THE TAX CLUB

Tax Effects of Rescission -- It's About Time

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"There was a young lady named Bright, Whose speed was far faster than light; She set out one day In a relative way, And returned home the previous night."

A.H.R. Buller. Limerick. In Punch December 19, 1923

"You could not step twice into the same rivers; for other waters are ever flowing on to you."

Heraclitus, c. 540 - c. 480 B.C. On the Universe, fragment 41.

"The flow of the river is ceaseless and its water is never the same."

Kamo no Chomei. Hojoki (The Ten Foot Square Hut), 1212.

Stephen W. Hawking, A Brief History of Time (1988), passim.

I. Nature of Rescission —

A rescission is the reversal, as nearly as possible, of a previous transaction, because of some infirmity in the original transaction or because of an agreement or understanding in effect at the time of the original transaction, so as to place the parties to the transaction in the
positions they would have been in had the rescinded transaction not occurred. Due to the nature of our physical universe, the parties can not in fact be placed in the same position as they would have been had an event not occurred, so the act of rescission takes the form of a return of property or a repayment of money or a change in the terms and conditions on which property or money is to be held.

Rescission has a retrospective aspect which, if recognized for federal tax purposes, can retroactively change the tax consequences of a previously completed transaction. The act of rescission itself also has no tax consequences when recognized as such.

II. Ruminations Regarding Tax Effects on Income Inclusion of Right to Avoid Wholly or Partially Executory Contract

A. Cash-basis Taxpayer

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1 The Second Law of Thermodynamics tells us that the degree of disorder in the universe constantly increases on a net basis. To use Hawking's figure, broken cups knocked off tables do not reassemble themselves and fly back up to the tabletop. It is this characteristic of our universe that gives us our sense that times moves in only one direction.
To a cash-basis taxpayer, the making of a contract wholly executory on both sides seems rather clearly not to constitute a taxable event. A fortiori, rescission of such a contract to which a cash-basis taxpayer is a party would not be a taxable event to the cash-basis taxpayer.

If a cash-basis taxpayer has performed his side of the contract and the other party has not yet performed, the cash-basis taxpayer may be in constructive receipt of the promised consideration at the time of payment called for by the contract or immediately if no time of payment is specified. In such a case, an infirmity (e.g., usury) or agreement in the original contract permitting the other party to the contract to rescind by tendering back the consideration supplied by the cash-basis taxpayer, should, so long as the right exists, in theory prevent constructive receipt for want of an immediate payment right in the cash-basis taxpayer. The annual reporting principle (described below) is believed not to affect this result if the rescission right is known to exist prior to year-end. If the right is not known to exist prior to year-end I believe the annual determination principle would require that the constructive receipt doctrine apply. A "rescission" of a ripened right to immediate payment comes too late to undo the
prior constructive receipt, however, as in the common case of an effort to defer receipt of earned and payable compensation.

An original infirmity or agreement permitting the cash-basis taxpayer to rescind and recover the consideration he supplied in a case in which the other party has not performed should prevent application of the doctrine of constructive receipt to the consideration receivable by the cash-basis taxpayer because the cash-basis taxpayer's right of election to receive his consideration back is a substantial restriction on his actual receipt of the consideration receivable by him. Estate of W.T. Hales, 40 BTA 1245 (1939), acq. on this issue and non-acq. on other issues noted, 1940-1 Cum. Bull. 2, 7.

The Xerox ruling, holding no constructive receipt of phantom stock plan benefits because loss of future benefits resulting from a cashout was considered a substantial restriction on receipt of amounts available on a current cashout, provides an analogy.

If the contract has been fully executed, apart from its rescissional aspects, more anon.

If the contract has been performed by the other party, but not by the cash-basis taxpayer, the likely income
inclusion question is whether or not the cash-basis taxpayer can defer inclusion of the received consideration in income because of the cash-basis taxpayer's duty to perform his side of the contract. This situation can be expected to involve a receipt of advance compensation because in a case involving receipt of interest or dividends the recipient has already performed his side of the bargain and in an exchange-type case the exchange of properties will be simultaneous and in a sale by the taxpayer the consideration will ordinarily either be received at the time of the sale or deferred, not vice versa.

Ordinarily the cash-basis taxpayer cannot defer inclusion in income of the amount received because of his duty to perform his side of the bargain, e.g., a salary advance or commitment fee is taxable when received. If there is an infirmity in the original contract entitling the cash-basis taxpayer to return the consideration and thereby terminate his duty to perform his side of the contract, it is believed that the result should be the same. Return within the same taxable year because of an infirmity either eliminates the income or produces an offsetting loss.

