Chapter 15

Accounting Periods and Methods

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Accounting Periods
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- Taxable year
  - The tax year may be shorter but is usually not longer than 12 months
  - Taxpayer elects a tax year by the timely filing of the initial return
  - Permission to change taxable years must be obtained from the IRS

Accounting Periods

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- Types of taxable years
  - Calendar year: January 1 - December 31
  - Fiscal year: must start on the first day of a month and end the last day of a month 12 months later
    - Example: July 1 - June 30

Accounting Periods

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- Types of taxable years
  - 52/53 week year: ends on same day of week that is either closest to its normal monthly year-end or occurs last in its year
    - Example: year-end is always the last Saturday in April

Accounting Periods- Partnerships

- Tax year-end must be that of (in descending order)
  - Majority interest partners,
  - Principal partners, or
  - Least aggregate deferral of income

Accounting Periods-
S Corps and PSCs

- Generally, these entities must have a calendar year
  - Other tax years may be available if certain requirements can be met

Accounting Periods-Other Allowable Year-ends

- Partnerships, S corps, and PSCs can elect to have other fiscal year-ends if any of the following are met:
  - A valid business purpose can be shown
  - §444 election is made and year-end results in no more than a 3-month deferral
    - Requires certain payments
  - §444 election was made to retain a pre-1987 fiscal year-end
    - Requires certain payments

Accounting Periods-Valid Business Purpose

- IRS acknowledges only one valid business purpose for using a fiscal year-end
  - Conforming the tax year to the entity’s natural business year (seasonal businesses)
    - Example: a September 30 year-end may be a natural business year-end for a swim suit manufacturer

Accounting Periods-§444 Deferral and Required Tax Payments

- Partnerships and S corporations (not their owners) must make tax payments at the highest individual rate plus 1% (e.g.,39.6%) on estimated deferral period income

Accounting Periods-§444 Deferral and Required Salary Payments

- PSCs must pay shareholder-employees salaries during the deferral period that are at least proportionate to their salaries for the preceding fiscal year
  - Failure to make required salary payments reduces PSCs deduction for salaries paid to shareholder-employees

Example of §444 Deferral and Required Salary Payments

- PSC has October 31 year-end
  - Provides 2 month deferral
  - Has one shareholder-employee with $60,000 in salary for prior fiscal year
  - PSC should pay shareholder-employee at least $10,000 in salary during the deferral period
    - $60,000 x 2/12 = $10,000

Change in Accounting Period

- Must obtain IRS consent before changing tax year
- IRS will not consent to a change unless taxpayer demonstrates a substantial business purpose for change, such as changing to natural business year

Change in Accounting Period-Natural Business Year

- Objective test: At least 25% of entity's gross receipts are realized in the final 2 months of the desired tax year for 3 consecutive years

Accounting Periods- Short Taxable Year

- A short taxable year can occur in the first taxable year, the last taxable year, or when there is a change in the taxable year
- If the short-period year is caused by a change in taxable year, the short-year income must be annualized

Accounting Methods
(slide 1 of 7)

- There are 3 permissible accounting methods
  - Cash receipts and disbursements
  - Accrual
  - Hybrid

Accounting Methods
(slide 2 of 7)

- Cash receipts and disbursements method
  - Income is recognized when it is actually or constructively received
  - Expenses are deductible when they are paid
    - Most courts have applied the "one year rule" for prepaid expenses
      - Requires that prepaid expenses whose benefits extend beyond the end of the following tax year must be capitalized and amortized

Accounting Methods
(slide 3 of 7)

- Cash receipts and disbursements method - Restrictions on use
  - Must use accrual accounting for sales and cost of goods sold if inventories are material
  - Cash method cannot be used by corporations and certain partnerships
    - Exceptions: Farming business, PSC, entity with $5 million or less average annual gross receipts during last three-year period

Accounting Methods
(slide 4 of 7)

- Accrual method: Income
  - Income is recognized when it is earned
    - Income is earned when all events have occurred to fix the taxpayer's rights to the income, and
    - The amount can be determined with reasonable accuracy

Accounting Methods
(slide 5 of 7)

- Accrual method: Deductions
  - Expenses are deductible when they meet the all events test and the economic performance test
  - Economic performance test is waived for certain recurring items

Accounting Methods
(slide 6 of 7)

- Hybrid method involves the use of more than one method
  - e.g., A combination of cash and accrual methods
  - Generally used when inventory is a material factor
    - Accrual accounting is used for determining the gross profit from inventory and cash accounting is used to report other income and expenses

Accounting Methods
(slide 7 of 7)

- Change in accounting method
  - Taxpayer elects accounting method for subsequent years by filing the initial return
  - Must obtain permission from IRS to change accounting methods and adjustments may be required to prevent distortion of taxable income
  - Correction of error is not a change in accounting method

