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Insatiable: *Estate of Kechijian* Limits Application of Tax Rescission Doctrine

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Shakespeare is credited with creating the meme "gilding the lily,"[2] which means to add unnecessary adornment to something that is already beautiful. This phrase is particularly apt to describe the tax planning addressed by the US Court of Appeals for the Fourth Circuit in *Estate of Kechijian v. Commissioner* in its decision released on June 23, 2020.[3] The taxpayers in this case artfully executed an S corporation employee stock ownership plan ("ESOP") that resulted in the deferral of a substantial amount of federal income tax and the tax-free creation of $174 million in asset basis. Their tax planning, however, was substantially unwound when their intrigues to turn the deferral into permanent tax exemptions were challenged by the Internal Revenue Service (the "IRS") and substantial tax penalties were imposed. Further footfalls during the litigation limited the ability of the taxpayers to use net operating loss ("NOL") carryback claims to reduce the tax bite. This Legal Update explores the decision and its implications for the use of the rescission doctrine in tax planning.

I. Background

The taxpayers, two individuals, operated a successful distressed debt trading and recovery business through limited liability companies ("LLCs") that appeared to have been taxable as partnerships for federal income tax purposes. In 1998, the taxpayers transferred their interests in the LLCs to a newly-formed "S corporation"[4] in exchange for the stock in the S corporation in a non-taxable transaction.[5] Although each taxpayer owned his interests in the LLCs without restriction, they each attached a "substantial risk of forfeiture" to the stock of the S corporation.[6] Specifically, each taxpayer agreed to forfeit all or a portion of his S corporation stock if he left the business within five years of the date of the transfer of the LLC interests to the S corporation. Neither taxpayer made an election to include the excess of the value of the S corporation stock over the amount paid for such stock in income.[7]

In December of 1998, the taxpayers created an ESOP and the ESOP purchased stock in the S corporation. Under the tax rules in effect at that time, the S corporation did not pass through any income on the stock that was subject to a substantial risk of forfeiture. Since the ESOP (which was tax-exempt) was the only S corporation shareholder who held unrestricted stock, all of the S corporation's taxable income was allocated to the ESOP. As a result, no one paid any tax on the income earned by the S corporation in 2000 through 2003. Congress eliminated this scheme of taxation, effective beginning in 2005.

In response to the then-prospective change in law, the S corporation sold all of its assets, at a profit of $174.6 million, to a newly-formed limited liability company ("Holdings") owned by the two taxpayers. Since the sale occurred prior to the law change, all of the gain from the sale was allocated to the ESOP. Holdings paid for the S corporation's assets by issuing its promissory note with a face amount of $190 million to the S corporation. The sale enabled the taxpayers to increase the bases of the assets held in the distressed debt trading business by $174.2 million without any tax being due and payable. So far, pretty good.

In 2004, the substantial risks of forfeiture applicable to the stock of the S corporation expired. If nothing else had happened, the taxpayers would each have recognized approximately $45.9 million in ordinary income (the fair market value of the S corporation stock at that time). In order to prevent this income recognition, each taxpayer voluntarily surrendered his stock back to the S corporation. Immediately following the stock surrender, however, each taxpayer purchased back stock from the S corporation by issuing a $41.5 million promissory note to the S corporation. The taxpayers reported the $4.4 million difference between the value of the stock that he purchased and the price paid as ordinary compensation income. Also in 2004, the S corporation redeemed the stock held by the ESOP, leaving the two taxpayers as the sole S corporation shareholders.

The business continued to operate until 2008. In 2008, the business failed in the financial crisis that occurred in such year. The taxpayers incurred substantial losses as their business failed.

