids has diminished as well.

It is my understanding that this idea came out of the Treasury Department last year.

I would ask Mr. Mikrut, was this Treasury's idea?

Mr. MIKRUT. I think this is an idea that has been around. In the deliberations for the 1986 Act, Congress considered this. The theory then was that the accrual method and the installment method are somewhat inconsistent methods of accounting and therefore the installment method should be reserved for the cash method taxpayers.

Mr. WELLER. As I stated, it is having a negative impact on middle-class people who are trying to build up an asset they want to pass on to the next generation.

I really want to commend my friend, Mr. Herger, for taking the lead on working to repeal this provision which is hurting a lot of people.

I am trying to get a great understanding of it. Who was the villain you were trying to slay when you proposed this last year?

Mr. MIKRUT. There was no particular transaction or particular abuse, Mr. Weller, we were trying to direct it toward. Again, we were trying to reconcile the different methods of accounting and we thought that accrual method and the installment method just did not line up as well as the installment method and the cash method. That is where we drew the line.

Mr. WELLER. Wouldn't you agree that for these insurance agents and these small business people it was working at that time? Shouldn't we admit now that it was a mistake and make this change?

Mr. MIKRUT. I think the price effect was unforeseen. I think the inability for certain small businesses to get bank financing and therefore have to extend seller financing was unforeseen. And I think, again, any legislative response should be to try to address those types of concerns.

I will point out, Mr. Weller, that the concern you had of your insurance agent who passes on his agency to his heirs—they should not be impacted by the provision. Again, the installment sale provision only applies to gains. When you pass on your business to your heirs, they get a step-up—

Mr. WELLER. How about if they decide, for retirement purposes, they want to sell their agency? They have been building up the value of this agency and decide it is time to retire, and that is their retirement income? And you have reduced the value of that asset.

Mr. MIKRUT. It would have an effect in that case, yes.

Mr. WELLER. You have indicated here that you have a proposal which is very narrow. I have always wondered about your Administration's definition of targeted relief, because it usually means that very few people get very little. In this case you are proposing a very targeted relief, which is only $1 million. A lot of small busi-

nesses today have over $1 million in gross sales. They may not make any money, but they have $1 million in gross receipts. You have indicated in comments to other Members of this Subcommittee that you might be willing to raise that threshold to $5 million.

Why do we even need a threshold? Doesn't an income threshold just complicate the Code? I think one of the goals we all have is to simplify things for people. Before we adopted the change you recommended last year, things were a lot simpler. Now we are making it more complicated. And then the solution that you are offering complicates it all the more.

Mr. MIKRUT. I will agree, Mr. Weller, that a threshold generally creates some level of complication. I will point out, though, that the $1 million threshold—looking at 1997 tax return data, amounts reported on those returns, not the average of the 3 years, which would normally be lower—would exempt 78 percent of C corporations, 85 percent of S corporations, and 95 percent of partnerships and sole proprietorships would be under the $1 million threshold. If you were to go up to $5 million, those percentages become much greater.

We think the $1 million threshold we have proposed, subject to the aggregation rules Mr. Herger was discussing, would exempt a great number of taxpayers.

Mr. WELLER. How does your proposal impact closely held small businesses that operate as corporations? Are they given relief under your proposal?

Mr. MIKRUT. Yes, Mr. Weller, we would apply this across the board to all forms of business entities.

Mr. WELLER. I see I have run out of time.

Thank you, Mr. Chairman.

Chairman HOUGHTON. Thank you very much.

Mr. McInnis.

Mr. MCINNIS. Thank you, Mr. Chairman.

Sir, this was effective December 17, 1999. Is that correct?

Mr. MIKRUT. Yes.

Mr. MCINNIS. In your opening remarks you said you intend to issue guidance in the near future that will address the availability of the installment method for the most common disposition transactions.

Is it your intent to make that retroactive to December 1999?

Mr. MIKRUT. Yes, Mr. McInnis. Again, methods of accounting—most of the businesses this would apply to we are simply clarifying that they continue on the cash method and therefore would not trip into the installment method provision. We fully intend to clarify that small gap period of essentially one to 2 weeks where the installment method would be available to those businesses as well.

Mr. MCINNIS. So in essence, based on your guidance, there will be no gap?

Mr. MIKRUT. We would hope not. That is right, sir.

Mr. MCINNIS. When is your guidance going to come out?

Mr. MIKRUT. As soon as we can address the details we were discussing with Mr. Herger, and in addition looking at other ways we could be helpful in providing additional guidance as to the use of the cash versus the accrual method.

Mr. MCINNIS. Your threshold is $1 million?

Mr. MIKRUT. Yes, $1 million of average annual gross receipts, which is usually a 3-year rolling average.

Mr. MCINNIS. And in the past we did not have a threshold over what was repealed. There was no threshold, was there?

Mr. MIKRUT. There was a threshold for a different form of the installment method that required the use of an interest charge if you received over $5 million annually of installment obligations.

Mr. MCINNIS. The problem we have today was really the result of—it kind of slipped through. We didn't envision the difficulties—neither Treasury nor the Congress. Now you are suggesting a partial repeal, not to go back to where we were, but does Treasury see an opportunity to grab some territory through the confusion? Is that you don't support a full repeal?

Mr. MIKRUT. No, Mr. McInnis. We believe in the policy of the use of the installment method being restricted to cash method taxpayers. We now understand that that had a significant and unforeseen effect upon certain small businesses. We are trying to address those situations where the business or the non-tax policy considerations override this policy concern.

Mr. MCINNIS. Thank you.

Thank you, Mr. Chairman.

Chairman HOUGHTON. Thank you, Mr. McInnis.

Any other questions?

[No response.]

Chairman HOUGHTON. If not, thank you very much, Mr. Mikrut. We appreciate your testimony.

Chairman HOUGHTON. I now call upon the next panel, which is David E. Crosby, Co-Owner, Jeremiah's Tavern, Rochester, New York—the garden spot of the country—on behalf of the National Federation of Independent Business; Darryl A. Hill, Owner-Operator, Savoy Restaurant, on behalf of the United States Chamber of Commerce; and Pamela F. Olson, Chair-Elect, section of Taxation, American Bar Association.

Please take your seats.

Mr. Crosby, we will begin with your testimony.

STATEMENT OF DAVID CROSBY, CO-OWNER, JEREMIAH'S TAVERN, ROCHESTER, NEW YORK, ON BEHALF OF THE NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. CROSBY. Thank you.

Good afternoon. My name is David Crosby. I am the co-owner of Jeremiah's Tavern in Rochester, New York. Jeremiah's is a 90-seat neighborhood restaurant located in the Upper Monroe area of Rochester. On behalf of the 600,000 members of the National Federation of Independent Business, I appreciate the opportunity to present the views of small business owners on the subject of repealing the installment sales provision.

I would ask that my written testimony be submitted for the record and I will summarize my remarks here.

As you have already heard, the installment sales provision is literally blocking the sale of small businesses across the country. Others have described the technical reasons why this is the case, let me state the bottom line reason: The installment sales provision

greatly increases the downpayment necessary to purchase a business or commercial property.

Let me explain using my own experience.

We started Jeremiah's Tavern by purchasing its current location in 1978. In 1982 we started buying houses around the original property so that we could use the backyards to expand parking. Except for two small mortgages, all those properties were purchased using seller financing. If this tax provision had been in effect at the time, I am confident that Jeremiah's would not exist today. I seriously doubt our original $15,000 downpayment would have covered all the taxes and closing costs owed by the previous owner when we bought this building. If he had been forced to pay all those taxes up front, he could not have afforded to sell his building to three under-financed entrepreneurs.

Now we are facing the other end of the issue. From the beginning, we planned to grow our business until we could afford to retire. Now that plan is in jeopardy. The banking community is not receptive to financing restaurants and rental properties, which means we must carry the note.

Under the old rule, we could spread whatever capital gains we realized over the life of the note. As an accrual method C corporation, we now have to pay tax in that first year. That means it would likely cost us money to sell our business. Gene has two children in college and my daughter starts next fall. We can't afford to go an entire year with negative income. So unless we can find someone who can pay cash or get a loan, we can't sell our business.

And my situation is not unique. When I first became aware of the provision, I called my accountant to determine if it would affect us. After he gave me the details, he told me that he was in the middle of a sale that was in danger of falling apart. The seller cannot afford to pay the capital gains tax due if the sale is structured as an asset sale, and the buyer is unwilling to purchase the stock of the business rather than just the assets.

Buyers rarely are willing to purchase stock in a closely held business. In this case, the buyer offered $2 million less for the company if he had to buy the stock.

Another concern I have is, What happens if the buyer fails to make all the promised payments? A friend of mine sold his restaurant to a buyer who went bankrupt 2 years later. My friend was forced to take back the business and spend the next 2 years rebuilding it so he could sell it again. If this had happened under the new law, he would have two problems: First, rescuing a badly damaged business, and second, recovering taxes he had paid on income he never received.

Finally, what happens if I die unexpectedly? Under the buy-sell agreement I have with my partner, my family will receive the proceeds of a life insurance policy as partial payment for my share of the business. The remaining payments will be handled through an installment sale. Under the new law, my family would not only deal with the loss of their father and husband, but also face a huge tax bill as well.

