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The Rescission Doctrine: Everything Old is New Again

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THE RESCISSION DOCTRINE: EVERYTHING OLD IS NEW AGAIN

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This paper considers rescissions—attempts by parties to undo a transaction and have that undoing respected for federal tax purposes. Some commentators have questioned the legal basis for the rescission doctrine as applied by the Internal Revenue Service, and others have argued for expansion or restriction of the doctrine. This paper traces the development of the rescission doctrine, examines a critical article that argues that there is no legal precedent that truly supports the rescission doctrine as it is currently applied by the Internal Revenue Service, considers whether there exists sufficient legal authority for the doctrine as applied by the Internal Service, and briefly considers alternatives.

Current Internal Revenue Service Position

Since 1980, the Internal Revenue Service has approved rescission treatment for certain transactions that unwind earlier transactions. Rev. Rul. 80-58\(^1\) considers two situations:

In Situation 1, in February 1978, A, a calendar year taxpayer, sold a tract of land to B and received cash for the entire purchase price. The contract of sale obligated A, at the request of B, to accept reconveyance of the land from B if at any time within nine months of the date of sale, B was unable to have the land rezoned. In October 1978, B determined that it was not possible to have the land rezoned and notified A of its intention to reconvey the land pursuant to the terms of the contract of sale. B reconveyed the land to A during October 1978, and B received back all amounts expended in connection with the transaction.

Situation 2 was the same as Situation 1 except that the period within which B could reconvey the land to A was one year. In January 1979, B determined that it was not possible to have the land rezoned and notified A of its intention to reconvey the land pursuant to the terms of the contract of sale. B reconveyed the land to A during February 1979, and B received back all amounts expended in connection with the transaction.

Rev. Rul. 80-58 explained its holdings as follows:

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

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\(^1\) 1980-1 C. B 181.
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.

The annual accounting concept requires that one must look at the transaction on an annual basis using the facts as they exist at the end of the year. That is, each taxable year is a separate unit for tax accounting purposes. See Security Flour Mills Co. v. Commissioner, 321 U.S. 281, 88 L. Ed. 725, 64 S. Ct. 596, 1944-1 C.B. 526 (1944), Ct. D. 1603, 1944 C.B. 526.

In Penn v. Robertson, 115 F.2d 167 (4th Cir. 1940), the taxpayer was a participant in an employees' stock benefit fund created by the directors of the company without the approval of the shareholders. Under the plan the taxpayer was credited with earnings from the fund for the years 1930 and 1931. In 1931, as a result of suits filed by a shareholder, the directors of the company passed a resolution whereby the plan would be rescinded as to all participants in the plan who agreed to relinquish their previous credits and rights. The United States Court of Appeals held that although the plan was rescinded for 1930, the annual accounting period principle required the determination of income at the close of the taxable year without regard to subsequent events. That is, the rescission in 1931 was disregarded for purposes of determining 1930 taxable income. With regard to whether the 1931 income should be taxed, the Court of Appeals said in the Penn case that the rescission in 1931 extinguished what otherwise would have been taxable income for that year.

The facts of the Penn case are similar to those in Situation 1 and Situation 2. In Penn, earnings were credited in 1930 and 1931 and there was a rescission in 1931 (that was intended to affect both years). Situation 1 relates to the earnings credited in 1931, the year of the rescission; and Situation 2 relates to the earnings credited in 1930, that is, a year different from the year of the rescission.

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. See Rev. Rul. 74-501, 1974-2 C.B. 98, which holds that there is no adjustment to the basis of the old stock where a shareholder exercised stock rights and paid the subscription price for the new stock, which subscription price was later returned to the shareholder in the same taxable year in which the rights were issued because the market price of the stock had depreciated to a price below the subscription offer.

In Situation 2, as in Situation 1, there was a completed sale in 1978. However, unlike Situation 1, because only the sale and not the rescission occurred in 1978,
at the end of 1978 A and B were not in the same positions as they were prior to the sale. Again, in light of the *Penn* case, the rescission in 1979 is disregarded with respect to the taxable events occurring in 1978.

In both situations, the annual accounting period principle requires the determination of income at the close of the taxable year without regard to subsequent events.