II. Tax Reporting

The taxpayers did not report income equal to the fair market value of the S corporation stock when the substantial risks of forfeiture expired in 2004, as required by Code § 83(a). They argued that since they surrendered the stock in the same year in which the stock vested, the rescission doctrine allowed them to treat the vesting of the stock as a nullity. The court refused to allow the taxpayers to use the rescission doctrine on two separate grounds. First, the court held that the doctrine was inapplicable because the services had been performed in a tax year prior to the year in which they voluntarily forfeited the stock. Second, the court held that the surrender, coupled with stock purchase, lacked any economic substance.[8]

III. The Rescission Doctrine

Applicable federal income tax principles allow taxpayers to treat transactions as though they never occurred if they are rescinded in the year in which they are entered into and certain other requirements are satisfied. Prior to *Estate of Kechijian*, the application of the rescission doctrine to compensatory payments had been limited to arrangements in which employees were contractually bound to return unearned compensation.[9] In *Estate of Kechijian*, the fourth circuit found these cases were inapposite because the taxpayers were not obligated to return the S corporation stock. Furthermore, the court refused to look to the year in which the substantial risks of forfeiture expired in the determining when the original transaction took place. The court concluded that the original transaction took place over the years in which services were rendered, even though the stock was subject to "cliff vesting," that is, all of the stock vested in 2004. We'll explore these holdings in light of the prior authorities applying the rescission doctrine.

The case that established that a taxpayer has the right to rescind a transaction and treat it as void *ab initio* is *Penn v. Robertson*, 115 F.2d 167 (4th Cir. 1940). Interestingly, this case involved stock transferred in connection with the performance of services. In *Penn v. Robertson*, the taxpayer purchased stock at below its value from his employer in 1930 and 1931. The stock purchase plan had not been approved by shareholders. Certain shareholders sued to enjoin the operation of the plan and the estate of the employee sold the stock back to his employer in 1931.[10] (The estate also returned amounts paid to the employee as dividends on the stock.) The IRS asserted that the employee recognized income from each stock grant and dividends and the estate was entitled to a deduction for the return of the stock and cash when they were returned. The taxpayer, however, asserted that the stock purchases and resales should be void *ab initio* and the dividends and the returns thereof should not have any federal income tax effects.

The *Penn v. Robertson* court held that the 1930 transactions could not be ignored because, as of the close of such year, that the taxpayer had an unrestricted right to keep the stock. Only events that occurred after the close of such year made clear that the taxpayer would have to return the stock and dividends. In contrast, the court held that the 1931 transfer of the stock and its return "extinguished what would have been taxable income to [the taxpayer] for the year." The court reasoned that the parties intended a "genuine rescission" and not a sale and separate resale.[11]

In *Hope v. Comm'r*, 55 T.C. 1020, aff'd 471 F.2d 738 (3rd Cir. 1973), the taxpayer sold a large block of stock to an investment company for cash. In the same year in which the sale occurred, the taxpayer brought a law suit to rescind the sale. In the succeeding year, the sale was partially rescinded. The taxpayer sought to treat the portion of the sale that was rescinded in the subsequent year as void *ab initio*. The courts refused to allow this treatment. Instead, they held that the initial stock sale resulted in a capital gain to the taxpayer and the reconveyance of the stock and return of the cash proceeds must be separately evaluated even though rescission had been sought in the same year as the sale. Since the taxpayer had the unrestricted right to the cash at the end of the year of the sale, the courts required that the transactions be treated as separate transactions.[12]

In *Davis Jr. v. United States*, 378 F. Supp. 579 (N.D. Tex. 1974), a father intended to make a gift of stock to his three sons. He entrusted an accountant to document and effectuate the transfer. The accountant inadvertently cast the transaction as a sale. (In prior years, the father mulled over selling the stock to his children.) In the same year as the sale transaction took place, the father "took the steps necessary to reform it so as to reflect his intent that the transfers be gifts." The IRS asserted that the initial transfers were taxable sales by the father to the sons. The court applied the rescission doctrine and held that regardless of the initial intent, since the transaction was recast as a gift in the same year as the sale had occurred, the sale would be ignored. As a result, the father did not recognize a capital gain from the transaction.