If the cash-basis taxpayer must return the consideration received, we are probably in a non-contractual duty to
return situation, e.g., an improper receipt of the returnable amount, in which case the claim of right doctrine will require inclusion of the received consideration in the cash-basis taxpayer's income unless and until he agrees to its return (innocent mistake) or in fact returns it (intentional taking) (discussed later).

B. Accrual-Basis Taxpayer

In the case of an accrual-basis taxpayer, the making of a contract wholly executory on both sides is not a taxable event because the performance by the taxpayer is a condition to the taxpayer's right to receive the bargained-for consideration. A fortiori, rescission of such a contract is not a taxable event to an accrual-basis taxpayer.

If the accrual-basis taxpayer has performed his side of the contract and the other party has not, the accrual-basis taxpayer must accrue the consideration receivable by him if his right to its receipt is then unconditional, as it ordinarily would be, and its money amount is reasonably ascertainable. In such a case, an infirmity in the original contract or an agreement permitting the other party to the contract to rescind the contract, should not, by its mere existence, permit the accrual-basis taxpayer to avoid an income inclusion otherwise
required, because the condition is a condition subsequent, rather than a condition precedent. The same appears true a fortiori if the accrual-basis taxpayer has performed, is entitled to rescind and the other party has not performed.

If the contract has been performed by the other party but not by the accrual-basis taxpayer, the accrual-basis taxpayer's receipt of the bargained-for consideration is includible in income unless a special deferral rule (e.g., that for prepaid subscription income IRC § 455) applies. Existence of an infirmity entitling the accrual-basis taxpayer to rescind the agreement by returning the consideration received should not change this result unless and until the right is exercised.

III. Ruminations Regarding Tax Effects on Deductions of Right to Avoid Wholly or Partially Executory Contract

A. Cash Basis Taxpayer

If the cash basis taxpayer has paid a deductible expense and the other party has not yet performed, we have a prepaid expense, ordinarily resulting in no deduction until performance by the other party occurs. Therefore, since the deduction is deferred anyway, a right in the other party to tender back the consideration received
and to avoid performance of its side of the contract would not further defer the deduction. A rescission right in the cash-basis taxpayer payor, exercisable before performance by the other party, likewise does not affect the timing of the deduction.

If the other party has performed, the deduction is nevertheless delayed at least until payment is made by the cash-basis taxpayer. If the other party has a right to rescind, e.g., a vendor with a right to rescind a sale to the cash-basis taxpayer of supplies not required to be inventoried, the existence of such right should not delay deductibility of an otherwise deductible payment. Oxford Institute, 33 BTA 1136 (1936), in which payments to an employees' bonus trust were held deductible when paid despite a provision for forfeiture if the employee did not remain employed and observe other conditions of his contract for a specified period. IRC § 83, § 402 and § 404 produce an opposite result under present law because of the "substantial risk of forfeiture" rules under Section 83. Absent such "special rule", the
possibility of reverter because of rescission by the other party should not prevent current deduction of paid expenses. Other cases involving rescission of a fully executed contract are discussed later.

B. Accrual Basis Taxpayer

The deductible expense accrues when the accrual-basis taxpayer is unconditionally obligated to pay it and its money amount is reasonably ascertainable, except that IRC § 461(h) further defers the deduction until economic performance occurs. In theory, an infirmity or agreement permitting the other party to rescind and avoid performance of his side of the contract should not prevent accrual and deduction of the expense by the accrual basis taxpayer if the other party has the option to affirm and carry out the contract (as is usually the case), but lack of economic performance will defer the deduction, anyway.

If the infirmity or agreement permits the accrual-basis taxpayer to rescind prior to performance by the other party, the existence of
the right would seem to prevent accrual of the expense for want of an unconditional obligation by the accrual-basis taxpayer to incur the expense. Cf., Wilcox Investment Co., 3 TC 458 (1944) (annuity premiums paid for annuity not necessarily useable for deductible purpose not deductible when paid).

If the other party has performed, the right of the accrual basis taxpayer to rescind would seem to prevent accrual of the expense for want of an unconditional obligation.

Losses on Sales or Exchanges

Since losses must be evidenced by closed and completed transactions in order to be allowed to either a cash-basis or accrual-basis taxpayer, the results in a case involving rescission rights will not vary because of the cash vs. accrual distinction.

A contract wholly executory on both sides will not justify a loss claim. If the taxpayer has received the other party's consideration
but has not parted with his own property, no loss should be allowed. Therefore, a right of either party to rescind in these situations should not affect non-allowability of the loss until transfer of the taxpayer's property.

