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Possible Opportunities to Correct Transaction Errors

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INTRODUCTION

After months of negotiations, countless modifications to financial models, and multiple iterations of step plans, the transaction is ready to close. The agreements are drafted, the parties and their advisors perform final reviews, and the transaction closes. Amidst the congratulations and deep breaths of relief, no one notices the "glitch" within one of the executed agreements.

Maybe the glitch is simply an incorrect date, for example, December 31, 2021, rather than December 31, 2022. Maybe the name of one of the parties was misspelled. Alternatively, perhaps a step included in one of the proposed structures was unintentionally omitted in the executed documents. For purposes of this discussion, we will assume an error of such significance that the doctrine of mutual mistake does not apply.

During negotiations, transaction structures change. For example, the parties may have initially contemplated contributing existing contracts along with operating assets into an entity to be taxed as a partnership. However, due to legal complexities that would arise by transferring the contracts, the parties agree that the proposed contribution of assets would specifically exclude the contracts.

Once the error has been identified, the logical next step is to evaluate its potential consequences. Typically, this conversation shifts to whether the error needs to be corrected and how the correction may be effectuated. For purposes of this article, we will assume that the parties would like to retroactively change both the legal and tax consequences associated with only part of the transaction. In other words, the parties do not wish to completely unwind all aspects of the transaction.

This article considers potential opportunities to correct errors with retroactive effect back to the date of the transaction relying upon:

1. Substance-over-form arguments,
2. Application of the rescission doctrine, or
3. Reformation of the transaction under state law provisions.

SUBSTANCE OVER FORM

In a recently decided case, the Tax Court addressed the question of whether a taxpayer may disavow the form of its transaction.[1] In *Complex Media*, the taxpayer sought to disavow the effectuated structure of a transaction to increase available amortization deductions. The Internal Revenue Service (IRS) challenged the taxpayer's contention to ignore the form of the transaction. In support of this position, the IRS relied primarily on *Commissioner v. National Alfalfa Dehydration and Milling Co.*[2] and *Commissioner v. Danielson*.[3]

In *National Alfalfa*, the Supreme Court noted, "[W] hile a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, * * * and may not enjoy the benefit of some other route he might have chosen to follow but did not."[4] In *Danielson*, the Third Circuit Court of Appeals adopted a rule whereby "a party can challenge the tax consequences of his agreement as

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[1] *Complex Media Inc. v. Commissioner*, T.C. Memo 2021-14, *nonacq.,* 2023-11 I.R.B. 529.

[2] 417 U.S. 134 (1974).

[3] 378 F.2d 771 (3d Cir. 1967).

[4] *National Alfalfa*, 417 U.S. 134.

construed by the Commissioner only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc.''[5]

In *Complex Media*, the taxpayer appeared to avoid the appearance of disavowing steps of an effected transaction. Rather, the taxpayer relied on policy arguments and non-applicability of *Danielson*.[6] The Tax Court nonetheless addressed the taxpayer's ability to disavow the form of its transaction. Somewhat surprisingly, the court appears to have opened a window to a taxpayer's ability to disavow the form of a transaction:

> In sum, petitioner's ineligibility to invoke grounds that would render its contracts unenforceable or call into question respondent's interpretation of those contracts does not prevent it from disavowing the form of the transactions implemented under them. We now turn to the question of what petitioner must show to disavow the form of the transactions. Is the substance-over-form doctrine, as we have sometimes said, as readily available to a taxpayer as it would be to the Commissioner (were he challenging the transactional form), so that the taxpayer need only show a disparity between the form of the transaction and its economic substance? Or, as we have suggested on other occasions, does the taxpayer have to show more and, if so, what is the nature and quantum of the required additional showing?[7]

The Tax Court went on to provide what may be considered a pathway for taxpayers to follow when attempting to disavow the form of their own transactions:

> In sum, as our caselaw has evolved, it has become more hospitable to taxpayers seeking to disavow the form of their transactions. While we no longer reject those arguments out of hand, as we did in *Swiss Oil Corp., J.M. Turner & Co.,* and *Television Indus.,* we have repeatedly indicated that taxpayers may face a higher burden than the Commissioner does in challenging transactional form. On occasion, as in *Glacier State Elec. Supply,* we have suggested that the taxpayer's higher burden might be an evidentiary one. But we have not identified specific factual questions that should be subject to a higher burden than that imposed by Rule 142(a) or articulated the quantum of evidence necessary to meet that burden. Nor have we offered a clear justification for imposing on the taxpayer a higher burden to prove facts relevant to the disavowal of form than the generally applicable preponderance of the evidence standard.
>
> Therefore, we now conclude that the additional burden the taxpayer has to meet in disavowing transactional form relates not to the quantum of evidence but instead to its content — not how much evidence but what that evidence must show by the usual preponderance. The Commissioner can succeed in disregarding the form of a transaction by showing that the form in which the taxpayer cast the transaction does not reflect its economic substance. For the taxpayer to disavow the form it chose (or at least acquiesced to), it must make that showing and more. In particular, the taxpayer must establish that the form of the transaction was not chosen for the purpose of obtaining tax benefits (to either the taxpayer itself, as in *Estate of Durkin,* or to a counterparty, as in *Coleman*) that are inconsistent with those the taxpayer seeks through disregarding that form. When the form that the taxpayer seeks to disavow was chosen for reasons other than providing tax benefits inconsistent with those the taxpayer seeks, the policy concerns articulated in *Danielson* will not be present.[8]

The IRS recently provided an analysis describing its non-acquiescence to the *Complex Media* decision.[9] Of particular interest to our discussion, the IRS addressed whether the taxpayer was bound by the form of a series of transactions, as consistently provided in the transaction agreements, and as implemented. As the IRS stated in AOD 2023-02, ''The main issue before the court was whether Taxpayer could disavow the transactional form it chose and reported and treat the transactions as resulting in increased basis for the Transferred assets. The court held that Taxpayer could do so.'' The IRS is concerned with two important aspects of the court's holding and opinion:

> 1. The court concluded that the taxpayer's failure to fully and consistently report the transaction was not a major factor in determining whether the taxpayer could disavow the form of its transactions. Query whether the IRS would be more agreeable to the taxpayer's application of the substance-over-form doctrine had the taxpayer consistently taken the position it sought to claim.

[5] *Danielson*, 378 F.2d 771.

[6] *Danielson* was decided by the Third Circuit Court of Appeals. Taxpayers within this circuit are subject to the decision. Additionally, the Fifth, Sixth, and Eleventh Circuits generally follow *Danielson*.

[7] T.C. Memo 2021-14 at II.B.1.

[8] *Id.* at II.B.2.

[9] Action on Decision 2023-02, 2023-11 I.R.B. 529.

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> 2. While the court agreed that taxpayers have a greater burden than the IRS when seeking to disavow the form of their transaction, case law has evolved to become more taxpayer favorable. The IRS is concerned that this standard could effectively prevent taxpayers from disavowing the form of their transactions only if the IRS could show purposefully conflicting tax benefits, even when the taxpayer withholds vital information.

It is clear the IRS does not agree with the court's decision in *Complex Media*. However, the rationale for this disagreement does not necessarily foreclose all opportunity for taxpayers to effectively disavow the form of their transaction. In the example set forth in this article, the parties sought to exclude the contribution of contracts to a partnership to avoid legal complexities associated with the transfer. No tax benefits were obtained from the inadvertent contribution. Given the stated reasons for the IRS's disagreement with the court's opinion in *Complex Media*, perhaps our illustration is one that could survive challenge. However, combining the unique nature of the facts and the Tax Court's analysis, the IRS's non-acquiescence, and lack of other supportive authority, reliance on a taxpayer-initiated substance-over-form argument is destined to be a perilous adventure. Business considerations associated with leaving the transaction as legally effected, however, may be more burdensome than following the guidance described by the Tax Court in *Complex Media*.

