

New IRS Rulings Approve Rescission Transactions that Change an Entity's Tax Status

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For various non-tax reasons (including IPOs), owners of pass-through entities might consider converting those entities into a C corporation. If they think the better of it in time—within the same tax year—they may be able to "undo" that move in the tax law's equivalent of not taking your hand off that chess piece you put into the path of the queen.

A recurring issue is whether taxpayers can unwind or rescind transfers of ownership interests that effectively change the tax status of the entities themselves (e.g., from C corporation to S corporation or to partnership tax status). If they can, in what circumstances? Moreover, what are the tangential tax consequences to all of the entity's owners?

To answer these questions, we will first identify the policy tensions that arise in determining whether rescissions and similar unwindings of transactions should be given tax effect, and then discuss the law applicable to valid rescissions for federal income tax purposes. Next, we analyze four types of rescissions that can favorably affect an entity's tax classification, with emphasis on attaining or retaining pass-through entity status or avoiding C corporation (potential double taxation) treatment. We will address rescissions resulting in C corporations being taxed as (1) S corporations, (2) REITs, and (3) partnerships. Finally, we will cover rescissions of pass-through entities into something else altogether, i.e., rescissions of partnerships into tenancies-in-common.

Two letter rulings issued in the past year, Ltr. Ruls. 200533002 and 200613027, provide the focal points for this analysis. These favorable letter rulings were issued to taxpayers seeking to rescind transfers of ownership interests in corporations and partnerships, respectively, with the result that the entities involved in the rulings were able to re-establish favorable entity-level tax treatment. The rulings, which build on Rev. Rul. 80-58, 1980-1 CB 181 (the Service's well-known "rescissions" pro-

nouncement) provide limited but helpful guidance as to rescission transactions that change the tax status of the entities involved. Nevertheless, tangential tax consequences involving such rescissions remain unclear.

UNWINDINGS AND RESCISSIONS: COLLIDING POLICIES

The question of whether an unwinding or rescission of an initial transaction will be given retroactive effect for federal income tax purposes has been the subject of controversy and litigation for more than 65 years.¹ Neither the Code nor the Regulations give guidance as to when a second (unwinding or rescission) transaction will be given effect, such that neither the first nor the second transaction will be deemed to have ever occurred for federal income tax purposes. Indeed, the boundaries are far from clear in determining (1) effective unwindings, (2) ineffective unwindings where both the first and the second transactions are given substantive tax effect, but with no further penalties or sanctions, or (3) ineffective unwindings which may constitute civil or criminal fraud.²

Taxpayers may wish to unwind, rescind, or substantially modify a transaction for non-tax and/or tax-related reasons. Non-tax motivations may include a mistake of law or of fact, including the failure of certain anticipated events to materialize, and, conversely, the occurrence of unanticipated events. Tax-motivated reasons to unwind may include the desire to minimize or avoid income or transfer taxes that have arisen due to faulty tax planning (or the lack of tax planning altogether), the failure of certain

events to materialize, the promulgation of retroactively effective legislation, Regulations or Rulings, and the failure to properly anticipate the taxpayer's tax profile prior to the occurrence of the transaction.

Because of the many types of transactions that arise in today's sophisticated business and investment world, it is often difficult to predict which types of unwinding events will be given effect for tax purposes, and under what conditions or situations. Indeed, the devices that may cause an unwinding to occur include:

- Rescission agreements.
- Reformation or reconveyance actions.
- Savings clauses.
- Escrows.
- Warranties.
- Conditional sales.
- Options.
- Put rights.³

In all these situations, the tax advisor's dilemma in unwinding a transaction is to avoid the "kryptonite" of the Code—mainly Sections 6653, 7201, and 7206, the civil and criminal fraud penalty sanctions⁴—and 18 U.S.C. section 1001.⁵

As a conceptual matter, there are a variety of policy concerns that are in tension with respect to permitting transactions to be unwound or substantially modified on a retroactive basis. These tensions in turn are reflected in the sometimes inconsistent positions taken by the courts (and occasionally the Service). Arguments (typically raised by the IRS) against permitting retroactive unwindings include the following (in no particular order):

(1) The substance over form doctrine requires the tax law to determine "what really happened?" Retroactivity brings a different result from what really happened.

(2) Approval of retroactive unwindings that are tax motivated permits taxpayers to play the audit lottery: If you are audited, only then do you unwind to avoid adverse tax results.

(3) Retroactive unwindings that are based on state law determinations (e.g., by court-ordered reformation of an agreement or by mutual agreement of the parties) do not affect the rights of third parties retroactively. The IRS is such a third party, i.e., its collections would be adversely affected by the retroactivity.

(4) Even if some retroactive unwindings are appropriate, the annual accounting principle precludes transactions from remaining "open"

indefinitely. Therefore, unwindings should not be recognized retroactively if not completed in the same tax year as that of the initial transaction.

There also are at least four strong arguments that favor retroactive unwindings (again, in no particular order):

(1) The tax law should be interpreted reasonably and mirror commercial reasonableness. It is commercially reasonable for people in business to have a transaction remain "open" for economic purposes. Thus, the tax law should reflect flexibility to recognize unwindings as of the original transaction.

(2) If tax-motivated unwindings are of concern, arguably a transaction that has some valid non-tax purpose (i.e., is not solely for tax-avoidance purposes) should be acceptable.

(3) Admittedly, state law determinations that are retroactively applied are not controlling on the IRS for tax purposes. Nevertheless, the government should defer to state law as to recognition of property and legal rights, and then apply federal tax law standards thereto. If state law gives retroactive effect to a transaction, the tax laws should respect that holding, unless it is based on collusion or some procedural finding not germane to the unwinding.

(4) As to the annual accounting principle, why shouldn't the relevant timeframe be based on whether the statute of limitations has expired (and not on the end of the tax year in which the initial transaction occurred), since one can (and perhaps should or must) amend the tax return retroactively within that limitation period in certain situations, anyway?

The annual accounting principle is the basis for much of the Service's concern about approving rescissions. As observed by the Supreme Court in *Burnet v. Sanford & Brooks Co.*, 9 AFTR 603, 282 US 359, 75 L Ed 383 (1931), "[i]t 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." Thus, a transaction cannot remain "open" indefinitely for tax purposes without violation of the annual accounting principle. Stated another way, it is fairly well established that in determining the year in which income should be reported, consideration cannot be given as to what may or may not happen in a subsequent year.⁶

As a matter of administration, the recognition or denial of retroactive unwindings must take into consideration additional concerns, e.g., (1) inconsistent positions being taken by the parties to the transaction (e.g., seller and buyer) as to whether the initial sale or event has occurred, (2) similar inconsistencies as to who is taxed on the income (or given the benefit of tax losses or depreciation deductions) during the interim, and (3) administrative uncertainty as to the Service's position on unwindings.

From the taxpayer's viewpoint, commercial practices and business exigencies may cause the parties to complete a transaction that has some potential for being substantially modified or unwound at a later date. The IRS has shown some administrative uncertainty (in audits, rulings and litigation) as to when unwinding is acceptable.⁷

VALID UNWINDINGS AND RESCISSIONS FOR TAX PURPOSES

In appropriate circumstances a transaction can be effectively unwound for tax purposes without a formal finding of rescission.⁸ Taxpayers, however, often seek to characterize their unwindings as rescissions because of real or perceived tax benefits pertaining thereto.⁹ As a general rule, if a "true" rescission occurs within the same tax year as the year of the initial sale or other transaction, the reconveyance will be effective retroactively and the initial sale or transaction will be unwound as of the original transaction. Conversely, if the year of sale has already passed, a subsequent rescission will be treated as a separate event, the initial buyer will be treated as owner (and taxed on income and loss from the property) between the time of the original sale and the date of reconveyance, and the reconveyance will have its own tax consequences as a second transaction.

This dichotomy appears to have originated in *Penn v. Robertson*, 25 AFTR 940, 115 F2d 167 (CA-4, 1940), the first appellate decision dealing directly with rescission. In *Penn*, the taxpayer was a participant in an employees' stock benefit fund created by the directors of the company without shareholder approval. Under the plan the taxpayer was credited with earnings from the fund for 1930 and 1931. In 1931, however, as a result of shareholder lawsuits, the company's directors passed a resolution whereby the plan would be rescinded as to all participants in the plan who would agree to relinquish their previous rights and credits. The Fourth Circuit held that although the plan was void for 1931, the annual accounting period principle required the determination of income at the close of the tax year without regard to subsequent events.

Thus, the 1931 rescission was disregarded for purposes of determining 1930 income.

As to 1931 income, the court concluded that the rescission was effective for tax purposes. The court reasoned that the rescission in 1931, before the close of the calendar year, extinguished what otherwise would have been taxable income to Penn for that year. The government contended that the rescission was not a genuine rescission but really a re-sale of the stock. This was refuted by the facts and findings of the district judge, however. The appellate court concluded that in no sense could it properly be termed a re-sale.¹⁰

After *Penn*, several cases were litigated that generally applied the "same-year-only rescission" holding of *Penn*—but not always.¹¹ Moreover, even if a transaction is modified or purportedly rescinded in the same tax year that it occurred, there is no guarantee that tax consequences will not arise from the initial transaction.¹²

Against this background, in Rev. Rul. 80-58 the IRS chose to follow *Penn* where a valid rescission has occurred, and the parties are placed in the same positions as they were prior to the initial sale. What constitutes a "valid rescission" and whether the parties are "placed in the same positions as they were prior to the initial sale" are important components of the Revenue Ruling that come into play in Ltr. Ruls. 200533002 and 200613027, discussed below. But first, an analysis of Rev. Rul. 80-58 is in order.

The 1980 Ruling

In Rev. Rul. 80-58, the Service was asked to rule on the federal income tax consequences of a reconveyance to a taxpayer of property previously sold by the taxpayer, under two factual situations. In situation 1, A, a calendar-year taxpayer, sold a parcel of land in February 1978 to B solely for cash. The sale contract obligated A, at the request of B, to accept reconveyance of the land from B if at any time within nine months of the date of sale B was unable to have the land rezoned for B's business purposes. If there were a reconveyance under the contract, A and B would be placed in the same positions they were in prior to the sale. In October 1978, B determined that it was not possible to have the land rezoned and notified A of its intention to reconvey the land pursuant to the terms of the contract of sale. The reconveyance was consummated during October 1978, and the parcel was returned to A, with B receiving back from A all amounts expended in connection with the transaction.

The facts in situation 2 were similar, except that the period within which B could reconvey the property to A was one year. In January 1979, B reconveyed the property, for the same non-tax reasons as described above. B received back from A all amounts B expended in connection with the transaction.

