NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON

THE RESCISSION DOCTRINE

August 11, 2010

Report No. 1216

This Report[1] responds to a request to assist Treasury and the Service in developing a framework to be used in formulating guidance relating to the circumstances under which the Internal Revenue Service (the "**Service**") will respect "rescission" or unwinding of an action or transaction as sufficient to permit the action or transaction to be disregarded for tax purposes.

Introduction

Generally, the "rescission doctrine" is broadly understood as providing that a transaction may be disregarded for federal tax purposes if the parties to the transaction, during the same taxable year in which they undertake the transaction, rescind the transaction and restore themselves to the same position they would have occupied had they not undertaken the transaction (*i.e.*, they return to the *status quo ante*). While the Service has issued a few published rulings and a number of private letter rulings dealing with the application of the rescission doctrine to corporate transactions, the case law in this area is somewhat confusing, and some of the private letter rulings extend the rescission doctrine to areas not covered by existing law or the existing published guidance. Because of the frequency with which the doctrine of rescission has been invoked in recent years (generally outside the private ruling context but encouraged by private ruling trends), the fact that private letter rulings are not precedential authority, and the desirability of bridging the gap between what may be acceptable in the controlled environment of the private ruling process and what may be acceptable where such controls do not exist, we believe that taxpayers, their advisors, and the tax system would benefit from more systematic guidance in this area.

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[1] This report was prepared by an *ad hoc* committee of the Tax Section. The principal drafters of this report were Kathleen Ferrell, Sarah Joy and Michelle Messer. Helpful comments were received from Lee Allison, Dan Altman, John Barrie, Richard Blaker, Peter Blessing, Kevin Brogan, Peter Canellos, Christopher Flanagan, Ralph Gerra, George Ince, Jr., Elizabeth Kessenides, Stephen Kruse, Abraham Leitner, Alexey Manasuev, Erika Nijenhuis, Regina Olshan, Andrew Oringer, Michael Schler, David Schnabel, Tiberio Schwartz, David Sicular, Eric Sloan, Eric Solomon, Karen Sowell, Linda Swartz, Laura Twomey, Kirk Wallace, Gordon Warnke, Diana Wollman.

Part II of this Report summarizes our recommendations. Part III discusses the current state of the law relating to rescission, as well as the taxpayer and the tax policy concerns we believe published guidance should address.

Part II - Recommendations for Guidance

Recommendations

We have the following recommendations, which we discuss more fully below in this Part II.

1. We recommend that the Treasury and Service publish guidance to clarify the circumstances under which the unwinding or rescission of a transaction will be given retroactive effect for federal tax purposes. Such guidance should include elaboration on the practical approach the Service has taken in private letter rulings with respect to the *status quo ante* requirement, and clarify that the same taxable year requirement means that the rescission must be effected by the last permitted date within the earlier of the relevant time periods, where the parties to a transaction have different tax years. Guidance should also address whether and to what extent a transaction intended as a rescission must be identified as such by the parties at the time it is undertaken. A specific identification or disclosure requirement (or incentives designed to encourage specific identification or disclosure) may be appropriate.

2. We believe that the Service generally should not endorse unfettered application of the rescission doctrine and recommend that the Service be attentive in particular to the application of the doctrine to transactions between related parties, unilateral actions or transactions, "partial" rescissions and cases where the underlying transaction is later "done over." Consideration of these types of transactions should inform any guidance concerning the *status quo ante* requirement, identification of transactions intended to effect a rescission, as well as the effects of a valid rescission.

3. We recommend that the rescission doctrine generally not be available to circumvent Congressional or Treasury pronouncements that restrict the taxpayer's ability to unwind an election, action or transaction. However, we also recommend that the Service consider adopting a more flexible approach in providing targeted administrative relief to correct various oversights, mistakes and execution errors in connection with entity classification elections, Section 83(b) elections. entering into gain recognition agreements and triggering events in relation thereto,

domestic use elections for dual consolidated losses and triggering events in relation thereto, and similar areas in which taxpayers might otherwise resort to "rescission" to cure foot-faults in the execution of the tax aspects of transactions.[2]

4. We recommend the Service clarify the scope of the rescission doctrine in the compensation context. In particular, we recommend that the Service clarify the extent to which common law remedies may be available in addition to the specific corrections procedures provided in various administrative pronouncements to correct plan document or operation "failures" under Section 409A.

Summary Discussion of Recommendations

In view of the gap between the case law and published guidance on the one hand, and the private rulings on the other hand, we recommend that the Service publish guidance to clarify the circumstances under which the unwinding or rescission of a transaction will be given retroactive effect for federal tax purposes. In this connection, it would be helpful to understand whether the Service believes that the principles of administratively authorized rescission are intended to be consistent with the case law or rather to reflect the reasonable exercise of discretion to provide relief that consciously goes beyond the case law. Guidance upon which taxpayers may rely as well as a revenue procedure providing the conditions under which private rulings will be granted would provide more predictability and consistency.

As a general matter, we believe that guidance should address the various policy issues concerning the scope of the rescission doctrine, the requirements for a valid rescission, and the tax effects of a valid rescission, in various specific contexts. For example, different rules might apply to: (i) bilateral agreements or transactions involving unrelated parties; (ii) related party transactions; (iii) unilateral actions or transactions (including dividends, gifts, and tax elections); (iv) "partial" rescissions where the underlying transaction is not fully unwound and (v) situations in which the underlying transaction is "done over" in modified form or at a later time.

Policy Issues Concerning Scope of the Rescission Doctrine. We believe that the rescission doctrine as developed in the courts generally reflects a taxpayer-

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[2] References in this report to the "Code" and "Sections," unless otherwise stated, are to the Internal Revenue Code of 1986, as amended and sections therein.

favorable tolerance for permitting taxpayers to correct mistakes by unwinding transactions in the context of bilateral agreements, balanced against the practical needs of the tax system to determine and tax income at predictable intervals. We acknowledge the difficulty inherent in any attempt to draw from the existing case law a coherent theory of rescission and understand that government efforts to define the availability of what is frequently a remedy of last resort may invite taxpayer challenges. Nonetheless, we think the Service generally should not endorse unfettered application of the rescission doctrine in potentially abusive situations, which we think include certain types of cases involving "do-overs" rather than true rescissions. Nor should the Service endorse blanket application of the rescission doctrine in situations where Congress or Treasury has explicitly spoken to the circumstances under which a taxpayer may change the status of a prior tax filing or election.

Although we do not believe that availability of the "rescission remedy" should be limited to contractual arrangements involving unrelated parties, rescissions involving related parties or unilateral actions are more likely to present the opportunity for retroactive tax planning and may therefore merit special scrutiny. This is especially true in cases in which the transaction at issue is not merely rescinded but, as part of an overall plan, is "redone" in a different manner or at a different time. We note that even in cases not involving "do-overs" there are implications for evaluating tax "substance" by reference to the commercial significance of actions if those actions can be nullified after the fact based on later developments; the possibility of unconditional rescission means that a related party transaction may not be "old and cold" until the tax year has passed. Guidance should clarify generally whether rescission treatment may be available without regard to the purpose of the original transaction or the motivation for a rescission, including in particular whether rescission is a technique generally available to effect business or tax planning with the benefit of hindsight. On balance, subject to the concern noted above for retroactive tax planning in the case of related party transactions, we believe that taxpayers generally should be permitted to definitively rescind contracted-for transactions for any reason, including the realization that the original transaction had undesirable tax consequences. However, we believe that the interests of the government would not be served by endorsing the application of the rescission doctrine to permit "rescissions" that are part of a plan to re-execute the same or similar transaction (what we mean by "do-overs"), other than in cases of execution error or other mistake existing at the time of the original transaction. Although we do not believe that "do-over" transactions are true rescissions, we do think it would be appropriate for the Service to provide guidance permitting taxpayers to correct execution errors and other mistakes within the same taxable year as the original transaction.

We also believe that where Congress or Treasury has explicitly spoken to the circumstances under which a taxpayer may make or revoke a tax election, the

rescission doctrine should not be available to circumvent these pronouncements. Thus we recommend that the Service consider the availability of rescission as applied to tax elections and transactions that are tantamount to tax elections in light of the policies underlying the particular tax elections and any applicable statutory scheme.[3] In this regard, we also believe the Service should consider whether it may be appropriate to provide additional administrative relief in certain situations not currently covered by 9100 or other administrative relief. For example, we do not believe that the rescission doctrine should be interpreted to permit rescission of a grant of restricted stock (with respect to which a Section[4] 83(b) election was made), followed by an immediate regrant of restricted stock, for the purpose of achieving a de facto revocation of the earlier Section 83(b) election if the relevant rules would not have permitted direct revocation of that election. However, we note that Rev. Proc. 2006-31 so narrowly describes the circumstances under which a Section 83(b) election can be revoked by reason of a "mistake of fact" that taxpayers and their advisors have considered using "rescission" as a more flexible way to achieve a similar effect.[5] We recommend that the Service revisit the guidance relating to correcting mistakes and oversights in this context with a view towards providing more flexible relief. Likewise, we recommend that the Service consider providing additional administrative relief to permit taxpayers to correct timing or other errors in the making of entity classification elections that cannot be dealt with pursuant to the late-election relief currently provided by Rev. Proc. 2009-4 or 9100 Relief.[6]

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[3] As an example of a transaction that has the effect of a tax election, a taxpayer can elect to treat a Delaware LLC as a corporation for tax purposes by making an express tax election pursuant to the "check-the-box" regulations, or can achieve the same tax effect by filing a form to convert the Delaware LLC to a Delaware corporation. While we are not troubled by the possibility that a taxpayer may revisit an entity-classification choice within the taxable year, we believe that a consistent policy should apply to taxpayers seeking to "undo" a de facto entity classification election and to taxpayers seeking to revoke an express "check-the-box" election.

4 References in this report to the "Code" and "Sections," unless otherwise stated, are to the Internal Revenue Code of 1986, as amended and sections therein.

5 We understand that taxpayers may also seek rescission and regrant of restricted stock in situations where the Section 83(b) election was not timely made.

