Can Rescission Cure Constructive Receipt?

By Robert W. Wood

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Rescission as a legal doctrine is a tax lawyer's dream, allowing one to undo something and start anew. The IRS approves of it under limited circumstances. Addressing settlements of lawsuits, Wood considers rescission as a possible cure to the tax doctrine of constructive receipt.

Constructive receipt is one of the bedrock principles of our federal income tax law. Under the constructive receipt doctrine, a taxpayer cannot turn his back on income. Unlike some other fundamental tax doctrines (such as discharge of indebtedness), even lay people tend to understand constructive receipt. You can't turn down a paycheck, at least not without incurring tax consequences.

This overarching doctrine is solely a creature of the cash method of accounting. Under the accrual method, there is no need for constructive receipt. After all, the accrual method assumes that income is taxed when the right to the income matures, even if payment is made much later. The constructive receipt doctrine imports one of the fundamental precepts of accrual accounting to cash method taxpayers.

Thus, for individuals and other taxpayers on the cash method of accounting, there are limits. If they try to manipulate the cash method in inappropriate ways, they face being put on the accrual method for some purposes. One of the classic examples of constructive receipt involves a taxpayer invoicing a buyer or employer but then telling the payer not to remit payment until later.

''Please pay me in January,'' the taxpayer asks in December. We know this manipulation of income is not allowed for tax purposes. The taxpayer is treated as receiving income when the right to the income has matured, even if he is not paid until much later.

The constructive receipt doctrine is commonly encountered when dealing with litigation recoveries. For example, plaintiffs may want to structure their recoveries or plaintiff's attorneys may want to structure their legal fees over time. They should monitor constructive receipt to ensure that the structures can be implemented.

If a plaintiff's lawyer has already received funds in his trust account, it will no longer be possible for the client to structure the recovery or for the lawyer to structure his fees. There is *actual* receipt in this example, not merely constructive receipt. Once you have cash, it is too late to agree to be paid over time. The lawyer is considered the agent of his client, so both the lawyer and his client have receipt of the money. In the same way, if you sell your house for cash, it is too late to say you want to be paid in 10 annual installments.

But suppose we take a step back in time from this situation. Assume that a settlement agreement for cash has been signed but the money has not yet been paid. Shortly after signing, the plaintiff decides he wants to structure the settlement so he will receive a stream of periodic payments.

This situation does not involve actual receipt because the money has not yet been paid. But with a signed settlement agreement, it sounds more like constructive receipt. Is it too late? Most tax advisers, structured settlement brokers, and life insurance companies would probably say it is.

Even though there has been no actual receipt of the funds, all of the events necessary to receive the money — including the plaintiff's signing of the settlement agreement and releasing of his legal rights — have occurred. Because the settlement agreement calling for all cash has been signed, the plaintiff has the right to the money in cash. Hence, the plaintiff can no longer sign structured settlement documents and know that the periodic payments under the structure arrangement will be taxed only when and as the payments are received.

Although structured settlement divisions of the life insurance companies compete aggressively for structured annuity business, I doubt any life insurance company would write a structure on these facts. Constructive receipt has already attached.

But could the plaintiff and defendant agree to rescind the original settlement agreement (calling for cash) and sign a new one a few days later calling for periodic payments? Many tax advisers, litigation lawyers, and structured settlement professionals may still answer that it is too late. After all, constructive receipt is a threshold doctrine. In that sense, it may seem to be a one-way street.

Once you have constructive receipt, we have been led to assume, the taint never goes away. However, on closer examination, I find this to be flawed logic. Indeed, if one can sometimes cure *actual* receipt of money in hand via rescission, shouldn't one be able to cure *constructive* receipt in the same way? Surely constructive receipt can be no worse than actual receipt.

The primary IRS authority dealing with rescission is Rev. Rul. 80-58,[1] enunciating the Service's position on rescission and its tax consequences. Rescission can undo the tax effects of a transaction if two requirements are met by:

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

Defined Terms and Timing

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.''[2] The rescission may be achieved by:

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

Rev. Rul. 80-58 considered two situations involving the sale of land. 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 first case, the transaction and its rescission are essentially treated as tax nonevents, so no gain or loss is recognized.