If the taxpayer has transferred his property but has not yet received the consideration therefor, a loss on the transfer would ordinarily be recognized at the transfer date. If the transfer is subject to rescission by the other party, the Service view, in the case of a completed but rescindable transaction, is that the annual reporting principle controls; i.e., if the retransfer in a rescindable completed transaction occurs before the taxpayer's year-end, no loss is allowed. If the retransfer occurs later, a loss is allowed for the year of transfer. Rev. Rul. 80-58, 1980-1 Cum. Bull. 181. The same result would seem to follow if the retransfer of the taxpayer's original property occurs before the taxpayer's year end, even if the taxpayer has never received the bargained-for consideration.

Allowability of a loss in the situation where the
taxpayer has transferred his property, has not yet received payment and the other party has a right to rescind where a year-end intervenes seems doubtful in theory because the existence of the rescission right in the other party would seem to prevent the "closing and completion" of the transaction, but Rev. Rul. 80-58 would support the claimed loss.

If the rescission right is in the taxpayer, rather than the other party and the taxpayer's property has been transferred although consideration has not been received therefor, it is believed that no loss would be allowed for want of a completed transaction, unless and until the rescission right is abandoned.

IV. Tax Effect of Avoidance of or Right to Avoid Completed Transaction

(1) Sales

(a) An Infirmitry or Reversal Agreement must Exist in the Original Transaction to Permit Rescission of a Completed Transaction without Tax Effect. A resale of property by an original
purchaser to an original seller, even in the same taxable year, absent any infirmity in the original sale or any conditional or provisional aspect of the original sale transaction is not a rescission but an independent resale transaction, Branum v. Campbell, 211 F.2d 147 (5th Cir. 1954); Reeves v. United States, 173 F.Supp. 779 (D. Ala. 1959). In these cases, the resale was traceable to events subsequent to the original sale, so that the original sale transaction was a taxable event, even though the repurchase occurred in the same taxable year as the original sale. Although the issue is not involved in the cited cases, the reversing transaction would also be a taxable event. Thus, if the value of the property has decreased (or increased) a resale at the original price will, if a separate transaction, require a tax characterization of the differential. It seems likely that no point would be made of the differential, absent possible gift motivation for the retransfer. If the property were depreciable or amortizable and used in the purchaser's trade
or business, the resale would have its own income tax consequences.

(b). The Unexercised Right to Rescind a Completed Sale Transaction Does Not Affect the Tax Treatment of the Original Transaction. A sale of property coupled with a right in the purchaser to require the original seller to repurchase the property at the same price does not render the original sale conditional or prevent its recognition as a taxable event. PLR 7802003 (Sept. 28, 1977). Surrounding circumstances may indicate that the transaction is not in fact a sale, e.g., a secured loan if reconveyance is economically compelled.

In a "sale or return" arrangement, as between magazine wholesalers and dealers, the sale is taxed as such and its reversal is recognized only when the goods are returned. Krauss News Agency, Inc., 23 TCM 1007 (1964). The accountants have specific requirements notably (i) a requirement

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2 This P.L.R. apparently underlies Rev. Rul. 80-58, discussed later.
that the dealer pays or is obligated to pay for goods received without regard to whether or not those goods have been sold (a fact present in Krauss) and (ii) an ability to estimate returns with reasonable accuracy, which must be met in order for sale treatment with income recognition on shipment to apply. FASB 48 (1981).

The economically similar but legally different delivery on consignment arrangement, more often found in, e.g., jewelry stores, involves no sale and no tax consequences until the goods are sold to the customer by the consignee (as agent of the consignor). O.D. 13, 1 Cum. Bull. 66 (1919), obsoleted by Rev. Rul. 68-575, 1968-2 Cum. Bull 603. Return of unsold consigned merchandise is a retransfer of possession and has no federal income tax significance.
(c) An Actual Reversal of a Sales Transaction Must Occur within the Same Taxable Year as the Original Transaction in order to Be Recognized as a Rescission of the Original Transaction Having No Tax Effects.

1. The Service holds that consummation of a resale and repurchase in the same taxable year of the taxpayer is essential to permit a repurchase transaction to qualify as a rescission so as to eliminate the tax consequences of the original sale transaction (and, presumably, to prevent the reversal from having tax consequences, as well). Rev. Rul. 80-58, 1980-1 Cum. Bull. 181.

This ruling involved an agreement for reconveyance of land with repayment of the purchase price if the land were found unusable by the buyer. If the reconveyance and repayment occurs within the same taxable year of the seller as the original sale transaction, the original
transaction "is to be disregarded for federal income tax purposes". Not so if the reconveyance and repayment occurs in the taxpayer's subsequent taxable year. An IRS concession in *Gacek*, 53 TCM 1342 (1987) is in accord.

