

were allowed and paid. It appears that this transpired with one of the extensions having been paid in 2006. Therefore, the petitioners received the sum of \$165,000 during 2006. Paragraph 26 of the Agreement provides that “TIME IS OF THE ESSENCE IN THIS AGREEMENT.” The Agreement also stated that the closing was to be no later than December 31, 2006,¹ and that the approximate amount due at closing would be \$1,330,000.² The purported buyer did not proceed to closing. The petitioners retained all rights to the property in question and kept the \$165,000 as liquidated damages pursuant to paragraph 24 of the Agreement.

Paragraph 23 provided:

ENTIRE AGREEMENT: This Agreement contains the entire Agreement of the parties respecting the matters herein set forth and supersedes all prior Agreements between the parties respecting such matters. No warranties, including, without limitation, any warranty of habitability agreements or representations not expressly set forth herein shall be binding upon either party.

On their 2006 Idaho income tax return, the petitioners claimed the Idaho capital gains deduction in the amount of \$99,000 (165,000 x 60 percent) stating that the income was from the sale of real property held more than 12 months. The auditor disallowed the Idaho capital gains deduction stating that the gain was not from the sale of real property, but rather the sale of an intangible right to acquire real property.

In this matter, the question to be resolved has to do with a tax deduction sought by the petitioners. If there is any ambiguity in the law concerning tax deductions, the law is to be construed strongly against the taxpayer. Potlatch Corp. v. Idaho State Tax Comm'n, 128 Idaho 387, 389, 913 P.2d 1157, 1159 (1996), Idaho State Tax Commission v. Stang, 135 Idaho 800, 802, 25 P.3d 113, 115 (2001).

¹ The Agreement at paragraph 27.

² The Agreement at paragraph 3.

Controversy over the meaning of earnest money agreements (EMA) is not uncommon. Earnest money agreements have some characteristics resembling sales documents and other characteristics which make them appear to be options. The petitioners strongly argue that Internal Revenue Code § 1234A dictates that the income from the transaction here in question must be considered to be from the sale of the same asset as was the subject of the contract. Internal Revenue Code § 1234A states:

Gains or losses from certain terminations.

Gain or loss attributable to the cancellation, lapse, expiration, or other termination of-

- (1) a right or obligation (other than a securities futures contract, as defined in section 1234B) with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer, or
- (2) a section 1256 contract (as defined in section 1256) not described in paragraph (1) which is a capital asset in the hands of the taxpayer, shall be treated as gain or loss from the sale of a capital asset.

The preceding sentence shall not apply to the retirement of any debt instrument (whether or not through a trust or other participation agreement).

(Italics added.)

The auditor concedes that the income is from the disposition of a capital asset but contends that it is not from the sale or exchange of real property. Therefore, he denied the deduction claimed by the petitioners.

A Texas Court discussed the differences between an option and a contract of sale at some length:

An option contract for the sale of land gives the optionee a right to choose to purchase the property within the time and the terms specified but does not obligate him to do so. Chambers County v. TSP Dev., Ltd., 63 S.W.3d 835, 838 (Tex.App.-Houston [14th Dist.] 2001, pet. denied); Rollingwood Trust No. 10 v. Schuhmann, 984 S.W.2d 312, 315 (Tex.App.-Austin 1998, no pet.); Lefevere v. Sears, 629 S.W.2d 768, 770 (Tex.Civ.App.-El Paso 1981, no writ). Title does not pass to the buyer at the time an option contract is formed, and time is of the essence. Chambers County, 63 S.W.3d at 838; Lefevere, 629 S.W.2d at 770.