IRS ruled that in situation 1 no gain on the sale would be recognized by A, but in situation 2 A must report the sale for 1978. In 1979, when the property was reconveyed to A, A acquired a new basis in the property, which was the price A paid to B for such reconveyance.

In the Ruling, the Service stated the legal concept of rescission refers to the abrogation, cancelling, 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 occupied had no contract been made (i.e., the "status quo ante" requirement¹³). Anything less will not suffice.¹⁴ The Ruling states 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.

Paying heed to the annual accounting concept and following *Penn v. Robertson*, Rev. Rul. 80-58 concludes that in situation 1 the rescission of the sale during 1978 placed A and B at the end of the tax year in the same positions as they were in prior to the sale. Thus, in light of *Penn*, the original sale was disregarded for federal income tax purposes because the rescission extinguished any taxable income for that year with regard to that transaction (i.e., it met the "same-year-only rescission" requirement) and did not violate the annual accounting period principle.

In situation 2, as in situation 1, there was a completed sale in 1978. Unlike Situation 1, however, because only the sale and not the rescission occurred in 1978, at the end of 1978 A and B were not in the same positions as they were prior to the sale. Again following *Penn*, the IRS ruled that the rescission in 1979 was disregarded with respect to the taxable events occurring in 1978. Thus, the annual accounting principle was held in both situations 1 and 2 of Rev. Rul. 80-58 to require the determination of income at the close of the tax year (1978) without regard to subsequent events.

RESCISSIONS AFFECTING ENTITY TAX CLASSIFICATION

Although Rev. Rul. 80-58 and other rulings and cases generally involve successful or failed rescissions or unwindings of sales of property, the issue of the tax treatment of (attempted) unwindings or rescissions can arise in many other types of transactions, including unilateral awards of employer stock or stock benefit fund credits to employees, gifts by a donor to donees, transfers in divorce pursuant to *nunc pro tunc* orders (i.e., retroactive property rights modifications), transfers into and out of trust, and payments of dividends by a corporation to its shareholders.¹⁵ It is by no means clear that Rev. Rul. 80-58 or, more broadly, the principles referred to therein will be dispositive as to whether any given attempted unwinding will be effective for federal tax purposes.

Given this uncertainty, should retroactive effect be given to attempts to change the tax status of an entity by rescinding certain transactions involving the ownership interests of the entity? In answering this question, to what extent should potential (substantial) income tax savings at the entity level affect or preclude giving effect to transactions attempting to unwind or rescind an initial transaction which generated adverse entity-level tax consequences?¹⁶

This question did not arise in Rev. Rul. 80-58 or in *Penn* or other cases, all of which focused on the transferor and transferee taxpayers. Thus, in Rev. Rul. 80-58, at issue was whether the owner of the property (akin to the owner of stock or a partnership interest) recognized gain or loss on the initial sale or other disposition, followed by a taxable reconveyance back to that owner (via repurchase). Instead, our current focus is whether an entity's tax classification (whether intentionally or inadvertently adversely affected by its owners' transactions) can be rehabilitated through rescission of the initial transaction that triggered the adverse entity-level tax consequences.

The question has recently arisen in two very different fact patterns, but in each the Service's answer turned on the application of Rev. Rul. 80-58. In Ltr. Rul. 200533002, the question was whether revocation of an S election (and imposition of corporate taxation on what now would be classified as a C corporation) could be reversed by rescinding the issuance of a class of preferred stock to three limited partnerships that wished to invest in the corporation. In Ltr. Rul. 200613027, at issue was whether a corporation (formed through a statutory conversion

of an LLC), which otherwise would be taxable as a C corporation, could be treated as a nullity for tax purposes from its beginning, so that the corporation's subsequent conversion back into an LLC (taxable as a partnership) would not be treated as a taxable liquidation. While the IRS reached favorable conclusions in both, the rulings do not discuss the tangential but potentially significant tax consequences that may flow from the approved rescissions.

THE CONSEQUENCES OF FAILURE: INEFFECTIVE 'RESCISSIONS'

In analyzing the two letter rulings, we should keep the stakes in mind. What are the potential adverse tax consequences if the rescission under consideration is *not* respected for tax purposes, i.e., if the second transaction is given independent tax effect?

If the second transaction involves a C corporation converting back into an entity taxable as a partnership (as in Ltr. Rul. 200613027), a failed rescission would cause the C corporation to be deemed to have made a taxable liquidation. This would result in classic double taxation, i.e., recognition of all built-in gain at the corporate level, and then additional capital gain at the shareholder level (long term or short term, depending on each hapless shareholder's holding period).¹⁷ The corporate assets would then be deemed to be contributed by the shareholders to the partnership, in a transaction governed by Section 721. (The sole silver lining is that the partnership would take a carryover basis in the assets deemed contributed, which in the aggregate should equal the amount realized by the shareholders on the corporation's deemed liquidation.)

If the second transaction involves the shareholders of a C corporation attempting to rescind a stock transfer (to an ineligible shareholder) that had terminated the corporation's S election, what are the adverse tax consequences if the attempted rescission is not respected for tax purposes, such that the second transfer is treated as a separate transaction? Assume individual A initially transferred her S corporation stock to ineligible shareholder XYZ, thus terminating the corporation's S election, and A then repurchases the stock from XYZ in a second transaction that fails to qualify as a rescission for tax purposes. A initially will have recognized gain on the sale of her stock to XYZ under Section 1001.¹⁸ XYZ's resale back to A, treated as a second sale governed by Section 1001, will not eliminate A's prior recognition of gain.¹⁹ Thus, A will hold (typically illiquid) stock but will have recognized taxable

gain (without cash proceeds to pay the tax, A having used her sale proceeds to repurchase the shares from XYZ). In addition, since A's sale to XYZ terminated the S corporation's election, the entity likely would be precluded from re-electing S corporation status for five years pursuant to Section 1362(g), absent IRS consent to an earlier re-election. Again there is a potential silver lining to A: her basis in the stock will be increased to equal the amount she paid XYZ (i.e., a new cost basis).²⁰

What are the potentially adverse consequences if an S corporation issues a second class of stock (e.g., convertible preferred) for cash to a shareholder (as occurred in Ltr. Rul. 200533002), and the corporation reacquires the stock for cash in a second transaction that does not constitute a valid rescission for tax purposes? First, loss of the S corporation's status will result (absent other qualification for relief or reinstatement by IRS). In addition, the preferred shareholder will recognize gain or loss on the repurchase of his stock, which presumably will be characterized as a Section 301 dividend-type distribution (unless the payment qualifies as a redemption under Section 302).

All of the above illustrates that much may be at stake if the attempted unwinding is not treated as a valid rescission for federal income tax purposes.

RESCISSIONS: C CORPORATIONS INTO S CORPORATIONS

Section 1361(a) grants "S corporation" status to a small business corporation for which an election under Section 1362(a) is in effect for the tax year. Section 1361(b) provides that a "small business corporation" is a domestic corporation that, among other things, does not have its shares owned by an impermissible shareholder (such as a partnership) and does not have more than one class of stock. Section 1362(d)(2)(A) provides that a Subchapter S election will be terminated whenever such corporation ceases to be a small business corporation (i.e., at any time on or after the first day of the first tax year for which the corporation is an S corporation).

An S corporation's status can be terminated intentionally or unintentionally, with the result that the entity becomes taxable as a C corporation. An S corporation faced with an *inadvertent* termination may qualify for relief by seeking a waiver from the Service pursuant to Section 1362(f). Obtaining a waiver of an inadvertent termination requires the cooperation of all of the persons that owned stock during the affected period.²¹

In some situations, an S corporation's shareholders may prefer another alternative if the inadvertent termination is due to a transfer of stock to an ineligible shareholder. The shareholders may wish to comply with Rev. Rul. 80-58 so that the reacquisition of the stock is a valid rescission for tax purposes. (This would not require IRS approval, unlike either Section 1362(f) or (g).) Your author is unaware of any IRS rulings or guidance involving this fact pattern (i.e., an inadvertent termination, followed by a good rescission) in the S corporation context, but there is no reason why the principles of Rev. Rul. 80-58 should not apply here, as well.²²

Will a rescission be respected by IRS to reinstate an S election that was *not* lost inadvertently? In Ltr. Rul. 8304134, the Service ruled that S corporation status that had terminated in 1980 (because all the S shares were sold to another corporation) could not be reinstated (retroactively) as a result of a court-ordered 1982 rescission of the stock sale. There was no indication in that ruling that the transferors in 1980 expected to return to S corporation status, given the ineligible corporate shareholder. The requirements of Rev. Rul. 80-58 are incorporated into Ltr. Rul. 8304134, but curiously the letter ruling makes no reference to the Revenue Ruling.

If the S election was *intentionally* terminated by transfer of stock to an ineligible shareholder, would timely rescission reinstate the election? Ltr. Rul. 8304134 implies that had the rescission occurred in 1980 (the tax year of sale), S corporation status would have been preserved. In Ltr. Rul. 200533002, the Service was asked to rule that the rescission of the issuance of convertible preferred stock, as part of the unwinding of the original purchase of such stock, would be given effect so as to preserve a corporation's S election. There, the shareholders of X corporation made an S election (assumed to be valid for purposes of the ruling). Subsequently, X entered into discussions with a venture capital fund for the sale of *n* shares of X stock to the fund. On a date believed to be in 2004 ("Date1"), X sold *n* shares of newly issued convertible preferred X stock to three limited partnerships controlled by the fund, for \$N. This sale terminated X's S election under Section 1362(d)(2) because X no longer met the definition of a small business corporation in Section 1361(b)(1).²³

In the months following the sale, disagreements arose between X's original shareholders and the partnerships. These disagreements led X and the partnerships to agree to unwind the partnerships' original stock purchases. X and the partnerships

entered into a stock rescission agreement "which was consummated as of" Date2, in the same tax year as the initial Date1 issuance of the preferred stock. The terms of the agreement provided that X remit \$N to the partnerships. On the execution of the agreement and delivery of the \$N (i.e., Date2), the issuance of X's convertible preferred stock would be deemed rescinded. The agreement required that X promptly cancel the issuance of the convertible preferred stock. It also provided for the resignation of the partnerships' representative from X's board of directors. In addition, the agreement released all parties from any liability or obligation that arose from the original stock purchase agreement, with the exception that the indemnification clauses for the partnerships and their representative remained in effect. X represented that during the period that the preferred stock was outstanding until the rescission agreement date (i.e., from Date1 to Date2), X did not make any distributions to the partnerships (i.e., presumably X paid no preferred stock dividends).²⁴

In Ltr. Rul. 200533002 the IRS ruled favorably for X and its original shareholders. The letter ruling quoted from Rev. Rul. 80-58, which provides the aforementioned general legal principles pertaining to the doctrine of rescission. The letter ruling stated that Rev. Rul. 80-58 requires at least two conditions that must be satisfied for the remedy of rescission to apply to disregard a transaction for federal income tax purposes:

(1) The parties to the transaction must return to the status quo ante,²⁵ that is, they must be restored to "the relative positions they would have occupied had no contract been made." Ltr. Rul. 200533002 concluded that X, X's original shareholders, and the three limited partnerships all were restored to the relative positions they would have occupied if the X stock had never been sold to the partnerships.

