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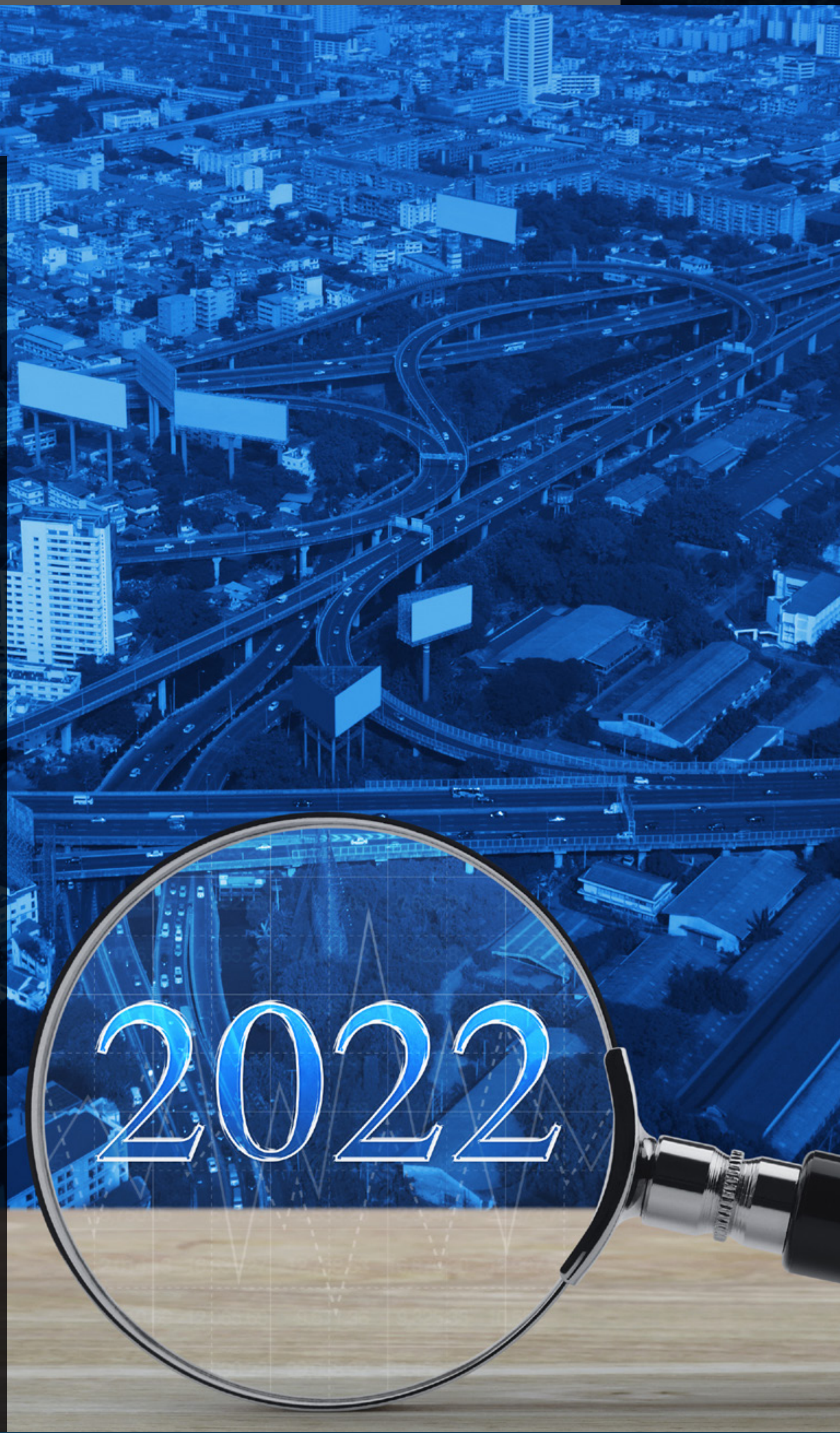

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PRESTO CHANGE-O: UNWINDING TRANSACTIONS IN THE FACE OF UNCERTAINTY – IT'S ALL ABOUT THE RESCISSION DOCTRINE[1]

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If 2021 has taught us anything, it is that neither the economy nor the tax law is stable and that any Congress may seek to drastically alter the tax laws, as opposed to such a change being made "once a generation." As a result, companies have been actively engaging in transactions, including restructuring their operations, based on what they are anticipating will occur. However, when the dust settles, some taxpayers are having buyer's or seller's remorse and wishing they did not engage in a transaction. To address some of those concerns, companies should be aware of the rescission doctrine and its potential uses. Generally viewed as a last resort, the rescission doctrine may allow companies to retroactively unwind a transaction they have entered into, as long as they are aware of the open questions and potential limitations attached to this course of action.

