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Rescission in the Time of COVID

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In this article, Wood and Board examine how rescission and the void-transaction doctrine can affect outcomes within and beyond a single tax year.

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2020 has been a strange year. Some deals are happening again now, but that is hardly a reboot. And even if some things are happening, just think about all those transactions that were changed or scuttled, all the tied-up deals that were undone, all the claims of distress, acts of God, force majeure, and more. Insurance companies and litigators will be digging out of this mess for years. But what about the IRS?

The IRS, too, will need more than sanitation and disinfection to move on from this once-in-a-lifetime (we hope) phenomenon, even once it is officially over. So far, there is no end in sight. But how might the IRS react to all the deals that were inked and later undone? We're guessing that 2020 might in some arcane circles go down as the year of the rescission.

Rescission in the Eyes of the IRS

The primary IRS authority dealing with rescission is Rev. Rul. 80-58, 1980-1 C.B. 181. The IRS had been willing to rule privately on rescissions, but in 2012 it announced that the area was under study and placed rescissions on the no-rule list.[1] The IRS appears to have suspended its study, but it still won't issue private rulings on rescissions.[2]

The IRS's position, as set forth in Rev. Rul. 80-58, is that rescission can undo the tax effects of a transaction if two requirements are met:

- the initial transaction and the rescission must occur in the same tax year; and
- the rescission must result in both parties to the original transaction being returned to the same positions they occupied before the original transaction — that is, they must be returned to the status quo ante.

The revenue ruling 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." A rescission may occur:

- by the parties' mutual agreement;
- by one party declaring a rescission without the other's consent, but with sufficient grounds to make that declaration; or

[1] Rev. Proc. 2012-3, 2012-1 IRB 113, section 5.02.

[2] Rev. Proc. 2020-3, 2020-1 IRB 131, section 3.02(8).

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- by applying to a court for a decree of rescission.

Mutual agreement is enough to rescind a transaction, so you don't actually have to come up with a business or legal justification for doing so. Notably, or even remarkably, the IRS appears comfortable with transactions that are motivated by a frank desire to avoid an unfavorable tax result. In LTR 200911004, for example, the IRS approved the rescission of a merger that was driven by concern that the combination "could yield adverse tax consequences that potentially could be devastating to the viability of [the acquiring corporation] as an ongoing entity."[3]

Rev. Rul. 80-58 considered two situations. In the first, all events occurred during one tax year. In the second, the transaction occurred in one year, but the rescission occurred in the next. In the former case, the transaction and its rescission were essentially treated as tax nothings, so no gain or loss was realized.

In the latter case, even though the money was repaid and the transaction was unwound, the IRS refused to abrogate the annual accounting concept. Thus, the original seller in the transaction had to report the results of the sale in year 1, even though he reacquired the property in year 2. He took a new cost basis in the property in year 2 equal to the price paid in the unwinding.

Case Law

Rev. Rul. 80-58 relied heavily on *Penn*, a Fourth Circuit case from 1940.[4] The court explained that, with cash-basis accounting, taxpayers receive income for tax purposes when they actually or constructively receive an amount that is definitely ascertainable and subject to their unrestricted control. Of course, federal income taxation requires annual returns and accounting.

Thus, the Fourth Circuit held that income should be determined at the end of each tax year without regard to events in subsequent years. The IRS has adopted this rigid view of rescission with a focus on a single year. By and large, the courts agree.

For example, in *Hope*[5] the taxpayer had been induced to sell his shares in a corporation at a substantially undervalued purchase price in 1960. Later that year, he filed suit against the buyers to rescind the transaction. The case was settled in 1961.

The taxpayer argued that he shouldn't be required to recognize gain from the sale in 1960 because he had sued for rescission in the same year. The Tax Court, however, characterized the lawsuit as a mere request for rescission. The taxpayer had received the purchase price in 1960, and he had been free to use the money as he pleased despite filing the lawsuit. Simply bringing suit in 1960 was insufficient to unwind the sale for tax purposes.

In *Hutcheson*,[6] the Tax Court refused to give effect to an attempted rescission that was timely but failed to restore the parties to exactly the same positions they had occupied before the original transaction. Richard Hutcheson had a cash management account with Merrill Lynch that contained only shares of Walmart. In January 1989 he sold some of the shares to meet a margin call. In December 1989 he borrowed $1.35 million from his father and purchased some Walmart stock from Merrill Lynch to restore his position.