A contract for the sale of land, on the other hand, is an agreement that binds the buyer to buy and the seller to sell under the terms of the contract. Chambers County, 63 S.W.3d at 838; Greve v. Cox, 683 S.W.2d 535, 536 (Tex.App.-Dallas 1984, no writ); Lefevere, 629 S.W.2d at 770. The term “sale” refers to the transfer of the seller's equitable title in consideration of the buyer's promise to pay the purchase price. Fraday v. May, 23 S.W.3d 558, 565 (Tex.App.-Fort Worth 2000, pet. denied). That is, a contract for sale passes equitable title to the buyer. Chambers County, 63 S.W.3d at 838; Lefevere, 629 S.W.2d at 770.

The primary test to determine whether an earnest money contract pertaining to the sale of real estate is an option contract or a contract of sale is whether the seller's only contractual remedy in the event of the buyer's default is liquidated damages. Chambers County, 63 S.W.3d at 838; Seelbach v. Clubb, 7 S.W.3d 749, 756 (Tex.App.-Texarkana 1999, pet. denied); Lefevere, 629 S.W.2d at 770-71. If the only contractual remedy for the seller is retention of the earnest money, the agreement is an option contract. Chambers County, 63 S.W.3d at 838; Seelbach, 7 S.W.3d at 756. Absent such a provision, the agreement typically is a contract of sale. Cadle Co. v. Harvey, 46 S.W.3d 282, 286 (Tex.App.-Fort Worth 2001, pet. denied).

Courts also look at other factors to determine whether the contract is an option contract or one of sale. One such factor is whether the language of the contract is prospective. See Chambers County, 63 S.W.3d at 839 (prospective language supported conclusion that contract was option contract); Seelbach, 7 S.W.3d at 756 (language in contract stating seller “agrees to sell” and buyer “agrees to buy” is not language of contract of sale but agreement to sell in future). Another factor is whether time is of the essence. See Chambers County, 63 S.W.3d at 840 (time-is-of-the-essence clause supported conclusion that contract was option contract); Lefevere, 629 S.W.2d at 770 (in option contract, time is of essence). Yet another factor is whether the language of the contract itself conveys to the party seeking standing any rights to possess or enjoy the property. Seelbach, 7 S.W.3d at 756; see Cadle Co., 46 S.W.3d at 286 (“Typically, contracts for sale provide that upon making a down payment, the buyer is entitled to immediate possession of the property, with the remaining purchase price paid in installments over a period of time.”).

City of Harlingen v. Obra Homes, Inc., 2005 WL 74121 (Tex.App.-Corpus Christi, 2005).

The Idaho Supreme Court addressed the failure of a seller to perform pursuant to an earnest money agreement. The lower court had found for the plaintiff and ordered the specific performance on the part of the seller. On appeal, the Idaho Supreme Court stated:

The following provision of the Earnest Money Agreement shows that it contemplated that a land sale contract would be entered into by the parties which would include the details of the financing and the conveyance:

'In case the Buyer shall fail to promptly perform any covenant or agreement aforesaid and to do all things necessary and prerequisite to the consummation of this sale, the Seller may declare a forfeiture of this contract, and all rights of the Buyer shall cease and payments made by him may be retained by the Seller as liquidated damages, and not as a penalty, or the Seller may pursue any other remedy available under the laws of the State of Idaho. In any action brought upon this agreement, the prevailing party shall be entitled to reasonable attorney fees.'

The trial court recognized the incompleteness of the Earnest Money Agreement as a final statement of the terms of the conveyance because it ordered that,

'(S)pecific performance of that certain agreement for conveyance of real property owned by the Defendants and set out in Exhibit 'A' attached to the complaint and in the Contract of Sale signed by Plaintiffs . . .'

Since the Earnest Money Agreement was incomplete and not a final statement of the terms of conveyance, the trial court erred as a matter of law in ordering specific performance. Anderson v. Whipple, 71 Idaho 112, 227 P.2d 351 (1951); Locklear v. Tucker, 69 Idaho 84, 203 P.2d 380 (1949); Morgan v. Firestone Tire & Rubber Co., 68 Idaho 506, 201 P.2d 976 (1949). The judgment for the respondents is reversed and on remand the trial court is directed to enter a judgment for the appellants.

