2018 Edition

CPA

Preparatory Program

Regulation

Sample Chapters:
Contracts &
Taxation of Property Transactions

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Published December 2017

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ISBN: 978-1-934494-10-3

Group B: Contracts

At the foundation of many business relationships is a contract. Therefore, we will start our discussion of business law with contracts. A **contract** may be defined as "A binding agreement that courts will enforce," or a more detailed definition is:

> "A promise or a set of promises for the breach of which the law gives a remedy, or the performance of which the law in some way recognizes a duty"

Contract law that is founded in **judge-made law (common law)** governs a great deal of the transactions encountered in business law. Most commonly, this type of contract law governs realty and personal service contracts.

By contrast, transactions involving the **sales of goods** are governed by Article 2 of the Uniform Commercial Code (UCC). Thus, **where the UCC is applicable, it overrides common-law rules**. We will start by looking at contracts that are governed by common law and then we will look at sales of goods governed by the UCC.

At this point, we need to have an understanding of the Uniform Commercial Code and its place in the conduct of business in the United States

Types of Contracts

In the following section we will cover the required elements that must exist in order for a contract to become a legally enforceable contract. Before doing that, we will look at some of the different classifications and types of contracts.

There are six primary types of contracts, and they are discussed below. Although there are six types of contracts, there are in a sense, three different classifications that a contract may be. They are:

- A **bilateral** contract is a **promise for a promise** that involves each person giving a promise. This means that each party to the contract must perform their part of the contract.

  > **Example:** Ann hires Jeff to look for her missing watch. Ann offers Jeff $10 for his services, and he agrees. This is a bilateral contract because Ann has promised to pay Jeff $10, and Jeff has promised to look for Ann's missing watch (even if he does not find it).

- A **unilateral** contract is a **promise for an act**. This commonly occurs in reward situations, in which one party promises to pay another party if they are able to accomplish something (find a lost object, for example). This means that the party that promises to do something (look for the lost object) does not need to perform and their failure to find the lost object does not constitute a breach of the contract.

  In a unilateral contract, the person who performs the act **must be aware of the offer** in order for the contract to be completed. If the party who performs the act is not aware of the offer, the offeror does not have to pay.

  > **Example:** Ann offers a $50 reward to anyone who finds and returns her missing watch. Bob sees Ann's reward poster on a telephone pole, and he locates Ann's watch and returns it to her. Is Ann obligated to pay Bob the reward?
  >
  > Yes, Ann must pay Bob $50. Unilateral acceptance occurred because Bob was aware of the reward, and he returned the watch pursuant to the reward's terms.
  >
  > If Bob had not seen the poster, but had simply found the watch and returned it to Ann, she would not have had to pay him the money because he was unaware of the offer.

- An **executed** contract is one that has been fully performed.
- An **executory** contract is a contract that has not been fully performed and some terms remain outstanding by one or both parties.
- An **express** contract is a contractual agreement based upon a written document or oral communication; this is the expression of the contract in words.
- An **implied** contract (also called quasi contract) exists when the actions and behaviors of two parties suggest that a contractual agreement is in place between the two parties even though the agreement is not in written form, or communicated orally.
- In an **output** contract the seller agrees to sell to the buyer all of their production.
- In a **requirements** contract the purchaser promises to buy all of the materials that they need from this specific supplier.

> **Note for Output and Requirements Contracts:** Despite the fact that both of these definitions include the word all, the courts interpret this to mean all of the output or requirements that occur in good faith. This means that the party that is the producer in an output contract is not allowed to double their production knowing that the other party will be required to purchase all of the "new" production.

Statuses of Contracts

After a contract has been entered into, or after two parties believe that they have entered into a contract, that contract may have different degrees of validity, or enforcement.

- A **valid** contract is one that meets all of the requirements of a binding contract.
- A **void** contract is **not enforceable against any of the contractual parties**. Contracts are void when they are formed with an illegal purpose or when there is no "meeting of minds" (no mutual agreement) between the parties. In essence a void contract is a contradiction in terms because the contract does not exist since it is void.
- A **voidable** contract is one in which **one of the parties has the right to rescind (cancel) the contract** without penalty (this means that there will have been no breach of the contract by the party who voids the contract). Note that the other party in the contract is required to perform the contract even if the contract is voidable by the other party.

> **Example:** A contract involving a minor (a person under the age of 18) may be voided at the option of the minor. Additionally, in a contract involving fraud, the defrauded party has the option to terminate the contract. Because both of these are able to be terminated by one of the parties, these are both voidable contracts.

- An **unenforceable** contract is a contract that cannot be enforced by the courts. This means that there is no remedy for the damaged party in the case of a breach.

Third-Party Beneficiary Contracts

This is a contract between two parties under which the benefits belonging to one of the contracting parties will be transferred to a third party. In order for the third party to have rights under the contract, he must be an **intended beneficiary** to the contract. (Incidental beneficiaries do not have any rights under the contract. They are covered in a Note below.)

There are **two types of intended** beneficiaries:

1) ***Donee Beneficiaries*** are individuals who will receive the proceeds of a contract **as a gift**. The most common example is related to insurance benefits when the beneficiary of the policy is someone other than the policy holder (the person who pays for the insurance).

   Example: Andy contracts with a Life Insurance Company, and Andy names his wife as the beneficiary on the policy. *Andy's wife is a donee beneficiary.*

2) ***Creditor Beneficiaries*** are individuals who receive the benefits of a contract as **compensation for amounts owed to them by one of the contractual parties**. There is no need for there to be privity to the contract in order for the creditor beneficiary to attempt to enforce the contract.

   Example: Andy owes John $500. Andy agrees to work for Bill for five days, and Andy instructs Bill to pay the $500 directly to John. If Bill fails to pay John, who is liable?

   John is a creditor beneficiary. Accordingly, John may sue either Andy or Bill if there is a breach.

Note: Incidental beneficiaries will have no rights to claim for damages under the contract. Incidental beneficiaries are individuals who would benefit from a contract, but are not parties to the contract themselves and were **not specifically intended** to be the beneficiary. Generally, these will be individuals who **belong to a class of people who were to benefit** (such as members of a social group or demographic group). Though they are a member of this class, or group, they were not individually or specifically part of the agreement.

Incidental beneficiaries do not have the right to collect for nonperformance of the contract.

Conditions to Contracts

A condition is an event that will affect the duties of performance under a contract. If the event occurs, there will be one set of obligations and if it does not occur there will be a different set of obligations that are owed. There may be conditions that must be fulfilled before a contractual obligation becomes a contractual obligation.

- A **condition precedent** is an uncertain future event that must occur before a party to the contract has the obligation to perform. This is any situation in which the two elements of the contract need to be performed in a specific order. If the first item is not completed, then any subsequent items do not need to be completed.
- A **condition subsequent** is a condition that when (or if) it occurs will terminate an existing duty under the contract. (These are very rarely in contract law.) Example, when goods are returned, the buyer no longer has an obligation to pay for them.
- A **condition concurrent** exists when each party has an obligation to perform that is dependent upon the other party's simultaneous performance of their contractual obligation. (Most contracts assume that performance will be concurrent.)

Elements of Valid Contracts

Under traditional contract law, there are six required elements for contracts to be enforceable. If any of these elements is not met, the contract will not be enforceable. The elements are:

1) Offer
2) Acceptance
3) Consideration
4) Proper Form (Statute of Frauds)
5) Lawful Object
6) Competent Parties (Legal Capacity to Contract)

Note: In addition to these six elements, there are also **some things that must not be present** for a contract to be formed. These are discussed later, and include duress, undue influence, fraud or mistakes. The presence of any of these may cause the contract to either not be formed, or able to be cancelled by one of the parties.

1. Offer

Note: This is the **first element** of an enforceable contract.

The offer is what it is that will be performed under the contract. One party (the **offeror**) must present the offer to the other party (the **offeree**). In order for an offer to be valid, it must be

1) Seriously intended,
2) Communicated, and
3) Definite in terms.

1) Seriously Intended. Offers are not enforceable unless they are seriously intended to be an offer. When determining the seriousness of an offer, courts apply a "reasonable person" standard under which, courts ask the following question: "Would a reasonable person have concluded that the offer was seriously intended by the offeror?" If they feel a reasonable person would have concluded an offer had been made, the courts will enforce the offer.

Illusory promises (promises made on a whim) or promises made in jest (jokes) fail the reasonable person test and therefore are not enforceable offers.

Example: Ann says to Bob: "I will sell you my car for $10." Is this a valid offer?

No, this is not a valid offer as it is not reasonable and probably made in frustration.

2) Communicated. Offers may be communicated either through written or spoken words or by the actions of the offeror. A **general offer** is communicated to no-one specific and could apply to anyone who responds. A **specific offer** is communicated to a specific individual.

3) Definite in Terms. The terms of the offer have to be specific enough that it is clear what the offer is and what the terms of the contract actually will be. Generally, the **time, subject matter and price must be stated** in the offer in order for it to be definite in terms.

Note: Advertisements and price quotations are not offers; instead, they are considered "invitations to bid." This is because the advertisement does not include many of the terms commonly required in contracts and they do not contain a promise.

Therefore, advertisements and price quotations merely invite a party to make an offer. When the customer (who is actually the offeror) makes such a bid, this is considered to be the offer. The business that gave the advertisement then will be able to accept or not accept the offer. This means that if the business no longer has the item in stock, they simply do not accept the offer made by the customer. This it is not a breach of contract by the selling party because there was no contract.

Revocation (Canceling) of an Offer

Offers may generally be revoked (taken back) by the offeror **before the offer is accepted**. However, there are some rules about the revocation of an offer that you need to be aware of:

- Generally, an offeror can revoke an offer any time **before the offer is accepted**.
- The revocation becomes effective only when it is **received by the offeree**. This means that if the offeree accepts the offer before they receive the revocation, the contract has been formed and the revocation is not valid. In order to ensure that the revocation is immediately made valid, the offeror should call the offeree in order to communicate the revocation.
- Even when the **offeror has guaranteed that** the offer will be held open, **the offeror can revoke the offer before it is accepted** (even if the guarantee has been written).

There are, however, **three exceptions** to these standard rules of revocation that you need to know.

1) If the **offeree pays consideration** to keep the offer open, then the offeror cannot revoke the offer. This type of agreement is called an ***option contract***.
2) **An offer ends** at the end of the **time stated by the offeror**, or if the time is not stated, **after a reasonable amount of time** has passed (this is another application of the reasonable person standard).
3) **Firm offers governed by UCC Article 2 are irrevocable**. Firm offers are covered in more detail in the section on Sales, but firm offers are written offers made by merchants pertaining to the sale of goods (not realty or personal services). A firm offer may not be revoked by the offeror. In order to qualify as a firm offer, there must be three elements present:
    - A **merchant** must be involved in the transaction;
    - The sales agreement must be **reduced to writing**; and
    - There must be a **guarantee** that the offer will be held open.

    Note: Firm Offers are covered in the section on Sales.

Termination of an Offer WITHOUT Acceptance

The following events or actions will end (terminate) an offer without acceptance:

- **Rejection**. Once the offeree rejects an offer, he may not change his mind and later try to resurrect the original offer. Rejection of an offer occurs when the **offeror receives notice** of the rejection.
- A **counteroffer**. A counteroffer is when the offeree changes one of the terms of the offer and resubmits it to the offeror. For example, Ann offers to sell Bob a car for $500. Bob then tells Ann that he only is willing to pay $400. Bob has made a **counteroffer**. Ann's original offer ended when Bob made his counteroffer.

Exception: Requests and inquiries do not end an offer. If the offeree asks for clarification of a term or asks for more information about an item involved in the contract, this does not constitute a rejection. For example, Ann offers to sell Bob a car for $500. Bob then asks Ann if she is willing to lower the price. This is only an **inquiry** and Ann's offer is still open.