Hutcheson tried to characterize his December 1989 transaction as a rescission of the sale in January 1989. Hutcheson likened it to Situation 1 in Rev. Rul. 80-58 because everything had occurred in one year. However, the Tax Court concluded that, for an attempted rescission to be effective, buyer and seller — the *same* buyer and seller — must *both* be put back in their original positions.

The buyers in the January 1989 transaction did not surrender any shares in December, so they weren't put back into their original positions. After all, Hutcheson's counterparty in the December 1989 transaction was Merrill Lynch, not the original buyers. Although Hutcheson had

[3] *See also* LTR 200701019 (corporation permitted to rescind liquidation of a newly acquired subsidiary to preserve its high cost basis in the sub's stock); and LTR 200309009 (limited partnership and partners could rescind distribution of a building to avoid triggering a new placed-in-service date that would have made the property ineligible for the low-income housing credit).

[4] *Penn v. Robertson*, 115 F.2d 167 (4th Cir. 1940).

[5] *Hope v. Commissioner*, 55 T.C. 1020 (1971), *aff'd*, 471 F.2d 738 (3d Cir. 1973).

[6] *Hutcheson v. Commissioner*, T.C. Memo. 1996-127.

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dealt with Merrill Lynch when he sold his shares in January, the firm had merely acted as an agent for the real buyers. In addition, Hutcheson hadn't owed his father $1.35 million before the January 1989 sale, but that changed as a consequence of purchasing replacement shares in December 1989.

These were material differences, said the court. Quite literally, the buyers and sellers weren't returned to their original positions. That meant the December 1989 transaction couldn't be viewed as a rescission for tax purposes.

Not all cases are as rigid as Rev. Rul. 80-58. One of the best examples is *Guffey*,[7] a case predating Rev. Rul. 80-58. Patrick and Betty Guffey sold their residence in 1951. In 1952 the buyers sued the Guffeys to rescind the transaction.

In 1954 the parties settled, and the buyers conveyed the residence back to the Guffeys. The Guffeys immediately sold the residence to a new purchaser. The Ninth Circuit concluded that the initial sale in 1951, three years before, had been a nullity for tax purposes.

The court's holding suggests that rescissions occurring after the tax year of the original transaction may sometimes be given effect. However, case law extending the rescission doctrine beyond the limits of Rev. Rul. 80-58 is rare. Most interesting questions regarding rescission involve the outer limits of time (when can one go beyond one year?) and of circumstance (does absolutely everything have to go back to the status quo ante?).

Slight Differences

Does absolutely *everything* have to go back to square one? Maybe not. In LTR 200952036, the IRS determined that its rescission authority would apply even though it was by no means clear that absolutely everything was restored to its past position. Reduced to simplicity, a limited partnership converted into a corporation. Shortly thereafter, the corporation was converted into a limited liability company. The letter ruling concluded that the transaction qualified as rescission for tax purposes, even though the parties really didn't go all the way back to square one.

Before the transaction, the individuals held interests in a limited partnership. After the purported rescission, they held membership interests in an LLC. To my mind, that's different. Of course, this may be splitting hairs. Indeed, a limited partnership is taxed as a partnership, as are most LLCs. Thus, a limited partnership and an LLC taxed as a partnership are arguably the same thing for tax purposes.

The taxpayers represented to the IRS that all parties would be restored to the *economic* positions they had previously occupied. The various classes of stock that had been issued in the corporation were converted into interests in the converted LLC. In each case, the interests in the LLC were bundles of rights and obligations that were substantially similar to the corresponding interests in the corporation and, before that, to the original interests in the limited partnership.

Should It Matter?

The big question is whether the arguably slight but nevertheless perceptible difference before and after should matter. When the smoke cleared after the rescission, this was an LLC, not a limited partnership. However, as the ruling noted, the corporation could have converted back into a limited partnership, and the limited partnership could then have converted into an LLC.

