PacificCPE

COURSE

34503A

Small Business Tax: Accounting Methods and Property Sales

Choosing the right accounting period and method can have lasting tax consequences for small business clients. This course covers the rules governing both, then shifts to dispositions of business property—including how to identify the type of disposition, apply special rules, and accurately calculate gain or loss. A solid refresher for practitioners who want to make sure their clients are handling these foundational compliance areas correctly.

CREDIT HOURS 2 | FIELD OF STUDY TAXES | EXAM QUESTIONS 10

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Final Exam Copy ↓

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Identify the options available for a business in selecting accounting periods and methods.
- Identify various methods of business dispositions.
- Recall the requirements for like-kind exchanges.

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Chapter 1: ACCOUNTING PERIODS AND METHODS

Chapter Objective

After completing this chapter, you should be able to:

- Identify the options available for a business in selecting accounting periods and methods.

A business must calculate its taxable income and file an income tax return for an annual accounting period called a "tax year." Also, it must consistently use an accounting method that clearly shows its income and expenses for the tax year.

I. ACCOUNTING PERIODS

When preparing a statement of income and expenses (generally an individual or business income tax return), the taxpayer must use his or her books and records for a specific interval of time called an "accounting period." The annual accounting period for income tax return purposes is called the taxpayer's tax year. A taxpayer can use one of the following tax years:

- A calendar tax year; or
- A fiscal tax year.

Unless the taxpayer has a required tax year, he or she adopts a tax year by filing his or her first income tax return using that tax year. A required tax year is a tax year required under the Internal Revenue Code or the Income Tax Regulations.

A. CALENDAR TAX YEAR

A calendar tax year is 12 consecutive months beginning January 1 and ending December 31. A taxpayer must adopt the calendar tax year if any of the following apply:

- He or she keeps no books;
- He or she has no annual accounting period;
- His or her present tax year does not qualify as a fiscal year; or
- His or her use of the calendar tax year is required under the Internal Revenue Code or the Income Tax Regulations.

If an individual filed his or her first income tax return using the calendar tax year, and he or she later begins business as a sole proprietor, he or she must continue to use the calendar tax year unless he or she receives IRS approval to change it or is otherwise allowed to change it without IRS approval. A taxpayer who adopts the calendar tax year must maintain his or her books and records and report his or her income and expenses for the period from January 1 through December 31 of each year.

B. FISCAL TAX YEAR

A fiscal tax year is 12 consecutive months ending on the last day of any month except December. A 52- 53 week tax year is a fiscal tax year that varies from 52 to 53 weeks but does not have to end on the last day of a month.

If a taxpayer adopts a fiscal tax year, he or she must maintain his or her books and records and report his or her income and expenses using the same tax year.

C. CHANGE IN TAX YEAR

Generally, a taxpayer must file Form 1128, Application To Adopt, Change, or Retain a Tax Year, to request IRS approval to change a tax year. If the taxpayer qualifies for an automatic approval request, a user fee is not required. If the taxpayer does not qualify for automatic approval, a ruling must be requested and a user fee may be required.

II. ACCOUNTING METHODS

A. OVERVIEW

An accounting method is a set of rules used to determine when and how income and expenses are reported. A business’s or individual’s accounting method includes not only the overall method of accounting they use, but also the accounting treatment used for any material item.

An owner chooses an accounting method for his or her business when the owner files his or her first income tax return that includes a Schedule C for the business. After that, a business that wants to change its accounting method must generally get IRS approval.

Generally, a business or individual can use any of the following accounting methods:

- Cash method;
- An accrual method;
- Special methods of accounting for certain items of income and expenses; or

- A combination method using elements of two or more of the above.

An individual or business must use the same accounting method to figure the taxable income and to keep the books. Also, an accounting method that clearly shows the income must be used.

1. Business and Personal Items

A taxpayer can account for business and personal items under different accounting methods. For example, a taxpayer can figure his or her business income under an accrual method, even if he or she uses the cash method to figure personal items.

2. Two or More Businesses

If an individual has two or more separate and distinct businesses, he or she can use a different accounting method for each, if the method clearly reflects the income of each business. The businesses are separate and distinct only if the taxpayer maintains complete and separate books and records for each business.

B. CASH METHOD

Most individuals and many sole proprietors with no inventory use the cash method because they find it easier to keep cash method records. However, if an inventory is necessary to account for an individual's income, he or she must generally use an accrual method of accounting for sales and purchases.

1. Income

Under the cash method, a taxpayer must include in his or her gross income all items of income he or she actually or constructively receives during the tax year. If the taxpayer receives property or services, he or she must include the fair market value in income.

Example

On December 30, 2025, Mrs. Sycamore sent William a check for interior decorating services he provided to her. William received the check on January 2, 2026. He must include the amount of the check in income for 2026.

Constructive Receipt

A taxpayer has constructive receipt of income when an amount is credited to his or her account or made available to him or her without restriction. The taxpayer does not need to have possession of it. If the taxpayer authorizes someone to be his or her agent and receive income for him or her, the taxpayer is treated as having received it when

his or her agent received it. Income is not constructively received if the taxpayer's control of its receipt is subject to substantial restrictions or limitations.

Example

Interest is credited to Mark's bank account in December 2025. Mark does not with draw it or enter it into his passbook until 2026. Mark must include it in his gross income for 2025.

Delaying Receipt of Income

A taxpayer cannot hold checks or postpone taking possession of similar property from one tax year to another to avoid paying tax on the income. The taxpayer must report the income in the year the property is received or made available to him or her without restriction.