[6] Rev. Proc. 2009-41, 2009-39, I.R.B. 439, generally permits relief for a late "check-the-box election" filed within three years and 75 days of the requested effective date, provided (1) the entity has not yet filed a federal tax or information return for the first year for which the election was intended (because the due date has not passed for such return) or has timely filed all required federal tax returns and information returns consistent with its requested classification for all the years the entity intended the requested classification to be effective, and (2) the entity has reasonable cause for its failure to timely make the entity classification election. Entities that do not meet the requirements of Rev. Proc. 2009-41 may be able to obtain 9100 Relief for a late
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In addition, we recommend that the Service clarify whether and the extent to which rescission, or the analogous concept relating to compensation as developed in the *Couch-Russel* line of authorities discussed below, is effectively available as a remedy in situations in which plan "failures" under Section 409A would result absent permitted correction. Notices 2008-113[7] and 2010-6[8] set forth corrections procedures for dealing with certain Section 409A failures in certain circumstances. The Service should specifically confirm that, as it has generally indicated, there may be circumstances under which plan document or operation failures can also be corrected by rescission. If, contrary to those indications, the corrections procedures in Notices 2008-113 and 2010-6 are intended as exclusive remedies, the Service should so state.[9]

As discussed below, in the compensation area generally, the relevant authorities support the proposition that mistaken payouts, or payouts otherwise not reflecting the intent of the parties, can be corrected in the same tax year without tax consequences. We are generally of the view that, as the Service has indicated, Section 409A should not be interpreted as an exclusive regime that precludes application of this common law relating to the waiver or repayment of compensation.[10]

Elements of a Valid Rescission. Guidance should address whether a rescission needs to be identified as such by the parties and should interpret the requirements that (i) a rescission return the parties to the *status quo ante* and (ii) be effected within the same taxable year as the underlying transaction.

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election, but must state why the requirements of the Rev. Proc. have not been met. Administrative relief for other errors could, for example, in appropriate circumstances, permit the effective date of an otherwise valid entity classification election to be changed, or permit correction of an otherwise valid entity classification election that was erroneously filed for the wrong entity.

[7] Notice 2008-113, 2008-51 I.R.B. 1305 (Dec. 5, 2008) (providing guidance on correcting certain operational failures of nonqualified deferred compensation plans to comply with Section 409A(a) and providing that the service recipient must take commercially reasonably steps to avoid recurrence of specified operational failures).

[8] Notice 2010-6, 2010-3 I.R.B. (Jan. 5, 2010) (providing "methods for taxpayers to voluntarily correct many types of failures to comply with the document requirements" applicable under Section 409A to nonqualified deferred compensation plans).

[9] *See* Notice 2010-6, § III(I) and Notice 2005-1, § I (paragraph 3). *See also* Andrew L. Oringer, *Some §*409A *Relief for the Weary—IRS Notices 2008-113 and 2010-6 . . . and More?*, 38 TAX MGMT. COMPENSATION PLAN. J. 67 (2010).

[10] See *id*.

As regards taxpayer identification of the transaction, we recommend that guidance address whether and when it is necessary for the taxpayer to have identified the purported rescission as such, as may be required under certain case law[11]. We believe that taxpayers seeking rescission treatment should be encouraged to adopt a form for the necessary steps that is unambiguously an "unwind" of a previous action or transaction or otherwise to identify contemporaneously an attempted rescission. This may be particularly important in cases in which the taxpayer seeks to unwind only a portion of an overall transaction, and in cases involving related parties or unilateral actions. In the compensation area, guidance should address whether it is necessary to document agreements evidencing that a voluntary rescission is intended, to preclude the possibility of an alternative recharacterization, e.g., as a capital contribution.

As regards the *status quo ante* requirement, we believe that published guidance should make it clear that the requirement applies to *all* parties to the original transaction, consistent with the rescission result which treats the underlying transaction as though it never existed. We also believe that satisfaction of the *status quo ante* requirement should be viewed as requiring consistent treatment by all the affected parties to the transaction.[12] In addition, published guidance should address whether a rescission must concern exactly the same property and parties that were subject to the underlying transaction, as has been suggested under certain case law, or whether it is sufficient that the taxpayer reproduce legal and financial arrangements with respect to parties and properties that are materially similar to those involved in the original transaction. Guidance should also address whether a rescission may involve the parties' entering into additional agreements (*e.g.*, indemnification agreements) or making additional payments in connection with the transaction.

We generally support an approach that permits the parties to achieve a rescission based on restoration of the *status quo ante* in all material respects. Therefore, we believe the Service should confirm the practical position it has taken in private letter rulings that it is necessary only that the parties be restored

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[11] *See* Branum v. Campbell, 211 F.2d 147 (5th Cir. 1954) (taxpayer's repurchase, within the same taxable year in which he sold it, of his share of a business was not styled as a rescission and was found to be two "separate and distinct" transactions).

[12] Guidance should also address which parties must be restored to the *status quo ante*. If the original transaction had collateral effects on taxpayers who are not direct parties to the transaction, would those collateral effects also need to be unwound in order to satisfy the *status quo ante* requirement? *See*, *e.g.*, Monte A. Jackel & Craig A. Gerson, *Do-Overs: Transaction Rescissions in a Partnership World*, 2010 TAX NOTES 55-10, at 1529 (2010) (discussing this issue in the context of partnerships unwinding entity-level transactions and the collateral effects on partners).

to a position that is "identical in all material respects" to the legal and financial arrangements in existence prior to the transaction, and that the effect of interim events need not necessarily be reversed so long as the parties are restored to the position they would have occupied had they not undertaken the underlying transaction.[13] We also support the view that additional agreements providing for mutual releases or indemnification in connection with the original transaction and the steps taken in pursuit of its rescission should not prevent satisfaction of the *status quo ante* requirement. On the other hand, we believe that the making of additional payments by the parties to an original transaction (as opposed to merely reversing payments) may not be consistent with the notion that an effective rescission restores the *status quo ante*, and recommend that a transaction that is intended to be treated as a rescission for tax purposes should be subject to special scrutiny where such additional payments are made. For example, a payment intended to compensate the buyer in a rescinded sale for the seller's use of the refunded proceeds during the interim period should be permissible, but only if the "interest" payment does not exceed an arm's length rate of interest. Last, as a philosophical matter, we believe the judicially developed *status quo ante* requirement should not be viewed as satisfied if the taxpayer "unwinds" a transaction but subsequently, as part of an overall plan, achieves substantially the same end result by effecting a new or modified transaction. However, as noted above, we think it would be appropriate for administrative guidance to permit taxpayers to correct execution errors or other mistakes existing at the time of the original transaction by "undoing" and then "re-doing" the same or similar transaction.

As regards the same taxable year requirement, the existing case law does not provide authority for treating as valid for tax purposes rescissions that are not effected within the same taxable year as the original transaction. However, the rescission authorities are unclear as to whose taxable year is controlling in instances where parties to a transaction have incompatible taxable years. We recommend that the Service clarify the determination of the relevant time period in those cases where parties have incompatible taxable years. Generally, in those cases in which the parties are otherwise supposed to take the transactions into account at the same time (e.g., there is no timing difference resulting from one party being on the cash basis while another is on the accrual method) but the parties do not have the same taxable year, the transaction should be unwound by

[13] Guidance should specifically address the effect of payments that cannot readily be reversed, such as transaction expenses (for both the original transaction and the rescission) and the effect of non-economic items such as shareholder votes that occur during the interim period between the original transaction and the rescission. Presumably, the inability to unwind these items would not adversely affect an otherwise valid rescission.

the last permitted date within the earliest of the relevant periods.[14] As discussed more fully below, special considerations may apply in the compensation area where employers, even if on a calendar year, may be permitted to take compensation expense into account in the year prior to the employee's income event.[15] In this context, existing authorities suggest that the Service requires only that repayment occur within the taxable year of the service recipient.

We also considered whether to recommend general relaxation of the same-taxable-year requirement, at least as applied to the rescission of transactions afflicted by mistake of law or fact. For example, the Service could consider extending the time period in which to effect a rescission to the filing due date for the year in which the underlying transaction was undertaken. While such a liberalization would alleviate the bias against transactions entered into near the end of the taxable year, which include some of the most sympathetic cases for rescission, we ultimately concluded that loosening the same taxable year requirement as a general matter is not advisable, both because it could expand opportunities for aggressive application of the rescission doctrine and because it is not supported by the case law.

However, the Service may wish to consider adopting a more flexible approach in providing targeted administrative relief, similar to the approach of the rules providing "9100 Relief," which has recently been expanded by Revenue Procedure 2009-41.[16] For example, if the taxpayer can demonstrate that the parties to a transaction agreed to a plan of rescission on December 31, but were unable to effect or "paper" the planned rescission until the following year, the Service could deem the taxpayer to have satisfied the same taxable year requirement on the basis of substantial completion of the rescission. Increased clarity on this sort of issue would allow taxpayers to better evaluate the potential success of a rescission attempt.

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[14] Incompatibilities in the parties' taxable years could be resolved by looking only to the taxable year of the taxpayer at issue. However, such a method would sometimes lead to unappealing results in that a rescission effective for one party to a transaction would not be effective for its counterparty whose taxable year has already ended, causing, for example, situations in which multiple parties (or no party) are considered the owner of property for tax purposes. Alternatively, the Service could require that rescission occur within the same taxable year of the taxpayer with the later year end, but before the time for filing the tax return for the taxpayer with the earlier year end.

[15] We therefore recommend that the Service's clarification as to the same taxable year requirement specifically address whether different standards govern in the compensation context.

[16] Rev. Proc. 2009-41, 2009-39 I.R.B. 439.

Effects of a Valid Rescission. Guidance should clarify that a rescission causes a transaction to be disregarded for all federal tax purposes. Such guidance should provide specific examples in various contexts to illustrate this principle. For example, if a January 1 sale of depreciable property is rescinded prior to the end of the taxable year, the "seller" should be respected as having been the owner of the property and entitled to depreciation deductions for the entire year. Likewise, the "seller" in a rescinded sale of a partnership interest or all the stock of a consolidated subsidiary should be treated as having been, respectively, a member of the partnership or the owner of a consolidated group member for the entire year. In addition, guidance should clarify that this concept applies equally to reporting and withholding requirements. For example, if the underlying transaction were a listed transaction, rescission of the transaction should obviate the need to comply with the "reportable transactions" rules. On the other hand, the fact that the taxpayer has taken an action or entered into a transaction that is intended to effect a rescission for tax purposes may be a circumstance that generates an independent reporting or disclosure requirement.[17]

In the compensation context, it seems clear that where repayment of compensation in the year paid is respected as "undoing" the original compensation event, rescission not only allows the recipient to exclude the repaid compensation from gross income, but also eliminates FICA tax and withholding tax obligations with respect to such income.[18] We recommend that the Service also provide guidance as to how the employer should deal with situations in which compensation is repaid in a year subsequent to the taxable year in which it was accrued as an expense by the employer. To the extent the repayment occurs before the filing of the employer's tax return for the year in which the compensation was accrued, we believe the employer should not take a deduction for any repaid compensation. To the extent repayment occurs after the filing of the employer's tax return for the year in which the deduction was taken, we recommend the employer be permitted to reduce its compensation expense for the subsequent year to the extent of the repayment.