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.

The PLR 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.\(^2\) The second condition, that the restoration be

\(^2\) 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. Also see PLR 2009520036 in which a partnership converted to a corporation and, upon learning that the business purpose it had thought it would achieve if it were a corporation would not be realized, the corporation converted to a limited liability company. The corporation converted to a limited liability company because of a change in the state’s franchise tax that caused partnerships no longer to enjoy an advantage over limited liability companies. Both conversions occurred in the
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. Interestingly, in Rev. Rul. 80-58, the IRS stated that taxpayer A was a calendar year taxpayer, but made no statement about the tax year of taxpayer B.

Note that Rev. Rul. 80-58 states that “rescission refers to…or voiding of a contract.” The IRS apparently does not apply the rescission doctrine 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. 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. In PLR 2009520036, the Service 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.”

More recently, for 2012 and 2013, “whether a completed transaction can be rescinded for Federal income tax purposes” was listed as one of the issues under study for which rulings will not be issued until the IRS resolves the issue through publication of a revenue ruling, a revenue
procedure, regulations or otherwise. Rev. Procs. 2012-3, 2013-3. Rescissions are not so listed in Rev. Proc. 2014-3, but in late June 2013, William Alexander, IRS associate chief counsel (corporate), announced that the Service was abandoning the guidance project and that the no-ruling policy would stay in place:

We’ve put a lot of time, effort, thought into looking at all sorts of aspects of the rescission doctrine—its history, its fingerprints, its scope, its relationship to other similar phenomena in the [C]ode . . . . And at the end of this, it appears that where we’re going to wind up is where we are now. And so I would expect that Rev. Rul. 80-58 [1980-1 C. B. 181] will be the Service’s guidance on the subject for the indefinite future, that rescission will remain a no-rule area for the indefinite future, and that next year’s guidance plan will not show a project on the topic.7

Development of the Annual Accounting Concept

Rev. Rul. 80-58’s rationale included its statement that “the annual accounting concept requires that one must look at the transaction on an annual basis using the facts as they exist at the end of the year.” The annual accounting concept developed from the very first after the adoption of the Sixteenth Amendment to the United States Constitution in 1913.8 In Burnet v. Sanford & Brooks Company,9 the taxpayer operated a dredging business and during the years 1913 to 1915 acted as a subcontractor for another company that had a contract with the United States for dredging the Delaware River. On its income tax returns for 1913-1916, taxpayer included for each year the payments received under its subcontract and deducted the expenses it paid each year in performing under the subcontract. The taxpayer reported net income for 1914, but the other returns reported net losses.10

Difficulties arose in the dredging work, and the prime contractor successfully sued the United States for breach of warranty of the character of the material to be dredged. From the prime contractor’s recovery, the taxpayer in 1920 received $192,577.59, representing the $176,271.88 by which taxpayer’s expenses under the contract had exceeded its receipts, plus $16,305.71 of accrued interest. Taxpayer did not report the $192,577.59 it received in 1920 for tax purposes, and in its argument before the Court asserted that the Sixteenth Amendment and

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8 “The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.”
9 282 U. S. 359 (1931).
10 282 U. S. at 361.
the Revenue Act of 1918 plainly contemplated tax only on net income or profits and could not be applied to tax a transaction from which the taxpayer realized no profit.11

The Court noted that even if taxpayer’s contention was accepted, “the question remains whether the gain or profit which is the subject of the tax may be ascertained, as here, on the basis of fixed accounting periods, or whether, as pressed upon us, it can only be net profit ascertained on the basis of particular transactions of the taxpayer when they are brought to a conclusion.”12

The Court rejected the taxpayer’s contention with observations that have become part of tax lore:

“All revenue acts which have been enacted since the adoption of the Sixteenth Amendment have uniformly assessed the tax on the basis of annual returns showing the net result of all the taxpayer’s transactions during a fixed accounting period, either the calendar year, or, at the option of the taxpayer, the particular fiscal year which he may adopt.”13