The IRS observed that converting directly to an LLC (a form of organization that had nontax benefits) saved transaction costs, always a good thing. Post-rescission, the converted LLC would file a partnership tax return for the full year, as though there had been no detour into corporate status. Despite the admitted structural and legal difference between an LLC and a limited partnership, the IRS treated them as essentially the same entities for federal income tax purposes. This was enough for rescission treatment, even though not everything was 100 percent the way it was before the incorporation was unwound.

Sometimes even legal settlement agreements are unwound. This is most likely to happen when both parties are unhappy with the deal they

[7] *Guffey v. United States*, 339 F.2d 759, 760-761 (9th Cir. 1964).

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struck. In *Cooper*,[8] for example, an ex-husband contracted to pay $60 in monthly alimony. The ex-husband paid the alimony for years until both he and his ex-wife decided to abandon their prior written agreement. She wanted more; he wanted to pay nothing.

The dispute led to a rescission of their written agreement. Of course, the matter was contested, with the rescission arising out of — really constituting — a new legal battle. But the effects should be the same whether the rescission comes about by court order or by an agreement executed consensually by the parties. How about settlement agreements concluding litigation?

Although legal settlement agreements are signed every day, rescission of legal settlements (consensually or by court order) seems rare. If a plaintiff is trying to abrogate a settlement agreement (and presumably to return all the settlement money), the defendant will typically object. The defendant wants the case resolved, signed an agreement to do so, and is unlikely to agree to reopen it. But consensual rescission is possible, and courts have been willing to grant mutual rescission requests in connection with settlement agreements.

For example, in *CVT Prepaid Solutions*,[9] the federal district court granted a joint rescission request based on, among other things, the parties' mutual misunderstanding concerning material language in their settlement agreement. Under the general (that is, nontax) doctrine of rescission, a contract for services or goods, a merger agreement, or virtually any other document or agreement can be rescinded, at least in theory. But sometimes the eggs just cannot be unscrambled.

Taxpayers face the same issue with the IRS. But even when everyone can be restored to the status quo ante, the timing problem persists. Under Rev. Rul. 80-58, the transaction that went awry and the rescission must both occur in the same tax year. If the transaction takes place near the end of the year, or if the parties are slow to recognize their mistake, that may turn out to be impossible.

Void Transactions

The IRS also acknowledges that some attempted transactions are void because they were originally flawed, even if their ineffectiveness isn't recognized or addressed until some later date. As with rescission, the parties must go back to their prior positions. However, in a major departure from its position regarding rescission, the IRS doesn't insist that the original transaction and the corrective action occur in the same tax year.

In fact, the correction might occur several years later. One commentator has summarized the differences between rescinded and void transactions this way:

> A separate type of tax-related corporate event similar to a rescission involves a transaction that has already occurred but that violates some contractual restriction that deems such violating act or acts to make the transaction "void ab initio". . . . While there are certainly overlapping characteristics of "void" and "rescinded" transactions . . . there is no requirement that the former be completed within the same calendar year, and the legal principles governing "void" transactions remain somewhat opaque.[10]

It is easy to see how the tax doctrines applicable to rescission and void transactions might be considered in tandem. Particularly, given the same-year requirement the IRS imposes for rescission, it is possible that parties might agree that a purported transaction was void. Of course, there presumably must be a legal basis for that, a flaw in the deal from a legal perspective.

Most of the federal income tax authorities in which the IRS has recognized that a transaction was void have been private letter rulings. Technically, of course, letter rulings are not "authority" on which another taxpayer can rely. Even so, tax professionals read them, and they are viewed as important indications of how the IRS sees issues, and how it might react to your own situation.

[8] *Cooper v. Cooper*, 35 A.2d 921 (D.C. 1944).

[9] *IDT Telecom Inc. v. CVT Prepaid Solutions Inc.*, No. 07-1076 (D.N.J. 2008).

[10] Robert Rizzi, "IRS Takes Another Look Back at Rescission," 39 *J. Corp. Tax'n* 33 (July/Aug. 2012).

