What Is Tax Accounting

Accounting 580T - Lecture 1
Gertzman: Chapter 1
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Purpose of the Course

• Provide a basis understanding of –
  – Overall methods of accounting
  – Accounting methods for specific items

Grading

• Grades will be based as follows:
  – Midterm Exam - 40%
  – Final Exam - 40%
  – Case Study - 10%
  – Class Participation - 10%
  – Open book exams
  – Grade curved to a 3.5 average
Scope and Definition of Method of Accounting

**Timing**
- Means for determining *when*
- Not a means for determining how much
- Accrual method generally recognizes income before the cash method does

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Assume a company has $10,000 of receivables at the end of its first year, no payables and a cash breakeven.
- How much income if cash basis?
- How much income if accrual basis?

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Assume the company broke even on a cash basis in the second year and had $10,000 of receivables and no payables at year end.
- How much income if cash basis?
- How much income if accrual basis?
Scope and Definition of Method of Accounting

- **Consistency**
  - Accounting method must be consistently used
  - Being consistent is more important than using a correct method

Scope and Definition of Method of Accounting

- **Certainty and Predictability**
  - The use of a method of accounting lends certainty and predictability to the recognition of transactions

Requirements of All Methods of Accounting

- **Book Conformity – Code sec. 446(a)**
  - Keep the general ledger on the same basis as you use for tax purposes
  - Use work papers to adjust for financial statements
Requirements Governing All Methods of Accounting

- **Clear Reflection of Income – Code sec. 446(b)**
  - Method must clearly reflect income
  - Method must be correctly applied

Taxpayer’s Discretion in Choice of Methods

- **Allowable Overall Methods – Code sec. 446(c)**
  - Cash Method
  - Accrual Method
  - Hybrid Method

Taxpayer’s Discretion in Choice of Method

- **Use of More Than One Method**
  - Can use different methods for separate trades or businesses – Code sec. 446(d)
Taxpayer’s Discretion in Choice of Method

- Incorrect Initial Choice
  - IRS position – once an incorrect method is identified, all discretion over the new method shifts to the IRS
  - There is no authority for the IRS's position

Taxpayer’s Discretion in Choice of Method

- Application of Correct Choice to Incorrect Year
  - Tax Court held that a correct method used in an incorrect year is binding on the taxpayer

Commissioner’s Discretion in Determining Method

- Proper Exercise of Discretion
- Abuse of Discretion
- Impact of IRS Actions on Commissioner’s Discretion