- **Revocation of the offer**. An offeree may not accept an offer once the offer has been revoked. Remember that the revocation of the offer is effective when the **offeree receives notice** of the revocation.
- **Death or incompetence**. An offer ends if either the offeror or offeree dies or becomes incompetent (for example, insane) **before the offer is accepted**. Because of their death or incompetence, the required "meeting of the minds" cannot occur. Thus, if the offeror dies or goes insane after making the offer, but before it was accepted, then the offeree cannot accept the offer even though it was made while the offeror was alive and competent.
- **Destruction of the subject matter**. If the subject matter is destroyed, there is no remaining object for the contract. As such, the offeree cannot accept the offer that was made while the subject matter was whole.
- **Known sale of subject matter**. If the offeror sells the subject matter to a party other than the original offeree and the original offeree learns of this sale, the offer ends when the original offeree learns of the sale.

2. Acceptance

Note: This is the **second element** of an enforceable contract.

Note: Sometimes the first two elements (offer and acceptance) are combined into one element and called ***mutual assent***. Mutual assent means that the two parties have agreed to the same terms and conditions as included in the offer. This agreement can be expressed in written or oral form or it can be implied through the actions of the parties.

After an offer is made, it must be accepted by the other party before there can be a contract. Acceptances must be both **unconditional and communicated**.

- **Unconditional**. The offeree must agree to **all the offeror's terms and conditions** – the offered terms or conditions cannot be changed. This requirement is called the **mirror image** rule (the same exact terms must exist in both offer and acceptance).
- **Communicated.** The offeree must communicate acceptance to the offeror in some manner. This may occur in a **written format** (see the discussion of effective acceptances below) or through **words or through actions** (such as using the property or performing the contract).

Note: Acceptance is not assignable. An offer can be accepted **only by the offeree** (the party to whom the offer was made). The offeree may not assign his right of acceptance to another person.

Effective Acceptances

Note: This section deals with the **delivery of written acceptance** to the offeror and the determination of when it is considered that the offer was accepted.

If the offer states a specific manner by which acceptance must be made, then in order for acceptance to occur, the acceptance must be done in exactly the way outlined by the offer.

However, when the offer is silent about the way in which the offer may be accepted, the offeree may accept in any way that they want. This may be by their actions or by oral or written communication. In the case of written communication, there must be a way to determine exactly WHEN that acceptance was made. This determination is important because there may be a situation in which the offeror attempts to revoke the offer and we need to be able to determine which occurred first – the revocation of the offer or the acceptance of the offer.

Written Acceptances

The **general rule is that the acceptance is valid when it is mailed** or otherwise sent, not when it is received. Outlined below is more information about the method used for acceptance and when the acceptance will be considered to have occurred. The timing of when the acceptance is recognized is important when there is a deadline or when the offeror attempts to revoke the offer.

- **Mailbox Rule (Deposited Acceptance Rule)**. Under the Mailbox Rule, if an offeror mails an offer to an offeree, an enforceable contract is formed as soon as the offeree delivers the acceptance to the mail. This is the case even if the mailed acceptance is lost in the mail or the offeror otherwise never receives the mailed acceptance.

  > **Exception**: If the offeror specifies that acceptance must be **received by** the offeror by a certain date, then the Mailbox Rule does not apply. In these cases, the offeree's acceptance is not effective until the offeror receives it. However, the acceptance is considered received when it is **delivered to the offeror**, even if it is not immediately read. This means that the offeror cannot simply refuse to open a letter and then claim it was never received.

- **Faster Means of Acceptance**. In a situation in which the method of acceptance is not stated in the offer, the offeree may accept by using either the same method of delivery of the offer, or a faster means of delivery. In this case, the offer is considered to be accepted when the acceptance is "sent."

  This means that if the offer is delivered by mail, it can be accepted by overnight courier, and will be considered as effective when it is delivered to the overnight courier.

  > **Exception**: If the offer specifies a specific method of delivery, then that, and only that method can be used to accept the offer.

- **Slower Means of Acceptance**. By contrast, if the offeree uses a means of acceptance that is slower than the manner in which the offer was delivered, a different rule applies: the acceptance is effective only when actually received by the offeror.

> **Note:** Remember that the method of acceptance is important if the offer specifically states the acceptable manner of acceptance. Using any other manner (even a faster manner) of acceptance does not constitute acceptance when there is a specific method stated in the offer.

> **Note:** The mailbox rule applies only to acceptances. Rejections are valid only when received by the offeror.

Acceptance Through Silence

Usually, an offer may not be accepted through silence. However, there are three situations in which silence can become acceptance. They are:

1) The offer indicated silence would constitute acceptance AND the offeree intended their silence to be acceptance.

2) The offeree has taken control of goods or services and has control over them when they could have (had the opportunity to) rejected the goods.

3) When there have been previous dealings between the parties, or through custom, in which silence was considered to be acceptance.

Who May Accept an Offer

The correct person to accept an offer depends upon the type of offer. A specific offer requires acceptance by that specific offeree or their agent. A general offer can be accepted by anyone who performs the act that is referenced in the general offer as long as the person knew about the offer and presumed that his act of completion would be understood as acceptance.

Note: Silence is generally not considered acceptance of an offer unless there exist circumstances that suggest that silence can be implied as acceptance by a reasonable person. Such circumstances include previous similar situations where silence was acceptance, or when the offer clearly states that silence is acceptance.

Example: On June 1, Ann mails a letter to Bob offering to rent Bob a boat for $1,000 for his personal use for the month of July. Ann's offer states that Bob may accept the offer by signing Ann's letter in the appropriate place and returning it to Ann. Bob receives the letter on June 3, signs it, and mails it back to Ann the same day.

On June 4, Ann calls Bob and revokes the rental offer, stating that she already has found a renter. Bob tells Ann that he already has signed and mailed the contract and that he wants to enforce the contract.

(a) Is Ann's revocation effective?

No, Bob wins; a binding contract was formed at the moment that Bob deposited his acceptance in the mailbox.

(b) Would your answer to (a) change if Bob had faxed his acceptance to Ann and she never received the fax?

No, the answer would not change if Bob had faxed his acceptance--even though Ann never received it. That is, the mailbox rule still applies because Bob used a faster method of acceptance.

3. Consideration

Note: This is the third element of an enforceable contract.

Consideration is what is given up by each party in the contract. Both parties must give up something (or be required to do something that they currently are not required to do) in order for a valid contract to be formed. However, the perceived dollar value of what each party will give up does not need to be equal. This concept of each party giving something up is called *quid pro quo* ***in Latin,*** "this for that."

There are some restrictions or requirements related to consideration that you need to know.

- **Must be legally sufficient – NOT financially equal**. In order for a contract to be enforceable, the consideration must be "legally sufficient." Legally sufficient **does not mean that considera-tion must be of equal value**; instead, courts expect and allow contractual parties to make their own deals. The courts assume that if each party entered into the contract, then each party must have felt the consideration to be appropriate.

Legally sufficient therefore means that a court of law would judge that the consideration fulfilled basic legal requirements so that the contract must be enforced. For example, consideration that was offered under duress or fraud would not be considered legally sufficient.

> **Example:** In the case of an antique table it is almost impossible to determine its actual value. The value will depend on the person who is considering purchasing it. To one person, it is simply a table and therefore has minimal value. However, to another person it may be incredibly valuable because it is a piece from a matching set that they are collecting, or it was made by their great-great grandfather. In this case, who is someone else to say what the value of the antique table is to one person or the other.

> **Exception for Unconscionable Contracts:** When a contract is one which no man in his senses would make, on the one hand, and which no fair and honest man would accept, on the other hand, this contract is said to be unconscionable. If a contract is considered to be unconscionable by a court, then the court may rule that the contract is not valid (because it is not legally sufficient), even if each party does give something up.

- **NOT limited to money**. Consideration can take many different forms. For example, consideration can involve personal services that are difficult to measure in a monetary sense, or assets that do not have a readily determinable fair market value.

> **Example:** Uncle Jim promises to pay Bob $25,000 if Bob stops smoking and drinking alcohol during his senior year in college. Bob stops smoking and drinking for the specified time, but when he tries to collect the $25,000, Uncle Jim refuses to pay and says, "I do not have to pay you. It was good for your health." Is Bob entitled to the $25,000?
>
> *Yes, Bob is entitled to the $25,000 because there was adequate consideration since he gave up something that he was legally able to do.*

- **Past consideration is NOT legally sufficient**. A promise to do something that already has been done (called past consideration) is not sufficient because there was no mutual bargaining between the parties.

- **Pre-existing obligations are NOT legally sufficient consideration**. Demanding additional monetary compensation to do something that one already is contractually obligated to do does not meet the definition of consideration.

- **Conditional promises may be included in the consideration**. A conditional promise is when one of the party's promise is contingent on the completion of another event.

> **Example:** Sally offers to pay Mary $800 for Mary's computer, provided that Sally is able to sell her computer for at least $600. This is a valid form of consideration given by Sally. If she does not sell her computer for $600, though, she will not be required to purchase Mary's computer.

> **Note:** When a court rules that there was not legally sufficient consideration, the contract simply did not come into force and is not enforceable.

Additional Consideration is Required When a Contract is Modified

When a contract term is changed, new consideration must be provided in order for the modified terms to be enforceable. This is because a new contract is created if a substantial contractual term is changed, and therefore new consideration is required to satisfy the elements of the new contract.

Exception: UCC **sales contracts** require no additional consideration when contractual modification occurs (this is covered in the section on Sales).

Example: Ann agrees to pay Cam $5,000 if he will build Ann a new garage by December 23. Cam agrees, but later discovers that he has insufficient staff to complete the job on time. Cam demands an additional $1,000 to finish the job on time, and Ann does not object to the extra payment. Cam finishes the job on December 23, but Ann refuses to pay the extra $1,000. Is Ann contractually obligated to pay Cam the extra $1,000?

No, Cam may not collect the extra $1,000 because there was a failure of consideration. The fact that Ann did not object to the payment, does not change the situation. Without Ann receiving some sort of additional consideration, Cam is not able to change the term of the contract.

If, however, Cam had said that he would ***also*** *paint her house number on the side of the garage, that would qualify as additional consideration and the change could be made. This would be an expensive number on the side of the garage for Ann, but the condition of consideration would have been met and Cam could then change the date of completion.*

Contracts That Are Enforceable WITHOUT Consideration

There are some contracts that are enforceable even if no consideration is provided by one of the parties. These types of contracts are:

- **Charitable Donation Pledges**. The law looks favorably upon charitable organizations. Therefore, all charitable pledges (promises to donate money) are enforceable even if the charity did not provide any consideration to the party giving the money. The question for the charity, however, is whether the collection of the amount pledged will cost more than the amount pledged.
- **Voluntary Agreements that do not need to be entered into**. When a person voluntarily agrees to do something that they do not need to do, an enforceable contract will have been formed, even if they do not receive any consideration.

  Example: If a debt has been in some way discharged (perhaps because of a statute of limitations that has in essence made the debt expire), but the debtor nonetheless agrees to pay the discharged debt, then the debtor's promise is enforceable without consideration.

- **Promissory Estoppel Situations (an Equity Consideration)**. When the party that did not provide consideration is harmed by relying on the promise the party that did provide consideration, courts sometimes will fashion an **equitable remedy for the injured party**. The result of this action by the court is that there will be deemed to be a contract, even though there was not sufficient consideration.

  Generally, there are three conditions that must be met for this to take place:

  1) there was **no contract**; and
  2) the **injured party believed, in good faith**, there was an enforceable agreement; and
  3) acting on that belief that there was an enforceable agreement, the party was injured because they did something (this generally is referred to as **"detrimental reliance"**).