In *Blanco v. United States*, 602 F. 2d 324 (Ct. C1. 1979), the taxpayer was involved in a transaction in which appreciated assets were distributed to taxpayer in redemption of taxpayer's stock. The taxpayer later tried to rescind the transaction by a subsequent transaction wherein redeemed shares were returned to the taxpayer in exchange for an interest-bearing note. The court held that there was no rescission, because the parties were not restored to their respective positions prior to the transaction. Specifically, prior to the transaction, the corporation owned the assets and the taxpayer was not indebted to the corporation. However, after the transaction the taxpayer was indebted to the corporation, but the taxpayer, rather than the corporation, owned the assets the corporation previously had owned.

In Revenue Ruling 80-58, 1980-1 C.B. 181, the IRS considered a sale of land by "A" to "B" for cash. Under the terms of the land sale, B had the right to return the land to A and receive his cash back if B was unable to have the land rezoned for its intended use. In the first scenario considered by the IRS, B reconveyed the land to A in the year of sale. In the second scenario considered, B reconveyed the land to A in the year after the year of the sale. The IRS, relying on *Penn v. Robertson*, *supra*, held that in the first scenario, the transactions are treated as void *ab initio*, but in the second scenario, there is a separate sale and re-sale. Analytically, the IRS reiterated that even though there was a valid rescission in both cases, the annual accounting concept requires that the second set of transactions be accounted for separately. In addition, the IRS provided a definition of a rescission transaction:

> [T]he abrogation, canceling, or voiding of a contract that has the effect of releasing the contracting parties from further obligations to each other and restoring the parties to the relative positions that they would have occupied had no contract been made. A rescission may be effected by mutual agreement of the parties, by one of the parties declaring a rescission of the contract without the consent of the other if sufficient grounds exist, or by applying to the court for a decree of rescission.[13]

In P.L.R. 9104039 (Oct. 31, 1990), the company voted to transfer shares of stock to employees subject to restrictions that constituted a substantial risk of forfeiture under Code § 83(a) and cash bonuses that were sufficient to pay the taxes for each employee who made a timely Code § 83(b) election with respect to the transfer. Later, the company planned to rescind the agreements with employees and require them to transfer the shares back to the company. In addition, the company did not intend to pay the cash bonus originally agreed upon. The IRS held that the elections made by the employees in accordance with Code § 83(b) will have no force and effect, because the company planned to rescind the stock grant within the same taxable year in which it was made, with the result that the stock grant will be disregarded for federal income tax purposes, and the effect of the rescission was to void the transfer upon which the Code § 83(b) election was based.

In *Hutcheson v. Comm'r*, T.C.Mem. 1996-127, the taxpayer held stocks in a margin account with a brokerage firm. The brokerage firm inadvertently sold 96,000 shares in the account in January 1989. In December 1989, the taxpayer purchased 96,000 shares of the same stock back through the same brokerage account, but at a much higher price.[14] The taxpayer argued that Revenue Ruling 80-58, *supra*, applied to the sale and repurchase. As a result, the taxpayer asserted that he should not be required to recognize the gain on the January 1989 sale. The Tax Court disagreed because the repurchase was not between the taxpayer and the original purchasers of the stock. The taxpayer effected an open market purchase from purchasers who were not related to the original buyers. Since the subsequent transaction was with different parties, the court held that the rescission doctrine did not apply.

In addition, in *Hutcheson*, *supra*, the subsequent repurchase did not restore the taxpayer to its original position. The brokerage did not rescind the original sale and the taxpayer did not return the original purchase price. Each transaction was undertaken at the then-current market price of the stock. Thus, the two transactions failed to qualify for the application of the rescission doctrine because the rescission did not restore the parties to their positions before the initial sale.

