Despited the best laid plans and careful draftsmanship, errors occur in transactions and their underlying documents. The parties may have had a misunderstanding of a crucial fact or there may have been a misunderstanding of the applicable law, leaving the parties with a practically or legally defective arrangement. Or a simple drafting error may have been made in one or more of the transaction’s underlying documents. Rescission, backdating and other forms of transactional modification are available to correct these mistakes. This program will provide you with a practical guide to using rescission, backdating and other forms of modification to fix transactional errors, teach you about the best uses and limits of each technique, and discuss the tax and other consequences of using these techniques.

- Types of temporal modification – rescission, backdated initial actions, backdated modification
- Legitimate reasons for after-the-fact modification of transactions
- Statutory and common law recognition of rescission
- Permissibility of back-dating certain transactions
- Special use of rescission to save S Corp status of a corporation
- Tax consequences of rescission and other corrective measures

Speaker:

Allen Sparkman is a partner in the Houston, Fort Worth, and Denver offices of Sparkman Foote, LLP. He has practiced law for over forty years in the areas of estate, tax, business, insurance, asset protection, and charitable giving. He has written and lectured extensively on choice-of-entity, charitable giving and estate planning topics. He is the Colorado reporter for the books "State Limited Partnership Laws" and "State Limited Liability Company Laws," both published by Aspen Law & Business and co-author of “Using Limited Liability Companies, Partnerships, and Limited Partnerships in Colorado,” publishing by CLE in Colorado, Inc. Mr. Sparkman received his A.B. with honors from Princeton University and his J.D. with high honors from the University of Texas School of Law.
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Undoing Deals and Do-Overs: How Far Can You Go with Backdating, Adding Partners, Rescission and More?

Allen Sparkman

The Moving Finger writes; and, having writ
Moves on; nor all thy Piety nor Wit
Shall lure it back to cancel half a Line,
Nor all thy Tears wash out a Word of it.²

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1 Allen Sparkman practices law in Denver, Colorado and Houston, Texas as a partner of Sparkman Foote Minor LLP.
2 From the Rubaiyat of Omar Khayyám (Fitzgerald translation).
I. Introduction

For federal tax purposes, rescission is the abrogation, canceling, or voiding of a transaction that has the effect of releasing the contracting parties from further obligations to each other and restoring the parties to the status quo ante as if the transaction had never occurred. “Backdating” generally refers to assigning an event to a date prior to that of actual occurrence, or dating a document “as of” a time prior to execution. Examples of “backdating” include documents that state that the document is dated “as of” the earlier day, “effective” as of the earlier date, or even “executed” on the earlier date. Backdating and rescission are not mutually exclusive and are referred to collectively in this article as “temporal modifications.”

Not all temporal modifications are illegal, unethical, or even ineffective. Some ineffective but nonfraudulent temporal modifications may not be illegal or unethical. All
fraudulent backdating is illegal, unethical, and may be ineffective and, as noted below, may have surprising and unfortunate consequences for the person committing the fraud. This article considers the propriety and efficacy of an attempt to assign a date to an action that is different than the date on which the action actually took place.

A. Types of Temporal Modification

There are three forms of temporal modifications: those that attempt to treat an event that has occurred as having never happened (a “Rescission”); those that treat an event that did not occur on a particular earlier date as having happened on that date (a “Backdated Initial Action”); and those that retroactively modify an event that actually did happen in the past (a “Backdated Modification”). In each case, a present action attempts to extinguish, modify, or create an event that occurred in the past.

1. Rescission. Some temporal modifications attempt to retroactively extinguish a transaction – viz a rescission – or create a transaction as of a retroactive date. Examples of rescissions include situations in which a sale or transfer is improvidently concluded, and the parties desire that the transaction had never taken place. For example, if a property-owner sells the property to a purchaser who wanted to acquire the property for a particular purpose, which purpose is frustrated after the closing, the purchaser may ask the seller to “rescind” the transaction (i.e., reconvey the property to the seller in exchange for a return of the purchase price and obligations. An important question is whether the two conveyances are separate transactions for income tax purposes.

Another common example of backdating is the attempt to establish that a relationship or arrangement existed before it actually did – for example, treating a person as having been admitted or removed as an owner or agent of an organization, or a contract or transfer is sought be effective, prior to the time that the legal steps to create the organization, admit or remove a member, or enter into the contract actually occurred.

2. Backdated Initial Action. In some circumstances, parties may wish to “backdate” a transaction. The term, “backdating” as used in this article means an attempt – regardless of whether intended to defraud – to assign a date to the action reflected in the document that is before the date on which the document is actually prepared and signed. In contrast to the definition used in this article, some courts have used the term “backdating” to
describe a wrongful backdating – backdating designed to mislead.\textsuperscript{6} Another common example of backdating is the attempt to establish that a relationship or arrangement existed before it actually did – for example, treating a person as having been admitted or removed as an owner or agent of an organization, or a contract or transfer is sought be effective, prior to the time that the legal steps to create the organization, admit or remove a member, or enter into the contract actually occurred.


An action having the effect of retroactively changing the terms of an existing transaction or contract constitutes a \textit{nunc pro tunc} change. For example, a change in a partner’s share of profits would constitute such a change if made effective as of a date earlier than the date the partners actually agreed to the change. If the equal partners A and B of a calendar year partnership agree on July 1 that their interests will be 60/40 from that date forward, they have not made a \textit{nunc pro tunc} change. If, however, the partners agree on July 1 that their interests will be 60/40 effective as of and from January 1 of that year, they have made a \textit{nunc pro tunc} change.

B. Reasons for Temporal Modifications.

Parties may desire temporal modifications for any one of more of several reasons, some appropriate, some inappropriate.

1. \textbf{Non fraudulent memorialization of past actions.} Transactions may be reduced to a written document, even though the parties take action before the document is reduced to writing. Among the most common memorialization is the preparation of minutes of a meeting at which an action was taken. The memorialization of a transaction in a written document generally acts as evidence of the transaction rather than the transaction itself,\textsuperscript{7} such as where there is not a requirement for a writing in order for the transaction to be effective.

\textsuperscript{6} See, e.g., \textit{Barry E. Moore, et ux.}, TC Memo 2007-134 (05/30/2007) (“We do not view the effective date provision as an attempt to backdate the assignment and assumption agreement in order to retroactively obtain an unwarranted tax benefit. Rather, we consider its purpose to have been to reduce to writing a prior oral understanding among the parties. As the cases petitioners cite make clear, “backdating” generally involves an effort to make it appear that the document in question was executed on a date prior to its actual execution date; i.e., there is an effort to mislead the reader. That is not true of the assignment and assumption agreement, where the “effective as of” phrase makes clear that the intended effective date differs from the execution date.”).

\textsuperscript{7} See text accompanying notes 9 to 18, infra.
Partnership and limited liability company agreements present another common circumstance in which the parties may prepare a written memorialization effective as of a date before the writing is created. Memorialization of the initial partnership or limited liability company agreement or memorialization of a modification of the partnership or limited liability company agreement through course of conduct may also be appropriate. For example, when A and B are partners under a partnership agreement calling for each to receive 50% of the profits of the organization but allocations, distributions, and reporting on the partnership 1065 have reflected a 55/45 split, an amendment memorializing the actual deal would be appropriate.8

For business corporations, a consent resolution of the shareholders of a corporation generally takes effect at the time the last required shareholder signs the consent.9 On the other hand, actions taken at a meeting at which all shareholders are present or with respect to which notice is waived10 are effective at the time of meeting, regardless of when the minutes are actually prepared and approved. Similar rules apply to actions by boards of directors. For example, assume you have drafted and sent to your corporate client a proposed 401(k) plan. To be effective for a tax year, a tax qualified plan such as a 401(k) plan must be adopted by the employer on or before the last day of the taxable year.11 The only directors of the corporation are Bob and Susie Brown, a married couple. On December 30, they call you while on a lunch break at the top of Buttermilk Run in Aspen to tell you that they discussed the plan the night before and think it’s good to go. They say they approve your draft and ask to begin preparing the employee communications and other steps that will be necessary to implement the plan. When

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8 See text accompanying notes 94 to 98, infra.
9 TBOC §§ 6.201(b), 6.202(b), Model Business Corporation Act (“MBCA”) § 7.04 Comment 2, 8 Del. C. § 228; C.R.S § 7-107-104(b). The Colorado statute provides, however, that “action taken pursuant to this section shall be effective as of the date the corporation receives the last writing necessary to effect the action unless all of the writings necessary to effect the action state another date as the effective date of the action, in which case such stated date shall be the effective date of the action.” (emphasis supplied) Inasmuch as shareholder consents cannot take effect under Colorado law unless and until the corporation receives sufficient consents to approve the action, approval of an action by shareholder consents that assigned an earlier effective date to the action would raise issues discussed in this paper. The likely purpose of the statutory language is to permit a delayed effective date.
10 TBOC § 6.052, C.R.S. §7-107-106, MBCA § 7.06, 8 Del. C. § 229 (“Whenever notice is required to be given under any provision of this chapter or the certificate of incorporation or bylaws, a written waiver, signed by the person entitled to notice, or a waiver by electronic transmission by the person entitled to notice, whether before or after the time stated therein, shall be deemed equivalent to notice.”).
11 IRC § 404(a)(6) permits a deduction for a contribution to a qualified plan if the deduction is made by the due date (including extensions) of the employer’s tax return; however, a contribution for a taxable year is deductible only if made to a plan that is existence by the last day of that year. See Treas. Reg. § 1.404(a)-9.
the Browns return home in January, you meet with them to prepare resolutions to memorialize their decision. You have a choice with dramatically different consequences. If you prepare minutes recording a meeting of the board of directors at which all directors were present and waived notice of the meeting, the action taken at the meeting (adopting the 401(k) plan) is effective the date of the meeting, December 30. In contrast, if you memorialize the Browns’ actions by a unanimous written consent, the consent, and presumably all actions approved thereby, is effective when the last director signs a copy of the consent. With alternative entities, the statutes generally simply call for consent of members or partners – for extraordinary actions, generally unanimous consent of the members or partners – and don’t require the formality of a meeting, and the partnership agreement or limited liability company agreement may provide for informal approval of actions.

2. **Ratification of past action.** If an agent takes an action on behalf of a principal without appropriate actual authority, under some circumstances the principal can ratify the action. For example, a party who is not bound by a voidable contract may elect to ratify the contract, in which case the contract will be retroactively enforceable. If the principal is not yet in existence, such as an entity-to-be-formed, an agent purporting to act on behalf of such entity must take care to obtain third party consent to the agent’s actions; otherwise, the agent may face liability even if the entity ratifies the agent’s action once the entity is formed.