If these conditions exist, the courts will attempt to force the party that made the promise to perform as if an enforceable contract had been formed.

Example: Joan plans to work during the summer to finance her next year's college tuition. Uncle Dan tells Joan "Take the summer off from school, and I will pay your tuition next year." Joan takes the summer off, but Uncle Dan refuses to pay. Will Uncle Dan be required to pay Joan's tuition for one year if this matter is adjudicated?

Yes, if this matter is adjudicated, promissory estoppel will apply, and Uncle Dan will be required to pay.

4. Proper Form

Note: This is the **fourth element** of an enforceable contract.

Generally, contracts do not need to be in writing, nor do they need to have a specific form or format. This means that in many situations, an oral agreement will create an enforceable contract.

There are some exceptions to this, though, and in these cases the contract must be in writing in order for the contract to be enforceable. These situations are covered under the **Statute of Frauds** (covered below). Any type of writing is acceptable so long as the major terms of the contract are specified. For example, even a diary entry may be considered adequate to form a contract, assuming that the entry is sufficiently complete.

Note: The contract does not need to be in writing in order to be created, but it needs to be in writing to be enforceable. This means that the parties can make an oral agreement in these situations and act on it. If, however, one party claims a breach by the other, the courts will not enforce the oral agreement.

In a statute of frauds situation, the contract only needs to be **signed by the party against whom the contract is trying to be enforced against**. This means that it does not need to be signed by both parties.

Additionally, the terms of the agreement may be **contained in more than one document** and this will still be considered a valid contract.

Whatever the form of the documentation, as covered by the Statute of Frauds, the contractual terms need to include the following:

- Parties to the contract
- The subject of the contract
- The primary terms and conditions such as dates, timing, etc.
- Description of the consideration
- The signature of the party against whom the contract would be enforced

The Statute of Frauds

Contracts that are covered by the Statute of Frauds must be in writing. There are five major types of contracts that fall under the purview of the Statute of Frauds, and therefore MUST be in writing:

- **Sale of Goods for $500 or More**. The contract for the sale of $500 or more of **goods** (this does not include realty or personal services) must be in writing. The offer itself does not need to be in writing in order to be a valid offer (only the contract must be written).

  > **Note:** Once the goods have been **delivered and accepted by the buyer**, an oral agreement can be enforced even if the price of the goods is more than $500.

- **Realty Contracts**. Contracts for the sale of realty (real property such as land or buildings) must be in writing (this refers to the purchase of realty, not to realty rental).

  > ***Exception***: Oral realty contracts are enforceable if **either** of the following situations exists:
  >
  > 1) The buyer is in possession of the realty and either has made a substantial down payment or has made substantial improvements to the property, or
  >
  > 2) The seller has given the buyer the deed to the realty. (The deed must be written.)

- **Contracts that CANNOT be completed within 12 months**. Contracts that are impossible to perform within one year must be in writing. This is measured from the time when the contract starts – not from the time when performance starts.

  > **Note:** A long-term contract that **has been performed by one party** and simply need the payment from the other party does not need to be in writing in order to be an enforceable contract.

- **Assumption of the Debt of Another Person**. Promises to pay the debts of another must be in writing. This includes an executor's promise to be personally liable for the debts of an estate.

- **Marriage Contracts**. To be binding, marriage contracts must be in writing.

> **Note:** In various states there are different lists of contracts that must be in writing. The list above is the most common of the types of contracts that must be in writing.

5. Lawful Object

> **Note:** This is the **fifth element** of an enforceable contract.

In order for a contract to be valid, the **subject matter of the contract must be legal**. There are three categories of contracts that you need to be aware of that are not lawful objects of contracts.

1) **Contracts with an Illegal Subject Matter**. (These are called *Per Se* Void Contracts.) – A contract must have a legal purpose in order to be enforceable. Thus, contracts that have an illegal subject matter are automatically **void** as a matter of law.

   Not only does this cover such extreme contract subjects like murder, theft, fraud or any other illegal criminal acts, it also covers anything else that is covered under a law. A much smaller, but important for the exam, example of this is the **Licensing Rule**. Under the licensing rule**,** if a person is required to have a license in order to perform certain works or services and they do not have the license, any contract to perform that work or service will be void because the person does not have the legal capacity to enter into that contract.

Example of the Licensing Rule: Bob represents himself as an attorney in the state of California, but Bob does not have a law degree and never passed the California Bar Exam. One of Bob's clients refuses to pay on the grounds that Bob was not legally able to provide the services, and Bob files a lawsuit to compel payment. What would be the result?

Under contract law, all professional service contracts between Bob and his clients are void. Thus, if challenged in court, there is a harsh result: Bob would be required to return all the professional fees that he has charged his clients.

Exception to the Licensing Rule: If the licensing process is merely a revenue-raising device and does not actually demonstrate a required level of professional skill, then a contract would still be enforceable if an unlicensed person provided this service. In these cases, the court simply will make the practitioner pay the licensing fee that they had not previously paid. Note that this exception does not apply to the previous example because licensing in the legal profession (and in the auditing profession) is much more than a mere revenue-raising device – it is also a measure of the individual's skills, training and abilities.

Example of the Licensing Rule Exception: Sam represents himself a licensed tour guide in the state of Alaska, but Sam does not have a tour guide license and never paid the necessary registration fee to obtain such license. After providing a tour, one of Sam's clients refuses to pay on the grounds that Sam was not legally able to give the tour, and Sam files a lawsuit to compel payment. What would be the result?

Because of the exception to the licensing rule due to the fact that the tour guide license is only a revenue source for Alaska, Sam will be able to collect the fees dues to him.

2) **Covenants Not To Compete** are included as clauses in the contracts of some employees and this clause will prevent the person from working for a competitor or establishing a competitive business should they leave their place of employment. They are not enforceable if they are for an unreasonable amount of time and an unreasonable geographic area and are not needed to protect the business. These agreements **are enforceable** as long as they are reasonably needed to protect a business, they are for a reasonable amount of time, and they are reasonable as to distance.

Example: Bill sells his bookstore to Cathy. Bill agrees not to open another bookstore within the same city for the next three years. Is this agreement enforceable?

This agreement is enforceable because it meets the reasonableness standards.

3) **Promise Not To Do Something Required by Law**. If a person has a duty to do something under law, a contract in which they "give up" this duty is not a contract with legal object.

Note: Reporting a crime is something that is required by law. Therefore, agreeing not to report a crime in return for other consideration is not a lawful object of a contract.

6. Competent Parties

Note: This is the **sixth element** of an enforceable contract.

In order for an enforceable contract to exist, there must be a "meeting of the minds" (also called mutual assent) between the involved parties. Incompetent parties are incapable of achieving the required mutual assent. The three most common types of incompetent parties include minors, those incapacitated due to drug or alcohol abuse, and the insane.

1) **Minors (Legal Infants).** Minors are individuals who have not yet reached the age of legal majority. This age, which varies depending upon the individual's state of residency, is usually 18.

   Though minors are not capable to enter into a valid contract, they can still enter into what we could call an "attempted contract." This contract can function as a contract, but it is not enforceable against the minor in the same way that a contract between competent parties is. Minors have **different rights and duties** in respect to contracts than people of legal age.

   - **Right to Disaffirm**. This is the most important difference in contracts involving minors - minors have the absolute right to disaffirm contracts at any time while they are minors or within a **"reasonable" time after reaching the age of majority**. When a minor disaffirms a contract, they are essentially telling the other party that they will no longer honor the contract and are no longer bound by what they agreed to in the contract.

     Note: For purposes of the exam, you may assume that minors can disaffirm contracts within three days after reaching the age of majority (a reasonable time).

     When a minor disaffirms a contract, they still have some responsibilities in respect to the property and the contract, but it is not strictly enforceable against them. They have the duty to return the property and they still have liability for any "crimes" they committed entering into the contract.

   - **Duty to Return the Property.** Minors who disaffirm contracts have the duty to return the contracted property that they possess or control at the time of their disaffirmance. They must return all of the property and they will be able to get back any money that they paid for the property. It does not matter the condition of the property; they will return the property and get their money back.

     Example: When 14, Ann bought a new car. She kept it for two years and drove it 40,000 miles. At the end of year two, Ann returned the car to the dealer. May the dealer deduct any money for vehicle wear and tear, or must he refund Ann's total purchase price?

     The dealer must refund Ann's original purchase price; the dealer may not deduct any money for vehicle wear and tear.

     Even if the car had been totaled in an accident, the dealer must return the full purchase price to Ann. However, Ann must return the car to the dealer, no matter its state.

   - **Liability under Tort Law**. Although minors have an absolute right to disaffirm contracts, minors also are liable for any civil wrongs (torts) they commit in their courses of dealing. This includes lying about their age. If an individual holds themselves out to be an adult (for example, they provide false identification that lies about their age), while they will still be able to disaffirm the contract, the other party will be able to collect for damages caused to the property while it was held by the minor.

> **Example:** Assume the same facts apply as in the previous example; furthermore, assume that at the time of the purchase Ann provided the dealer with false identification indicating that she was an adult. Is the dealer required to refund the total purchase price to Ann?
>
> *Although Ann still has the right to disaffirm the contract, she also is liable for tort damages. Accordingly, to compensate for damages caused by Ann's fraud, the dealer will be allowed to retain a reasonable amount from Ann's original purchase price*.
>
> *This enables the dealer to protect themselves from the extreme situation in the previous example*. If they ask the customer for identification proving their age, if the customer provides false documentation, the dealer will not be liable in the case of the destruction of the car.

- **Ratification of the Contract Upon Reaching Majority**. Upon reaching the age of majority (or shortly afterwards), the minor has the option of ratifying the contract. When the individual who had entered into the contract while they were a minor ratifies the contract, he or she agrees to be bound by **all of the contract's terms**. It is not possible to ratify only some of the contracts terms.

  Ratification of the contract can be either expressed or implied, but it may take place only after the individual has reached the age of majority. Minors cannot ratify contracts since they are not competent to enter into a contract.

2) **Incapacitation Due to Alcohol or Drug Use**. Individuals may disaffirm contracts only if, due to their consumption of alcohol or drugs, they were incapable of understanding the nature of the contracts when it was entered into. This disaffirmation of the contract must take place soon after they have regained their capacity and are aware of the contract that they entered into.

3) **Insanity**. Insane parties to a contract may disaffirm the contract. If an insane person fails to disaffirm the contract, then a valid contract remains in place. However, once an individual is **adjudicated insane** (determined to be insane by a court of law), all future contracts entered into by that individual are void as a matter of law. Thus, individuals who are adjudicated insane have no capacity as contractual parties (because legally no meeting of minds can occur).

Conduct or Events that Invalidate the Mutual Assent of the Contract

Though this is not one of the specific elements, the law requires that the agreement to the terms of the contract be **voluntary** and **willing**. If the agreement is not voluntary and willing, the agreement will be either

- **Void** (automatically not an enforceable contract) or
- **Voidable** (able to be cancelled by one of the parties).

These events or conduct that cause this contract not to be willing and voluntary are:

1) Fraud
2) Innocent (or nonfraudulent) misrepresentation
3) Mistakes
4) Duress
5) Undue influence

1. Fraud

Note: This is the first of the five events that cause a contract not to be voluntary and willing.

In general, fraud is when a person fails to act in an upright and ethical manner to the detriment (harm) of others. There are two major types of fraud: A) actual fraud and B) constructive fraud. In addition, you also need to be familiar with C) fraud in the inducement and D) fraud in the exception.

Note: Fraud is also called **intentional** misrepresentation.

1A. Actual Fraud (Four Elements)

Actual fraud means that fraud was committed. For actual fraud to exist, there must be four elements present in the situation:

1) **Material Misrepresentation or Concealment**. There must have been a deliberate misrepresentation of material facts or a deliberate concealment of material facts.