History of the Rescission Doctrine

Neither the Internal Revenue Code nor any Treasury Regulations describe the rescission doctrine, but its genesis and application in the tax realm can be traced to *Penn v. Robertson*.[2] In that case, Charles A. Penn was a vice president and director of the American Tobacco Company (ATC). In 1929, the company directors passed a resolution that resulted in the sale of 10,000 shares of ATC stock to Penn in exchange for a note, in which dividends on the stock would be credited to the note. In 1931, in response to litigation, the directors of ATC passed a resolution to rescind and cancel the 1929 sale and the dividends that were credited in 1930 and 1931. The court, based on annual income tax accounting, required Penn to recognize dividend income with respect to the 1930 dividend, but allowed the rescission of the 1931 dividend.

Forty years later, in Revenue Ruling 80-58,[3] the Internal Revenue Service acknowledged that rescission could be accomplished by mutual agreement, by one party's declaration of rescission of the contract without the other's consent if sufficient grounds exist, or by court order. However, the IRS required that:

- the parties to the original transaction are the same parties that entered into the rescission;
- the parties be returned to the "relative positions that they would have occupied had no contract been made"; and
- the rescission and restoration occur within the same taxable year as the original transaction.

It is important to note that, in formulating these requirements, the IRS did not refer to a nontax business purpose in order to apply the rescission doctrine. In fact, the IRS has issued numerous private letter rulings allowing taxpayers to rescind a transaction in order to obtain a better tax result or to correct a tax error, including:

- unwinding a liquidation or merger to restore the shareholder's basis in the stock of the liquidated entity or to address uncertainties about the tax consequences of the transaction;
- unwinding a sale so that it can be structured as a qualified stock purchase to which a Section 338(h)(10) election can be made;
- unwinding the satisfaction of debt using corporate stock to adjust the amount of debt satisfied, with the remainder being cancelled via a capital contribution; and
- unwinding the transfer of an S corporation so that its suspended losses are not eliminated.

These rulings are significant in that they have not only allowed taxpayers to rescind a transaction solely for tax reasons but also essentially offered taxpayers a mulligan that allows them to recast a previously agreed-upon transaction. In other words, mere rescission would involve undoing a transaction, whereas a mulligan allows the taxpayer to undo a transaction and reengage in a modified form of the same transaction.

Taxpayers should be aware that the IRS no longer issues private letter rulings on rescissions and that it may no longer support some past rulings.[4] Additionally, the courts and the IRS generally do not allow for rescission

[1] This article is a revised version of an article that originally appeared in the November–December 2021 issue of *Tax Executive*, the professional journal of Tax Executives Institute, and is reprinted with the permission of TEI and the authors. Kevin M. Jacobs and Lee G. Zimet, "Presto Change-o: Unwinding Transactions in the Face of Uncertainty," *Tax Executive*, Nov.–Dec. 2021, at 25, https://taxexecutive.org/presto-change-o-unwinding-transactions-in-the-face-of-uncertainty/.

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

[3] 1980-1 C.B. 181.

[4] Revenue Procedure 2021-3 Section 3.02(8).

if the transaction involves stock that post-transaction, but pre-rescission, declared a dividend that created an irrevocable vested legal right to the payment.[5]

The Returning-Parties-to-the-Same-Relative-Position Requirement

The concept of returning taxpayers to the same relative position they would have occupied if the underlying transaction were never entered into seems relatively straightforward. The rescission must involve the same parties and the same property. However, several nuances must be explored, because this requirement has not been strictly applied. For example, if a taxpayer sells property for cash, a strict interpretation would require the taxpayer to return the cash in exchange for the property in order to qualify for the rescission doctrine. Nonetheless, several courts have held that the rescission doctrine applies even if the taxpayer issues a note instead of returning the underlying cash. Additionally, the application of the rescission doctrine does not appear to require the taxpayer to compensate the buyer for the use of its cash between the time of the transaction and the rescission. Therefore, the taxpayer, in essence, has received an interest-free loan from the buyer.

Another nuance that taxpayers should be cognizant of is the potential application of the doctrine in the case of a partial rescission, which occurs when the parties want to rescind a portion of the transaction rather than the entire transaction. But very little guidance exists concerning what requirements a taxpayer must satisfy to engage in a partial rescission. That said, in the few instances where the courts and the IRS have permitted a partial rescission, the following additional requirements appear to have been imposed:

- the original transaction could be clearly bifurcated into the portion of the transaction that would remain and the portion that was rescinded, and
- the parties clearly intended to engage in a partial rescission.

