I Love Rescission

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I've always been fascinated by authorities dealing with rescission. It comes in several guises. There is rescission as a legal or contractual concept. There is also rescission for tax purposes. They often go together, but not always. I'll confine myself here to rescission as a tax concept.

One of the reasons rescission in the tax world is interesting is that it seems to fly in the face of several traditional tax principles. For example, the annual accounting rule normally makes us look at each tax year separately. One could also argue that rescission conflicts with tax precepts that are usually unwilling to ignore events.

Rescission is different, of course, for it involves a legally sanctioned return to square one. Understandably, the IRS has never particularly liked it and is stingy on its timing. Yet they have allowed it, provided that you come within the IRS's narrow view of the rescission doctrine. Way back in Rev. Rul. 80-58, 1980-1 CB 181, the IRS ruled that a transaction would not be treated as having occurred for federal income tax purposes if it is actually rescinded (for purposes of the commercial transaction) in the same tax year, and if the parties are restored to the positions they would have occupied had the initial transaction not occurred.

The IRS and the courts recognize rescission as a tax concept, and allow rescission to undo the tax effects of the initial transaction, provided two requirements are met:

- The initial transaction and the rescission must 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*.

In Rev. Rul. 80-58, 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 of Year 1, Jack, a calendar-year taxpayer, sold Jill real estate ("the Property") and received cash from Jill for the entire purchase price. Pursuant to their contract, if Jill could not have the Property re-zoned for certain business purposes within nine months of the February Year 1 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 of 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.

Spanning 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 of Year 2, Jill notified Jack she could not have the land re-zoned. In February of Year 2, Jack accepted reconveyance of the Property and refunded the sales price.

Jack had to report the sale 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 agreed the 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 in Year 1.

A Rose Is a Rose?

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." Rescission may be achieved:

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

Many taxpayers have sought to squeak by Rev. Rul. 80-58's two-prong test. In *R.L. Hutcheson*, the Tax Court refused to give effect to an attempted rescission because both requirements were not met. [71 TCM 2425, Dec. 51,234(M), TC Memo. 1996-127.] 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.

But sometimes misunderstandings occur, and this one was a whopper. The Merrill Lynch representative understood that she should sell 100,000 *shares* of Hutcheson's Wal-Mart stock (rather than $100,000 worth), which is what she did. Because of the misunderstanding, a subsequent dispute developed between Hutcheson and Merrill Lynch.

To resolve the dispute, 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.

Back to Square One?

Hutcheson wished to characterize the latter December 28, 1989, transaction as a rescission with respect to 96,600 shares that were erroneously sold by Merrill Lynch in January 1989. The Tax Court agreed with the IRS that buyer and seller must both be returned to their original positions. This did not happen with Hutcheson (the seller) and the January 1989 buyers of his Wal-Mart stock.

After all, the buyers in the January 1989 transaction were not returned to the *same* position as a result of the December 1989 transaction. In the latter 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.

Furthermore, prior to the January 1989 transaction, Hutcheson did not owe $1.35 million to his father, while Hutcheson did owe his father that amount as a consequence of the December 1989 transaction. As such, the buyers and sellers in the January 1989 transaction were not returned to their original positions.

Recent Rulings

In LTR 200952036 (Sept. 23, 2009), the IRS determined that its rescission authority would apply even though it was by no means clear that what was occurring was *actually* a rescission. Reduced to simplicity, a partnership converted into a corporation. Shortly thereafter, the corporation was converted into an LLC. The letter ruling concludes that such a transaction qualified as rescission for tax purposes, even though the parties *really* didn't go back to square one.

After all, before the transaction, individuals held interests in a partnership. After the purported "rescission," they held membership interests in an LLC. To my mind, that's different.

Of course, perhaps this is splitting hairs. Indeed, a partnership is taxed as a partnership, as are most LLCs. As a result, a partnership (taxed as a partnership) and an LLC taxed as a partnership are arguably the same thing for tax purposes. Still, prior rescission authorities have seemed to take the *status quo* ante threshold requirement as a literal one.

In LTR 200952036, the limited partnership operated three distinct lines of business.