   Note: Opinions do not count as a material misrepresentation unless an **expert** gives them.

   Example: Frank takes his watch to a jeweler, and the jeweler, who knows the watch is worth $10,000 and has an interested buyer for the watch, tells Frank that the watch's value is only $500.

   The jeweler is an expert; therefore, his fraudulent appraisal is a material misrepresentation.

   However, if Frank had asked a friend the same question, the friend's answer would not constitute fraud because his friend is not an expert.

2) **Scienter**. The misrepresenting party must have acted with scienter; that is, the party must have acted deliberately and with **intent to deceive**. Scienter is seen in the use of the word deliberate in the first point. There must have been an intentional act by the party for their behavior to be actual fraud.

3) **Detrimental Reliance**. The defrauded party must have **reasonably relied (justifiably relied)** on the culpable party's fraudulent statements.

   Example: A potential buyer of realty asks if there is well water under the land. The seller says "yes," but he knows that there really is no well water under the land.

   If the buyer purchases the land based on the seller's misrepresentation, then this is detrimental reliance on the part of the buyer.

4) **Damage**. The defrauded party must have **sustained damage as a result of this reliance** on the culpable party's fraudulent statements. This makes sense because if there are no damages, there is nothing for the party to recover.

1B. Constructive Fraud

Constructive fraud means that the person did not actually commit fraud (meaning that their behavior did not meet all of the requirements for actual fraud), but the result of the behavior was essentially the same as if they had.

For constructive fraud to exist, there also must be four elements present. However, the four elements are not the same. The requirement of scienter that was required for actual fraud is replaced with recklessness in constructive fraud. As a result, it is easier to prove constructive fraud than it is to prove actual fraud.

The four elements of constructive fraud are:

1) **Material Misrepresentation**. This is the same as for actual fraud.

2) **Recklessness**. The misrepresenting party must have acted with a reckless disregard for the truth (turned a "blind eye" or made a positive assertion without knowledge of such assertion's accuracy). In essence this means that the person did not deliberately and intentionally lie, but they did not do everything that they should have to determine if what they represented was true.

3) **Detrimental Reliance**. This is the same as for actual fraud.

4) **Damage**. This is the same as for actual fraud.

Example of Recklessness: A buyer says that he will buy a house as long as there is well water on the land. The seller does not know whether there is well water under the house, but he tells the buyer that there is. *This is constructive fraud* because there was no intent to deceive, but the seller did not make reasonable efforts to find the truth.

Note: Constructive fraud has the same elements as actual fraud, but instead of the culpable party having intent to deceive, this party's recklessness will require the courts to determine (impute) whether or not constructive fraud occurred.

When fraud has occurred, there are two different classifications of fraud that are based on what the fraudulent activity was. These two types of fraud are Fraud in the Inducement and Fraud in the Execution.

1C. Fraud in the Inducement

This occurs when the defrauded party knows that a contract was made, but the accused (culpable) party has intentionally **misrepresented** one or more material contract terms in order to get the other party to enter the contract (this is to induce the party to enter the contract).

When there is fraud in the inducement, the defrauded party may either:

- **Rescind** the contract, or
- **Accept** the contract and sue for damages.

Note: Under UCC Article 2 (sales), the defrauded party may rescind the contract **and** may sue for damages. Thus, contract remedies and tort remedies can be used together.

1D. Fraud in the Execution

This occurs when the defrauded party was not even aware that a contract had been made. This will occur when one party substitutes a contract that has not been agreed upon for a contract that has been agreed upon. As a result, one of the parties is induced to perform under a contract that they did not agree to. Contracts involving fraud in the execution are **void** as a matter of law.

Note: Fraud in the execution is a very rare occurrence.

Example: John comes to Allen's door and asks Allen to sign a petition to ban a garbage dump. Allen signs. The document really was not a petition; it actually was a promissory note for $20,000. Is the promissory note enforceable against Allen?

The promissory note is not enforceable against Allen because he was tricked. That is, he never knew that he had formed a contract. Therefore, no meeting of minds occurred.

2) Innocent Misrepresentation

Note: This is the second of the five events that cause a contract not to be voluntary and willing.

Innocent misrepresentation is similar to fraud in that material misinformation has been given by one party to the other. However, there is a very significant difference in that the **misinformation was given unintentionally**. Because it was given unintentionally it does not meet the definition of fraud – either actual fraud or constructive fraud.

Innocent misrepresentation is a false representation of a **material fact** that is made without knowledge of the falsity. Thus, the party who misrepresents the fact has exercised due care but **simply has made an error**.

In cases of innocent misrepresentation, the injured party must prove:

- That he or she **reasonably relied** on the culpable party's erroneous statements, and
- There was a **material misrepresentation**, and
- They **sustained damage** as a result of relying on the erroneous statements.

When there has been an innocent misrepresentation, the injured party may also choose to **rescind the contract or sue for damages.**

However, if they rescind the contract, they then may not sue for damages because there is no actual or constructive fraud on the part of the culpable party. In the rescission of the contract, both parties are returned to their original positions as if no contract ever existed. (Recission is covered in detail later in the material.)

3) Mistakes

Note: This is the third of the five events that cause a contract not to be voluntary and willing.

Generally, mistakes that are made in the contract have no effect on contracts (basis of contract law: "a deal is a deal; either perform or pay damages") and the contract is valid as written. However, there are situations in which a **material mistake** can cause the contract to be voidable. Mistakes may be classified based on how many of the parties made the mistake.

1) A **mutual mistake (or bilateral mistake)** involves materials facts that are made by **both parties**. A mutual mistake makes the contract **voidable by either party**.

2) A **unilateral mistake** occurs when **only one party** makes a material mistake. The party who made the mistake may **disaffirm** the contract only if the **other party**

   - caused the mistake, or
   - knew, or should have known, about the mistake.

   Example: The following mistakes would be unilateral mistakes: carelessly failing to read the contract before signing it, failing to examine the information presented to them or an obvious miscalculation related to the price of the contract.

Note: An **immaterial mistake**, even if it is unilateral, usually does not void a contract or make it voidable. The contract is still valid as it is written as long as the main and material elements of the contract are agreed upon.

Example: Mike sold Ann an item with a selling price of $1,000, but Mike made a typing error on the written contract and erroneously set the price at $100. Can Ann pay $100 and compel Mike to sell her the item?

Mike may disaffirm the contract because Ann knew about the mistake. Enforcement of the contract against Mike would constitute an unjust enrichment to Ann (an unfair profit at the expense of another).

4) Duress

Note: This is the fourth of the five events that cause a contract not to be voluntary and willing.

Duress is the use of threats and/or violence to **induce (cause) someone to be an unwilling party to a contract**. The duress takes the choice of free will away from the other party and leaves the other party with no reasonable alternative other than to accept the terms of the contract that are being presented to them.

There are four kinds of duress that are generally considered to be duress:

1) The threat of **physical violence or harm** to the individual or to their family or property,
2) The threat of criminal prosecution or threat of a lawsuit **if** the threat is made with the knowledge that there is **no basis** for the lawsuit or prosecution,
3) The threat of personal or family social disgrace and extreme embarrassment, and
4) The **threat of economic devastation** or loss if the person under duress can show that the actions of the other party will cause the economic devastation.

Note: The threat of **civil litigation** or the **threat of economic loss** does not constitute duress if there is a reason to believe that there is a basis, or reason, for such litigation or economic loss.

A contract made under **physical force** (at gunpoint, for example) is **void**. This is usually item #1 in the above list.

A contract made under **mental duress** is **voidable**. These are usually Items #2-4 in the above list.

5) Undue Influence

Note: This is the fifth of the five events that cause a contract not to be voluntary and willing.

This involves unfair use of a **position of trust, confidence or affection** to compel an individual to be a party to a contract. Undue influence is much more subtle than duress.

Contracts formed under these conditions are **voidable**.

Example: A dying patient signing over valuable property to a doctor would be a contract that may fall under the category of undue influence. The relatives or heirs of the patient would sue to void the contract on the basis of undue influence.

Summary Table

Event	Effect on the Contract
Lack of Mutual Assent	Void
Lack of Consideration	Void
Duress by Physical Force	Void
Fraud in the Execution	Void
Lack of Capacity by Party to Contract	Voidable
Conduct Invalidating the Contract	Voidable
Duress by Improper Threats or Mental Duress	Voidable
Undue Influence	Voidable
Fraud in the Inducement	Voidable
Innocent Misrepresentation	Voidable
Mutual Mistake	Voidable by either party
Unilateral Mistake	May be disaffirmed by the mistaken party of the other party knew, or should have known, about the mistake.
Illegal Subject Matter	Unenforceable Contract
Statute of Frauds Requirements Not Met	Unenforceable Contract

The Parol Evidence Rule

Note: The term parol means "words" or "speech."

The Parol Evidence Rule governs what evidence can be presented in court in order to interpret, or clarify, or change a contract that has been signed by both parties. Generally, the rule is that the signed contract is the agreed contract and **nothing can be presented** to change what is signed by both parties. This is called the **four-corners rule** and states that once a contract has been reduced to a signed, written form, that written contract prevails over all other types of evidence.

This means that even if the contract reflects different terms than had been discussed through all of the negotiations (even when those negotiations are documented and written), those final terms that are in the contract will usually be considered to be the final contract. Evidence that relates to what the parties were discussing **before** the contract was signed or **at the same time** the contract was signed (contemporaneously) is **not admissible** in court.

Note: The Parol Evidence Rule applies to all written contracts regardless of whether the contract "had" to have been in writing. In other words, the Rule applies to written contracts where common law requirements would have allowed an oral contract. It is not limited to contracts that are governed by the Statute of Fraud rules.

Events that occur **after** the contract was signed (this is called subsequent evidence) **will be admitted** into court to clarify or interpret the contract. In addition, subsequent agreements that change the original written contract, sometimes called contractual amendments, are valid as long as they are valid contractual arrangements.

Example: During negotiations, the discussed price was $100 per unit. However, in the contract the price $110 was written and this version of the contract was signed by both parties. If, after the contract was signed, an invoice was issued for $100 and was paid for $100 per unit, this evidence can be introduced to show that the contract was really supposed to be $100. This is because if the contract was supposed to be for $110, presumably the selling party would not have issued an invoice for $100 per unit. But, the fact that they did issue an invoice for $100 shows that they believed that the contract was for $100 per unit, as per the prior negotiations.

There are some situations, however, in which previous or contemporaneous evidence may be introduced in court to **clarify or change the terms of the contract**.

Exceptions to the Parol Evidence Rule

In the following situations, the parol evidence rule will **not prevent** the introduction of prior or contemporaneous evidence to the courts about the contract.

- **Fraud**. Parties are always allowed to introduce prior or contemporaneous evidence that would indicate fraud or other circumstances that would cause the contract to be void or voidable.
- **A partially written contract**. When the written contract is not intended to be the complete and full writing of the contract, previous evidence may be introduced about the contract to fill in the "holes" in the contract.
- **A clerical, or typographical error**. Parties always are permitted to introduce evidence of material mistakes in contract formation. An example of this would be to demonstrate that there is a typing mistake in the serial number of the machine identified to the contract. It would be difficult to argue that a changed price in the final contract is a typing mistake because the courts will say that perhaps at the last minute the terms of the contract were changed.
- **Ambiguity of Language**. Parties always are permitted to introduce evidence to explain (but not contradict) the written contract when it is uncertain what is meant by the contract.
- **The lack of capacity of one of the parties**. This evidence does not change the terms of the contract, but would show that the contract may be voidable by one of the parties because they did not have the capacity to enter into the contract.