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12 TBOC § 21.415(a), MBCA § 8.24(c), 8 Del. C. § 141(b), C.R.S § 7-108-205(3).
13 TBOC § 21.415(b), MBCA § 8.21(b), 8 Del. C. § 141(f), C.R.S § 7-108-202(2). C.R.S. § 7-18-202(3) permits the directors to assign a different effective date to their consents. See discussion in note 9, supra.
14 But see, 8 Del. C. § 18-302(d) (“Unless otherwise provided in a limited liability company agreement, on any matter that is to be voted on, consented to or approved by members, the members may take such action without a meeting, without prior notice and without a vote if a consent or consents in writing, setting forth the action so taken, shall be signed by the members having not less than the minimum number of votes that would be necessary to authorize or take such action at a meeting at which all members entitled to vote thereon were present and voted.”).
15 See Restatement (third) of Agency § 4.02 (Effect Of Ratification)
(1) Subject to the exceptions stated in subsection (2), ratification retroactively creates the effects of actual authority.
(2) Ratification is not effective:
(a) in favor of a person who causes it by misrepresentation or other conduct that would make a contract voidable;
(b) in favor of an agent against a principal when the principal ratifies to avoid a loss; or
(c) to diminish the rights or other interests of persons, not parties to the transaction, that were acquired in the subject matter prior to the ratification.
16 See Restatement (third) of Agency § 6.04 (Principal Does Not Exist or Lacks Capacity). Some entity statutes state a similar rule without providing relief for third party consent. See, e.g., C.R.S. § 7-102-104 (corporations); §7-80-105 (LLCs).
3. **Ambiguous situations.** A more gnarly situation arises when the actor is not clear as to his or her intentions at the time of the action and the intention behind the action needs to be established at a later time. If the owner of a closely-held business puts cash into the business, is it a contribution to capital or a loan? If the owner takes cash out of the organization, is it a distribution, repayment of a loan to the organization by the owner, or a loan from the organization to the owner? If the owner actually has an intention and subsequently changes his mind about the intention, it is a temporal change which would be subject to the legal, ethical, and tax rules described below. But what if the owner never actually thought about the reason for the action until confronted later?

To the extent that the parties document a transaction with incomplete or ambiguous terms, it may be possible to rectify the ambiguity by agreement, provided: that the ambiguities are not so great as to cause the contract to be invalid to begin with. In this respect, practitioners should note that not all contracts are created equal. For example, the formation of a partnership or limited liability company, while requiring the intent of the member, members, or partners, may not require more than the agreement to form an organization as the relevant statute will supply many of the provisions of the arrangement in the absence of a contrary provision of the partnership or limited liability company agreement. For example, if Bob and Allen agree that their lawyer should file with the Texas Secretary of State a certificate of formation for Boballen, LLC and don’t otherwise consciously agree to any terms of a company agreement, they have nevertheless surely agreed to a company agreement, i.e., to operate Boballen, LLC in accordance with the default rules of the TBOC such as its provision that membership interests are freely assignable (though the assignee does not become a member without consent).

Parties contemplating operating a partnership or limited liability company without a written agreement should be aware that courts have held that the statute of frauds applies to partnership and limited liability company agreements. **17**

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17 TBOC § 101.108. 18 *Olson v. Halvorsen*, (Del. Ch. October 22, 2008) (C.A. No. 1884-VCC). See also *Abbott v. Hurst*, 643 So. 2d 589 (Ala. 1994). In 2010, Delaware amended its limited liability company and partnership statutes to add language of uncertain scope intended to legislatively overturn *Olson v. Halvorsen*. For example, the new provision in Delaware’s limited liability company statute states that “a limited liability company agreement is not subject to any statute of frauds (including § 2714 of this title).” 8 Del. C. § 18-101(7). 8 Del. C. § 2714 is Delaware’s general statute of frauds for contracts.
To the extent there is an inadvertent mistake in the manner in which the written documentation reflects the transaction, a correction to the written documentation should be retroactively effective.

4. **Formal modification or correction of a legally defective situation.** To the extent the transaction is ambiguous, void, or voidable, the action which clarifies or remedies the defect may constitute a temporal modification. Circumstances in which this sort of correction might be necessary include ambiguous or incompletely documented actions and defectively authorized actions. Often such defects can be cured in such a way as to make the cure effective retrospectively.

5. **Defrauding a third party.** To the extent the date on which an action occurs determines the rights of a third party, a party to the action may intend that a temporal modification attempt to change the third party’s rights. For purposes of this article, the third party generally concerned is the Internal Revenue Service (“Service”). The use of temporal modification to obtain a tax or other benefit to which the actor would not otherwise be entitled for fraudulent purposes will generally be ineffective to accomplish the intended result – or in some cases will achieve a result different that that intended by participants – and may subject the actor and those who provide assistance to civil or criminal penalties. *United States v Miller* 19 presents an instructive case. While representing clients before the United States Tax Court, Herbert Miller, a Denver tax lawyer, offered into evidence deeds and other documents verified and vouched for by Miller as a notary that were facially dated September 3, 1980. However, at Miller’s trial on charges of making fraudulent statements in an effort to deceive and obstruct the federal tax authorities in violation of 18 U.S.C. § 1001, two secretaries who worked for Miller in 1982 testified that, at his direction, they actually prepared the deeds and other documents in October, 1982. Miller was convicted of these charges. He evidently acted as he did in an attempt to establish that certain plans purporting to be qualified within the meaning of section 401 of the Code were adopted and funded in September 1980. 20

A voidable contract is one where one or more parties have the power, by a manifestation of election to do so, to avoid the legal relations created by the contract, or by ratification of the

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19 907 F. 2d 994 (10th Cir. 1990).
20 Presumably because he had assured his clients that the plans were timely adopted to support deductions for contributions in 1980.
contract to extinguish the power of avoidance.\textsuperscript{21} Generally a voidable transaction will be considered a completed transaction while a void transaction will not. For an attempt to use the concept of voidable transactions to effectively cause a transaction not to have happened see \textit{Linton v. U.S.}.\textsuperscript{22} The service has ruled that in order for a dividend to be disregarded, it must be void, not merely voidable.\textsuperscript{23} In Rev. Rul. 71-269\textsuperscript{24} minor students who borrowed money for education sought to treat repayment of the loans as charitable contributions because their agreement to repay the loans was voidable as a result of their status as minors. The ruling held that they were not entitled to the charitable deduction even if the loan documents were voidable.\textsuperscript{25}

II. Efficacy of Temporal Modification.

A. Statutory recognition of temporal modification.

As a result of the number of common situations in which temporal modifications arise, both state and tax law have come to recognize the efficacy and validity of temporal modifications.

1. Non-tax recognition of rescission and backdated initial action.

   a) Statutory Recognition. There are statutes that expressly contemplate that documents will be backdated, thereby acknowledging the effectiveness of such documents. For example, Delaware has acknowledged that a limited liability company agreement\textsuperscript{26} or limited partnership agreement\textsuperscript{27} may be made retroactively effective. Colorado provides a similar rule for operating agreements of limited liability companies.\textsuperscript{28} Similarly, the Uniform

\begin{flushright}
\textsuperscript{21} Restatement (Second) of Contracts § 7 (1981).
\textsuperscript{22} 104 AFTR 2d 2009-5176 (DC Wash. 2009).
\textsuperscript{23} Rev. Rul. 75-375, 1975-2 CB 266 citing \textit{Charles G. Duffy}, 2 T.C. 568 (1943) “Before the Federal income tax effect of a declaration and payment of a dividend may be ignored, the action of a corporation’s board of directors in declaring and paying the dividend must be void and not merely voidable.”).
\textsuperscript{24} 1971-1 CB 93.
\textsuperscript{25} For an excellent discussion of the appropriate treatment of ambiguity, see Kwall and Duhl, \textit{supra} note 5 at pages 14-23.
\textsuperscript{26} 6 Del. Code § 18-201(d) provides:
A limited liability company agreement shall be entered into or otherwise existing either before, after or at the time of the filing of a certificate of formation and, whether entered into or otherwise existing before, after or at the time of such filing, may be made effective as of the formation of the limited liability company or at such other time or date as provided in or reflected by the limited liability company agreement.
\textsuperscript{27} 6 Del. Code § 17-201(d).
\textsuperscript{28} C.R.S. § 7-80-108(1)(c).
\end{flushright}
Partnership Act (1997) expressly provides for “undissolving” a dissolved general partnership. The Texas Business Organizations Code defines “company agreement” as “any agreement, written or oral, of the members concerning the affairs or the conduct of the business of a limited liability company.” Of course, once a Texas limited liability company is formed and has members, the members may, subject to the considerations discussed in this paper, agree to retroactively effective provisions of their company agreement, at least back to the effective date of the limited liability company’s certificate of formation. Absent a statutory provision like Delaware’s, there appear to be technical difficulties with trying to make a company agreement for a Texas limited liability company effective back to a time before the company’s certificate of formation became effective. Before formation, the limited liability company does not exist, and there can be no “members” to agree as to the conduct of its business or affairs. Conversely, persons who plan to form a limited liability company can certainly agree in advance of formation on what their company agreement will be. The TBOC provides for revoking a voluntary winding up and reinstating certain terminated entities. Delaware law provides for certificates of correction with respect to certificates of formation and other documents filed by a Delaware limited liability company, permits the dissolution of a limited liability company to be revoked if done before the filing of a certificate of cancellation, and allows revival of a limited liability company whose certificate of formation has been cancelled. Colorado permits documents on file with the Secretary of State to be corrected effective back to date of filing if there was

29 Uniform Partnership Act (1997) § 802(b)(1) provides:
At any time after the dissolution of a partnership and before the winding up of its business is completed, all of the partners, including any dissociating partner other than a wrongfully dissociating partner, may waive the right to have the partnership’s business wound up and the partnership terminated. In that event . . . the partnership resumes carrying on its business as if dissolution had never occurred, and any liability incurred by the partnership or a partner after the dissolution and before the waiver is determined as if dissolution had never occurred;

30 TBOC § 101.001(1). “Partnership agreement” is defined similarly. TBOC § 151.001(5).
31 If the parties want their retroactive company agreement provisions to be effective for federal tax purposes, see text accompanying notes 94 to 98, infra.
32 TBOC §§ 11.151 (revocation of voluntary winding up of an entity); 11.201-11.206 (reinstatement of a terminated entity); 101.618 (revocation of voluntary winding up of a series); 152.709 (cancellation or revocation of event requiring winding up of a partnership); 152.710 (reinstatement of a partnership); 153.701 (cancellation or revocation of event requiring winding up of a limited partnership); 153.505 (reinstatement of a limited partnership).
33 6 Del. Code § 18-211.
34 6 Del. Code § 18-806.
35 6 Del. Code § 18-1109.
erroneous information in the document when filed, and allows the reinstatement of almost all dissolved entities regardless of the passage of time since dissolution.

b) Protection of Third Parties. Many of the provisions allowing temporal modification expressly protect the rights of third parties.

B. Common law.

Retrospective modification of an agreement is legally permissible but if the agreement is insufficiently certain, it may not rise to the level of being a contract and will be invalid. If the transaction is created or modified retroactively there are three possible consequences, each of which should be considered: (1) the transaction will be treated as having occurred or been modified at the time assigned to it by the document, (2) the transaction or modification will treated as never having occurred, or (3) the transaction will be treated as having occurred or been modified at the time the document was created.

