RESCISSION:
The Tax Consequences of Undoing A Transaction

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CURRENT SCOPE OF PRACTICE

Mr. Katz's practice focuses on tax litigation, tax malpractice defense and financial litigation. He has extensive experience in federal and state appeals, having handled over 75 cases. He served five years with the Justice Department, Tax Division, where he briefed and argued numerous cases in the federal appellate courts involving a wide range of complex issues involving corporate and individual income tax, tax shelters, gift and estate tax, and tax procedure. He also briefed the government's Supreme Court victory in *Dickman v. Commissioner*, 465 U.S. 330 (1984). More recently, he has successfully handled cases in the Texas appellate courts and the Texas Supreme Court, including a series of cases involving allegations of tax malpractice. He has over 45 reported appellate opinions. Mr. Katz is a frequent speaker and writer on a wide variety of substantive and procedural tax topics.

SELECT PUBLICATIONS

Clowning Around With the UBIT, 87 Tax Notes 1277 (May 2000).

Lawsuit Recoveries and Attorney's Fees: Taxation, Reporting and Withholding, 58th Annual NYU Tax Institute (2000).

Reporting and Withholding Requirements for Litigation Settlements and Judgments, 81 Tax Notes 1265 (Dec. 1998).

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Independent Contractor or Employee? Understanding and Avoiding Tax Liabilities Based on Worker Classification, San Antonio Lawyer (Spring 1997) (co-author).
Disputing Unemployment Taxes in Texas: A Guide for Employers, Texas Labor Letter (Sept. 1996).

Procedural Rights and Remedies Under the Texas Property Tax Code, 18 St. Mary's Law Journal 1209 (1987) (co-author).

PROFESSIONAL AFFILIATIONS

Admitted, Texas, New York, U.S. District Courts for the Northern, Southern and Western Districts of Texas, U.S. Court of Appeals for the Fifth Circuit, U.S. Supreme Court, U.S. Tax Court.

EDUCATION

Columbia University, J.D. 1977 (Phi Beta Kappa, Harlan Fiske Stone Scholar); University of California, B.A. (*with distinction*) 1971. Mr. Katz is listed in *Best Lawyers in America*.

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RESCISSION: "Annulling or abrogation or unmaking of contract and the placing of the parties to it in status quo." BLACK'S LAW DICTIONARY (4th Ed. 1968) at 1472.

I. TAX PRINCIPLES

A. Annual Accounting Principle

Under the "annual accounting principle," tax liability is determined based on transactions that occur during a single taxable year and transactions in subsequent years are not relevant. See *Security Flour Mills, Co. v. Commissioner*, 321 U.S. 281 (1944). There are limited statutory exceptions. For example, a taxpayer may deduct IRA contributions made up to April 15 of the following taxable year. See also 1994 GLB LEXIS 5, concluding that IRC § 1398(b)(1), which states that no separate entity exists where a bankruptcy petition is dismissed, applies retroactively and requires amendment of prior years tax returns.

The annual accounting principle has also been applied to base tax consequences on the net result of a series of transactions within a taxable year, ignoring the intermediate transactions. See Revenue Ruling 80-58, 1980-1 C.B. 181, discussed below.

B. Claim of Right Doctrine

Under the "claim of right doctrine," a taxpayer who receives money under a claim of right and without restriction as to disposition is currently taxable even if, in a later tax year, he is required to return part or all of the money. *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931); *North American Oil Consolidated v. Burnet*, 286 U.S. 417 (1932).

II. RESCISSION

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

1. A corporation in 1929 and 1930 allotted shares of stock to its directors and officers in exchange for their notes in a bargain sale. In 1930 and 1931, a director received a dividends on the stock allotted to him, which were credited against his note. He also received income from a "employee's stock benefit fund," in both years, apparently also consisting of dividends. In late 1931, the taxpayer died. As a result of a shareholder derivative suit objecting to these transactions, the taxpayer's estate in 1931 returned the amounts credited to him in 1930 and 1931.