Guidance should also elaborate on how a rescission binds the parties' future actions and their ability to reexecute the underlying (or similar) transaction. Generally, other than in situations involving mistakes in existence at the time of

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[17] As noted above, we believe that taxpayers seeking rescission treatment should be encouraged to adopt a form for the necessary steps that is unambiguously an "unwind" of a previous action or transaction or otherwise to identify contemporaneously an attempted rescission.

[18] See Rev. Rul. 79-311, 1979-2 C.B. 25 (Service held pay advances returned in same year as original receipt by resigning employee were not subject to federal income tax withholding or FICA tax withholding).

entering into the original transaction, we believe that the rescission doctrine should not be viewed as permitting a transaction to be unwound and then, pursuant to the same plan, re-executed in a modified form or at a later, more favorable, time. For example, in the context of the provision of compensation for services, we believe that the Service should clarify that absent a mistake of fact or other special circumstances, a valid rescission of a compensatory transaction precludes the payment of compensation in a future year in respect of the services to which the rescinded compensation related. In other words, while the *Couch-Russel* line of authorities should be applicable to permit same-year corrections of the amount of current compensation, those authorities should not be read as generally permitting service providers to agree with the service recipient to "rescind" compensation in order to achieve deferral to a later year. In this regard, we note that it may be appropriate for the Service to determine to what extent the principles of the *Couch-Russel* line of authorities should be viewed as applicable in non-compensation contexts.

Part II – "Rescission" and Analogous Principles

This Part[19] summarizes the basis for and current state of the law relating to rescission and identifies some of the areas of ambiguity that would benefit from formal guidance.

Foundations

The rescission doctrine finds theoretical footing in the annual accounting period principle which "requires the determination of income at the close of the taxable year without regard to subsequent events,"[20] and in the claim of right doctrine, which holds generally that amounts received under a claim of right, and which appear to be unrestricted as to their use, are includible in income even if the right is subject to challenge and the amounts may ultimately have to be returned.[21]

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[19] In this Part we acknowledge our indebtedness to the exhaustive accounts of the rescission doctrine provided in Sheldon I. Banoff, *Unwinding or Rescinding a Transaction: Good Tax Planning or Tax Fraud*, TAXES – THE TAX MAG., Dec. 1984, at 942; and David H. Schnabel, *Revisionist History:* Retroactive *Federal Tax Planning* (2009) (unpublished manuscript). An earlier version of the Schnabel paper is published at 60 Tax L. 685 (2007). Discussion of the rescission doctrine and other common law theories as applied to unwinding payments of compensation draw extensively from Rosina B. Barker & Kevin P. O'Brien, *409A Failures: Correcting With and Without Notice 2008-113*, 124 TAX NOTES 557 (Aug. 10, 2009).

[20] Rev. Rul. 80-58, 1980-1 C.B. 181, 182.

[21] See, e.g., N. Am. Oil Consol. v. Burnet, 286 U.S. 417 (1932).

Drawing on these two concepts, the Fourth Circuit held in *Penn v. Robertson*[22] that the 1931 abandonment, due to challenges as to its legality, of a stock purchase plan under which the taxpayer had received dividend income in 1930 and 1931 caused only the taxpayer's 1931 dividend income to be disregarded for tax purposes.[23]

Following *Penn*, the Service ruled in Revenue Ruling 80-58 that a taxpayer recognizes no gain where, pursuant to a contractual provision triggered by a zoning change and within the same year in which he sells land, he both accepts reconveyance of the land and returns the proceeds received from its sale.[24] However, where the land is reconveyed and proceeds are returned in the following taxable year, there is no rescission and the taxpayer recognizes gain in the year of sale.[25] In the Ruling the Service expressly recognizes the principle of rescission:

> The legal concept of rescission refers to the abrogation, canceling, or voiding of a contract that has the effect of releasing the contracting parties from further obligations to each other and restoring the parties to the relative positions that they would have

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[22] 115 F. 2d 167 (4th Cir. 1940).

[23] In *Penn* the taxpayer participated in an employee compensation plan under which he purchased employer stock using proceeds lent to him by that employer, with the expectation that he would repay the loan with dividend income from this stock. The taxpayer received dividends on this stock in 1930 and 1931. In response to shareholder suits alleging the compensation arrangement had not been duly authorized, the board of directors rescinded the arrangement in December 1931.

[24] The Service also cited Rev. Rul. 74-501, 1974-2 C.B. 98, and, in describing its holding, ruled that a stock basis adjustment that would otherwise have been required by reason of the distribution of stock rights was not required where a shareholder exercised the stock rights, and paid the subscription price for the new stock, which subscription price was later returned to the shareholder in the same taxable year in which the rights were issued, because the rights plan was rescinded for non-tax reasons when the public market price of the stock fell to a price below the subscription offer. Rev. Rul. 80-58, 1980-1 C.B. 181, at 182. We understand that some taxpayers have taken the position that Rev. Rul. 74-501 and Rev. Rul. 80-58 support the proposition that a taxpayer may rescind the exercise of a compensatory stock option. *See, e.g.*, Michael E. Mooney, *Mitigating the Pain of Equity Compensation in a Down Market*, 93 TAX NOTES 1099 (2001).

[25] Rev. Rul. 80-58, 1980-1 C.B. 181. The facts of the Ruling were as follows: *A* sold land to *B* subject to a contract whereby *A* was obligated to take back the land at *B*'s request if it could not be rezoned within nine months. In the first situation, *B* determined within the same year of the sale that the land could not be rezoned and reconveyed the land to *A*, receiving in exchange the return of the amount *B* had paid. The Service respected this rescission. In the second situation, the facts were identical to the first except that *B* reconveyed the land to *A* in February of the following year. The Service did not respect this as a rescission.

occupied had no contract been made. A rescission may be effected by mutual agreement of the parties, by one of the parties declaring a rescission of the contract without the consent of the other if sufficient grounds exist, or by applying to the court for a decree of rescission.[26]

In subsequent private letter rulings, the Service has come to interpret Rev. Rul. 80-58 to stand for the proposition that rescission requires the satisfaction of "at least" two conditions: (1) "the parties to the transaction must return to the *status quo ante*;" and (2) "this restoration must be achieved within the taxable year of the transaction."[27]

The Status Quo Ante Requirement

Revenue Ruling 80-58 establishes the *status quo ante* requirement but there is very little other published guidance or case law dealing with exactly what is required to satisfy that condition. Based on the private letter rulings, it appears that to meet the first requirement, the Service requires the parties to the transaction to represent only that the rescission has resulted in "no material changes in the legal or financial arrangements" as they existed before the parties undertook the underlying transaction.[28] As applied in the private letter rulings, the condition apparently is not violated by the transpiring of interim events so long as the parties are restored to the position they *would have* occupied had they not undertaken the underlying transaction.[29] While this is a sensible approach, the

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[26] Rev. Rul. 80-58, 1980-1 C.B. 181, 181-82.

[27] P.L.R. 9829044 (July 17, 1998). *See also* P.L.R. 200533002 (Aug. 19, 2005); PLR 200752035 (Dec. 28, 2007); PLR 200843001 (Oct. 24, 2008); PLR 200923010 (June 5, 2009).

It is worth noting that in Rev. Rul. 80-58, the right to reconvey the land was pursuant to a contract and based on the occurrence of an external event (zoning approval) and thus the agreement to rescind in that ruling was not motivated by hindsight relating to tax considerations. However, subsequent private letter rulings relying on Rev. Rul. 80-58 have not interpreted the ruling as containing a safeguard against hindsight.

[28] P.L.R. 200701019 (Jan. 5, 2007) (parent corporation's acquisition of its subsidiary is disregarded where parent, upon realizing the acquisition had negative tax consequences, contributed within the taxable year the sole asset of the old subsidiary to a new subsidiary). *See also* P.L.R. 200716024 (Apr. 20, 2007) (rescission respected where "Rescission Transaction" caused "the legal and financial arrangements between [the parties] to be identical in all material respects . . . to such arrangements that would have existed had [the underlying transaction] not occurred").

[29] *See* P.L.R. 200701019 (Jan. 5, 2007) (rescission respected where taxpayer makes representations that interim activities would have occurred regardless of rescinded transaction);
(…continued)

lack of published guidance may make it difficult for careful tax practitioners to advise with certainty that the *status quo ante* condition is met where interim events cannot be undone. Possibly implicit in the *status quo ante* requirement are the ill-defined prerequisites that (1) the parties and property that are subject to the rescission should be the same as those that were at issue in the underlying transaction,[30] and (2) no consideration is paid by either party to induce the other's assent to the rescission transaction.[31]

Concern regarding the treatment under the status quo ante requirement of items that cannot readily be returned to the *status quo* can affect the ability of tax practitioners to advise clients on the application of this requirement. Items such as transaction expenses, on both the original transaction and the rescission, generally cannot be unwound for all involved parties. The same is generally true for non-economic items such as shareholder votes that occur during the interim period between the original transaction and the rescission. Taxpayers and their advisors would benefit from guidance confirming that the inability to unwind these types of items will not invalidate an otherwise valid rescission.[32]

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P.L.R. 200716024 (Apr. 20, 2007) (rescission of a redemption of preferred stock is respected where at the time the redemption is unwound the stock holder receives dividends he would have received during period of rescinded redemption).

[30] *See* Hope v. Comm'r, 55 T.C. 1020 (1971) (cited for the proposition that the parties to the rescission transaction must be the same as those in the rescinded transaction); Hutcheson v. Comm'r, 71 T.C.M. (CCH) 2425 (1996) (cited for the proposition that property subject to the rescission transaction must be the same as that which was subject to the rescinded transaction.) *But see* P.L.R. 200701019 (Jan. 5, 2007) (merger of a subsidiary into its parent was effectively rescinded by creation of a new subsidiary to receive the assets and liabilities of the subsidiary that was merged out of existence); Fleischman v. Comm'r, BTA Memo 1936-312 (1936) (where underlying transaction was rescinded as a matter of state law and property sold in the underlying transaction was returned in exchange for cash and a note issued by taxpayer, rescission was respected despite the fact that taxpayer retained $52,500 of the cash paid to him in the rescinded sale); Clark v. Comm'r, 11 T.C. 672 (1948), (court held that bonus amounts that the taxpayer repaid to his employer with a promissory note instead of with cash were excludable from the taxpayer's gross income).