“A taxpayer may be in receipt of net income in one year and not in another, The net result of the two years, if combined in a single taxable period, might still be a loss; but it has never been supposed that that fact would relieve him from a tax on the first, or that it affords any reason for postponing the assessment of the tax until the end of a lifetime, or for some other indefinite period, to ascertain more precisely whether the final outcome of the period, or of a given transaction, will be a gain or a loss.”14

“The Sixteenth Amendment was adopted to enable the government to raise revenue by taxation. It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation.”15

*In Security Flour Mills Co. v. Commissioner,*16 the Court cited and quoted from *Burnet v. Sanford & Brooks Company* in holding that Security Flour Mills Co. could not deduct on its income tax return for 1935 payments made by it in 1936, 1937, and 1938. In 1953, the Court again cited *Burnet v. Sanford & Brooks Company* in holding that an individual taxpayer was not

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11 282 U. S. at 361-362.
12 282 U. S. at 362-363.
13 282 U. S. at 363.
14 282 U. S. at 365.
15 Id.
entitled to reduce his salary compensation received in one year because of repayment of a portion of the salary in a later year.\textsuperscript{17}

The Internal Revenue Code now contains exceptions to the annual accounting concept, such as installment sale treatment\textsuperscript{18} and the percentage of completion method of reporting for certain contracts that will not be completed in the year in which entered into.\textsuperscript{19} In addition, the Internal Revenue Code affords other relief, such as the deduction for carrybacks and carryovers of net operating losses,\textsuperscript{20} averaging of income from farming and fishing operations,\textsuperscript{21} mitigation of limitations,\textsuperscript{22} and special computation of tax when a taxpayer restores more than $3,000 held under a claim of right.\textsuperscript{23} Apart from special rules like these, the annual accounting concept remains fundamental to the income tax system in the United States.\textsuperscript{24}

\textit{Suggestions for Improvement and Alternatives}

Commentators and the Tax Section of the New York State Bar Association have looked at the rescission doctrine as it has developed and been applied by the courts and the IRS. On August 11, 2010, the New York State Bar Association Tax Section submitted a report (the “NYSBA Report”).\textsuperscript{25} 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

\textsuperscript{17} \textit{Healy v. Commissioner}, 345 U. S. 278, 284 (1953), stating “Congress has enacted an annual accounting system under which income is counted up at the end of each year.”

\textsuperscript{18} I. R. C. § 453.

\textsuperscript{19} I. R. C. § 460.

\textsuperscript{20} I. R. C. § 172.

\textsuperscript{21} I. R. C § 1301.

\textsuperscript{22} I. R. C. §§ 1311-1314.

\textsuperscript{23} I. R. C. § 1341.

\textsuperscript{24} See, Treas. Reg. § 1.441-1(b)(3): “Annual accounting period means the annual period (calendar year or fiscal year) on the basis of which the taxpayer regularly computes its income in keeping its books.”

additional payments in the course of an “unwind” might have in this regard; defining the same taxable year requirement in the event 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.

In addition to the clarifying recommendations made by the NYSBR, notwithstanding the annual accounting principle, it has been 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. In addition, and sometimes in the alternative, commentators have argued that validity of a rescission should not depend on whether it fails within the same taxable

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26 Note 25, supra, and accompanying text.
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.  

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].

However one views the policy merits of this argument, in light of the Court cases discussed above under Development of the Annual Accounting Concept, relaxation of the same-year rule for rescission treatment would appear to require Congressional action. On the other hand, restricting rescission treatment to unwindings that are carried out because “the mistake or error giving rise to it is justified” would likely be at least as fact-driven as are determinations whether, for example, compensation is reasonable. As explained below, this paper takes the position that the annual accounting concept provides ample legal justification for the rescission doctrine as articulated by Rev. Rul. 80-58. The annual accounting concept promotes simplicity by providing a bright-line limitation on rescission treatment.