2. The IRS argued, and the Fourth Circuit agreed, that the amounts credited to the taxpayer in 1930 were taxable to him that year, even though he had to return them in the next year. As to the 1931 income, the court held that "the rescission in 1931 before the close of the calendar year, extinguished what otherwise would have been taxable income to Penn for that year." The court rejected the IRS' argument that the rescission was "not a genuine rescission, but really a re-sale of the stock." The court also rejected the Government's argument that the taxpayer and his estate were separate taxable entities, and since the estate effectuated the rescission, the rescission should not affect the taxpayer. The court found that the executor was the personal representative of the decedent and was acting on his behalf. The court refused to apply the annual accounting principle to the taxpayer's short taxable year ending on his date of death, without real explanation.

3. One judge concurred, but noted that, had the transaction not been voidable, but had been void initially, no income should have resulted in any either year, stating "no taxable income could possibly result from void entries of credit on a void note."

B. Estate of Crellin v. Commissioner

In *Estate of Crellin v. Commissioner*, 17 T.C. 781 (1951), aff'd, 203 F.2d 812 (9th Cir. 1953), a corporation's board of directors were told by their accountant that it had to make a dividend to avoid a personal holding corporation surtax. Accordingly, the corporation declared and paid a dividend on its stock. Later that same year, the board learned that the advice was erroneous and issued a resolution declaring the dividend rescinded and, notified the shareholders that the dividends should be returned to the corporation. The shareholders returned the amounts they had received that same year.

The Tax Court held that the shareholders were taxable on the dividend, reasoning that the corporation had no legal power to rescind it under applicable corporate law. The court found their repayment of the funds to the corporation to have been voluntary and, therefore, a capital contribution. On appeal, the Ninth Circuit affirmed, noting that had the corporation been able to compel the repayment, it would have found the rescission effective for tax purposes, but since the corporation did not have that power, the shareholders were taxable on the dividend. Neither opinion cited *Penn v. Robertson*.

The Tax Court noted that under state law, "a dividend which has been lawfully declared and paid cannot be rescinded by the corporation without the consent of the stockholders." 17 T.C. at 785 (emphasis supplied).

> Query. Didn't the shareholders implicitly consent to the rescission? Would the result have been different had the shareholders formally consented to rescission of the dividend? See Part II (D) 2, below.

C. Revenue Ruling 80-58, 1980-1 C.B. 181

The Internal Revenue Service held that where a transaction is rescinded in the same year in which it occurred, the transaction will be ignored for tax purposes. In the ruling an individual sold land to another. In situation (1), in the same year as the sale, the parties agreed to rescind the transaction and convey the land back to the seller. In situation (2), the facts were the same, but the rescission occurred in the following tax year. Citing *Security Flour Mills,* the IRS stated (at 182):

> The annual accounting concept requires that **one must look at the transaction on an annual basis using the facts as they exist at the end of the year.** That is, each taxable year is a separate unit for tax accounting purposes.

(emphasis supplied).

The IRS then analyzed *Penn v. Robertson* and ruled that, where the reconveyance takes place in the same year as the original transfer, the original sale is to be disregarded. The rescission extinguishes any income from the sale. If, however, a reconveyance occurs in a later year, the original sale is recognized. Any gain or loss to the seller must be reported in the year of the sale. On the reconveyance, the original seller reacquires a basis in the property equal to what he pays for the reconveyance.[1]

Private Letter Ruling 9408004 (Nov. 10, 1993) reaffirmed the conclusions reached in Revenue Ruling 80-58, stating:

> There are at least two conditions that must be satisfied for the remedy of rescission to apply to prevent current recognition of the gain from the disposition of the capital asset: (1) the parties to the transaction must return to the *status quo ante*; that is, they must be restored to "the relative positions they would have occupied had no contract been made"; and (2) this restoration must be achieved within the same year.