(2) This restoration (to the status quo ante) must be achieved within the tax year of the transaction. Ltr. Rul. 200533002 concluded that the restoration was achieved within the same tax year. (Thus, Date2 presumably was in 2004, also.)

Therefore, having met the conditions of Rev. Rul. 80-58, the legal doctrine of rescission was held to apply so as to (1) disregard the creation of convertible preferred stock and X's issuance of that stock to the partnerships, and (2) prevent the termination of X's S corporation status.

Based on the above, in Ltr. Rul. 200533002 the IRS ruled as follows:

- X would be treated as continuing to be an S corporation during the period from Date1 to Date2 and thereafter, provided that X's S election was valid and was not otherwise terminated under Section 1362(d).
- During the period from Date1 to Date2, X's original shareholders would be treated as the shareholders of X. X's original shareholders had to include in income their pro rata shares of the separately and non-separately stated items of X as provided in Section 1366 and had to make any adjustments to stock basis as provided in Section 1367 and take into account any distributions made by X as provided in Section 1368.²⁶

Ltr. Rul. 200533002 reaches the proper result, and fits within the requirements of Rev. Rul. 80-58. Although not stated in the ruling, it is highly likely that the parties involved in the letter ruling knew that the initial transfer would terminate S election status, and the original and new shareholders (i.e., the limited partnerships) would be willing to have the entity taxed as a C corporation. If this speculation is correct, it was only the falling out of X's original shareholders and the new shareholders that led to the reconveyance of the stock.

The shareholders' falling out undoubtedly was a valid non-tax reason (should one be needed²⁷) for giving effect to the reconveyance, and the initial issuance and reconveyance together cannot be characterized as a tax-motivated sham. Nevertheless, the importance of Ltr. Rul. 200533002 may lie in the remittance price, which happened to be the exact amount of the original purchase price. This identity in amounts, of course, gives no effect to the time value of money, to any appreciation or depreciation in the value of the underlying corporation (X), or to X's profitability (or lack thereof) during the interim. Rather, one could speculate that the \$N remittance price was selected to be exactly equal to the initial purchase price in order to meet Rev. Rul. 80-58's admonition that the unwinding must have the effect of placing the parties in the same positions as they were in prior to the initial transaction.²⁸

But for the Revenue Ruling's requirement and the tax-oriented purpose of qualifying the rescission so that S corporation status could be retained (and double taxation as a C corporation avoided), would the pricing of the rescission have been different?

No dividends or other distributions were made on the preferred stock during the interim. The letter ruling does not state whether the convertible preferred stock had a cumulative dividend to which the preferred shareholders (i.e., the three partnerships) would have been entitled, but for the rescission. Although your author has no additional knowledge of the facts underlying the ruling, one can speculate that here the tax tail may have wagged the dog, and the remittance price was set to be equal to the original purchase price, without an interest component, yield factor, or other pricing adjustment, to meet the status quo ante requirement.

RESCISSIONS: C CORPORATIONS INTO REITs

Section 856(a)(6) provides that an entity seeking to qualify for or retain REIT status cannot be "closely held." An entity is closely held if more than 50% of the value of its shares is owned directly or indirectly by or for five or fewer individuals at any time during the last half of the REIT's tax year.²⁹ A sale or transfer of an excessive amount of shares to one individual can thus jeopardize REIT status, in the same fashion that a transfer to an ineligible shareholder as defined under Section 1361 can terminate S corporation status.

A valid rescission of the transfer of the REIT stock (via repurchase by or retransfer to the original shareholder) should be effective to retain REIT status. Your author is unaware of any cases or rulings on point, unlike transfers to ineligible S corporation shareholders.³⁰ Nevertheless, there is no reason why IRS would not apply the principles of Rev. Rul. 80-58 to REIT stock rescissions, just as the Service has done in the S corporation stock rescission letter rulings discussed above. Moreover, a favorable letter ruling should be obtainable even if the sole purpose of the rescission is to reinstate the favorable tax treatment afforded REITs.³¹

As an alternative method of retaining REIT status and not violating the closely held ownership rule of Section 856(h), the REIT's governing documents may contain a restriction (e.g., an "excess share" provision) that is designed to treat the *acquisition* by a person of REIT shares in excess of a specified percentage as being void to begin with.³² Under such provision, if any person acquires REIT shares in excess of the specified percentage, the excess shares are deemed to be transferred to a trust and the acquiror is not entitled to voting rights or dividends on such shares and is not entitled to any portion of the gain realized on the disposition of

such shares. IRS has ruled that, should a person acquire REIT shares in violation of the "excess share" provision, such person will not be considered the owner of the excess shares for federal income tax purposes if the restrictions on such excess transfers are valid under state law and the REIT uses its best efforts to enforce such transfer restrictions.³³

The result of the "excess share" transfer restriction—as void to begin with—is not a true rescission.³⁴ Nonetheless, the restriction may permit the entity to retain (or reinstate) REIT status by having the initial transfer of stock treated as if that transfer had never occurred—similar to the desired objective of S corporation stock transfer restrictions, also favorably ruled on by IRS, as discussed above.³⁵

RESCISSIONS: C CORPORATIONS INTO PARTNERSHIPS

In Ltr. Rul. 200613027, IRS permitted a partnership that had become taxable as a corporation to revert to partnership tax status, pursuant to a successful rescission before year-end. There, LLC1, a domestic LLC (treated for federal tax purposes as a partnership) statutorily converted into Corp (taxable as a C corporation) by filing a certificate of conversion and a certificate of incorporation under state Z law. As a result, A and B, the sole owners of LLC1, became the sole shareholders of Corp.

The statutory conversion (referred to in the letter ruling as the "incorporation transaction"), which occurred pursuant to a contract previously entered into among A, B, and LLC1, took place on Date1. After Date1, Corp redeemed some of its outstanding stock as a result of the death or separation from service of members of its management team. Although not disclosed in the ruling, it appears that certain employees of Corp were granted corporation stock after Date1³⁶ and had their stock redeemed all within the same tax year. Separately, after Date1 Corp paid A and B an "LLC tax distribution payment" (which was provided for in LLC1's operating agreement and was intended to help cover A's and B's tax liabilities on their allocable share of LLC1's taxable income), to which they were entitled for the period through Date1.³⁷

The ruling states that the incorporation transaction was effected in anticipation of making an initial public offering (IPO) of Corp's stock. As a result of a "precipitous and unexpected deterioration in market conditions" following the incorporation transaction, however, the IPO was cancelled shortly thereafter (as of Date2). There was no plan to attempt another IPO "in the near future."

As Corp would not make a public offering of its stock, the parties desired that Corp convert back into an LLC taxable as a partnership (referred to as LLC2) before the end of Corp's tax year that included the original conversion, so that it and A and B again would be subject to only a single level of federal income taxation. The proposed reversion of Corp into an LLC was referred to as the "rescission transaction" in the letter ruling³⁸ and would be conducted pursuant to a rescission agreement that the parties would enter into beforehand. The rescission transaction would be effected by filing a certificate of conversion with state Z. The "taxpayer" (meaning collectively LLC1 and Corp) represented that the incorporation transaction "constituted a transaction qualifying under §351"³⁹ and that the current tax years of A, B, and the taxpayer all would end on December 31 (of a redacted year, most likely 2005). Date1 fell within the current tax year of each party that ends on that December 31.

The taxpayer made several other representations, presumably required by IRS, including the following:

- (1) Prior to the incorporation transaction, the taxpayer was an LLC taxable as a partnership for federal income tax purposes.
- (2) Other than the redemptions made as a result of the death or separation from service of certain members of the taxpayer's management team and the LLC1 tax distribution payment, the taxpayer had not made any distributions to its equity holders since the date of the incorporation transaction.
- (3) Since Date1, the taxpayer had not taken any actions with respect to, or engaged in any transactions with, A or B that were inconsistent with the actions and transactions the taxpayer would have undertaken had it remained a partnership for federal income tax purposes at all relevant times, except that the taxpayer had not distributed certain amounts to A and B with respect to each member's share of allocated net income since Date1 (i.e., tax distributions) that it would have distributed had the taxpayer remained a partnership for federal income tax purposes. If the rescission transaction became effective, the taxpayer would make these tax distributions to A and B in accordance with the operating agreement that governed the relationship among A, B, and LLC1.
- (4) If the rescission transaction became effective, the taxpayer would file its federal income tax return as if it was a partnership during all of

the calendar year (again, presumably 2005), and A and B each would include in income its allocable share of the taxpayer's items of income, deduction, gain, and loss for that year. A and B each would report the amounts received in the redemptions (of the taxpayer's management team) consistently with the taxpayer's having been an LLC taxable as a partnership during all of that tax year (2005).

(5) On the rescission transaction's becoming effective, the relationship among A, B, and LLC2 would be governed by the same operating agreement that governed the relationship among A, B and LLC1 (although the agreement would be re-executed).

(6) The rescission agreement was intended to restore the legal and financial arrangements between the owners and the taxpayer as they would have existed had the taxpayer not converted from an LLC taxable as a partnership into a corporation taxable under Subchapter C.

(7) The effect of the rescission agreement would be to cause the legal and financial arrangements between the owners and the taxpayer to be identical in all material respects, from the date immediately before the conversion, to such arrangements as would have existed had the conversion not occurred.

(8) Neither A, B, nor the Taxpayer have taken or would take any material position inconsistent with the position that would have existed had the conversion not occurred.

Based on the facts and aforementioned representations and the parties' restoration by December 31 (2005) of the relative positions they would have occupied if the incorporation transaction had not occurred, IRS (citing Rev. Rul. 80-58) ruled in Ltr. Rul. 200613027 that, for federal income tax purposes:

(1) The taxpayer would be treated as a partnership at all times during the calendar year (2005).

(2) A and B would be treated as partners of the taxpayer during such period.

(3) The conversion of the taxpayer from a corporation into an LLC taxable as a partnership pursuant to the rescission transaction would not be treated as a liquidation of Corp for purposes of determining the taxable income of the taxpayer, A, or B.