Recent Critique of Rescission Doctrine

28 Id. at 943-44 (footnote omitted).
In Rev. Rul. 80-58, the Internal Revenue Service based its analysis in part on Penn v. Robertson, stating that "the facts of the Penn case are similar to those in Situation 1 and Situation 2." Two commentators have mounted an attack on Rev. Rul. 80-58 and the rescission doctrine as currently articulated by Rev. Rul. 80-58. In "The Fabricated Unwind Doctrine: The True Meaning of Penn v. Robertson" (hereinafter, "Fabricated Doctrine"), John Prebble and Chye-Ching Huang assert that the entire rescission analysis in Rev. Rul. 80-58 lacks any real basis in precedent, that the rescission doctrine is a "fabrication" by the Internal Revenue Service, that the Internal Revenue Service, practitioners, and academic commentators have all misunderstood Penn v. Robertson, and that the case, as analyzed by them, 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 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. At its conclusion, Fabricated Doctrine recommends that Rev. Rul. 80-58 be revoked and offers scant comfort to taxpayers who might be disadvantaged thereby. This article demonstrates that the authors of Fabricated Doctrine have completely misread Penn v. Robertson, that their conclusions should be ignored on that basis alone, but that Penn v. Robertson in fact provides ample legal support for the rescission doctrine as announced in Rev. Rul. 80-58. Moreover, this paper argues that, even

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29 Note 1, supra, and accompanying text.
31 Note 1, supra, and accompanying text.
33 John Prebble is a Professor of Law at the Victoria University of Wellington School of Law and a Senior Fellow, Taxation Law and Policy Research Institute, Monash University, Melbourne.
34 Chye-Ching Huang, according to Fabricated Doctrine, is a Senior Lecturer in Commercial Law, University of Auckland. Apparently, she has since taken a position as a tax policy analyst with the Federal Fiscal Policy Team of the Center on Budget and Policy Priorities in Washington, D. C.
35 Fabricated Doctrine, note 32, supra, at 119.
36 Professor Prebble and Ms. Huang have also written a shorter piece, based in part on an earlier version of Fabricated Doctrine. John Prebble and Chye-Ching Huang, “The Rescission Doctrine: Clothes Without an Emperor?”, Special Report, Tax Analysts Tax Notes Today (May 16, 2011) (hereafter referred to as “Tax Notes Paper”). Some of the material in the Tax Notes Paper now appears in the current version of Fabricated Doctrine. This paper discusses only the current version of Fabricated Doctrine.
37 Fabricated Doctrine, note 32, supra, at 163.
if *Penn v. Robertson* had never been decided, the annual accounting concept provides an ample legal and policy basis for Rev. Rul. 80-58. The annual accounting concept is a fundamental principle of United States income tax law established by the United States Supreme Court in the cases discussed above under Development of the Annual Accounting Concept. Rev. Rul. 80-58 cites the annual accounting concept as one of the two grounds (*Penn v. Robertson* being the other) for its holdings.\(^{38}\)

Fabricated Doctrine begins its analysis by making the following statements:

Taxpayers routinely rely on the unwind doctrine found in Internal Revenue Service Revenue Ruling 80-58 when they discover that their transactions have unwanted tax consequences. Nowadays, “unwinding” has become a “common if not ubiquitous feature of tax practice.” This article finds that the unwind doctrine has no firm basis in case law. Instead, the unwind doctrine is an Internal Revenue Service (IRS) fabrication based on the IRS’ misinterpretation of the case *Penn v. Robertson*.

Also referred to as the “rescission doctrine,” a tax “do-over,” or a “tax mulligan,” the effect of the unwind doctrine is that if you change your mind about a transaction, you can avoid its income tax consequences by returning to the economic status quo ante, so long as you do so by the end of the tax year.

... The Internal Revenue Code, Treasury Regulations, case law, and IRS rulings do not refer to any unwind doctrine or rescission doctrine by name.\(^{39}\)

The IRS has allowed taxpayers to use unwind treatment to erase from tax history not only tax effects, such as the derivation of income from a sale of property but also tax effects such as changes in entity status, the liquidation of a company, and a company’s exit from a consolidated group. It has allowed unwind treatment when the economic reversal was motivated by changes in business conditions, and also in circumstances where the reversal was motivated by tax outcomes that the parties later came to regret. It has allowed unwind treatment not only when the unwind was legally connected with the original transaction, such as a contractual payment rescinded for mistake, but also where the two transactions were legally independent, such as when two parties voluntarily reached a fresh agreement to reverse the economic effects of a completed and legally independent transaction.\(^{40}\)

The unwind doctrine is attractive to taxpayers because they can use it to achieve better tax results than would otherwise be possible. Transactions that cancel each other’s economic effects will not necessarily—absent the unwind doctrine—have tax effects that also cancel each other. For example, a taxpayer might derive

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\(^{38}\) Note 1, supra, and accompanying text.