Another Private Letter Ruling recognizing the principle is LTR 9140487 (July 16, 1991), where the Service stated:

> It is well settled under general federal income tax principles that a transaction, including a sale of property, will be disregarded if the transaction is rescinded (whether by mutual agreement, court order or other appropriate means) before the end of the taxable year in which the sale occurred.

See also LTR 9104039 (Oct. 31, 1990) (employees received restricted stock and made Section 83(b) elections; later the same year determined that stock had been seriously undervalued; stock returned by agreement; held, valid rescission).

> Query. Is Revenue Ruling 80-58 contrary to *Estate of Crellin*?

The principle in Rev. Rul. 80-58 that a transaction is taxed based on the facts as they exist at the end of the taxable year is extremely important. It has been applied in various circumstances. See, for example, Part III below where a taxpayer is taxed on his net income for the year. See also Part IV(C) below. See also *Schenk v. Commissioner*, 686 F.2d 315, 319, n. 20 (5th Cir. 1982) (income tax is determined "on the basis of annual returns showing the net result

[1] Revenue Ruling 80-58 appears to be based on LTR 7802003 (Sept. 28, 1977).

of all the taxpayer's transactions during a fixed accounting period") (emphasis supplied). But see GCM 38426 (June 26, 1980), ruling that collectability of interest, for accrual purposes, is determined at the time the right to receive interest becomes fixed, and not at the end of that tax year.

1. Parties Must Be Restored to Status Quo Ante

In *Hutcheson v. Commissioner*, 71 T.C.M. 2425 (1996), the court examined a taxpayer's sale of Wal Mart stock in January 1989, followed by the December 1989 repurchase of an equivalent amount of stock. While the court recognized and applied the principles discussed in Revenue Ruling 80-58, it held that a rescission had not taken place because the stock repurchased in December of that year was not the same shares of stock sold in January.

The requirement that the parties be restored to their pre-transaction circumstances may raise issues. In Revenue Ruling 78-119, 1978-1 C.B. 277, a B reorganization was unwound, but the parties kept dividends that had been paid on the returned stock during the time they held it. The IRS ruled that the parties had not been restored to their prior situation and therefore the rescission was ineffective and they would be taxed as two separate transactions. In contrast, in Revenue Ruling 80-58, which involved cash consideration, the IRS did not require that any earnings on the cash be returned.

2. Is Tax Motivation Relevant?

Estate of Gacek v. Commissioner, 53 T.C.M. 1342 (1987), involved a sale of an apartment building which, unknown to the seller at the time of the sale, would have resulted in "a significant tax problem due to depreciation recapture." The seller consulted with his tax attorney and was told that "if the sale were rescinded in the same tax year, the tax consequences would be nullified." Both the taxpayer and the Commissioner agreed that "if a rescission occurred in 1977, its effect would be to nullify the tax impact of the June 1977 sale." The disputed issue in the case, whether a rescission had in fact taken place, was decided against the taxpayer because of insufficient evidence.

In LTR 9829044 (Apr. 21, 1998), the IRS ruled that a complete unwinding of a transaction would result in it being ignored for tax purposes, even though the rescission was purely tax motivated. The taxpayers had contributed an S corporation (X) to another S corporation (Y) and intended to make a QSSS election for X, the new subsidiary. However, after the contribution, the taxpayers' accountants advised that the subsidiary had a large suspended loss which might be lost if the QSSS election were made. The IRS ruled that, if the X stock were distributed back to the shareholders the same year, the transaction would be completely ignored for federal tax purposes.

3. Different Tax Years

Interesting questions arise where the parties who seek to unwind a transaction have different tax years and the unwind is complete within one party's tax year, but not the other's. Because a taxpayer's tax liability is in general determined by reference to the taxpayer's own circumstances, and not those of other persons, I believe that each party should be considered independently. If the unwind occurs within one party's tax year, it would be complete and the transaction would be ignored for him, but the other party would have two separate transactions for tax purposes. Cf. *Fender Sales, Inc. v. Commissioner,* 22 T.C.M. 550 (1963), rev'd on other issues, 338 F.2d 924 (9th Cir. 1964), where an employer accrued compensation to its employee in year 1, which was paid in year 2. The employee repaid most of the compensation in year 2. The Tax Court held the employee was taxable on the net amount received and the employer properly deducted the compensation in year 1, although it was returned in year 2.