Note: Writing is desirable for any contract because there is a permanent record of the terms and conditions of the agreement, and the courts can scrutinize this record in the event of any contractual dispute. Written contracts remove most of the subjectivity from dispute analysis.

Area III: Federal Taxation of Property Transactions

This Area deals with the income tax consequences of property transactions. The main topics that we are going to cover in this area are:

- The basis and holding period of the asset
- Taxable and nontaxable dispositions of property
- The amount and character of gains and losses
- Related party transactions
- Cost recovery (depreciation)
- Estate and gift taxation.

Content Group A. Acquisition and Disposal of Assets

Within this content group are the following topics:

- Basis and holding period of assets
- Taxable and nontaxable distributions
- Amount and character of gains and losses
- Related party transactions

Note: We will cover Content Group B (Cost Recovery) in the middle of the material for Content Group A.

Basis and Holding Period of Assets

In this topic we will look in detail at the basis and holding period of assets that were acquired by **purchase**, by **gift** and by **inheritance**, starting first with a brief discussion of what original basis and holding period are.

Original Basis of Property

The **original basis** of property is the value that the owner of the property has for that property. Original basis will be adjusted for certain events, and at the time of sale the adjusted basis will be used to determine the gain or loss on the disposal of the property. The amount of the original basis depends on how that property was acquired.

Holding Period of Property

The **holding period** of property will be either short-term or long-term. When the property is not purchased, the holding period of the new owner of the property may or may not include the holding period of the party that the property was received from.

Purchased Property

Original Basis of *Purchased* Property

As is the case in financial accounting, the **original basis** for tax purposes in property acquired in a taxable transaction is the **amount paid for the property, plus any incidental expenses** paid (e.g., recording fees, appraisal fees, installation costs, sales tax, back taxes paid by the purchaser, etc.) to prepare the asset to be placed into service. It is important to note that the "amount paid" for property could be **cash, other property, services, and/or an assumption of liabilities by the purchaser**, or a combination of these.

If the property is received as a form of compensation and is reported in the gross income of the taxpayer for income tax purposes, then the basis for the property is the value that is included in gross income.

If property is purchased and fully expensed in the same year, then the basis for the property is $0.

Example: Bill bought a house. Bill paid $1,000,000 cash and as part of the transaction provided services for the benefit of the seller of the house worth $200,000. Bill also had to pay recording fees of $3,000 connected to the purchase of the home. Therefore, Bill's basis in the house is $1,203,000.

Holding Period of *Purchased* Property

The holding period of purchased property begins when the property is purchased.

Property Acquired as a Gift

Original Basis of Property Acquired By *Gift*

When property is acquired by gift, the basis for the recipient will be determined **either** at the time when the gift is made **or** when the gifted property is disposed of. The correct point in time depends upon the fair market value of the gift compared to the donor's basis in the gift **at the time of the gift**.

Note: Acquisition by gift is different than acquisition by inheritance, which is covered next.

Basis and Calculation of Gain or Loss on Gifted Property

The determination of the basis of the gifted property for the recipient is based on the fair market value of the property at the time of the gift and the donor's adjusted basis in the property plus any gift taxes paid by the donor on the gift. In the materials, we will use the term "donor's adjusted basis" (DAB) to include their basis in the property plus any gift taxes paid by the donor on the gift.

FMV EQUAL to or MORE THAN the Donor's Adjusted Basis (Gift of APPRECIATED Property)

When the fair market value of the property at the time of the gift is equal to or greater than the donor's basis in the property, the property will have a basis for the recipient equal to the **donor's adjusted basis, plus any gift taxes paid** by the donor. Essentially, the gain on the property is being deferred to a future period when it is sold. The gain must be deferred because the person who gave the gift does not have any cash with which to pay any taxes on the gift because they did not actually sell the property.

Example: Aunt Martha gave a necklace to her niece. The necklace cost Aunt Martha $100 and at the time of the gift had a fair market value of $150. Because the FMV of the necklace was larger than the donor's basis in the property, the recipient's basis will be the donor's basis in the property ($100) plus any gift taxes paid by the donor (in this case, $0).

Example: Debby received a watch from her aunt as a gift. The watch had a fair value of $25,000 and a basis of $15,000 to her aunt. Additionally, the aunt paid $500 of gift tax on the gift. The basis of the watch to Debby is $15,500 because the watch's FMV was greater than the donor's adjusted basis in the watch. Debby later sold the watch to a friend for $16,000, giving Debby had a $500 gain on the sale of the watch.

FMV LESS THAN the Donor's Adjusted Basis (Gift of DEPRECIATED Property)

If the fair market value of the property at the time of the gift is less than the donor's adjusted basis, the donee's basis in the property will depend on whether the donee has a gain or a loss when **he or she subsequently disposes the property**. *This means that the property's basis for the donee will not be known until it is sold.*

The gain or loss will be calculated as follows, depending on the sale price.

If the Subsequent Sales Price is	The Gain/Loss is
Greater than donor's adjusted basis	**Gain** = Sales Price – Donor's Adjusted Basis
Between the FMV and the Donor's Adjusted Basis	**No Gain or Loss**
Lower that FMV	**Loss** = Price – FMV of the gifted property

Example: Aunt Laura gave a necklace to her niece. The necklace cost Aunt Laura $250 and had a fair market value of $200 when gifted to her niece. Because the donor's adjusted basis in the necklace was greater than the FMV of the property, the niece's basis when she sells the necklace will depend on the sales price.

If the sale price is **> $250,** then the **gain** will be the difference between the sale price and $250.

If the sale price is **between $200 and $250**, there will be **no gain or loss**.

If the sale price is **< $200**, the **loss** will be equal to the difference between $200 and the sale price.

Examples with numbers:

If the sales price were **$300**, the gain would be $50 ($300 sales price – donor's basis of $250).

If the sales price were **$230**, then there will be no gain or loss.

If the sales price were **$180**, the loss would be $20 ($180 sales price – $200 FMV of the property).

Exam Tip: In order to avoid confusion, write the donor's basis and the fair market value in vertical order, highest to lowest, on your note board. Then, place the sales price where required.

Holding Period for Gifted Property

The holding period for the recipient depends on the valuation that is used by the gifted property.

Basis for the Recipient	Holding Period for the Recipient
Donor's adjusted Basis	**Includes** the donor's holding period
FMV of the property at time of the gift	**Begins** on the date of the gift

Property Acquired By *Inheritance*

Basis for Inherited Property

Inherited property will have as its basis either the fair market value (FMV) on:

1) The **date of death**, or

2) At an **alternative valuation date**, which is usually 6 months after the date of death. This alternative date may be chosen **only if it decreases both** the value of the gross estate and the estate tax liability. The executor of the estate makes the decision regarding the valuation date.

Note: If the **alternate valuation date is elected**, and the property is distributed or otherwise disposed of before this date by the recipient, the basis used is the **fair market value on the date of distribution or disposition**. This means that there will be no gain or loss on this sale because the basis will be the same as the sales price.

Example: On December 31, Boris received a car from his mother who died on June 21. The vehicle had a fair market value on June 21 of $20,000. The vehicle had a fair market value on December 21 of $15,000 and a fair market value on December 31 of $14,000.

Option 1: The executor did **not elect** the alternate valuation date. Boris has a basis in the vehicle of $20,000, which was the FMV on the date of death.

Option 2: The executor **does elect** the alternate valuation date. Boris's basis in the vehicle is $15,000 because this was the FMV on the alternative valuation date.

Example: On November 30, Boris received a car from his mother, who died on June 21. The vehicle had a fair market value on June 21 of $20,000. The vehicle had a fair market value on December 21 of $15,000. On November 30 the car had a value of $18,000.

Option 1: The executor does **not elect** the alternate valuation date. Boris's basis in the vehicle is still $20,000 because the executor did not choose the alternative valuation date and the property is valued at the FMV on the date of death.

Option 2: The executor **does elect** the alternate valuation date. Boris's basis in the vehicle is $18,000, the value on the **date of distribution** because the date of distribution was **prior to** the selected alternative valuation date.

Holding Period for Inherited Property

For inherited property**, the holding period is always long-term**, no matter when it is received and disposed of by the new owner.

Adjusted Basis of Property

Before calculating the gain or loss on a sale, exchange, or other disposition of property it is important to make certain adjustments to the basis of the property. It is **adjusted basis** that is used to calculate the gain or loss on the disposal of the property.

The adjusted basis is the original basis **increased for any capital expenditures and decreased for any depreciation, amortization or depletion charges**. Depreciation is covered in Content Group B.

If the property appreciates in value over time, the basis is not adjusted upwards for this appreciation.

Note: The **mere payment of a liability that was assumed as part of the acquisition does not adjust the basis of that property**. When a mortgage is assumed as part of the acquisition, that mortgage is included in the original basis of the property. The payment of the mortgage does not change the basis of the property.

Note: In the determination of the **adjusted basis of a business interest**, all items that are related to capital accounts will be included in the adjusted basis. This includes earnings of the business that are by themselves tax deductible.

Note: In the determination of the **adjusted basis of bonds**, the amortization of the bond premium reduces the basis of that bond. The amount of the amortized premium on taxable bonds is permitted as an interest deduction and is considered a recovery of the cost or basis of the bond. (The amortized amount is an offset to interest income for bonds purchased after December 31, 1987.) The amortization is treated as a deduction from adjusted gross income.

Content Group B. Cost Recovery

For property, cost recovery is the depreciation of the property for tax purposes. This calculation for tax purposes may be different than the calculation of depreciation expense for the financial statements. For the exam we are focused only on the depreciation for tax purposes.

Depreciation of Property

While a company may make occasional expenditures that increase the value of property, most property (with a possible exception of undeveloped real estate) loses its usefulness over time. A tax deduction based on the original basis in the property and a predetermined useful life is allowed to recover this lost usefulness as a tax-deductible expense. This cost recovery is **depreciation** (or amortization or depletion) and reduces the property's basis.

Property that May Be Depreciated

To be depreciated, property must meet all the following requirements. The property must be:

- **Owned** by the taxpayer
- Used in a taxpayer's **business or income-producing activity**
- Have a **determinable useful life**
- Be expected to **last more than one year**
- Not be excepted (excluded) property.

In other words, tangible personal property, buildings, structures, and leasehold improvements, if used in a trade or business or held as investment property to produce income (such as a rental apartment), may be depreciated for tax purposes.

The following items **cannot be depreciated** because they fail to meet one of these requirements:

- **Leased property**, unless the company retains the incidents of ownership for the property (this means control over the property, e.g. right to receive income)
- Property that is used solely **for personal use** (e.g. an individual's residence)
- Investment property if the **income** from it is **not taxable**
- **Inventory** is not depreciated because it is not held for **use** in a business, but rather for **sale** to customers in ordinary course of business
- **Land** is not depreciated because it does not wear out, become obsolete, or get used up. The cost of land generally includes the cost of clearing, grading, planting, and landscaping. However, certain costs (such as landscaping) incurred in preparing land for business use **can** be depreciated, but those costs must be very closely associated with other depreciable property in order to be depreciated.
- **Internally generated goodwill is not depreciated** because its basis cannot be determined. However, if a price paid to acquire a business after August 10, 1993 included goodwill, **acquired goodwill may be amortized over 15 years for tax purposes**. (Other acquired intangibles such as a **covenant not to compete** may also be amortized over 15 years.)

Note: Natural resources are **depleted** rather than depreciated. There are specific rules for the calculation of depletion that are dependent upon the type of resource. This specific calculation is outside the scope of the exam.