For these reasons, I strongly encourage this Committee to support the Herger-Tanner Bill to repeal the installment sales provision. This new law destroys plans that have been formed over

years and decades, creates new insurmountable obstacles for young entrepreneurs trying to get started, and it unnecessarily complicates transactions that are already full of complications.

What really concerns me is that the IRS will get the same amount of taxes whether we use the installment method or not. This prohibition does not increase taxes collected by the IRS, it just speeds them up. All this harm is caused by a provision that doesn't really raise any new revenues.

I thank the Committee for the opportunity to speak today. I also thank the chairman and the other Members of the Committee for taking the lead to reverse this provision. I would be happy to answer any questions.

Thank you.

[The prepared statement follows:]

Statement of David Crosby, Co-Owner, Jeremiah's Tavern, Rochester, New York on behalf of the National Federation of Independent Business

Good morning. On behalf of the 600,000 members of the National Federation of Independent Business (NFIB), I appreciate the opportunity to present the views of small business owners on the subject of repealing the installment sales provision.

My name is David Crosby. I am the co-owner of Jeremiah's Tavern in Rochester, New York. Jeremiah's is a 90 seat neighborhood restaurant located in the Upper Monroe area of Rochester. We opened our doors on August 25, 1978 with one building, three partners and no employees. Today, we have grown to four buildings, eighteen apartments, four store fronts, and 34 employees. Our first year we had about $250,000 in sales. This year we should top $1.3 million.

Jeremiah's has also grown as a presence in the community. We have held fundraisers for the local YMCA, the Hillside Children's Center, and we contribute thousands of dollars in gift certificates every year to various charities. We hold charity golf tournaments. We donate food to our neighborhood association. We even donate chicken wings to two area high schools for their senior class parties.

In addition to being an NFIB member, I am also the incoming president of the local Restaurant Association chapter.

As you have already heard, the installment sales provision is literally blocking the sale of numerous closely-held businesses. Others have described the technical reasons why this is the case. Let me state the bottom line reason—the installment sales provision greatly increases the down payment necessary to purchase a business or commercial property. Let me explain why using my own experience.

When we started Jeremiah's Tavern, we financed the purchase of the building with seller financing. In 1982 we started buying houses around the original property so we could use the back yards to expand parking. Except for two small mortgages, all the financing was private because the banks wanted no part of the restaurant or non-owner occupied rental property.

If this tax provision had been in effect at the time, none of this would have taken place! I seriously doubt our original $15,000 down payment would have covered all the taxes and closing costs owed by the previous owner when we bought his building. If he had been forced to pay all those taxes up front, rather than over the life of the note, I doubt he could have afforded to sell his building to three under-financed entrepreneurs.

Now we are facing the other end of the issue. From the beginning, Gene and I planned to grow our business until we could afford to retire. We have IRA's, but the bulk of our retirement income will come from the sale of the tavern and the surrounding properties. Before this provision took effect, I planned to continue to work for four or five more years and then sell.

Now that plan is in jeopardy. We have always assumed we would finance the sale of the business ourselves. The banking community is still not receptive to financing restaurants and rental properties. While we have developed an excellent credit record over the past twenty years, it's not our credit that counts. Banks won't even look at a young potential restaurant buyer.

Which means we must carry the note. Under the old rule, we could spread whatever capital gains we realize over the life of the note. As an accrual method C-Corp, we now have to pay that tax in year one. I do not know of anybody capable of paying enough cash up front to cover the tax we would owe, let alone the other costs involved. That means it would cost us money to sell our business. Gene has two chil-

dren in college. My daughter starts next fall. We can't afford to go an entire year with negative income.

So, unless we can find someone who can pay cash or can get a loan, we can't sell our business. My future plans are dictated not by our hard work and the economy in Upstate New York, but rather by a tax provision proposed by the Clinton Administration. My retirement plans have been in the making for twenty-five years. I took me years to save the $10,000 I used to start this restaurant and twenty-two years to build the business to the point it could be sold. Now, we're starting all over again.

My situation is not unique. When I first became aware of the new provision, I called my accountant to determine whether it would affect us. After he gave me the details, he told me that he was in the middle of a sale that was in danger of falling apart. The seller cannot afford to pay the capital gains tax due if the sale is structured as an asset sale, and the buyer is unwilling to purchase the stock of the business rather than just the assets. In an asset sale, the buyer gets increased depreciation. In a stock sale, the buyer assumes any liabilities -known or unknown -in a stock purchase. Therefore, the value of the company is significantly less to the buyer. In this case, the buyer offered $2 million less for the company if he had to buy the stock.

Another concern I have is what happens if the buyer fails to make all the promised payments? A few years ago, a friend of mine sold his restaurant to a buyer who went bankrupt two years later, defaulting on his promised payments. My friend was forced to take back the business and spent the next two years rebuilding it so he could sell it again! If this had happened under the new law, he would two problems -first rescuing a badly damaged business and, second, recovering taxes he paid on income he never received.

Finally, what happens if I die unexpectedly? Under the buy/sell agreement I have with my partner, my family will receive the proceeds of a life insurance policy as partial payment for my share of the business. The remaining payments will be handled through an installment sale. Under the new law, then, my family will not only deal with the loss of their father and husband, but also face a huge tax bill as well!

For these reasons, I strongly encourage this Committee to support the Herger/Tanner bill to repeal the installment sales provision. For small business owners like myself, the impact goes far beyond the immediate effect of paying the capital gains tax upfront. It destroys plans that have been formed over years and decades. It also creates new obstacles for young entrepreneurs trying to get started and unnecessarily complicates transactions that are already full of complications.

What really annoys me about this provision is that the IRS will get the same amount of taxes whether we can use the installment method or not. This prohibition does not increase taxes collected by the IRS—it just speeds them up. All this harm caused by a provision that doesn't really raise any new revenues.

I thank the Committee for the opportunity to speak today. I also thank the Chairman and the other members of this Committee for taking the lead to reverse this provision, and I would be happy to answer any questions.

Chairman HOUGHTON. Thank you very much, Mr. Crosby.

Mr. Hill.

STATEMENT OF DARRYL A. HILL, OWNER, SAVOY RESTAURANT, ON BEHALF OF THE U.S. CHAMBER OF COMMERCE

Mr. HILL. Good afternoon, Mr. Chairman.

My name is Darryl Hill and I am the owner of the Savoy Restaurant, a small business headquartered here in Washington, D.C.

I would like to give special commendation to Congressmen Herger, Sweeney, and Tanner for proposing this much needed legislation.

I assure you, considering the nature of the business of the previous witness, restaurants aren't the only small businesses. It is just a coincidence that we are in the same line of business.

Our enterprise employs 65 individuals dedicated to providing excellent top quality food in a warm, friendly atmosphere. I am also

a member of the U.S. Chamber of Commerce, the world's largest business federation. I appreciate this opportunity to relate my story on the repeal of the installment method of accounting for accrual basis taxpayers, and its bad effects on the small business community.

When you enter a small business, all small businessmen generally think about one thing: An exit strategy. Most exit strategies have two solutions: You sell your business, or you die. The second exit strategy is not one I want to opt for, so I am concerned with the first exit strategy.

Over the last 25 years I have started, owned, operated, and sold many successful small businesses. Every enterprise has created jobs and investment for the community. When the time came for me to sell, I provided a great opportunity for the next owner to succeed and be a productive member of society. In every case I was able to reinvest the proceeds of the sale into my next small business.

Also, because bank financing is generally not available, in virtually every sale I have had to finance the purchase by taking back the note. A situation which my accountant tells me would be financially prohibitive under the recent change in the law.

It also takes a bastion of creative financing to make these small business sale works. I have been on both sides. I have been a buyer and I have been a seller. If this law were previously enacted, most if not all of my arrangements to buy and sell would have been financially impossible. It just wouldn't have happened.

Buyers only have so much money to put down, they are generally not bank-financeable, generally small businesses are not attractive to venture capitalists at the outset, and brokers want their money at the time of settlement. And God forbid, as a previous witness stated, if you offer credit and someone goes bankrupt, then you have a double problem.

In my previous life, I was a director of an organization called the Greater Washington Business Center, which had as its mission the development of minority and small and disadvantaged businesses. In almost every case in these type of businesses, these purchases are done on an installment purchase basis. Women and minorities and disadvantaged businesses will be severely affected by this act because they won't have the entre. This would put quite an imposition on them.

Ladies and gentlemen, it is grossly unfair for the government to require me to come up with cash in order to sell my business and to pay taxes on money I have not received. I have labored many years reinvested a lot of tax dollars in order to build equity in my enterprises. Current law would have a chilling effect on the transfer of small business ownership, denying many people like myself from enjoying the fruits of small business ownership.

I do understand that the consequences of this legislation were unintended. Now that the lawmakers realize the effect on small business, I strongly urge the Congress and the administration to act quickly to pass the Installment Tax Correction Act.

I just have an analogy and a couple of comments on the testimony given by Joe Mikrut from the Treasury Department.

He cited that 85 percent of small businesses have gross receipts of $1 million or less. That is quite true, but those businesses of $1 million or less generally have nothing to sell. They are just not affected by this. Most of those are individuals, sole proprietorships who hang out their shingles, consultants and so forth. The businesses above $1 million are the ones affected by this act.