Ltr. Rul. 200613027 is of interest for several reasons, discussed below.

Rescissions include statutory conversions and re-conversions. The ruling is apparently the first IRS ruling—published or private—to deal with the issue of whether a statutory conversion of an entity and its re-conversion constitutes a rescission for federal income tax purposes. A statutory conversion is one that is recognized through a simple filing with the appropriate state office and which typically provides that on the conversion, title to any real or personal property, and all liabilities, are deemed transferred to and vested in the new entity without any further act.⁴⁰ The rescissionary act in Ltr. Rul. 200613027 was "the proposed conversion back into an LLC," which (as noted above) was referred to in the ruling as the "rescission transaction" and was to be conducted pursuant to the parties' "rescission agreement." One might assume that the "conversion back" is also by statutory conversion, if state Z (like a majority of other states⁴¹) also permits "opposite direction" statutory conversions, i.e., from corporations to LLCs, just as it permits such conversions of LLCs into corporations.

It would appear that the rescission should be respected for tax purposes even if the rescission transaction was *not* via a statutory conversion, so long as the status quo ante requirement (discussed below) was met. The fact that substance matters (i.e., is given effect for tax purposes) when a corporation terminates and its shareholders become partners⁴² supports this conclusion in the corporation-to-LLC rescission scenario. As a broader principle, however, even where form controls (if the second transaction should be given tax effect),⁴³ the focus is on the bedrock question of whether the parties were restored to the status quo ante—not *how* they were so restored.

The status quo ante requirement. As stated above, the status quo ante requirement in Rev. Rul. 80-58, involving a sale of property, requires "restoring the parties to the relative positions that they would have occupied had no contract been made." Situation 1 of the Revenue Ruling approves the rescission of the sale of the land, which placed the buyer and seller "in the same positions as they were prior to the sale." Ltr. Rul. 200613027, involving an incorporation transaction which the taxpayer represented constituted a transaction qualifying under Section 351, contained additional representations (presumably required by IRS to obtain the favorable rulings), one of which is that the "effect of

the Rescission Agreement is to cause the legal and financial arrangements between the owners and the Taxpayer to be identical in all material respects, from the date immediately before the conversion, to such arrangements as would have existed had the conversion not occurred." The IRS conditioned its ruling in Ltr. Rul. 200613027 on, among other things, "the parties' restoration by December 31, [2005], of the relative positions they would have occupied if the Incorporation Transaction had not occurred" (citing Rev. Rul. 80-58).

The taxpayers' representations in Ltr. Rul. 200613027 are substantially similar to those in Ltr. Rul. 9829044, the S corporation stock rescission ruling described above.⁴⁴ In the latter ruling, IRS concluded that the two commonly owned corporations in question, as well as their shareholders (who had transferred all of the stock of one corporation to the other, and then received the same stock back as a distribution from the transferee corporation) were restored to the relative positions they would have occupied if the initial capital contribution had never occurred. Those shareholders represented, among other things, that there "were no material changes in the legal or financial arrangements" between the commonly controlled corporations, or between one or more of the shareholders and the corporations, and that after the rescissionary transaction (i.e., the distribution of the contributed stock back to the shareholders), the "legal and financial arrangements among all of the parties were identical in all material respects to such arrangements prior to" the contribution of the stock. Taken together, Ltr. Ruls. 9829044 and 200613027 indicate that the status quo ante requirement for a valid rescission that restores favorable entity tax status turns on re-establishing the legal and financial aspects of the entities and their owners in all material respects.

Intervening equity transactions need not affect rescission status. The transactions involving the management team did not adversely affect the rescission in Ltr. Rul. 200613027, even though such transactions (occurring while the entity was a corporation) apparently were not rescinded. Thus, there *were* equity transactions involving corporate employees who received Corp stock and were redeemed of such shareholdings during the short period between Date1 and Date2 (i.e., after the incorporation transaction but before the rescission transaction). Such management team members were *not* listed as parties to the ruling (in the statement of parties whose names were redacted at the beginning of the letter ruling), and it is highly unlike-

ly that such management team members or their heirs (whose stock was redeemed as a result of the employees' separation from service or death) would willingly rescind their transactions, repay any cash they received in their stock redemptions, and be returned to the status quo ante.

To the author's knowledge, no prior rescission case or ruling involved a fact pattern that had intervening third-party ownership and equity redemptions as described above.

Intervening (non-equity) transactions inside the entity also need not affect rescission status.

Although not discussed in the letter ruling, there undoubtedly also were intervening (non-equity) transactions that occurred inside Corp, affecting its value⁴⁵ (in addition to the aforementioned issuance and redemption of management's stock). Nonetheless, the requirement that there be a restoration of the parties to the status quo ante apparently did not require the value of the consideration be identical, so long as the members of the LLC (A and B) were the owners both before and after the transactions.

To illustrate, assume A and B have a zero tax basis in their interests in LLC1, and the FMV of LLC1 was \$100 on the date of the incorporation transaction (when the prospects of the IPO were good) and the FMV of Corp was only \$80 on the date of the rescission transaction (due to the failure of the IPO). Analyzed at the ownership level, A and B initially owned property (i.e., their interests in LLC1) worth in the aggregate \$100 (for stock presumably worth \$100), and pursuant to the rescission transaction A and B effectively were restored to owning property (i.e., the LLC2 interests) worth in the aggregate only \$80.⁴⁶

Contrast this with Ltr. Rul. 200533002, discussed above, in which it was critical for purposes of the status quo ante requirement that the amount reconveyed be the same amount (\$N) as the original sale price. Suffice it to say that since A and B were the sole owners both before and after the incorporation transaction and rescission transaction, there was nothing more that they could do to meet the requirement that they be restored to their prior position even if the value of Corp/LLC2 had decreased (say from \$100 to \$80).⁴⁷ Viewed on an entity-level basis, that certainly was true—A and B presumably have the same ownership interests in LLC1 and LLC2, respectively.

Does this represent an extension of Rev. Rul. 80-58? Is it merely a recognition that the entity-level analysis should apply to A, B, and LLC1/Corp (the taxpayer) for purposes of analysis?

It is submitted that, in general, any intervening transactions⁴⁸ have no bearing on the determination of whether there has been a valid rescission of A's and B's ownership in Corp. As noted, the status quo ante requirement of Rev. Rul. 80-58 is meant to restore the parties to the same "relative positions they would have occupied had no contract been made," i.e., if LLC1 had continued in existence as a tax partnership throughout the year with A and B as owners (disregarding for the moment the management team's intervening ownership). As the taxpayers represented in Ltr. Rul. 200613027, the effect of the rescission transaction and rescission agreement was to cause the legal and financial arrangements between A, B, and LLC2 to be identical in all material respects to such arrangements as would have existed had the LLC1-to-Corp conversion (incorporation transaction) not occurred. Here, if Corp and LLC2 had never been created and the incorporation transaction and rescission transaction never occurred, LLC1 presumably would have suffered the same decrease in value (i.e., from \$100 to \$80) on failure of the IPO to occur. Therefore, the difference in value of A's and B's ownership in LLC1 (at the time of the incorporation transaction) and in LLC2 (immediately following the rescission transaction) arising from intervening events⁴⁹ should have no bearing on the conclusion that the status quo ante requirement was met and a valid rescission occurred for federal income tax purposes in Ltr. Rul. 200613027.

No distributions to equity owners. The representation in Ltr. Rul. 200613027 that the taxpayer (Corp) has not made any distributions to its equity holders (other than the LLC tax distribution payment) since the date of the incorporation transaction is noteworthy. If Corp had made dividend-type distributions to A and B in 2005 that were not returned by them in 2005 to Corp prior to the rescission transaction, would IRS have determined that A and B did not meet the status quo ante requirement?

In Rev. Rul. 78-119, 1978-1 CB 277, the Service ruled there was no valid rescission for tax purposes of a stock transfer agreement which initially qualified as a B reorganization (on 3/13/77) because dividends that were distributed during the interim period (3/13/77 to 11/30/77) were retained by the recipients, and thus the parties were not returned to their original positions. IRS concluded that the attempt to unwind (by return of the stock on 11/30/77) constituted a second (separate) transaction that year 1977 for tax purposes, and the taxpayers who received and retained the dividends during that interim period in 1977 would be treated

as the owners of the stock each temporarily owned during the interim.

Thus, the representation in Ltr. Rul. 200613027 enabled the parties to avoid running afoul of Rev. Rul. 78-119.

The LLC tax distribution payment, while atypical in a C corporation setting, is commercially reasonable (given that A and B, LLC1's owners, were liable for taxes on their allocable shares of the entity's pre-incorporation income). The payment was made to A and B after the incorporation transaction; it technically was a corporate distribution. Unlike the result in Rev. Rul. 77-119, where an unwinding was not treated as a valid rescission because the dividends received were not repaid by the shareholders, Ltr. Rul. 200613027 allows the rescission transaction to qualify notwithstanding A's and B's failure to repay the corporate distribution.

Is IRS being overly generous in the letter ruling, or silently extending Rev. Rul. 80-58? It is doing neither. A and B would have received the same distribution from LLC1 had the incorporation transaction never occurred. Had A and B remained partners of the partnership for the entire year, as the ruling so holds, they would have received and retained the LLC tax distribution payment. In accordance with the ruling's stated standard that the legal and financial arrangements between A, B, and LLC1/Corp be identical in all material respects, it would be wrong for A and B to regurgitate the tax distribution payment to Corp or LLC2—A's and B's financial arrangements would then differ from what they had been immediately before the incorporation transaction, when they were entitled to receive and retain the LLC tax distribution payment that was to be made in the next few months.

Unanswered Questions

Ltr. Rul. 200613027 does not address several questions involving rescissions that affect entity tax status and the collateral tax consequences to other equity owners.

1. Which parties must be restored to the status quo ante in the rescission of a statutory conversion? In Ltr. Rul. 200613027, there are five named parties involved in the transaction:

- LLC1 (the previously existing LLC taxable as a partnership).
- A and B (LLC1's owners).
- Corp (the corporation into which LLC1 converts).
- LLC2 (the LLC into which Corp converts back).

