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Reconsidering Rescission

By David E. Libman • Wood & Porter • San Francisco

Most of us occasionally like to undo something. The purchase, the sale, the deal, the option exercise; surely we can go back and start over. In these economic hard times, it is perhaps even more likely that rescission will be considered as a concept.

Even if the parties are amenable to a consensual rescission, or if resorting to the courts for rescission is successful, one question is whether and how effective rescission will be for tax purposes. The IRS and courts will recognize rescission as a tax concept, and allow that rescission to undo the tax effects of the initial transaction, provided that two requirements are met:

- The initial transaction and the rescission occur in the same tax year.
- As a result of the rescission, both parties to the original transaction must be returned to the same position they occupied prior to the original transaction, *i.e.*, they must be returned to the *status quo ante*. (Getting a do-over and having the opportunity to spout Latin make this a doubly good thing.)

If these two conditions are not met, the rescission will not be recognized for tax purposes. [See *Hutcheson*, 71 TCM 2425, Dec. 51,234(M), TC Memo. 1996-127 (1996).]

Classic Statement

In Rev. Rul. 80-58, 1980-1 CB 181, the IRS set forth what has become an enduring and oft-cited position on rescission and the tax consequences flowing from it. The revenue ruling considered the following two situations:

All in One Year. In February Year 1, Jack sold Jill real estate (“the Property”) and received cash from Jill. Pursuant to their contract, if Jill could not have the Property re-zoned for certain business purposes within nine months of the sale, (1) Jack would accept a reconveyance of the Property; and (2) Jack and Jill would be placed in the same positions they were prior to sale. In October Year 1, Jill notified Jack that she could not have the land re-zoned, Jack accepted reconveyance of the Property, and Jill received back all amounts expended on the sale.

Jack did not have to recognize any gain on the sale of Property in Year 1. [Rev. Rul. 80-58, *supra*, citing Code Sec. 1001.]

Over Two Years. This has similar facts to Situation 1, except the parties agreed that the reconveyance to Jack could take place for up to one year (not just nine months) from the February Year 1 sale. In January Year 2, Jill notified Jack that she could not have the land re-zoned. In February Year 2, Jack accepted reconveyance of the Property, and Jill received back all amounts expended on the sale.

Jack had to report on his Year 1 taxes as though the sale occurred in Year 1. In Year 2, when Jack reacquired the Property, he had a new cost basis in the Property equal to the price paid to Jill for the reconveyance.

In Situation 1, the IRS acted as if the February Year 1 sale from Jack to Jill never happened. In Situation 2, even though the Year 1 sale was rescinded in February of Year 2, the IRS treated the sale as occurring for tax purposes in Year 1.

The revenue ruling provided the following explanation for these distinctions:

Defined Terms

The IRS defines rescission as the “abrogation, canceling, or voiding of a contract that has the effect of releasing the contracting parties from further obligations to each other and restoring the parties to the relative positions that they would have occupied had no contract been made.” The rescission may be achieved:

- by the parties’ mutual agreement;
- by one party declaring a rescission without the other’s consent, but with sufficient grounds to make such a declaration; or
- by applying to the court for a decree of rescission.

The concept of annual accounting requires transactions to be viewed on an annual basis at the end of each year. Each tax year is a separate unit. [Rev. Rul. 80-58, *supra*, citing *Security Flour Mills Co.*, S Ct, 44-1 USTC ¶9219, 321 US 281 (1944).] In Situation 1, Jack and Jill’s sale and rescission occurred in the same tax year.

In Situation 2, the sale occurred in Year 1, but the rescission occurred in Year 2. At the end of tax year 1, Jack and Jill were not in the same positions as they were at the beginning of Year 1. Hence, the rescission in Year 2 is disregarded with respect to taxable events that occurred in Year 1.

Storied Cases

The IRS’s analysis in Rev. Rul. 80-58 relied heavily on a Fourth Circuit case from 1940, *S.E. Penn v. Robertson*, CA-4, 40-2 USTC ¶9707, 115 F2d 167 (1940). In that case, Charles Penn (“Penn”), as vice president of American Tobacco Company (“Tobacco Company”), participated in an employee stock benefit plan, which had not been approved by Tobacco Company’s shareholders. While the plan was in effect, it credited Penn with dividend income in 1930 and 1931.