To attract potential investors, the limited partnership converted into a corporation under state law, with the former partners receiving shares in the new corporation. The corporation then issued options to employees.

Shortly thereafter, though, the corporation cancelled the options, determining (in a way) that it should go back to square one. The reason was that, contrary to expectations, the conversion of the limited partnership into a corporation turned out not to attract investors.

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The corporation planned to "rescind" by filing a Certificate of Conversion with the state, converting the corporation into a limited liability company. 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 had rights, preferences and restrictions that were substantially similar in all material respects to the corresponding interests in the corporation (and before that, to the original corresponding interests in the limited partnership).

Should It Matter?

The $64,000 question here, of course, 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, no longer a limited partnership. The ruling suggests it is significant that this was not done for tax reasons, and that the rescission would allow the converted LLC to file a partnership tax return uninterrupted from its status as a limited partnership. In other words, despite the admitted structural and legal difference between an LLC and a limited partnership, for federal income tax purposes they are identical.

Another recent letter ruling, LTR 201008033 (Nov. 20, 2009), involved a Parent that owned all of the stock of Acquiring, which in turned owned all of the stock of Sub. Sub is a controlled foreign corporation. Acquiring also owned all of the stock of Target. Acquiring was a member of parent's consolidated group, as was Target.

Target was formed by Acquiring to hold an interest in Target-Sub. Portions of Target-Sub were owned by unrelated persons. In connection with forming Target-Sub, Target committed to make loans to Target-Sub. In partial satisfaction of that loan commitment, Target loaned Target-Sub money in exchange for a promissory note.

However, because Target had no material assets other than its interest in Target-Sub, the money was first loaned to Target by Acquiring, and then to Target-Sub.

For valid business reasons, Target and unrelated persons contributed all of their Target-Sub debt to Target-Sub in exchange for Target-Sub stock. Thereafter, Acquiring contributed the Target notes to the capital of Target. This contribution was in contemplation of a transfer of the Target-Sub ownership interest to Sub.

Finally, pursuant to a share purchase agreement, Acquiring sold all of the stock to Sub for cash. The idea of this series of transactions was to provide Sub with certain benefits that would result from owning Target-Sub. Originally, Target was to sell its interests in Target-Sub directly to Sub for cash.

However, there were concerns that such a sale would violate Parent's third-party debt covenants. Accordingly, the parties had Acquiring sell its stock in Target to Sub. Parent was advised by its counsel that such a sale would not violate any of its debt covenants.

Unbake the Cake

After the sale was completed, Parent was advised by its tax advisors that the sale would result in unintended and adverse tax consequences to the group. At that point, Acquiring and Sub entered into a rescission agreement, calling the share purchase agreement null and void. The rescission agreement was explicit that neither Acquiring nor Sub would have any enforceable rights or obligations under the share purchase agreement.

Moreover, the existing certificates representing shares of Target's stock issued in Acquiring's name would continue to be valid. Acquiring would have no obligation to deliver Target stock certificates to Sub. In all, the parties agreed to treat this as a rescission of the share purchase agreement and not as an acquisition of Target stock by Sub (followed by a reacquisition of the Target stock by Acquiring).

Following the rescission, Parent undertook the following: First, Target converted under state law to an LLC. Then, pursuant to a new agreement, Acquiring sold its interest in Target LLC (the new LLC) to Sub for cash. This conversion was intended to qualify as a reorganization.

The taxpayer requested a whole slew of rulings, including C reorganization status. More pertinent to our topic here, the taxpayer also asked for a ruling that the original sale would be disregarded. Because dates are deleted, the exact timing of all of the steps is not clear. However, it looks as if everything was fixed within the timetable enunciated in Rev. Rul. 80-58. That made the rescission effective for tax purposes.

Conclusion

Rescission is hardly a tax planner's panacea. Indeed, you almost invariably are fixing a mistake (or more exactly, something that turned out to be a mistake viewed in hindsight). Yet for those of us fascinated by the rescission concept and its possibilities for tax purposes, it's comforting to collect rescission authorities. Plus, LTR 200952036 may suggest a broadening—even if only a slight one—of the rescission doctrine available to taxpayers who make mistakes and try to fix them.