\(^{39}\) Fabricated Doctrine, note 32, supra, at 117-118. (footnotes omitted)

\(^{40}\) Id. at 118.
taxable income, but then pay that amount back later in the year. Without the unwind doctrine, the outgoing in the second transaction will offset the tax effect of the first only if it is deductible in its own right. If the outgoing is not deductible in its own right, the taxpayer will owe tax as a result of the two transactions, even though she has economically returned to the status quo ante. By contrast, under the unwind doctrine, both transactions would be treated as if they had never occurred, regardless of whether the second outgoing is deductible.41

Just in these few statements, Fabricated Doctrine advances questionable positions. Although this author has not tried to undertake (or even see if it is possible) to determine the frequency of taxpayers’ use of rescission, a West Law search did disclose only two private letter rulings since 2012 dealing with rescissions.42 Thus, it appears questionable whether the authors have objective evidence that the use of rescissions is routine, common, or ubiquitous. On the other hand, anecdotal evidence suggests that taxpayers and their advisors are comfortable enough with the rescission doctrine that they are willing to undertake plain vanilla rescissions without seeking a private letter ruling. For example, if one party has sold real estate to another and within the same taxable year, either because a condition in the contract has not been satisfied, or by mutual agreement because of economic changes, the parties unwind the transaction, with the buyer conveying the real estate back to the seller and the seller returning the purchase price to the buyer, many if not most experienced tax practitioners would be comfortable advising the parties that it would be appropriate to take a return position that this was a valid rescission, i.e., the transaction would not be reported on either party’s return for the applicable year. Fabricated Doctrine also implies that these “routine” rescission transactions are undertaken only when taxpayers “discover that their transactions have unwanted tax consequences”43 and the effect of the availability of rescissions is that “if you change your mind about a transaction, you can avoid its income tax consequences by returning to the status quo ante, so long as you do so by the end of the tax year.”44 Contrary to Fabricated Doctrine, many private letter rulings45 describe situations where the parties entered into a rescission transaction for what appear to be substantial business reasons. Moreover, saying that one can rescind a transaction for tax purposes upon a

41 Id. at 118-119.
42 This is unsurprising in light of the developments discussed earlier at note 7, supra, and accompanying text.
43 Fabricated Doctrine, note 32, supra, at 117.
44 Id. at 117-118.
45 See, e.g., PLR 2009520036, supra, note 2.
change of mind about a transaction is a correct statement only if the authors of Fabricated Doctrine are using the word “you” as a plural noun. That is, in the situations described in Rev. Rul. 80-58, there was a sale by one party to another pursuant to a contract that allowed the buyer to rescind if desired zoning was not achieved. The sales were rescinded only because both parties had agreed to do so in their original contracts. However, Rev. Rul. 80-58 states that another way in which a valid rescission may occur is by mutual agreement. Presumably, this mutual agreement to rescind may occur after the initial sale and does not have to be included in the original contract. If A sells Blackacre to B in January, 2014, and B decides in July 2014 that he doesn’t like Blackacre and wishes he’d never bought it, there’s nothing he can do if A responds negatively to B’s request to rescind the sale. If B has grounds for alleging that A defrauded him, he might bring a suit for rescission, but even if he is successful and obtains a judgment that the sale, because fraudulently induced, was void ab initio, he may not receive rescission treatment for federal tax purposes if the court ordered rescission does not occur in 2014.

As discussed above, Rev. Rul. 80-58 contains this statement:

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.

So far as the authors of Fabricated Doctrine are concerned, this does not amount to a reference to the “rescission doctrine” by name. Would they have thought differently if the ruling had stated “The legal concept of the rescission doctrine…”? Perhaps not, as they assert, although without citing any authority, that “commentators coined the appellation.” Is not Rev. Rul. 80-58 in fact a statement of a rescission doctrine, at least as to Situation 1, in which the rescission took place in the same taxable year as the original sale?

