

14. Tax Laws

Although this book is about financial and managerial accounting, it is certainly necessary to call your attention to the unique features of depreciation under the tax code. First, it is important to note that tax methods and financial accounting methods are not always the same; that is certainly true when it comes to the subject of depreciation. For example, when the economy “slows down” governments will often try to stimulate economic investment activity by providing special incentives that are realized through rapid depreciation for tax purposes (even immediate write-off in some cases). Now, you may wonder how this is supposed to help the economy. Well, suppose you were thinking of buying a new truck for use in your trade or business. If the government said you could reduce your taxable income by the amount of the purchase price immediately (rather than depreciating the asset over a much longer period of time), you see how this might prompt you to buy and bring about an incremental improvement in the economy.

The history of the tax laws is marked by many changes to the rates and methods that are permitted in any given year. As a result, it is difficult to generalize about the operation of the tax code as it relates to depreciation. But, in general, the USA tax rules provide for a depreciation technique known as the Modified Accelerated Cost Recovery System (MACRS -- called “makers”). MACRS provides a general depreciation system and an alternative system -- and within those systems are generally provisions relating to the 200% declining balance, 150% declining balance, and straight-line techniques.

Further, the tax system will generally stipulate the useful life of an asset rather than leaving it to the imagination of the taxpayer. For example, a race horse over two-years old when placed in service is assumed to have a three-year life; obviously very few stones are left unturned. The tax code tends to be very complete in identifying assets and their lives. As a general rule, the tax code lives tend to be “favorable” to taxpayers, and generally result in depreciation occurring at a faster rate than under generally accepted accounting principles.

It is noteworthy that the government has reduced the depreciation calculations down to percentage values that are reproduced in numerous reference tables. This reduces the possibility of error and makes it easy for someone who never studied depreciation methods to still come up with the right amount of depreciation in any given year.

You may be bothered to consider that a company would use one accounting method for financial reporting and another for tax. But, this is often the case, and there is nothing devious involved. Accounting rules are about measuring economic activity of a business and require a proper scheme of matching revenues and cost to achieve this objective. Meanwhile, the tax code must be followed, and it often changes to meet the revenue or social objectives of the government. As a result, temporary (and sometimes not so temporary) differences will arise between accounting and tax measurements. Records of these differences must be maintained, making the accounting task all the more challenging for a complex business organization.