C. Are Temporal Modifications Inherently Wrong?

Contracts may be executed in various ways:

- Executing a contract on May 1, 2010 by a signature line that states “executed this 1st day of May 2010.”
- Executing a contract on May 15, 2010 by a signature line that states “executed as of May 1, 2010.”
- Executing a contract on May 15, 2010 by a signature line that states “executed to be effective May 1, 2010.”
- Executing a contact on May 15, 2010 by a signature line that states “executed May 15,

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36 C. R. S. § 7-90-305. Texas provides a similar rule for correcting filed documents. TBOC § 4.101.
37 C. R. S. § 7-90-1001.
38 See, e.g., Restatement (third) of Agency § 4.02(2)(c) and Uniform Partnership Act (1997) § 802(b)(2) which provides that in the event the dissolution of the partnership is rescinded:
the rights of a third party accruing under Section 804(1) or arising out of conduct in reliance on the dissolution before the third party knew or received a notification of the waiver may not be adversely affected.
See also, e.g. C. R. S. § 7-90-305(4):
a statement of correction is effective on the effective date of the filed document it corrects as such date is stated in the records of the secretary of state. As to persons relying on the uncorrected filed document and adversely affected by the correction, a statement of correction is effective when filed.
39 Restatement (second) of Contracts § 33
40 For a particularly unhappy example of this result, see EMISC 2009-006 discussed in text accompanying notes 102 to 106, infra.
2010 to be effective as of May 1, 2010.”

- Executing a contract on May 15, 2010 by a signature line that states “executed May 1, 2010.”

Although the term “backdating” perhaps implies doing something suspect, in the four examples above where a contract is executed on May 15, only one, the last one, clearly carries a whiff of fraud. Perhaps parties might cluelessly execute a contract that recited its execution on an earlier date; however, it seems likely that third parties, such as the IRS, will assume and look for a bad purpose. Without knowing more, though, it would seem as likely that the parties in the last contract were, just like the other three, memorializing on May 15, 2010, a deal that they wanted to be effective as of May 1, but just did it in an artful way.

What have been described as the most egregious cases of backdating actually do not involve backdating. In these cases, the documentation purported to memorialize events that had not actually happened at any time. Of course, if an event didn’t actually ever occur, stating that it occurred on any date would be false. Thus United States v. Wilson, 118 F.3d 228, 231-32 (4th Cir. 1997) (attorney tried to conceal a client’s assets from the IRS by backdating promissory notes to make it appear that the client was obligated to repay certain unconditionally received amounts); Quick & ZR Consulting v. Samp, 697 N.W. 2d 741, 743 (SD 2005) (malpractice action against an attorney who prepared a document to make it appear that a corporation had assigned its rights under a contract to its sole shareholder because the attorney had mistakenly named the shareholder instead of the corporation as the plaintiff in an action against an third party).

Inappropriate backdating may arise where a writing memorializes action that actually occurred but third parties, such as a court, are misled about when the writing was done. Consider In re Stern, 529 N.E.2d 562 (Ill. 1988), in which the court censured a lawyer for backdating a document that accurately reflected the date the event had occurred. A 1981 divorce decree required Stern to maintain health insurance for his ex-wife and children. On December 7, 1982, he obtained a new health insurance policy that the insurance agent stated would be effective immediately. Stern then permitted his old policy to lapse. When Stern’s ex-wife learned that the old policy had lapsed, she petitioned the court to find Stern in contempt for failing to maintain

41 Discussed in Kwall and Duhl supra note 5, text accompanying notes 88-109.
insurance. On January 10, 1983, Stern learned that his insurance agent had been mistaken and that a lapse in coverage had occurred:

On January 11, 1983, the date on which Stern was to appear before the court, [he] allegedly told the insurance agent to prepare a letter on the agent’s stationery accurately stating that the agent had told Stern the new policy was effective on December 7[蔚, 1982]. The agent brought the letter to court and showed it to Stern and Stern’s attorney. Stern’s attorney showed the letter to Mrs. Stern’s attorney, who examined the insurance agent about the letter. The agent initially falsely testified that he had written the letter on December 15 but then admitted that the letter had been backdated. The Review Board of the Illinois Attorney Registration and Disciplinary Commission found that Stern’s conduct violated disciplinary rules prohibiting “conduct involving dishonesty, fraud, deceit or misrepresentation,” “knowingly mak[ing] a false statement of law or fact,” and conduct “which tends to defeat the administration of justice or to bring the courts or the legal profession into disrepute.”

Will “as of” dating always protect against a charge of impropriety? Although some courts have held “as of” dating to be inconsistent with a characterization of backdating, reciting that an event happened “as of”, say, January 1, 1986, is improper if the event didn’t happen at all or happened at a later date when the consequences would not be as advantageous as would be the case if the event had happened at the earlier date.

The non-tax criminal sanctions with respect to temporal modification are applicable to fraudulent conduct generally, or fraudulent conduct in particular contexts such as securities law or bankruptcy law. It is important to remember that it is the fraud, not the backdating itself, that is subject to the penalties.

D. Why might one want to backdate?

42 Id text accompanying notes 94-99.
43 Id text accompanying notes 125-136.
44 See, Jenna Greene, Million Backdating Settlement for Former Comverse CEO, 53 The National Law Journal (November 29, 2010) describing the SEC’s sanctions against Former Comverse Technology CEO Jacob “Kobi” Alexander ($53 million in disgorgement and penalties) in addition to facing a 35-count criminal indictment brought by the Justice Department on charges including conspiracy, securities fraud, mail fraud, money laundering, fraudulent backdating of stock options, and granting options to fictitious employees.
Parties often reach agreement on the terms of deals before the paper work can be completed. Note that rescission transactions may involve backdating, or may not. If a rescission transaction involves backdating, the question, as in all other backdating situations, will be whether the backdating is appropriate or fraudulent. For example, the preparation of corporate minutes properly and accurately recording board of director action would be appropriate. On the other hand, preparing minutes for a board of directors meeting that didn’t actually occur or backdating a document to make it appear that the recession transaction had occurred before the end of a taxable year when it had not, would be fraudulent.

A business that wants to hire a new employee, or a partnership that wants to bring in a lateral partner, may want or be induced to make the effective date of such hire or admission prior to the date the deal is done or, indeed, even before the new employee or partner is identified.

III. Federal Tax Consequences of Temporal Modifications

The federal income tax system is founded on the concept of an annual accounting year, with each taxable year – for individual taxpayers, generally the calendar year – being treated distinctly from each other taxable year. As such, the timing of an event may have as much significance for tax purposes as the event itself. Rescission is subject to its own tax rules because of all temporal modifications, rescission is the only one that relates to the existence, as opposed to the timing, of the event.

IV. Rescission

A. Development of Rescission Doctrine

The IRS in Rev. Rul. 80-58 adopted an approach that can be traced back to a 1940 appellate court tax case holding that if the unwinding transaction takes place in the same taxable year as the original transaction and if the parties are placed in the same positions as they were prior to the initial transaction, and the unwinding is a “true” rescission, the unwinding will be treated a rescission for federal tax purposes.

45 In the case of sole directors, there may be great difficulty in saying when or if a meeting occurred.
46 IRC § 441(a) (“Taxable income shall be computed on the basis of the taxpayer's taxable year.”). Burnet v. Sanford & Brooks Co., 282 U.S. 359 (1931).
47 1980-1 CB 181.
48 Penn v. Robertson, 115 F. 2d 167, 40-2 USTC ¶ 9707 (4th Cir. 1940).
What is a “true” rescission? In his seminal 1984 article, Sheldon Banoff discusses *Penn v. Robertson* in this context. In that case, Charles A. Penn for many years until his death was a senior executive and director of American Tobacco Company. As such he participated in an employees’ stock benefit fund. The fund credited the taxpayer with earnings in 1930 and 1931. In 1931, however, as a result of shareholder lawsuits, the employer’s board of directors voted to rescind the plan as to all participants in the plan who would agree to relinquish their previous rights and credits. In addition to a formal vote of the board, the district court found (and the parties stipulated on appeal) that a valid rescission had occurred; full restitution was made, with no profit or loss to either Mr. Penn or American Tobacco Company. In addition, although not explicitly stated in the opinion, Banoff notes that a rescission must be recognized as valid for state law purposes before it will be recognized for federal tax purposes. Moreover, it must have a business purpose. However, as discussed below, the IRS has approved rescission treatment in situations in which the taxpayer’s motivation for the rescission was to avoid an unanticipated adverse income tax result.

More recently, the IRS articulated its view of rescissions in PLR 200923010:

The Service recognizes that a rescission may be given full effect in abrogating a transaction under certain conditions. When these conditions are met, the transaction is disregarded for federal income tax purposes. In this connection, Rev. Rul. 80-58, 1980-1 C.B. 181, states the general legal principles pertaining to the doctrine of rescission in the following terms:

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

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50 *Id* at 960.
The ruling states that there are at least two conditions that must be satisfied for the remedy of rescission to apply to disregard a transaction for federal income tax purposes. First, 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.” Second, this restoration must be achieved within the taxable year of the transaction.

The IRS applies the two stated conditions somewhat differently. The first, that the parties be restored to the relative positions they would have occupied had no contract been made, appears to be satisfied upon material compliance. The second condition, that the restoration be achieved within the taxable year of the transaction, appears to be an either-or proposition. That is, either the condition is satisfied or it is not. If the multiple parties to a contract have different taxable years, the original transaction and the rescission apparently have to occur in the same taxable year with respect to each party. For example, if A purchases Blackacre on March 31, 2014, from Fiscal Year Corp, which has a taxable year ending March 31, it does not appear that this sale could be rescinded effective for federal tax purposes other than on the day of closing because otherwise the rescission would be in a different taxable year of Fiscal Year Corp. See PLR 201211009; PLR 201021002.

B. New York State Bar Report

On August 11, 2010, the New York State Bar Association Tax Section submitted a report (the “NYSBA Report”). The NYSBA Report urged greater certainty with respect to rescission, specifically making the following four recommendations:

1. We recommend that Treasury and Service clarify the elements of a valid rescission for federal tax purposes by, for example, confirming the practical approach the Service has taken in private letter rulings that the status quo ante requirement is met where parties are restored to their prior positions “in all material respects”; addressing the effect that the making or receiving of additional payments in the course of an “unwind” might have in this regard; defining the same taxable year requirement in the event

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51 See PLR 200613027, holding that a valid rescission of the conversion of a partnership to a corporation occurred even though corporate employees who received stock and were redeemed before the rescission were not parties to the ruling and presumably were not required to pay back the redemption proceeds.

that the parties involved have different tax years; and detailing whether and to what extent a rescission must be identified as such by the parties at the time it is undertaken.

2. We believe that, in providing guidance concerning the elements and effects of a valid rescission, Treasury and the Service should be especially attentive to the doctrine's application in the context of related party transactions, unilateral actions or transactions, “partial” rescissions and cases where the underlying transaction is later “done over.”

3. We also believe that the rescission doctrine generally should not be available to skirt explicit Congressional or Treasury pronouncements limiting a taxpayer's ability to unwind an election, action or transaction. At the same time, however, we ask that the Service consider adopting a more flexible approach in providing administrative relief to correct oversights, mistakes and execution errors in connection with various elective regimes, including entity classification elections and Section 83(b) elections.