[31] *See, e.g.*, P.L.R. 200716024 (Apr. 20, 2007) (relying on the parties' representation that "no consideration will be paid by either party to induce the other to agree to enter into the Rescission Agreement"). However, the Service did permit the rescission agreement in that ruling to include a mutual release. *See also* P.L.R. 200533002 (Aug. 19, 2005) (permitting the inclusion of an indemnity in connection with rescission).

[32] As a related point, presumably the agreement between the parties that one party will bear a disproportionate portion of the transaction expenses would not be treated as impermissible consideration to induce the other party's assent to the rescission transaction. Confirmation that
(…continued)

Uncertainties also arise with respect to the *status quo ante* requirement in the context of a rescission affecting only some steps of an overall transaction or series of transactions.[33] Partial rescission may be pursued either because the parties intend to modify a transaction, to unwind only a part of a transaction, or because it is impossible to unwind all steps of the transaction that the parties intend to rescind. At least one recent private letter ruling permitted the parties to unwind only one part of a transaction. In P.L.R. 200908016, where three corporations were amalgamated and within the same year a series of "rescission transactions" were undertaken to restore one of the corporations to its pre-amalgamation status, the Service allowed the rescission with respect to the restored corporation despite the fact that the other two corporations amalgamated in the underlying transaction remained combined.[34] Presumably the taxpayer's ability to elect to rescind only part of a transaction is not unlimited – at some point the freedom to partially rescind will run afoul of the *status quo ante* requirement.[35] Taxpayers and their advisors would benefit from published guidance concerning when and how a taxpayer may choose to only partially unwind a transaction, and how much of a transaction must be unwound to satisfy the *status quo ante* requirement. Generally, we believe that this allowance for partial rescission should be confined to situations, as in P.L.R. 200908016, in which an overall transaction may be easily separated into distinct parts that are not necessarily interdependent.

Further, it is unclear whether an effective rescission can occur where the parties intend, or are required by state law, to rescind a transaction, but find it *impossible* to unwind all steps of or consequences resulting from the transaction. Private letter rulings suggest that a rescission may be respected in some situations

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such an agreement will not negatively impact the parties' ability to effect a valid rescission would be helpful.

[33] *Compare* Blanco v. U.S., 602 F. 2d 324 (Ct. Cl. 1979) (holding that a transaction wherein appreciated assets were distributed to taxpayer in redemption of taxpayer's stock was not rescinded by a subsequent transaction wherein redeemed shares were returned to taxpayer in exchange for an interest-bearing note), *with* Fleischman v. Comm'r, BTA Memo 1936-312 (1936) (where underlying transaction was rescinded as a matter of state law and property sold in the underlying transaction was returned in exchange for cash and a note issued by taxpayer, rescission was respected despite the fact that taxpayer retained $52,500 of the cash paid to him in the rescinded sale).

[34] P.L.R. 200908016 (Feb. 20, 2009).

[35] *See, e.g.*, Blanco v. U.S., 602 F. 2d 324 (Ct. Cl. 1979) where the court concluded that the (tax-motivated) attempted rescission modified the original transaction but did not rescind it.

even if it is not possible to technically unwind a transaction completely so long as the parties substantially recreate the legal and financial arrangements as they existed prior to the underlying transaction. For example, in P.L.R. 200813028 the taxpayer sought to unwind an acquisition which had in part involved the transfer for no money or other consideration of one subsidiary's operations to another subsidiary.[36] For regulatory reasons these transfers could not simply be reversed. The taxpayer was able to engineer a *status quo ante* outcome through undertaking a series of "rescission transactions" that, while not strictly effecting a reconveyance of the transfer, placed the parties in the position they would have occupied had the transfer never happened. This ruling suggests that the Service may be willing to respect a rescission where it is impossible to unwind all steps of a transaction, so long as the legal and financial arrangements in place at the close of the rescission transactions do not materially differ from those that would have existed had the underlying transaction not taken place.[37] Again, however, notwithstanding the apparent administrative practice, in the absence of published guidelines, it is difficult for careful tax practitioners to advise on the basis of a "close-enough" satisfaction of the *status quo ante* requirement. We recommend that guidance specifically address these types of situations by confirming the availability of rescission treatment, but only if the steps intended to recreate the legal and financial *status quo ante* are identified as an intended rescission transaction.

The Same-Taxable-Year Requirement

Revenue Ruling 80-58 also lays out what has come to be understood as a bright-line rule mandating that, as a prerequisite to be effective for tax purposes, a rescission must be completed within the same taxable year in which the underlying transaction was executed.[38] The precise application of the same

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[36] P.L.R. 200813028 (Mar. 28, 2008).

[37] *See also* P.L.R. 200701019 (Jan. 5, 2007) (where subsidiary was merged out of existence (and could not simply be "unmerged"), rescission of the merger was respected where a new subsidiary was created to occupy the position the old subsidiary would have occupied).

[38] In Rev. Rul. 80-58, the Service stated: "The annual accounting concept requires that one must look at the transaction on an annual basis using the facts as they exist at the end of the year. That is, each taxable year is a separate unit for tax accounting purposes." *See* Gacek v. Comm'r, 53 T.C.M. (CCH) 1342 (1987) (rescission of a 1977 transaction was not respected because there was no evidence the rescission was effected earlier than March 1978); P.L.R. 9341010 (Jul. 14, 1993) (recontribution in subsequent year of an S corporation's distribution was not respected as a rescission); Hope v. Comm'r, 55 T.C. 1020 (1971) (rescission doctrine not available where within the same year in which taxpayer sold stock he merely filed suit to have it rescinded). *But see* Guffey v. U.S., 339 F.2d 759 (9th Cir. 1964) (relaxing the same-taxable-year requirement to accommodate the open transaction doctrine); P.L.R. 8020140 (Feb. 26, 1980) (same).

taxable year requirement is not entirely clear, particularly where not all of the parties have the same tax year. For example, Rev. Rul. 80-58, 1980-1 C.B. 181, states only that the transferor was a calendar year taxpayer, thereby suggesting that the transferee's taxable year may be irrelevant, whereas recent private letter rulings recite the representation that rescission transactions occurred in the "same taxable year of all the relevant parties."[39] In the compensation context, employees and other service providers generally will use the cash method of accounting using a calendar year, while the corporate service will generally utilize the accrual method of accounting and may not be on the calendar year. Although the accrual method of accounting does not generally govern the timing of compensation deductions, the accrual method will be available in certain circumstances as permitted by Section 404(b).[40] Thus, where permitted by Section 404(b), compensation (such as bonuses) paid after the taxable year of the employer comes to a close may be included in the employee's income in a taxable year that is subsequent to the tax year in which the employer is permitted to deduct the expense. This disconnect raises the question as to whose taxable year is relevant in determining whether the same-taxable-year requirement has been satisfied. *Fender Sales, Inc.*[41] suggests that only the employee's taxable year is relevant, but it is unclear whether this should be interpreted to mean that among taxpayers with incompatible taxable years one should look at the later taxable year or whether the same-taxable-year requirement is uniquely applied only to the taxpayer at hand in the compensation context.

Same Taxable Year Requirement as Contrasted With Time Period for 9100 Relief

The taxable-year limitation derives from the policy considerations underlying the rescission doctrine: (1) that there should be a tolerance for permitting taxpayers to correct mistakes by reversing a transaction, with the result that neither the transaction nor its rescission has any effect for tax purposes,[42] and

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[39] See, e.g, P.L.R. 200908016 (Feb. 20, 2009).

[40] *See also* Reg. § 1.404(b)-1T.

[41] 22 T.C.M. (CCH) 550 (1963), *rev'd on other grounds*, 338 F.2d 924 (9th Cir. 1964) (employee returned compensation in same year in which he was entitled to it, but after corporation's year of deduction). *See also* Rev. Rul. 79-311, 1979-2 C.B. 25 (finding controlling that the employee repaid the excess commissions to the employer in same year in which it had received such commissions, without discussing whether the repayment occurred in the same tax year as employer).

[42] While it is not clear that the case law is so generous outside the compensation context, the more expansive "lore" of rescission seems to be that transaction terms may be amended after the fact, and that almost any action can be undone after the fact, so long as effected within the taxable year.

(2) that the efficient collection of revenue and the annual accounting period principle recommend that the taxpayer's ability to rescind a transaction be restricted to situations that do not impair the ability to determine tax liability for any particular tax year.[43]

A comparison of rescission to the relief granted under Reg. 301.9100 (**"9100 Relief"**) is instructive as both mechanisms attempt to balance policy considerations of fairness and administrability, but impose different timing restraints. As discussed in further detail below, 9100 Relief allows for the extension of time in which certain elections may be made under the Code. The relevant regulations describe the policies that inform the limitations on and privileges of 9100 Relief as "the policy of promoting efficient tax administration by providing limited time periods for taxpayers to choose among alternative tax treatments and encouraging prompt tax reporting" and "the policy of permitting taxpayers that are in reasonable compliance with the tax laws to minimize their tax liability by collecting from them only the amount of tax they would have paid if they had been fully informed and well advised."[44] Rather than implement a strict same-taxable-year requirement, 9100 Relief provides automatic six or twelve month extensions for certain listed elections,[45] and discretionary relief that is more liberally time-constrained[46] for other elections.

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[43] Justification for adherence to the annual accounting concept can be found in *Burnet v. Sanford & Brooks Co.*: "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." 282 U.S. 359, 365 (1931). *Cf.* Ripley Realty Co. v. Commissioner, 23 B.T.A. 1247, 1249 (1931) (referencing annual accounting principle, but stating in dicta "[P]erhaps if a certain transaction, seemingly valid, is some years later discovered to have been void *ab initio*, that fact may affect the tax liability of the earlier year").

[44] T.D. 8742, 1998-1 C.B. 388, 389 (1997).

[45] Reg. § 301.9100-2. Reg. 301.9100-2(c) requires that taxpayers who make an election under an automatic extension (and all taxpayers whose tax liability would be affected by the election) file their return in a manner that is consistent with the election and comply with all other requirements for making the election for the year the election should have been made and for all affected years; otherwise, the IRS may invalidate the election.