Which of the named parties must be restored to the status quo ante in order to meet that requirement of Rev. Rul. 80-58? Ltr. Rul. 200613027 does not directly answer this question; its brief rationale for its favorable rulings is "[b]ased solely on the facts submitted, the representations made, and the parties' restoration, by December 31 [2005], of the relative position they would have occupied if the Incorporation Transaction had not occurred...." (Emphasis added.) It does not explicitly state who the "parties" are.⁵⁰ If the incorporation transaction had not occurred, there would be no Corp, and no need to create LLC2 (i.e., to replace LLC1)—only A, B, and LLC1 existed prior to the incorporation transaction. Since LLC1 has (irrevocably?) dissolved under state law and is effectively replaced by LLC2 as a matter of state law on Corp's "conversion back," are the parties that must be restored only A, B, and LLC2? As stated earlier, the letter ruling defines the "taxpayer" to be LLC1 and Corp together, and the representations involving the restoration of legal and financial arrangements between owners A and B and the taxpayer indicates (without explicitly providing) that A, B, and the entity (which started out as LLC1, converted into Corp and converted back into LLC2) all must meet the status quo ante requirement.

2. What if the incorporation transaction instead took the form of an "assets-over" transfer?

Would IRS have applied the same analysis and issued the same favorable rescission rulings if the incorporation transaction had been implemented by LLC1 using an assets-over form of transfer, whereby LLC1 actually contributed all its assets (subject to all liabilities) to newly formed Corp in exchange for Corp stock, and then LLC1 distributed the stock to its members (A and B) in liquidation of LLC1? In that situation, would the rescission transaction require A and B to reverse their steps in mirror image fashion to the incorporation transaction, to obtain the favorable rescission rulings?

If so, the rescission transaction presumably would require, first, the reconveyance of A's and B's stock in Corp to LLC1 (if it still were in existence for state law purposes; if LLC1 had been dissolved for state law as well as tax purposes, then presumably A and B would have to resurrect LLC1 under state law, or alternatively form LLC2, as occurred in Ltr. Rul. 200613027). Next, LLC1 (or LLC2) would reconvey Corp's stock back to Corp (or have it cancelled by Corp) in conjunction with Corp's liquidation. In exchange, Corp would reconvey all its assets to LLC1 (or LLC2), Corp having no other shareholders.

Of course, during the period between the incorporation transaction and the rescission transaction Corp's assets may have increased, decreased, been converted, modified physically, sold, exchanged, liquidated, or reinvested. Thus, on Corp's reconveyance of the assets, LLC1 (or LLC2) by definition would *not* get the exact same assets that were previously transferred by LLC1 to Corp. In an assets-over form of incorporation transaction, does the restoration to the status quo ante requirement apply at the entity level?⁵¹ If so, would the (presumed) changes in assets preclude LLC1 (or LLC2) from meeting the status quo ante requirement?

To the author's knowledge, no ruling or case has involved the question of whether a valid rescission occurred for tax purposes where the transfer of an ongoing business initially constituted a Section 351 or Section 721 transfer followed by a rescission transaction returning the assets (and liabilities) to the transferor. Thus, there is no guidance directly on point as to the validity or invalidity of an attempted rescission of the transfer of an ongoing business in an assets-over transaction.

Ltr. Rul. 9829044⁵² involves a Section 351 transfer by individual shareholders of a single asset (SCo1 stock)—not an ongoing business—and the subsequent distribution of the same asset (the SCo1 stock) by the transferee (SCo2) back to the transferor shareholders; indeed, that ruling supports the conclusion that an assets-over incorporation transaction can be validly rescinded if the requirements of Rev. Rul. 80-58 (including the status quo ante requirement) are met. Moreover, Ltr. Rul. 9829044, in holding that the legal doctrine of rescission applies for tax purposes, concludes that under the applicable facts and representations SCo1, SCo2, and the shareholders in each corporation were restored to the relative positions they would have occupied if SCo1 stock had never been contributed to SCo2, with the restoration being achieved in the same tax year. As stated earlier, the same principle—namely, that A, B, and LLC1 (and its successor, LLC2) were restored to the relative positions they would have occupied if LLC1's statutory conversion (read: assets-over transfer, as described in the next paragraph) were reversed in the same tax year—should be sufficient to meet the status quo ante requirement.

The preceding assets-over transfer and rescission analysis may be relevant to rescissions involving entities that were formed by statutory conversion (such as occurred in Ltr. Rul. 200613027). In Rev.

Rul. 2004-59, 2004-1 CB 1050, IRS ruled that a formless state law conversion is treated as an assets-over transaction for purposes of analyzing the tax consequences of the parties. In the Revenue Ruling, an unincorporated entity (Q) organized in state Z was classified as a partnership for federal tax purposes. Q elected to convert under a state law formless conversion statute into a state law corporation. As a result of the conversion, Q was classified as a corporation for federal tax purposes under Regs. 301.7701-2 and -3.

Rev. Rul. 2004-59 refers to Rev. Rul. 84-111, 1984-2 CB 88, which describes the tax consequences when steps are taken as parts of a plan to transfer partnership operations to a corporation organized for valid business reasons. For each of the three methods of incorporating a partnership,⁵³ Rev. Rul. 84-111 gives tax effect (describing the differences in basis and holding periods) to the form taken provided the steps described are actually undertaken. Noting that Rev. Rul. 84-111 does not apply to a partnership that converts into a corporation in accordance with a state law formless conversion statute, Rev. Rul. 2004-59 holds that a partnership that converts to a corporation under a state law formless conversion statute will be treated in the same manner as one that makes an election to be treated as an association taxable as a corporation under Reg. 301.7701-3(c)(1)(i). Therefore, when unincorporated entity Q converts, under state law, to corporation Q, for federal tax purposes the following steps are deemed to occur: unincorporated entity Q contributes all of its assets and liabilities to corporation Q in exchange for stock in corporation Q, and immediately thereafter, unincorporated entity Q liquidates, distributing the stock of corporation Q to its partners. Thus, Rev. Rul. 2004-59 applies an assets-over analysis to formless conversions, in the same fashion as alternative 1 in Rev. Rul. 84-111.

Therefore, it would follow that the incorporation transaction (via statutory conversion) in Ltr. Rul. 200613027 would be viewed under Rev. Rul. 2004-59 as an assets-over transfer. In that instance, should the Service have focused on whether (1) the owners of the unincorporated entity (i.e., A and B, the owners of LLC1), (2) the entity itself, LLC1 (later to be LLC2), or (3) *both* the owners of the unincorporated entity (A and B) *and* the deemed asset transferor (LLC1, later to be LLC2), met the status quo ante requirement?

3. If not an assets-over transfer, how can the parties achieve a valid rescission? Can there be a valid rescission if the incorporation transaction is

not deemed to be an assets-over transfer? The transfer from Corp to LLC2 can be accomplished by a number of means, including:

- (1) Statutory conversion (as in Ltr. Rul. 200613027).
- (2) Corp's formation of LLC2 (as a momentary single-member LLC), transfer of all Corp's assets (and liabilities) to LLC2, and distribution of the LLC2 interests to A and B.
- (3) Distribution of all of Corp's assets (and liabilities) to A and B, followed by A's and B's capital contribution of the same to LLC2.

Regardless of the form, the analysis in Ltr. Rul. 200613027 that the parties (A, B, LLC1, and LLC2) will be restored to the relative positions they would have occupied if the incorporation transaction had not occurred, should suffice to constitute a valid rescission, in accordance with Rev. Rul. 80-58. The letter ruling, being based on its information and representations, does not address any alternative forms of unwinding.

4. How should the intervening stock redemptions be reflected for tax purposes? The proper tax reporting of the management team's stock transactions is not the subject of Ltr. Rul. 200613027, but one might first surmise that they had been issued the equivalent of options or unvested ownership interests in LLC1 that vested on the incorporation transaction or shortly thereafter, and thus the management team members sprung into being as owners of the taxpayer (Corp) about that time.⁵⁴

For tax purposes, how should the redeemed and non-redeemed management team members report their status? We assume (1) they were mere employees of LLC1 prior to the incorporation transaction, (2) they were employee-shareholders during the period (or, for the redeemed shareholders, a portion of the time) that Corp was taxable as a C corporation (but for the forthcoming rescission), and (3) they remained as employees after the rescission transaction but no longer owned any equity interest in LLC2. The 2005 Proposed Regulations on compensatory partnership interests and options for services⁵⁵ clearly do not contemplate a rescission scenario and provide no guidance.

As mentioned above, Corp redeemed the stock owned by management team members who died or separated from service (during the year of the rescission, of course). At the time of those redemptions, Corp presumably was taxable as a corpora-

tion, and one might speculate that at the time of their stock redemptions, the redeemed (living) shareholders and the deceased shareholders' heirs did not then know or even contemplate that the rescission transaction would occur and that, for federal income tax purposes, LLC1 and Corp would be ruled on 12/16/05 to be an LLC taxable as a partnership at all times during the calendar year (2005). Where did that leave the redeemed shareholders? Presumably, they would report on their Form 1040 income tax returns for 2005 their transactions as having been the initial receipt of stock for services (presumably subject to Section 83) and the redemption of the stock being treated as a Section 301 dividend-type distribution that likely would qualify for (short-term?) capital (gain or loss) treatment under Section 302. Ltr. Rul. 200613027 includes a representation that "[e]ach of [A and B, the owners] will report the amounts received in the redemptions described in [the management team redemptions] consistently with the [t]axpayer's [i.e., Corp/LLC1] having been an LLC taxable as a partnership during all of taxable year [2005]." Note that "the amounts received" were received *by the management team* and *not* by A and B—unless A and/or B were also recipients of management team shares, which seems unlikely (as together they already had 100% ownership). Thus, the representation appears to be that A and B (who are the sole owners of LLC2 and presumably are the parties who determine how the tax return(s) for 2005 will be prepared by the entities) agreed to report the redemption payments to the management team as paid by the LLC taxable as a partnership, and thereby governed by Section 736.

Does this mean the LLC1/Corp/LLC2 tax partnership may be sending Schedules K-1 for 2005 to the redeemed management team members, while the latter report the transactions as *stock redemptions* on their Form 1040 tax returns for 2005? Might the tax consequences be materially different to the redeemed shareholders (or their heirs, with respect to those management team members referred to in the ruling as having died and being redeemed prior to the rescission transaction)? The amounts and terms of the redemption payments are not described in the ruling. One may speculate, however, that viewed as a stock redemption the payment would generate a capital gain (or loss) under Section 302 to the recipient, while if viewed as a Section 736 payment some portion of the payment might be characterized as ordinary income under Section 751 or (less likely, but theoretically possible) ordinary income under Section 736(a)(2).