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

C. Ill-founded Critique of Rescission Doctrine

Recently, two commentators have taken the position that the entire recession analysis based on Penn v. Robertson is misconceived. In “The Fabricated Unwind Doctrine: The True Meaning of Penn v. Robertson” (hereinafter, “Fabricated Doctrine”), John Prebble and Chye-Ching Huang assert that the Internal Revenue Service, practitioners, and academic commentators have all misunderstood Penn v. Robertson and that the case, properly analyzed, provides no authority for Rev. Rul. 80-58. Fabricated Doctrine takes the position that the court in Penn v. Robertson, far from holding that the taxpayer was entitled to treat the benefit received from his employer’s stock benefit fund in 1931 as “extinguished” when the establishment of the fund was rescinded in 1931, actually articulated a rationale based on allowing the taxpayer’s return in

54 Id. at 119.
1931 to treat the repayment of the benefit received from the fund as a deductible payment offsetting the receipt of a taxable benefit from the fund earlier in 1931. Unfortunately for the authors of Fabricated Doctrine, but fortunately for all practitioners who have relied on Rev. Rul. 80-58, Fabricated Doctrine commits much worse errors of analysis of *Penn v. Robertson* than practitioners or the Internal Revenue Service have ever done.

In 1984, Sheldon I. Banhoff demonstrated how to write a thorough, thoughtful analysis of the rescission doctrine.\(^{55}\) The authors of Fabricated Doctrine do not build on Banhoff’s analysis nor, indeed, even cite his thorough 1984 article.\(^ {56}\) Instead, they seem to be obsessed with the possibility that a taxpayer might achieve an inappropriate result. They appear wrought with anxiety about the possible income tax treatment available to Douglas Poling, who in 2009 received a $6.4 million bonus from AIG, which AIG paid out of funds it had received from the Troubled Assets Relief Program.\(^ {57}\) Following great public outcry and threatened federal legislation to impose punitive taxes on such “TARP bonuses,” in March 2009 Poling announced that he would repay his bonus “because [he] thought it was the correct thing to do.”\(^ {58}\) The authors of Fabricated Doctrine state their belief that it is likely that Poling would be able to treat his repayment as a rescission of the bonus under *Penn v. Robertson* and Rev. Rul. 80-58.\(^ {59}\) Although they discuss the apparently good possibility that Poling would be able to deduct his repayment even if he did not get rescission treatment,\(^ {60}\) the authors of Fabricated Doctrine assume for purposes of their paper that the repayment would not be deductible.\(^ {61}\) They then contrast this assumed nondeductibility under the income tax law without the rescission doctrine with the favorable treatment they assume Poling would receive under the rescission doctrine.\(^ {62}\)

\(^{55}\) Banoff, *supra*, note 49.

\(^{56}\) Fabricated Doctrine does cite a later and much shorter piece by Banoff at 119, 165-166.

\(^{57}\) Fabricated Doctrine at 122.

\(^{58}\) Fabricated Doctrine at 123-124.

\(^{59}\) *Id* at 127 and note 50. The author is not so sure that Mr. Poling would be able to treat repayment of the bonus as a rescission. The IRS might well argue that the repayment did not amount to the “abrogation, canceling, or voiding of a contract.” Rev. Rul. 80-58, *supra*, note 47. (emphasis added) Also see note 89, *infra*, and accompanying text. On the other hand, Rev. Rul. 79-31, 1979-2 C.B. 25 provides that a bonus repaid in the year of receipt is treated as not having been paid, stating “The repayment [in the same year] results in a reduction in gross income and wages rather than a deduction.” See Rosina B. Barker and Kevin P. O’Brien, “Taxing Clawbacks: Theory and Practice,” *Tax Analysts Tax Notes Special Report* 425 and cases cited there (October 15, 2010).

\(^{60}\) Fabricated Doctrine at 126.

\(^{61}\) *Id*.

\(^{62}\) Fabricated Doctrine returns to Mr. Poling several times, at 121-127, 134-136, 147-148, 162, and 164.
As the New York State Bar Report\textsuperscript{63} demonstrates, if one believes the rescission doctrine as currently applied by the IRS leads to inappropriate results in certain cases, responsible analysis can suggest tweaks to minimize inappropriate results. Instead, the authors of Fabricated Doctrine set up a straw man and engage in sloppy, occasionally incoherent, sophomoric analysis of \textit{Penn v. Robertson} that would be unacceptable in a first year law school legal writing class. Fabricated Doctrine presents the case of Douglas Poling to try to make a case that the rescission doctrine as announced by Rev. Rul. 80-58 allows massive inappropriate tax benefits. Yet Poling’s actual tax treatment if he repaid his TARP bonus in the year of receipt, as opposed to the hypothetical treatment the authors of Fabricated Doctrine posit without any justification, per Rev. Rul. 79-311 would be as if the bonus had never been paid, without any resort either to a rescission theory or a deduction theory. Rev. Rul. 79-311’s treatment of repayments of compensation made in the same year as the receipt of the compensation is however consistent with the rescission theory announced a year later by Rev. Rul. 80-58 and is also consistent with the annual accounting concept that is the basis of our federal income tax law.\textsuperscript{64}

The authors of Fabricated Doctrine acknowledge that the court in \textit{Penn v Robertson} did use rescission language, such as describing the repayment of the 1931 payment by the taxpayer as a rescission that “extinguished” the entire stock fund transaction for 1931. However, Fabricated Doctrine asserts that there are two possible rationales for the result in Penn v. Robertson that Mr. Penn did not owe tax in 1931 on the earnings from the stock fund:

The deduction rationale is that since Penn owed the value of the repayment to the American Tobacco Company (being value that had been transferred to him pursuant to a void contract), and since that obligation arose as a result of Penn’s income-earning activities by way of service to the American Tobacco Company, the value of the repayment was an allowable deduction to Penn. Since the deduction was of greater value that the 1931 credit it offset that credit for tax purposes and Penn had no taxable income in respect of the credit. The deduction rationale is simply the subtraction of an allowable deduction from a gain. It is an application of ordinary tax law principles.

The conflation rationale is that, being self-cancelling, the crediting transaction and the repayment transaction were conflated into a single transaction, a transaction that was in effect a nullity and ignored for income tax purposes. That is, for tax

\textsuperscript{63} \textit{Supra}, note 52.

\textsuperscript{64} See note 46, \textit{supra}, and text accompanying note 80, \textit{infra}.
purposes both transactions became in law as if they had never occurred, with neither assessable income derived nor a deductible expense incurred. 65

Fabricated Doctrine then goes on to assert that:

Only one of the deduction and conflation rationales is the ratio of Penn v. Robertson. The ratio of a case is the principle of law found in it that has the force of law as regards the world of[sic] large. The ratio of a case is not just any rationale that can be used to explain the case’s outcome. Instead, as Goodhart’s Determining the Ratio Decidendi of a Case explained, the principle of a case is found by taking account of the facts treated by the judge as material, and his or her decision as based on those material facts. 66

Following this sweeping assertion, the authors of Fabricated Doctrine state their case as follows: 67

Despite the lack of explicit clarity in the judgment, close reading reveals four indicators that their Honours 68 implicitly, but nevertheless clearly, operated under the deduction rationale, the simple subtraction of a deduction from a gain.

First, the Commissioner assumed that the case was about a countervailing deduction, not about a conflation. 69 As their Honours understood it, counsel for the Commissioner submitted that, “the loss to Penn by the rescission or re-sale could only serve as a deduction against income received by his executors after his death during the calendar year.”

65 Fabricated Doctrine at 129.
67 Fabricated Doctrine at 131-132.
68 This is the language used in Fabricated Doctrine instead of the more usual “as the court understood it” or “as the majority understood it.”
69 Fabricated Doctrine’s term sometimes used to describe rescission.
The court rejected this submission of the Commissioner by holding that Penn himself, though dead, could take advantage of the loss that emerged from the rescission. The judges did not explicitly address the question of whether the loss was a deduction or a cancellation that had to be conflated with the 1931 credit to make the credit a nullity. Their Honours did however call the outgoing \(^70\) from the rescission “a deduction” and “such deduction.” This indicates that the court was operating under the deduction rationale (the subtraction of an allowable deduction from a derived gain) because, under the conflation and extinction rationale, a deduction would not in fact arise, since the conflation rationale treats the two transactions together as a nullity.

The author wholly fails to understand how the Commissioner’s characterization of the case discloses the court’s thinking as to what were the material facts of the case. The authors of Fabricated Doctrine show their misunderstanding of the court’s opinion, and perhaps their misunderstanding of much else, by their statement that the court “did however call the outgoing from the rescission, a ‘deduction’ and ‘such deduction.’ This indicates that the court was operating under the deduction rationale …. “ The court used the terms “deduction” and “such deduction” only in its discussion of the Commissioner’s contention,\(^71\) as those are the terms the Commissioner used in his argument. How this suggests what the rationale of the court was is not readily apparent.

The authors of Fabricated Doctrine continue:

Now, examine the issue in terms of Goodhart’s analysis of ratio and material facts. For Judges Parker and Chestnut, it was material that the repayment was deductible.\(^72\) (“That the repayment was deductible” appears on its face to be a conclusion of law, rather than the statement of a fact. However, in the context of

\(^70\) In the language of Fabricated Doctrine, an “outgoing” is a payment made by the taxpayer.

\(^71\) \textit{Penn v. Robertson}, 115 F. 2d at 176. In discussing the Commissioner’s argument, the court states:

[The Commissioner contends that] the loss to Penn by the rescission or re-sale could only serve as a \textit{deduction} against income received by his executors after his death during the calendar year. In the instant case the tax assessed by the Commissioner against Penn for 1931 was about $80,000, while the tax payable by the executors for the balance of the calendar year without \textit{such deduction} was only $108.65. (emphasis supplied)

\(^72\) There is no support in Fabricated Doctrine for this assertion. The authors of Fabricated Doctrine appear to assume that because the court used the word “deduction” in describing their response to the Commissioner’s argument, the court was adopting a deduction rationale for its decision. This is plainly wrong. Indeed, the opinion states at one point that the Commissioner “contends that the rescission was not a genuine rescission but really a re-sale of the stock.” 115 F.2nd at 175. The court continues: “But this [the Commissioner’s contention] is refuted by the record, the stipulation of counsel and the findings of the district judge.” The court earlier in the opinion states “But we agree with the district judge that the rescission in 1931 before the close of the calendar year, extinguished what otherwise would have been taxable income to Penn in that year.” 115 F.2nd at 175. The author does not believe that judges, lawyers, or commentators commonly describe taxable income as being “extinguished” by deductions; rather, taxable income is offset by deductions.
the tax question at issue in *Penn v. Robertson* the deductibility of the repayment was a matter of fact on which the court built its conclusion of law. Taking it that the repayment was deductible, the court moved to the issue before it: could Penn’s estate take advantage of the deduction notwithstanding that he had died before the repayment was made? That is, in terms of the court’s process of reasoning, deductibility of the repayment was a material fact. It follows that we cannot extract authority from *Penn v. Robertson* that in the circumstances of the case, and for tax purposes, the repayment was extinguished. Since extinguishment of the second of a pair of transactions is crucial to the unwind doctrine, it follows that *Penn v. Robertson* is not authority for that doctrine.\(^{73}\)

Secondly, had the question of conflation of transactions been at issue as an alternative argument (alternative, that is, to the receipt/deduction argument just addressed) the Commissioner would surely have submitted that conflation could not span two tax periods marked off from one another by Penn’s death.\(^{74}\) After all, he certainly argued that a deduction could not jump back to the period when Penn was alive (and therefore could not be considered in Penn’s tax position rather than the executor’s).

