You can unwind the deal, but not necessarily the taxes

By Robert W. Wood

Occasionally we all want to start over and try again, but can you ever go back? It should be simple, but sometimes it can feel like putting spilled milk back in the bottle. Still, once in a while we all have to undo a deal, either because we want to or because the other side forces it.

We may call it a do-over on the schoolyard or athletic field, but the pertinent legal doctrine is *rescission.* It has had a storied tradition in contract law and real estate law and can be done consensually or by court order. Going back to square one may sound easy, but many legal entanglements must be unraveled. One that can be terribly important to your bottom line is the tax impact.

Suppose you sell your house but six months later you undo the sale, refund the money and take the house back. Did you ever sell it? Suppose you buy stock, but the company later unwinds the offering and refunds your money. Was it two transactions for tax purposes or none? Plug in some numbers and you can see just how important this can be.

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You also might be surprised how frequently the tax impact of such flip-flops arises. The IRS has generally maintained a consistent position over the years on what it's willing to do on your taxes. However, these days some taxpayers and advisers seem to be pushing the envelope about how far the concept of rescission can be stretched.

First, the basics. The IRS has long recognized that transactions can be unwound. If you meet IRS guidelines, it's as if it never happened for your taxes. Even the IRS admits that it's unfair to tax many such circumstances as two separate transactions. It's more appropriate to simply regard it as never having occurred.

But the IRS says you must meet two tough conditions. First, all parties must go back to their respective positions before the transaction—to the status they occupied as if the deal never occurred. Rescission isn't one-sided. Second, the go-back must occur in the same tax year as the original deal. *See* Rev. Rul. 80-58; 1980-1 C.B. 181. It's this latter requirement that is often the biggest problem. Sure, sometimes parties agree to undo a sale before year-end. A contract deal inked in February or March might have soured by September or October, and can be unwound in November before the end of the same year.

But the later in the tax year the deal is originally struck, the slimmer the chances of undoing it in the same year. Besides, legal disputes take time. If there's a dispute between buyer and seller—say you sell your house and the buyer sues for rescission claiming the house is infested with mold—it's unlikely to be resolved immediately. That often means that any unwinding of the deal is in a subsequent tax year, perhaps even *several* years later. Because of such timing issues, it can be tempting to push the proverbial envelope. Some taxpayers who don't meet the IRS's second criteria may still feel OK about unwinding a deal during the year *after* the original deal, as long as they do it before they file their tax return for the year of the original deal.

After all, they reason, the sale hasn't even been *reported* yet, and can still be unwound. They may take the position that their do-over qualifies for the tax doctrine of rescission even though the go-back happens early in the year *after* the original deal.

Suppose you sell your van to your brother-in-law for $25,000 in September of 2012 for use in his delivery business. He has some legal problems and you agree to unwind the sale. He gives you the van back in May of 2013 and you refund his money. Although your 2012 tax return was due April 15, 2013, you went on extension, so you haven't yet filed your 2012 return when you take the van back.

When you file your 2012 tax return in August of 2013, can you treat this sale as never having occurred? Some advisers answer yes, but the IRS would say no. There's a slim reed of authority to support those advisers, but probably not enough to beat the IRS in court.

Some taxpayers may count on the fact that if they can tidy up the transaction and go back to square one before they—or the other side of the deal—files a tax return, who's to know? Remember, any rescission involves at least two parties. Even in this simple van sale example, what if your brother-in-law has already filed his 2012 tax return before the rescission, perhaps even depreciating or expensing the van?

In more complicated deals, there may be many parties involved. Besides, going outside the one-year rule is dangerous. Of course, even if you are several years after the original deal, you can still rescind a transaction. You just have to treat the original deal and the later "rescission" as two separate, (and taxable) events. Paying a tax both times can be painful.

Apart from pushing the envelope with timing, some transactions raise other questions of degree. For example, do *all* parties to the deal have to go back? Unfortunately, yes. And does going back literally mean *everything* must be the same? Generally, yes, but on this point even the IRS may be loosening up.

In several IRS private letter rulings, the IRS has approved rescission for tax purposes even though the parties didn't *exactly* go back to square one. In IRS Letter Ruling 200952036, a partnership was converted into a corporation, and was then converted back to a limited liability company (LLC). The partners didn't entirely go back to square one: when the smoke cleared they were members of an LLC, but not partners in a partnership.

An LLC is not *exactly* the same as a partnership, but the IRS agreed to treat the transaction as rescinded and as having no tax affect. This is an encouraging sign. Conversely, the IRS may be tightening up in some respects. Starting in 2012, the IRS will no longer issue private letter rulings on rescission. *See* Rev. Proc. 2012-3, 2012-1 I.R.B. 113.

So can you go back? Sometimes, yes, even for tax purposes. Still, be careful out there.

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