Tax News

a publication of the Tax Section of the State Bar of Arizona

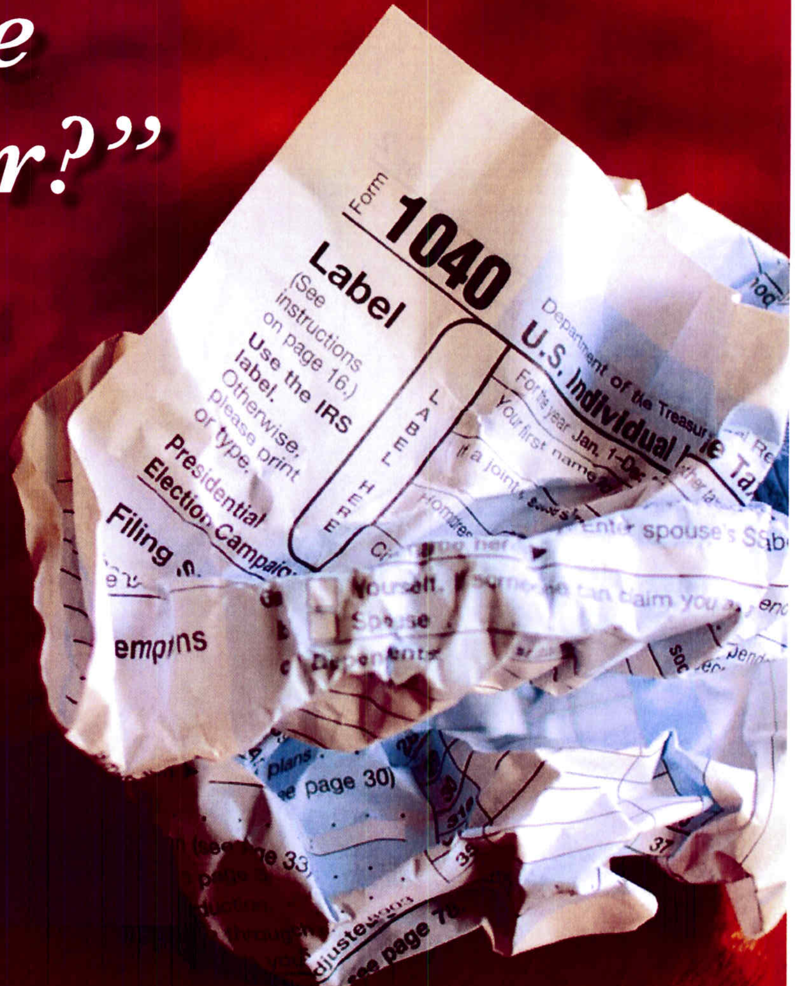
STATE BAR OF ARIZONA

October 2008

this issue...

"Can We Have a Do-Over?"

Rescinding Transactions for Federal Tax Purposes



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In certain circumstances, taxpayers can rescind a transaction for federal tax purposes and avoid recognizing gain or loss or other unfavorable tax consequences as a result of the original transaction. This ability to get a "do-over" for federal tax purposes has been used by taxpayers in a myriad of ways to avoid recognizing adverse or unexpected tax consequences from a completed transaction. For example, taxpayers have successfully rescinded various transactions in order to:

(i) avoid the recognition of gain or loss on the sale of real property;

(ii) unwind the revocation of a corporation's Subchapter S election;

(iii) prevent a merger from being treated as a complete liquidation; and

(iv) revoke a Section 83(b) election.

In light of the obvious benefits to both clients and practitioners of getting a "do-over" for federal tax purposes, this article briefly summarizes the Internal Revenue Service's ("IRS") position on rescission and the instances in which the IRS has acquiesced to a rescission for federal tax purposes.

Neither the Internal Revenue Code (the "IRC") nor the Treasury Regulations address whether un-winding or rescinding a transaction will be given effect for

tax purposes, such that the rescinded transaction will be treated as a tax nullity. However, in Revenue Ruling ("Rev. Rul.") 80-58, 1980-1 C.B. 181, the IRS directly addressed this issue, formulating the following general rules:

(i) if a transaction is rescinded within the same tax year and the parties to the transaction are restored to their original positions, the rescission will be given retroactive effect for tax purposes and the parties will be treated as though the original transaction never occurred; and

(ii) if a transaction is rescinded after the close of the tax year in which the transaction occurred, the rescission will not be given retroactive effect and will be treated as a separate taxable event.

In Rev. Rul. 80-58, the IRS considered two different scenarios. In the first scenario, taxpayer A sold a tract of land to third party buyer B in exchange for cash. The purchase contract obligated A to accept the reconveyance of the property if B was unable to rezone the property within the next nine months. When B was, in fact, unable to rezone the property during the year of the sale, A accepted the reconveyance of the property and returned the purchase price to B. Because the sale transaction and the reconveyance occurred in the same taxable year, the IRS held that the rescission nullified the original conveyance and extinguished the need for A to recognize any taxable income from the sale.