III. TAXING THE NET MONEY FLOW WITHIN A TAXABLE YEAR

A. General

As noted above, courts and the IRS have sometimes applied the "annual accounting principle" so as to base tax consequences on the net effect of a series of transactions that occurred within a single taxable year. This is most evident in compensation and loan transactions. However, the principle has not consistently been applied in those situations and has often been ignored in other analogous situations where it might appear to apply.

B. Compensation Returned

Where a taxpayer receives compensation, but within the same taxable year returns a portion of that compensation to his employer, it has long been held that the employee is taxable on the net amount received, and is not taxable on the portion returned. See *Hill v. Commissioner*, 3 B.T.A. 761 (1926) (the effect is a modification of an existing salary agreement and substitution of a new agreement), acq. 1926-1 C. B. 3; *Couch v. Commissioner*, 1 B.T.A. 103 (1924) (same), acq. 1925-1 C.B.1; *Fulton v. Commissioner*, 11 B.T.A. 641 (1928) (president agreed to return salary if corporation faired poorly; not taxable), acq. 1928-1 CB. 11; *Revenue Ruling* 79-322, 1979-2 C.B. 76 (return of sick pay; employee not taxed). As the Tax Court stated in *Fender Sales, Inc. v. Commissioner*, 22 T.C.M. 550, 559 (1963):

> This Court has adopted and consistently followed the legal proposition that where prior to the close of the taxable year there has been an adjustment of the contract or obligation and a repayment of a portion of the amount received, the tax liability is to be determined on the basis of such adjusted amount....

(citations omitted).

If the amount is returned in a subsequent taxable year, the original year is not affected, although the taxpayer may be entitled to a deduction in the year of repayment. See *Jones v. United States*, 88-2 U.S.T.C. ¶ 9455 (S.D. Ca. June 22, 1988); Rev. Rul. 79-322, *supra;* IRS Pub. 15, Circular E, Employer's Tax Guide (rev. Jan 2002), 26:

> Wage Repayments
> If an employee repays you for wages received in error, do not offset the repayments against current-year wages unless the repayments are for amounts received in error in the current year.

Although the cited authorities typically involved non-tax motivations, e.g., mistake or the employer in hindsight could not afford the compensation, etc., Revenue Ruling 79-322 appears to have involved at least in part a tax motivation. There, an employee had received sick pay, and later in the year qualified retroactively for non-taxable Workmens' Compensation income, but "as a condition precedent" to receiving the tax exempt income was required to buy back sick leave used earlier.

C. Loans and Repayments

In a variety of circumstances where there have been a series of loan advances and repayments between persons in a single taxable year, the tax consequences may differ significantly if each advance and repayment is viewed separately or if one looks instead at the net money flow during the taxable year.

This issue arises, for example, where amounts have been recorded as loans and repayments between a corporation and shareholder, and the payments to the shareholder are later determined to be taxable dividends. In such circumstances, the Tax Court has looked to the net amount transferred to the shareholder during the taxable year. See *Epps v. Commissioner*, 70 T.C.M. 1 (1995) and *Stovall v. Commissioner*, 46 T.C.M. 894, 901-902 (1983), aff'd 762 F.2d 891 (11th Cir. 1985). As stated in *Jones v. Commissioner*, 74 T.C.M. 473, 481 (1997), aff'd, 99-1 U.S.T.C. ¶ 50, 389 (11th Cir. Mar.17, 1999):

> Federal income tax is computed on the basis of an annual accounting. Sec. 441; *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931). Consistent with annual accounting, *Epps* and *Stovall* hold that the distributed amount is the net amount distributed *each* year, not the net amount distributed over multiple years. . . .