[46] Reg. § 301.9100-3. Under the regulatory standards for granting discretionary 9100 Relief, the request for an extension will be granted if the taxpayer establishes that (1) he acted reasonably and in good faith, and (2) the grant of relief will not prejudice the interests of the government. Reg. § 301.9100-3(a). Reg. § [301].9100-3(c)(1)(ii) provides that the interests of the government "are ordinarily prejudiced if the taxable year in which the regulatory election should have been made or any taxable years that would have been affected by the election had it been timely made are closed by the period of limitations on assessment under section 6501(a) [generally, three years after a return is filed] before the taxpayer's receipt of a ruling granting [9100 Relief]." In this way, the (…continued)

Similarly, the deadline for making several elections under the Code and accompanying Treasury Regulations is not the end of the taxable year, but some other measure. For example, taxpayers have until the 15th day of the 9th month beginning after the month in which an acquisition occurs to make a Section 338 election. As well, under Treas. Reg. Section 1.761-2(b)(2)(i), a taxpayer has until the time prescribed for the filing of the partnership return (including extensions) for the first taxable year for which the exclusion is desired to elect that an entity not be taxed under Subchapter K.

The Role of Taxpayer Intent in Rescission

It is unclear to what extent, if any, the parties' motivations for effecting a rescission matter. There are any number of reasons why parties might be motivated to unwind a transaction. They may have discovered a clerical error or mutual mistake in the contractual arrangement effecting the underlying transaction. Or, for example, the underlying transaction may have resulted in an unanticipated adverse outcome for one party and the counterparty may acquiesce to a rescission. The party, or parties, may be motivated by a realization that the underlying action or transaction resulted in adverse tax consequences, or otherwise did not prove strategically desirable. Or the party or parties may be adversely affected by the promulgation of retroactively effective legislation or may have inaccurately predicted the outcome of pending tax legislation.

A number of cases deal with rescissions motivated by mistake of fact[47] or mistake of law.[48] The rescission authorities also include situations where the

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regulations provide a "deadline" for granting discretionary 9100 Relief though not a firm one, as a request made outside this period of limitations *ordinarily*, and therefore does not *always*, prejudice the interests of the government.

[47] *See, e.g.*, Van Fleet v. Commissioner, 2 B.T.A. 825, 827-28 (1925) (where a client and a cash basis law firm entered into a contingent fee agreement, and the fee was mistakenly paid by "mutual mistake of fact" in a year before the contingency was satisfied, the court held the law firm not taxable on the amount of the fee which was put in a trust for the payor); Barker v. Commissioner, 3 B.T.A. 1180, 1186 (1926) (where a shareholder received a liquidating dividend and in the same year paid taxes owed but unpaid by the corporation, the dividend was received under a "mistake of fact" to the extent of taxes still owed by the corporation and the portion that shareholder was required to refund by way of payments of the corporation's taxes was not taxable to the shareholder because it was repaid in the year received); Cremin v. Commissioner, 5 B.T.A. 1164, 1168 (1927) (citing *Barker* to reach a similar holding on similar facts.); Rev. Rul. 2002-84, 2002-2 C.B. 953 (where a qualified plan participant receives an overpayment of a lump sum distribution from the plan but returns the excess to the plan in the year of receipt, "the amount repaid reduces the taxable amount received as a distribution by the participant from the plan in the taxable year").

"mistake" was an illegal act (e.g., embezzlement).[49] In addition, a published ruling extends the doctrine to an action that became uneconomic in hindsight for public shareholders because of a subsequent decline in market value.[50] While the motivation for the rescission is usually identified in the cases, the cases generally do not turn on why the parties were seeking rescission.[51] Nonetheless, in formulating guidance in this area, we believe the Service should consider whether to distinguish between rescissions intended to fully unwind transactions or correct mistakes in transactions from potentially abusive situations that seek to "rescind" and then "do over" a transaction not afflicted by any mistake or other infirmity existing at the time of the original transaction to take advantage of the benefit of hindsight to improve a tax position.[52]

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[48] United States v. Merrill, 211 F.2d 297, 304 (9th Cir. 1954) (where the surviving husband-executor charged the entirety of the executor fees from his wife's estate instead of only half, as required in a community property state, the court, citing *Van Fleet* and *Curran Realty*, held that the taxpayer was not taxable on the excess fees to the extent they were returned in same tax year in which they were received).

[49] *See, e.g.*, Mais v. Commissioner, 51 T.C. 494, 497 (1968); Leaf v. Commissioner, 33 T.C. 1093, 1096 (1960); Stovall v. Commissioner, 46 T.C.M. (CCH) 894 (1983), *aff'd*, 762 F.2d 891 (11th Cir. 1985); *see also* 1994 FSA LEXIS 83 (Apr. 8, 1994) (while noting that case law has found that funds returned in the same year as embezzlement can be netted against funds embezzled in that year, holding that funds returned in a later year can be taken only as deduction); Quinn v. Commissioner, 524 F.2d 617, 623-4 (7th Cir. 1975) (noting in dictum that funds restored in the same year as embezzlement are netted against those embezzled funds); Buff v. Commissioner, 496 F.2d 847, 849-50 (2d Cir. 1974) (Oakes, J., concurring) (similar). *Cf.* I.R.S. G.C.M. 33,602 (Aug. 25, 1967) (concluding that a usurious lender may exclude from gross income the illegal interest it receives from borrowers during the year if the lender returns the amounts in the same year).

[50] Rev. Rul. 74-501, 1974-2 C.B. 98 (following a distribution of stock subscription rights, the value of which exceeded 15% of the value of the underlying stock, the stock price fell below the subscription price; in the same year the corporation rescinded the rights offering and cancelled the stock purchases that had already been made via the exercise of the subscription rights, returning the subscription price to the shareholders.) As noted above, this ruling, even though it involved a rescission motivated by nontax considerations relevant to the public markets, has been cited as support for the proposition that exercise of a compensatory stock option can be rescinded. We believe the Service should specifically address whether a taxpayer can rescind the exercise of a non-qualified stock option where the underlying stock option grant remains outstanding.

[51] *But see* Davis v. United States, 378 F.Supp. 579 (N.D. Tex. 1974) (where a conveyance intended as gift was, by an accountant's mistake, structured as a sale and then unwound to be reconveyed as a gift, the court held that the sales proceeds were not taxable, because they were returned in same tax year to effectuate the parties' intent).

[52] We note that several members of the Executive Committee did not endorse this view.

Several private letter rulings indicate that the Service does not feel compelled to inquire into the parties' intent, suggesting that the motivation of the rescinding parties may be irrelevant. In P.L.R. 9829044, for example, shareholders were permitted to rescind the transfer of their S corporation stock upon realizing the underlying transfer would have limited their use of tax losses.[53] In this and other rulings respecting rescissions that appear to have been motivated by a desire to correct defective tax planning on a retroactive basis, the Service does not appear to have required that the parties demonstrate any non-tax business purpose for the original transaction or the purported rescission.[54]

Furthermore, the private letter rulings suggest that a rescission may be respected even where it is prompted, not by a defect in the underlying transaction, but by a change in circumstances that causes the taxpayer to regret a business decision, or a tax planning exercise, in hindsight. In P.L.R. 200613027, for example, an LLC had converted into a corporation in anticipation of going public, but was later permitted to rescind its conversion upon realizing that a decline in the market dampened its IPO prospects.[55] Contrast this outcome with that mandated by the Regulation section 301.7701 check-the-box regulations wherein an entity that elects to change its classification generally "cannot change its

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[53] P.L.R. 9829044 (July 17, 1998).

[54] *See* P.L.R. 200613027 (Mar. 31, 2006) (allowing an LLC's conversion into a corporation in anticipation of an IPO to be rescinded despite the fact that the conversion back to an LLC was tax-motivated); P.L.R. 200911004 (Mar. 13, 2009) (allowing a merger to be disregarded where acquiring corporation took steps to rescind the merger within the same taxable year upon realizing the merger "could yield adverse tax consequences that potentially could be devastating to the viability of [the acquiring corporation] as an ongoing entity"). In these Rulings the Service refrains from addressing the parties' motives.

In the compensation context, the Service has on a number of occasions "blessed" rescissions that might be viewed as tax-motivated. For example, in P.L.R. 200752035, an S-corporation issued its stock to an employee's IRA. Upon learning that an IRA was an ineligible holder and therefore the issuance terminated the corporation's S-corporation status, the corporation, the employee and the IRA entered into a rescission agreement under which the issuer voided the stock certificate issued to the IRA and returned to the IRA the purchase price. Because the restoration and the original transaction both occurred within the company's taxable year, the Service ruled that the legal doctrine of rescission applied to both disregard the stock issuance to the IRA and to prevent termination of the S-corporation status. (Dec. 28, 2007).

[55] P.L.R. 200613027 (Mar. 31, 2006). *See also* P.L.R. 200923010 (June 5, 2009) (permitting a rescission motivated by new officers' belief that in the "changed business environment", the costs of the underlying transaction outweighed the benefits of the underlying transaction).

classification by election again during the sixty months succeeding the effective date of the election."[56]

The private letter rulings also suggest there is no requirement that, in order to be respected for tax purposes, a rescission must be the result of a mistake, a right contained within the terms of a contractual arrangement or the result of adversarial proceedings between or among the parties.[57] For example, in P.L.R. 200613027 (noted above) the facts involved a one party transaction that was akin to a tax election where the taxpayer changed its mind in hindsight, though the changed was prompted by a public stock market decline. Also, in P.L.R. 200701019 the Service ruled favorably in a situation in which a parent sought to rescind the liquidation of its subsidiary when, among other reasons, it realized that the transaction had eliminated the parent's basis in the subsidiary's stock.[58] The parent effected the rescission by contributing the acquired subsidiary's lone asset to a newly formed subsidiary. The rescission was respected despite clearly being tax motivated in substantial part (though the tax motivation was to preserve a tax attribute that mistakenly would have been eliminated) and driven entirely by the parent. More recently, in P.L.R. 201008033,[59] the Service permitted a corporate taxpayer to rescind the sale of the stock of a subsidiary to another one of its affiliates upon learning that the sale would create unintended adverse federal income tax consequences to the group. In this same ruling, the Service ruled that a transaction which produced a business result substantially equivalent to those of

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[56] Reg. § 301.7701-3(c)(1)(iv). However, the Commissioner may permit an entity to change its classification again within the sixty months if there is a greater than 50% change in ownership. *Id*. As noted above, we believe the same rules should apply to taxpayers seeking to "undo" a de facto entity classification election and taxpayers seeking to revoke an express "check-the-box" election.

[57] Note, however, that Rev. Rul. 80-58 concerns a rescission of a land sold pursuant to a contract that specifically provided for a conditional reconveyance. *See* note 25 above. The Ruling acknowledges that "rescission may be effected by mutual agreement of the parties, by one of the parties declaring a rescission of the contract without the consent of the other if sufficient grounds exist, or by applying to the court for a decree of rescission."