Second, the act itself—if you took the statistics another way and instead of measuring it in numbers of small businesses if you measured it in gross receipts, you would find that the statistics were reversed and 85 percent of the gross receipts come from businesses of $1 million or more. So I think you have to look at who is getting hit here, and it is the guys in the $1 million and up bracket who are affected by this.

I thank you for allowing me to testify here today and strongly urge you to pass this legislation.

[The prepared statement follows:]

Statement of Darryl A. Hill, Owner, Savoy Restaurant, on behalf of the U.S. Chamber of Commerce

Mr. Chairman and members of the Committee, my name is Darryl Hill and I am an owner of the Savoy Restaurant, a small business headquartered in the District of Columbia. Our enterprise employs 65 individuals dedicated to providing excellent top quality food in a warm friendly atmosphere. I am also a member of the U.S. Chamber of Commerce—the world's largest business federation, representing more than three million businesses and organizations of every size, sector, and region. I appreciate this opportunity to relate my story, and to express the views of the U.S. Chamber on the repeal of the installment method of accounting for accrual basis taxpayers and its effects on the small business community.

I hereby ask that my entire oral and written statement be incorporated into the record.

BACKGROUND

The provision denying installment sale treatment for accrual basis taxpayers was originally in the Administration's FY 2000 budget proposal. The Chamber provided live testimony against the provision before the Ways and Means Committee on March 10, 1999. Also, the Chamber's opposition to the provision was included in written testimony for the Ways and Means Committee's, March 10 hearing on revenue provisions in the Administration's FY 2000 budget. Written testimony was submitted in opposition for the Finance Committee's April 27 hearing on revenue provisions in the Administration's FY 2000 budget.

Repeal of the installment sale method then resurfaced in the waning days of the first session of the 106th Congress during the Administration's attempt to negotiate an offset with Congress on the cost of the "extenders package," HR 1180. The repeal of the installment sale treatment for accrual basis taxpayers was passed and signed into law on December 17, 1999, as a provision in the *Ticket to Work and Work Incentives Improvement Act of 1999* (PL 106–107).

As a result of its enactment, it appears that many small business owners attempting to structure the sale of their accrual method businesses by means of an asset sale with them providing "seller-financing," may be required to report their total gain in the year of sale, i.e., recognize the profit, irrespective of when payment is actually received. However, prior to the law change, the installment sale method could have been elected irrespective of the accounting method of the business sold and gain would not have been recognized until the tax year in which payments were actually received by the seller.

ASSET SALE METHOD OF SELLING A BUSINESS

The traditional method by which small business owners sell closely owned enterprises is by the asset sale method. In most of these cases, the seller will self-finance the purchase with an installment sale note secured by the assets of the sold business. The seller's corporation transfers ownership of all assets and goodwill to the purchaser's newly formed taxpaying entity, usually a C-corporation or an S-corporation. The seller then has the flexibility of retaining the shell corporation for a vari-

ety of reasons. The purchaser operates the business free from any potential hidden liabilities that may have been imbedded in the seller's corporation. To the average patron, the transition is seamless and the business shows no visible signs of change except the new ownership team.

The new law is having, and will continue to have, a dramatic negative impact on small business owners attempting to structure an exit strategy for the sale of their business or for the partial sale of assets from an ongoing business. For most small business purchases, traditional bank financing is not available to fund the sale of a business, thus requiring the selling owner to hold any balance due over and above the down payment. The purchaser would then remit installment payments over time on the remaining balance to the seller.

Before the change in the law, the seller could defer the tax by reporting the gain as the installments were received. The gain on the sale by the seller would then be reported and the tax liability would accrue at the time the installment payment was received by the taxpayer. With the new provision, the total gain would be required to be immediately recognized and reported, subjecting the taxpayer to the full tax liability on the sale regardless of how much actual cash is received. The tax liability could exceed the cash generated for the sale by several times in the first year, severely distressing the business and its owners. In addition, the business broker usually requires his fees at the time of settlement exacerbating the demand for cash at the time of sale.

ADVERSE CONSEQUENCES FOR SMALL BUSINESS

In the short time since it became law, this provision—which denies the installment sale treatment for accrual basis taxpayers—has had an unintended and significant negative financial impact on many small business owners attempting to sell their enterprises.

Small business owners who would have previously been allowed to elect the use of the installment sale option in the sale of a closely held business are experiencing dramatic reductions in sales price in order to execute a contract. It is estimated that a devaluation of 8.2 percent in the equity of a business is the average.[1] If this figure were applied to only a fraction of the estimated six million small businesses, the hundreds of billions of dollars the owners would loose in equity would dwarf the $2 billion the government hopes to collect from this onerous tax law change over the next 10 years. This is inequitable and unfair to those small business owners that labor and sacrifice their whole lives in order to achieve a small sense of financial security. This also amounts to a hidden tax on those who, on average, make less than $50,000 a year and, in many cases, depend on the sale of their business for their retirement.

The recently enacted provision sets an artificial barrier to the traditional methods for small business ownership changes and has had a chilling effect on the ability of an owner of a small business to sell. An important ingredient in structuring an exit strategy is flexibility. Bank financing is generally not available to the purchaser. The new law dramatically reduces the ability for a purchaser to tender enough money to cover the sellers closing costs and taxes. Sellers are reluctant or incapable of entering into a transaction that requires out of pocket expenditures.

Small business ownership has been the vehicle by which many people, including women and minorities, have achieved financial empowerment. In many cases, this has been accomplished by the purchase of existing businesses on the installment method. Restricting or complicating the process of transferring ownership inhibits the means by which all people can access the doors of economic prosperity by being your own boss.

Many small business owners use the sale of their businesses as the primary means of funding their retirement. For some, the worth of their business reflects the majority of their life savings. Denying the use of the installment sale treatment for accrual basis taxpayers has frustrated many business owners in developing an exit strategy for retirement. To look forward to living the first years of retirement strapped for cash due to the tax requirements necessary to orchestrate a sale and the subsequent years at a reduced rate due to the devalued equity in the business is unfair and bad policy.

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[1] Mike Adhikari, Illinois Corporate Investments Inc., "Analysis of Installment Sale Repeal (ISR), 175 Olde Half Day Rd., Lincolnshire, IL 60047.

MY PERSONAL EXPERIENCE WITH THE INSTALLMENT SALE METHOD FOR ACCRUAL BASIS TAXPAYERS

Over the last 25 years, I have sarted, owned, operated and sold many successful small businesses. In every enterprise, I have created jobs and investment in the community. When the time came for me to sell, I provided a great opportunity for the next owner to succeed and be a productive member of society. In every case I was able to reinvest the proceeds of the sale into my next small business. Also, in virtually every sale, I have had to finance the purchase by taking back a note, a situation my accountant tells me would be financially prohibitive under the recent change in the law. If this law were previously enacted, most if not all of my arrangements to sell would have been financially impossible. Buyers only have so much money to put down on a purchase. Brokers want their money at the time of settlement and I need a certain amount of cash to live on and reinvest in my next venture.

Ladies and Gentlemen, it is grossly unfair for the government to require me to come up with cash in order to sell my business to pay taxes on money I have not yet received. I have labored many years and reinvested a lot of taxed dollars in order to build equity in my enterprises. The current law will have a chilling effect on the transfer of small business ownership denying many people like myself from enjoying the fruits of small business ownership.

I do understand that the consequences of this legislation were unintended. Now that lawmakers realize its effects on small business, I strongly encourage the Congress and the Administration to act quickly to pass H.R. 3594, *The Installment Tax Correction Act*.

CONCLUSION

Bank financing for the sale of small businesses is generally not available. For those selling a closely held business, flexibility is an important ingredient in structuring an exit strategy. The recently enacted provision sets an artificial barrier to the traditional methods for small business ownership changes and has had a dramatic negative impact on the process. Restricting or complicating the ability of small business owners to "cash out" of their businesses after laboring to achieve a level of success is destructive and bad policy. The U.S. Chamber of Commerce believes the provision denying accrual basis taxpayers should be fully and quickly repealed.

I want to thank you for allowing me the opportunity to testify here today.

Chairman HOUGHTON. Thank you very much, Mr. Hill. I appreciate your testimony.

Ms. Olson.

STATEMENT OF PAMELA F. OLSON, CHAIR-ELECT, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

Ms. OLSON. Good afternoon, Mr. Chairman, Congressman Coyne, and members of the Oversight Committee. My name is Pam Olson and I am the chair-elect of the ABA section of Taxation and testifying this afternoon on behalf of the section of Taxation.

With me today is Fred Witt, the immediate past chair of our Real Estate Committee and a principal drafter of our testimony.

We appreciate the opportunity to appear before the Committee today. We believe the repeal of installment sales treatment for accrual method taxpayers is a topic deserving of prompt action. In short, we believe the repeal was a mistake. It adversely affects small and closely held businesses attempting to sell business assets, it creates traps for the unwary, and it eliminates the certainty and consistency the installment sales rules brought to sales of assets for contingent payments. And that latter point is not just a small business point.

First, some background on installment sales treatment. This is ground that has already been trod this afternoon, but I think it is worth treading it again because we reach a very different conclusion from the conclusion reached by the Treasury Department.

