Chapter 7 Accounting Periods and Methods and Depreciation

- Determine different accounting periods and methods for tax periods
- Understand concept of depreciation
- Calculate depreciation using MACRS tables and identify when §179 election to expense may be applied
- Apply listed property and luxury automobile limitations
- Understand tax treatment of intangibles
- Determine whether parties are considered related and how to treat related party transactions

Accounting Periods

- Most individuals file tax returns that utilize a calendar year
- Most partnerships, S corporations, and personal service corporations owned by individuals have same calendar year as almost all individuals
- In these entities
  - Allowed a September, October, or November year-end if owners make tax deposit
  - Details are beyond scope of this text

Note: Partnerships don't pay tax as an entity

Short Period Taxable Income (TI)

- If taxpayer has a short year (other than first or last year of operation), tax is calculated based on following example:
  - In 2014, Organic Dairy LLC changes from a calendar year to tax year ending 9/30. For the short period 1/1/14 – 9/30/14, Organic Dairy LLC's taxable income = $20,000*

Steps to calculate tax for the short period

Annualize TI	$20,000 x 12/9 = $26,667
Estimated tax on annualized TI	$26,667 x 15% = $4,000
Allocate tax to short period	$ 4,000 x 9/12 = $3,000

Note: Calculations for short year TI requires special adjustments. Also, individual taxpayers rarely change tax years

Accounting Methods

- There are three acceptable accounting methods for reporting taxable income
  - Cash
  - Hybrid
  - Accrual

must use same method for tax & books

- Must use one method consistently
  - Make an election on your first return by filing using a particular method
  - Must obtain permission from IRS to change accounting methods

Accounting Methods

- Cash receipts/disbursements method
  - This method most common for individuals
  - Recognize income when cash actually or constructively received
  - Recognize deduction in year of payment
    - Exception - can’t deduct prepaid rent or interest
  - Can’t use cash basis if taxpayer is a
    - C corporation
    - Partnership with a corporation as a partner
    - Tax exempt trust with unrelated business income
      - Doesn’t apply to certain organizations

Accounting Methods (continued)

- Accrual method
  - Recognize income when earned and can be reasonably estimated
  - Recognize deductions when incurred and can be reasonably estimated
- Hybrid method
  - An example of a hybrid taxpayer is one that utilizes cash method for receipts and disbursements, but accrual for cost of products sold

Depreciation

- Depreciation is a process of allocating and deducting the cost of assets over their useful lives
  - Does *not mean* devaluation of asset
  - Land is not depreciated
- Maintenance vs. depreciation
  - Maintenance expenses are incurred to keep asset in good operating order
  - Depreciation refers to deducting part of the original cost of the asset

Report depreciation on Form 4562

Depreciation Methods

- Straight-line depreciation is easiest, for accounting purposes, and is calculated as
  (Cost of asset – Salvage value)/Years in estimated life
- Modified Accelerated Cost Recovery System (MACRS), for tax purposes, allows capital assets to be written off over a period identified in tax law
  - Accelerated method used for all assets except real estate

Personal Property Recovery Periods

- With MACRS, each asset is depreciated according to an IRS-specified recovery period

  - *3 years* ADR* midpoint of 4 years or less
  - *5 year* Computers, cars and light trucks, R&D equipment, certain energy property and certain equipment
  - *7 year* Mostly business furniture and equipment and property with no ADR life

See Table 7.1 on page 7-7 for Asset Depreciation Ranges (ADR) for recovery periods for all classes of assets

Calculating Depreciation for Personal Property

- Depreciation is determined using IRS tables
  - MACRS rates found in Table 7.2 on page 7-8
  - Rates multiplied by cost (salvage value not used in MACRS calculations)
  - Tables based on half-year convention
    - Means 1/2 year depreciation taken in year of acquisition and 1/2 year taken in final year
- May elect to use tables based on straight-line instead (percentages in Table 7.3 on page 7-9)
- In 2013, IRS issued 'safeharbors' for taxpayers wishing to expense certain items that may not be material (see page 7-12)

Note: Must use either MACRS or straight-line for all property in a given class placed in service during that year

Using Tables – Personal Property

Example 1: On March 15, Naturatech Co. purchased furniture for $180,000; what is the recovery period and depreciation? *(assume no bonus depreciation taken)*