In P.L.R. 9829044 (Jul. 17, 1998), seven individuals owned the stock of two corporations ("X" and "Y") in the same proportions. X and Y were S corporations. The shareholders contributed their Y stock to X. The contribution would have caused Y to be taxed as a C corporation unless Y elected to be taxed as a qualified subchapter S subsidiary (a "QSSS").[15] After the contribution, however, accountants for the corporations realized that if Y made an election to be taxed as a QSSS, it would have lost valuable federal income tax attributes, specifically, net operating losses which could be used to shelter future income. Accordingly, in the same taxable year in which the shareholders contributed the Y stock to X, in order to prevent the loss of such attributes, X distributed back the stock of Y to the shareholders. During the time that X held the Y stock, Y did not make any distributions to X. Accordingly, the distribution of the Y stock to the shareholders returned the parties to the *status quo ante*. On these facts, the IRS held that the rescission doctrine applied and the Y stock would be treated as though it had been held by the shareholders uninterrupted for the entire year.[16]

In P.L.R. 200533002 (Apr. 28, 2005), an S corporation sold stock in itself to several partnerships. The stock sale caused the corporation to become taxable as a C corporation.[17] Following the sale, but in the same taxable year, a disagreement arose between the partnerships and the corporation and the stock sale was rescinded pursuant to a written agreement. On these facts, the IRS ruled that stock sale would be ignored and the corporation would be treated as an S corporation for the full tax year.

In P.L.R. 200701019 (Jan. 15, 2007), a corporation ("P") acquired all of the outstanding stock of another company ("Sub-1"). The sole asset of Sub-1 was the stock of a third corporation ("Sub-2"). Immediately following P's acquisition of Sub-1, Sub-1 liquidated. As a result, P held the stock of Sub-2 directly. The liquidation caused P to lose its basis in the stock of Sub-1 (which was high and, therefore, favorable).[18] P realized that the liquidation, which caused this loss of stock basis, was not "prudent." In order to restore the stock basis, *inter alia*, in the same tax year as the liquidation, P formed a new corporation with exactly the same terms and provisions as had been in the charter and bylaws of Sub-1 and contributed the Sub-2 stock to the new corporation. The IRS ruled that the new corporation would be treated as though it was Sub-1:

1. The liquidation of Sub-1 and formation of the new corporation would be ignored and instead P and Sub-1 would be treated as separate corporations for the full tax year.
2. P would be treated as the shareholder of Sub-1 at all times during the year; and
3. The liquidation of Sub-1 would be ignored for federal income tax purposes.

The IRS provided these rulings even though the liquidation was reversed to achieve a federal income tax advantage.

In P.L.R. 200843001 (Oct. 24, 2008), a corporation ("A") held 10% of "X," an entity that elected to be treated as a disregarded entity. A sold equity in X to a third party, but the transaction was rescinded in the same year in which it occurred. The IRS ruled that two conditions must be met in order for the transactions (in this case, the sale and the repurchase) to be treated as a nullity. First, the second transaction must restore the parties to the positions that they were in prior to the first transaction, *i.e., the status quo ante*. Second, the rescission transaction must occur in the same tax year as the first transaction. Since both of these requirements were met on the facts presented, the IRS agreed to ignore the stock sale and re-sale and the treat X as a disregarded entity for the entire year.

In P.L.R. 200923010 (Jun. 5, 2009), the IRS ruled that the rescission doctrine applied when the taxpayers unwound less than all of the steps in a series of transactions. In this ruling, a US corporation ("Parent") contributed the assets and liabilities comprising a business to a new corporation ("Controlled") and distributed the Controlled stock to a shareholder in partial redemption of the shareholder's stock. Following these transactions, the management of the companies determined that changed business conditions caused the distribution of the Controlled stock to be disadvantageous from a business perspective. Accordingly, in the same tax year as the contribution and distribution occurred, the parties unwound the distribution of the Controlled stock to the shareholder, but did not disturb the contribution of the business to Controlled. Notwithstanding that the parties did not unwind all of the steps of the transaction, the IRS held that the distribution of the Controlled stock would be treated as a nullity and not as a distribution and recontribution.[19]