In the latter case, while the money was repaid and the transaction was unwound, the IRS refused to disregard the annual accounting concept. Thus, the original seller in the transaction had to report the sale in year 1, even though he reacquired the property in year 2. He would take a new cost basis in the property in year 2 equal to the price paid to the buyer for the reconveyance.

Case Law

Rev. Rul. 80-58 relied heavily on a 1940 Fourth Circuit opinion, *Penn v. Robertson*.[3] Of course, federal income taxation requires annual returns and accounting. The Fourth Circuit explained that with cash basis accounting, the taxpayer receives income for tax purposes when he actually or constructively receives an amount that is definitely ascertainable and that is subject to his unrestricted control.

In *Penn*, the Fourth Circuit held that income should be determined at the end of each tax year without regard to subsequent events. Thus, the IRS applied this rigid view of rescission in Rev. Rul. 80-58 with a focus on a single year. By and large, the courts agree.

Most of the interesting questions surrounding rescission concern the outer limits of time (when can one go beyond one year?) and of circumstance (does absolutely everything need to go back to the status quo ante?). For example, in *Hope v. Commissioner*,[4] the Tax Court rejected a seller's attempt to postpone the recognition of gain even though he had sued to rescind the transaction in the year of the sale. In 1960, Hope sold his shares in a local corporation at a substantially undervalued purchase price. Later that year, Hope sued the buyers to rescind the transaction.

The case was settled in 1961. Hope argued that he should not 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 Hope's lawsuit as a mere request for rescission.

Hope had still received the purchase price in 1960. Moreover, he had an unrestricted right to use the money as he pleased despite the filing of the lawsuit. The filing of Hope's lawsuit, albeit in the same tax year, was insufficient to rescind the sale for tax purposes.

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[1] 1980-1 C.B. 181.
[2] *Id.*

[3] 115 F.2d 167 (4th Cir. 1940).
[4] 55 T.C. 1020 (1971), *aff'd*, 471 F.2d 738 (3d Cir. 1973).

Moreover, in *Hutcheson v. Commissioner*,[5] the Tax Court refused to give effect to an attempted rescission that the taxpayer argued satisfied the requirements of Rev. Rul. 80-58. The court held that because the parties were not returned to exactly the same positions they had occupied before the original transaction, the requirements of the revenue ruling were not met.

Richard Hutcheson and his wife opened a cash management account with Merrill Lynch in 1983 that contained only shares of Wal-Mart stock. His account manager told Hutcheson that he needed to reduce the amount owed in his margin account, so he sold shares of Wal-Mart stock. In late December 1989, Hutcheson reopened his account at Merrill Lynch, which agreed to add nearly $2.95 million to his margin account. Using those funds, plus $1.35 million that Hutcheson borrowed from his father, Merrill Lynch purchased (at Hutcheson's direction and on his behalf) 96,000 shares of Wal-Mart common stock, albeit not the same shares of stock he had purchased in January 1989.

Hutcheson tried to characterize the December 1989 transaction as a rescission of shares erroneously sold in January 1989. Hutcheson likened his situation 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 for tax purposes, the same buyer and seller must both be put back in their original positions.

Although Merrill Lynch was the buyer in the December 1989 transaction, the company had merely acted as an agent, not as a buyer, in the January 1989 transaction. Further, before the January 1989 transaction, Hutcheson did not owe $1.35 million to his father, which he did as a result of the December 1989 transaction.

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

However, not all fact patterns are as rigid as Rev. Rul. 80-58. One of the best examples is *Guffey v. United States*,[6] a case predating Rev. Rul. 80-58. The Guffeys sold their residence in 1951. In 1952, the buyers sued the Guffeys to rescind the transaction.

In 1954, the parties settled and the buyers reconveyed the residence to the Guffeys, who immediately sold it to a new purchaser. In determining the tax consequences emanating from these transactions, the Ninth Circuit ultimately concluded that the initial sale in 1951 was a nullity for tax purposes.