Generally, an accrual method taxpayer is required to recognize income when all events have occurred that fix the right to receipt and the amount can be determined with reasonable accuracy. The installment method is an exception that permits a taxpayer to report the recognition of gain from the sale of capital assets in the year payment is actually received.

First set forth in Treasury regulations in 1918, codified by Congress in 1926, the law has permitted accrual method taxpayers and cash method alike to sell business assets for installment payments and report the gain in the year cash is actually received. The policies underlying the installment method were best summarized by the Supreme Court in Commissioner v. South Texas Lumber Co. as follows: The installment basis of reporting was enacted, as shown by its history, to relieve taxpayers who adopted it from having to pay an income tax in the year of sale based on the full amount of anticipated profits when in fact they had received in cash only a small portion of the sales price. Another reason was the difficult and time-consuming effort of appraising the uncertain market value of installment obligations.

In the Installment Sales Revision Act of 1980, just 20 years ago, Congress streamlined the rules, made them easier for taxpayers to apply, and applied them to sales for contingent payments. Since 1980, Congress has enacted a number of limitations on the use and benefits of installment reporting while maintaining its simplicity and fairness.

In our view, the limitations that have been placed on the use and benefit of installment reporting adequately address any potential problems with it.

As against the strong policy reasons supporting installment sales treatment, we understand there was essentially one reason, and that reason was reiterated earlier this afternoon in support of repealing the installment method: that the installment method is inconsistent with the accrual method because by allowing deferral of recognition the annual economic results of an accrual method taxpayer's business are not properly reflected.

We believe this quest for theoretical purity is an insufficient basis for overturning 80 years of consistently applied tax policy. We also believe it fails to withstand careful scrutiny.

The accrual method of accounting requires the recognition of income from business operations in the year the income is earned and the right to receive the amount is fixed, without regard to the time payment is received. While a taxpayer may be expected to pay taxes on ordinary profits earned from business operations, the nonrecurring sale of a capital asset falls into an entirely different category. The imposition of immediate taxation on the anticipated gain from the disposition of a business or substantial capital asset, such as real estate, places a burden on the business seller that is unfair, unexpected, and cannot be justified by the rationale underlying the accrual method of accounting.

The installment sales method adjusts the payment of taxes to the demands of the marketplace. In our experience representing business taxpayers, arms-length buyers and sellers have opposing views of the market and objectives in negotiating a business asset sale transaction. Buyers want the lowest possible price and nothing down, and sellers want the highest price with cash paid in full at closing. It is against these market forces that an installment sale is finally negotiated. The ability of the seller to take back an installment note for the balance of the sales price without being subject to an immediate tax liability maybe the most critical issue in the transaction.

In the case of contingent payment sales, the tax consequences could be even worse. Not only will tax be due immediately on the fixed component of the sales price, but the IRS would likely assert that the contingent amount must be valued and reported as taxable income in the year of sale. The result? An installment seller would be taxed on amounts that are only estimated and might never be received.

We have a number of examples of the adverse effects of the repeal contained in our written statement, which has been submitted for the record.

In conclusion, let me just say that the repeal of installment sales reporting reverses 80 years of sound tax policy without any compelling reason or abuse cited. This change adversely affects the price and liquidity of small and closely held business assets, and will substantially increase complexity for taxpayers and the IRS alike.

I would be pleased to answer any questions the Committee might have.

[The prepared statement follows:]

Statement of Pamela F. Olson, Chair-Elect Section of Taxation, American Bar Association

My name is Pamela F. Olson. I appear before you today in my capacity as Chair-Elect of the American Bar Association Section of Taxation. This testimony is presented on behalf of the Section of Taxation. It has not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, accordingly, should not be construed as representing the policy of the Association.

The Section of Taxation appreciates the opportunity to appear before the Committee today. We believe the repeal of the installment method of accounting for accrual method taxpayers is a serious topic deserving prompt action.

As you are aware, following a proposal set forth in President Clinton's Fiscal Year 2000 Budget Proposal, Congress repealed the installment method of tax accounting for accrual method taxpayers in the Tax Relief Act of 1999 (Title V, Subtitle C, Section 536), enacted as part of the "Ticket to Work and Work Incentives Improvement Act of 1999" (H.R. 1180). The repeal of installment sales treatment for accrual method taxpayers will adversely impact small and closely held businesses attempting to sell business assets, because they will be taxed immediately even if payments are received years later. Immediate taxation of business sellers, and its chilling effect on the marketplace, simply does not represent sound tax policy. For these and other reasons outlined below, we respectfully request that Congress reenact prior law which, for over 80 years, has permitted accrual method taxpayers to sell business assets for installment payments and defer the gain until the year cash is actually received.

BACKGROUND: THE 80-YEAR HISTORY OF INSTALLMENT SALES.

A brief review of the history of installment sales provides an important framework for discussion. Generally, an accrual method taxpayer is required to recognize income when all events have occurred that fix the right to receipt and the amount can be determined with reasonable accuracy. The installment method is an exception that permits a taxpayer to defer the recognition of gain from the sale of capital

assets until the year payment is actually received. The treatment given installment sales was recognized almost from the inception of the income tax laws. Although first set forth in Treasury regulations promulgated in 1918, Congress codified the installment method of tax reporting in Section 212(d) of the 1926 Revenue Act. The policies underlying the installment method were best summarized by the Supreme Court in *Commissioner* v. *South Texas Lumber Co.*, 333 U.S. 496, 503 (1948):

> The installment basis of reporting was enacted, as shown by its history, to relieve taxpayers who adopted it from having to pay an income tax in the year of sale based on the full amount of anticipated profits when in fact they had received in cash only a small portion of the sales price. Another reason was the difficult and time-consuming effort of appraising the uncertain market value of installment obligations.

In the Installment Sales Revision Act of 1980, P.L. 96–471, 96th Cong., 2d Sess. (1980), Congress streamlined the rules and made them easier for taxpayers to apply. Since 1980, Congress has enacted a number of limitations on the use and benefit of installment reporting. Installment treatment is not available for dealer dispositions, it does not apply to the sales of publicly traded property, and gain is recognized if the seller monetizes the installment note through a pledge transaction. To further limit the benefit, there is an interest charge for the tax deferral to the extent a taxpayer holds installment notes in excess of $5 million.

Reason For Repeal

We understand there was essentially one reason cited in support of repealing the installment method for accrual method taxpayers—the installment method is inconsistent with the accrual method because, by allowing deferral of recognition, the annual economic results of an accrual method taxpayer's business are not properly reflected.

This reason fails to withstand careful analysis and is insufficient to overturn 80 years of consistently applied tax policy. The accrual method of tax accounting reflects a business's economic performance by requiring the recognition of income in the year in which the income is earned and the right to receive the amount is fixed, without regard to the time payment is received. Coupled with the economic performance requirement for deductions, the accrual method matches income and deductions from operations in a manner that measures a business's economic results each year. However, the installment exception essentially applies only to nonrecurring dispositions of business assets. While a taxpayer should be expected to pay taxes on ordinary profits earned from business operations, the nonrecurring sale of a capital asset falls into an entirely different category. The imposition of immediate taxation on the anticipated gain from the disposition of a business or substantial capital asset, such as real estate, places an unexpected and unfair burden on the business seller.

Market Effect of Repeal on Business Sales—Liquidity, Price and Deals That Will Not Be Done

Since 1918, the installment sales method has been an important rule in our Federal income tax system, because it adjusted the payment of taxes to the demands of the marketplace. In our experience representing business taxpayers, arms-length buyers and sellers have opposing views of the market and objectives in negotiating a business assets sale transaction. Buyers want the lowest price and nothing down and Sellers want the highest price with cash paid in full at closing. It is against these market forces that an installment sale is finally negotiated. Often the buyer only has 10 to 20% of the purchase price in cash, but the seller is convinced the cash flow generated by the asset will enable the buyer to pay the balance over a period of years. The ability of the seller to take back an installment note for the balance of the sales price without being subject to an immediate tax liability may be the most critical issue in the transaction. In today's marketplace, it is difficult to find a bank willing to lend to a small business buyer. Small business buyers cannot access the capital markets or draw down on their bank line of credit. Simply put, in today's tax and economic environment, sellers take back an installment note because there are no other viable financing options available.

In addition to adversely affecting the liquidity of sellers, repeal of installment treatment will tend to depress the price paid by small business purchasers. A small business buyer is often limited in the amount it can pay for business assets. In order to increase the sales price, a business seller may increase the term of years or agree to a fixed price with an additional contingent or "earnout" based on future performance of the assets sold. After repeal of installment reporting for accrual tax-

payers, the tax consequences of structuring such an arrangement may be devastating. As the payments are spread over an increasing number of years, so will the burden of immediate taxation in the year of sale be increased. For example, assume an accrual method taxpayer sells a building (with adjusted basis $100) for $1,100 payable $100 cash and $100 a year for 10 years. In the year of sale the taxpayer will report the full $1,000 gain and, assuming a 35% tax rate, will have an immediate tax due of $350. Since the taxpayer only received $100 cash down, the asset sale will have produced negative cash flow of $250—meaning the taxpayer will need to find additional cash of $250 just to pay taxes.