Another circumstance where a tax issue may arise is where an S corporation has borrowed money from its shareholders and, through losses, the basis of the debt has been decreased. If the corporation were to repay the debt, income or gain would result. See Rev. Rul. 64-162, 1964-1 (Part I) C.B. 304. However, if, after the corporation has paid a part or all of the loan, later in the same tax year the shareholder re-lends the corporation money, the tax consequences would differ or be eliminated if one looked to the net transaction. But see *Cornelius v. Commissioner*, 58 T.C. 417 (1972), aff'd, 494 F.2d 465 (5th Cir. 1974) (after loan paid off in January, subsequent loan was treated as a separate transaction).

D. Dividends

Although the treatment of dividends arguably should be the same as compensation or loans, i.e., shareholders should be taxed on net amount, a few courts have disagreed.

1. Dividends Netted

In cases involving corporate diversions, the courts have held that shareholders are taxable on the net amount diverted from a corporation, less any repayments. See *Foster v. Commissioner*, 391 F.2d 727, 739 (4th Cir. 1968); *Leaf v. Commissioner*, 33 T.C. 1093, 1096 (1960) (taxpayer not taxed on the "portion of the diverted funds" returned to the corporation the same year), aff'd, 295 F.2d 303 (6th Cir. 1961).

2. No Netting

See *Estate of Crellin*, supra, holding that, for repayment of a dividend to result in the dividend being ignored, the corporation must have legal power to compel its rescission. Cf. *Soreng v. Commissioner*, 158 F.2d 340 (7th Cir. 1946), where the court held that shareholders were taxable on dividends they returned to their corporation the same year they were paid. The repayment was required by a corporate creditor and the borrowed funds used to redeem other shareholders.

In *Chapman v. Commissioner*, 44 T.C.M. 35 (1982), a corporation declared dividends to its shareholder in 1973 and 1974. The shareholder applied those dividends against his outstanding loan balance to the corporation. In 1974, the IRS began an examination of the 1973 tax return. The shareholder told the agent that since no money had changed hands between him and the corporation, he would "erase" the declared dividends from the corporation's books and would restore the loan to its original balance. The Tax Court held this was ineffective, as to both tax years, stating:

> When a dividend has been declared and paid, it is income to the recipient shareholder. This is true even if the recipient shareholder immediately restores the amounts he has received to the distributing company pursuant to a prior agreement, by his own initiative, or upon request of the issuing board of directors. See *Crellin's Estate v. Commissioner*, 203 F. 2d 812 (9th Cir. 1953); *Soreng v. Commissioner*, 158 F. 2d 340 (7th Cir. 1946); *Barnhardt v. United States*, 98 F. Supp. 552 (D.N.C. 1951); *Swanson v. Commissioner*, 2 B.T.A. 1112 (1925). …

IV. MODIFYING A TRANSACTION

A. General

Where a transaction has been entered into, but is modified subsequently, this could be treated as (1) a single, changed transaction, (2) two separate transactions each with tax consequences or (3) a sham, with the result that the original transaction is not charged. For example, in general, a negotiated or legislated change in the terms of a bond, if significant, may be treated as an exchange of instruments resulting in a taxable gain or loss. *See, e.g.*, *Emery v. Commissioner*, 8 T.C. 979 (1947), aff'd, 166 F.2d 27 (2nd Cir. 1948). See generally Reg. Sec. 1.1001-1(g). But what if the issuance of the bonds and the modification both occur in the same tax year?

B. *Court Holding Co. v. Commissioner,* 2 T.C. 531 (1943), rev'g 143 F.2d 823 (5th Cir. 1944), rev'd, 324 U.S. 331 (1944)

Court Holding Company was owned by an individual and his wife. The corporation acquired an apartment building. The shareholders reached an oral agreement to sell the property to another. They went to their attorney to have the oral agreement reduced to writing, but the contract was never executed. The attorney advised against having the corporation sell the property, because that would result in a taxable gain at the corporate level and a subsequent gain on distribution. Instead, he advised the corporation should declare a dividend of the property and the shareholders should then sell the property. The shareholders adopted a resolution, had the property conveyed to them and subsequently drafted a contract selling the property to the new purchasers.

