**Chapter Seven**

**Accounting Periods and Methods and Depreciation**

**Learning Objective 7.1 Accounting Periods**

Almost all individual taxpayers file their returns based on a calendar year accounting period. However, there are no restrictions on an individual taking a tax year other than a calendar year. The choice to file on a fiscal year basis must be made with an initial tax return and books and records must be kept on that basis. Many individual tax returns include the pass through of income from partnerships, S corporations and personal service corporations. In the past, partnerships and corporations had a great deal of freedom in establishing their year, but Congress has limited the choices by establishing provisions. The first provision applies to partnerships. Partnerships must establish a tax year that is the same as the partners with majority interest. S Corporations must also adopt their tax year following a similar rule. Partnerships and S Corporations may adopt a different business year if one of two conditions can be met. The first condition is that the business purpose of the fiscal year can be demonstrated. Typically, only seasonal businesses have natural business years. The second condition is the partnership’s or S corporation’s fiscal year does not result in a deferral period of more than three months or more than the deferral period in existence before the change to the new fiscal year, whichever is shorter and the partnership or S corporation agrees to make their annual “required tax payment.” Since partnerships and S corporations do not pay income taxes (the taxes are paid by the individual owners), the required tax payment is essentially a noninterest bearing deposit with the IRS.

A personal service corporation is a corporation whose shareholder-employees provide personal services, such as medical, legal or consulting services, for the corporation’s patients or clients. Personal service corporations typically must adopt a calendar year end. Personal service corporations may adopt a different business year if one of two conditions can be met. The first condition is that the business purpose of the fiscal year can be demonstrated. The second condition is that the fiscal tax year results in a deferral period of no more than three months or the deferral period of the tax year being changed, whichever is shorter and the corporation pays the shareholder-employees’ salaries for the deferral period at least proportionate to the salaries received from the most recent fiscal year or the corporation limits its deduction for shareholder-employees’ salaries.

Once taxpayers elect their tax year, they cannot change the tax year without consent of the IRS. During the first or last year of operations, taxpayers may experience a short year, a tax year less than twelve months. The short year return must be annualized for both revenue and expenses.

**Learning Objective 7.2 Accounting Methods**

The main accounting methods allowed under tax law are the cash receipts and disbursements (cash) method, the accrual method and the hybrid method. The cash method results in the recognition of revenue when cash is received and the recognition of expenses when the cash is expended. (Regular corporations, partnerships that have a regular corporate partner and tax-exempt trust with unrelated business income are generally restricted from using the cash basis.) The accrual method results in the recognition of revenue when the revenue is earned (regardless of cash receipt) and the recognition of expense when the expense is incurred (regardless of cash expenditure). Tax provisions require that cash basis taxpayers use the accrual method for interest and rent. Accrual basis taxpayers who receive certain types of prepaid income must generally recognize the income on a cash basis. A hybrid method implements both cash and accrual bases of accounting. Taxpayers must elect a method and can change only with consent of the IRS.

**Learning Objective 7.3 Depreciation**

Depreciation is the allocation of the cost of an asset over the use of the asset. Many depreciation methods are used but the simplest method is straight-line depreciation. The cost of the asset is reduced by any estimated salvage value to get the depreciable base. The depreciable base is divided by the estimated useful life of the asset to derive the depreciation for the period.

**Learning Objective 7.4 Modified Accelerated Cost Recovery System (MACRS)**

Accelerated tax methods allow depreciation expenses to be larger in the first years of operations and decrease over the life of the asset. Under the Modified Accelerated Cost Recovery System (MACRS), taxpayers calculate the depreciation of an asset using a table that contains a percentage rate based on the year of ownership. MACRS uses a half-year convention which means that a five year asset would be depreciated for six years since only half of the year depreciation would be allowed in year one and half in year six. Depreciation expense is reported on Form 4562.

**Learning Objective 7.5 Election to Expense**

Taxpayers may elect to expense certain personal property during the year the asset is acquired. Currently, the maximum cost that be expensed in year of acquisition is $25,000 for 2014. (It is highly likely congress will authorize an increase to Section 179. Please check the Whittenburg companion website for updates.) A taxpayer who has made the election to expense must reduce the depreciable basis of the property before computing future depreciation expenses.

**Learning Objective 7.6 Listed Property**

Listed property includes assets that could be used for personal, rather than strictly business reasons. Examples included:

1. Passenger automobiles
2. Other property used as a means of transportation, except vehicles that are not likely to be used for personal purposes, such as marked police cars.
3. Property generally used for entertainment, recreation or amusement
4. Computer or peripheral equipment, unless used exclusively at a regular business establishment

If listed property is used 50 percent or less by the business, any depreciation deduction must be calculated using the straight-line method of depreciation.

**Learning Objective 7.7 Limitation on Depreciation of Luxury Automobiles**

Luxury automobiles that are used by a business are limited to an annual dollar limitation. The annual limit is determined by the year the automobile was acquired. Additionally, the annual dollar limit is reduced if the vehicle was not used 100 percent by the business.

**Learning Objective 7.8 Intangibles**

Intangible assets are assets that cannot be seen or touched. Section 197 intangibles are amortized over fifteen years beginning with the month purchased, regardless of estimated useful life. Examples of Section 197 intangibles are goodwill, going-concern value, workforce in place, information bases, know-how, any customer-based intangible, any license, permit or right granted by a governmental unit, any covenant not to compete, and any franchise, trademark or trade name. Some intangibles are specifically excluded from Section 197. Examples of the exclusions are interest in a corporation, partnership, trust or estate, interests in patents and copyrights, interests in land, computer software readily available for purchase by the general public, sports franchises, interest in films, sound recordings, video tapes and similar property and self-created intangible assets.

**Learning Objective 7.9 Related Parties (§ 267)**

When taxpayers conduct business with other taxpayers that are not independent of each other, abuse of the tax system can occur. Tax law closely regulates related party transactions. Related parties, as defined in § 267, include family members, corporations that are held by the same controlled group, owner of a corporation to the corporation and trusts, corporations and certain charitable organizations. Specifically, two types of related party transactions are restricted by § 267: sales of property at a loss and unpaid expenses and interest. Losses from the sale or exchange of property as a result of a related party transaction are not allowed. If related taxpayers are trying to avoid paying taxes by operating different accounting methods, the action is not deductible.