[58] P.L.R. 200701019 (Jan. 5, 2007). Under the facts of this P.L.R., the parent acquired all outstanding stock of Sub 1 for cash and retired debt of Sub 2 (the outstanding stock of which was Sub 1's sole asset) in exchange for a note from Sub 2 in the same amount. The parent then caused Sub 1 to merge into parent, with parent surviving and holding the Sub 2 stock. Upon realizing it may need to sell certain lines of business, including that of Sub 1, and that it had been imprudent to liquidate Sub 1 rather than preserve its basis in Sub 1 stock, parent formed a new subsidiary to which it contributed the Sub 2 stock in exchange for all the common stock of the new subsidiary. The new subsidiary had all the assets and liabilities of Sub 1 and the ruling permitted Sub 1 to be treated as never having been merged into the parent.

[59] Feb. 26, 2010.

the rescinded transaction and which was subsequently effected by the taxpayer constituted a valid reorganization under Section 368, implying that the Service does not view a "do-over" as an impediment to achieving a valid rescission of an earlier transaction.

These rulings suggest that, in the context of a private ruling request, the rescission remedy may be available not only in those situations where it is applied to correct an unintended infirmity in the underlying transaction or resolve a conflict between the parties, but also as a strategy within limits (i.e., either a tax mistake that had no or little potential federal income tax merit or, in the case of hindsight, based on a commercial occurrence outside of the control of the parties and where there was no meaningful federal income tax benefit sought by the rescinded transaction) to effect more favorable tax consequences or to reengineer the underlying transaction using the benefit of hindsight. The recent administrative practice in applying the rescission doctrine should be contrasted to analogous taxpayer relief available as 9100 Relief.

Scope of 9100 Relief – Relevance of Taxpayer Intent

Regulation section 301.9100 sets forth the standards the Commissioner will use to determine whether to grant a taxpayer an extension of time to make certain regulatory elections.[60] The Commissioner's discretion only comes into play if the election for which an extension is requested does not meet the requirements of Regulation section 301.9100-2, which provides automatic six or twelve month extensions for making certain listed regulatory and statutory elections when the deadline for making the election is the due date of the return (or due date of the return including extensions). The Service explains that these standards for election extensions reflect a balancing of considerations of administrability and fairness:

> There are two policies that must be balanced in formulating the standards for section 301.9100 relief. The first is the policy of promoting efficient tax administration by providing limited time periods for taxpayers to choose among alternative tax treatments and encouraging prompt tax reporting. The second is the policy of permitting taxpayers that are in reasonable compliance with the tax laws to minimize their tax liability by collecting from them only

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[60] Reg. § 301.9100-1 and -3.

> the amount of tax they would have paid if they had been fully informed and well advised.[61]

Published guidance and the Code indicate that, in accordance with these policy considerations, discretionary 9100 relief (1) has been restrained in contexts where the request for relief is motivated by tax planning considerations, and (2) is unavailable if the taxpayer uses hindsight in requesting relief.[62]

The Regulations provide that 9100 Relief will be granted only where the taxpayer provides evidence to establish (1) that he has acted reasonably and in good faith,[63] and (2) that the grant of relief will not prejudice the government's interests.[64] In P.L.R. 200607016 the Commissioner found that a taxpayer corporation had not acted reasonably and in good faith where it sought 9100 relief to correct a defect in its tax planning strategy.[65] Under the facts of that Ruling, a foreign corporation was created to accept a transfer of the taxpayer's appreciated assets under the belief that this would permit the taxpayer to avoid taxes on the sale of these assets. When notified that Section 367 defeated this strategy, the taxpayer sought an extension to elect to treat the foreign corporation as a disregarded entity. The Commissioner found that under these facts the requirements for 9100 Relief had not been met because the taxpayer failed to meet the "reasonable action and good faith" standard.[66] The Ruling provides a

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[61] T.D. 8742, 1998-1 C.B. 388, 389 (1997).

[62] Reg. § 301.9100-3(b)(3)(iii). In contrast, *automatic* relief is available with respect to making certain elections under Reg. 301.9100-2 within a certain time period after the due date for making such election and does not entail inquiries into taxpayer intent.

[63] The Service's approach in Rev. Proc. 2009-41, 2009-39 I.R.B. 439 illustrates that an inquiry into "good faith" can be almost as "strictly logistical" as the requirements of Rev. Rul. 80-58. Under Rev. Proc. 2009-41, a taxpayer may demonstrate good faith by reporting consistently with a mistaken belief that an election was timely or correctly filed: As an illustration, an entity that intends to be treated as a partnership for federal tax purposes but defaults into corporate status because of an erroneously filed election can demonstrate good faith by filing partnership returns consistent with its intent.

[64] Reg. § 301.9100-3(a).

[65] P.L.R. 200607016 (Feb. 17, 2006).

[66] Reg. § 301.9100-3(b) provides, in general, that a taxpayer is deemed to have acted reasonably and in good faith if he (i) requests relief before the failure to make the regulatory election is discovered by the Service, (ii) failed to make the election because of intervening events beyond the taxpayer's control, (iii) failed to make the election because, after exercising reasonable diligence, the taxpayer was unaware of the necessity for the election, (iv) reasonably relied on the written advice of the Service, or (v) reasonably relied on a qualified tax professional and the tax professional failed to make, or advise the taxpayer to make, the election.

useful contrast to certain of the rulings issued with respect to rescission relief. The rescission rulings rely, not on codified standards (as there are none relating to rescission), but generally on references to the two minimum requirements set forth in Rev. Rul. 80-58. These minimum requirements are strictly logistical and entail no inquiry into the "good faith" or intent of the parties requesting relief. In this way the availability of relief through rescission may be broader and more open ended than is the availability of 9100 Relief.

Further, the regulations that establish standards for determining if a taxpayer has acted reasonably and in good faith specifically provide that 9100 Relief is not available if the taxpayer uses hindsight in requesting relief. Regulation section 301.9100-3(b)(3)(iii) provides:

> If specific facts have changed since the due date for making the election that make the election advantageous to a taxpayer, the IRS will not ordinarily grant relief. In such a case, the IRS will grant relief only when the taxpayer provides strong proof that the taxpayer's decision to seek relief did not involve hindsight.

Thus, the circumstances under which 9100 Relief is available are more limited than the circumstances under which relief has been granted under the rescission doctrine. For example, the result of P.L.R. 200613027, where a corporation was permitted to revert to pass-through status without tax consequences in light of dimming IPO prospects, may not have been permitted under the 9100 Relief standards.

In sum, while 9100 Relief and the rescission doctrine are shaped by the same policy considerations of administrability of revenue collection and fairness, they manifest these underlying considerations differently. The scope of discretionary 9100 relief is narrower than some of the rescission relief granted in private letter rulings insofar as 9100 Relief is not generally available where motivated by tax planning considerations or hindsight. However, discretionary 9100 relief is not limited by the same-taxable-year requirement.[67]

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[67] The foregoing discussion of 9100 Relief is not intended to suggest that the rescission doctrine is alone in refraining from inquiries into parties' intent. Under each of section 761(c) (permitting allocations among partners to be modified or eliminated up to the date for filing the partnership's tax return), section 1362 (permitting a corporation to elect, up to 75 days following its formation, to be treated as an S corporation), section 338 (providing parties to a qualified stock purchase to elect, nearly eight-and-a-half-months following the purchase, to treat the stock acquisition as an asset purchase), and Regulation section 301.7701-3 (permitting an eligible entity to elect its tax classification as a corporation or partnership up to 75 days after the deemed effective date of this
(…continued)

Unilateral Actions: Dividends, Gifts, and Tax Elections

While the scope of the rescission doctrine as applied to bilateral agreements and transactions involving more than one party appears to be fairly expansive, this may be less true in the context of unilateral actions, such as dividend payments, gifts, tax elections, and certain types of transactions that have the effect of tax elections. For example, in *Crellin's Estate v. Commissioner*,[68] a personal holding company's purported rescission of a dividend was not respected for federal tax purposes, notwithstanding the fact that the shareholders returned their dividends in the same year in which they were received. The Ninth Circuit held that under the claim of right doctrine, the dividend income was still taxable because the purported rescission was "in fact no more than a voluntary payment by stockholders."[69]

In the dividend context, the underlying transaction, a dividend declaration, is a unilateral action that does not take the form of a contractual arrangement. Rev. Rul. 80-58 notes that the "legal concept of rescission refers to the abrogation, canceling, or voiding of a contract."[70] While Rev. Rul. 80-58 may be read to require that an underlying transaction must be contractual in order for its rescission to be respected for tax purposes, we do not think it is clear that the case law compels this limitation. The existing case law dealing with unilateral actions does, however, appear to reflect a policy concern that taxpayers generally should not be permitted to "undo" a voluntary or unilateral action that has tax consequences, other than perhaps to correct a mistake. We believe this policy concern would be better addressed by evaluating whether permitting rescission in

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treatment), Congress and/or Treasury permit the taxpayer to revise past tax events, yet make no inquiry into taxpayer intent.

[68] 203 F.2d 812 (9th Cir. 1953).

[69] *Id*. At 815. The Service cited the reasoning of the *Crellin's Estate* court in F.S.A. 200124008 (Mar. 14, 2001) (noting that "a dividend once legally declared by the corporation's board of directors cannot be revoked").

The *Crellin's Estate* result would have been avoided under two variations. First, if a shareholder returns a dividend out of obligation during the same year in which the shareholder received the dividend, recognition is not mandated by the claim or right doctrine. *See, e.g.*, U.S. v. Merrill, 211 F.2d 297 (9th Cir. 1954). Second, if the dividend had been paid on stock received in a transaction that was later rescinded, and the dividend was returned pursuant to the rescission of that underlying transaction, the taxpayer would not be taxed on the dividend income. *See, e.g.*, P.L.R. 200813028 (Mar. 28, 2008).

[70] Rev. Rul. 80-58, 1980-1 C.B. 181.

certain circumstances would prejudice the government's interests than by applying a formal requirement that there be an underlying contractual arrangement. The Service has respected rescission in other contexts where the underlying transactions would not ordinarily be understood as contractual. For example, in P.L.R. 200613027 the Service respected the rescission of an LLC's incorporation after struggling to find a contractual arrangement in the underlying change of entity status, noting that the incorporation transaction was conducted pursuant to a contract between the owners and the LLC and that the "certificate of incorporation may also have constituted a contract" between these parties.[71]

Similar concerns regarding the potential for retroactive tax planning arise in the gift context.[72] Although the court cases and rulings in this area are limited, it appears that rescission of a gift for tax purposes will generally be permitted only where a mistake of fact exists at the time a gift is made, effectively preventing a completed gift.[73] A mistake as to the applicability of the gift tax laws, even where the return of the gift is effective under state law, has been found to constitute an insufficient basis for rescission.[74]

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[71] *See, e.g.*, P.L.R. 200613027 (Mar. 31, 2006). An alternative characterization would be to analyze this fact pattern similarly to the attempted revocation of a check-the-box election. *See also* P.L.R. 200701019 (Jan. 5, 2007).

