

## **FIRST-TIME HOMEBUYER TAX CREDIT – WHAT IS A “WRITTEN BINDING CONTRACT”?**

As most REALTORS® are aware, the First-Time Homebuyers Tax Credit (“Tax Credit”) expires on May 1, 2010. However, there is an exception for any taxpayer who enters into a written binding contract on or before April 30, 2010 to close on the purchase of a principal residence before July 1, 2010. Two questions have been raised a number of times by REALTORS® with respect to this exception. First, what constitutes a “binding contract” under the terms of the exception? Second, if the terms of a binding contract entered into on or before April 30, 2010 are amended after that date, does the buyer still qualify for the Tax Credit? As a practical matter, the two questions are part and parcel of the same analysis.

There is no case law or other documentary analysis of what constitutes a “binding contract” as that term is used in connection with the Tax Credit. However, the phrase was used in a similar provision of the Tax Reform Act of 1986 (the “TRA”). In the TRA, a qualifying “written binding contract” was determined to be:

- (1) A contract that is enforceable under state law; AND
- (2) A contract that does not limit damages for breach of the contract to an amount less than 5% of the contract price; AND
- (3) A contract in which any contingencies are beyond the reasonable control of the taxpayer.

Obviously, the intent was to prevent taxpayers from hastily concocting incomplete “contracts” before the specified deadline and then negotiating or renegotiating the actual terms and details of the transaction after the deadline.

Assuming the Internal Revenue Service would apply the same test for a written “binding contract” for purposes of the Tax Credit as it did under the TRA, then there are at least two (2) areas of risk which REALTORS® should be aware of in preparing purchase agreements which are intended to qualify for the Tax Credit. First, most inspection clauses in purchase agreement forms used throughout the State simply permit the buyers to accept or reject the results of an inspection within their sole discretion. It certainly could be argued that such an inspection contingency is not beyond the reasonable control of the buyer/taxpayer but, instead, is under the total control of the taxpayer/buyer. There would appear to be two alternative solutions to this problem. First, the buyer could complete and/or waive any inspection contingencies on or before April 30, 2010. Second, the inspection contingency could be amended to establish conditions by which the buyer would be permitted to terminate the transaction based upon inspection results, for example, the buyer could only terminate the contract if the inspection uncovers defects or damage in excess of \$10,000. While normally we do not recommend the use of such a provision as it leads to all types of controversy as to the existence and extent of a defect, the benefit of the Tax Credit to the buyer may outweigh this concern.

Second, many forms of purchase agreements throughout the State call for a buyer to make an earnest money deposit (“EMD”) upon the making of the offer or upon seller’s acceptance of the offer. If the provision in the purchase agreement provides that upon the buyer’s default, the seller’s sole remedy is to keep the EMD and the EMD is less than five (5%) percent of the purchase price, then the purchase agreement may not constitute a written “binding contract” for purposes of the Tax Credit. On the other hand, if

the provision in the purchase agreement provides the seller with the option of either accepting the EMD as liquidated damages or pursuing other legal remedies (*i.e.*, suing for the amount of her damage by reason of the breach of contract), then there should not be a problem with qualifying the purchase agreement as a written “binding contract” for purposes of the Tax Credit.

Many REALTORS® have inquired as to whether an amendment to a purchase agreement that would otherwise qualify as a written “binding contract” under the Tax Credit made after April 30, 2010 will render the transaction ineligible for the Tax Credit. If we look to Michigan law, the answer would clearly be “no.” In Michigan, a contract must contain the “essential elements of a contract with sufficient certainty and definiteness regarding the parties, property, consideration, terms and time of performance.” The Michigan Statute of Frauds, MCL 566.1 (the “Statute of Frauds”) provides that such contracts can be modified without new consideration provided that “the agreement changing, modifying, or discharging such contract, obligation, lease, mortgage or security interest shall not be valid or binding unless it shall be in writing and signed by the party against whom it is sought to enforce the change, modification, or discharge.” The Statute of Frauds demonstrates that subsequent modifications to the terms of a purchase agreement are just that, modifications, rather than an entirely new and distinct contract. Thus, there is no reason to believe that the date the purchase agreement was “entered into” would not endure even where amendments are made after April 30, 2010 in accordance with the Statute of Frauds.

There is authority in other contexts, however, for the proposition that at some point the IRS may view an amendment to a contract as being so substantial that the final contract “is a wholly different instrument from the original document.” In this situation, the IRS could take the position that the amended purchase contract does not qualify for the Tax Credit. In order to avoid an argument as to qualification for the Tax Credit, REALTORS® should avoid writing purchase agreements that include vague or broad future conditions or contingencies and avoid making significant or substantial changes to the essential terms of the purchase agreement after April 30, 2010.

Finally, it is not difficult to imagine that some zealous sellers or buyers may try to induce their REALTOR® to fudge the date when the contract was entered into, *e.g.* a contract signed on May 3, 2010 would provide that it was entered into “as of April 30, 2010.” Similarly, zealous sellers or buyers may wish their REALTOR® to prepare a purchase agreement dated on or before April 30, 2010 which is signed by a “straw” buyer and which will later be assigned to a new buyer and close before July 1, 2010. Obviously, there are any number of ways to attempt to perpetrate a fraud in order to obtain the Tax Credit. REALTORS® should run away as fast as they can if any seller or buyer attempts to induce them to participate in such activity.

Under 26 USC § 7206(2), any person who “willfully aids or assists in, or procures, counsels or advises the preparation or presentation under, or in connection with any matter arising under the Internal Revenue laws, of a return . . . or other document which is fraudulent or is false as to any material matter, shall be guilty of a felony and, upon conviction thereof shall be imprisoned not more than 3 years or fined not more than

\$250,000 for individuals (\$500,000 for corporations) or both, together with cost of prosecution.”

Finally, it should go without saying that if there are any issues as to whether a proposed purchase agreement will constitute a written “binding contract” for purposes of the Tax Credit, REALTORS® are urged to send their buyers to an attorney or accountant knowledgeable in the application of the Tax Credit.