In P.L.R. 201008033 (Feb. 26, 2010), a corporation ("A") sold all of the outstanding stock of one of its subsidiaries ("T") to another one of its subsidiaries ("S"). The taxpayers apparently were unaware that the sale would be treated as a dividend. *See* Code § 304(a). After the sale, the parties were informed by their tax advisors that "the Sale would result in unintended adverse Federal income tax consequences." In order to avoid this dividend treatment, in the same tax year in which the sale occurred, A and S entered into a rescission agreement. Under the rescission agreement, A returned the cash purchase price to S and S returned the T stock to A. In the same year in which the sale and rescission occurred, T made an election to be treated as a disregarded entity. A then immediately transferred the ownership interests in T to A. In other words, shortly following the rescission transaction, A restructured the ownership of T and then transferred the restructured ownership interests to S. This revised transaction format did not pose the adverse federal income tax consequences that the stock sale had posed to A.

The IRS ruled that the initial sale and rescission would be treated as a nullity, even though the transaction was stated to be motivated by avoiding an adverse federal income tax result. In addition, the IRS provided a favorable ruling that the transaction occurring immediately after the rescission transaction would be given independent significance. Stated alternatively, the rescission was unaffected by the fact that the transaction was undertaken in a more favorable format than the rescinded transaction.

In P.L.R. 201008033, the taxpayer provided the following representations, *inter alia*:

1. The intent and effect of the rescission was to restore, "in all material respects the legal and financial arrangements" that would have existed had the sale not occurred.
2. There was no activity that was "materially inconsistent with the rescission."
3. The rescission restored the parties to the position that they were in *status quo ante*.
4. The parties agreed to treat the rescission as such and not as a sale and repurchase of the T stock for legal and tax purposes.

In P.L.R. 201016048 (Apr. 23, 2010), a non-US parent corporation ("FCo") held all of the outstanding stock and indebtedness of a US subsidiary ("USCo"). FCo surrendered the USCo indebtedness back to USCo in exchange for the stock of a USCo subsidiary ("US-Sub"). The parties then entered into a rescission agreement in the same year in which USCo transferred the US-Sub stock to FCo. Pursuant to the rescission agreement, the debt was retroactively reinstated and interest was to be paid as though the initial set of transactions had not been consummated.

In the same year in which the original and rescission transactions occurred, FCo exchanged the indebtedness for a single share of USCo stock. The single share of USCo stock was cancelled pursuant to a pre-arranged plan within days of its issuance. On these facts, notwithstanding that parties intended and in fact did cancel the USCo debt following the rescission, the IRS ruled that the rescission caused the original transaction to be treated as a nullity for federal income tax purposes. *See also* P.L.R. 201140008 (Oct. 7, 2011) (series of stock sale transactions rescinded and then re-implemented; held subsequent re-implementation did not affect validity of rescission transactions).

IV. Application to the Facts Presented in *Estate of Kechijian*

The decision in *Estate of Kechijian*, *supra*, is really interesting because it presents the issue as to *whether* the rescission doctrine should apply as a matter of tax policy, not what would the result be if the established predicate rules for the doctrine were applied to the facts. If the rescission doctrine was applied without regard to context, all of the elements necessary were present:

1. The intent and effect of the rescission was to restore, "in all material respects the legal and financial arrangements" that would have existed had the sale not occurred.
2. There was no activity that was "materially inconsistent with the rescission."
3. The rescission restored the parties to the position that they were in *status quo ante*.
4. The parties agreed to treat the rescission as such and not as a separate transaction for legal and tax purposes.