[72] One could easily imagine that if rescission were liberally applied to gifts made within the same taxable year, a donor could, for example, rescind a gift of stock if its value drops later that year and simply re-gift it at the lower valuation so as to achieve better tax results. Whether or not rescission, where permitted, applies equally for gift or other tax purposes as it does for federal income tax purposes is unclear, though we see no reason to distinguish among the federal taxes in this context.

[73] *Cf.* P.L.R. 8433024 (May 10, 1984) (refusing to give retroactive effect to a trust amendment made to qualify transfers to the trust for the annual gift tax exclusion and, therefore, concluding that a transfer to the trust that had been made prior to the amendment, but within the same taxable year, did not qualify for the exclusion). However, courts have permitted rescission of a sale, within the same taxable year, where the taxpayer's intent was to make a gift. *See, e.g.*, Davis v. United States, 378 F. Supp. 579 (N.D. Tex. 1974).

[74] In *Board v. Commissioner*, 14 T.C. 322 (1950), gifts made solely for the purpose of saving estate taxes were reconveyed to the donor in a later year when it was discovered that the donor had mistakenly interpreted estate tax law. The Tax Court held that the transfer was taxable as a gift and that the donor's disappointed hope for estate tax relief was insufficient to defeat the gift tax on a completed gift. *See also* P.L.R. 8205019 (Nov. 3, 1981). In P.L.R. 9408005 (Nov. 15, 1993), the Service refused to permit a refund of gift taxes paid by a taxpayer who rescinded the releases of her reversionary interests in two grantor trusts that had first given rise to the gift taxes. The rescission was made after a retroactive change in law which revised certain safe harbor rules upon which the taxpayer had relied in executing the releases in an earlier taxable year.

Tax elections provide another useful way to think about the contours of the rescission doctrine, in particular because the underlying transaction at issue—the election—is not only a unilateral act, but also inherently tax-motivated. In view of these characteristics, it is not surprising that the ability to revoke or rescind a tax election may be limited by statute or regulation, nor that the Service has generally been unwilling to expand upon the provisions of the applicable statutes and regulations to permit additional administrative relief. Thus, in P.L.R. 8336029 the Service refused the taxpayer's request to rescind its voluntary revocation of a Subchapter S election, even though the request was made in the same taxable year as the revocation.[75] The Service explained that it had "no statutory authority" to grant the taxpayer's request.[76] Similarly, Treasury regulations provide that the Commissioner will grant a revocation of a Section 83(b) election only "where the transferee is under a mistake of fact as to the underlying transaction and [requests the revocation] within 60 days of the date on which the mistake of fact first became known to the person who made the election."[77] Revenue Procedure 2006-31 defines "mistake of fact" narrowly in this context, excluding from its scope mistakes such as "[t]he failure . . . to understand the tax consequences of making [a Section 83(b)] election."[78]

Nevertheless, the caution the Service has shown in applying the rescission doctrine in the context of tax elections may be contrasted with the Service's apparent willingness to respect rescission in circumstances that may achieve a substantially similar effect. For example, as noted above, the Service has respected rescission of an LLC's incorporation in circumstances under which revocation of an entity election classification would not be permitted.[79]

Form of the Rescission

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[75] P.L.R. 8336029 (June 6, 1983). *See also* P.L.R. 8206085. *But see* P.L.R. 200613027 (Mar. 31, 2006) (effectively permitting the taxpayer to revoke an S election by issuing shares to disqualified persons and then "undo" that revocation by rescinding the stock issuance).

[76] P.L.R. 8336029 (June 6, 1983). The Service noted, however, that because the taxpayer's revocation was made before the effective date of the Subchapter S Revision Act of 1982, the taxpayer qualified for an exception to the five-year waiting period in the new law and could reelect Subchapter S status for its next taxable year.

[77] Reg. 1.83-2(f).

[78] Rev. Proc. 2006-31, 2006-2 C.B. 13.

[79] P.L.R. 200613027 (Mar. 31, 2006) (allowing an LLC's conversion into a corporation in anticipation of an IPO to be rescinded in light of a "precipitous and unexpected deterioration in market conditions" that dimmed the corporation's IPO prospects).

The requirements for executing a rescission in a manner that will be effective for tax purposes are not well defined. As noted above, private letter rulings suggest that an underlying transaction need not be fully unwound or strictly reversed to satisfy the *status quo ante* requirement, and the Service is seemingly willing to respect some amount of taxpayer creativity in engineering the form of a rescission. For example, as discussed above, P.L.R. 200813028 permits the parties to undertake a complicated series of steps forward, rather than backwards, to reproduce their *status quo ante* legal and financial arrangements.[80]

However, case law suggests that the freedom to structure a rescission transaction is not unlimited and that a rescission by mutual agreement must be styled explicitly as such and not as a separate transaction. For example, in *Branum v. Campbell*, a taxpayer sold and then repurchased his share of a business within the same taxable year.[81] The repurchase was not styled as a rescission, and the Fifth Circuit found that the sale and repurchase were two distinct transactions, not a single rescinded transaction. To the extent the concept of rescission has been endorsed in advance private rulings, the identification of the transaction as a rescission has been explicit, whether in the documents or in the ruling process itself.

Similarly, where it has issued private letter rulings respecting rescissions, the Service has required representations that no consideration was paid to induce either party's assent to the rescission,[82] presumably because the exchange of consideration would suggest the purported rescission is in fact a separate and distinct follow-on transaction.

Guidance in this area would reduce uncertainty as to what form a rescission should take and create some consistency between the disclosure and identification process associated with seeking a private ruling and rescissions in the absence of a ruling. For example, a formal filing requirement within, e.g., 30 days of a rescission would go some way towards bridging the gap between the formal controls of a ruling process and rescissions done outside of that process. Regardless of whether it imposes a formal disclosure requirement on rescission transactions, the Service should encourage contemporaneous identification of the transactions intended as rescissions, so as to preclude the retroactive

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[80] P.L.R. 200813028 (Mar. 28, 2008). *See supra* text accompanying note 36.

[81] 211 F.2d 147 (5th Cir. 1954).

[82] *See, e.g.*, P.L.R. 200716024 (Apr. 20, 2007). The Service did, however, permit the rescission agreement in that ruling to include a mutual release. *See also* P.L.R. 200533002 (Aug. 19, 2005) (permitting the inclusion of an indemnity in connection with a rescission).

characterization of transactions as "rescissions" where they could conceivably be respected as separate transactions with independent tax consequences. The Service might encourage taxpayers to so identify rescission transactions by, for example, providing in guidance that a rescission transaction that was not identified as such in the underlying agreements, resolutions or other accompanying documents generally will not be respected.

Guidance in this area would also reduce uncertainty as to how form requirements may constrain the parties after a rescission. For example, may a taxpayer redo a rescinded transaction in the same or modified form later in the same year? May a taxpayer redo a transaction that was rescinded in the previous year? The Court's decision in *Commissioner v. Court Holding Co.*[83] might suggest that a purported rescission should not be respected where the rescinded transaction is reexecuted in a modified form, particularly where the "rescission" is intended to facilitate retroactive tax planning. In that case, a corporation had orally agreed to sell its only asset to a purchaser, but decided not to consummate the sale upon realizing it would result in the imposition of a large income tax on the corporation. The corporation instead declared a "liquidating dividend" to distribute the asset to the corporation's sole shareholders in exchange for the surrender of all of the corporation's outstanding stock. The former shareholders then executed the sale under a contract "which embodied substantially the same terms and conditions previously agreed upon."[84] The Court affirmed the Tax Court's finding "that, despite the declaration of a 'liquidating dividend' followed by the transfers of legal title, the corporation had not abandoned the sales negotiations; that these were mere formalities designed 'to make the transaction appear to be other than what it was' in order to avoid tax liability."[85] On the other hand, in P.L.R. 201008033, the Service issued a private letter ruling expressly based on application of the rescission doctrine to permit a taxpayer to restructure the transfer of a business to an affiliate to avoid adverse Federal income tax consequences associated with the original completed transaction.

Impact of a Successful Rescission

It is not explicitly clear whether a respected rescission merely affects the requirement that a taxpayer report income or loss attributable to the underlying transaction, or whether it causes the underlying transaction to be disregarded for

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[83] 324 U.S. 331 (1945).

[84] *Id.* at 333.

[85] *Id.* (quoting Court Holding Co. v. Comm'r, 2 T.C. 531, 538 (1943)).

all federal income tax purposes. While Rev. Rul. 80-58 merely establishes the availability of rescission as a means of avoiding gain recognition, Rev. Rul. 74-501[86] and certain of the private letter rulings suggest that a rescission that is respected for tax purposes causes the original transaction to be completely disregarded for tax purposes. For example, in P.L.R. 200843001 the sole shareholder of a disregarded entity sold stock in that disregarded entity, *X*, to a foreign taxpayer, *B*.[87] The sale was rescinded within the taxable year and the Service held that "the legal doctrine of rescission applies to (1) disregard the sale of *X* stock to *B* and (2) prevent any change in the entity classification of *X* arising from the sale of X's stock to *B*." The ruling indicates that a rescission will cause a transaction to be disregarded more broadly than merely for income recognition purposes.[88] Guidance in this area should balance giving effect to the concept that a rescinded transaction "never occurred" with the legitimate need of the tax system for transparency.

Waivers and Repayments of Compensation

In the compensation context, certain adjustments to salaries and other payments within the same taxable year have long been respected for federal tax purposes under principles that are different than but have some similarity to the rescission doctrine.[89] In *H.C. Couch*,[90] the Board of Tax Appeals explained, "Salary arrangements between corporations and their principal shareholders and

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[86] Rev. Rul. 74-501, 1974-2 C.B. 98. *See supra* note 24.

[87] P.L.R. 200843001 (Oct. 24, 2008).

[88] *See also* P.L.R. 200533002 (Aug. 19, 2005) (providing that, where an S corporation issued convertible preferred stock to a private equity fund and later rescinded the issuance within the same taxable year because of disagreements with the fund, the legal doctrine of rescission applied to (i) disregard the creation of the stock and its issuance to the fund, and (ii) prevent the termination of the entity's S corporation status).