46 Fabricated Doctrine, note 32, supra, at 117.
47 Banoff, supra note 30 at 967-68 discusses the rare instances, all involving adversarial court action, in which an original transaction has been declared void ab initio and rescission treatment allowed for an unwinding in one year of a transaction that occurred in a prior year.
48 Note 1, supra, and accompanying text.
49 Fabricated Doctrine, note 32, supra, at 118.
50 Id.
Fabricated Doctrine’s litany of situations in which the IRS has approved rescission treatment\(^{51}\) is apparently an attempt to show from a policy standpoint that the rescission treatment allowed by Rev. Rul. 80-58 is overbroad. It is difficult to be sure what the point is, because Fabricated Doctrine does not offer any analysis other than its statements quoted above\(^{52}\) to the effect that, absent the rescission treatment allowed by Rev. Rul. 80-58, “transactions that cancel each other’s economic effects will not necessarily … have tax effects that also cancel each other.” Saying that taxpayers have better results under Rev. Rul. 80-58 that they would have in its absence does not seem to an argument against the validity of the ruling. To illustrate its point, Fabricated Doctrine states: “For example, a taxpayer might derive taxable income, but then pay that amount back later in the year. Without the unwind doctrine, the outgoing in the second transaction will offset the tax effect of the first only if it is deductible in its own right.”\(^{53}\) This statement by Fabricated Doctrine ignores authorities discussed later in this paper\(^{54}\) that would allow a taxpayer who receives income and repays later in the same year to exclude the repaid amount from the taxpayer’s reportable taxable income—authorities that do not rely on Rev. Rul. 80-58.

More importantly, the authors of Fabricated Doctrine do not recognize the importance of the annual accounting concept in federal tax law and its importance from a policy point of allowing rescission treatment for tax purposes if the unwinding transaction takes place in the same taxable year as the original transaction and also as acting as a brake on rescission treatment for tax purposes by not allowing such treatment if the unwinding transaction takes place in a taxable year subsequent to the taxable year of the original transaction.

The Supreme Court explained the annual accounting concept as follows:

Congress has enacted an annual accounting system under which *income is counted up at the end of each year*. It would be disruptive of an orderly collection of the revenue to rule that the accounting must be done over again to reflect events occurring after the year for which the accounting is made.\(^{55}\)

Rev. Rul. 80-58 states a similar view in explaining the rationale for its holdings:

\(^{51}\) Note 40, *supra*, and accompanying text.
\(^{52}\) Note 41, *supra*, and accompanying text.
\(^{53}\) Fabricated Doctrine, note 32, *supra*, at 118. (emphasis in original)
\(^{54}\) Notes 134-140, *infra*, and accompanying text.
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*.\(^5\)

If a taxpayer’s income is to be determined each year by “counting [it] up at the end of the year” and “using the facts as they exist at the end of the year,” then why would one not think rescission treatment appropriate for tax purpose if the original transaction and the unwinding transaction both take place in the same year?

Fabricated Doctrine does not analyze the applicability of the annual accounting concept or, indeed, even mention it.\(^5\) Fabricated Doctrine nowhere notes that the annual accounting concept was one of the two grounds (*Penn v. Robertson* being the other) cited by the Internal Revenue Service for its holdings in Rev. Rul. 80-58. Fabricated Doctrine’s failure to analyze the applicability of the annual accounting concept may explain why it ignored authorities discussed later in this paper\(^5\) that would allow a taxpayer who receives income and repays later in the same year to exclude the repaid amount from the taxpayer’s reportable taxable income—authorities that do not rely on Rev. Rul. 80-58.