In the case of a contingent payment sale the tax consequences could even be worse. Not only will tax be due immediately on the fixed component of the sales price, but under the original issue discount and installment reporting regulations the IRS might assert that the contingent amount must be valued and reported as taxable income in the year of sale. If this interpretation of the regulations were upheld, an installment seller would be taxed on amounts that are unknown and might never be received. Taxpayers will resist this treatment and argue that the "open transaction" doctrine applies to defer taxation on the contingent piece until actual payments are received. So, in addition to the adverse effect on price and liquidity, repeal of the installment method for this group of taxpayers raises the possibility of unnecessary complexity and increased controversy between taxpayers and the IRS.

EXAMPLES OF TRANSACTIONS ADVERSELY AFFECTED BY REPEAL

Passthrough entities exist, in great part, to serve the needs of the small or closely held business owner. With the numerous restrictions placed on the use of the cash method of accounting, and based on our experience with business clients, we expect that the vast majority of S corporations, business partnerships and limited liability companies taxed as partnerships use the accrual method of accounting. Accordingly, we believe many common transactions will be adversely affected by this change in law.

Employee Buyouts.

It is common for a retiring owner or family group to sell to key employees. The employees typically lack the cash to complete the purchase, hence the owner must act as the lender and take back an installment note. This is a "win-win" transaction; the retiring owner is selling an illiquid asset and receiving a stream of cash (with interest) paid over a period of years, and the employees are realizing a life long dream of becoming the owners of the business. With bank financing difficult or impossible to obtain, the ability to seller-finance, without an immediate tax burden, is essential. We are aware of a number of these types of transactions that have been canceled since December 1999 due to the change in the law.

S Corporation Selling Assets.

We understand that most S corporations use the accrual method of tax accounting and thus, under the change in law made last year, cannot use the installment method to sell business assets or the entire business. The entire gain is taxable in the year of sale even though the installment obligations, payable years later, are immediately passed through to the cash-basis shareholders. Although the individual cash method shareholders could sell their stock on the installment method, as pointed out in the 1999 legislative history, buyers generally want to purchase assets and will refuse to assume, directly or indirectly, the contingent liabilities inherent in the acquired S corporation entity. As a result both the price and liquidity of S corporation businesses have been adversely affected.

S Corporation Selling Assets to Family Under Succession Plan.

For the reasons stated above, repeal of the installment method will negatively impact family succession planning. Unless all of the family members involved are willing to transfer stock in the family S corporation, it will no longer be possible to sell corporate assets to younger family members using the business profits to pay the senior family members and fund their tax liability over a period of years.

S Corporation Selling Assets and Liquidating.

A common plan when the owners of an S corporation wish to sell their business is the adoption of a plan of complete liquidation for the S corporation, followed by distributions of the cash and notes received from the sale to the shareholders as liquidating distributions. Under prior law, the distribution of an installment note to the shareholders in complete liquidation was not a taxable disposition and the

shareholders, in effect, took the place of the S corporation for purposes of installment reporting. After the 1999 repeal of the installment method for accrual method taxpayers, whether the S corporation sells assets and liquidates or the buyer buys stock and makes a Section 338(h)(10) election, the shareholders will be required to pay tax on the sale immediately.

Accrual Method Partnerships.

For partnerships, we believe the change produces unneccessary complexity and creates a trap for the unwary.

If an accrual method partnership sells its assets for an installment note, the full gain must be recognized and passed through to its partners. On the other hand, if the cash method partners sell their partnership interests, the installment rules apply and there is no gain recognition until payments are received. This rule applies even if one buyer acquires all of the interests in the partnership. This means that if the buyer desires to purchase less than all of the partnership's assets, full gain must be recognized on the installment notes received. Moreover, often one of the partners wants to withdraw from the partnership and receive a liquidating distribution at the time of the sale. However, it is not clear that the gain realized on the sale can be specially allocated to the departing partner who actually receives the distribution, and thus taxation of the transaction will unnecessarily complicate matters for all of the partners.

We appreciate your interest in this matter. The Section would be pleased to work with the Committee and its staff on this important issue.

Chairman HOUGHTON. Thank you very much, Ms. Olson.

We will go to the questioning now.

Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman.

Mr. Kleczka is the main sponsor of H.R. 3568, which would return the situation to prior law. Inasmuch as the panel will support that provision, I would like to yield to Mr. Kleczka for questioning.

Mr. KLECZKA. Thank you, Mr. Coyne.

Mr. Chairman, I don't really have any questions of the panel except to thank them all for appearing today.

Mr. Hill, in your testimony, you adequately pointed out the problem with the Treasury proposal of $1 million. We all think $1 million is a lot of money—and in fact it is—but in a business, having gross receipts—underscoring "gross"—of $1 million covers a lot of small businesses today. I have to agree with the panel that the $1 million Treasury figure is arbitrary and something that this panel and this Congress is going to have to talk about.

After listening to not only Treasury but to this panel as well, I would think that $5 million would not be out of line, bout we can talk about that later.

Ms. Olson, you also pointed out that we are talking about nonrecurring transactions. That also must be underscored. These are not normal everyday business transactions. This is something that just happens on occasion. It doesn't happen every year. If we are looking for abuses in the Tax Code, we should look at those, find those, and get rid of them.

But clearly this was not one of those abuses, so I would hope that—in fact, I know you do support legislation I introduced to return back to the old method. If in fact we need a cap of a dollar amount, clearly I don't think it should be any less than $5 million. Possibly the panel can respond to that, the $1 million Treasury proposal versus the higher amount.

Mr. Hill.

Mr. HILL. Defining small business is a complicated and intricate procedure. What may constitute a small steel mill, for example, may be very much different than a small restaurant. I don't think it is as simple to just put a number on it. I think the Treasury and this body and this panel should work—I think you should repeal the act and then start all over again.

Mr. KLECZKA. Restore the old act?

Mr. HILL. Yes, restore the old act and then start again. I think Treasury can better define what it wants to get at and then you can go from there.

Mr. KLECZKA. I think a better way to put it would be like the chairman stated, repeal the repeal.

Ms. Olson.

Ms. OLSON. I would like to say that I agree. We ought to start by repealing what was done last year and then start over. The ABA has previously testified before this Committee that we would support, as a simplification measure, the use of the cash method of accounting for small businesses, which we defined by reference to section 448 and section 263 as $5 million or more. We think the $1 million is too low to be particularly useful and that small businesses up to $5 million should be able to use the cash method.

I would also say that we don't think that just allowing small businesses to use the cash method and therefore to still be eligible to use the installment method of reporting addresses all of the problems that have been created by the repeal.

Mr. KLECZKA. Thank you very much.

Chairman HOUGHTON. Thank you very much.

Mr. Herger.

Mr. HERGER. Thank you, Mr. Chairman.

I want to thank you, Mr. Hill, for bringing out a very important point, and that is that $1 million can vary an awful lot. If someone is being paid for their services, perhaps $1 million is much more than it would be as it is in your restaurant business where you are going through your gross—your margin of profit may be very, very narrow of that $1 million, whereas someone who is receiving payment for services may be much more. Therefore that is a major inequity. I appreciate you for bringing that out, as several have.

We have just received today the Treasury's recommendation of how they would correct it. Ms. Olson, I don't know how much you have been able to look at it or really analyze it, but what is your general analysis of their recommendation?

Ms. OLSON. With respect to their recommendation that they issue guidance allowing taxpayers with gross receipts under $1 million to use the cash method of accounting, we would support that. It is a proposal that the Tax section has supported in the past, but we would go with a higher number. We would go with something more on the order of $5 million.

With respect to the remainder of it, I am wearing a big orange button that says "simplify". The Tax section has joined with AICPA and TEI in an effort to work together to find ways to simplify the tax law. My biggest concern about what Treasury has suggested today is that it is another layer of complexity upon complexity and it seems to us that a far preferable way to go is just go back to the drawing board and start over. We don't think there are abuses

out there that need to be addressed with a repeal of the installment method of accounting, so we would like to see old law returned.

Mr. HERGER. Thank you. That is very helpful.

As I visit with my constituents, particularly our small business people, one thing we continually here is that the tax system needs to be simplified. It is just so complicated now. Even the smallest of businesses are required to go out and pay large sums of money for a CPA to figure out the system. It would be so much easier to just go back as it was. We are human, the Treasury is human, we as Members of Congress voted on this and certainly contributed to it as well. It would make much better sense to just go and repeal what we did and start over again on how we can make it more simple.

Mr. Crosby, do you have any further comments?

Mr. CROSBY. Yes.

The NFIB continues to push for the repeal of the provision. In my particular instance, our business will gross over the $1 million cap this year, so the Treasury issue would not apply to us. I believe that when you start looking at thresholds you create a situation where anyone who is either just below or just above the threshold—those who are below the threshold are in a position where they may find it necessary to put the brakes on the growth of their business because they don't want to cross that threshold. Those who are just above the threshold are in a position where they may be tempted to tamper with their business to put themselves back under the threshold.

So I think the position of the NFIB is sound and we should repeal it and not have thresholds.

Mr. HERGER. Another very good point. If anything, we do not need the government throwing monkey wrenches into our system to be slowing down business growth and slowing down the hiring of new people.

I thank you very much and I yield back my time, Mr. Chairman.

Chairman HOUGHTON. Thank you very much, Mr. Herger.

Mr. Sweeney.

Mr. SWEENEY. Thank you, Mr. Chairman.