[89] As discussed *supra* in note 23 and accompanying text, *Penn*, a foundational rescission case, permitted the rescission of dividend income granted under an employee compensation plan. The Service has issued a number of rulings concerning compensation. *See, e.g.*, P.L.R. 9104039 (Oct. 31, 1990) (ruling that a Section 83(b) election can effectively be revoked if the transfer of restricted stock upon which the election was based is properly rescinded within the same taxable year). An effective repayment not only allows the recipient to exclude the returned compensation from its gross income, but also eliminates FICA taxes and withholding tax obligations with respect to such amount; Rev. Rul. 79-311, 1979-2 C.B. 25 (Service held that pay advances returned in the same year as their original receipt by resigning employee were not subject to federal income tax withholding and to FICA tax withholding).

[90] 1 B.T.A. 103, 105 (1924).

managers . . . where the manager is expected by his associates to protect the interests and the future prospects of the company even at sacrifice to himself, are and must be at all times subject to such modification as may be made by agreement from time to time." *Couch* involved the employee of a corporation whose board of directors authorized payment of a fixed sum of salary for the year. He drew only a portion of it and waived the rest because of his concerns about the company's financial health. The Board of Tax Appeals held that the employee should be taxed only on the amount he actually received during the year and not on the amount waived. *Russel v. Commissioner*[91] extended *Couch* to hold that an officer was not liable for income taxes on the portion of his compensation that he received but that he, in the same year, voluntarily returned out of concern for the company's performance that year. Reasoning that taxable compensation is the amount "finally agreed upon during the year," the court held that the amounts received but returned by year-end were not taxable.[92]

Couch and *Russel* were followed by many similar cases holding that employees are not taxed on salary paid in cash but returned to the employer in the same tax year.[93] Generally, however, these cases have, much like *Couch* and

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[91] 35 B.T.A. 602 (1937), *acq.* 1937-1 C.B. 22.

[92] *Id.* at 604.

[93] H.B. Hill, 3 B.T.A. 761, 763-64 (1926) (Where an officer-director of a company received a salary and repaid a portion of it before the close of the year, the court held that the returned portion was not includable in gross income. It found that there was a preexisting "understanding" that the high salary agreed on at beginning of the year would be returned if business conditions did not justify that salary.), *acq.* 1926-1 C.B. 3; *see also* Fulton v. Comm'r, 11 B.T.A. 641, 642 (1928) (Where corporate officer had agreed with a majority of preferred stockholders that he would return part of his salary if business conditions did not improve, and he returned a portion of the cash salary in the same year it was received, the court held that the repaid portion was excluded from gross income under *Couch*.), *acq.* 1928-1 C.B. 11; Smucker v. Comm'r, 6 T.C.M. (CCH) 1054 (1947) (Where bonuses were voted for two officers, and there was an "agreement" then in force between officers and the corporation that officers would return bonuses to help fund the corporation's expansion program, the court found, as a matter of fact, that the bonuses would not have been paid absent the board's "understanding" that the officers would be immediately repaid. It held, under *Couch* and *Russel,* that the bonuses were not includable in gross income to the extent they were repaid in the same year.), *aff'd,* 170 F.2d 147 (6th Cir. 1948); Clark v. Commissioner, 11 T.C. 672, 674-76 (1948) (per curiam) (Where a corporate officer agreed in 1942 to return part of his 1942 compensation, in an amount equal to the portion of his 1941 compensation denied as a deduction for 1941, believing it would be "unfair" to keep more, the court held that the 1942 compensation returned in 1942 was not includable in 1942 income under *Fulton, Russel, Couch,* and *Hill*.), *nonacq.* 1949-1 C.B. 5, *nonacq. withdrawn,* 1953-1 C.B. 3; Fender Sales, Inc. v. Comm'r, T.C. Memo. 1963-119 (Where taxpayer received cash bonuses in 1956 and 1957, and in each year returned the check or repaid the bonus from his funds by year-end because of concern about the company's "precarious" financial condition, the court, citing *Couch, Russel, Hill, Fulton, Clark,* and *Curran Realty Co. v. Commissioner,* 15 T.C. 341 (1950),
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Russel, involved some concern on the part of the payee about the financial health of the employer, as well as at least an implicit assumption by the courts or the Service that the repaid compensation was surrendered permanently by the taxpayer and not merely deferred to a later tax year. The exceptions – that is, where the rule for repayments or adjustments of compensations has been respected even though the payee retained the right to the returned payment in a later year – appear to have been limited mainly to cases involving mistakes in payment by the employer[94] or cases that implicate competing federal statutes.[95]

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held that repaid amounts were not includable in compensation for those years.); I.R.S. Field Serv. Adv. Mem., 1994 FSA LEXIS 192 (Oct. 18, 1994) (Where a minister enters into a renegotiated employment contract with his church to reduce his salary in lieu of his making a charitable contribution as he had done in the past, the waived salary amounts are not included in income under *Couch*.). *But see* Leicht v. Comm'r, 137 F.2d 433, 435 (8th Cir. 1943) (holding that an employee's voluntary repayment of his salary in the form of offsets against loans owed to him by the company, with no stated business purpose, was not excludable from his taxable income).

[94] *See, e.g.*, Ewers v. Comm'r, 45 T.C.M. (CCH) 802 n.2 (1983) (where severance pay was intended to be paid in installments but was mistakenly paid in lump sum, stating in dictum that if the taxpayer had returned a portion of the lump sum in the year of receipt, under *Russel* and *Clark v. Commissioner*, 11 T.C. 672 (1948), he could have excluded that amount from income in that year); *see also* P.L.R. 200752035 (Sept. 26, 2007) (respecting a company's rescission of stock transferred to the IRA of an employee when the company learned that it had mistakenly terminated its S corporation status by making the original transfer). Indeed, the instructions to Forms W-2 and W-3 for 2010 explain that a repayment made by an employee for wages received in error in the same year should be offset against the employee's wages for that year; they provide further that a repayment in respect of a prior year's wages must be made in gross and will not offset wages in the current year, though it will entitle the employee to a deduction. Instructions for Forms W-2 and W-3 (2010), *available at* http://www.irs.gov/pub/irs-pdf/iw2w3.pdf.

[95] *E.g.*, Rev. Rul. 75-531, 1975-2 C.B. 31; Rev. Rul. 79-322, 1979-2 C.B. 76. Revenue Ruling 75-531 involved a federal employee who received a payout of accumulated annual leave when he separated from service with a government agency but then started work only two business days later at a different government agency. He repaid most of the lump sum, as required by a federal statute governing annual leave benefits when a former government employee is reemployed by a different government agency, and was recredited with the corresponding amount of paid leave. Citing both *Couch* and *Russel*, the ruling held that although the lump sum payment was "gross income when received," the employee's "repayment . . . to the second government agency within the same tax year, *as required by law*, established the fact that ultimately this amount was not income to him in that year." Rev. Rul. 75-531, 1975-2 C.B. 31 (emphasis added). Revenue Ruling 79-322 reached a similar result for a federal employee who "bought back" paid sick leave by repaying the already paid amounts to the federal government. The employee bought back the sick leave, as he was required to do, once he was approved for disability benefits under the Federal Employees Compensation Act ("FECA") for the relevant time period. The Service ruled that where an employee, "as a condition precedent to receiving tax exempt income such as FECA compensation, must 'buy back' leave," the repaid amounts are excludable from gross income to the extent repaid in the same year as payment, and are deductible under section 165 of the Code to the extent repaid in a subsequent year. Rev. Rul. 79-322, 1979-2 C.B. 76.

These exceptions are in line with the principles and authorities governing the general rescission doctrine. Thus, the Couch-Russel rule may best be stated as operating to respect within-year compensation adjustments and corrections for purposes of calculating an employee's gross income as of the end of the tax year,[96] but, absent a mistake of fact or other special circumstances, only to the extent such adjustments do not amount to mere deferrals of income.[97]

However, this willingness to permit the receipt of compensation to be unwound differs from the rescission doctrine as it has developed in non-compensation contexts. For example, the application of the *status quo ante* requirement in the compensation context is complicated by the fact that strict return to the *status quo ante* is impossible because the provision of services creates value which cannot be eliminated by rescinding the payment. Once the compensatory payment is rescinded, the value of these services must accrue to one party or the other, either as a windfall to the employer or by the employer's payment of replacement pay to the service provider.

Moreover, the *Couch-Russel* authorities treat the "underlying transaction" in these compensation cases as an evolving contract that is modifiable within the year. In this way, compensation rescissions are fundamentally different from most of the transactions rescinded in other business and commercial contexts, and it may not be appropriate to apply principles drawn from the case law in this area to other contexts. This distinction may also explain why many of the cases in the compensation area permit recipients to disregard income to which they were entitled but voluntarily chose to return,[98] whereas the opposite conclusion has been reached in analogous cases in the dividend context. As noted above, in

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[96] *See, e.g.*, Rev. Rul. 79-311, 1979-2 C.B. 25 (employee entitled to exclude from gross income only those advanced commissions that he received and repaid in that year). If compensation which was included in gross income for a prior taxable year under the claim of right doctrine (because it appeared that the employee had an unrestricted right to the income) is repaid beyond the taxable year in which received, the employee will not be entitled to invoke the rescission doctrine. However, the employee may be able to deduct the amount that is repaid under Section 1341, which generally operates to provide relief to a taxpayer who is required to refund income previously includable under claim of right.

[97] We note that some commentators and practitioners interpret the authorities in this area more broadly, and others more narrowly, than we have here. *See, e.g.*, Rosina B. Barker & Kevin P. O'Brien, *409A Failures: Correcting With and Without Notice 2008-113*, 124 TAX NOTES 557 (Aug. 10, 2009).

[98] *See, e.g.*, Russel v. Comm'r, 35 B.T.A. 602, 603-04 (1937), *acq.* 1937-1 C.B. 22.

Crellin's Estate[99] the Ninth Circuit held that dividend income was taxable to the recipients because the attempted rescission was "no more than a voluntary payment by stockholders." We recommend that the Service confirm that the voluntary repayment of compensation within the same taxable year can be effective to permit the tax consequences of the original payment of compensation to be disregarded, and address more generally whether voluntary actions can lead to effective rescissions outside of the compensation context.

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[99] Crellin's Estate v. Comm'r, 203 F.2d 812, 815 (9th Cir. 1953). Note that the *Crellin's Estate* reasoning has been cited by the Service. *See supra* notes 68-69 and accompanying text.