In the second scenario, the purchase contract obligated A to accept the reconveyance of the property if B was unable to rezone the property at any time during the one year period following the execution of the purchase contract. In January of the tax year following the year of the sale, B notified A that it was unable to rezone the property. A accepted the reconveyance of the property and returned the purchase price to B. Because the sale transaction and the reconveyance occurred in different taxable years, the IRS held that the rescission should be disregarded with respect to the taxable events occurring in the year of the sale. As a result, both the original conveyance and the subsequent recovenyance were treated as separate taxable events.

The different tax treatment accorded to rescissions in Rev. Rul. 80-58, depending on whether the rescission occurred during the same tax year as the original transaction or a subsequent tax year, is a result of the annual accounting concept. In general, the annual accounting concept requires that transactions be viewed "on an annual basis using the facts as they exist at the end of the year." Id. According to the IRS, "the annual accounting [concept] requires the determination of income at the close of the taxable year without regard to subsequent events." Id. As a result, in Rev. Rul. 80-58, the IRS concluded that, in order to be effective for tax purposes, a rescission must occur in the same taxable year as the original transaction.

Since the issuance of Rev. Rul. 80-58, the IRS has ruled in a number of scenarios that rescissions taking place during the same taxable year as the original transaction are effective for tax purposes. A majority of these rulings are highlighted below.

Reversal of Revocation of Subchapter S Election – In Private Letter Ruling ("PLR") 200533002, the IRS considered whether the termination of a corporation's Subchapter S election could be reversed by rescinding the issuance of a second class of stock. The S corporation at issue in PLR 200533002 issued convertible preferred stock to three limited partnerships. Since S corporations can not have partnerships as shareholders or issue a second class of stock, the conveyance of the preferred stock to the limited partnerships terminated the corporation's S election. However, after a period of serious disagreement between the original shareholders and the partnerships, the corporation rescinded the issuance of the convertible preferred stock to the ineligible partnerships. Because the stock issuance and the rescission occurred in the same taxable year, the IRS ruled that the rescission restored the corporation's Subchapter S election.

Rescission of Merger Treated as Complete Liquidation – In PLR 200701019, the IRS ruled that the rescission of a merger of a subsidiary and its parent, which would have been treated as a complete liquidation of the subsidiary under IRC §§ 332 and 336, was effective for tax purposes. As a result, the parent corporation was entitled to preserve its basis in the subsidiary's stock; basis which otherwise would have been lost as a result of the deemed liquidation of the subsidiary. Even though the rescission in PLR 200701019 appears to have been motivated solely by tax concerns (i.e., the parent's loss of its stock basis), the IRS ruled that the rescission was effective.

Rescission of Change of Entity's Tax Status – In PLR 200613027, the IRS allowed a partnership that had been converted to a C corporation as a result of a statutory merger to revert to partnership tax status. The taxpayer in PLR 200613027, a domestic limited liability company (an "LLC") statutorily converted into a C corporation by filing a certificate of conversion and a certificate of incorporation. The conversion was undertaken in order to make an initial public offering. When market conditions changed, the shareholders decided to enter into a rescission agreement to convert the entity back to an LLC taxed as a partnership. Because the conversion of the LLC to a corporation and the rescission took place during the same taxable year, the IRS ruled that the LLC should be treated as a partnership for tax purposes, regardless of the statutory conversion.

Revocation of IRC § 83(b) Election – In PLR 9104039, a corporation approved the transfer of 300 shares of stock to its employees. The transferred stock was subject to a substantial risk of forfeiture under IRC § 83(a), so a number of the employees made timely IRC § 83(b) elections to include the value of the stock in income during the year of receipt. After the stock transfer, the corporation's accountants determined that the transfer would have a significantly greater impact on the corporation's profits than originally estimated. As a consequence, the corporation and the employees agreed to rescind the stock transfers. Because the rescission and the stock transfers occurred during the same taxable year, the IRS held that the IRC § 83(b) elections made by the employees would have no force and effect, such that the employees would not be required to recognize income as a result of the IRC § 83(b) elections.

Despite the IRS' apparent willingness to give effect to rescissions occurring in the same taxable year as the original transaction, it is not clear how receptive the IRS is to rescissions that are purely tax motivated. Although the rescission in PLR 200701019 appears to have been motivated by tax considerations, a majority of the IRS' rulings with respect to rescinded transactions deal with cases in which the rescission was motivated, to some extent, by business concerns. For that reason, while rescission may be a viable technique for correcting some tax "mistakes," especially in situations such as those highlighted above, practitioners should be cognizant of the fact that (i) a tax motivated rescission will not work if the rescission does not occur in the same tax year as the original transaction; and (ii) given the IRS' arsenal of civil and criminal penalties, tax motivated rescissions should be undertaken with caution, even if the rescission occurs in the same tax year as the original transaction.

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