THE RESCISSION DOCTRINE

In lieu of arguing that the substance of an executed transaction should change the result flowing from its form, perhaps the parties in our example could simply unwind part of the transaction. In this regard, the rescission doctrine may be a viable option.

The general concept behind the rescission doctrine is that a taxpayer may effectively unwind a transaction and put the involved parties back to their pre-transaction positions. As described below, practical applicability of the rescission doctrine is not always clear. In fact, its application is often limited to such an extent that it may be an impractical solution. However, when the facts align with relevant authorities, the rescission doctrine can be a valuable tool.

The starting point in an analysis of the rescission doctrine is often *Penn v. Robertson*.[10] In *Penn*, the taxpayer was a participant in an employees' stock benefit fund created by the directors of the company without the approval of the shareholders. Under the plan, the taxpayer was credited with earnings from the fund for the years 1930 and 1931. In 1931, as a result of lawsuits filed by a shareholder, the directors of the company passed a resolution whereby the plan would be rescinded as to all plan participants who agreed to relinquish their previous credits and rights. The U.S. Court of Appeals for the Fourth Circuit held that although the plan was rescinded for 1930, the annual accounting period principle required the determination of income at the close of the taxable year without regard to subsequent events. That is, the rescission in 1931 was disregarded for purposes of determining 1930 taxable income. Regarding whether the 1931 income should be taxed, the court said in *Penn* that the rescission in 1931 extinguished what otherwise would have been taxable income for that year.

As noted, the court held that an attempt to rescind a transaction failed because the attempt did not occur in the same taxable year as the transaction. The Supreme Court in *Security Flour Mills Co. v. Commissioner*[11] clearly articulated the importance of the annual accounting method underlying the U.S. federal income tax system. In reaching its conclusion, the Court referenced several important decisions:[12]

> All the revenue acts which have been enacted since the adoption of the Sixteenth Amendment have uniformly assessed the tax on the basis of annual returns showing the net result of all the taxpayer's transactions during a fixed accounting period, either the calendar year, or, at the option of the taxpayer, the particular fiscal year which he may adopt.[13]
>
> It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation.[14]
>
> This legal principle has often been stated and applied. The uniform result has been denial both to government and to taxpayer of the privilege of allocating income or outgo to a year other than the year of actual receipt or payment, or, applying the accrual basis, the year in which the right to receive, or the obligation to pay, has become final and definite in amount.[15]

[10] 115 F.2d 167 (4th Cir. 1940).

[11] 321 U.S. 281 (1944).

[12] *Id.* at 286–287.

[13] *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 363 (1931) (as cited in *Security Flour Mills*, n.12 above).

[14] *Id.* at 365 (as cited in *Security Flour Mills*, n.12 above).

[15] *See, e.g., Lucas v. Ox Fibre Brush Co.*, 281 U.S. 115, 120

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In Revenue Ruling 80-58,[16] looking to the decision in *Penn*, the IRS concluded that no gain would be recognized under Internal Revenue Code §1001 on the sale of land by a taxpayer who accepted reconveyance of the land and returned the buyer's funds during the taxable year of the sale. The IRS further concluded that if the reconveyance occurs after the taxable year of sale, the seller reports the sale in the taxable year of sale and, when the property is reconveyed, acquires a new basis equal to the amount paid for the reconveyance.