Fabricated Doctrine analyzes *Penn v. Robertson* by attempting to show that the court applied only a deduction rationale in the analysis that led to its holding. Fabricated Doctrine then takes a detour to examine the potential tax results of voluntary repayment of a bonus in the same year as receipt of the bonus, but its analysis is flawed because it assumes deductibility of the bonus and fails to discuss relevant authorities suggesting that the taxpayer would get to exclude (not deduct) the bonus from income if the taxpayer repays the bonus in the year of receipt. Fabricated Doctrine then applies this flawed analysis to argue that the taxpayer might be afforded rescission treatment under Rev. Rul. 80-58 because of the repayment even though it is unlikely that Rev. Rul. 80-58 would be applicable.\(^5\) This is another instance in Fabricated Doctrine where the authors describe allegedly likely or possible results of the rescission doctrine

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57 Fabricated Doctrine at page 164 does refer to the “tax year accounting principle in *Saunders v. Commissioner*.” The reference to *Saunders* is to *Saunders v. Commissioner*, 101 F. 2nd 407 (10th Cir. 1939). Saunders is a very short opinion in a claim of right case and does not mention a “tax year accounting principle” or any other accounting principle or concept.
58 Notes 132-149, *infra*, and accompanying text.
of Rev. Rul. 80-58 in apparent attempts to demonstrate that Rev. Rul. 80-58 leads to inappropriate results.60

Fabricated Doctrine’s Analysis of Penn v. Robertson

Fabricated Doctrine states that it has undertaken a close reading of Penn v. Robertson, and found no support in that case for the unwind doctrine ascribed to it:61

This article examines Penn v. Robertson closely in order to determine its ratio. We find that Penn v. Robertson is not in fact authority for the unwind doctrine. The IRS in Rev. Rul. 80-58 made two mistakes in interpreting Penn v. Robertson.62

First, the IRS mistakenly understood Penn as treating two transactions within the same tax year, which returned the parties to the economic status quo, as having never occurred. In fact, Penn v. Robertson simply allowed taxable income derived in a year to be offset by a deduction generated later in the same tax year. Penn v. Robertson does not sanction ignoring two economically canceling transactions, nor does it transform an outgoing that is not deductible in its own right, into a deductible expense.63

The second mistake that the IRS made in Rev. Rul. 80-58 was to appear to extend unwind treatment to cases where the second (unwind) transaction has no legal connection to the first, rather than restricting it to cases of true rescissions, that is where the second transaction is legally connected to the first.64

These mistakes came about because Revenue Ruling 80-57[sic] and subsequent private letter rulings made the classic error of confusing the timing question of when a particular outgoing is deductible with the substantive question of whether the outgoing is deductible at all.65

Penn v. Robertson was a “when” case. The issue was whether a certain outgoing, undeniably deductible in its own right if incurred by the taxpayer, should be taken into account for tax purposes in period one (when the taxpayer Penn was alive) or in period two (after Penn’s death). Penn v. Robertson is authority for the ordinary proposition that an allowable deduction can offset a taxable gain when both the gain and deduction occur in the same tax year. It is authority that such an offset can occur even when the (deceased) taxpayer’s executor undertakes the transaction that gives rise to the deductible outgoing. However, it is not authority that two economically self-cancelling transactions should be treated as

60 The quote from Fabricated Doctrine at note 40, supra, being another.
61 Fabricated Doctrine, note 32, supra, at 127-128.
62 Id.
63 Id.
64 Id.
65 Fabricated Doctrine, note 32, supra, at 119-120.
extinguishing each other for tax purposes, as if for income tax purposes neither transaction had occurred. Nor is it authority that a transaction should be treated as deductible solely on the basis that it reverses the economic effect of an earlier transaction in which taxable income was derived.

The IRS’ misinterpretation of *Penn v. Robertson* does not generally matter for practical purposes (although it is incorrect in law) in cases where the unwind transaction is also a true rescission. At least in most cases, when a taxpayer derives taxable income under a contract, then rescinds the contract, that rescission will inevitably give rise to an allowable deduction in its own right. The outgoing (repayment) in the second transaction is legally related to the first outgoing, so the repayment will necessarily relate to the taxpayer’s income-earning process, which is a touchstone of deductibility. Ordinary principles of tax law operate to allow the deduction to offset the taxable gain if the two transactions occur in the same tax year. The result will be no net tax to pay on the rescinded contract, the same outcome reached under the unwind doctrine that treats the two transactions as having never occurred.