In 1931, Tobacco Company’s directors adopted a plan to rescind the employee stock benefit plan for all participants who agreed to the rescission. When the rescission plan was adopted, Penn was dead, but his estate ultimately agreed to the rescission.

However, as a matter of practical necessity, the federal government must do income tax accounting on an annual basis. Because federal income taxation requires annual returns and accounting, income should be determined at

the end of the tax year without regard to subsequent events.

Hence, Penn’s income from the employee stock benefit plan for 1930 had to be determined at the end of 1930 without regard to subsequent events that occurred in 1931. On the other hand, the Fourth Circuit noted its agreement with the district court that “the rescission in 1931 before the close of the calendar year, extinguished what otherwise would have been taxable income to Penn” in 1931. [*Id.*, at 175.] Notably, there is a paucity of authority considering the idea in *Penn v. Robertson*, that rescission in the subsequent year, although it does not alter the tax effects of a previous year, can affect the tax consequences for the subsequent year.

Example. Suppose a transaction took place in Year 1, and a rescission of that transaction took place in Year 5. One could argue that the rescission in Year 5 may not affect the tax consequences of Years 1 through 4. However, shouldn’t that rescission affect the tax consequences in Year 5?

No Rescission Allowed. To restate the rule (according to the IRS), rescission can only undo the tax effects of the initial transaction if two requirements are met:

1. The initial transaction and the rescission must occur in the same tax year—essentially because the annual accounting principle requires that income be determined at the close of the tax year without regard to subsequent taxable events.
2. Both parties to the original transaction must be returned to the same position they were in prior to the original transaction, *i.e.*, to the *status quo ante*. [*Salsberg v. Trico Marine Servs. (In re Trico Marine Servs.)*, DC-NY, 343 BR 68, 73 (2006).]

What if you satisfy one but not the other? In *Hutcheson supra*, the Tax Court refused to give effect to an attempted rescission because both requirements were not met. Hutcheson had a Merrill Lynch account, and on January 3, 1989, Hutcheson asked his Merrill Lynch representative to sell \$100,000 worth of Wal-Mart stock—at least that is what he thought he asked her. The Merrill Lynch representative understood that she should sell 100,000 *shares* of Hutcheson’s Wal-Mart stock, which is what she did.

A dispute developed between Hutcheson and Merrill Lynch. To resolve it, on December 28,

1989 (when the value of the Wal-Mart stock had risen significantly since the ill-fated January 1989 sale), Merrill Lynch provided \$2,948,702 and Hutcheson provided \$1.35 million of borrowed money from his father to purchase 96,600 shares of Wal-Mart stock. The purchase was of 96,600 shares, not 100,000 shares, based on Hutcheson's acknowledgment that the first 3,400 shares of stock the Merrill Lynch representative originally sold in January 1989 approximated the \$100,000 sale that Hutcheson had originally requested.

Hutcheson wished to characterize the December 28, 1989, transaction as a rescission with respect to 96,600 shares that were erroneously sold by Merrill Lynch in January 1989. Hutcheson likened his situation to Rev. Rul. 80-58, Situation 1. But the Tax Court disagreed.

For the rescission to be effective, buyer and seller must both be put back in their

original positions. This did not happen with respect to Hutcheson (the seller) and the January 1989 buyers of his Wal-Mart stock. The buyers in the January 1989 transaction were not put in their same position as a result of the December 1989 transaction, for in the December 1989 transaction, there was a different buyer, Merrill Lynch. For the January 1989 transaction, Merrill Lynch had merely acted as an agent, not as a buyer.

That (plus the \$1.35 million loan) meant the December 1989 transaction could not be viewed as a rescission for tax purposes.

Outer Limits?

There's much more than could be said about rescission. Taxpayers can certainly *argue* for rescission, even outside of the rather narrow confines of Rev. Rul. 80-58.