Based on Rev. Rul. 80-58, there are three implicit requirements necessary to successfully rescind a transaction:

1. A rescission must occur that releases the parties from further obligation to each other;

2. The parties must be restored to their relative position before the events occur, i.e., the *status quo ante*;[17] and

3. All events must occur within the same tax year.[18]

Since issuance of Rev. Rul. 80-58, the IRS has approved application of the rescission doctrine in published private letter rulings.[19] These rulings are consistent with Rev. Rul. 80-58. Additionally, courts have addressed application of the rescission doctrine in several instances.[20]

Ultimately, attempting to apply the rescission doctrine for a transaction executed in a prior taxable year seems unlikely to succeed. If the error in our example is identified and corrected within the same taxable year, applying the rescission doctrine may be successful. However, consideration must be given to whether unwinding a single step or part of a step of a larger transaction would result in achieving *status quo ante.*

STATE LAW REFORMATION

Substance-over-form arguments and rescinding a transaction may allow a taxpayer to retroactively change the tax consequences of an executed transaction. Unfortunately, application of these rules is often limited. The result is taxpayers may be left in the unenviable position of living with unintended consequences which could have material business and/or income tax implications. In these situations, consideration may be given to "reforming" the unintended part(s) of the transaction pursuant to state law.

In *New IRS Rulings Approve Rescission Transactions that Change an Entity's Tax Status,*[21] Sheldon Banoff astutely observed situations in which strong arguments appear to favor the retroactive unwinding of a transaction, including, for example:

1. Unwinding a transaction for valid non-tax business purposes and
2. Federal tax deference to state law unwinding of a transaction.

The remainder of this article discusses the possibility of bringing these arguments together to retroactively unwind an unintended transaction step discovered in a subsequent taxable year.

(1930); *Burnet v. Thompson Oil & Gas Co.*, 283 U.S. 301, 306 (1931); *Woolford Realty Co. v. Rose*, 286 U.S. 319, 326 (1932); *Tait v. Western Maryland Ry. Co.*, 289 U.S. 620, 624 (1933); *Brown v. Helvering*, 291 U.S. 193 (1934); and *Guaranty Trust Co. v. Commissioner*, 303 U.S. 493, 498 (1938) (as cited in *Security Flour Mills*, n.12 above).

[16] 1980-1 C.B. 181.

[17] Black's Law Dictionary defines *status quo ante* as "[a] previous or last contested state before the current state."

[18] In *Burnet v. Sanford & Brooks Co.*, above n. 13, the Supreme Court considered whether taxable gain may be ascertained on the basis of a fixed accounting period or only upon the conclusion of a transaction. The U.S. system of taxation, which relies on use of fixed accounting periods and application of these periods to determine the consequences of a transaction completed in a particular year, seems "fair" assuming the transactions are completed. Query whether it is appropriate to consider a transaction closed if the unintended transaction has been identified and steps are being taken to unwind the offending steps prior to the reporting of taxable income for the year in which the transaction occurred. Under common law principles, could this transaction be considered "open"?

[19] *See, e.g.,* PLR 201016048, PLR 201008033, PLR 200813028, PLR 200752025, PLR 200613027, and PLR 200533002. For a comprehensive discussion on the rescission transaction doctrine and its potential application in the context of changing an entity's tax status, see Sheldon I. Banoff, *New IRS Rulings Approve Rescission Transactions that Change an Entity's Tax Status,* J. of Tax'n, Vol. 105, No. 1 (July 2006).

[20] For example, in *Gateway Hotel Partners, LLC v. Commissioner*, T.C. Memo 2014-5 (Jan. 9, 2014), the Tax Court ruled on two distinct proposed rescissions. The first attempted rescission was denied simply because the taxpayer sought to unwind a transaction that had occurred in a prior tax year. The second attempted rescission was sustained. The relevant facts involved a transaction whereby Gateway Hotel Partners, LLC ("GHP") intended to have certain Missouri Historic Preservation Tax Credits (MHTCs) transferred from GHP to Historic Restoration, Inc. ("HRI") and then from HRI to Firstar Community Development Corp. ("Firstar CDC"). Rather than executing the transaction in this manner, the MHTCs were transferred directly from GHP to Firstar CDC. Upon realization of this error, the parties requested a reissuance of the MHTCs as originally intended. During the same taxable year, the original transfer of MHTCs was voided and new documentation was created establishing the transfers of the MHTCs from GHP to HRI and then from HRI to Firstar CDC. The court ruled that because the original transaction and rescission occurred within the same taxable year the original transfer had no effect for tax purposes. The only authority cited by the court in support of this conclusion was Rev. Rul. 80-58.