Had the Commissioner submitted that a conflation could not span two periods their Honours would have recorded their response in their judgment, but they did not. The reason is clearly that counsel for Penn did not argue that the case was one of conflation, but was satisfied to argue the case as one of a deduction offsetting an earlier receipt.\(^{75}\)

The third reason for concluding that *Penn v. Robertson* did not involve the conflation rationale is that this interpretation would require accepting that the judges chose to make new law, even though they could have reached the same result via the established and perfectly ordinary route of subtracting a deduction from income.

\(^{73}\) As explained above, Fabricated Doctrine’s assertion that the court in *Penn v. Robertson* characterized the taxpayer’s repayment as a deduction rests on a plainly wrong reading of the court’s opinion. Accordingly, this entire paragraph is wrong because it relies on the authors’ earlier erroneous reading. Furthermore, the authors of Fabricated Doctrine demonstrate their misunderstanding of the concept of rescission with their statements that the “repayment was extinguished” and “extinguishment of the second of a pair of transactions is crucial to the unwind doctrine. If A sells Blackacre to B, and A and B later agree to rescind the sale, if the rescission works for income tax purposes, both the original sale and the reconveyance are ignored for income tax purposes. However, the rescission works only because of the timely reconveyance, not because the reconveyance is extinguished.

\(^{74}\) Given the authors’ other statements, it is not surprising that they claim an ability to discern the mind of the Commissioner in a case decided over sixty years ago. In any case, the court refused in *Penn v. Robertson* to accept the Commissioner’s argument that the period from January 1, 1931 to the date of Mr. Penn’s death and the period after his death to December 31, 1931 constituted two separate taxable periods. 115 F.2nd at 176. Accordingly, the Commissioner knew that the court would be no more sympathetic to an argument that the 1931 transactions were a rescission transaction spanning two taxable periods.

\(^{75}\) Here the authors of Fabricated Doctrine appear to conflate the counsel for the taxpayer with the counsel for the Commissioner. Taxpayer’s counsel made several arguments in *Penn v. Robertson*, but the opinion never describes any of those arguments as an argument for a deduction.
There were two transactions relevant to this particular issue: the crediting transaction, the 1931 credit to Penn in his lifetime, and the repayment transaction, the outgoing that the executors incurred months later. Both events were relevant for income tax purposes. To treat the credit as a receipt and the repayment as a deduction requires no magic, no new law. That is how income tax works: on net results. Indeed, the court used the expression, “net profit.”

On the other hand, to conclude that the court adopted the conflation rationale one has to assume that for some reason their Honours believed that it was necessary for the court to hold innovatively that some alchemy had operated to conflate the two transactions and to leave them a fiscal nullity as well as being an economic nullity. This conclusion also requires one to believe that the court would have adopted this innovation without explicitly noting that it had done so.

With regard to Fabricated Doctrine’s third point, above, why is not equally if not more plausible to say that the court in Penn v. Robertson treated the 1931 transactions in the way it did not because of some deduction rationale or because the court was being innovative—rather, it was just applying its understanding of the annual accounting concept of federal income tax law, which was already a commonplace by 1940. As discussed below, if the annual accounting concept means that a taxpayer’s transactions are to be examined at the close of each taxable year, once the court in Penn v. Robertson rejected the Commissioner’s argument that the period from the date of Mr. Penn’s death to the end of 1931 should be treated as a separate tax period, the court was looking at the facts at the end of 1931. Determined as of that time, Mr. Penn had received no credits from the American Tobacco Company plan.

Fabricated Doctrine cites to page 173 of the court’s opinion for this statement. There the court uses the term “net profit” as follows:

At the outset of the discussion it should be noted that the tax controversy exists only because the stock allotment plan was initiated in 1929 and abandoned in a subsequent tax year. If the plan had been terminated during Penn’s lifetime in the same tax year that it originated, it is obvious that there would have been no tax, as there was no net profit. On the items in controversy the Commissioner has made tax assessments of about $90,000, which the taxpayers have paid, and the Government contends may not be recovered although the transaction resulted in no net profit. The author fails to see how the court’s use of the term “net profit” in this context has any relevance to the argument asserted by Fabricated Doctrine. Moreover, in 1929, the value of the stock allotted to directors of American Tobacco Company exceeded the cost price to the recipients by close to $2,000,000. If the plan terminated in 1929, saying that then there would be “no net profit” sounds to the author as though one would be describing a rescission.

The court, however, did characterize its task as follows:

Thus two questions are presented for our determination; one, whether the credits on Penn’s notes constituted income constructively received by him for both years, and if so, second, whether the rescission in 1931 extinguished what otherwise would have been income to Penn in that year. 115 F.2nd at 173.
Fourthly, if the conflation rationale is correct it is an invention of tax law that has no counterpart in the general law. Ordinarily, tax law is part of and reflects the rest of the law. Where tax creates its own special rules the courts point this out. For instance, Judges Parker and Chestnut took care to explain that Penn was taxable on the 1930 credit to him, and why this was so, even though the credit to him was void. They summarized the reason in these terms:

But while we regard the [share purchase] plan as void. . . .

It is taxable when the amount is definitely liquidated and available to the taxpayer without restriction. The circumstances under which the credits were made met these conditions. The credits were precise in amount and were absolutely made as reductions of the notes.

It would have been much more radical for their Honours to say that for tax purposes a rescission makes a nondeductible expense deductible. Considering how carefully they explained the constructive receipt rule that tests derivation for tax purposes, which had by then been established law for years, it is inconceivable that they would have laid down a completely fresh rule without explaining their reasons.

And yet, as we explain in Part IV below, the IRS in Rev. Rul. 80-58, 1980-1 CB 181 seems to assume that their Honours invented a rule that had the remarkable effect both of making a nondeductible expense deductible and of causing deductible expenses to extinguish an earlier receipt, transforming that earlier receipt into something that notionally had never occurred for purposes of fiscal law. When unpacked in this manner, the unstated assumption behind Rev. Rul. 80-58, 1980-1 CB 181 is seen to be based on a misunderstanding.

Rev. Rul. 80-58 considers two Situations. In Situation 1, in February, 1978, A sells land to B for a cash purchase price paid in full at closing. The agreement between A and B provides that B may convey the land back to A and receive a refund of the purchase price paid by B if within nine months of the sale B is unable to have the land rezoned for business purposes.

78 It is entirely unclear what point the authors of Fabricated Doctrine are trying to make here. What on earth does it mean to say that “Ordinarily, tax law is part of and reflects the rest of the law. Where tax creates its own special rules the courts point this out.” In the author’s decades of practicing tax and business law, it has been apparent that tax, securities, and corporate and alternative entity law all have their specific concerns, are not consistent, and in sense can be said be to part of each other. Moreover, what can the authors of Fabricated Doctrine possibly mean by “if the conflation doctrine [i.e., rescission] is correct it is an invention of tax law that has no counterpart in the general law.” What is general law?

79 115 F.2d at 174-175. Here Fabricated Doctrine takes what the court said about the tax consequences in 1930 to explain the court’s rationale for 1931—yet the court applied different theories in 1930 and 1931 because the rescission transaction took place in 1931 and could not change the tax consequences in 1930, a prior year.

80 1980-1 CB 181.
In October, 1978, B determined that B would be unable to obtain the desired zoning, and during that same month, A and B agree to rescind the sale, with B conveying land back to A and A returning the purchase price to A. The facts of Situation 2 were the same except that B had one year to obtain the desired zoning. In January 1979, B conveys the land back to A and A returns the purchase price to B. In its analysis, Rev. Rul. 80-58 states that “the annual accounting concept requires that one look at the transaction on an annual basis using the facts as they exist at the end of the year.” Then, citing Penn v. Robertson, Rev. Rul. 80-58 holds that in Situation 1 no gain or loss is recognized to A from the sale to B, stating:

In Situation 1 the rescission of the sale during 1978 placed A and B at the end of the taxable year in the same positions as they were prior to the sale. Thus, in light of the Penn case, the original sale is to be disregarded for federal income tax purposes because the rescission extinguished any taxable income for that year with regard to that transaction.

In Situation B, however, Rev. Rul. 80-58 holds A must report the gain from the sale in February, 1978.

Fabricated Doctrine discusses the holding of Rev. Rul. 80-58 in Situation 1 by asserting that the phrase “extinguished any taxable income for that year with regard to the transaction” by itself could be read as supporting either

the deduction rationale (the subtraction of a deduction against a gain) or the conflation rationale (treating the sale and rescission as if they had not occurred). Or, perhaps, consistent with the conflation rationale, the ruling means that the transactions themselves for tax purposes are treated as null. That is, the taxable income from the hypothetical sale of land no longer exists, and the deduction from its reversal does not arise (as opposed to simply being set off against each other. 81

Fabricated Doctrine thus continues its misreading and misunderstanding of authorities. First and foremost, when B in 1978 conveys the land back to A and receives back his purchase price, what is the deduction? Is it A’s repayment of the purchase price? If so, what kind of deduction would A have? This author suspects it would probably no more than a short-term capital loss. Whether this would put A in the same position as a rescission depends on what the amount and nature of the gain on A’s sale was and what the consequences are under the alternative minimum tax. Second, Fabricated Doctrine misconceives the effects of rescission—

81 Fabricated Doctrine at 137.
the sale by A was not “hypothetical” and the transactions are not treated as “null.” Rather, under the annual accounting concept, as Rev. Rul. 80-58 explains, a taxpayer’s transactions for the year are examined based on the facts as of the end of the year. At the end of 1978, in Situation 1 in Rev. Rul. 80-58, B had conveyed the land back to A, and A had paid B’s purchase price back to B. Perhaps the most reasonable interpretation of Rev. Rul. 80-58 is that it meant what it said when it stated that the rescission in 1978 of the sale had “extinguished any taxable income for that year” with regard to the sale. It is senseless to try to explain Rev. Rul. 80-58 in terms of some kind of “deduction” rationale.

If Rev. Rul. 80-58 states a correct interpretation of the annual accounting concept, and this author knows of no reason to quarrel with it, then why should it matter, as Fabricated Doctrine would have it, that Rev. Rul. 80-58 extends its treatment to “bare reversals,” which is the term Fabricated Doctrine uses to describe transactions where in the view of Fabricated Doctrine there is no legal tie between the original transaction and the transaction by which the parties agree to rescind it. That is, for example, should it matter if A sells land to B in January 2014 and, without any agreement in connection with the sale, A and B agree in May, 2104 to rescind the sale? Assuming A and B are both calendar-year taxpayers, at the end of 2014, A will still own the land, and B will still have the consideration he conveyed to A in January. What reason of tax policy or equity would require treating this as other than a rescission under which the sale in January is ignored? Interestingly, Fabricated Doctrine in its discussion of “bare reversals,” states that Rev. Rul. 80-58 extends favorable rescission treatment to bare reversals, “so long as the parties are careful enough to use the word ‘rescission’ when describing the reversal transaction” but then cites a private letter ruling from 2007 in which the taxpayers received rescission treatment but, as Fabricated Doctrine notes, did not describe the later transaction as a “rescission.”