Use Table 7.1 to see it's a 7-year asset

Use Table 7.2 to get percentages

Year 1: $180,000 x .1429 = $25,722

Year 2: $180,000 x .2449 = $44,082

Example 2: On February 3, Bad Boy Bling LLC bought a inventory control system (computerized) for $12,000; what is the recovery period and depreciation? *(assume no bonus depreciation taken)*

Use Table 7.1 to see it's a 5-year asset

Use Table 7.2 to get percentages

Year 1: $12,000 x .20 = $2,400

Year 2: $12,000 x .32 = $3,840

Mid-Quarter Convention

- Mid-quarter convention is required if taxpayer acquires more than 40% of total assets (except real estate) in the last quarter of tax year
  - Must apply this convention to every asset purchased in the year
  - Excludes real property and §179 property
  - Must use special mid-quarter tables
    - Found at major tax service such as Commerce Clearing House (CCH) or Research Institute of America (RIA)

Bonus Depreciation

Bonus depreciation has been a part of tax law on and off since 2001

- Additional depreciation immediately available for assets with MACRS recovery period of 20 years or less
- Applies only to new property for use in business
- For 2014, no bonus depreciation amount is allowed

Personal Property Depreciation Example

Example

Nicole purchases a cherry desk and executive chair for use in her engineering firm on July 16, 2014 for $8,150. What is her depreciation for 2014 using half-year convention and MACRS tables? 2015?

Solution

Example

Nicole purchases a cherry desk and executive chair for use in her engineering firm on July 16, 2014 for $8,150. What is her depreciation for 2014 using half-year convention and MACRS tables? 2015?

Solution

Using Table 1, we can see that business furniture has a 7-year life. Table 2 shows the percentages to use for recovery years 1 and 2:

2014 depreciation = $1,165 ($8,150 x .1429)

2015 depreciation = $1,996 ($8,150 x .2449)

Real Estate

- Real estate depreciated based on a recovery period – two types of real property
  - 27.5 years Residential real estate
  - 39 years Nonresidential real estate

Real assets are depreciated using the straight-line method with a mid-month convention

- Mid-month convention assumes all purchases made in middle of month
- Used for real estate acquired after 1986
- Rates found on Table 7.4 on page 7-11

Note: Different rates apply for real property acquired before 1981 and after 1980 but before 1987

Real Estate Example

Example

Gwen purchased a residential tri-plex on 8/1/14 for $290,000 (including land cost of $50,000). What is her depreciation for 2014? 2015?

Solution

Example

Gwen purchased a residential tri-plex on 8/1/14 for $290,000 (including land cost of $50,000). What is her depreciation for 2014? 2015?

Solution

Since land is not depreciable, only $240,000 may be multiplied by percentages from Table 7.4 on page 7-11 (27.5-year residential real property). The purchase occurred in the eighth month; therefore, depreciation equals

2014 $240,000 x 1.364% = $3,274

2015 $240,000 x 3.636% = $8,726

Election to Expense - §179

- §179 allows immediate expensing of qualifying property (tangible personal property used in a business, new or used)
  - For 2014, the annual cost that may be expensed is $25,000 in year of acquisition*
- §179 election to expense is limited by 2 things
  - If cost of qualifying property placed in service in a year > $200,000, then reduce §179 expense dollar for dollar
    - For example, if assets purchased in current year = $222,000, taxpayer must reduce §179 by $22,000. Therefore, election to expense is limited to = $3,000 [$25,000 - ($222,000 – $200,000)]. The remaining $219,000 of basis is depreciated over assets' useful lives.
    - Cannot take §179 expense in excess of taxable income

****Check the Whittenburg companion website for update on limits for 2014***

Election to Expense - §179

- When using with regular MACRS, take §179 first, then reduce basis to calculate bonus depreciation, then reduce basis to calculate MACRS
- For example
  - In 2014, NanoPaint Inc.'s taxable income = $1.25 million. They placed a 7-year piece of property into service costing $139,000 – it was their only asset purchase in 2014. What is total depreciation, including election to expense?
  - The entire $25,000 maximum may be claimed in 2014 as the election to expense since assets purchased don't exceed $200,000 and taxable income is sufficient to absorb the entire amount.

§179 Example

Example

On 7/11/14, O'Neill Machinery LLC purchases a used tooling machine (7-year asset) for $459,000. The taxable income from the business is $445,500. What is the company's total depreciation deduction for the current year, including §179 and MACRS?