[21] *See* n.19, above.

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In situations in which a taxpayer discovers a mistake in the controlling legal instruments, the taxpayer may seek an order that reforms the instruments *nunc pro tunc.*[22] However, whether a reformation under state law will be given retroactive effect for federal income tax purposes is a matter of uncertainty dependent on the relevant facts.

Consider, for example, ratification pursuant to Delaware state law. Under §18-106(e) of the Delaware Limited Liability Company Act (DLLCA), limited liability companies may ratify certain defective acts undertaken by the entity.[23] Under this provision, the ratification will be applied retroactively.[24] Separately, §204 and §205 of the Delaware General Corporation Law (DGCL) provide rules allowing corporations to ratify certain defective corporate acts. Similar to DLCCA §18-106(e), DGCL §204 applies retroactively.[25] Importantly, DGCL §205 provides a mechanism for the Delaware Court of Chancery to consider the validity of a defective corporate act. As discussed below, a unilateral change in a transaction step is unlikely to have retroactive effect for federal income tax purposes. However, where the IRS has the opportunity to challenge the ratification, retroactive relief for federal income tax purposes may be available. Query, though, whether simply having an opportunity to participate in the ratification would be sufficient as compared to actually participating.

Before discussing relevant authorities addressing federal income tax consequences resulting from state law reformations, it is necessary to consider how state law may impact the federal determination. In *Commissioner v. Estate of Bosch*,[26] the Supreme Court addressed what weight, if any, a federal court should place on a state court decree. The Court held that where the issue involved is the determination of property interests for federal estate tax purposes, and the determination is based on state law, the highest court of the state is the best authority on its own law. The IRS, however, is not bound by a lower court decision. If there is a decision by a lower court, then the federal authority must apply what it finds to be state law after giving ''proper regard'' to the state trial court's determination and to relevant rulings of other courts of the state. In this respect, the federal agency may be said, in effect, to be sitting as a state court.

With this backdrop, we now consider relevant authorities addressing federal income tax consequences of retroactive state law reformations. The general position of the IRS as it relates to retroactive effect is discussed in Rev. Rul. 93-79.[27] In this ruling, the IRS addressed whether a state court's retroactive order reforming a trust has retroactive effect for purposes of determining the trust's eligibility to be a shareholder in an S corporation. The IRS concluded that the state's order would not have retroactive effect for federal income tax purposes, citing several cases, including *American Nurseryman Publishing Co. v. Commissioner.*[28]

As referenced in Rev. Rul. 93-79, the court in *American Nurseryman* reached a conclusion similar to that of *Van Den Wymelenberg*. The issue in *American Nurseryman* involved the transfer of S corporation stock to a trust that was not an eligible S corporation shareholder. Following the death of the transferring shareholder, an Illinois court determined the transfer to be a mistake and held it to be *void ab initio.* The Tax Court, however, refused to provide retroactive relief to the reformation and found the S corporation status to have terminated. The court noted that:

> At the outset, there is no merit in the petitioner's argument that this Court should give retroactive effect to the State court order voiding Mrs. Kilner's transfer of her stock in trust. There is no dispute that in 1975 Mrs. Kilner desired to transfer her stock in trust, and there is no dispute that in 1975 she transferred her stock in a valid and completed transaction. As between Mrs. Kilner and the trust, the State court order may have had retroactive effect, but this Court and the Courts of Appeals have consistently expressed the view that not even judicial reformation can operate to change the federal tax consequences of a completed transaction.[29]

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[22] The term ''nunc pro tunc'' in this context refers to a court action that applies retroactively to correct an earlier ruling.

