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Backdating, Rescission & Reformation

16th Annual
Choice, Governance & Acquisition
of Entities
May 18, 2018

Texas Bar CLE



THIS STOCK PURCHASE AGREEMENT (“Agreement”), dated effective as of _____, 2018, is made and entered into between _____, (“Seller”), _____, (“Buyer”), and _____., a Texas corporation (“Corporation”).

.....

Seller, Buyer and Corporation have each signed this Agreement all as of the date first above written.



THIS STOCK PURCHASE AGREEMENT (“Agreement”), dated **effective as of _____, 2018**, is made and entered into between _____, (“Seller”), _____, (“Buyer”), and _____., a Texas corporation (“Corporation”).

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Overview

Acceptable:

Memorializes an earlier understanding

Wrong:

Fabricates

Backdating: Memorializes Prior Understanding

Practical Realities

- Complete signing of all parties at one time difficult
- Signature pages circulated
- Electronic or digital signatures
- TBOC permits decisions without meeting

Backdating: Who Wants Earlier Date?

Taxpayer

IRS

Baird v. Comm’r, 68 TC 115

1. Preliminary Agreement-
Aug 29.
2. Signing of Deed-Oct. 28.
3. Recording of Deed –
Nov. 17.
4. Taxpayer argued for Aug
29.
5. IRS argued Nov. 17.

Moore v. Comm’r, 93 TCM 1275

1. July 2000 – realignment of
LLC interests “as of Jan. 1,
1997”.
2. Signing date unclear.
3. TP argued for July 2000.
4. IRS argued for Jan. 1,
1997.

Undocumented Shareholder Withdrawals

Corporation has made distributions to sole shareholder without any documentation.

Paperwork to be prepared later to evidence distribution to be loans.

E.g. Regensburg v. Comm'r, 144 F.2d 31 (2d Cir. 1944), cert. denied, 323 US 783 (1944)(Held: dividend because of lack of evidence supporting loan – such as note or repayment).

Separating Good from Bad & Ugly

- Intention – parties free whatever date they want.
- Who is disadvantaged by backdating?

E.g. Lease effective January 1, signed March 1, rent paid for January and February.

E.g. Employment agreement agreed to March 1, but compensation paid since January 1.

Disclosure

Agreement:

- States when effective.
- Describes clearly date of agreement
- Dates signed stated.

Acceptable Backdating

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.....

The parties have signed this Agreement at the dates indicated below their signatures.

Name: _____

Date of Signing: _____,

2018

Acceptable Backdating



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Name: _____

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2018

May 1, investment fund to liquidate.

April 1, written agreements prepared to reflect carried interests awarded to selected employees.

Awards effective when employees joined company, some years before.

Company states that oral promise was made to employees when hired that they would have carried interests in all funds. Fund created sometime later.

When will IRS respect rescission?

Bedrock tax principles:

1. Annual Accounting Period
2. Claim of right doctrine

Controlling case on rescission was decided in 1940.

Controlling ruling was issued in 1984.

Rescission : Penn v. Robertson

1930: Stock purchase plan adopted.
Employee purchased stock with employer loans.
Dividend income to repay loan.

December 1931: Rescission of stock purchase plan.

Dividends paid in 1930 and 1931.

HELD: Only 1931 dividends disregarded because of rescission

Rev. Rul. 80-58 Safe Harbor

Rescission in same tax year.

Restore parties to relative position had no contract been made (“status quo ante”)

May be effected:

1. Mutual agreement
2. Unilateral rescission, if sufficient grounds exist
3. Court rescission

Rev. Rul. 80-58 Safe Harbor – Situation 1

Land sold Feb. 1978.

Condition:

Failure to obtain favorable zoning in 9 months.

If not, then rescission.

Oct. 1978 – Zoning not possible.

Land reconveyed.

All amounts repaid.

HELD: Rescission respected.

Rev. Rul. 80-58 Safe Harbor – Situation 2

Same as Situation 1.

Feb. 1979 – Zoning not possible.

Land reconveyed.

All amounts repaid.

HELD: rescission not respected.

IRS Position in 2018

No ruling policy.

Rev. Proc. 2018-3.

Status Quo Ante

Key Phrase:

“Restoring the parties to the relative positions that they would have occupied had no contract been made.”

Challenge:

Giving legal advice on certainty of rescission

Status Quo Ante

Private rulings, now suspended, have been more liberal.

Guiding Principles:

1. No material change in legal or financial arrangement of parties.
2. Ignore interim events.
3. Same parties

Status Quo Ante

Guiding Principles – continued:

4. No consideration
5. Non-reversible items
6. Partial rescission
7. Close enough

Other Issues

1. Same tax year
2. Related taxpayers
3. Taxpayer's intent
 - a. Mistakes of law
 - b. Mistakes of fact

Hypo

For an IPO, LLC converted to corporation.

IPO cancelled – unfavorable market

Can LLC-to-corporation conversion be rescinded – in same tax year?

Unilateral Actions

Rev Rul 80-58 – involved contract being rescinded

PLRs permit unilateral actions to be rescinded

1. Dividends – scrivener's error – mixed results
2. Gifts – Mistake of fact – okay
 - Misunderstanding tax law – not okay
3. Tax elections – inconsistent
 - S elections and revocations

During Negotiation

Generally okay

Limitations:

1. Substance over form
2. Partial agreement

After Contract Signing

Less certain

Limitations:

1. Substance over form
2. Partial agreement

After Contract Signing

Form of agreement respected

§1031 agreements

Conditions

Escrows

Issue: Sale of exchange of contracts?

After Closing

Use of contract mechanism

- Options
- Conditional sales
- Escrows
- Representations and warranties
- Express right of rescission

Issue: Sale of exchange of contracts?

Court order reforming a transaction or document

Distinguish amendment

IRS not a party - usually

State Law Concepts

Fraud, duress

Mistake of fact or law – scrivener’s error

- *Brinker* – “issue of settlor” clarified

Mistake as to tax consequences

- *Davis* – sale of stock reformed into gifts

Is State Law Controlling?

Bosch doctrine

Controlling nature of state law

- State trial court versus highest court
- State court determines property rights

Compromise and Settlement

Lyeth doctrine – Settlement of claim
controlling tax effects

Amount received in settlement is taxed
according to what it represents.

Compromise and Settlement

Lyeth doctrine – Settlement of claim controlling tax effects.

Amount received in settlement is taxed according to what it represents.

Gift tax effects - uncertain

Backdating

Memorialization of prior agreement

Rescission

Safe harbor

- Same tax year
- Status quo ante

Reformation

Uncertain since IRS not a party