Example

Frances Jones, a service contractor, was entitled to receive a $10,000 payment on a contract in December 2025. She was told in December that her payment was available. At her request, she was not paid until January 2026. She must include this payment in her 2025 income because it was constructively received in 2025.

Checks

Receipt of a valid check by the end of the tax year is constructive receipt of income in that year, even if the recipient cannot cash or deposit the check until the following year.

Example

Dr. Redd received a check for $500 on December 31, 2025 from a patient. She could not deposit the check in her business account until January 2, 2026. She must include this fee in her income for 2025.

Debts Paid by Another Person or Canceled

If a taxpayer's debts are paid by another person or are canceled by his or her creditors, the taxpayer may have to report part or all of this debt relief as income.

Repayment of Income

If a taxpayer includes an amount in income, and in a later year has to repay all or part of it, the taxpayer can usually deduct the repayment in the year in which he or she makes it. If the amount repaid is over $3,000, a special rule applies.

2. Expenses

Under the cash method, a taxpayer generally deducts expenses in the tax year in which he or she actually pays them. This includes business expenses for which the taxpayer contests liability. However, the taxpayer may not be able to deduct an expense paid in advance, or he or she may be required to capitalize certain costs.

Expenses Paid in Advance

Taxpayers can deduct an expense paid in advance only in the year to which it applies.

C. ACCRUAL METHOD

Under an accrual method of accounting, taxpayers generally report income in the year earned and deduct or capitalize expenses in the year incurred. The purpose of an accrual method of accounting is to match income and expenses in the correct year.

1. Income – General Rule

Under an accrual method, taxpayers generally include an amount in their gross income for the tax year in which all events that fix their right to receive the income have occurred and they can determine the amount with reasonable accuracy.

Example

Luke is a calendar year, accrual method taxpayer. He sold a computer on December 28, 2025. Luke billed the customer in the first week of January 2026, but he did not receive payment until February 2026. Luke must include the amount received for the computer in his 2025 income.

2. Income – Special Rules

The following are special rules that apply to advance payments, estimating income, and changing a payment schedule for services.

Estimated Income If a taxpayer includes a reasonably estimated amount in gross income, and later determines the exact amount is different, he or she should take the difference into account in the tax year in which he or she makes the determination.

Change in Payment Schedule for Services If a taxpayer performs services for a basic rate specified in a contract, he or she must accrue the income at the basic rate, even if the taxpayer agrees to receive payments at a lower rate until he or she completes the services and then receives the difference.

Advance Payments for Services Generally, taxpayers report an advance payment as income in the year they receive the payment. However, if taxpayers receive an advance payment, they can elect to postpone including the advance payment in income until the next tax year. Taxpayers cannot postpone including any payment beyond that tax year.

Advance Payments for Sales Special rules apply to including income from advance payments on agreements for future sales or other dispositions of goods held primarily for sale to customers in the ordinary course of the taxpayer's trade

or business. However, the rules do not apply to a payment (or part of a payment) for services that are not an integral part of the main activities covered under the agreement. An agreement includes a gift certificate that can be redeemed for goods. Amounts due and payable are considered received.

3. Expenses

Under the accrual method of accounting, taxpayers generally deduct or capitalize a business expense when both of the following apply:

- The all-events test has been met. The test has been met when:
  - All events have occurred that fix the fact of liability, and
  - The liability can be determined with reasonable accuracy.
- Economic performance has occurred.

Economic Performance

Taxpayers generally cannot deduct or capitalize a business expense until economic performance occurs. If the expense is for property or services provided to the taxpayer, or for his or her use of property, economic performance occurs as the property or services are provided or as the property is used. If the expense is for property or services the taxpayer provides to others, economic performance occurs as the taxpayer provides the property or services. An exception allows certain recurring items to be treated as incurred during a tax year even though economic performance has not occurred.

Example

ABC Partners is a calendar year taxpayer and uses an accrual method of accounting. ABC buys office supplies in December 2025. ABC received the supplies and the bill in December, but paid the bill in January 2026. ABC can deduct the expense in 2025 because all events that fix the fact of liability have occurred, the amount of the liability could be reasonably determined, and economic performance occurred in that year. ABC's office supplies may qualify as a recurring expense. In that case, ABC can deduct them in 2025 even if the supplies are not delivered until 2026 (when economic performance occurs).

Keeping Inventories

When the production, purchase, or sale of merchandise is an income-producing factor in a taxpayer's business, the taxpayer must generally take inventories into account at the beginning and the end of his or her tax year. If the taxpayer must account for inventory, he or she must generally use the accrual method of accounting for purchases and sales.

Special Rule for Related Persons

A taxpayer cannot deduct business expenses and interest owed to a related person who uses the cash method of accounting until he or she makes the payment and the corresponding amount is includible in the related person's gross income. Determine the relationship for this rule as of the end of the tax year for which the expense or interest would otherwise be deductible. If a deduction is not allowed under this rule, the rule will continue to apply even if the relationship with the person ends before the expense or interest is includible in the gross income of that person. Related persons include members of the taxpayer's immediate family, including brothers and sisters (either whole or half), his or her spouse, ancestors, and lineal descendants.

D. COMBINATION METHOD

A taxpayer can generally use any combination of cash, accrual, and special methods of accounting if the combination clearly shows his or her income and expenses and it is used consistently. However, the following restrictions apply:

- If an inventory is necessary to account for the taxpayer's income, he or she must generally use an accrual method for purchases and sales. The taxpayer can use the cash method for all other items of income and expenses.