[23] The statute specifically provides, ''Any act or transaction that may be taken by or in respect of a limited liability company under this chapter or a limited liability company agreement, but that is void or voidable when taken, may be ratified (or the failure to comply with any requirements of the limited liability company agreement making such act or transaction void or voidable may be waived) by the members, managers or other persons whose approval would be required under the limited liability company agreement: (1) for such act or transaction to be validly taken. . . .''

[24] The flush language in §18-106(e) provides, ''Any act or transaction ratified, or with respect to which the failure to comply with any requirements of the limited liability company agreement is waived, pursuant to this subsection shall be deemed validly taken at the time of such act or transaction.''

[25] DGCL §204(f)(1) provides, ''[E]ach defective corporate act ratified in accordance with this section shall no longer be deemed void or voidable as a result of the failure of authorization described in the resolutions adopted pursuant to subsection (b) of this section and such effect shall be retroactive to the time of the defective corporate act.''

[26] 387 U.S. 456 (1967).

[27] 1993-2 C.B. 269.

[28] 75 T.C. 271, 276–277 (1980), *aff'd without pub. opin.,* 673 F.2d 1333 (7th Cir. 1982).

[29] *Id.* at 275.

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Notwithstanding the holdings in *American Nurseryman*[30] and similar cases, retroactive effect for federal income tax purposes has been granted in several cases that appear to favorably align in situations where retroactive tax planning isn't present. For example, retroactive effect for federal income tax purposes was granted in *Flitcroft v. Commissioner*.[31] In *Flitcroft*, the taxpayers established trusts that were not by their terms irrevocable. State law mandated that a trust was not irrevocable unless expressly stated in the trust instrument. A state court reformed the trusts, based on the asserted original intent of the grantors, and decreed that the trusts were irrevocable from their execution. The Ninth Circuit reversed the Tax Court's decision and held that the trusts were retroactively irrevocable for federal income tax purposes.

In reversing the Tax Court's decision, the Ninth Circuit cited *Mary Kent Miller v. Commissioner*.[32] Interestingly, the Tax Court decided *Miller* while *Flitcroft* was being appealed. The issue in *Miller* was the effectiveness of a state court's determination that a trust established by the taxpayer was irrevocable for federal income tax purposes. The Tax Court concluded ''that the State court judgment was rendered in an adversary proceeding and cannot be ignored.'' This ultimately led to a decision that the federal income tax consequences would be applied retroactively based on the state court's determination. As stated in Rev. Rul. 93-79, however, ''The Service does not follow the Ninth Circuit's decision in *Flitcroft* to the extent it requires the Service to give effect to a retroactive reformation.''

In *Mason v. Commissioner*,[33] the Ninth Circuit affirmed the Tax Court's holding giving retroactive effect to a bankruptcy court order allowing the taxpayer to abandon stock of an S corporation. The Tax Court concluded:

> We concede that the doctrine of relating abandonment back over a period of years may require the courts to establish limits to its applicability in the area of Federal taxation to accommodate the need for an annual accounting of income. The narrow facts of the instant case do not present the occasion to speculate about those parameters. Here the subchapter S corporation had filed for and been discharged in bankruptcy when the individual shareholder himself filed for bankruptcy. The trustee for the individual shareholder acquired worthless stock in a bankrupt corporation. After filing for bankruptcy in early 1967, the corporation never again engaged in business. We are thus here concerned with only the last year of business, and uncertainty over how earnings of the corporation would be handled in future years is not present. On the limited facts before us we hold that the doctrine of abandonment is applicable.

Notwithstanding these favorable authorities, other courts have concluded that retroactive effect for federal income tax purposes is not available through state law reformation.