Rev. Rul. 80-58 involves a sale at a gain. Suppose a loss had been incurred? Rescission in the year of sale should eliminate a loss as well as a gain. What about rescission in a subsequent year? If the rescission right is in the buyer (as in Rev. Rul. 80-58) and exists at the close of the year of sale, the mere existence of the right should not eliminate a gain or loss realized in the year of sale.

In Rev. Rul. 80-58 the right of return is in the purchaser. Suppose the seller has a repurchase right or
has the right to rescind the sale transaction because of an infirmity. It is believed that actual reversal of the sale in the taxable year of the sale should eliminate the seller's gain or loss in such a case, since the actuality of the reversal should be controlling, not the identity of the party at whose instance the reversal occurred. If the reversal does not occur by year-end, the existence of a repurchase right at the same price where the price approximates market value, reduced by the value of the retained repurchase right, should not undercut the bona fide nature of the sale so as to deny a loss. Cf., Frank & Seder Co., 13 BTA 1 (1928) acq. on this issue noted, VIII-1 Cum. Bull. 15, 16 (1929); rev'd on another issue, 44 F.2d 147 (3rd Cir. 1930).
P.L.R. 8210015 (a TAM) (Nov. 23, 1981) applies the Rev. Rul. 80-58 rule to rescission of a sale of real property in a subsequent year pursuant to the buyer's rescission rights under the Interstate Land Sales Full Disclosure Act for want of proper information filings by the seller. The consensual source of the rescission right in Rev. Rul. 80-58 thus appears not essential to the result. The TAM is largely concerned with inclusion in income of the gain on the original sale despite the unlawfulness of the sale.

Rev. Rul. 80-58 does not say whether the taxpayer was on the cash or accrual basis nor does the apparently underlying P.L.R. 7802003.

The effect of an actual rescission on a completed transaction should be the same for a cash-basis as for an accrual basis taxpayer. A
promise to repay the consideration received on a sale or exchange would be conditional on receipt of the property originally parted with, so that accrual of the repayment or redelivery obligation would not precede its performance. For this reason, a seller's filing of a well-founded but subsequently settled suit for rescission of a stock sale does not permit the seller to exclude the sale gain from income. Karl Hope, 55 TC 1020 (1971), aff'd, 471 F.2d 738 (3rd Cir. 1973), cert. den. 414 U.S. 824 (1973). Accordingly, an actual retransfer would be required to justify exclusion of original gain for both a cash-basis and an accrual-basis taxpayer.

An obligation by an accrual-basis taxpayer to repay or return consideration received in a transaction other than a sale or
exchange should be recognized when incurred, if unconditional. Bates Motor Transport, Inc. v. Comm'r., 200 F.2d 20 (7th Cir. 1952) (apparently approving principle but finding estimate of excludible amount unreasonable for want of substantiation).

A notification of the buyer's exercise of its right to retransfer the property before year-end with a subsequent actual transfer is not dealt with in Rev. Rul. 80-58. The clear implication from the ruling is, however, that such a transaction would not be treated as a rescission by either a cash-basis or an accrual-basis taxpayer.

The tax effect of Section 1341 on the subsequent year rescission, if available, would seem to equate to the rescission treatment if reduction of the prior year's tax is elected.
Of course IRC § 1341 does not deal with losses and is not available if the rescission right is sourced in an agreement because, in such a case, the original receipt of the income item was in fact unrestricted. IRC § 1341 operates only if it "appeared" in the receipt year that the taxpayer had an unrestricted right to the income item but it is subsequently established that he or she did not have an unrestricted right to the item. A common example is a "hedge repayment agreement" to repay salary of a corporate officer-stockholder if the Service denies the payor a tax deduction. Rev. Rul. 69-115, 1969-1 Cum. Bull. 50.

Note that a sale with an option in the purchaser to resell at the same price might not be a sale at all but a disguised loan from "purchaser" to "seller", if the "purchaser" is
under economic compulsion to make the "resale". The accountants do not book gain or loss from such a sale, even in the absence of economic compulsion. FASB 66 (1982). For their purposes, such a sale is characterized as a financing, leasing or profit-sharing transaction. This accounting treatment may produce a tax and book accounting variation in such a case.

Consider e.g., "sale" for 150 of tax-exempt bonds having a fair market value of 100 with an "option" in the purchaser to "resell" the bonds to the original seller at 150 on a date one year hence. Because of the substantial certainty that the bonds will have a market value far less than 150 on the "optional" resale date, I think the resale is likely to be considered as economically compelled and the transaction treated as
a secured loan from the outset for tax as well as accounting purposes.