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The rulings on transactions that the IRS has been willing to treat as void involve disparate factual settings. However, more than a few seem to involve stock transfers that violated transfer restrictions. For example:

1. In LTR 201026006, the IRS ruled that an S corporation did not lose its status when shares were transferred to an ineligible shareholder. A court had held that the purported transfer was null and void because it violated a shareholders' agreement.
2. In LTR 201010009, the IRS approved the use of a restrictive "stock trading order" to invalidate purported share transfers. The transfers could have triggered an ownership change, which would have limited the corporation's ability to use its substantial net operating losses. The IRS noted that the offending transfers had been unwound and declared "*void ab initio*."
3. In LTR 9733002, the IRS ruled that an S corporation didn't lose its status as such when some of its shares were transferred to a C corporation, even though that transfer ordinarily would have resulted in disqualification. The purported stock transfer was made in violation of a right of first refusal in a contract that declared that noncomplying transfers were ineffective.
4. In LTR 9409023, the IRS ruled that an S corporation could continue as such despite an apparent stock transfer to an ineligible shareholder. A court had declared the attempted transfer *void ab initio* because the shares were already subject to a garnishment lien.

Timing Issues

Let's return to rescission and the IRS position that the deal and its unwinding must occur in the same tax year. Anyone facing the legal system knows that court proceedings take time — years, in most cases. Your case may not become a modern version of *Jarndyce v. Jarndyce* in Charles Dickens's *Bleak House*, in which estate litigation that dragged on for generations until legal costs devoured the estate, and there was nothing left to fight over.

But litigation today may not be much better, and results may take years, if not decades. The IRS expects you to file a tax return every year and tally up your annual gains and losses. Perhaps it isn't surprising that the IRS position is that the deal and its unwinding must all happen in the same tax year.

What if a deal closes in one year, but is rescinded early the following year, before any tax returns are filed? Is that close enough? It is an interesting point to consider.

Some taxpayers who don't meet the IRS's strict timing criteria will probably be OK with taking the position that their rescission qualifies, if the transaction is unwound before they have reported it on their tax return. Some of this may be the commonsense observation that nothing has been filed to fix the taxes, even if December 31 has passed.

In such a case, the tax return filing deadline might seem, in at least a kind of layman's sense, to be the day of reckoning for what did or didn't happen with the transaction. True, the tax year *itself* may have ended December 31. Yet the alluring logic might be that there was nothing filed, and if both parties agree and undo it, what's the harm?

Example: You sell your car to your brother-in-law for $25,000 in September 2020 for use in his delivery business. He has some problems, and you agree to unwind the sale. He returns the car to you in May 2021, and you refund the money. Although your 2020 tax return was due April 15, 2021, you requested an extension, so you haven't yet filed when you take the car back. When you file your 2020 return in August, can you treat this sale as having never occurred? Some advisers might answer yes, but based on straddling two years, the IRS would presumably say no.

Was there a credible case that the transaction was void on some basis? Perhaps the car's title wasn't handled properly, was illegal to transfer, or there was some other defect. If so, the parties might all agree that the sale was void, perhaps even getting a legal opinion that notes the flaw and concludes that the deal was void.

The IRS could always look behind an agreement to void the transaction, and maybe even look into the bona fides of a legal opinion that the transaction was void because of some

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defect. But except in glaring cases, the scrutiny may not be high. Of course, invoking the "void" authorities should help the parties get around the one-year rule applicable to rescission. But what if there *is* no credible case that the original deal was void?

Here, one faces the seemingly rigid one-year rule enunciated in Rev. Rul. 80-58. However, even without claiming that the transaction was void, some taxpayers may be comfortable going outside the same-tax-year limit in the revenue ruling, as long as the unwinding occurs before tax returns are due the following year. If no tax returns have yet been filed, one at least has the argument that, in spirit, the rescission may not squarely violate the annual accounting concept.

Thus, even that belated unwinding may still be worth considering. The tax year is over, of course, but there is no reporting to undo or amend on either side of the deal. Perhaps that may not matter to the IRS. Yet some taxpayers might see this is a mere stretching of the rescission principle out of necessity that can be understood, even if not entirely forgiven.

Conclusion

No one enters into a transaction hoping and planning to undo it later. Similarly, it is unlikely that anyone executes a transaction, or even issues or transfers a share of stock, with an eye toward later saying, "That was void; it didn't really happen." Still, we all make mistakes, and there might be more things in 2020 we want to undo than in most years. If you are doing that, document it well. And if you might be deviating a little from what you think the IRS wants to see, try to consider all the ways in which the IRS might respond. ■

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