The first requirement was clearly satisfied on the facts. The taxpayers forfeited the stock. In each of PLR 201008033 and PLR 201016048, the taxpayers unwound their transactions for tax motivated reasons and the IRS did not deny the use of the rescission doctrine. In PLR 201008033 in particular, the taxpayer explicitly stated that the adverse tax consequences of the original transaction were the sole motivation for the rescission. Furthermore, in both cases, in the same year as the rescission occurred, the taxpayers engaged in subsequent transactions that replicated the consequences of the original transactions but without the adverse tax consequences. And in both cases, the IRS drew a "hard line" at the end of the rescission and held that the subsequent restructuring transaction did not affect whether the taxpayer was entitled to rescind the original transaction. How could the taxpayers in *Estate of Kechijian, supra*, be faulted for assuming that the IRS would take the same position with them as they took with the taxpayers in those recent private rulings?

The second criterion is somewhat ambiguous, but on the facts of *Estate of Kechijian, supra*, should be interpreted as requiring that there not be a restricted transfer of stock to the taxpayers. On its face, the fact that the taxpayers relinquished their compensatory stock and then purchased stock for fair value plus some taxable compensation should not be treated as materially inconsistent with the surrender of the compensatory stock. As stated above, in each of PLR 201008033 and PLR 201016048, shortly following the rescission transaction, the taxpayers staged "do-overs" in which they accomplished the same business objectives as the rescinded transactions accomplished without jeopardizing their ability to take advantage of the rescission doctrine. On a deeper inquiry, however, the fact that the taxpayers paid $41.5 million for their stock is somewhat illusory. Each taxpayer executed a promissory note to a pass-through entity (the S corporation) in which he had a 50% interest. In substance, the taxpayers were both debtors and creditors. Although the *Estate of Kechijian, supra*, is silent about this fact, it clearly was a factor in its decision to recharacterize the transactions under the economic substance doctrine.

The third requirement, that the parties be restored to their positions *status quo ante*, was also met. Both the original transaction and the rescission itself were between the same parties. The vesting of the stock, which should be treated as a transfer of property at that time, and the forfeiture of the stock occurred in the same year. The fact that the taxpayers performed services over a period of years should not affect the "transactions." The imposition of the restrictions was not to provide compensation; it was to provide a disincentive for the principals to walk away from the business. In addition, presumably, the taxpayers were properly compensated for their services.

The fourth factor, that the parties treat the transactions as a rescission and not as separate transactions, was clearly met. Thus, based on the authorities discussed above, if the rescission doctrine applied to the stock surrender, the rescission should have been respected.

If one takes into account the purchase of the new stock, the result of applying the rescission doctrine would have allowed the taxpayers to have ended up in the same economic position that they would have been in if they had simply continued to have held the stock after the substantial risks of forfeiture had expired. The court itself concluded that the surrender lacked economic substance for this very reason. Accordingly, it's our view that the court came to the right conclusion for the wrong reasons. In this respect, holding of the case muddies the application of the rescission doctrine in ways that the court did not have to resort to in order to reach the right answer.

The application of the rescission doctrine would have allowed the taxpayers to end up in the same economic position as they would have been in if the stock had vested. Furthermore, the taxpayers enjoyed substantial tax benefits from the holding of the unvested stock. First, it enabled them to allocate all of the S corporation income to the ESOP. Second, the restrictions provided "golden handcuffs" for four years, ensuring that each of them remained in the business. After the taxpayers had enjoyed these benefits for as long as they, it would have been inequitable to have allowed them to repudiate the stock after it had vested. In our opinion, different considerations may have applied if the taxpayers had repudiated the stock before it vested, but they did not do so. Accordingly, tax policy, not the failure of the conditions precedent for the application of the rescission doctrine, support the court's holding.