I want to thank the panelists as well. Mr. Crosby is a fellow New Yorker. Welcome and thank you very much. Mr. Hill, it is good to see you again. I thank both of you for putting a real human face on what the implications are here.

Ms. Olson, you have given us some very sound technical analysis, and I thank you for that.

I have really two areas I would like to question.

The first relates to discussing the cash method versus the accrual method.

I am a member of the Small Business Committee, as I mentioned before. I am concerned that in part this may be an effort by the IRS to broaden its efforts to impose accrual accounting on more small businesses. With that background, I am concerned that the IRS may be using the installment issue to issue broader guidance on whether a business uses cash or accrual methods.

As we have mentioned, Congress has set the cash accrual threshold at $5 million. I am very concerned here that the IRS may be

attempting by regulation to impose the $1 million and set some precedents that may cause some real harm.

I would like to hear comments from any of you regarding that, which have not been said, and whether you share in my concern regarding the IRS' attempt to impose accrual accounting on small businesses.

Ms. OLSON. I am not sure whether I think this is an effort on the part of the IRS to impose the accrual method more than it has been used, but I would note that anytime you introduce additional rules, the additional rules create additional complexity. When there is additional complexity, there are people who won't understand what the rules are, and some of those people include IRS agents who are trying to do their jobs and understand the law, but can't always get it right.

So it is certainly possible that the effect of the rules would be to take service businesses, for example, who don't maintain inventories who would not be required to use the accrual method of accounting currently and end up with an audit where it would be suggested that they should be on the accrual rather than the cash method of accounting. That could certainly happen in the future.

Mr. SWEENEY. In conjunction with that, I want to get a sense from the panel on how you would feel about using an asset threshold as we try to look at the arbitrariness of what is happening here.

The Tax Code in section 1202 that defines C corporation is at $50 million in assets, I believe. Considering that many gas stations have more than $50 million in sales and insurance agencies must include policy revenue in their receipts, $1 million or $5 million wouldn't come close for such businesses.

Can you discuss further how we would begin to define small businesses and give us a sense of establishing thresholds?

What would your recommendation be?

Mr. HILL. I tend to agree with Mr. Crosby. I think thresholds may not be the answer here. I think there are other ways of defining small business, if it is necessary to define at all. It is a complex issue. But it is not so simple to put a dollar amount on it because $5 million means different things to different classes of business—severely different. It would be a boon to some and a hardship to others.

Ms. OLSON. I agree with that statement. I would also say that we don't think that just fixing this for small business is the right thing to do. The repeal of the installment method for accrual taxpayers doesn't just affect small business. In the area of contingent payment, it affects large C corporations as well with the result that there is likely to be an increased amount of controversy as taxpayers try to move to a different method of reporting their income altogether.

Right now you have an interest charge already if the taxpayer receives an installment obligation in excess of $5 million. That seems to me to be enough of a tightener on the use of the installment method of reporting. I wouldn't do anything more. I wouldn't put in a rule that limited it to small businesses.

Mr. SWEENEY. I would take it then that you would disagree with Mr. Mikrut's testimony or his perception that the guidance that is

going to be offered by Treasury does take care of closely held corporations? In a real tangible way, it does not.

Ms. OLSON. No, I don't think it will. I think there is more work to do.

Mr. SWEENEY. Thank you very much.

Thank you, Mr. Chairman.

Chairman HOUGHTON. Thank you, Mr. Sweeney.

I just have one question to Mr. Crosby.

If you repeal the installment method, what effect does that have on your life? What effect does that have on your retirement plans?

Mr. CROSBY. If it is repealed and it returns to the way that it was prior to December, it puts me back in a position where I feel like I have some control over the next several years of my life. My partner and I have spent roughly 25 years buying, building, and growing a business all along with the intention that we would use the proceeds from the sale of that business when we chose to retire. Whether that is 3 or 4 years from now or beyond, I can't say with certainty.

But the issue that I see with the new provision is that in the first year after we sell the business we can be saddled with an enormous tax burden that we can potentially—as we hopefully begin retirement years—we could be faced with a situation where we would literally have to go to a bank to get financing to borrow money to pay our obligations to the government. To me, that seems like a particularly unfair way for a person who has worked very hard growing a business over a lot of years to start out retirement.

Chairman HOUGHTON. Thank you very much. That helps.

Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman.

I just had a question for Mr. Hill.

You are representing the Chamber. Is your testimony applied just to small businesses, or are you talking for all small and large businesses?

Mr. HILL. We are talking about businesses in general, small and large.

Mr. COYNE. So it is not limited to the—

Mr. HILL. But our focus is on the small businesses because we think this bill is onerous on that level.

Mr. COYNE. So the focus is on small businesses, but really all businesses?

Mr. HILL. Ultimately.

Mr. COYNE. Thank you.

Chairman HOUGHTON. We have been joined by Mr. Neal of Massachusetts.

Mr. Neal, would you like to ask questions?

Mr. NEAL. Thank you, Mr. Chairman.

This question came up last week when I addressed the Boston Bar Association and their Tax section.

Ms. Olson, can we patch the current law? Or should we start over?

Ms. OLSON. It is my view that you should start over. You should repeal the repeal and go back. If there are changes that need to be made, you should make those changes directly. But in our view, there is no abuse that has been identified, no problem that has

been identified, that justifies the repeal of the installment method to begin with. We think you should start by going back to where you were.

Mr. NEAL. Thank you.

Thank you, Mr. Chairman.

Chairman HOUGHTON. Anybody else have any other questions?

[No response.]

Chairman HOUGHTON. If not, thank you very much for being with us.

There being no further business before the Subcommittee, the hearing is adjourned.

[Whereupon, at 2:25 p.m., the hearing was adjourned.]

[Submissions for the record follows:]

Statement of American Institute of Certified Public Accountants, Tax Division

Mr. Chairman and Members of this Distinguished Subcommittee:

The American Institute of Certified Public Accountants (AICPA) is the national, professional organization of certified public accountants comprised of more than 330,000 members. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. They provide services to individuals, not-for-profit organizations, small and medium-size businesses, as well as America's major businesses, including multi-national corporations. Many serve businesses as employees. It is from this broad base of experience that we offer our comments.

The AICPA appreciates the opportunity to provide written testimony on the subject of Section 536 of the *Ticket to Work and Work Incentives Improvement Act of 1999* (P.L. 106–170) (*Act*). This section of the *Act* added section 453(a)(2) to the Internal Revenue Code of 1986 (IRC), effectively repealing the use of the installment method of accounting for most accrual method taxpayers. **The AICPA, as do numerous small business trade and membership associations, believes that Congress should reinstate the ability of accrual basis businesses to utilize the installment method of accounting on the sale of assets and of the business**. The issue is one of equitable treatment for closely held or small businesses, and reinstating that ability would reverse the adverse economic impact on small business created by enactment of Public Law 106–170 last year. Further, there is no historical basis for limiting the installment method to cash basis taxpayers. The installment method of tax accounting was promulgated, enacted and upheld for the purpose of relieving the tax burden on small businesses without regard to conformity with book accounting principles.

While this provision also affects larger, accrual method businesses when they sell a particular asset or assets, its real effect has been to harm small and closely held businesses. When such businesses are sold, the new owner may wish to acquire assets rather than the stock of the business corporation (to avoid taking on the business liabilities, for example), and common practice is for payment to be made over a number of years in installments. Most such businesses use an accrual accounting method (tax law requires them, for example, to use an accrual method of accounting with respect to inventories). However, under the *Act*, they will now be forced to report the full gain from the sale of the business in the year of sale, even though payment for the assets will be made years into the future, and the first year payment may well not even cover the tax due on the sale.

This provision is already having a significant effect on the sales of small businesses. We have heard directly from numerous CPAs whose clients have had and are having trouble selling their businesses; many negotiated transactions for the sale of all or part of a taxpayer's business have recently fallen apart. As a result of the change in tax law, either the purchaser finds it uneconomic to pay the full purchase price up front, or the seller finds that he or she will have to produce funds from sources outside the business to pay part of the now immediately due, full tax on the sale. Alternatively, sellers are forced to take a substantial cut in sales price to persuade a buyer to accelerate the payments in the year of sale or they abort the transaction completely.

A sale of stock by a cash method shareholder is sometimes an option to transfer a business. More often than not, however, the buyer is not interested in purchasing the stock because doing so transfers the corporate liabilities to the new stockholder.

In the case of an S corporation, because of unique shareholder restrictions, a stock purchase is often not even an option. Further, it is still not clear whether a deemed asset sale by an S corporation under section 338(h)(10) could be treated as a stock sale for this purpose. Again, from a practical standpoint, the inflexibility of requiring a stock purchase compounds the problem of market illiquidity because it further reduces the pool of willing buyers.

The use of the installment method of accounting for tax purposes is widespread. It is used by all types of taxpayers, small and large, both C and S corporations, sole proprietorships, partnerships and individuals. It is used by businesses that are selling assets piecemeal but it is also used for the sale of an entire business. Regardless of whether a business is winding up or just selling assets, it may finance the sale by taking back a note. This is especially true for small businesses where financing may not be readily available to the purchaser and the seller becomes the financier of last resort. Before the change in the law, the business could defer tax by reporting the gain in installments, recognizing gain as the note was collected. This resulted in a deferral of the income tax and was consistent with the cash collected from the sale. With the new provision, the gain is immediately recognized. Tax liability could exceed cash generated from the sale by several times in the first year, severely distressing the business and its owners.