Other Excepted Property

Even if the requirements for depreciation are met, the following property cannot be depreciated:

- Property **placed in service and disposed of in the same year** (there is no time period in which to depreciate it)
- **Non-Acquired Section 197 intangibles** (goodwill)
- Interests in a **corporation**, **partnership**, **trust**, or **estate**
- Interests in **land**
- Interests in **films, sound recordings, video tapes, or books if not acquired with the assets of a trade or business**
- Some other items which are outside the scope of the CPA exam

Depreciation for Tax Purposes

Assets are depreciated using either the Accelerated Cost Recovery System (**ACRS**) (used for assets acquired between **1980-1986)** or the Modified Accelerated Cost Recovery System (**MACRS**) (used for assets acquired from **1987 to the present**). If neither of these systems are used, then the straight-line method must be used.

More likely than not, depreciation problems on the CPA exam will deal with MACRS.

Note: For financial accounting and reporting purposes, a company may use any reasonable depreciation method. However, for tax purposes, the methods and useful lives are dictated by the tax code. This difference in depreciation methods is one of the main causes of deferred tax items.

Depreciable property under MACRS is divided into the following two main categories and their subcategories:

1) **Real Property** (Section 1250 property – note the character § means Section)

- Residential rental property (**depreciated straight-line over** 27½ years)
- Nonresidential real estate (**depreciated straight-line over** 39 years)

Note: Depreciable leasehold improvements have a 39-year life, regardless of the term of the lease, based on a theory that leases can be renewed. As a practical matter, if the lease is not renewed, the balance of the leasehold improvements will be written off at that time.

2) **Personal Property** includes all tangible property that is not real property. This includes office furniture, machines, and equipment. This classification is further broken down into the following categories based upon the useful life of the asset.

- **3**-year – tractor units and race horses over 2 years old
- **5**-year – automobiles, light trucks, and computers
- **7**-year – office furniture and fixtures
- **10**-year – ships and water transportation

Note: 3, 5, 7 and 10-year property is depreciated first using the **200% declining balance** method then switching to straight-line when it results in a larger deduction.

- **15**-year – wastewater treatment plants
- **20**-year – municipal sewers and farm buildings

Note: 15 and 20-year property is depreciated first using the **150% declining balance** method then switching to straight-line when it results in a larger deduction.

Note: Salvage value of the property is not considered for MACRS purposes. The depreciation expense is calculated as the original basis of the property multiplied by the appropriate depreciation percentage that can be obtained from the depreciation tables. You do not need to know these amounts yourself for the exam.

Depreciation Conventions (Methods)

Depreciation **begins when property is placed in service**. Property placed in service when it is ready and available for a specific use, even if it not actually used in business or income-producing activity.

Personal Property Depreciation

For MACRS personal property, it is assumed that the property is put into service at the middle of the year, causing this to be a **mid-year depreciation convention.** This means that 6 months of depreciation is taken in the year of acquisition and 6 months in the year of disposal.

However, if **more than 40% of the total cost** of property placed into service during the year is **placed into service in the last quarter of the year**, then **all** property is depreciated under the mid-quarter convention. The percentages under the mid-quarter method are:

Quarter Acquired	Percentage of Annual Depreciation
First	87.5 %
Second	62.5%
Third	37.5%
Fourth	12.5%

Real Property Depreciation

Real property uses the **mid-month depreciation convention** to determine when it is placed into service and disposed of (no matter how much is purchased, or when during the year it is purchased.

The election of the applicable depreciation convention must be made after the Section 179 deduction.

> **Note:** It should be remembered that in general, **straight-line depreciation** can be elected annually in most cases when it produces a larger deduction than the required method.

Section 179 Deduction (Deducted on Schedule C; Supported by Form 4562)

A qualifying taxpayer can choose to treat the cost of certain property as an expense and fully deduct it in the year the property is placed in service instead of depreciating it over several years. This property is frequently referred to as section 179 property of the Internal Revenue Code.

Under Section 179, a company that buys less than $2,000,000 of qualifying property **may generally choose to expense up to $500,000** of the purchased property.

> **Note:** The amount that is expensed under Section 179 may not exceed taxable income from the active conduct of a trade or business during the year. This means that the Section 179 depreciation **cannot create a tax loss**. However, any amount disallowed as a result of this limitation may be **carried forward indefinitely**.

If the amount of property acquired during the year exceeds $2,000,000, the $500,000 amount that may be expensed is reduced dollar-for-dollar for the amount over $2,000,000. Thus, if the property acquired is more than $2,500,000 then none of the property purchased may be expensed. This Section 179 expense reduces the basis of the property when it is acquired and the remaining cost is depreciated according to the MACRS requirements.

To qualify under Section 179, property must meet all of these requirements:

- **Personal property** including computer software bought from a third party and certain limited types of real property (examples include leasehold improvement property, qualified restaurant property, and qualified retail improvement property)
- Purchased **exclusively for business use**
- Purchased **from an unrelated party**.

Note: Land and improvements, property leased to others, property used mainly to provide lodging, property used outside the U.S. and some other minor classifications may **not** have the Section 179 provision used on them.

Example 1: In 2016 Corporation X purchased $600,000 of Section 179 qualifying property. Its taxable income was $700,000. Corporation X may expense immediately $500,000 of the Section 179 property for tax purposes because it purchased less than $2,000,000 of Section 179 property in 2016 and its taxable income exceeds $500,000 (the value of the Section 179 expense to be taken). The remaining $100,000 of purchased assets will be depreciated according to MACRS, starting in 2016.

Example 2: In 2016 Corporation Y purchased $2,100,000 of Section 179 qualifying property. Its taxable income was $125,000. Because its $2,100,000 of purchases is $100,000 larger than the $2,000,000 threshold amount, Corporation Y must reduce the maximum value of the Section 179 deduction by $100,000. This reduces the maximum possible deduction to $400,000. However, the amount it may expense is limited to only $125,000 in 2016 because this deduction may not exceed taxable income. The excess Section 179 deduction ($275,000) may be carried forward to reduce future taxable income.

Special Depreciation Allowance

The Tax Code provides a special depreciation allowance (sometimes referred to as bonus depreciation) for qualified taxpayers and qualified assets. The special depreciation allowance is 50% of **the first year's regular depreciation**.

To be eligible for the special depreciation allowance, the property must be one of the following:

- Certain qualified property acquired after December 31, 2007 and placed in service before January 1, 2016. Qualified property includes:
  - Tangible property depreciated under MACRS with a recovery period of 20 years or less.
  - Water utility property.
  - Computer software that is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified.
  - Qualified leasehold improvement property
- Qualified **reuse and recycling property** (the details are outside the scope of the exam)
- Qualified **second generation biofuel plant property** (again, beyond the scope of the exam)

This special depreciation allowance is calculated **after the Section 179 deduction and before regular depreciation.**

Example from the IRS: On November 1, 2016, Tom bought and placed in service in his business qualified property that cost $450,000. He did not elect to claim a section 179 deduction. He deducts 50% of the cost ($225,000) as a special depreciation allowance for 2016. He uses the remaining $225,000 of cost to figure his regular MACRS depreciation deduction for 2016 and later years.

Depreciation of Automobiles

The **maximum depreciation** in the first year for a car acquired in 2016 for use in a business is $11,160. This amount is reduced to $3,160 or less if the special depreciation allowance is not considered. The maximum allowable depreciation for trucks and vans is $11,560 ($3,560 if the special depreciation allowance is not taken).

These limits assume that the vehicle is used 100% for business. If the use of the vehicle is not 100% for business, these limits are reduced and the deductible depreciation is even less. The reduction is based on the percentage used for business. If the vehicle is used 75% for business, the allowable depreciation is 75% of the limited amount. If business use is less than 50% the alternative deduction system must be used, which is essentially straight-line spread out over a longer period.

The limits for "clean fuel," hybrid cars, and electric cars are roughly three times higher than above.

Note: The maximum depreciation for vehicles applies only to standard depreciation. The Section 179 deduction can be taken on automobiles before the automobile maximum depreciation limit applies.

Example: In November 2016, Burch Co. purchased and placed into service a number of utility vehicles that cost $525,000. No other assets were purchased during the year. Burch Co. decided to deduct for tax purposes the maximum allowable amount for these vehicles without consideration of the bonus depreciation. Burch can expense up to $500,000 in fixed assets in a first year under Section 179. This makes the depreciable amount that will be applied to MACRS $25,000. The vans were purchased in the last quarter of the year so the mid-quarter convention must be used, calculated as $25,000 * 40% * 12.5% = $1,250. The total depreciation deduction for the year is 500,000 + 1,250 = $501,250. (The basis of the asset is multiplied by 40% because it is double declining depreciation for an asset with a useful life of 5 years. The 12.5% is because of mid-quarter convention.)

Sale and Other Disposition of Property

In addition to the amount of the gain or loss, there are also different classifications (and tax treatments) of gains and losses that arise from different property transactions. As a practical matter, a taxpayer's tax return (whether it is an individual, corporation, or in some instances, a trust) is concerned with two types of gains or losses: **ordinary or capital**.

The distinction between ordinary and capital gains/losses is important because the type of gain or loss influences the manner in which the item is taxed, and in some cases the **rate** at which it is taxed. Capital gains have a more favorable tax treatment than ordinary gains.

Note: Although gains and losses still have to be calculated, Partnerships and Subchapter S corporations are specifically excluded from this discussion, because they are not the ultimate taxpayers (they are pass-through entities).

The sale or disposition of property generally results in a gain or a loss. On the exam, you will need to be able to determine:

- Whether or not the gain or loss should be **recognized** in the current year
- The **amount** of the gain or loss
- The **character** of the gain or loss

Capital Assets

The starting point is to divide property into **"capital"** and **"non-capital" assets**. It is quite important to note that the definition of a capital asset is "exclusionary," which means that anything not on the list of excluded items is a capital asset. Generally, almost everything **owned and used for personal purposes or investment is a capital asset.**

Capital Assets INCLUDE	Capital Assets EXCLUDE
• All investment property • Property held for personal use Specific examples include: • Houses • Cars for personal use • Shares held as investments	• **Inventory** (also called stock in trade), • **Depreciable or real property** (including section 197 intangibles) used in a trade or business, • **Copyrights** or **artistic, literary, etc. compositions** created by or for the taxpayer, • **Accounts or notes receivable** from normal business activities, and • **U.S. Government publications** acquired for free or less than the purchase price at which the publications are sold to the general public.

With the exception of depreciable or real property used in a trade or business, all transactions with other types of assets will result in ordinary income.

Holding Period for Capital Assets

The time period that a capital asset has been held is important, because the holding period determines whether the item is a short-term or long-term capital gain or loss. If it is short term, it is treated like ordinary income.

The significance of the holding period is to determine the character of the "**net capital gain transactions**" after all the capital gains have been netted against each other. Capital losses, whether short-term or long-term, are deducted against capital gains (both short and long). After capital losses have zeroed out all capital gains, then the treatment of the net result can be determined for tax purposes.

A sale or exchange of a capital asset held **more than one year** can generate a capital gain/loss.

> **Note:** "More than one year" does not mean "exactly" one year; in order to be long term, the asset must have been held for one year and one day.

Treatment of Capital Gains and Losses for *Individual* Taxpayers

Net Capital Gains

For individual taxpayers, the significance of a net long-term capital gain is **reduced tax** on the capital gain as compared to the short-term ordinary income tax rate. The net long-term capital gains of non-corporate taxpayers are generally taxed at a **maximum rate of 15%**. Reduced maximum rates apply to gains from stocks and bonds (except qualified small business stock) as well as real property for certain entities. Short-term capital gains are taxed at the ordinary tax rate.

Capital asset tax rate notes:

- These reduced maximum rates do not apply to most collectibles (artwork, antiques, stamps, coins, metals, and gems), which are taxed at 28%.
- If the taxpayer is in the 15% tax bracket, long term capital gains have a maximum rate of 5% and are often taxed at 0%.