**Bancitaly, 34 BTA 494 (1936)** found a taxable sale of stock to have occurred, despite a put/right in the affiliated transferee. The transfer and put prices appears to have approximated fair market value at the transfer date although the stock price was volatile. **Bancitaly** also involved installment sale of other stock of the same issue to shareholders at about one-half of estimated fair market value with a put right which, if exercised, would result in a full refund of installments paid. The Board also described this arrangement as a sale. **Rev. Rul. 82-144, 1982-2 Cum. Bull. 34** sets out the Service general position that a sale at market with a put at the same price issued for additional consideration is recognized as a sale.
The more common case of a sale well below market with a call at a higher price still well below market retained by the seller should be treated as a secured loan, rather than a sale.

A retained repurchase option may prevent the original sale from being recognized as such but, rather, treated as a loan of the sales price depending on surrounding circumstances. A sale at market with a retained repurchase right at the same price as the sale price, without other evidence of a loan, should, however, not prevent recognition of the sale as such. Bank of California, N.A., 30 BTA 556 (1934), aff'd, 80 F.2d 389 (9th Cir. 1935)

The accountants do not appear to distinguish the put situation from the call situation (FASB 66) but all
tax cases I know of which have treated an ostensible sale as a secured loan have involved some call rights in the "seller".

(2) Cases Other Than Sales

(a) Actual Same Calendar Year Reversal of a Completed Transaction Other Than a Sale Is Not Always Required to Justify Rescission Treatment of the Reversal for Income Tax Purposes.

The Courts have not been completely sympathetic with the Service view expressed in Rev. Rul. 80-58 requiring same year reversal for rescission treatment.

These cases have arisen in non-sale contexts. Thus, repayment in 1931 by a decedent's estate of stock plan earnings for 1930 and 1931 received by a calendar year decedent under a plan rescinded by the employer's board of directors in 1931 was held effective to exclude the 1931 earnings from the decedent's 1931 income even though the repayment was made in the first taxable year
of the estate following the decedent's death. The court followed the Service "same taxable year" view later expressed in Rev. Rul. 80-58 as respects non-recognition of a rescission of the 1930 receipt of 1930 earnings, but refused to extend the same taxable year rule to deny effect to the estate's repayment of 1931 earnings which occurred in calendar 1931 but in a different taxable year. Penn v. Robertson, 115 F.2d 167 (4th Cir. 1940).

Again, acknowledgment in the year of receipt of a repayment duty (not actual reversal) in a case in which income was mistakenly received under a claim of right was held sufficient to eliminate the income realized by the original receipt. Actual repayment occurred in a later year. United States vs. Merrill, 211 F.2d 297 (9th Cir. 1954).

In Merrill, the taxpayer mistakenly received excessive executor's commissions with respect to his late wife's share of their community property. J.W. Gaddy, 38 TC 943 (1962), rev'd on other grounds, 344 F.2d 460 (5th Cir. 1965), is in
accord with Merrill in recognizing a rescission on the basis of an acknowledgment in the year of receipt of a repayment duty to repay income received by mistake. If, however, the income was received by way of theft or embezzlement, actual repayment in the year of receipt is required in order for rescission of the receipt to be recognized as rendering the receipt non-taxable. United States v. Hauff, 461 F.2d 1061 (7th Cir. 1972), cert. den. 409 U.S. 873 (1972); Norman Mais, 51 TC 494 (1968); Rev. Rul. 65-254, 1965-2 Cum. Bull. 50.

The Seventh Circuit in Quinn v. Comm'r, 524 F.2d 617 (1975) refused to apply the doctrine of Merrill in a wrongful taking case and found Merrill to have been incorrectly decided because violation of the annual accounting principle. The concurring opinion in Buff v. Comm'r, 496 F.2d 847 (2d Cir. 1974) (embezzler's acknowledgment of duty to repay disregarded as sham) also disapproved Merrill on the same ground.
Assuming Merrill and the Gaddy Tax Court opinion are still viable, they seem reconcilable with the wrongful taking cases only on the ground of a stronger public policy against rescission by acknowledgement in a case of knowing wrongdoing than in a case involving an "innocent mistake". Why the annual accounting principle should be stronger in one case than the other is difficult to tell. IRC § 1341 makes a similar distinction, however, and is not available to the embezzler. Rev. Rul. 65-254, 1965-2 Cum. Bull. 50. Greater doubt as to the sincerity of the acknowledgment in the knowing wrong-doing situation is no doubt a factor.

