**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.

* There are no restrictions on an individual taking a tax year other than a calendar year.
* Choice to file on a fiscal year basis must be made with initial tax return
* Many individual tax returns include pass through of income from partnerships, S corporations and personal service corporations (PSC).

A PSC is a corporation whose shareholder-employees provide personal services such as medical, legal or consulting services, for the corporation’s patients or clients.

* PSCs typically must adopt a calendar year end
* May adopt a different business year if one of two conditions can be met
  1. The business purpose of the fiscal year can be demonstrated
  2. 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

Once taxpayers elect their tax year, they cannot change it without consent of the IRS.

During the first or last year of operations, taxpayer may have a short year

* This is 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
  + A hybrid method incorporates 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 useful life of the asset.

* Simplest method is straight-line (SL) depreciation.
  + Cost – Salvage Value/# of years in useful life = annual decpreciation

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

Accelerated tax methods allow depreciation write offs to be larger in the first years of operations and then decrease over the life of the asset

* MACRS requires taxpayers use a table that contains a percentage rate based on the year of ownership to get depreciation
  + MACRS uses a *half-year convention*
    - This means that a five-year asset would be depreciated for six years
    - Only 6 months of depreciation in year 1 and another 6 months in year 6
  + Taxpayer can use SL rather than MACRS, but then all assets in that class placed in service during the year must use the same method
  + *Mid-quarter convention* must be utilized (rather than half-year) if 40%+ of assets (excluding real estate) are purchased in the last quarter of the year.
    - Mid-quarter tables may be found at major tax service websites
* Real estate purchased after 1986 is depreciated using SL
  + MACRS publishes tables that use *mid-month convention*
    - Residential real estate goes over 27.5 yrs and nonresidential over 39 yrs
    - Land is never depreciated

Depreciation expense is reported on Form 4562.

**Learning Objective 7.5 Election to Expense (§179)**

Taxpayers may elect to expense certain personal property during the year the asset is acquired.

* Maximum cost that be expensed in year of acquisition is $500,000 for 2016.
* The election to expense is also limited to
  + Taxable income from the activity
  + And is subject to phase-outs when asset purchases exceed a threshold of $2,010,000.
* When election to expense is used, must reduce the depreciable basis of the property by that amount and *then* depreciate the rest according to MACRS

Reported in Part I of Form 4562

**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 (such as buses, boats, airplanes, etc)
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% or less by the business, any depreciation deduction must be calculated using the straight-line method of depreciation.

Reported in Part V of Form 4562

**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.

* Annual limit is determined by the year the automobile was acquired
* Any automobile which would have actual MACRS depreciation exceeding the limits must comply
* Also - dollar limit is reduced if the vehicle was not used 100% by the business
* SUVs weighing more than 6000 pounds can be immediately expensed up to $25,000; the balance is depreciated utilizing MACRS 5-year tables

**Learning Objective 7.8 Intangibles**

Intangible assets are assets that cannot be seen or touched.

* §197 intangibles are amortized over 15 years *beginning with the month purchased*
* Examples of §197 intangibles are
  + Goodwill
  + Going-concern value and workforce in place
  + Licenses or permits
  + Covenant not to compete
  + Franchises, trademarks or trade names
* 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)**

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, and certain charitable organizations.
* Specifically, two types of related party transactions are restricted by § 267
  + Sales of property at a loss and
  + Deductibility of unpaid expenses and interest
* Losses from 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 employing different accounting methods, the action is not deductible.