We believe the broad nature of the *Act's* language leaves Treasury relatively little room in solving this problem through regulation because there is no room in the statute for exceptions, particularly for the sale of small businesses. There are some highly complex fixes and exceptions that may be available to a few taxpayers, but regulatory responses, overall, would simply be small bandages on a large wound, even if the administrative response were generous.

To provide the measure of relief which approaches the level of hardship currently being suffered by small business owners contemplating a sale of their business, we strongly believe a legislative solution is necessary. Congress should make it simple and fair for all business owners to pay the often substantial tax due from the successful sale of their business when the sales price is received in installments over many years.

We welcome the opportunity to discuss this matter with you further.

Statement of National Association of Manufacturers

The National Association of Manufacturers (NAM) appreciates the opportunity offered by Subcommittee Chairman Houghton to comment on the recent repeal of the installment method of accounting for accrual basis taxpayers. The NAM—"18 million people who make things in America"—is the nation's largest and oldest multi-industry trade association. The NAM represents 14,000 members (including 10,000 small and mid-sized companies) and 350 member associations serving manufacturers and employees in every industrial sector and all 50 states. Headquartered in Washington, D.C., the NAM has 10 additional offices across the country.

Repeal of the installment sales provision, which was originally proposed by the Administration in its fiscal 2000 budget proposal, was included in P.L. 106–170, the Ticket to Work and Work Incentives Improvement Act of 1999, enacted on December 17. Unlike many other negative tax law changes, the provision became effective on enactment and did not include any binding contract language or transitional rules. This tax law change is having and will continue to have a significant negative impact on sales of small enterprises. We urge Congress to act quickly to restore the ability of accrual method taxpayers to use the installment method of accounting for asset sales.

IMPACT OF THE TAX LAW CHANGE

The impact of the installment sales provision goes well beyond anything hinted at in the explanation of the revenue proposals in the President's Fiscal 2000 Budget or the legislative history of P.L. 106–170. While the provision appeared to target larger, accrual method businesses when they sold a particular asset or assets, its real effect is to reduce the value of closely held businesses when they are sold in their entirety.

In the past, many small and medium manufacturers used the installment method in business sales for a variety of reasons, including the ability to spread the capital gains tax payment over the life of the sale. The installment method also has benefits beyond those related to taxes. It enables sellers to be more flexible in structuring the sale and to get a higher price for the business and it allows buyers to purchase

a business for which bank financing is unavailable. The installment method also ensures that the seller will continue to have a financial interest in the ongoing success of the business.

The conference report on the Ticket to Work and Work Incentives Improvement Act states that when a cash method taxpayer sells stock in an accrual method business-either an'S or C Corporation-the seller could use the installment sales method. However, in sales of closely held businesses, the stock sale is not always possible or most efficient. Even when stock exists, many sales of small businesses are structured as asset sales, for a variety of non-tax reasons. One of the most common reasons is that the buyer is interested in the assets of a business but not the imbedded liabilities that come with buying the stock. In fact, potential buyers sometimes refuse to buy the stock of a closely held company.

Depending on the structure of the sale, the loss of the installment sales provision will reduce the sale price of a closely held business, in some cases by as much as 20 percent. For instance, a seller may be forced to sell the stock, rather than the assets of his business so that he can use the installment method. Because of the potential liabilities that go along with the stock, an owner is likely to get a lower price for his business.

In other cases, the loss of the installment sales rule will prevent a sale from going forward. Many sales of small businesses are seller financed, in part because small business buyers have a difficult time obtaining commercial financing. Without the installment sales provision, a seller offering seller financing now has to pay the tax on his capital gain at the time of the sale rather than spreading the payments over the term of the installment note.

Under the deprecation recapture rules, a small business owner using the installment method already is required to recognize any recapture income in the year of the sale. Requiring the owner to also recognize capital gain at the time of the sale places yet another financial burden on the seller. In many cases, the seller may not have enough cash to pay his total tax bill, making it difficult or impossible to go through with the deal.

The loss of the installment sales rule also can exacerbate the problems faced by families when a business owner dies. In the United States today, two-thirds of family-owned businesses do not survive into the next generation, often because of the burden of estate taxes. Families are forced to sell the business to pay the estate tax liability. As noted above, repeal of the installment treatment could make it more difficult for a family to sell a business and/or reduce the price they are able to get for the business.

PROPOSED TREASURY GUIDANCE

After the changes in the installment sales rules were enacted last December, we were hopeful that regulatory guidance could ameliorate the impact of this change on our small and medium manufacturers. However, this is not the case. The proposed guidance outlined by Treasury on February 29, while helpful to some small businesses, will not address the situation faced by our small and medium members.

For instance, one of the Treasury proposals would allow business taxpayers with average annual gross receipts of $1 million or less to use the cash method and, thus, the installment sales method. While this will provide relief to some taxpayers, it could force some taxpayers to choose a method of accounting for tax purposes, rather than business purposes.

Moreover, even if our members decided to use the cash method, very few, if any, would fit into this category. Based on a 1999 survey of our small and medium members, only 17% of our members have annual sales of less than $3 million and its estimated that a much lower number have annual sales of $1 million or less.

LEGISLATIVE FIX

In previewing the guidance at the Oversight Subcommittee hearing on February 29, Joseph Mikrut, Treasury's tax legislative counsel, acknowledged that a legislative fix is needed to "alleviate this unforeseen impact of the installment sales provision." In particular, he suggested that sellers of small businesses with less than $5 million in gross receipts be allowed to use the installment method.

Unfortunately, the possible legislative fix outlined by Mr. Mikrut does not go far enough. The carve-out for businesses with less than $5 million in gross receipts would benefit, at most, one-third of our small and medium manufacturers. It would create winners and losers within our industry, with about two-thirds of our small and medium members unable to use the installment method.

CONCLUSION

In comments before the House Ways and Means Committee on February 8, Treasury Secretary Larry Summers acknowledged that the provision has had a broader impact than initially anticipated. We believe that total repeal of the provision enacted in December is the fairest, simplest and most effective way to address the problem faced by small business owners who are selling their businesses. On behalf of the National Association of Manufacturers (NAM) and our 14,000 member companies, I urge you to support immediate legislation to undo the damage inflicted on small businesses by changes in the installment sales rules enacted last year.

Statement of the National Association of Professional Insurance Agents, Alexandria, VA

The National Association of Professional Insurance Agents (PIA National) applauds Chairman Houghton and the Ways and Means Subcommittee on Oversight for holding today's hearing to discuss last year's repeal of the installment method of accounting for accrual basis taxpayers. PIA National represents 180,000 insurance professionals nationwide, many of whom are small business owners. The topic of today's hearing is of vital importance to our members. We appreciate this opportunity to present our views and real life testimonials from a number of our members who have already begun to experience the devastating affects of this unexpected change in tax law.

In short, insurance agencies are more difficult to sell and acquire, and could lose as much as 15% of their value as a result of tax provisions included in the Ticket to Work and Work Incentives Improvement Act of 1999. These provisions force agents to pay taxes on the sale of their agency all at once even if the proceeds of the sale are received in installments over several years. In some instances, tax liability exceeds the agent's first year revenue, making the sale impossible or forcing the agent to borrow money to pay taxes. The new law equally disadvantages buyers. Unable to spread the purchase price over a number of years, buyers are forced to secure financing or deplete savings to acquire an agency.

As you can see, the provisions prohibiting the use of the installment sales method by accrual basis taxpayers are already having a negative impact on the sale of small enterprises such as many insurance agencies. The net impact is that many insurance agencies are now worth considerably less money. This potentially devastating problem is compounded by the fact that many agents use the proceeds from the sale of their agency to finance their retirement.

The installment sales method is used by small businesses for a variety of reasons. It enables sellers to be more flexible in structuring the sale and can lead to a higher purchase price. Buyers unable to secure financing often prefer the installment method. It also ensures the seller will have an interest in the ongoing success of the business, which is important for buyers when a large portion of the purchase price is attributable to good will, as is the case with an insurance agent's book of business. We see no good public policy reason why small business owners who happen to be accrual basis taxpayers should be prevented from using the installment sales method.

While the onerous tax provision is not new—it was also included in the President's FY 2000 budget proposal and the tax relief bill ultimately vetoed last year—its consequence for small business owners is just recently surfacing. The provision was originally designed to target larger accrual method businesses when they sold particular assets or a portion of their ongoing concern. Unfortunately, as we now know, it also ensnares closely held businesses such as insurance agencies when they are sold in their entirety. This is an unintended consequence and it should be fixed.

Fortunately, legislation has been introduced in the House and Senate to repeal the new tax law prohibiting use of the installment sales method by accrual basis taxpayers. PIA supports these efforts and implores the Ways and Means Committee to move quickly on H.R. 3594 introduced by Congressman Wally Herger (R–CA). This bill already has well over 100 co-sponsors and is universally supported by the small business community. We appreciate this opportunity to present our views and look forward to working with the Committee and Congress as a whole to see H.R. 3594 enacted into law.

Attachments A-D are letters from PIA members explaining in their own words the chilling effect this new law has had on their livelihood.