(b) Actual Reversal after the Close of the Transaction Taxable Year Can Be Effective in Gift Tax Cases to Eliminate the Prior Gift.

Not surprisingly, even though the government's need for revenue on a current annual basis applies to the gift tax as much as it does to the income tax, the Courts are less hospitable to the annual return analysis in gift tax cases than they seem to be in income tax cases perhaps
because of the cumulative nature of the gift tax
(although the opinions do not refer to this factor).

(a) A 1960 deed of gift to a charity of a 100% interest in real property was consensually reformed in 1964 to cover only a 20% interest. The donors established that they intended to give only a 20% interest in 1960 in order that the entire gift would be within the then-applicable 30% limitation on deductibility of charitable gifts. They conveyed a 20% interest in 1961 and in 1964, shortly after the reformation, conveyed the remaining
interest in the property to the charity. The court recognized the 1964 reformation (which had the effect of rescinding 80% of the 1960 purported gift), on the ground that under local law the reformation was valid. Dodge v. United States, 413 F.2d 1239 (5th Cir. 1969). Similarly, in Touche, 58 TC 565 (1972) the court held that a 1966 mistaken deed conveying 100% of certain real property interests, as opposed to the intended 50%, left equitable ownership of 50% in the donor, limiting the gift tax to one
based on 50% of the 1966 value of the transferred property.

On the other hand, a 1945 deed reserving life estates to the donor-taxpayer and his wife with remainder to their children was held to be a completed gift, even though the children reconveyed their interest to the taxpayer in 1947 and the wife reconveyed her interest to the taxpayer in 1948, in each case at the taxpayer's request. The taxpayer had intended that the conveyance remove the conveyed property from his federal gross estate and
requested the reconveyances when he learned that the 1945 transfer was ineffective for this purpose.

The court's decision is not based on the fact that the reconveyances were in years after the original conveyance but rather on the fact that the taxpayer's "disappointed hope" for an estate tax exclusion of the property did not render the original conveyance conditional.

_W.H. Board, 14 TC. 322 (1950)_

In two cases in which the taxpayer donor of trust property attempted to reform the
instruments in a subsequent year in order to qualify the interests of donees for the gift tax exclusion available for gifts in trust to minors having specified characteristics, the courts refused to recognize the reformation as effective on the ground that the initial conveyances had been complete and unconditional transfers.

In these cases the intervening of a year end does not provide the rule of decision.

The results in these gift tax cases can be reconciled by a rule under which a transfer made under a mistake of fact is rescindable and one of law is not. The Courts' opinions do not articulate this distinction as a rule of decision. The Restatement of Restitution, Ch. 2, Topic 3 characterizes the distinction as applied to the basic law of restitution for mistake as an 1802 error of Lord Ellenborough, carried forward by numerous American decisions explainable on other grounds. Corbin, Contracts § 616 takes a similar view. The distinction is, however, alive and well in the federal tax law as witness (i) the rule of Reg. § 1.83-2(f) permitting revocation of a Section 83(b) election for a mistake of fact but not of law; and (ii) GCM 39214 (April 13, 1984) permitting recovery within one year of an employer contribution made to a qualified employee benefit pension plan without adverse effect on the plan's qualification if the contribution was made by mistake of fact (by analogy to Sec. 403(c)(2) of ERISA). PLR 8418037 (Jan. 26, 1984) denying permission to revoke a Section 83(b) election based on inaccurate advice as to the legal effect of the election describes a mistake of fact as "an unconscious ignorance" of a fact material to the transaction and a mistake
of law as "an incorrect exercise of judgment based on the facts as they are."

I would suggest a slightly different analysis of the rule of decision reconciling these gift tax cases, i.e., that action taken pursuant to a taxpayer's instruction (even when based on legal rules) imperfectly carried out - e.g., "make gifts only up to an amount qualifying for the charitable contribution deduction" as in Dodge can be rescinded; but action taken pursuant to an instruction correctly carried out but motivated by an erroneous view of the law (as in Board) cannot be rescinded.

Lewis M. Ludlow, 36 TC 102 (1961), acq. noted, 1961-2 Cum. Bull. 5 (an income tax case) is in accord. In Ludlow, the seller intended to sell only if the transactions met the former not-more-than-30%-of-the-sale-price-received-in-the-initial-year-rule to qualify for installment treatment. The signed agreement called for more and more was in fact paid, due to an erroneous computation reflected in the agreement. The excess was returned to the buyer early the next year. The Court held that the "true agreement", i.e., for payment of less than 30% in the year of sale controlled, despite the
error. The rule permitting rescission of action based on erroneous carrying out of a proper instruction applies.