5. How should the issuance of equity compensation to the management team be reflected for tax purposes? Lacking all the relevant facts, one nevertheless might speculate that the management team members who (ultimately) received stock from Corp first received LLC1 compensatory options or uninvested partnership profits or capital interests, which interests might have become vested for state law purposes once Corp was formed and/or issued shares of stock to the management team. So viewed, the initial receipt of the compensatory partnership interests might be treated for income tax purposes quite differently from the treatment of the receipt of stock for tax purposes.⁵⁶

Alternatively, there may have been no LLC1 equity compensation program. In that event the equity (stock) awards would then first have arisen after Corp came into being, in anticipation of (but before) the IPO. In either scenario, some or all of the management team members—those redeemed and those (if any) not redeemed—well might prefer Corp not to be recognized as a corporation for federal income tax purposes. Instead, the former and current management team members might prefer to be treated as K-1 partners for that portion of the year in which they owned equity interests in Corp. Analysis of the terms of the Corp stock grants to the management team members and the relevant facts and circumstances of each equitized management team member would be necessary to determine whether each would be better off as a K-1 partner for 2005 (and thereafter, for those team members not being redeemed) or as a stockholder.

Assume one or more management team members take a reporting position inconsistent with that taken by A and B, the owners of the LLC (who have represented they will report the redemptions consistently with LLC1 and Corp having been an LLC taxable as a partnership for the entire calendar year (2005)). *Query* whether on the (likely) audit of the entities or the members for 2005 there will be the need for filings of notices of inconsistent position by the "partners." If LLC sends K-1s to the redeemed shareholders (which the latter disregard), might there be potential penalties applied to the shareholders? Arguably they have reasonable cause for believing their stock redemption was just that for tax purposes. Would the redeemed shareholders' penalty defense position be undermined if LLC2 sent them a copy of the letter ruling along with their K-1s, so that the shareholders were on notice of the valid rescission for tax purposes?

6. Did the ongoing management team members rescind their receipt of Corp stock? Although not clear from Ltr. Rul. 200613027, it is quite possible that the Corp stock issued to the management team was itself the subject of rescission, or at least modification. The representations and holding in the letter ruling state that if the rescission transaction were effectuated, A and B would be treated as partners of the taxpayer (i.e., LLC1 and Corp) during such period. Are the management team members *not* treated as partners during the year (2005)? Does the ruling not deal with their equity ownership status (as partners) because (perhaps) their stock awards were mutually rescinded? The letter ruling is silent on this point.

7. What are the payroll and withholding tax consequences of the rescission? Assume that during the period that Corp was in existence (i.e., from Date1 to Date2) the management team was paid cash (in addition to equity) compensation for services. Even though the team members were shareholders, their cash compensation for services would be subject to FICA, HI tax, and federal (and, if applicable, state and local) income tax withholdings, with Corp paying its (employer) share of the FICA and HI taxes.

As a result of the rescission transaction, Corp is no longer treated as having existed for tax purposes, and as held in Ltr. Rul. 200613027, LLC1/Corporation/LLC2 are treated as a partnership for tax purposes for the entire year. Can LLC2 (the surviving legal entity) obtain a refund of its payroll taxes, as a result of the valid rescission, because the shareholder-employees are properly recharacterized as K-1 partners (and whose W-2 salaries arguably are reclassified as being guaranteed payments under Section 707(c), and thus *not* subject to payroll tax withholding pursuant to Reg. 1.707-1(c))? Moreover, can the partnership successfully recover all federal, state, and local income tax withholdings it remitted on behalf of Corp's putative shareholder-employees (who in light of the valid rescission logically would be deemed partners for tax purposes from the moment they owned equity in Corp)?

If Corp/LLC2 *is* entitled to a refund for paying such taxes, LLC2 presumably will be legally obligated to pay the recovery (i.e., the amount wrongly withheld, in hindsight) to the management team members who are deemed to be partners for tax purposes. Conversely, aren't those equity-owing management team members, thanks to 20-20 hindsight via the rescission, now liable for their own self-employment

taxes as partners under Section 1402(a) (unless Section 1402(a)(13) is applicable)? If so, they may be potentially subject to late payment penalties or estimated tax penalties because they failed to take their (formerly W-2, now characterized as K-1) income into consideration in 2005 for self-employment and income tax withholding purposes! It seems only appropriate that IRS waive any potential penalties of such management team members, given they had reasonable cause to believe they were W-2 employees (not K-1 partners) with proper withholding taxes being remitted by Corp during the period they were shareholder-employees—notwithstanding that the subsequent rescission transaction was given retroactive effect.⁵⁷

RESCISSIONS: PARTNERSHIPS INTO TENANCIES-IN-COMMON

To the author's knowledge, there have been no Revenue Rulings, letter rulings, or other IRS guidance involving the unwinding of a partnership via rescission. The case law is sparse.⁵⁸

In an undated 1992 field service advice (FSA 1999-1079, 1992 WL 1354785), the Service's National Office was asked to determine whether the rescission rights exercised by the partners in several cattle-breeding tax-shelter partnerships precluded the existence of the partnerships, for federal income tax purposes, from the beginning. The response took the form of a partially redacted IRS Memorandum from the Assistant Chief Counsel (Field Service) to District Counsel.

In the FSA, the IRS was confronted with limited partnerships formed under state law in year P. Subsequently, the promoter of the partnerships was advised by his counsel that it was not advantageous to operate as partnerships because of potential violations of federal securities laws. In year Q, the promoter offered the investors the option of rescinding their agreements to become partners in the partnership. The purported rescission was retroactive to an unspecified date.

Forms 1065 for an unspecified number of tax years of the partnerships were filed, with all relevant lines on the returns being struck through or containing zeroes. Notes attached to each tax return stated, among other things, that for tax purposes the partnership was never in existence, and that "[t]he owners of the business have determined the business was operated as a 'Tenants [sic] in Common' arrangement during [a redacted time period]."

To confuse matters further, although the partnerships were rescinded for state law purposes many of the partners, relying on the K-1s that they had received from the promoter, took losses for the (redacted) tax year. IRS asserted that the partners were not entitled to these losses.

The facts in FSA 1999-1079 probably would be somewhat ambiguous and confusing even in their unredacted form—and they are far more so in the available version. Nonetheless, the FSA is clear in its discussion of the issue of whether the state law partnership was a partnership for the (redacted) tax year for tax purposes. The FSA's discussion states in relevant part:

"Our impression is that the decision to rescind by the partners was based on potential securities law violations. These concerns arose *after* the partnership had purportedly been formed. We have found no authority which would allow partners in a partnership to retroactively rescind the existence of a partnership in a *prior* taxable year for tax purposes.[Footnote 1 appears here in the original, and is discussed below.] Thus, the rescission rights would not preclude formation." (Emphasis added.)

The Service's refusal in FSA 1999-1079 to allow a retroactive rescission for a prior tax year is consistent with Rev. Rul. 80-58. The FSA implies, however, that a rescission of the formation of the partnership occurring in the *same* year of formation *could* be respected for tax purposes. In the FSA's footnote 1 to the penultimate sentence in the quote, above, the IRS National Office notes that amendments (in regards to allocation of partnership items) to the partnership agreement *are* allowed before the partnership return for the year is legally due and owing (i.e., in the next year), pursuant to Section 761(c). Moreover, "as a general principal [sic] of tax law some sales or contract transactions may be 'unwound' in the *same* tax year. See Rev. Rul. 80-58...."

Is the National Office hinting (albeit in dictum, buried in a footnote, wrapped in a nonprecedential FSA) that a rescission by all (or by all but one) of the partners of a partnership in the same year as it is formed could be given effect for tax purposes?

- If so (and perhaps we are reading too much into the tea leaves), what are the tax consequences to the state-law entity and its state-law partners—a tenancy-in-common, as the tax return disclosure claimed? Aren't the taxable losses (as reported in FSA 1999-1079) or income from the state-law partnership's

operations nonetheless reportable by the owners?

- In a tenancy-in-common for tax purposes, must the losses and income be borne proportionately (i.e., on a "straight up" basis), with no special allocations being permitted (given that Section 704(b) by its terms applies only to the tax partners in a tax partnership, which by definition this tenancy-in-common is not)?
- If the rescission is effective such that no partnership in fact existed under federal income tax law and if no partnership return is filed, do the TEFRA audit rules apply? (The FSA indicates it does not.)
- If a partnership return was filed by a state-law entity (e.g., a limited partnership) for a tax year, but it is determined that the entity is not a partnership (e.g., because of a valid rescission by all the parties), do the TEFRA rules nonetheless extend to such entity and to persons holding an interest in the entity? (Apparently they do, according to the FSA, and authority cited therein.)

These and other aspects of partnership unwindings and rescissions could clearly benefit from further IRS guidance.

Assuming partnership rescissions are otherwise permissible if in compliance with the two requirements of Rev. Rul. 80-58, will a partnership unwinding that is motivated solely for income tax reasons be respected by IRS and the courts? Assume that a family limited partnership is formed for valid personal, non-tax purposes in July 2006. Five months later the partnership's accountant, in analyzing the details of the partners' capital contributions, determines the partnership will be classified as an investment company under Section 721(b), with gain being recognized by the partners on all appreciated property so contributed. Solely to avoid this gain the partners agree to rescind the partnership. In the rescinding transaction the partnership reconveys the assets back to each contributing partner, while meeting the status quo ante requirement, and the partners relinquish their interests in the partnership (which dissolves, having neither assets nor partners). If this is viewed as a valid rescission, the gain otherwise arising under the investment company rules would be avoided.

The partners' motive for the attempted rescission, however, is purely tax driven, i.e., to avoid gain recognition. Would the Service permit a purely tax-

motivated rescission from a partnership to individual owners on these facts? The answer is unclear.⁵⁹

CONCLUSION

As described above, during the past year IRS has issued two favorable letter rulings permitting taxpayers to rescind transfers of ownership interests in S corporations and partnerships, respectively, resulting in the re-establishment of those entities' favorable entity-level tax treatment. Ltr. Rul. 200533002 confirms the reinstatement of S corporation status of an entity otherwise taxable as a C corporation (by recognizing a valid rescission of stock transfers made to otherwise ineligible shareholders). Ltr. Rul. 200613027 approves a rescission that permitted an LLC (taxable as a partnership) to regain its partnership tax status after having been statutorily converted into a C corporation.

Both rulings apply the rescission principles in Rev. Rul. 80-58 and authority cited therein to permit the entity to reinstate its favorable status. The rulings are not remarkable in that regard, but serve as a useful road map for identifying the conditions IRS requires to have a rescission respected for federal income tax purposes.

The rulings do not address the income tax consequences to the owners of the interests in the respective entities, other than to confirm that the rescinding transaction does not generate recognition of taxable gain or loss to the entities or their owners.