The IRS determined that the corporation was taxable on the sale and asserted the fraud penalty.

The Tax Court found that the corporation in fact had made the sale and was taxable on it. The court first concluded that the shareholders had been acting on the corporation's behalf and that the corporation subsequently ratified the contract and in fact received a payment of $1,000 of the purchase price. The court thus stated that the corporation, "having entered into a oral contract to sell its property, and having received payment of the part of the agreed price, at the last moment, and admittedly for the sole purpose of avoiding taxes, distributed the property to its stockholders who promptly thereupon bound themselves in writing to perform individually the act which they had theretofor agreed to perform as a corporation." *Id*. at 538.

The Tax Court reached this conclusion, despite the fact that under Florida law, the oral contract was unenforceable, even if a partial payment of the purchase price had been received. *Id*. at 538. Instead, the court found that the statute of frauds issue was avoided since the shareholders' deed was in fact the deed of the corporation and binding on it, even though "not formally authorized." The Tax Court, however, rejected the imposition of the fraud penalty, finding that the corporation apparently acted in good faith and disclosed the substance of the transaction on a statement attached to its return.

The court of appeals reversed, finding that since there was only an oral contract to sell real estate the corporation was not bound and "was free . . . to declare that it would not go forward the sale, for any reason or no reason. It did so declare, and thereafter there was not even a oral contract." A dissent found the case to be a "borderline tax avoidance case[s] in which it is only by the skin of its teeth, if at all, that a family holding corporation has escaped taxes... "

The Supreme Court again reversed the case. The Court's primary rationale was simply to uphold a factual finding of the Tax Court as to who made the sale: "There was evidence to support the findings of the Tax Court, and its findings must therefore be accepted by the [appellate] court." The Court dismissed the fact that an oral agreement to sell real estate is not enforceable, again relying on the Tax Court's finding that "the executed sale was in substance the sale of the corporation."

C. Modification to Sales Price

Instructions to Form 8594 "Asset Acquisition Statement Under Section 1060" (Revised 7/98) provide:

> If an increase or decrease in consideration that must be taken into account to redetermine the seller's amount realized on the sale, or the buyer's cost basis in the assets, occurs after the purchase date, the seller and/or buyer must allocate the increase or decrease among the assets. **If the increase or decrease occurs in the same tax year as the purchase date, consider the increase or decrease to have occurred on the purchase date.** If the increase or decrease occurs after the tax year of the purchase date, consider it in the tax year in which it occurs.

(emphasis supplied).

V. ABANDONING CLAIM OF RIGHT

Where a taxpayer initially receives money or property under a claim of right, but later in the same tax year, gives up the claim of right in favor of another, the courts have held the income is not taxable. For example, in *United States v. Merrill*, 211 F.2d 297 (9th Cir. 1954), a taxpayer received $7,500 purportedly due him as an executor's fee from his wife's estate. It was later determined that same tax year that the amount had been paid erroneously and on December 31 of the same year, book entries were made showing that the taxpayer owed that amount to the estate. The appellate court analyzed the case under the "claim of right" principle, finalized that in the same tax year the funds were received, the taxpayer discovered the mistake and renounced his claim to the funds. Accordingly, the court held that he was not taxable on the money.

In *Bishop v. Commissioner*, 25 T.C. 969 (1956), acq. 1956-2 C.B. 5, a minority shareholder of a corporation complained that the corporate officers and majority shareholders were improperly diverting corporate profits to partnerships they owned. In a settlement reached on December 31, 1946, it was agreed the partnership's income in fact belonged to the corporation and all income earned since January

1, 1946 was transferred to the corporation. The Tax Court held the partners were not taxable on the income as they had "lost their claim to it in the year of receipt." *Id.* at 975.

