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ACTION ON DECISION

SUBJECT: Ahadpour v. Commissioner
T. C. Memo. 1999-9
T.C. Dkt. No. 4843-96

Issue: Whether certain payments received by petitioners, pursuant to a sales agreement for real property, should be included in gross income in the year received.

Discussion: At issue were escrow payments received by petitioners (sellers) pursuant to a sales agreement for real property prior to the consummation of the sale. In accordance with the sales agreement, the payments were nonrefundable except in the case of sellers' breach and were applicable to the purchase price. The agreement also provided that, if close of escrow failed to occur due to sellers' default, or for any reason other than a default by buyer, buyer was entitled to a refund. The funds were immediately released to petitioners from escrow in 1989 (\$500,000) and 1990 (\$200,000). The funds were not reported as income in 1989 or 1990. In 1990, the State of California contended that the property was subject to a public trust easement. Because petitioners were unable to deliver title free of the State's public easement claim, the parties entered into a mutual release agreement in 1992 cancelling escrow. Pursuant to the mutual release agreement, petitioners paid \$642,500 to the buyer in 1992. Petitioners failed to include the difference between the escrow payments and the release payments (\$57,500) in income in any year.

The court held that petitioners had only a conditional right to retain the escrow payments. In the court's view, the unconditional right to retain the escrow payments arose only after buyer paid the remainder of the purchase price and the deed was delivered. This is because under the agreement, if the sale was not consummated, buyer was entitled to a refund under any circumstance except its own breach. Hence, the court concluded that the escrow payments were deposits and thus, the claim of right doctrine did not apply to the escrow payments paid before the consummation of the sale of real property.

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While we agree that the court was correct in determining that the petitioners were not taxable on the funds released from escrow in 1989 and 1990, we differ, in part, with the court's rationale. We believe that, for situations involving nondealers in real estate, escrow payments should not be treated as deposits (as they were viewed by the court). Nonetheless, they similarly should not be considered taxable income until the year the sale is consummated.

Recommendation:

Acquiescence in result only

Reviewers:

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Attorney

Approved: STUART L. BROWN
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By: _____
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