Net Capital Losses

In respect to net capital losses, individuals may **deduct the lesser of:**

- **$3,000** of **net** capital loss per year ($1,500 if married filing separately), or
- **Taxable income** before capital loss that year from their income.

Individuals cannot carry capital losses back to prior years to obtain benefit, but can carry capital losses forward indefinitely to be utilized against future income. Married couples filing jointly are still restricted to the $3,000 limit.

Individual taxpayers report their capital gains and losses using **Schedule D and Form 8949**.

Treatment of Capital Gains and Losses for *Corporate* Taxpayers

Corporations do **not receive a reduced tax rate** for capital gains compared to ordinary income. Corporations can **deduct capital losses only to the extent of capital gains**. However, they may offset a net long-term capital loss against a net short term-capital gain.

Corporations may carry a net capital loss **back three years and forward five**. The carryforward and carryback of excess capital losses are always treated as a **short-term capital loss** regardless of whether or not a net capital loss was short-term when originally sustained.

Starting in 2012, corporations must report their capital gains and losses on both Schedule D and Form 8949.

Note: You should expect exam questions on the utilization of capital loss by individuals and/or corporations

Sale of Real and Tangible Personal Property Used in Business (Section 1231)

Even if an asset is not classified as a capital asset, it is still possible that the gain from the sale of the asset will be classified as a capital asset. One category of property that is not a capital asset that may give rise to a capital gain is what is called **Section 1231 property**, which is **depreciable property or land that is used in a trade or business** that has been held for at least one year.

Treatment of Gains and Losses for 1231 Property

If gains from Section 1231 property exceed losses, some of the net gain is treated as a **capital gain**. If, however, the losses exceed the gains, then the net losses are treated as **ordinary losses**.

Recapture (Reclassification) of Section 1231 Gains

Section 1231 property gives rise to capital gains. However, there are two situations in which some (or all) of that gain will be reclassified as ordinary gain.

1) Any losses from Section 1231 property in the past five years that have not already been used to reclassify capital gains to ordinary gains must be used to reclassify current year Section 1231 gains as ordinary gains.

2) When Section 1231 property is disposed of at a gain, some of the capital gain may have to be **recaptured (reclassified) as ordinary income**. This means that the total gain will be subdivided into two parts, a capital gain and an ordinary gain.

The property that is subject to the recapture of depreciation include two subsections of Section 1231 Property:

- **Section 1245 Property**: primarily depreciable **personal property**. **All depreciation** claimed prior to the sale must be recaptured as ordinary income when the item is sold.
- **Section 1250 Property**: depreciable **real property**. For sales or exchanges prior to May 7, 1997, all depreciation taken in **excess** of straight-line depreciation must be recaptured as ordinary income. Starting May 7, 1997, all depreciation, to the extent of the gain, is recaptured at a maximum rate of 25% for non-corporate taxpayers.

Therefore, the net gain from Section 1231 property transaction includes both the capital gain and the ordinary gain (to the extent of depreciation recapture - 100% for Section 1245 and 25% for Section 1250). **A net loss on these transactions is always treated as ordinary loss**.

The result of this recapture of income is that the company will have a capital gain that is equal to the amount of increase in the value of the asset while they held it. This is the difference between the amount they paid for the asset and the amount that the sold it for. Any gain on the sale that is simply a result of depreciation will be taxed as ordinary income. This makes sense, because only the increase in the value of the property from acquisition to disposal is really a capital gain.

Example: Assume that we own Section 1245 property that cost $500 and has $310 of accumulated depreciation. This means that the adjusted basis of the property is $190. We then sell the property for the following amounts:

a) $600 – In this case, the total realized gain is $410. In a situation like this in which the asset has appreciated (i.e. sold for an amount greater than the original cost), **part of the gain will be ordinary gain and part will be capital gain**. The amount of depreciation that has been recognized will be treated as **ordinary income ($310)**, and the remaining gain of **$100** will be treated as a **Section 1231 (capital) gain**. This is the appreciation in the value of the property.

If we look at the total situation, this makes sense. The taxpayer paid $500 to acquire the asset and sold it for a $100 gain. However, because of depreciation expense (which decreases ordinary income) the calculated gain on the sale was $410. $310 of this gain resulted from the fact that the property had been depreciated. So, $310 of the gain is classified as ordinary gain, which offsets the $310 of ordinary expense that was recognized through depreciation.

b) $400 – in this case the total realized gain is $210 and the **entire amount will be recaptured and treated as ordinary income** (the entire amount of the gain is due to depreciation – there has been no appreciation in the value of the asset above its purchase price).

In total, the taxpayer lost $100 on this investment. However, because of depreciation, the calculated gain is $210. This gain is classified as ordinary gain in order to offset the ordinary expenses that were recognized as depreciation.

Determining if a Gain or Loss Should be Recognized in the Current Year

To determine when a gain or loss should be recognized, we must look at:

- What type of transaction it is, and
- If there is something in this transaction that will **cause** gain/loss recognition.

The sale of property can be divided into two types of transactions: 1) normal sales, and 2) non-recognition sales.

1) The "Normal" Sale (Gain Recognized Immediately)

In a normal sale, the gain or loss is the difference between selling price and adjusted basis. This is the standard transaction in which property is sold for consideration (cash or otherwise) in a single transaction.

	Fair Market Value Received (Cash and other goods or services received)
Less	Adjusted Basis of Asset at Time of Sale
Equals	**Gain or Loss on the Sale of the Asset**

Note: Remember that the seller could receive cash, other property, services, or an assumption of a liability by the purchaser. All of these should be measured at their fair market value.

Example: Sergei wants to sell his land he is holding for investment. Anya wants to buy it, but can only give him her car as payment. Sergei paid $10,000 for his land and Anya's car is worth $12,000. If they exchange properties, Sergei will have a $2,000 gain on the sale of his land to Anya.

Example: Vladimir has a machine with a $20,000 adjusted basis and the machine also secures a $10,000 debt. Marina wants to buy the machine and offers Vladimir $15,000 cash and she will completely assume his debt. Vladimir has a $5,000 gain on the sale of his machine because Vladimir received a total of $25,000 of consideration for the machine - $15,000 in cash and $10,000 in the form of the liability that has been assumed by Marina.

Installment Sales

When some of the payment for the item is received in the tax year after the sale is made, the installment sale method may be used to **calculate the amount of the gain recognized**. It is a three-step process:

1. The first calculation is to determine the total gross profit. This is done in the normal way:

	Sales price
Less	Adjusted Basis
Equals	**Gross Profit**

2. The Gross Profit is divided by the sales price to determine the gross profit percentage.
3. Finally, the amount of gain that needs to be recognized in the year of the sale calculated as:

Gross profit percentage * Payments received during the year = **Gain Recognized This Year**

Example: Boris sold some undeveloped land to Alexei for $1,000,000 (payable $200,000 per year for 5 years). Boris had an adjusted basis in the land of $400,000. Normally, Boris would have a $600,000 gain in the year of sale if he had received the $1,000,000 immediately. However, under the installment method, not all of that gain will be recognized in the year of the sale. The gross profit percentage is 60% ($600,000 / $1,000,000) and the gain recognized in the year of sale will be 60% of the cash received. $200,000 was received during the year, so $120,000 will be recognized as taxable income this year. Assuming the payments are made as scheduled, this is the amount of taxable gain that Boris will have each year.

Note: The total taxable gain does not change under the installment method. What changes is the year in which it is taxed, and the savings to the taxpayer is the time value of the money of the tax payments that are delayed until future periods.

The installment sales method is **not available to dealers in property**. This means that it cannot be used for property held for sale in the ordinary course of business. There are some exceptions to this, but they are outside the scope of the exam.

2) Non-Recognition Sales

There are a few transactions in which there is no gain or loss recognized. Usually, the gain or loss is deferred and will be recognized when the new owner disposes of the property in a taxable transaction.

The types of transactions in which the gain or loss will not be taxable are:

1) Gifts by a donor; transfers pursuant to a will (inheritance)
2) Sale of a residence
3) Exchange of like-kind business or investment properties
4) Involuntary conversions

We will now look at these in more detail.

2A. Gifts and Inheritances

Generally, neither the donor (giver of the gift) nor the testator (the deceased) will recognize a gain or loss. Any exception to this are outside the scope of the examination. Further, remember that neither the donee nor the beneficiary recognizes a gain or loss on gifts or inheritance.

2B. Sale of a Residence

If a single taxpayer sells a home that they have occupied **as their principal residence for at least two of the five years** preceding the sale, they may exclude $250,000 of the gain on the sale of the residence from his income. Married taxpayers may exclude $500,000 assuming neither spouse has used their exclusion in the past two years.

> **Note:** Because of the way the law is written, this exclusion may be used as often as every two years.

If a taxpayer did not occupy the home for at least two years, but their departure was for health problems, employment relocation, or other "unforeseen" circumstances, the exclusion can be prorated.

The $500,000 married taxpayer exclusion can also be extended for up to two years for the sale of a residence that was jointly owned and occupied by a taxpayer and their deceased spouse as long as the residence is sold during that 2-year time period.

The **basis in the newly acquired residence** is calculated as follows:

	Purchase price of the new home
minus	The deferred gain from the sale of the old home
Equals	**The Basis of the New Home**

> **Note: No loss may be recognized on the sale of a personal residence** (or for that matter, in general, any personal asset).

2C. Exchange of LIKE-KIND Business or Investment Properties (Section 1031 Property)

As the name implies, like-kind properties are properties that are similar to each other and used for similar purposes. In general, for tax purposes, like-kind properties are used in a trade or business or for investment. The IRS provides further explanation and examples of like-kind properties.

> Both properties must be held for use in a trade or business or for investment. Property used primarily for personal use, like a primary residence or a second home or vacation home, does not qualify for like-kind exchange treatment.
>
> Both properties must be similar enough to qualify as "like-kind." Like-kind property is property of the same nature, character or class. Quality or grade does not matter. Most real estate will be like-kind to other real estate. For example, real property that is improved with a residential rental house is like-kind to vacant land. One exception for real estate is that property within the United States is not like-kind to property outside of the United States. Also, improvements that are conveyed without land are not of like kind to land.
>
> Real property and personal property can both qualify as exchange properties under Section 1031; but real property can never be like-kind to personal property. In personal property exchanges, the rules pertaining to what qualifies as like-kind are more restrictive than the rules pertaining to real property. As an example, cars are not like-kind to trucks.

General Rule for Like-Kind Exchanges

The general rule is that if the properties in an exchange are **"like-kind" properties** (similar in nature or character), and the properties are held either for

- productive use in a trade or business, **or**
- for investment,

then **no gain or loss** will be recognized on the transaction by either party.

However, a gain may be recognized if "boot" is also received in the transaction. Boot is cash, other property, or the assumption of liabilities that belonged to the other party not similar to the core property being exchanged. If boot is paid, no gain or loss is recognized.

> **Note:** The like-kind exchange rules do not apply to property held for **personal** use, stocks, bonds, notes, certificates of trust, beneficial interests, or partnership interests. Trade-in allowances are covered by the like-kind exchange rules.

Gain on a Like-Kind Exchange *With Boot Included*

If boot is received as part of like-kind exchange, **some gain will be recognized by the recipient of the boot**. The total amount of the gain realized is calculated as:

	Fair market value received
Minus	Basis given up
Equals	**Gain Realized**

The gain that will be recognized by the recipient of the boot will be equal to the **lesser** of:

- The realized gain
- The amount of boot received

> **Note:** A **loss is never recognized in like-kind exchanges**. This is the case even when there is boot included in the transaction.

The Basis of the New "Like-Kind" Asset

The basis in the new like-kind asset is the basis in the old assets surrendered adjusted for any gain recognized and any boot in the transaction. It is calculated as below (**you should memorize this formula**):

	Basis of the old property exchanged
+	Basis of any boot given
+	Gain recognized
–	Fair market value of any boot received
=	Basis in the newly acquired property

> **Note:** The basis of the boot received will be its fair market value.