Installment Method
(slide 1 of 11)

- Installment method of reporting gain allows the taxpayer to recognize gain as payments on the sale are received

Installment Method
(slide 2 of 11)

- To qualify for installment treatment, the taxpayer must receive at least one payment after the year of sale
- May elect out of installment treatment

Installment Method
(slide 3 of 11)

- Installment treatment is not allowed for the following:
  - Sale of inventory
  - Depreciation recapture under §1245 and §1250
  - Sale of securities traded on established markets

Installment Method
(slide 4 of 11)

- Computing the gain recognized:
  - Gain recognized each year is dependent on the payments received during the year
  - Recognized Gain =

    (Total gain/contract price) X Payments Received

Installment Method

(slide 5 of 11)

- Definitions
  - Total gain = selling price less selling expenses less adjusted basis of property
  - Contract price = Sales price less liabilities assumed by buyer
    - Generally is equal to amount (other than interest) seller will receive from purchaser

Installment Method
(slide 6 of 11)

- If liabilities assumed by buyer exceed the seller's basis and selling expenses, then the difference must be added to the contract price and to the payments received in the year of sale

Installment Method

(slide 7 of 11)

- Depreciation recapture under §1245 and §1250
  - Depreciation recapture is ineligible for installment treatment; thus, all recapture must be recognized in year of sale
  - Because most, if not all, of the gain on the sale of tangible property is §1245 recapture, benefit of installment treatment is generally limited to sales of real property

Installment Method
(slide 8 of 11)

- Imputed interest
  - Deferred payment contracts where the sales price exceeds $3,000
    - Reasonable rate of interest (at least the applicable Federal rate) must be charged by taxpayer on the outstanding balance
    - Failure to charge adequate interest will result in imputed interest at Federal rate

Installment Method

(slide 9 of 11)

- Related party installment sales
  - Limitations on the use of the installment method
    - Nondepreciable property: disposition of property by related purchaser generally accelerates recognition of gain on installment obligation for related seller
    - Depreciable property: installment method is not available on sale to controlled entity (i.e., more than 50% interest) unless it can be demonstrated that tax avoidance was not a principal purpose

Installment Method
(slide 10 of 11)

- Disposition of obligation
  - Disposition of an installment obligation triggers recognition of remaining deferred gain

Installment Method
(slide 11 of 11)

- Interest on Deferred Taxes
  - Required to pay interest on the deferred taxes related to the excess obligation amount (excess of $5 million) when
    - Installment obligation is from sale of property for more than $150,000, and
    - Sum of such obligations outstanding at year-end exceeds $5 million

Long-Term Contracts
(slide 1 of 5)

- Long-term contract defined
  - Contract that is not completed within the same taxable year in which it began
- A manufacturing contract is long term only if a contract to manufacture:
  - A unique item not normally carried in finished goods inventory, or
  - Items that normally require more than 12 months to complete

Long-Term Contracts
(slide 2 of 5)

- Methods of accounting for long-term contracts
  - Completed contract: Home construction and certain other real estate construction contracts
  - Percentage of completion: All other contracts

Long-Term Contracts

(slide 3 of 5)

- Completed contract method
  - Income recognition occurs when the contract is completed and accepted

Long-Term Contracts
(slide 4 of 5)

- Percentage of completion
  - A portion of the gross contract price is included in income each year as the work progresses
  - Amount of revenue accrued:
    - (Costs incurred in tax year/total estimated costs) x contract price = revenue accrued in tax year
  - Current year costs are deductible

Long-Term Contracts
(slide 5 of 5)

- Percentage of completion lookback provisions
  - In the year that the contract is completed, the profit and related taxes must be recalculated
    - If taxpayer overpaid taxes, interest on the overpayment is paid to taxpayer
    - If taxpayer underpaid taxes, interest on the underpayment is due from taxpayer

Inventories (slide 1 of 4)

- Uniform capitalization rules
  - For inventory and property produced by the taxpayer, the direct costs and an allocable share of indirect costs must be capitalized as the cost of inventory

Inventories (slide 2 of 4)

- Lower of cost or market
  - Inventories may be valued at the lower of cost or market
  - LIFO inventories must be valued at cost

Inventories (slide 3 of 4)

- Identifying the cost of goods sold
  - Taxpayers may use the following identification methods:
    - Specific identification
    - First-in First-out (FIFO)
    - Last-in First-out (LIFO)
    - Average Cost
    - Dollar Value LIFO

Inventories (slide 4 of 4)

- LIFO
  - Taxpayer does not need permission from the IRS to change to LIFO
  - However, if LIFO is used for tax purposes, it must also be used for financial accounting purposes

If you have any comments or suggestions concerning this PowerPoint Presentation for West's Federal Taxation, please contact:

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