However, it is worth noting that some courts have held that a partial rescission may not be eligible for the rescission doctrine.[6]

The Same-Taxable-Year Requirement

Like the returning-to-the-same-relative-position requirement, the same-taxable-year-requirement seems relatively straightforward. But does one determine the applicability of the doctrine if the parties to the original transaction have different taxable years? For example, assume that on May 1, 2021, seller S, a calendar-year taxpayer, sells a building to buyer B, whose fiscal year ends on March 31. On August 1, 2021, the parties want to rescind the sale. Would that satisfy the same-taxable-year requirement? August 1 occurs within the same taxable year of the sale for S but in a different taxable year for B. These situations demand caution, since there is limited guidance on this issue, and the answer may depend on what consideration B transferred. In other words, if B transferred cash, then trying to rescind on August 1 may allow the rescission doctrine to apply. However, if B transferred property, then trying to rescind on August 1 may not allow the doctrine to apply, because in addition to being a buyer of the building, B was also a seller of property. It may be possible that the rescission may be valid for S but not for B, but again it is important to look at all of the underlying facts and consult with a trusted advisor when making that determination.

What Happens Now?

If the rescission doctrine does in fact apply, then it is treated for tax purposes as if the underlying transaction never occurred. For example, if on July 9 seller S sells depreciable property that it purchased in the prior year to buyer B, and the transaction is subsequently rescinded on November 9, then S is entitled to a full year's worth of depreciation deductions because it is deemed to have held the property for the entire year on account of the rescission. This rationale applies to full and partial rescissions. However, multiple dates can be involved in a transaction if the rescission is also part of a change of the terms (that is, a renegotiation of the original transaction). In those cases, the IRS has ruled that the rescission nullifies the original transaction, and the new transaction is treated as occurring on the date it was entered into (that is, not the date of the original transaction).[7] This treatment, however, could become more complex in a partial rescission: Is it treated as if the taxpayers entered into two different agreements, or are the two viewed as part of a plan and therefore treated as being entered into on the same day?

Revoking a Check-the-Box Election

Another option taxpayers should be aware of is the potential ability to withdraw a check-the-box election. In general, many business entities are permitted to choose or change their entity classification for US income tax purposes by making a check-the-box election. However, unless the election is made effective as of formation (or, in the case of foreign entities, as of the date it is first relevant), an entity may generally make only one election in a five-year period. In the absence of an election, the taxpayer retains its default classification, as determined under the applicable Treasury Regulations.[8]

5 See, for example, *Crellin's Estate v. Comm'r*, 203 F.2d 812 (9th Cir. 1953), *cert. denied*, 346 US 873 (1953).

6 *See*, for example, *Estate of Kechijian v. Comm'r*, 962 F.3d 800 (4th Cir.).

7 *See*, for example, Private Letter Ruling 201211009.

8 Treasury Regulations Sections 301.7701-2 and 301.7701-3(b).

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There may be situations where an entity (foreign or domestic) files a check-the-box election but later regrets having done so. Even if the entity is permitted to file a new election to change its classification, the choice is not retroactive and thus cannot unwind the effects of the original election. However, the IRS provides relief whereby, under certain circumstances, the IRS may allow a taxpayer to withdraw a check-the-box election.[9]

Specifically, a taxpayer may withdraw a previously filed check-the-box election if it initiates the process by the due date of the tax return for the taxable year in which the election was effective. It is unclear whether extensions are taken into account for this purpose. If the process applies, the entity returns to its pre-election classification status and is eligible to make a new check-the-box entity election (with the effective date based on the new election). Even if the taxpayer does not initiate the process by the due date of the initial tax return, it may be possible for a taxpayer to apply to have the tax status of the entity returned to the default status. However, there is uncertainty as to how this process applies.

Companies are strongly encouraged to work with a trusted advisor to determine their eligibility for this withdrawal relief.

Conclusion

Taxpayers always try to structure tax-efficient transactions. However, changing circumstances, including a potential change in law, may render previously well-reasoned and tax-advantageous transactions rather costly. The potential applicability of the rescission doctrine to unwind a transaction or potentially undo a check-the-box election may alleviate some of the distress associated with those changes in circumstances. The potential application of the rescission doctrine is a facts-and-circumstances determination. As a result, companies considering whether they may be eligible for relief are advised to consult with a trusted advisor as soon as possible, because when it comes to the potential application of the rules for undoing transactions, timing is crucial.

9 Internal Revenue Manual 3.13.2.27.9 (January 1, 2022). However, the ability to withdraw a check-the-box election may not always be automatic. *See*, for example, Private Letter Ruling 202123001.

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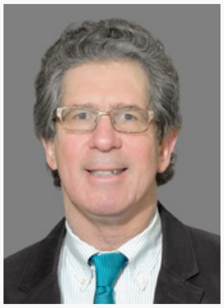

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