Fabricated Doctrine offers no explanation for its position that rescission treatment is inappropriate for “bare reversals,” other than to return to its beating of the Douglas Polling horse. However, as explained earlier, published authority predating Rev. Rul. 80-58, and not

82 Id.
83 Fabricated Doctrine at 140-143.
84 Fabricated Doctrine at 145-146, citing PLR 200701019 (January 5, 2007).
85 See text accompanying notes 57 to 64, supra.
discussed or cited by Fabricated Doctrine, holds that Mr. Poling would be entitled to disregard the payment to him of his controversial TARP bonus if he repays in the same year he received the bonus.\textsuperscript{87} Having set up a straw man that proper analysis scatters, and having misread \textit{Penn v. Robertson},\textsuperscript{88} Fabricated Doctrine offers no support for the proposition that the rescission doctrine as applied by Rev. Rul. 80-58 leads to unacceptable tax results that are not otherwise available.

A reader of this paper might reasonably ask why the author has spent so much space criticizing Fabricated Doctrine. It is because the author believes that in an age when information abounds on the internet, and researchers face difficulties in assuring that they have thoroughly researched a topic, papers like Fabricated Doctrine that appear in facially creditable publications present a danger and do a disservice to scholarship in a complicated field that could benefit from thoughtful analysis.

D. Private Letter Rulings on Rescission

1. Reversing a Section 355 Spin-Off. In PLR 200923010, above, the IRS approved rescission treatment where, after a change in management to executives who believed the benefits of separating the businesses involved were overstated, the parties reversed a spin-off and redemption.

2. Recasting a Conversion. PLR 2009520036 considered a transaction in which Partnership believed it would have better access to capital for its three lines of business if it were a corporation. Pursuant to a plan of conversion, and pursuant to the relevant state law of State, Partnership continued its existence in the organizational form of a corporation (“Corporation”). In the conversion, partners holding Class A interests in Partnership received Class A common stock of Corporation, and partners holding Class B interests in Partnership received Class B or Class C stock of Corporation.

Two months after the conversion, Corporation made a partnership profits and tax distribution with respect to the previous taxable year to its shareholders in their capacity as former partners of Partnership.

Shortly after the conversion, Corporation issued three employees options to acquire nonvoting Class D common stock of Corporation; however, Corporation cancelled these options

\textsuperscript{86} See text accompanying notes 58 to 63, \textit{supra}.  
\textsuperscript{87} Rev. Rul. 79-31, \textit{supra}, note 58.  
\textsuperscript{88} See text accompanying notes 53 to 79, \textit{supra}.  

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soon thereafter in anticipation of the rescission described below. The options were completely
nonvested at the time of cancellation, and Corporation did not pay any consideration for the
cancellation.

As noted, Partnership undertook the conversion because its management believed that it
would improve its access to capital. Soon after the conversion, however, it became apparent that
it could not raise the desired capital at acceptable cost so long as it continued to operate Business
3 as well as Businesses 1 and 2. Corporation approached potential investors about their interest
in funding Businesses 1 and 2 on a stand alone basis, and, after receiving more positive
responses, proposed a rescission in which it would convert to a State limited liability company.

In this second conversion, except for the fact that the end result would be a limited
liability company instead of a partnership, all affected parties would be restored to the relative
economic positions they would have had at the time of the first conversion had it not occurred.
Corporation’s three classes of stock would convert into interests in Converted LLC having rights,
preferences, and restrictions substantially similar in all material respects to the corresponding
interests in Corporation and, prior to that, the original corresponding interests in Partnership.

Taxpayer explained that it would convert Corporation directly to Converted LLC rather
than first back to Partnership because when Partnership was first formed, partnerships were not
subject to State’s franchise tax. Now, partnerships are subject to that franchise tax, as are limited
liability companies, but taxpayer believes that being a limited liability company provides certain
non-tax benefits as compared to being a partnership. Though Corporation could convert to a
partnership and then to a limited liability company, it would incur greater expense to do so.

The IRS blessed the rescission holding, among other things, that the conversion of
Corporation to Converted LLC would not be treated as a liquidation for tax purposes of
Corporation. Some interesting points.

- The IRS concluded that the requirement 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” would be satisfied because the parties would be
returned to substantially the same economic positions in all material respects even
though they would now be members of a limited liability company instead of general
and limited partners of a limited partnership and even though the tax distributions that
would receive from Converted LLC would be paid later than the corresponding payments that Partnership would have made had it not converted to Corporation.

- The IRS required the taxpayer to represent that “under the laws of State A the Plan of Conversion constituted a contract between and among the parties thereto.”

The IRS apparently does not apply the doctrine of rescission to transactions that do not involve the reversing or undoing of a contract. Thus, for example, where a taxpayer who was receiving distributions from an IRA that were intended to be a series of substantially equal periodic payments per IRC § 72(t)(2)(A)(iv), which arrangement avoided the otherwise applicable 10% penalty on early distributions, converted part of the IRA to cash and had it transferred to a new IRA via a trustee-to-trustee transfer, that constituted a modification of the payment stream, making the penalty applicable. PLR 200925044 held, without any discussion of rescission theory or whether the retransfer had occurred in the same taxable year, that the consequences of the modification could not be avoided by causing the transferred amount to be transferred back to the original IRA. PLR 200925044. Where there is a contract, e.g., a subscription agreement that is cancelled, the IRS has granted rescission treatment without a formal rescission designation in the cancellation. Rev. Rul. 74-501, 174-2 C.B. 98, Situation 2. In addition, if compensation is repaid to the employer in the year it is received, the amount repaid is treated for tax purposes as if never paid, apparently without regard to whether the repayment was pursuant to a contract. See Rev. Rul. 79-311, 1979-2 C.B. 25.

3. Rescission Undertaken to Avoid Adverse Tax Consequences. The IRS has issued at least three private letter rulings approving rescissions that were undertaken to avoid adverse federal income tax consequences. PLR 201113023 approved the rescission of an up-stream merger where the rescission was undertaken because the parent corporation became

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89 Another PLR, PLR 201236035, is not a rescission ruling but is nevertheless interesting because there the IRS granted a waiver of the requirement that a taxpayer who wants to “rollover” a qualified plan distribution must do so with 60 days. The taxpayer received a qualifying distribution from a qualified plan of his former employer and rolled the distribution over into a new plan established by a new corporation set up by the taxpayer. Based on advice from his former employer and a tax lawyer with qualified plan experience, taxpayer caused the new plan to purchase stock from his new corporation, thereby providing funds to capitalize the new corporation. In the following year, the taxpayer met with his accountant and another lawyer, who advised him to rescind these transactions. Based on this new advice, taxpayer approved a corporate resolution for his new corporation rescinding the corporate actions that had established the new plan and allowed it to invest in stock of the corporation. Based on the taxpayer’s representations that his original actions had been based on the advice from his former employer and the tax lawyer with qualified plan experience, the IRS granted the waiver.
concerned about the uncertain tax consequences of the merger of a subsidiary into the parent. In the original transaction in PLR 201008033, Parent owned all the stock of Acquiring, a State corporation, and Acquiring owned all the stock of Sub, a foreign entity. Acquiring formed Target to hold an interest in Target Sub, also a foreign entity. Acquiring sold all the stock of Target to Sub for cash. After the sale was completed, Parent’s tax advisors informed it that the sale would result in unintended adverse federal income tax consequences to Parent’s consolidated group.

To avoid the adverse tax consequences, Acquired and Sub agreed to rescind the sale. Following the rescission, Target converted pursuant to state law to a limited liability company, and Acquiring sold its interest in Target LLC to Sub for cash. The IRS ruled that the original sale was disregarded, that the shares of Target stock that Acquiring held were treated as having been owned by Acquiring throughout the interim period, and Target was treated as having remained a wholly-owned subsidiary of Acquiring and a member of the affiliated group until consummation of the conversion. Pursuant to IRC § 368(a)(2)(c) and Treas. Regs. §§ 1.368-1(d)(4(ii) and 1.368-2(k), the conversion was a reorganization under IRC § 368(a)(1)(C).

In the original transaction considered in PLR 200911004, Acquiring purchased all of Target’s outstanding preferred stock for cash. Acquiring and Target then entered into a merger agreement pursuant to which Target was merged into Acquiring in exchange for Acquiring common stock, Acquiring notes, and cash. In the merger, the Target preferred stock owned by Acquiring was cancelled, and Acquiring changed its name to that of Target.

Within a few months after consummation of the merger, Acquiring learned that the merger might have adverse tax consequences that potentially could be devastating to Acquiring’s ability to continue as a going concern. After learning of these consequences, Target and certain of Target’s shareholders filed suit seeking, and obtained, a judgment of the court (a) rescinding the merger agreement, (b) providing that because the merger agreement was void ab initio, any actions taken on the basis of that void agreement, including but not limited to the filing of a Certificate of Merger with the state official were void and of no effect, (c) providing that without limiting the foregoing, because the Certificate of Merger was void and without effect, the merger contemplated thereby was also void and without effect, and (d) directing the state official to
reinstate Target as a corporation in good standing. In addition, Acquiring’s name was changed back. Acquiring’s purchase of Target preferred stock was not rescinded.

Following consummation of the rescission, Acquiring, Target, and certain Target shareholders entered into an Agreement and Plan of Acquisition pursuant to which Acquiring acquired all of the common stock of Target for an amount of consideration equal to the consideration agreed to in the merger agreement.

The IRS held that the merger of Target into Acquiring was disregarded, Target and Acquiring were treated as separate corporations at all times during the relevant tax year, and Acquiring was treated as having acquired all of Target’s common stock on the date on which such transaction actually occurred following the rescission.

4. **Undoing a Business Amalgamation.** PLR 201140008 approved the rescission of several sales between members of an affiliated group of corporations. The parent corporation sought to rescind the sales because, at the time of the sales, the parent was not aware that one of its subsidiaries owned a small, indirect interest in another subsidiary that, if the sales were not rescinded, would require an expensive and time-consuming fair market valuation of several properties. PLR 200908016 approved rescission treatment for the unwinding of combinations of corporate entities that had resulted in the combination of Businesses 1 and 2 where the unwinding was undertaken to facilitate the disposal of one of the Businesses so that the entities could focus on the remaining business.