SHENANDOAH INSURANCE AGENCY
STUARTS DRAFT, VA 24477
February 8, 2000

Honorable Robert W. Goodlatte
United States House of Representatives
Washington, DC 20515

Dear Congressman Goodlatte:

I am writing to ask you to join Congressman Walter Herger (R–CA) in his plan to introduce legislation to repeal the Ticket to Work and Work Incentives Improvement Act of 1999. This is my story:

During the year of 1999 I placed my insurance agency on the market and in the fall of 1999 I concluded the sale. In fact the buyer and I signed a buy and sell agreement in December 1999 about the time President Clinton signed the Act which went into effect the day the President signed. The buy and sell agreement went into effect January 1, 2000. Soon after January 1, 2000 I met with my CPA who informed me because of this Act I would probably owe taxes on the sale of $30,000 plus which because of the Act would be a one time payment. I was not aware that such an Act was even being considered by the Congress and I now find out that this was something that Congress did on the last day of your session last fall. I like hundreds of small businesses use the sale of our business as retirement income and we planned to pay income tax on the interest that we receive from the sale but now we are being hit with another tax.

I do not understand why you, the other members of Congress and President Clinton tell us in the press that you want to cut our taxes and at the same time pass the above mentioned Act.

I sincerely hope that you will join Congressman Herger in his effort to strike this unfair provision from the tax code as it will kill the sale of every small business in the country.

Thanking you for the help that you can give me on this matter.

Sincerely yours,

WILLIAM S. SWECKER

BOHMER AGENCY, INC.
BROOTEN, MINNESOTA 56316
February 8, 2000

Honorable Collin C. Peterson
United States House of Representatives
Washington, DC 20515

Dear Congressman Peterson: RE: Wally Herger's Upcoming Tax Bill

I am writing to ask that you co-sponsor legislation that will soon be offered by Rep. Wally Herger (R–Ca). The Professional Insurance Agents (PIA) organization informs me that a correction in the tax provisions contained in the "Ticket to Work and Work Incentives Improvement Act of 1999" is needed. It seems that we small, incorporated businesses are being caught up in a tax correction aimed at larger businesses.

I have a small insurance agency in Brooten, Minnesota and am forced to use the accrual basis of accounting since I am dealing with insurance companies. With the current law I would have difficulty selling all, or a portion, of my stock to one of my employees: I would be unable to finance them with an installment contract if I have to pay all the taxes "up front." In addition, if I chose to sell the agency outright only large existing agencies will be able to afford to purchase my agency. I don't think this is what was intended by the existing law.

I haven't been able to thank you in person for the help you gave our community in organizing a cooperative frozen food plant several years ago. THANK YOU. I have reminded local people of your assistance and am still your strong supporter.

Please feel free to call me at (320) 346–2234 or write me if you have any questions of me. I appreciate your assistance in this matter.

Thank you.

RESPECTFULLY,
DAVID W. BOHMER

BALLAND-ZIMMERMAN AGENCY
BALTIMORE, MARYLAND 21202–3311
February 28, 2000

Representative Ben Gardin
Unites States House of Representatives
Washington, DC 20515

Dear Representative Gardin:

As a small businessperson and professional insurance agent in your district, I am writing to ask that you co-sponsor legislation soon to be offered by Rep. Wally Herger (R–CA) which repeals onerous new tax provisions contained in the Ticket to Work and Work Incentives Improvement Act of 1999. The new law effectively prohibits the use of the installment sales method by accrual basis taxpayers and will have a tremendous negative impact on all small business owners wishing to sell their business.

I have been in the insurance business for 54 years, and have been taxed on an accrual basis. This year was to be my final one, and I had planned to sell the agency to another agent, and on an installment basis. The new law would force me to pay all taxes up front, reducing the value of the agency to me as well as to the buyer. As I understand it, the new law was intended to target large businesses that were selling off one or more assets, but it's impact would fall hardest on the transfer or sale of small businesses like independent agencies. This was an unintended consequence and should be fixed.

The installment method of selling an insurance agency is one of long standing. It allows more flexibility in structuring the sale of their business and buyers often prefer the installment method as it ensures that the seller has an interest in the business' on going success. This is important to the buyer when a large portion of the purchase price is attributable to good will.

I am counting on you to remedy this terrible situation faced by all small business owners and to co-sponsor repeal measures. I look forward to hearing back from you on this topic.

Respectfully yours,

WILLIAM S. STACK

FREDERICKSON-BROWN INSURANCE SERVICE, INC.
CANON CITY, COLORADO 81212
February 28, 2000

PIA
Attn: Allison Lewis
Re: Ticket to Work Act of 1999

Dear Allison:

Please stress to those involved what a tremendous hardship this bill places on small businesses in general.

I have worked for 26 years at Frederickson-Brown Insurance and plan to retire the end of this year. If I am required to pay all of the tax on the sale of my agency in the first year, it would be impossible since the income will be spread over a period of 20 years. This law will prevent the use of installment sales and could cripple small business owners selling their businesses or passing them along to other stockholders or family members. Thanks for all of the hard work being done by PIA.

Sincerely,

BRAD KNOTEK

Statement of the Printing Industries of America, Alexandria, VA

Mr. Chairman and members of the committee, thank you for providing an opportunity for the Printing Industries of America to provide comments on the installment method of reporting income from an installment sale that would otherwise be reported on an accrual method of accounting. PIA is the nation's largest graphic arts trade association with more than 14,000 members nationwide.

Although little was said about this provision before it was included as an offset to the tax extenders included in the Ticket to Work and Work Incentives Improvement Act of 1999, the unanticipated consequences have caused uproar in the small business community. Since repeal of the installment method of reporting sales for accrual basis taxpayers was signed into law on December 17,1999 (Public Law 106–

170), I have received numerous calls from our members concerned about the effect the disallowance could have on their current and future business plans. Countless businesses will be adversely affected if this repeal is allowed to stand unheeded.

Until this year, sellers have been able to set up sales of the assets of their businesses by financing a note using the installment method. Owners were able to defer capital gains taxes until the year payments were actually received. This was particularly important since many small business sales must be financed by the seller, because traditional bank financing is often not available to the average buyer.

As the committee is aware, the December change in law will now force business owners to pay taxes on sales in the first year, rather than when payments are actually made. Because many small business owners simply do not have the cash on hand to pay the taxes now required in the year of the sale, sellers are faced with limited options such as lowering the sale price or borrowing the money from a bank.

Either of these scenarios would place new burdens on a small business owner as they often use the sale of their business to finance their retirement. An unexpected reduction in expected income could very well require continued work rather than selling to retire. Another unfortunate circumstance that could result from this requirement is the position a seller would be put in if the buyer were to go bankrupt a couple of years down the road. In this instance with the current law, an individual would already have paid taxes on money he now will never receive.

A difficult situation arose for a New England member recently, as a result of the disallowance of the installment sales method of accounting. This particular member happens to be the proud ten-year owner of a direct mail printing company employing approximately 45 employees. This printer was in the process of purchasing a mailing house company, which employs approximately 195 employees, in an attempt to add to the current growth of his direct mail printing company. He had arranged a loan with the sellers of a mailing house company, which would come from the proceeds of the sale of the company to our member. This money was crucial to our member in order to obtain approval from the bank for the loan to buy the mailing house company.

At the time when the repeal was signed into law in December of 1999, our member and the sellers of the mailing house company were nearing the end of their negotiations and were almost ready to close. However, the tax implications of the newly enacted law almost caused the sellers to balk on the deal as the realization of the additional tax responsibility dawned on the sellers. It was only their desire to sell to a fellow small business owner that kept them from pulling out of the deal altogether. In order to close the deal, our member had to agree to a repayment schedule at a higher interest rate and on an accelerated basis. He also agreed to give the amount of money equal to the taxes due in the coming year or pay a significant penalty in addition to the amount borrowed from the sellers. Our member continues to hope for a "repeal of the repeal" in order to relieve this incredible burden placed on him as a result of the disallowance of the installment method of reporting this sale. If repeal is not enacted by the time the taxes are due on this sale, our member will be forced to borrow this sum of money and go further into debt in order to satisfy the terms of the agreement.

Further, our member has expressed his concern as to the continuation of the business plans of the people involved in the sale. Should this provision remain intact, many business owners, including our member, may have to consider selling to a consolidator, instead of to their current management or perhaps a family member, in order to get the price needed to sustain future plans and retirement.

Our member has said that for years it has been his plan to finance the sale of his business when he is ready to retire. However, with the current law, this option would probably not be considered due to the tax responsibilities of the current law. This will certainly curtail the employee advantage in this scenario and limit the future of small businesses while at the same time encouraging sales to larger companies.

Is this really what Congress would want? Do we want to make selling a small business company so difficult as to endanger the future of small businesses overall in our community; those same small businesses that have been a staple for providing jobs and economic growth in our communities for years on end? For the reasons provided in this statement, the Printing Industries of America urges your support for a complete "repeal of the repeal," as this is the only way to keep the playing field level for the small business community. On behalf of printers across the nation, PIA encourages you to support H.R. 3594, sponsored by Representative Wally Herger, for a complete repeal of the disallowance of the installment method of sales. Thank you for the opportunity to submit this statement into the record.

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