Solution

Example

On 7/11/14, O'Neill Machinery LLC purchases a used tooling machine (7-year asset) for $459,000. The taxable income from the business is $445,500. What is the company's total depreciation deduction for the current year, including §179 and MACRS?

Solution

Asset purchases exceeded $200,000, and the entire election to expense is lost:

Cost	$459,000
§179 expense	0
Adjusted depreciable basis	459,000
x Table %	.1429
MACRS	6,559

Listed Property

- Special rules exist to limit deductions on assets that lend themselves to personal use, called ‘listed property’
  - Cars and trucks/vans under 6000 lbs. gross vehicle weight with specific exclusions
  - Computers and peripheral equipment (unless used exclusively at business)
  - Equipment used for entertainment, recreation or amusement
- If asset used <= 50% for business (or if business use falls below 50% in subsequent years) *must use straight-line and election to expense not allowed*
- If asset used > 50% for business, must use MACRS
- Separate section (Part V) on page 2 of Form 4562

Luxury Auto Limitations

- IRS limits annual depreciation expense that may be claimed on passenger auto
- Maximum allowed amount is
  luxury auto limits x business %
- Luxury auto limits are quite low
  - Annual depreciation limit on 'luxury' autos placed into service in 2014 are as follows
    - 2014 - $3,460 (or $11,160 if taking bonus depreciation*)
    - 2015 - $5,500
    - 2016 - $3,350
    - 2017 and subsequent years - $1,975

Only allowed if used more than 50% in business and purchased new during 2014

Exception to Luxury Auto Limitations

- Passenger auto includes any 4-wheeled vehicle manufactured primarily for use on public streets and weighing less than 6000 lbs.
  - Some SUVs weigh more than 6000 lbs. and so can be expensed under §179
  - Beginning 10/22/04, could ‘only’ expense $25,000 and then depreciate remainder using five year MACRS percentages
  - Annual limitations must reflect business-use percentage

Luxury Auto Example

Example

On 3/15/14, Jim purchased a new automobile for $50,000; it is a passenger auto weighing less than 6000 lb. The automobile is used 60% for business and Jim wants to know how much depreciation to claim.

Solution

Example

On 3/15/14, Jim purchased a new automobile for $50,000; it is a passenger auto weighing less than 6000 lb. The automobile was used 60% for business and Jim wants to know how much depreciation to claim.

Solution

Regular depreciation ($50,000 x 20%)	$10,000
Times business use percentage 60%	x .60
Possible depreciation	6,000
"Luxury auto" limitation (60% of $3,460)	**$2,076 total**

Intangible Assets

- Amortization is cost recovery for intangible assets, similar to depreciation
- §197 intangible assets are acquired by purchase
  - Amortized over 15-years *beginning in month acquired*, includes assets such as
    - Goodwill (value attributable to expected continuation of customers' patronage)
    - Covenant not to compete
    - Franchise or trademark
  - Many intangible assets are excluded from §197
    - May not amortize self created assets like patents and copyrights

Amortization Example

Example

FionaWear Inc. purchased a small artisan textile company in May 2014 for $980,000. $54,000 of the purchase price was allocated to goodwill in the buy-sell agreement. How much goodwill may FionaWear amortize in 2014?

Solution

Example

FionaWear Inc. purchased a small artisan textile company in May 2014 for $980,000. $54,000 of the purchase price was allocated to goodwill in the buy-sell agreement. How much goodwill may FionaWear amortize in 2014?

Solution

$54,000/15 years = $3,600/12 months = $300 per month

§197 amortization $300 x 8 months = $2,400

Related Party Transactions §267

- Restricted transaction between related parties include
  - Recognizing losses on sales between related parties
  - One accrual basis and one cash basis taxpayer as pertains to expensing unpaid expenses and interest
- Related parties are:
  - Family members such as spouses, lineal descendants, siblings
  - A corporation and more than 50% owner
  - Brother/sister corporations
  - Parent/subsidiary corporations
  - Complex 'constructive ownership' rules

Related Party Transactions §267

- Losses disallowed between related parties
  - When property sold later to an unrelated party, all previously disallowed losses may be taken against gain
- May not avoid tax when one taxpayer uses cash method for expenses and interest and the other taxpayer uses accrual method