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Do-overs Work Even For Tax Purposes

Sometimes we all want to start over and try again. And sometimes we undo a deal, either willingly or not. You may call it a do-over in the schoolyard or on the athletic field, but the pertinent legal doctrine is ***rescission***, and it has had a storied tradition. Going back to square one may sound simple, but many legal entanglements must be unraveled.

One of them is the tax impact. Suppose you sell your house but six months later undo the sale, refund the money and take the house back. Did you ever sell it? Similarly, suppose you buy stock but the company later unwinds the offering and refunds your money. Was it two transactions for tax purposes or none?

You 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.

IRS Doctrine. The IRS has long recognized that transactions can be unwound. 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 conditions:

- Each party must go back to its position before the transaction as if it never occurred. Rescission isn't a one-sided deal.

- The go-back must occur in the same tax year. See [Revenue Ruling 80-58].

Timing Matters. It's this latter requirement that is usually the problem. Sometimes parties agree to undo a sale before year-end. However, if there's a dispute between buyer and seller—say you sell your house and the buyer sues for rescission claiming the house is infected with mold—it's not likely to be resolved immediately. That often means a subsequent tax year.

Tax Return Time. Some taxpayers who don't meet the IRS's second criteria will still feel OK about taking the position their rescission qualifies if the transaction is unwound before they've reported the transaction on their tax return.

Example: You sell your car to your brother-in-law for $25,000 in September of 2009 for use in his delivery business. He has some problems and you agree to unwind the sale. He gives you the car back in May 2010 and you refund the money. Although your 2009 tax return was due April 15th, you went on extension, so you haven't yet filed when you take the car back.

When you file your 2009 return in August, can you treat this sale as never having occurred? Some advisers would probably answer yes, but the IRS would say no. The reason most advisers may be a little more positive is the fact there are some tax cases in which people have beat the IRS in court.

IRS More Liberal? Even the IRS may be loosening up. In several rulings, the IRS has approved rescissions even though one could argue that the parties didn't exactly go back to square one. For example, in IRS Letter Ruling 200952036, a partnership was converted into a corporation, and then was 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 not partners in a partnership. Even though an LLC is not exactly the same as a partnership, the IRS agreed to treat the transaction as rescinded and having no tax affect. See I Love Rescission.

Caution. Any rescission involves at least two parties, and often more than that. Even in the simple car example, what if your brother-in-law has already filed his 2009 tax return before the rescission, perhaps even depreciating or expensing the car? Plus, in more complicated deals, there may be many parties. The IRS will even issue private letter rulings on rescission. If there's enough money involved to warrant it—say a major business transaction—it may be worth considering that option.

For more about rescission, see:

I Love Rescission

Presto Chango, or Successor Liability

Reconsidering Rescission

New York State Bar Association Tax Section Report on The Recission Doctrine

Can a Completed Transaction be Reversed?

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