Hanco Distributing Co. v. United States, 73-2 USTC Par. 9632 (D. Utah, 1973) holds that prompt payover to the correct shareholders of the excess over the amounts described in the director's resolution for a deficiency dividend prevented the dividend from being disproportionate and hence non-deductible as a deficiency dividend. The adjustment was required because an out of date shareholder's list (showing the correct shareholders but an incorrect number of shares) was used by the clerk making up the dividend roll. The correction was made in the same calendar year as the erroneous payment. Again, there is an erroneous carrying out of an instruction which, if carried out correctly would have achieved the desired tax result.

V. Comm'r v. Procter - The "Think You're Smart Case." 3

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3 The phrase is that of the late T.R. Powell, Professor of Constitutional law at the Harvard Law School. It refers to a case involving trifling with the judicial process, perhaps by over-literal reliance on legislative or judicial language. T.R.'s example was an effort to avoid a tariff charge on importation of movies filmed abroad by projecting the image over the U.S.-Canadian border to be received on blank film on the U.S. side.
Comm'r. v. Procter, 142 F.2d 824 (4th Cir., 1944) cert. denied, 323 US 756 (1944) the transferor of property to a trust for the benefit of others provided in the trust instrument for exclusion from the transfer of any property, the transfer of which was held with finality to constitute a taxable gift. The court held that the condition was a condition subsequent and void because against public policy. The condition subsequent analysis seems correct, i.e., the condition did not prevent the transfer to the trust from occurring. It therefore seems to me that the transfer was presently effective and a retransfer (because of the effectiveness of the original transfer) would occur only if and to the extent that the original transfer were held a gift. The public policy argument thus seems unnecessary to prevent characterization of the original transfer as a taxable gift because even if the retransfer clause is valid and enforceable the original transfer is not thereby voided and is made for less than a full and adequate consideration. The fact that the retransfer might be required does not cause the original transfer to be "incomplete" because the retransfer condition is not within the control of the transferor.

Note that the case is not of the "think you're smart" type, if the rescission condition produces a tax result
consistent with the Service action. In *Surface Combustion Corporation*, 9 TC 631 (1947), *aff'd*, 181 F.2d 444 (6th Cir. 1950), the condition allowed repayment of contributions to an employee benefit profit sharing trust, if the Commissioner (and the court in the event of an appeal from the Commissioner's action) found the trust to be taxable. The Commissioner argued that the existence of this election to terminate the trust and recover the contributions prevented the deduction. The Court in *Surface Combustion* assumed that the contingency was valid, not void under *Procter* (because, if void, it would have no effect on deductibility). The Court then held that because the contingency was within the control of the Commissioner the contingency should be likened to one in the control of the employees, in which case the deduction would not be denied under the *Oxford Institute* principle and so should not be denied here. The result of disallowance is a return of the contributions which is consistent with the Court's decision. Similarly, the result of allowance is retention of the contributions by the trust which is, again, consistent with the Court's holding. In contrast, in *Procter*, a holding of "gift" would result in "no gift" which would be inconsistent with the Court's conclusion.
After a period of resistance, the Service acquiesced in the Surface Combustion conclusion and now permits conditioning the initial plan contribution on a Service determination that the plan is tax-qualified. Rev. Rul. 60-276, 1960-2 Cum. Bull. 150. Plan provisions permitting recovery of any plan contribution made by a mistake of fact or specifically conditioned on deductibility if deduction is disallowed provided the return occurs within a one-year period also do not disqualify a plan. Rev. Rul. 77-200, 1977-1 Cum. Bull. 98. These bases for return of contributions were permitted under Section 403(c) of ERISA, without a corresponding tax law provision. The Service resisted the deduction determination provision for some years but eventually gave in. The deduction disallowance provision works like the return of contributions for lack of initial qualification provision, i.e., the result is consistent with the Service action. Audit lottery concerns presumably explain the Service resistance to the disallowance of deduction provision.

Transfer agreements which make no attempt to reverse the transfer; but, rather, start out as a sale with a provision adjusting the price to that found by the Service, if the Service determines that the fair market value of the transferred property differs from the transfer price stand on a different
footing and have been sustained as avoiding gift tax. *King vs. United States*, 545 F.2d 700 (10th Cir. 1976).