The two letter rulings do not provide guidance (and leave unanswered several questions) with respect to tangential tax consequences, including the taxation of non-rescinding owners of the equity interests. As discussed above, this might result in certain taxpayers reporting transactions as having been treated as stock redemptions governed by Section 302 for federal income tax purposes, while other owners and/or the entity itself treat those transactions as partnership redemptions, governed by Section 736.

The letter rulings involve valid non-tax reasons for the rescissions and do not appear subject to manipulation. Nonetheless, the tax consequences to the members (including potential Section 302/736 disparities) may not be symmetrical. As reflected in Rev. Rul. 99-6, 1999-1 CB 432,⁶⁰ the parties to a transaction need not be treated consistently, for federal income tax purposes, and that result has not brought the tax system crashing down.

Reinstatement of REIT status pursuant to the rescission of a transfer of stock that otherwise would violate the "closely held" rules of Section 856(h) has not yet been the subject of rulings or cases involving rescissions. Nevertheless, the analysis and requirements should be very similar to those described in Ltr. Rul. 200533002 with respect to rescissions of stock transfers to ineligible shareholders of an S corporation. Rescission of partnerships (and the members' alleged characterization as mere tenants-in-common) was alleged by the taxpayer in FSA 1999-1079, but that redacted IRS document does not give crystalline guidance (and sheds little light in its redacted form) on the topics discussed herein.

Practice Notes

Two recent letter rulings provide guidance as to the status quo ante requirement applied by IRS in Rev. Rul. 80-58 and letter rulings that followed. Care must be exercised in accomplishing a valid rescission for tax purposes, given the potentially adverse (if not catastrophic) tax consequences that can arise if the attempted unwinding is not respected and both the first and second transactions are given independent tax effect. In order to effectuate a valid rescission for tax purposes which changes the entity's tax status (as described above), IRS requires the unwinding to cause the legal and financial arrangements between the owners and the entity involved to be identical in all material respects, as would have existed if the initial transaction (e.g., the statutory conversion of the LLC in Ltr. Rul. 200613027; the transfer of SCo1 stock in Ltr. Rul. 200533002) had never occurred.

¹ See, e.g., *Penn v. Robertson*, 25 AFTR 940, 115 F2d 167 (CA-4, 1940), involving 1930-31 rescission transactions.

² See, e.g., Banoff, "Unwinding or Rescinding a Transaction: Good Tax Planning or Tax Fraud?," 62 Taxes 942 (December 1984).

³ See, e.g., Banoff, "Tax Planning for the Unexpected," 68 Taxes 1033 (December 1990).

⁴ See Banoff, *supra* note 2, pages 943 and 947-48. As to whether intentional "backdating" of documents may successfully constitute a valid rescission for tax purposes or instead constitute fraud, see *id.*, pages 947-48, 970, and 979-980 (in certain limited circumstances, backdating a contract or agreement may be of value in retroactively unwinding or modifying a transaction, but improper backdating, if done to conceal the document or to

change the original intent of the parties, is subject to civil or criminal penalties).

⁵ See, e.g., Miller, 66 AFTR 2d 90-5337, 907 F2d 994 (CA-10, 1990), fn. 2 (affirming tax attorney's conviction for making false statements in violation of 18 U.S.C. section 1001).

⁶ Banoff, *supra* note 2, pages 944-945.

⁷ *Id.*, page 946.

⁸ See, e.g., Rev. Rul. 74-501, 1974-2 CB 98, Situation 2.

⁹ Banoff, *supra* note 2, page 965. See, e.g., Ltr. Ruls. 8645047, 9409023, and 199935035.

¹⁰ *Id.*, page 960.

¹¹ See, e.g., Ripley Realty Co., 23 BTA 1247 (1931), *aff'd per cur.* 61 F2d 1038 (CA-2, 1932). *Cf.* Hope, 55 TC 1020 (1971), *aff'd* 31 AFTR 2d 73-577, 471 F2d 738 (CA-3, 1973), *cert. den.*, which also involved a taxpayer contending that a rescission should be given multi-year retroactive effect. The Tax Court there noted that "[t]his court is not faced with the situation where the sale is rescinded in the same year. Compare *Penn v. Robertson*.... In fact, it is not necessary to decide what might have been the result if this sale had been rescinded in the following year. Compare *Penn* ... with *Ripley Realty Co.*..." The Tax Court in Hope thus did not reject the dictum of Ripley Realty, and one might speculate that had the facts in Hope presented an actual rescission, a different result might have followed, i.e., the rescission might have been given retroactive effect for multiple years for tax purposes. Several commentators have suggested that it is arguable that a rescission is a nontaxable event on a retroactive (multi-year) basis, while others are far less optimistic. See authorities discussed in Banoff, *supra* note 2, page 961 and fns. 153-155.

¹² See, e.g., Branum v. Campbell, 45 AFTR 455, 211 F2d 147 (CA-5, 1954); Reeves, 3 AFTR 2d 1562, 173 F Supp 779 (DC Ala., 1959). See Banoff, *supra* note 2, pages 968-69.

¹³ *Black's Law Dictionary*, Seventh Edition (West, 1999), defines "status quo ante" as "the situation that existed before something else (being discussed) occurred." IRS did not use the phrase "status quo ante" in Rev. Rul. 80-58, but has done so in more recent letter rulings, e.g., Ltr. Ruls. 9829044 and 200533002 (both stating that, according to Rev. Rul. 80-58, the first of the two conditions that must be satisfied for the remedy of rescission to apply to disregard a transaction for tax purposes is

that "the parties to the transaction must return to the status quo ante; that is, they must be restored to 'the relative positions they would have occupied had no contract been made'"). There are several meanings of "rescission" in general parlance. "The term 'rescission' is often used by lawyers, courts and businessmen in many different senses; for example, termination of a contract by virtue of an option to terminate in the agreement, cancellation for breach and avoidance on the grounds of infancy or fraud.... [In the Commercial Code] 'rescission' is utilized as a term of art to refer to a mutual agreement to discharge contractual duties...." Calamari and Perillo, *The Law of Contracts*, Third Edition (West, 1987), §21-2, pages 864-65. An earlier edition of Black's Law Dictionary, as quoted in Banoff, *supra* note 2, page 957, defined "rescission of contract" as "annulling or abrogation or unmaking of contract and the placing of the parties to it in *status quo*." The more modern definition of "rescission" in the Seventh Edition of *Black's* eliminates explicit reference to "status quo" or "status quo ante" and defines an "agreement of rescission" as "an agreement by contracting parties to discharge all remaining duties of performance and terminate the contract." *Black's* defines the verb "rescind" to mean "1. to abrogate or cancel (a contract) unilaterally or by agreement, 2. to make void; to repeal or annul."

¹⁴ In TAM 7802003, which predates Rev. Rul. 80-58, IRS stated that "the little authority available does indicate that there may be a rescission where a bona fide sale or exchange, otherwise taxable, is undone and the parties to the transaction are restored to the status quo, whether the restoration is complete or *less than complete*." (Emphasis added.) The Service cited "the fact that the parties were returned to *substantially the same position* as they were in before the sale ... tends to indicate that there was an intent to return to the status quo." (Emphasis added.) The TAM's "less than complete" phrase is dictum, and in light of Rev. Rul. 80-58, it would be extremely aggressive for a taxpayer to rely on TAM 7802003 for the proposition that a "less than complete" restoration may qualify for rescission treatment for tax purposes. Indeed, the TAM no longer constitutes meaningful authority for purposes of establishing "substantial authority" to avert the accuracy-related penalty of Section 6662(b)(2). Although the TAM was issued (about one year) after 10/31/76, so as to constitute "authority" for purposes of this penalty (see Reg. 1.6662-4(d)(3)(iii)), the fact that it is more than ten years old (actually, nearly 30) will cause it to be accorded "very little weight" (see Reg. 1.6662-

4(d)(3)(ii)), and the persuasiveness and relevance of that TAM, in light of subsequent developments (particularly, the issuance of Rev. Rul. 80-58, which requires *complete* restoration of the parties), diminishes the weight of the TAM's dictum to near weightlessness. (Reg. 1.6662-4(d)(3)(ii) also states that a Revenue Ruling (e.g., Rev. Rul. 80-58) is accorded greater weight than a letter ruling addressing the same issue.)

¹⁵ See *Penn v. Robertson*, *supra* note 1; Banoff, *supra* note 2, pages 975-983 and cases cited therein; Letter Rulings, "IRS Recognizes Rescission of Stock Grant," 74 JTAX 262 (April 1991); Shop Talk, "IRS Disregards Taxpayer's Attempt to Unwind Dividend," 95 JTAX 188 (September 2001); Shop Talk, "Do State Court Nunc Pro Tunc Orders Have Tax Effect?," 80 JTAX 253 (April 1994); FSA 200124008; Ltr. Rul. 9104039.

¹⁶ Rev. Rul. 80-58 contains a valid non-tax reason for its rescission, but does not state that a non-tax reason is necessary for a rescission to be valid for tax purposes. *Cf.* Ltr. Rul. 9829044, where IRS approved a rescission of a transfer of S corporation stock undertaken to preserve the S corporation's election. In the initial transaction, the shareholders of SCo1 (all of whom also were the shareholders of SCo2) transferred their SCo1 stock to SCo2 for valid non-tax reasons. SCo2 planned to make a qualified Subchapter S subsidiary (QSSS) election, but the company's accounting firm advised SCo2 that SCo1's suspended loss could disappear if SCo2 made a QSSS election with respect to SCo1, and SCo2 followed this advice. Shortly thereafter, SCo2 distributed the SCo1 stock back to the shareholders in the same proportions as they originally had contributed the SCo1 stock to SCo2. Applying Rev. Rul. 80-58, IRS held the legal doctrine of rescission applied to (1) disregard the transfer of the SCo1 stock to SCo2, and (2) prevent the termination of SCo1's S corporation status.

¹⁷ This assumes the shareholder's basis is less than the amount deemed realized. The shareholder likely would recognize a capital loss if the opposite were true.

¹⁸ Conversely, A likely would recognize a capital loss if her stock basis exceeded the amount she received from XYZ and she is not subject to loss limitations (e.g., under Section 267).

¹⁹ XYZ also would recognize gain (or loss) to the extent the amount it receives from A exceeds (or is less than) XYZ's then-current basis in the C corporation's stock.

²⁰ If A holds the corporation's shares until her death, even this silver lining is illusory, as A's heirs would have obtained a basis step-up for her shares (without having to recognize gain) under Section 1014 at the shares' then-current value.

