ACEC

American Council of Engineering Companies

Cash Basis Method of Accounting

FACT SHEET

ISSUE

Former congressional tax-writers proposed limiting the use of the cash basis method of accounting to sole proprietorships and firms with less than $10 million in gross receipts. ACEC strongly opposes efforts to restrict the use of cash accounting to firms with less than $10 million in gross receipts and supports modernizing the function and stock ownership tests for QPSCs.

OVERVIEW

Section 448 of the Internal Revenue Code generally allows engineering firms organized as passthrough entities, such as S corporations or partnerships, or qualified personal service corporations (QPSC) to use cash accounting. QPSCs may only provide professional services, including engineering and architecture, and substantially all of the corporation's stock must be owned by employees or retirees of the firm.

Engineering firms normally carry large balances of accounts receivable and work in progress, representing work performed for clients for which they have not yet been paid. The primary cost for engineering firms is labor, and approximately 85 percent of a typical firm's expenses can be attributed to payroll, benefits, and similar regular expenses. Engineering firms generally have to wait at least 120 days to be paid for services rendered to their clients, and at the same time must pay their employees every two weeks. While this situation can create cash flow challenges for firms, the use of cash accounting helps to mitigate those challenges by allowing firms to make tax payments after receiving payment for their services.

By contrast, forcing firms to switch to accrual accounting would create a number of problems, most notably requiring firms to use debt financing to cover the delta between expenses and receipts, which can be difficult for small and mid-size firms to access. The cash flow challenges that would result from a switch to accrual accounting would create additional negative consequences, including workforce downsizing among some firms, delayed expansion plans, and decreased shareholder distributions. All of these outcomes would take money out of the productive economy and jeopardize well-paying jobs.

ACEC also supports modernizing the function and stock ownership tests that apply to QPSCs. The function test is met if substantially all of the corporation's services in a taxable year involve any of the following fields: health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting (professional services). The ownership test is met if at all times during the taxable year, substantially all of the value of the corporation's stock is held directly or indirectly by employees or retirees who performed professional services of the QPSC.

Changes in the practice of engineering — including the need to hire larger numbers of non-engineers due to the needs of current project delivery — have caused many engineering companies to fear losing eligibility to use the cash method of accounting. The rules should be clarified so that such services will meet the definition of engineering and therefore not restrict the service provider's ability to continue to qualify as a QPSC.