The *King* opinion is not persuasive to the extent it relies on the subsequent worthlessness of the transferred property to justify its conclusion. A taxable gift of property is nevertheless a taxable gift in the amount of the fair market value of the property at the transfer date, even though the property becomes worthless later. A price adjustment clause differs superficially from the rescission type clause of *Procter* because the transaction is not reversed but a further payment is made. From the Commissioner's viewpoint, however, the effort made to impose a gift tax is wasted. Of course, the Commissioner may be able to collect an income tax on the additional gain realized by the transferor from the additional payment. The Commissioner's attitude is explainable by the fact that the original transaction will stand as a sale at the original valuation if there is no gift tax audit and the existence of the price adjustment provision not only serves to avoid fraud or negligence penalties in the event of an audit but makes it easier to carry out the transaction at the lowest possible reasonable value without qualms of conscience or objections from "neutrals" involved in the transaction.
But the price adjustment must be in fact required.
In Virginia Z. Harwood, 82 TC 239 (1984), aff'd, 786 F.2d 1174 (9th Cir. 1986), cert. den., 479 U.S. 1007 (1986), the transferee trustee was empowered to issue notes to the grantor in an amount equal to the excess of the value of the transferred property as "finally determined for gift tax purposes" over $400,000 if, in the trustee's opinion a "lower value is not reasonably defendable". The Tax Court held that these provisions did not empower the trustee to issue notes after a court decision valuing the transferred property for gift tax purposes at an amount in excess of $400,000 because, after a court decision, there is no longer any defense available for a lower valuation. Since the trustee had not issued notes prior to the court's decision, issuance thereafter would be too late and unauthorized. The Court reserved as to what its opinion would have been had notes been issued or required to be issued.

Rev. Rul. 59-243, 1959-2 Cum. Bull. 123 resembles King and reflects the Service attitude toward adjustments eliminating the tax consequences of a Service determination. In Rev Rul. 59-243 the Service held that an option requiring increase of the option price to 95% of the fair market value of the stock at the option issuance date if the Service found that the price was less than such amount could not qualify as a
restricted stock option because the adjustment clause prevented the option price from being fixed or determinable at the option issuance date. Sheldon I. Banoff, Esq. in a wide-ranging article on the general subject entitled "Unwinding or Rescinding A Transaction: Good Tax Planning or Tax Fraud?" December 1984 Taxes 942, 988 suggests, I believe correctly, that the true Service concern here is the protection such a provision provides against loss of the audit lottery. The Service refused to eliminate the audit lottery element by providing a valuation of the stock. Rev. Rul. 60-242, 1960-2 Cum. Bull. 158.

Since the change of an option price only to accord with a determination by the IRS would seem to leave the option price "determinable", the Service position in Rev. Rul. 59-243 would seem to rest on a public policy position as Mr. Banoff suggests. The issue has been largely laid to rest by a provision in IRC Section 422A(c) that if a good faith effort to set the option price is made, the requirement that the option price be at least 100% of the fair market value of the stock on the grant date and, under regulations, the $100,000 worth of stock limit will be "considered to have been met".

VI. Conclusions
The rules as to the income tax effects of a reversal right under wholly or partially executory contracts on cash and accrual basis taxpayers seem to be in satisfactory shape.

The distinction between erroneous carrying out of proper instructions (correction recognized to achieve the intended tax effect) and correct carrying out of instructions erroneously believed to have a tax effect differing from the intended effect (correction not recognized) evidenced by the cases seems sound.

The Service is clearly wedded to a single taxable year of the taxpayer requirement where rescission of completed sales transactions are concerned and has argued for the same rule as to reversal of completed non-sale transactions. Like all mechanical rules this approach can be expected to have inequitable results in hard cases and the Congress has eliminated the harsh results by enactment of IRC § 1341 in cases involving restoration of income received under claim of right. The results in the erroneous instruction cases
justify the conclusion that in that area the passing of a year-end is of no significance in determining recognition of rescission treatment for a reversing transaction.

It is easy to conceive of hardship cases in which a substantial gain or other income item in an earlier year is wiped out by a rescission in a subsequent year without corresponding tax benefit. And an argument can be made that consideration should be given to Congressional relief for such cases, as has been done by enactment of the net operating loss carryover and carryback rules to ameliorate some of the harshness flowing from the requirement of annual returns. I think, however, that the availability of net operating loss carrybacks and carryforwards in rescission cases affecting operating income, the tendency of the Courts to ameliorate the harshness of the same year rule at least in non-sale cases, and the general undesirability of statutory changes in addition to the barrage we have recently suffered outweigh the advisability of Congressional action to ameliorate or eliminate the same year rule.
"But thought's the slave of life, and life time's fool; And time, that takes survey of all the world, Must have a stop."
Shakespeare, King Henry IV, Part I, Act V, Scene IV.

R.O. Winger