²¹ The procedures, conditions, and requirements to obtain an IRS waiver are beyond the scope of this article. See generally Eustice and Kuntz, *Federal Income Taxation of S Corporations*, Fourth Edition (Warren, Gorham & Lamont, 2001), ¶5.07. Alternatively, in rare circumstances S corporation status may be retained by having the initial transfer of stock being declared void *ab initio* by a court of competent jurisdiction. See, e.g., Ltr. Ruls. 9409023, 9733002, and 199935035 (which in result are analogous to a valid rescission, i.e., for federal tax purposes there was no transfer of the stock).

²² In some letter rulings involving similar fact patterns (i.e., inadvertent termination; initial transfers by shareholders to new, ineligible shareholders; transfers effectuated by the same shareholders "rescinding the transaction"), IRS applied relief under Section 1362(f) rather than applying Rev. Rul. 80-58 to treat the rescission as effective for tax purposes and restoring S corporation status. See, e.g., Ltr. Rul. 9304007 (not mentioning Rev. Rul. 80-58).

²³ X failed to meet the eligibility requirements for two reasons—the issuance of a class of preferred stock and the purchase of such stock by ineligible shareholders, i.e., the three limited partnerships.

²⁴ Although not discussed in the ruling, X most likely did not make any dividend-type distributions on its common stock, either.

²⁵ See note 13, *supra*.

²⁶ These are standard rulings that are given and desirable with respect to unwinding or rescinding intentional or inadvertent terminations of S corporation status.

²⁷ Ltr. Rul. 9829044 indicates that a rescission that has economic consequences but is solely tax-motivated nonetheless will be respected for tax purposes.

²⁸ *Query* whether unrelated parties typically will agree to rescind a transaction at the exact amount required under Rev. Rul. 80-58, even if the market indicates the value or income of the company has increased (or decreased).

²⁹ Sections 856(h) and 542(a)(2).

³⁰ This is understandable. In your author's experience, REITs (whether public or private) generally

are formed by principal shareholders who benefit from sophisticated advice from their lawyers and accountants regarding qualification for and maintenance of REIT status. Thus, REIT sponsors generally have familiarity with the REIT's "closely held" ownership rules. Moreover, REITs use self-operating provisions in their corporate by-laws or other governing documents to preclude stock transfers that would jeopardize the REIT's retention of qualification. In contrast, many S corporations are created by shareholders who are less than knowledgeable about the ineligible shareholder rules under Section 1361. Perhaps more important, many if not most S corporations' by-laws and other governing documents do not preclude or treat as void from the start transfers that would jeopardize the corporation's retention of its S election. Therefore, some S corporations have resorted to rescissions of stock transfers, and obtained IRS letter rulings to confirm the rescissions were effective to reinstate S corporation status as of the initial transfer.

³¹ Cf. Ltr. Rul. 9829044. See note 16, *supra*.

³² See Tolles and Arash, "Unwinding the Deal: The Tax Doctrine of Rescission," 52 Major Tax Planning (U.S.C. Ann. Inst. on Fed. Tax'n) Ch. 3 (2000).

³³ See, e.g., Ltr. Ruls. 9627017 and 9719018.

³⁴ Tolles and Arash, *supra* note 32, observe at 307.2C that operation of the "excess share" provision does not satisfy all the requirements of Rev. Rul. 80-58. The person from whom the excess shares are purchased will not be returned to the same position if the excess shares are not returned to that person. In addition, the person who purchased the excess shares may not be returned to the status quo ante since it will bear the risk of loss associated with any decline in the value of the excess shares between the time of initial purchase and the subsequent sale by the trust.

³⁵ See note 21, *supra*.

³⁶ The letter ruling states that as a result of the statutory conversion, A and B, the sole owners of LLC1, became the sole shareholders of Corp. Therefore, the management team members must have become shareholders of Corp thereafter.

³⁷ This presumably relates to taxable income for the pre-conversion period, as to which the LLC agreement had provided for cash distributions at a later date.

³⁸ Nomenclature selected for unwinding transactions should not have substantive effect in obtaining

favorable rulings, but one's self-serving reference to the unwinding as the "rescission transaction" rather than, say, the "botched unwinding" is more likely to find favor with IRS.

³⁹ The taxpayer does *not* represent that A and B are the "transferors" for purposes of Section 351 in the incorporation transaction.

⁴⁰ This provides simplicity and may eliminate state and local transfer tax liability since no deed recording is necessary. Unlike a statutory merger, which involves two entities coming together, in a statutory conversion an existing entity is transformed into a new entity that did not exist before the conversion. See Banoff, "Mr. Popeil Gets 'Reel' About Conversions of Legal Entities: The Pocket Fisherman Flycasts for 'Form' but Snags on 'Substance,'" 75 Taxes 887 (December 1997) (the "Conversions article"), page 889, fn. 12.

⁴¹ See, e.g., Del. Code tit. 6, section 18-214(g).

⁴² See, e.g., Rev. Rul. 69-6, 1969-1 CB 104, and Rev. Rul. 77-321, 1977-2 CB 98; Conversions article, *supra* note 40, pages 906-07.

⁴³ For example, on a partnership-to-corporation conversion, the form is respected, often resulting in substantially different tax consequences depending on which form is selected. See Rev. Rul. 84-111, 1984-2 CB 88; Conversions article, *supra* note 40, pages 893-896 and 899-901.

⁴⁴ See note 16, *supra*.

⁴⁵ For example, business operations; changes in cash position; increase or decrease in the value of assets and amounts of liabilities; and acquisition and/or disposition of corporate property.

⁴⁶ This analysis focuses on the aggregate values of the entities (LLC1 and LLC2) and disregards discounts that ordinarily would be reflected in valuing A's and B's respective member interests in the LLCs. Nonetheless, the analysis described in the text would be the same, i.e., the rescission transaction does not restore A and B to the same values of the property they owned at the time of the incorporation transaction. This can be proven by assigning a 40% (or any other) discount for A's and B's respective ownership interests in LLC1, Corp, and LLC2. A's and B's interests in LLC1 each would have been valued at \$30 (i.e., 60% of 50% of \$100) at the date of the incorporation transaction and their interests in LLC2 each would have been valued at \$24 (i.e., 60% of 50% of \$80) at the date of the rescission transaction.

⁴⁷ If in Ltr. Rul. 200613027 A and B were cognizant that the value of LLC1 was \$100 at the date of the incorporation transaction and that (on the date of the rescission transaction) Corp/LLC2 was only worth \$80, A and B could first contribute \$20 (increasing Corp/LLC2's value to \$100 at the date of the rescission transaction) so that the values of LLC1 and Corp/LLC2 were equal. This seems to be a formalistic, needless approach to meeting the status quo ante requirement. Moreover, A and B would not personally be in the same relative positions they would have occupied had no incorporation transaction occurred, as they personally would have reduced their net worth by the \$20 cash they would contribute to Corp/LLC2 under this alternative.

⁴⁸ Such as those described in note 45, *supra*.

⁴⁹ Again, this assumes all other requirements for a valid rescission have been maintained, e.g., Corp and LLC2 made no distributions to the equity holders except as represented in the ruling.

⁵⁰ Most likely IRS does not mean to include as "parties" those "certain members of the [t]axpayer's management team" whose stock in Corp was redeemed. Moreover, unless all of those redeemed shareholders voluntarily returned (to Corp or LLC2) the redemption proceeds they would not have been restored to "the relative position they would have occupied if the Incorporation Transaction had not occurred," which, as emphasized above in the text, is the Service's rationale for its favorable rulings.

⁵¹ That is, either solely at the entity level, or at *both* the entity level and the member/shareholder level.

⁵² See note 16, *supra*.

⁵³ These are (1) the partnership contributes its assets to the corporation in exchange for stock of the corporation, and then distributes the stock to its partners in liquidation ("alternative 1"); (2) the partnership liquidates and distributes undivided interests in its assets and liabilities to its partners, who then contribute their undivided interests to the corporation for stock ("alternative 2"); and (3) the partners contribute the partnership interests to the corporation in exchange for stock ("alternative 3").

⁵⁴ See note 36, *supra*.

⁵⁵ REG-105346-03, 5/24/05. See generally Banoff, Carman, and Maxfield, "Prop. Regs. on Partnership Equity for Services: The Collision of Section 83 and Subchapter K," 103 JTAX 69 (August 2005).

⁵⁶ See, e.g., Rev. Proc. 93-27, 1993-2 CB 343; Rev. Proc. 2001-43, 2001-2 CB 191; REG-105346-03, 5/24/05; Mincey, Sloan, and Banoff, "Rev. Proc. 2001-43, Section 83(b) and Unvested Profits Interests—The Final Facet of *Diamond?*," 95 JTAX 205 (October 2001); Banoff, Carman, and Maxfield, *id.*

⁵⁷ We have pointed out analogous conundrums for unincorporated entities taxable as partnerships which, within 75 days of the beginning of the tax year, elect under the check-the-box Regulations to be taxable as corporations. Under Reg. 301.7701-3(c)(1)(iii), the 75-day "look back" provides certain advantages to the entity and its owners but also can wreak havoc with payments to service providers who own equity in the unincorporated entity. Initially viewed as compensation to K-1 partners, such payments for services would constitute guaranteed payments under Section 707(c), not subject to employer withholding or payroll taxes. If the LLC later made a retroactive election to be taxed as a corporation, the compensation payments could no longer be characterized as Section 707(c) guaranteed payments since the entity would not at any time be treated as a partnership for tax purposes. The payments instead presumably would be wages to an employee of the corporation, raising many questions with respect to payroll tax liability, penalties and interest, particularly as to service "partners" who withdraw from the unincorporated entity prior to its election to be taxable as a corporation. See Shop Talk, "LLCs Electing to Be Taxable as Corporations: Tangential Problems," 96 JTAX 127 (February 2002).

⁵⁸ See *Branum v. Campbell*, *supra* note 12, involving the tax consequences resulting from the formation and purported rescission of a partnership in the same tax year. See generally Robb and McNulty, "The Tax Consequences of Rescinding a Partnership or One Partner's Investment," 12 J. Partnership Tax'n 18 (1995).

⁵⁹ One author concludes on these facts that it is unlikely that the Service would permit a purely tax-motivated rescission (at least in this context). Shenkman, "Avoiding the Investment Company Trap When Forming FLPs and LLCs," 26 Estate Planning 484 (December 1999). Cf. Ltr. Rul. 9829044, discussed in note 16, *supra*, where IRS approved a rescission of a transfer of S corporation stock that was done to preserve the S corporation's election (indicating a non-tax reason is not required for a rescission to be valid for tax purposes).

⁶⁰ There, IRS ruled that the sellers of all of a partnership's interests were each deemed to have sold partnership interests for federal income tax purposes, while the sole buyer was deemed to have purchased the partnership's assets (subject to its liabilities).

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