5. **Avoiding Cancellation of Debt Income.** PLR 201016048 approved a foreign parent’s cancellation of debt of U.S subsidiary to improve the financial position of U.S. subsidiary and issuance of shares pursuant to a transaction where, *inter alia*: (1) the rescission occurred in the same taxable years of both corporations, (2) the intent and effect of the rescission is to restore in all material respects the legal and financial arrangements with respect to the debt and shares that would have existed had the cancellation and issuance never occurred. (3) no dividends were declared on the stock, (4) the issuance of shares have had no legal or material economic consequences to either corporation, (5) neither corporation is bound by any legal obligation regarding the transaction at or before the effective time of the rescission; (6) the corporations will not effect the cancellation of debt with the US subsidiary; and (7) neither
corporation nor any member of the US subsidiary’s consolidated group has taken or will take any material position for U.S. federal tax purposes that is inconsistent with the rescission.

6. Rescission to Preserve Disregarded Entity Status. PLR 200843001 held that a foreign entity’s disregarded status was preserved when its sole shareholder rescinded the sale of a portion of its stock to another foreign entity.

In PLR 201021002, Parent undertook an integration plan to reduce the number of its subsidiary entities to streamline its entity structure and to facilitate aligning companies based on their business activities and area of operations. The IRS approved rescission treatment when Parent undid some of the parts of its integration plan after realizing that the plan had caused some disregarded entities to become regarded and, consequently, causing some disregarded debt to become regarded.

7. Rescission to Preserve Status as S Corporation. PLR 200533002 held that the rescission of a preferred stock issuance was effective to preserve the status of the issuer as an S corporation. PLR 8304134 reaches a contrary result, apparently because the issuance of the preferred stock and the rescission of the issuance did not occur in the same taxable year.

8. Rescission to Avoid Consequences of Unavailable Election. PLR 201211009 approved rescission treatment for the rescission of the sale of all of the stock of an S corporation where the taxpayers mistakenly believed that an IRC § 338(h)(10) election would be available.

E. Other Possible Approaches.

As discussed above, the IRS takes the position, consistent with Penn v. Robertson and later cases, that an unwinding transaction will not be treated as a rescission for federal tax purposes unless it occurs in the same taxable year as the original transaction. This position arises out of the annual accounting principal.90 Thus, in Penn v. Robertson, the court allowed the rescission in 1931 to eliminate the taxpayer’s income from the stock fund in 1931 but not the taxpayer’s income from the fund in 1930. “The Fourth Circuit Court of Appeals held that although the plan was void for 1930, the annual accounting principal required the determination of income at the close of the taxable year without regard to subsequent events.”91

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90 See text accompanying note 46, supra.
91 Banoff, supra note 48 at 960.
Notwithstanding the annual accounting principle, it could be argued that rescission should be allowed (if otherwise proper) so long as the statute of limitations for the taxable year of the original transaction remains open. Alternatively, commentators have argued that validity of a rescission should not depend on whether it fails within the same taxable year as the original transaction, or some other period, but on whether the rescission is entered into because of, for example, the failure of the parties’ expectations for the original transaction.92

[If unwinding is viewed as an appropriate remedy, there is no reason to limit it in the ways that it is limited under current law. [Allowing] unwinding relief along the lines available under the claim of right doctrine and the [tax benefit rule] would seem to do no more violence to the annual accounting principle or to tax administration more generally than it does in these areas. Thus, one would hope for both a narrowing of the rule that permits unwinds for rescissions no matter what the reason as long as the rescission occurs in the same taxable year, and relaxation of the rule that limits any unwind to the same taxable year. Any reversal, to merit unwind treatment, ought to be allowed only if the mistake or error giving rise to it is justified. When the error is justified, however, it does not seem that the same-year rule should limit the relief, though it might modify it. Thus, unwinding presumably could extend both to reversals that constitute modifications and to reversals in donative situations or other non-arm’s length arrangements under the income tax, such as tax elections; it would not be limited a priori to rescissions. The same-year rule might continue to have an effect, however, on the nature of the relief. Under this partly narrower and partly broader standard, a same-year reversal that merits unwind treatment could simply result in complete disregard of both transactions, as under current law. A later-year reversal meriting unwind treatment could be treated much as a deduction under the claim of right doctrine or an inclusion under the [tax benefit rule].93

V. Backdating.

A. Permissable retroactive action. IRC § 761(c) states:

For purposes of this subchapter, a partnership agreement includes any modifications of the partnership agreement made prior to, or at, the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions) which are agreed to by all the partners, or which are adopted in such manner as may be provided by the partnership agreement.

93 Id at 943-44 (footnote omitted).
Agreements and modifications for purposes of IRC § 761 include oral agreements and modifications.\textsuperscript{94} The effect of this provision is to allow amendments to be effective for a period before the amendment.\textsuperscript{95} Such amendments are not effective to change the existence and ownership of the partnership.\textsuperscript{96} In other words, the undoing of the issuance and redemption of a partnership interest and the creation or liquidation of a partnership may only be accomplished, if at all, through the rescission rules, while the statute does permit the retroactive modification of the interest of an existing partner in an existing partnership, subject to the requirements of IRC §§ 706(d) and 761(c). Note that the written memorialization of an amendment to a partnership agreement that has taken place by course of conduct, such as reporting allocations on the Form 1065 in a way differing from the original deal, should not implicate section 761(c), and should not be considered backdating, if the written memorialization does not attempt to take the effective date of the amendment to a date earlier than that established by the partners’ course of conduct.

Assuming a calendar year partnership, the partnership return for a year is due April 15 of the following year. Thus, on or before April 15, 2015, the partnership may amend its partnership agreement back to January 1, 2014. Presumably, subject to such rules as substantial economic effect, this means that the partnership may admit partners, expel partners, increase or decrease partners’ interests, add or eliminate guaranteed payments, and so on, and these changes will be effective for federal income tax purposes if made effective any date in 2014 so long as the changes are made on or before April 15, 2015. This rule has been limited by IRC §706(d); which provides for a limitation of the allocation of cash basis items to take into account the varying interests.\textsuperscript{97} The varying interest rule does not override the rule of section 761(c)

\textsuperscript{94} Treas. Regs §1.761-1(c).
\textsuperscript{95} Treas. Reg. § 1.761-1(c) (“A partnership agreement may be modified with respect to a particular taxable year subsequent to the close of such taxable year, but not later than the date (not including any extension of time) prescribed by law for the filing of the partnership return.”).
\textsuperscript{96} IRC §706(d).
\textsuperscript{97} See, McKee, Nelson, and Whitmire, McKee, Nelson & Whitmire: Federal Taxation of Partnerships & Partners (Warren, Gorham and LaMont):

Although the language of § 706(d) admits of no exceptions, its legislative history makes it clear that at least one pre-1984 exception survived its enactment. The exception described in the legislative history is the right of persons who are partners for the entire year to retroactively adjust their distributive shares according to the rules of §§ 704(a) and 761(c) as long as the adjustments are not attributable to additional capital contributions. A third-party purchaser of a partnership interest cannot be allocated a share of partnership income or loss realized prior to the purchase of the interest, however, nor can a
generally permitting interest shifts among partners who are members of the partnership for the entire year. Amendments to the partnership agreement pursuant to IRC § 761(c), unlike the rules applicable to common-law rescissions, may be effective if made after the end of the taxable year to which the amendment applies.

The rescission of a person’s admission as a partner, even if effective for federal income purposes, would not be binding on other third parties, such as creditors of a general partnership that is not a limited liability partnership.

What if partners want to rescind the formation of a partnership? Can this done within the time constraints of IRC § 761? If, for example, A and B agree to form partnership AB on July 1, 2014 with A contributing Blackacre and B contributing cash, IRC § 761 presumably would allow this to be undone assuming that the term “any modifications” would include a cancellation. But see Branum v. Campbell, 211 F.2d 147 (5th Cir. 1954). In that case, taxpayer formed a partnership effective April 1, 1948 by selling one-half of his brokerage business for $15,000. The partnership proved unsatisfactory, and taxpayer and his partner on September 1, 1948 entered into an agreement whereby the partnership was dissolved, and taxpayer returned the $15,000. The court held that these were separate transactions, and taxpayer was taxable on the April 1 sale. The court implied that the result might have been different had the parties included a condition in the April 1 agreement calling for an unwinding of the partnership.

Conversely, if the parties are willing to accept the tax and other consequences, a partnership agreement presumably may be amended or agreed to at any time to be effective at any time and it will be binding as stated among the parties inter se.

B. Tax Consequences of Impermissible Backdating. To the extent that the backdating is not authorized or done to mislead the taxing authorities, it may not be effective, and may result in civil penalties as described below, criminal penalties, and even, possibly,
unexpected consequences such as the application of the economic substance doctrine or being respected but redated as of the effective date.

1. **Backdating as an indication of lack of business purpose.** Beyond seeking to obtain a tax benefit in itself, backdating may also be an indication of lack of business purpose, although in some cases, if the backdating does not change the facts, it may be overlooked by the courts.99 In considering a Son of BOSS transaction, the Federal Court of Claims in *Stobie Creek Investments, LLC v. U.S.*, 102 AFTR 2d 2008-5442 (2008) noted:

   The backdating of the legal documents, creating the structures through which Jeffrey Welles carried out his transactions, reveals an intentional emphasis on ensuring the proper implementation of the J&G strategy, rather than a motive of turning over an economic profit on an investment that could have been executed outside of the order required by the J&G strategy. This focus on the sheltering aspect of the transactions by backdating the order in which the transactions actually occurred further belies the claim that the FXDOTs were motivated by a business purpose of making a profit.

   The lack of business purpose becomes a greater concern after March 30, 2010 as a result of the addition of the economic substance rules in IRC § 7701(o). Lack of business purpose is an indication of lack of economic substance.100 To the extent a transaction lacks economic substance, it is subject to a 20% penalty.101

2. **Backdating of options.** As of mid-2007 over 100 public companies had confirmed backdating stock options.102 Using misdated or undervalued stock options caused

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99 *Jackson v. U.S.*, 105 AFTR 2d 2010-2899. (DC Mo June 15, 2010) (although son may have “caused a notary to backdate and notarize his mother’s signature, may have had his mother sign an authorization for sale of the Vehicle after the fact, and may have puffed his testimony some to support his mother getting the return of the Vehicle. Were these acts in support of an elaborate scheme, or a son trying to scramble and help his mother after his loose handling of their investment put it at risk of loss? We must keep in mind that Phil Jackson’s bad acts standing alone do not change the ownership of the Vehicle.” 105 AFTR 2d 2010-2899, 2904-2905)

100 IRC § 7701(o)( 5)(A), (“For purposes of this subsection . . .The term “economic substance doctrine” means the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.”).

101 IRC § 6662(b)(6). See also IRC §6664(d)(2) eliminating the reasonable cause exception in the case of reportable transactions lacking economic substance.