Luke v. Conrad, 96 Idaho 221, 222 (1974).

Given the similarity in the language of the earnest money agreement in the instant case and that in Luke v. Conrad, it would appear that the remedy of specific performance was probably not available, thereby further indicating that the earnest money agreement here at issue is more like an option than a sale of property. At no time during the time the purported purchaser had the right to purchase the property did any further right to the property (e.g. possession) transfer to the purported buyer. At the end of the matter, the petitioners held exactly the same rights in exactly the same property as was held prior to entering into the contract. The payments they received were not gains from the sale of real property, for there was no completed sale. Smith v. Commissioner, 50 T.C. 273, 285 (1968), affd. 418 F.2d 573 (9th Cir. 1969).

Further, even if the character of the asset here in question was found to be real property, it would not necessarily follow that the gain in question would qualify for the Idaho capital gains deduction. Idaho Code § 63-3022H stated, in part:

Deduction of capital gains. (1) If an individual taxpayer reports capital gain net income in determining taxable income, eighty percent (80%) in taxable year 2001 and sixty percent (60%) in taxable years thereafter of the capital gain net income from the sale or exchange of qualified property shall be a deduction in determining Idaho taxable income.

(2) The deduction provided in this section is limited to the amount of the capital gain net income from all property included in taxable income. Gains treated as ordinary income by the Internal Revenue Code do not qualify for the deduction allowed in this section. The deduction otherwise allowable under this section shall be reduced by the amount of any federal capital gains deduction relating to such property, but not below zero.

(3) As used in this section “qualified property” means the following property having an Idaho situs at the time of sale:

(a) Real property held at least twelve (12) months;

The petitioners did not have rights in the income until the execution of the contract which took place on June 7, 2006. The only income here in question was that received in 2006. Therefore, it appears that the twelve-month holding period could not have been met. Even if the Internal Revenue Code requires that the income be treated as income from the disposition of *a* capital asset, it does not dictate that the beginning of the holding period should be considered to be the same as the underlying asset.

The Commission finds that gain from such an option is not eligible for the Idaho capital gains deduction.

The auditor asserted the substantial understatement penalty, which is set out in Idaho Code § 63-3046(d) which stated, in pertinent part:

(d) (1) If there is a substantial understatement of tax for any taxable year, there shall be added to the tax an amount equal to ten percent (10%) of the amount of any underpayment attributable to such understatement.

(2) For purposes of this subsection, there is a substantial understatement of tax for any taxable year if the amount of the understatement for the taxable year exceeds the greater of:

- (i) Ten percent (10%) of the tax required to be shown on the return for the taxable year, or
- (ii) Five thousand dollars (\$5,000).

* * *

(5) The amount of the understatement under paragraph (4) shall be reduced by that portion of the understatement which is attributable to:

- (i) The tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment, or
- (ii) Any item with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return.

On the petitioners' tax return,³ the description of the property sold was listed as "nonrefundable earnest money" and "nonrefundable contract extension." The Commission finds that the relevant facts affecting the item's tax treatment were adequately disclosed in the return. Therefore, the penalty is not applicable.

WHEREFORE, the Notice of Deficiency Determination dated August 5, 2009, is hereby MODIFIED and as so modified is APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the petitioners pay the following tax and interest (computed to May 31, 2010):

<u>YEAR</u>	<u>TAX</u>	<u>INTEREST</u>	<u>TOTAL</u>
2006	\$7,721	\$1,472	\$9,193

DEMAND for immediate payment of the foregoing amount is hereby made and given.

An explanation of the petitioners' right to appeal this decision is enclosed.

DATED this _____ day of _____ 2010.

IDAHO STATE TAX COMMISSION

³ Idaho Form CG, line 1.

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____ 2010, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[Redacted]

Receipt No.

Copy Mailed to:

[Redacted]