The old saw about the best-laid plans of mice and men also goes for international tax planning and transactions with significant tax consequences. Sometimes the business and/or financial assumptions around the planning turn out to be mistaken, sometimes the resulting structure turns out to be too complex to manage relative to the savings it produces, and sometimes parties just mutually decide to back out of a deal after some or all of its parts have been executed. What is to be done when the consequences of such a transaction or set of transactions might create undesirable commercial or tax effects?

Most of the time, the answer is, unfortunately: not much, absent “strong proof” that the form of the transaction did not comport with the parties’ intent, or mistake (in the formal legal sense) or fraud (i.e., the common law grounds for unilateral rescission), circumstances quite challenging to find in the inter-company context. It may be that the parties need to terminate the original agreement, and transfer assets and liabilities back between them at the then-current values – thus, creating two separate transactions, with separate, likely unwanted, consequences.

There is, however, an important exception to the ordinarily steep hurdles for unwinding a transaction back to the beginning for US tax purposes: the rescission doctrine.

In Rev. Rul. 80-58, the IRS held that a rescission having retroactive effect may be achieved for federal income tax purposes by mutual agreement of the parties, even by one of the parties declaring a rescission of the contract without the consent of the other, if sufficient grounds exist, or by successfully applying to a court for a decree of rescission. Under the ruling, a rescission effected by mutual agreement will be respected for federal income tax purposes if (i) the transaction and the rescission take place in the same taxable year; (ii) the parties to the rescission are the original parties to the transaction; and (iii) the parties are restored to their status quo ante positions by the end of the same taxable year.

For example, if a US entity and its foreign affiliate started a Cost Sharing Arrangement (CSA), or integrated a new acquisition into an existing CSA, or made capital contributions or loans between them, but subsequently want the transactions to vanish, then the US tax rescission doctrine might come to the rescue in certain circumstances – without concern that the unwind was ethically untoward.

In *Penn v. Robertson*, the case upon which Rev. Rul. 80-58 primarily relied, the Fourth Circuit explained the rationale behind the “same year” requirement: “[a] cardinal principle of federal income taxation requires annual
returns and accounting; and this principle requires the determination of income at the close of the taxable year without regard to the effect of subsequent events.” This principle is based on the need for definite, periodic determination of the government’s revenues from income taxes and the need to prevent extended delays that might occur if continuing transactions were held open indefinitely for the computation of profit and loss.

Whether the original parties have been restored to their status quo ante positions in the same taxable year as the transaction(s) in question is an inherently fact-intensive inquiry, and thus there is little specific guidance on this test. Nonetheless, there are some private letter rulings and authorities that outline the contours of what it means to be restored to the status quo ante.

Clearly, at a minimum, a validly effected rescission of the parties’ respective rights and obligations under contract principles (i.e., governing state or local country law) is a key piece of the tax rescission puzzle. This is one reason why we, as international tax advisors, often recommend the use of certain US state law choice of law clauses in operative agreements.

Notably, and perhaps in recognition of the fact-intensive nature of the status quo ante inquiry, the IRS has recently decided to cease issuing private letter rulings on applicability of the rescission doctrine. Nevertheless, Rev. Rul. 80-58 remains in effect and is binding on the IRS.

Furthermore, high-ranking IRS officials have recently commented in the press that the IRS is contemplating issuing further guidance on the doctrine. For the present, Rev. Rul. 80-58 and the Penn case discussed above remain the leading authorities, and accordingly, the US tax-based version of a golf “mulligan” of the rescission doctrine remains very much in play for taxpayers seeking to avoid the tax consequences of transactions that may have landed in the rough.

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1 See, e.g., Commissioner v. Danielson, 378 F2d 771 (3d Cir. 1967) (holding that a taxpayer can challenge IRS’ construction of an agreement’s unambiguous form only by proving that the agreement was unenforceable), cert. denied, 389 US 858 (1967); Elrod v. Commissioner, 87 TC 1046, 1066 (1986) (adopting the “strong proof” standard).
2 115 F.2d 167 (1940).

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