In *Van Den Wymelenberg v. United States*,[34] taxpayers executed a trust agreement creating a trust for their 12 minor grandchildren. By the terms of the agreement the corpus was to vest as each beneficiary reached 21 years of age, and income was to be distributed to them at least annually. The trustee was given broad powers to deal with the trust property. Taxpayers presented evidence that, some months before the execution of the trust agreement, they met with their accountant, their lawyer, and a son who acted as their financial advisor to discuss creation of the trust. A tentative draft agreement was prepared incorporating Taxpayers' initial ideas. Taxpayers were informed by their advisors, however, that modifications would be necessary if the gifts in trust were to qualify for the annual gift tax exclusion. Taxpayers agreed and instructed their attorney to conform the draft agreement to the requirements for the annual gift tax exclusion under I.R.C. §2503(c). Through inadvertence the draft agreement did not empower the trustee to invade corpus to meet the needs of the beneficiaries and did not allow the beneficiaries to dispose of their interests by will. The gifts therefore did not qualify for the annual gift tax exclusion under §2503(c). Following IRS notification that the exclusions were to be disallowed, Taxpayers amended the trust agreement and provided an effective date back to the original agreement date.

The district court in *Van Den Wymelenberg* concluded, and the Seventh Circuit affirmed, that the purported reformation of the trust agreement did not have retroactive effect. In looking to cases such as *Flitcroft*, the court highlighted the importance of the government having the opportunity to be a party in the state action. The district court quoted the court in *Flitcroft*:

> It is our conclusion that the state court was correct in finding that it was the intention of the parties to

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[30] In this case, a shareholder's transfer of stock to a revocable trust of which she was sole trustee and beneficiary terminated the subchapter S election of the corporation. The termination of the subchapter S election was not altered as a result of a state court order voiding the transfer since judicial reformation couldn't change a completed transaction. The court's decision was heavily informed by the decision in *Van Den Wymelenberg*, cited and discussed below.

[31] 328 F.2d 449 (9th Cir. 1964), *rev'g* 39 T.C. 52 (1962).

[32] T.C. Memo 1963-215.

[33] 646 F.2d 1309 (9th Cir. 1980), *aff'g* 68 T.C. 163 (1977).

[34] 397 F.2d 443 (7th Cir. 1968).

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> create irrevocable trusts from their inception; that the decree of the state court adjudicated property rights and should be given effect in the federal courts; and that the decree of the state court was not in fact collusive, particularly in view of the fact that the District Director of Internal Revenue had full knowledge of the state court proceedings, having been joined initially as a party in that action.[35]

Based on this guidance, the *Van Den Wymelenberg* district court concluded that ''when the United States has an opportunity to participate in the state court when reformation is sought, such reformation may have a *nunc pro tunc* effect, even as it relates to federal taxes.''[36]

In *Breakiron v. Gudonis*,[37] a district court addressed the retroactive applicability of a state law rescission for federal income tax purposes straddling more than one year. In its opinion, the court discussed the seemingly disparate lines of cases holding either for or against retroactive application of a state court determination for federal income tax purposes. For example, the court noted at 5–6:

> The lead case so holding is *Dodge v. United States*, 413 F.2d 1239, 1243 (5th Cir. 1969). In that case, plaintiff mistakenly transferred her entire interest in property (six acres) to charity when her intent was to convey only a 1/5 undivided interest in order to qualify for the charitable deduction on her federal income taxes. Thereafter, a reformation agreement was executed stating that the grantors intended to transfer only a 1/5 interest, and a reformed deed was issued to reflect the conveyance of the 1/5 interest. The IRS rejected the charitable deduction on the ground that the entire property had already been conveyed the year before. The district court held that state law reformation of the original transfer abrogated the federal tax liability. The Fifth Circuit affirmed because, it reasoned, the original instrument contained a mistake, and was ''defective and imperfect at the moment it was created''; therefore the gift was ''incomplete.'' *See id.* at 1243. Given the language of the tax regulation, the court held that a gift is not complete where the instrument may be reformed because ''the grantor [] ha[s] in law a reserved power to revest the beneficial interest in [himself]. . . .'' *Id.*
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> Similarly, in *Berger v. United States*, 487 F. Supp. 49, 52 (W.D. Pa. 1980), the court held that a mistaken transfer is not a completed gift by virtue of the equitable right of reformation. Apparently misunderstanding the conflict rules pertaining to political appointees, the taxpayer sought political appointment and liquidated his property and transferred it to two irrevocable trusts for the benefit of his wife and his children. Berger then sought judicial reformation of the trusts to make them revocable, which was granted. On cross-motions for summary judgment, the district court held that the instrument was properly reformed under state law, thus abrogating the gift tax imposed on the original transactions. It held that ''[Berger's] gift into trust was incomplete for mistake, [thus] there can be no transfer tax . . .'' and, in cases of mistake, ''courts have relieved taxpayers of gift tax liability on the ground that there existed a right to reformation under the applicable state law upon the production of requisite proof to the courts to establish the basis for reformation.'' *Id.* at 52.