In *Van Fleet v. Commissioner*, 2 B.T.A. 825 (1925), acq. 1925-2 CB. 5, a law firm received a contingency fee in a case, but later in the year the judgment was withdrawn and the attorneys agreed to hold the funds until the case was finally resolved and to return them if their clients ultimately lost. The court held that the funds were then held in trust for the clients and the attorneys were not taxable.

In *Buff v. Commissioner*, 58 T.C. 224 (1972), *rev'd* 496 F.2d 847 (2nd Cir. 1974), thetaxpayer embezzled monies from his employer, but in the same taxable year, the taxpayer and his employer agreed that the amount taken would be treated as a debt due to the employer. The Tax Court, holding that the taxpayer did not have taxable income in the year of the embezzlement, stated (at 232):

> In the instant case, ... the embezzlement of funds by the petitioner, his recognition of the obligation to repay the embezzled funds, and the making of arrangements for the repayment of those funds, all took place within the same taxable year. Furthermore, in the instant case, there was a consensual recognition of an obligation to repay the embezzled funds in that the petitioner, at the request of his employer, confessed judgment for the amount due.
>
> ... Where there is "consensual recognition" of indebtedness within the same taxable year, formalized by a confession of judgment, such a transaction does not result in the realization of taxable gain.

In *Fox v. Commissioner*, 61 T.C. 704, 713 (1974), the Tax Court stated the following about *Buff*:

> Thus, the crucial fact in the *Buff* decision is the consensual recognition of a debt *in the same taxable year* as the embezzlement. The significance of that fact lies in the general rule that each taxable period is to be treated as separate and independent, and items of income and deductions for one year may not be offset and adjusted in computing the tax for another year. *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931). The agreement by the employer in *Buff* to recognize and accept the confession of judgment before the end of the tax year in which the embezzlement occurred was found to prevent the realization of taxable income in that year.

VI. RETROACTIVELY CHANGING THE TAX CONSEQUENCES

As noted above, the courts have applied the rescission principle of *Penn v. Robertson* and Revenue Ruling 80-58, to provide that, to be effective, a rescission must take place in the same tax year as the original transaction. Thus, the courts and IRS have generally held that a transaction that occurred in a prior year cannot be changed by rescission in a subsequent tax year.

A. Nunc Pro Tunc Orders

A nunc pro tunc order is a ruling by a court purporting to have retroactive effect. However, the courts and the IRS have held that "not even judicial reformation can operate to change the federal tax consequences of a completed transaction." *Van Den Wymelenberg v. United States*, 397 F.2d 443 (7th Cir. 1968). See also *American Nurseryman Publishing Company v. Commissioner*, 75 T.C. 271 (1980), holding that an order of a state court voiding a transfer of stock to a trust will be disregarded for federal purposes, and *Estate of Hill v. Commissioner,* 64 T.C. 867, 875-876 (1975) (collecting cases). See generally 1993 FSA LEXIS 1992 (June 18, 1993).

However, in limited circumstances, courts have held that a subsequent court ruling may retroactively affect the tax consequences of a transaction in a prior year. For example, post hoc correction of clerical errors are given tax effect . See, e.g., *Zurn v. Commissioner,* 72 T.C.M. 440 (1996) (correction of amount of alimony payment); Rev. Rul. 71-416, 1971-2 C.B. 83 (same).

A few courts, for example, have given retroactive effect to a rescission when a transaction was void ab initio, i.e., it was declared that the transaction had no legal effect from its inception. See *Mason v. Commissioner*, 68 T.C. 163 (1977), aff'd, 646 F.2d 1309 (9th Cir. 1980), non acq. 1978-2 C.B. 4, where a shareholder of an S corporation filed bankruptcy. Under the bankruptcy statute, the stock was deemed transferred on filing to the debtor's estate, which would have disqualified the corporation for S status. In a subsequent year, the trustee abandoned the stock back to the debtor. Under bankruptcy law, that abandonment related back to the time of filing the bankruptcy petition, and was treated as if it had never happened. On these facts, the Tax Court held that the shareholder would have been treated as having always owned the stock of the corporation, and consequently, its status as an S corporation was not jeopardized. The court noted that its doctrine of relating back could conflict with the annual accounting principle, but did not speculate as to that issue for other cases. See also LTR 7824077. See further the concurrence in *Penn v. Robertson*, *supra*.