102 Industry Director Directive on Backdated Stock Options Directive #1 (LMSB Control No. 04–0407–036) (June 15, 2007) (“This issue was identified from media reports of a practice among some publicly traded companies to backdate stock option exercise prices to a date that provides a lower cost to acquire the underlying stock. This issue also exists for stock options described as discounted, mis-priced, mis-dated, or in-the-money, and may arise from clerical or other errors in addition to deliberate backdating. Over one hundred companies have confirmed backdating stock options in SEC filings and press releases.”)
adverse tax consequences for the issuing corporation\textsuperscript{103} and for the service provider.\textsuperscript{104} The tax consequences of temporal modifications may result in negative tax consequences.\textsuperscript{105} Civil and criminal penalties have been asserted by the SEC and the IRS in connection with misrepresentations concerning backdated options, not based on the backdating itself but the misrepresentation accompanied by the backdating.\textsuperscript{106}

In EMISC 2009-006, citing Treas. Reg. § 1.421-1(c)(1) dealing with the effective date of statutory options, the service considered the date of issue of options. The date of actual issue determines whether the options were issued with a strike price equal to fair market value of the optioned stock. It ruled:

For purposes of § 162(m), the date of grant of a stock option is the date the granting corporation completes the corporate action constituting an offer of sale to an individual of a certain number of shares of stock at a fixed price per share. The grant dates LMSB examination used to compute adjustments, which are generally based on the measurement dates the taxpayers used for accounting purposes, are reasonable and appropriate dates under the present circumstances to use for purposes of applying § 162(m).

In other words, whether the option is “in the money” will turn on the date on which the corporate action approving the issuance of the option is taken. Thus, in order to determine whether a “backdated” option is effective, the date of valid corporate action will govern.

\textsuperscript{103} Because the option did not equal or exceed the per share value on the grant date, the compensation attributable to the option exercise to be subject to the $1 million deduction limit or IRC § 162(e). Treasury Regulations § 1.162-27(e)(2)(vi).

\textsuperscript{104} Because the option was in fact “in the money” at the time issued, it will not qualify as an incentive stock option under IRC § 422 (so the employee may have income tax at the time of issuance and time of exercise and the employer will have withholding obligations) and may be subject to IRC § 409A.

\textsuperscript{105} Notice 2006-79 Paragraph 3.07, 2006-2 CB 763 (October 4, 2006) (granting transitional relief under IRC § 409A in some circumstances but expressly excluding “[T]he transition relief provided in the preamble to the proposed regulations and described in this notice is not extended for any stock option or stock appreciation right (stock right) that: (A) was granted with respect to stock of a corporation that as of the date of grant had issued any class of common equity securities required to be registered under section 12 of the Securities Exchange Act of 1934; (B) was granted to a person who, as of the date of grant, was subject to the disclosure requirements of section 16(a) of the Securities Exchange Act of 1934 with respect to such issuer; and (C) with respect to the grant of such stock right, such corporation either has reported or reasonably expects to report a financial expense due to the issuance of a stock right with an exercise price lower than the fair market value of the underlying stock at the date of grant that was not timely reported on financial statements or reports for the period in which the related expense should have been reported under generally accepted accounting principles.”).

\textsuperscript{106} United States v. Reyes, 577 F.3d 1069, 1073 (9th Cir., 2009) (“Backdating is not itself illegal, provided that the benefit to the employees is recorded on the corporate books as a non-cash compensation expense to the corporation, in accordance with an accounting convention promulgated in 1972 referred to as Accounting Principles Board Opinion No. 25.”)
VI. Professional Responsibility Considerations.

Attorneys assisting clients with temporal modifications have obligations to comply with state and federal laws governing fraud generally, their obligations under the state and federal laws and rules governing their conduct as professionals, and, in the case of temporal modifications that will have tax significance, under the standards of conduct for practice before the Service and certain penalty provisions of the Internal Revenue Code.

A. Legal Ethics Rules:

Under the Model Rules of Professional Conduct (“MRPC”) a lawyer is generally proscribed from committing or assisting in fraudulent conduct.\(^\text{107}\)

1. **MRPC Rule 1.2(d).**

   A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.

2. **MRPC Rule 1.6(b)(2).**

   A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary . . . to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer’s services . . .

3. **MRPC Rule 1.6(b)(3).**

   A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary . . . to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client’s

\(^\text{107}\) Fraud is defined in MRPC Rule 1.0 (d) “‘Fraud’ or ‘fraudulent’ denotes conduct that is fraudulent under the substantive or procedural law of the applicable jurisdiction and has a purpose to deceive.”
commission of a crime or fraud in furtherance of which the client has used the lawyer’s services . . .

4. MRPC Rule 3.3(a)(3)
   A lawyer shall not knowingly . . . offer evidence that the lawyer knows to be false. If a lawyer, the lawyer’s client, or a witness called by the lawyer, has offered material evidence and the lawyer comes to know of its falsity, the lawyer shall take reasonable remedial measures, including, if necessary, disclosure to the tribunal. A lawyer may refuse to offer evidence, other than the testimony of a defendant in a criminal matter, that the lawyer reasonably believes is false.

5. MRPC Rule 3.4(b)
   A lawyer shall not . . . falsify evidence, counsel or assist a witness to testify falsely . .

6. MRPC Rule 4.1(a)
   In the course of representing a client a lawyer shall not knowingly . . . make a false statement of material fact or law to a third person.

7. MRPC Rule 8.4(c) and (d)
   It is professional misconduct for a lawyer to . . . commit a criminal act that reflects adversely on the lawyer’s honesty, trustworthiness or fitness as a lawyer in other respects; [or] engage in conduct involving dishonesty, fraud, deceit or misrepresentation . . .

B. Circular 230.
   United States Treasury Department Circular 230—Regulations Governing the Practice of Attorneys [and others] before the Internal Revenue Service imposes standards of conduct and penalties on those practicing before the Service. If a lawyer has a potential problem under the applicable rules corresponding to MRPC Rule 1.2(d) or Rule 4.1(a) in the lawyer’s practice location arising of representing a client before the IRS, the lawyer likely will also have a potential problem under Circular 230. However, a lawyer should not assume that if the lawyer has no problem under such rules the lawyer has no problem under Circular 230.

   Circular 230 § 10.2(a)(4) defines “Practice before the Internal Revenue Service” as “all matters connected with a presentation to the Internal Revenue Service or any of its officers or
employees relating to a taxpayer’s rights, privileges, or liabilities under laws or regulations administered by the Internal Revenue Service. Such presentations include, but are not limited to, preparing and filing documents, corresponding and communicating with the Internal Revenue Service, rendering written advice with respect to any entity, transaction, plan or arrangement, or other plan or arrangement having a potential for tax avoidance or evasion, and representing a client at conferences, hearings and meetings.”

Circular 230 § 10.34 prohibits assisting clients with “frivolous” positions.

Circular 230 § 10.26 prohibits an attorney from acting as a notary with respect to “any matter administered by the Internal Revenue Service” and for which the attorney is employed as an attorney or in which the attorney “may in any way be interested.”

Circular 230 in section 10.29 contains a conflict of interest rule that is essentially the same as MRPC Rule 1.7 except that under Circular 230 the informed consent of each affected client must be confirmed in writing by each such client within a reasonable period not to exceed 30 days, and the writing must be kept for 36 months after conclusion of the representation. The conflicts rule in Circular 230 is also different from the current conflicts rules of certain states, such as Texas, that have not yet adopted the most recent amendments to Model Rule 1.07 (which amendments included, for example, eliminating the concept of the lawyer acting as intermediary but subsuming that concept under the general rule of 1.07).

A lawyer cannot use the assistance of another person who has been suspended under Circular 230 and cannot assist or accept assistance from anyone who obtains clients in violation of Circular 230’s solicitation rules. Circular 230 §§ 10.24, 10.30. Among the other sections of Circular 230 that might apply are:

1. Section 10.21 (knowledge of client’s omission).
2. Section 10.22 (diligence as to accuracy).
3. Section 10.33 (best practices, including evaluating reasonableness of representations).
4. Section 10.37 (written advice and unreasonable factual representations).

C. Tax Penalty Provisions

There are no tax penalties applicable to temporal modifications per se; the penalties are applicable to fraud and negligence with respect to misrepresentation or misreporting of tax
matters. That being said, both the taxpayer and the advisor are at risk with regard to an ever-growing collection of penalties.\textsuperscript{108}

1. **Civil Penalties.**
   a) IRC § 6662 (accuracy-related penalty).
   b) IRC § 6662A (accuracy-related penalty with respect to reportable transactions; defined in IRC 6707A(c)).
   c) IRC § 6663 (fraud)
   d) IRC § 6701 (aiding and abetting understatement of tax liability).
   e) IRC § 6694 (return preparer penalties).

2. **Criminal Penalties.**
   a) 18 U.S.C. § 371 (conspiracy)
   b) IRC § 7201 (attempt to evade or defeat tax).
   c) IRC § 7206 (fraud and false statements).
   d) IRC § 7207 (fraudulent returns, statements, or other documents).

VII. **Fundamental Rules**

1. **Don’t lie.**

   Not only is it morally, ethically, and legally wrong, but in an era of E-mail and electronic documents that last forever, the lie will get caught. If you can’t do it legally, don’t do it.

2. **Don’t mislead.**

   If you can attain the result you are trying to legally, you shouldn’t need to mislead. Remember the lesson of Watergate.

3. **Understand the legal consequences of the action.**

   Analyze the consequences of the action if rather than changing the deal nunc pro tunc, it is treated as a new taxable transaction. As with any transaction having tax or economic significance, you should understand and counsel on the stakes and likelihood of the modification’s not being respected.

4. **Understand the available legal processes.**

   Both tax and state laws have become increasingly accommodating of changes. State laws often allow the retroactive correction of documents (if there was a mistake at the outset) and the

\textsuperscript{108} The multifarious penalties attendant to underpayments, fraud, and negligence continue to grow with each successive tax act. See, e.g., the new penalty for violation of the economic substance doctrine discussed at Section V. B. 1.
curing of such problems as inadvertent dissolutions. The fallibility and changing nature of deals is also recognized in IRC § 761(c). In particular, understand agency and contract law.
Example 1

- Allen and Bob agree to form Partnership and contribute property to the Partnership.
- The deed conveying the property is executed on 3/1/2014 and recorded on 3/15/2014.
- After extensive negotiation, Allen and Bob agree to an allocation of profits and losses between them on 1/10/2015.
- On 5/1/2015, Allen and Bob execute a partnership agreement reflecting their agreement.
- The Partnership Agreement states that it is executed, alternatively:
  - As of 1/1/2014
  - 1/1/2014
Example 2

- Bob, a partner in Partnership receives a check for $100 distribution from Partnership 7/31/14.
- Bob’s outside basis at 12/31/2014 (Partnership’s year-end) is $50 (without giving effect to the $100 distribution).
- On a date after 7/31/14, Crafty, Bob’s lawyer, suggests that he treat the $100 distribution as a loan. Bob executes and delivers to Partnership a promissory note dated “as of” 7/31/14.
Example 3

- Bob becomes a partner in existing Partnership on June 1, 2014 receiving his 10% partnership interest in exchange for services performed for the Partnership.

- On January 15, 2015, Crafty advises Bob and Partnership that if Bob’s partnership interest were a “profits interest,” Bob would not have income.

- The amendment of Partnership’s partnership agreement is drafted and signed on February 15, 2015 effective as of June 1, 2014, reflecting Bob’s partnership interest as a “profits interest” as defined in Rev. Proc. 93-27.

- Is the answer different, if the intent on June 1, 2014 were that Bob’s interest would include 10% of the Partnership’s capital at June 1, 2014?