In rendering its decision in *Breakiron*, the district court observed:

> [T]he court in *Van Den Wymelenberg* required the IRS to be a party to guard against the possibility of ''collusion,'' that is, usurpation of the federal interest in collecting federal taxes, since both parties to a state court proceeding may have a common interest in minimizing federal tax liability. * * * A contested proceeding in which the IRS is a party would provide it with the opportunity to cross-examine the plaintiff to ensure that there was a genuine mistake (as in *Dodge* and *Berger*), rather than a post hoc attempt to minimize a federal tax obligation or to avail oneself of a tax advantage unbeknownst to the plaintiff at the time of the original transfer.[38]

Ultimately, the *Breakiron* court ruled that the transaction was rescinded *nunc pro tunc*. Consequently, the rescission binds all parties and is conclusive for federal income tax purposes.

CONCLUSION

So where does this discussion leave us when the parties to an executed transaction have discovered an error in the executed documents? Correcting the error as a scrivener's error would be the simplest path forward. In situations where this isn't feasible, reasonable options to consider include substance-over-form arguments, the rescission doctrine, or a state law reformation.

[35] 272 F. Supp. 571, 573 (E.D. Wis. 1967), *aff'd*, 397 F.2d 443 (7th Cir. 1968).

[36] *Id.*

[37] No. 09-10427-RWZ (D. Mass. Aug. 10, 2010).

[38] *Id.* at 6.

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As discussed above, notwithstanding the decision in *Complex Media*, the IRS is of the view that taxpayers are bound by their form. This is especially true in circuits that follow *Danielson*. However, the Tax Court appears to have opened the door for taxpayers seeking to disavow the form of an executed transaction. Given the fact-intensive nature of a substance-over-form argument coupled with the IRS's non-acquiescence in *Complex Media*, taxpayers should proceed down this path with caution.

In lieu of a substance-over-form argument, perhaps a taxpayer can simply rescind the transaction creating the problem. To meet the requirements of Rev. Rul. 80-58, though, the rescission must occur during the taxable year the transaction was executed. Additionally, the rescission must achieve *status quo ante*. Query whether rescinding only part of a transaction satisfies the requirement that the parties be returned to their pre-transaction state.

Assuming substance over form isn't a viable position and the requirements of Rev. Rul. 80-58 can't be met, can the taxpayers retroactively "reform" the transaction under state law? For example, can the parties to the transaction ratify the transaction under Delaware state law? If this is possible, the next question is whether retroactive treatment granted under state law will be respected for federal income tax purposes. Based on Rev. Rul. 93-79, the IRS doesn't appear to look favorably on retroactive effect of a state law reformation. However, as discussed above, there is conflicting case law addressing this question. A state law reformation in which the IRS is party to court proceedings may have the greatest chance of achieving retroactive effect. Query whether a reformation under state law in which there is no tax motivation could have retroactive effect in the absence of the IRS's participation.

Fortunately, for taxpayers who find themselves in the situation described in this article, there are potential corrective measures available. Ideally, the particular facts will align with one of these available approaches. However, the actual facts are often less than ideal. In those situations, it is essential to exercise care and consideration in evaluating the best path forward.

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