In *Neal v. United States*, 187 F.3d 626 (3rd Cir. 1999), a taxpayer had created a GRIT trust. In 1989, the IRS issued a notice addressing contingent reversionary interests and, to avoid a tax liability under that notice, the taxpayer released her contingent rights and paid the resulting gift tax. The following year, Congress repealed the statute retroactively to its date of enactment. The taxpayer brought a state court action to rescind the 1989 gifts, which was granted based on a mistake of law. The appellate court held the rescission retroactively eliminated the gifts. *Neal* obviously presents unusual and compelling facts, but does not square well with the annual accounting principle cases.

B. Retroactively Recharacterizing Transaction

Another approach is to reconsider whether a transaction in a prior year in fact occurred or occurred as previously believed. For example, where there was a purported sale of property, perhaps it could be contended that because of some defect in the sale, it had no legal effect. This approach, however, may conflict with the claim of right doctrine, under which a taxpayer will be taxable on money or property received if the taxpayer acts with a claim of right to that property or money, even if a taxpayer does not, in fact, have a legal right to the property. For example, in *Knight Newspapers, Inc. v. Commissioner*, 143 F.2d 1007 (6th Cir. 1944), a subsidiary declared a dividend to its corporate parent. The parent offset the amount of the dividend against a debt it owed the subsidiary. In the next taxable year, it was discovered that the dividend violated the rights of the subsidiary's preferred shareholders and could have been paid only if the balance sheet had a greater equity balance. That year the dividend was rescinded. The court concluded that because the dividend had been paid based on a mutual factual mistake, the parent held it in constructive trust for the benefit of the preferred shareholders. As a result, the parent corporation was not taxable in the year the dividend was declared and offset.

Query. Is *Knight Newspapers* consistent with the claim of right doctrine? Cf. *St. Regis Pager Co. v. Higgins*, 157 F. 2d 884 (2d Cir. 1946) (claim of right doctrine requires taxation despite shareholder's post hoc claim of constructive trust).

PROBLEMS

1. A sells closely held stock to B for $50,000. Later the same year, A and B decide to unwind the transaction. B gives A the stock back and A gives B $50,000. What if A doesn't have the funds and instead gives B a note? Does it matter if A is purely tax motivated? What if B asks to be paid to agree to the rescission?
Rev. Rul. 80-58, 1980-1 C.B. 181.

2. Facts same as above, but during the time B held the stock it paid a dividend of $5,000. During that same period, A received $4,000 of interest on his $50,000. Do A and B have to restore the earnings?
LTR 9829044.

3. A calls his broker and instructs him to sell $10,000 worth of company X stock (= 100 shares). The broker misunderstand and sells 10,000 shares for $1,000,000. The market price of the stock immediately skyrockets. A and broker get into dispute over the transaction and A files suit against the broker within the same taxable year. In a later taxable year, the broker settles and purchases on behalf of A 9.900 shares on the open market, which cost $ 2,000,000. Was A taxed in the first year? What could A have done to avoid taxation?
LTR 9408004; Hope v. Commissioner, 53 T.C. 1020 (1971).

4. A has received compensation from his corporation during the taxable year of $200,000. In December, it is determined that the corporation needs additional funds, and that A should return half of his compensation. A does not have the funds available. A gives a note to the corporation for $100,000. The following year A pays off the note.
Bishop v. Commissioner, 25 T.C. 940 (1956); *Buff v. Commissioner*, 58 T.C. 224 (1972).