Example: Roger had some land with an adjusted basis of $3,000 and a fair market value of $11,000, and some stock with an adjusted basis of $6,000 and a fair market value of $2,000. He exchanged these assets with Walter for some other land worth $12,000. Walter's basis in his land was $4,000. Roger gave boot (the stock) with a fair market value different from its basis.

Walter has a **realized gain of $9,000** (the fair market value of the land received $11,000 + fair market value of stock received $2,000 − basis of his land $4,000).

Because Walter received boot (the stock) he will recognize a gain that equal to the lesser of the gain realized or the boot received. The realized gain was $9,000 and the boot received was only $2,000, so **Walter's recognized gain is $2,000**.

Walter's basis in his new land will be $4,000 calculated as follows:

	Basis of the old property exchanged	$4,000
+	Basis of any boot given	0
+	Gain recognized	2,000
–	Fair market value of any boot received	(2,000)
=	Basis in the newly acquired property	$4,000

Example: Cattle held by John for investment with a basis of $10,000 was exchanged for other investment livestock with a fair market value of $9,000, and a snowmobile with a fair market value of $2,000 and $1,500 in cash.

In this case, John's **realized gain is $2,500**. ($12,500 of FV received minus $10,000 of basis given up.)

Even though $3,500 of boot was received, the amount of **recognized gain is limited to only $2,500** because the recognized gain may not exceed the realized gain.

The basis of the snowmobile is calculated as follows:

	Basis of the old property exchanged	$10,000
+	Basis of any boot given	0
+	Gain recognized	2,500
–	Fair market value of any boot received	(3,500)
=	Basis in the newly acquired property	$9,000

2D. Involuntary Conversions

Involuntary conversions cover transactions like fire, theft, loss and also condemnations (seizures) of property by governmental entities. A gain is recognized only to the extent that all of the proceeds as a result of the involuntary conversion (i.e., insurance or other money received) are not used to buy qualified replacement property.

The general rule is that if the property which is **involuntarily converted is replaced**

- With property of **similar or related use**,
- By **the end of the second tax year** after the tax year in which the gain is first realized (the end of the third year for condemnations of business or investment real property),
- the taxpayer may elect **not to recognize the gain on the disposal** of the property.

Therefore, missing the replacement period (2 or 3 years) or not replacing with property of similar or related use property will make the involuntary conversion taxable.

Note: For purposes of the exam, "similar or related use" for the recognition of gain on involuntary conversions is a much more restrictive test than "like-kind" for the exchange of similar assets. "Similar or related use" property (so as to be able to avoid a taxable gain) must be **functionally the same or perform the same services**.

The basis of the replacement property is calculated as follows:

Cost of the new replacement property

minus Any gain that was not recognized on the disposal

Equals Basis of the Replacement Property

Note: By reducing the basis of the replacement by the amount of unrecognized gain, what is happening is that the gain is simply being deferred to future periods. Because the basis of the replacement property is less than what was paid for it, there will be a larger gain on any subsequent disposal of that property.

Example: Dima had some land with a basis of $30,000. This land was condemned (seized) by the state. The state paid him $35,000 for the land, which gives him a $5,000 gain on the event. Dima reinvested $32,000 in similar use property. Because not all of the money was reinvested in the replacement property, Dima must recognize $3,000 of gain for tax purposes.

The basis in the new land for Dima will be $30,000. This is the $32,000 he paid for it minus the $2,000 of gain that was not taxed. In essence, the missing $2,000 gain on the disposal will be deferred until Dima sells the replacement land. The $3,000 taxable gain is the amount of additional cash that Dima had after all transactions are completed: He received $35,000 for his land and used only $32,000 of it to buy replacement land.

Following Hurricane Katrina and other natural disasters in the US, "Special Disaster Relief" rules allow taxpayers to:

- Exclude from taxable gain any insurance proceeds received for unscheduled personal property.
- Elect for insurance proceeds for a home and/or its contents to be treated as one item. If the taxpayer makes a timely reinvestment in another home or contents, they can elect not to recognize the gain.
- Have a 4-year period in which to replace the assets. This 4-year period starts at the end of the tax year in which the gain is realized.

Sale of Securities – Gains and Losses on Different Transactions

In general, the gain or loss on the sale of a security is a taxable or tax deductible event. There are five specific events that you need to be aware of with respect to security transactions.

1. Wash Sales – NO LOSS Recognized

A wash sale is when substantially the same stock is purchased **within 30 days** of the sale (this means 30 days before the sale of the stock, or 30 days after the sale of the stock).

The **loss from the wash sale is not tax deductible**. When a loss is disallowed, the basis of the new stock is the same as the basis of the old stock.

Note: If the number of shares repurchased is less than all of the shares that were sold, a proportional percentage of the loss is deductible because the entire sale was not a wash sale.

2. Shares Received as Stock Dividends

Stock dividends received in the form of stock shares are **not taxable**. However, if there was an option to receive a cash dividend or a shares dividend and the shares are selected, the shares will be taxable at their fair market value.

When stock dividends are received, the amount paid for the original shares that were held prior to the dividend is divided between the shares previously held and the newly received dividend shares. This reduces the basis of the shares that were held prior to the stock dividend. When the originally-owned shares are sold, there will be a greater gain as a result of the decreased basis.

The holding period of the shares received as a dividend will be the same as the original shares.

Example: Jones purchases 100 shares of ABC Corp. for $5,000 on January 1. The basis for each share is $50. On July 18, ABC Corp. announces a 20% stock dividend. As a result of the stock dividend, Jones will own 120 shares. The $5,000 purchase price needs to be allocated to all of the ABC shares. Thus, the basis for the 120 shares is now $41.67 for each of the 120 shares. On October 12, Jones sells 50 shares for $3,000. The gain for Jones is $917 (calculated as $3,000 - $2,083 basis).

Note: If preferred shares are received as a dividend on common shares, the basis of the common shares is allocated to the preferred shares and the common shares based on the FMV of the common and preferred shares at the time of the dividend.

3. Shares Received in Stock Splits

A stock split is a transaction where existing shareholders of stock receive additional shares of stock, though the value of all of the held shares is reduced. The price is adjusted such that the before and after market capitalization of the company remains the same. The **stock split itself is not taxable** but it does **lower the taxpayer's basis in the shares that they previously held**. The original cost that the shareholder paid now needs to be allocated to the purchased shares and the shares received as part of the stock split. When the shares are sold in the future, this new, lower basis for each share will be used to calculate the gain or loss on the sale of the stock.

Note: If a shareholder sells their entire position, the net gain or loss is not affected by the split. The increased number of shares is offset by a proportional reduction in the basis of each share.

4. Worthless Stock

When stock becomes completely worthless, the basis of the stock is **deductible as a capital loss**.

An exception is that if the stock is a small business investment company, known as **Section 1244 stock**; then the loss is an **ordinary loss** deductible in Form 4797-Sales of Business Property. This ordinary loss classification is limited to $50,000 (or $100,000 for joint filers).

Note: This worthless stock provision is **applicable only for the person who originally acquired the shares from the issuing company**. If an individual bought shares on the open market or received them as a gift or inheritance, and they become worthless, this exception is not available to the holder and the loss from the shares is treated as a capital loss.

5. Small-Business Stock (sometimes referred to as QSB stock – for Qualified Small Business stock)

Section 1202 allows a noncorporate taxpayer who holds **small-business stock** for at least 5 years to normally exclude at least 50% of the gain from the sale of the stock from taxable income. Depending on the purchase date, the exclusion may be more:

- If the stock was purchased between February 18, 2009 and September 26, 2010, the exclusion of gain from the sale is increased to 75%.
- The exclusion of gain from the sale is increased to 100% for stock acquired after September 27, 2010 and before 2012.

This gain that may be excluded is limited to the greater of

- 10 times the taxpayer's basis in the stock, **or**
- A $10 million gain from the stock.

The small-business stock that was owned must have been a C Corporation and meet some other requirements as well. These other requirements are not necessary for you to know.

Note: The **trade date** is considered to be the date of sale. It is the date the broker completes the transaction on the stock exchange. The holding period for the stock sold ends with the trade date. For a cash basis taxpayer, the **gain or loss on a sale of listed stock is calculated on the trade date**.

Transactions Between Related Parties – *No Loss* Recognized

In this topic we need to understand what is a related party and how gains or losses are treated on transactions with related parties. The treatment of the gain or loss will also impact the basis in the item for the purchaser.

Related Parties

Related parties are:

- Family members, including ancestors, descendants, brothers, sisters, and your spouse

  Note: Family members through marriage (the "in-laws") are not considered to be related parties for tax purposes. For example, the man who marries my daughter is my "son-in-law". The woman who marries my brother is my "sister-in-law."

- A corporation and an individual when more than 50% of the corporation is owned directly by that individual

  Note: Stock in a corporation may be **indirectly owned** because of the constructive ownership rules that state that an "individual" shall be considered to own the stock owned directly by her/his spouse, children, grandchildren, and parents.

- Two or more corporations that are part of the same group
- Partners in a partnership
- Trusts and their grantor or trustee

Treatment of Gain or Loss

No loss is recognized by the seller when there are sales or exchanges between related parties. However, the seller's **gains are taxed as ordinary income**, even if the property is a capital asset.

The Basis in the Property for the Recipient in Related Party Transactions

When there is a loss that is not recognized, **the basis for the recipient will be the same as the basis that the seller had in the property**.

Using The Unrecognized Loss When the Recipient Subsequently Sells the Shares

The **unrecognized loss of the related party seller may be used to offset the gain of a subsequent sale** of the item to an unrelated party. This means that the person who originally sells the property to their related party will not receive the loss deduction, but the related party to whom they sold it may benefit in the form of a smaller taxable gain on their subsequent sale of the property.

However, the previously disallowed loss **may not be used to create, or add to, a loss** on a subsequent sale by the related party purchaser.

Example: Father bought 100 shares of ABC Co. for $10,000 on April 10, 2015. On June 13, 2016, Father sold the shares to Daughter for $6,000.

On this sale to Daughter, Father has a $4,000 loss. However, Father recognizes no loss because the sale was to a related party. The basis to Daughter of the shares is going to be no lower than $6,000 and no higher than $10,000. If Daughter sells the shares for more than $6,000 and less than $10,000, she will recognize no gain on the sale. If she sells the shares for more than $10,000, her gain will be the difference between $10,000 and the sales price. If she sells the shares for less than $6,000 she will recognize a loss equal to the difference between the sales price and $6,000.

Continued Example #1: Daughter sells the shares to Unrelated for $8,000.

Even though Daughter actually has a $2,000 realized gain on the transaction, she will not need to recognize any of it because she can use the $4,000 loss that was unrecognized by Father to offset her gain. However, she cannot use the $4,000 loss to create a $2,000 loss on her transaction. Father's unrecognized loss can be used only to offset any gain by Daughter on a subsequent sale to an unrelated party. This means that as a Family they have a $2,000 loss that was not recognized on the stock. The Family bought the shares for $10,000 and sold them for $8,000. However, there was never a $2,000 loss in either Daughter's or Father's tax calculations.

Continued Example #2: Daughter sells the shares to Unrelated for $13,000.

Even though Daughter actually has a $7,000 realized gain on the transaction, she will need to recognize only $3,000 of that gain as taxable because she can use the $4,000 loss that was unrecognized by Father to offset her gain. This means that as a Family they have a $3,000 gain on the stock. The Family bought the shares for $10,000 and sold them for $13,000. The Daughter recognized this gain in her taxable income because she owned the shares when they were sold to Unrelated.