V. The Net Operating Loss

As we stated above, the taxpayers lost their business in the 2008 financial crisis. The losses that the taxpayers sustained in 2008 created an NOL. After the court held that the taxpayers recognized compensation income as a result of the 2004 lapse of the substantial risks of forfeiture, the taxpayers asserted that they should be entitled to carryback such NOL to offset the compensation income. The tax court and the fourth circuit court of appeals both refused to allow the carryback claim on the ground that it was a new issue first raised in a proceeding to determine the tax liability stemming from the case (a "Rule 155 Proceeding"). This is a well-established principle.[20] The taxpayers must have raised the NOL carryback in their pleadings or addressed the issue at trial in order for it to have been taken into account in determining the 2004 tax liability. The taxpayers also would have been entitled to consider the NOL carryback if the tax court had discussed the issue in its opinion. Since none of these conditions were met, the taxpayers were not entitled to carryback their 2008 NOL to offset the 2004 compensation income.

VI. Summary

The decision in *Estate of Kechijian, supra*, unfortunately creates uncertainty with respect to the application of the rescission doctrine as applied to compensation cases. Analytically, there is no reason why the doctrine should not apply to these cases in same way that the doctrine applies in other contexts. The court was properly influenced by the totality of the facts and circumstances presented by the use of the ESOP and the stock repurchase. Nonetheless, it would have created less confusion if the court had limited its holding to an application of the economic substance doctrine.

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[2] *The Life and Death of King John* (4:2): "To gild refined gold, to paint the lily … is wasteful and ridiculous excess."

[3] No. 18-2277 (June 23, 2020), aff'g Tax Court No. 8967-10.

[4] See Section 1361 of the Internal Revenue Code of 1986, as amended (the "Code").

[5] See Code § 351(a).

[6] See Code § 83(a).

[7] See Code § 83(b).

[8] A discussion of the business purpose analysis is beyond the scope of this Legal Update.

[9] *Russell v. Comm'r*, 35 BTA 602 (1937); Rev. Rul. 79-311, 19879-2 CB 25.

[10] The actual taxpayer died before the employer rescinded the stock purchase plan. The taxpayer's estate returned the stock and the dividends paid on the stock.

[11] The facts of the case appear to have been the basis of the IRS's holdings in Rev. Rul. 79-311, 19879-2 CB 25.

[12] *But see Guffey v. United States*, 339 F.2d 759 (9th Cir. 1964) (Sale transaction entitled to rescission treatment even though reversed three after original sale); *United States v. Merrill*, 211 F.2d 297 (9th Cir. 1954) (Excess executors fees paid not taxable to executor where executor created as receivable in favor of estate in year of overpayment, even though actual excess fees were not repaid until a later year).

[13] *See also* Rev. Rul. 74-501, 1974-2 C.B. 98 (basis adjustment to stock for distribution of stock rights not required when exercised stock rights transaction was rescinded in the same year in which the stock rights were issued and exercised).

[14] The taxpayer brought an arbitration action against the brokerage firm and was awarded cash compensation for the difference between the sales and repurchase price in 1990.

[15] *See* Code § 1361(b)(1)(B).

[16] The New York State Bar Association, in discussing this Private Letter Ruling, noted that the ruling supports the proposition that the IRS "does not feel compelled to inquire into the parties' intent, suggesting that the motivation of the rescinding parties may be irrelevant." *See* New York State Bar Ass'n Tax Section Report 1216 (August 11, 2010), *reprinted in* Daily Tax Report (August 13, 2010).

[17] *See* Code § 1361(b)(1)(B) (an S corporation may only have individual shareholders).

[18] *See* Code § 334(b)(1).

[19] *See also* P.L.R. 200613027 (Mar. 31, 2006) (entity permitted to rescind conversion from a partnership to a corporation in anticipation of an initial public offering ("IPO") after IPO conditions became unfavorable).

[20] *Vest v. Comm'r*, T.C. Memo. 1995-188; *Miller v. Comm'r*, T.C. Memo. 1993-588; *Gladstone v. Commissioner*, T.C. Memo. 1992-010; *see also Molasky v. Commissioner*, 91 T.C. 683 (1988), affd. on this issue 897 F.2d 334 (8th Cir. 1990) (taxpayer cannot raise income averaging for the first time in a Rule 155 proceeding).