The court's decision suggests that rescissions occurring after the tax year of the original transaction sometimes may be given effect. However, case law extending the rescission doctrine beyond the limits of Rev. Rul. 80-58 is rare.

Settlement Agreements

Although legal settlement agreements are signed every day, I believe rescission of legal settlements (consensually or by court order) is rare. When rescission occurs *and* gives rise to case law, we can probably assume one party doesn't like it. If a plaintiff is trying to abrogate a settlement agreement (presumably to return all the settlement money), the defendant may object. The defendant wants the case resolved, signed an agreement to do so, and is unlikely to want to reopen it.

So what do these fact patterns and authorities say about constructive receipt and rescission of settlement agreements in litigation? Perhaps not much. The litigation settlement fact pattern does not even begin to approach the interesting fact patterns and questions surrounding rescission. Yet a review of nontax case law shows that sometimes settlement agreements are actually unwound.

Sometimes a plaintiff and defendant sign a settlement agreement but amend or rescind it before any money is paid. At others, a plaintiff and defendant sign a settlement agreement, the defendant pays the money, and then they unwind the deal.

This may be most likely to happen when both parties are unhappy with the deal they struck. In *Cooper v. Cooper*,[7] 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, this dispute was contested, with rescission constituting a new legal battle. But the legal effects should be the same whether the rescission comes about by court order or by an agreement executed consensually by the parties.

Thus, consensual rescission is possible, and courts have been willing to grant mutual rescission requests in connection with settlement agreements. For example, in *IDT Telecom Inc. v. CVT Prepaid Solutions Inc.*,[8] a federal district court granted a joint

[5]T.C. Memo. 1996-127, *Doc 96-7985*, *96 TNT 53-12*.
[6]339 F.2d 759, 760-761 (9th Cir. 1964).
[7]35 A.2d 921 (D.C. 1944).
[8]No. 07-1076 (D.N.J. 2008).

rescission request based on the parties' mutual misunderstanding over material language in their settlement agreement.

To return to my premise, consider the following example:

> Plaintiff and Defendant have been litigating an auto accident case. At a late-night mediation session shortly before trial, they ultimately resolve to settle. At the mediation, they sign a term sheet saying they agree on $500,000 and that it's a binding settlement. The next morning the plaintiff hears that it's now too late to structure her recovery as she had hoped to do over her remaining life expectancy. Can she still do it?

I see no reason why not, if the defendant cooperates. After all, the term sheet may have contemplated that there would be a more comprehensive settlement agreement. Even if it did not — and even if a comprehensive and typewritten settlement agreement has been signed — where's the harm?

The first term sheet (or full-blown settlement agreement) can be rescinded. A new one calling for periodic payments can be signed. Under the doctrine of rescission, a contract for services or goods, a merger agreement, or virtually any other document or agreement can be rescinded. The parties must be put back in the positions they were in before. To fit within IRS guidelines, both events must occur in the same tax year.

With these modest limitations in mind, is there any reason why this plaintiff and this defendant cannot rescind their all-cash settlement agreement and sign one calling for periodic payments? Not that I can find or imagine. If cash can be handed back via rescission (actual receipt), then mere constructive receipt apparently can be cured in the same way.

Conclusion

Rescission is not for everyone, and the IRS guidelines are strict. Both parties must be fully restored to their prior positions. To comply with the IRS position, the transaction that went awry and the rescission must both occur in the same tax year. The documentation should be clear.

Yet for the plaintiff who is told it is now too late to structure, or that it is now too late to ask the defendant to pay settlement monies in January rather than December, rescission can offer a way out.

The defendant must be willing to cooperate because rescission typically requires the parties to agree. Many defendants would probably not agree to rescind a signed settlement agreement if it means resuming the litigation. But many defendants would probably agree to signing a document rescinding a settlement agreement if they simultaneously sign one fully disposing of the case, and paying exactly the same amount of money to a third party annuity provider (rather than directly to the plaintiff). Not all, but many.

Litigation lawyers, life insurance companies, and structured settlement brokers should consider this possibility if they find themselves hearing, ''Oops, it's too late.''