Fabricated Doctrine defines “true rescissions” as “that category of unwinds [any transaction that places the parties in the economic status quo ante economically] [sic] in which the unwind transaction has some legal connection to the original transaction that it undoes the economic effect of. True rescissions include both judicially imposed rescissions and unwinds conducted to vindicate a legal claim embedded in the original agreement between the parties.” Any “transactions that simply reverse the economic effect of an earlier transaction, but which are not legally connected to the relevant earlier transaction” are referred to by Fabricated Doctrine as “reversals.”

As noted above, Fabricated Doctrine asserts that Rev. Rul. 80-58’s incorrectness (in its view) doesn’t generally matter practically in the case of a true rescission. Fabricated Doctrine also views Situation 1 in Rev. Rul. 80-58 as a “true rescission” because the unwinding was “conducted pursuant to a legal right embedded in the original agreement.” At several points, Fabricated Doctrine asserts that it doesn’t matter much whether a transaction like the one in Situation 1 of Rev. Rul. 80-58 is treated as a rescission because “at least in most cases, when a

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66 Actually, that’s not exactly what Rev. Rul. 80-58 says happens. As to Situation 1, Rev. Rul. 80-58 states that “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.” Note 1, *supra*, and accompanying text.
67 Fabricated Doctrine, note 32, *supra*, at 120.
68 Id.
69 Id. at 141 and Note 88.
70 Id. at 143.
71 Id. at 142.
taxpayer derives taxable income under a contract, then rescinds the contract, that rescission will inevitably give rise to an allowable deduction in its own right. Ordinary principles of tax law operate to allow the deduction to offset the taxable gain if the two transactions occur in the same year.\(^7_2\)

If we examine Fabricated Doctrine’s assumptions in light of the income tax results that likely would apply to the parties in Situation 1 of Rev. Rul. 80-58 if that transaction was not treated as a rescission, we see that the “doesn’t matter much” approach is incorrect. In Situation 1, A sells a tract of land to B in February, 1978, and receives the full purchase price at closing. If we view this sale without regard to the later unwinding, A has a gain or loss equal to the amount by which the purchase price exceeds or is less than A’s basis in the property sold. Unless A is considered to be a dealer in real estate, the gain or loss will be a capital gain or loss—long or short-term depending on A’s holding period. B has a basis in the land equal to the purchase price paid by B. When, in October, 1978, B conveys the property back to A, if the reconveyance is treated independently for tax purposes and does not cause the February sale to be disregarded for tax purposes, A gets the land back with a new basis equal to the purchase price A returns to B, and B has no gain or loss because he had a basis in the land equal to the purchase price he paid to A in February—assuming that the tract of land was just land and didn’t include any depreciable or amortizable assets. If the conveyance back to A does not cause the sale in February to be disregarded for tax purposes, what is there in the conveyance back transaction that will give rise to a deduction to A to offset A’s capital gain from the sale in February? There is nothing—accordingly, it matters greatly to A whether Rev. Rul. 80-58 is correct.

Fabricated Doctrine continues:

The theme of the following sections is that the holdings in *Penn v. Robertson* were wholly concerned with matters of timing, not with matters of substantive deductibility. (In later sections, we explain how the IRS and commentators have erroneously misinterpreted *Penn v. Robertson* by taking the case to relate not only to timing but also to substantive deductibility.)\(^7_3\)

*All parties*, and the Court of Appeals, agreed, and proceeded on the assumption that the outgoings that were at issue were deductible in their own right as a matter of substance. The issue in the case related to timing:

\(^{72}\) *Id.* at 120. Similar assertions are made at 142.

\(^{73}\) *Id.* at 127.
in which tax year were those outgoings deductible? And, in respect of one outgoing, incurred in 1931, was the outgoing deductible by Mr. Penn, the taxpayer (who died during 1931), or by his executors?74

Let’s take a look at the assertion that “all parties, and the Court of Appeals, agreed that the outgoings were deductible.” The court in *Penn v. Robertson* framed the case as follows:

The Government’s present contention is (1) that all the credits on Penn's note, both for dividends and share of profits, were taxable income in the years in which they were respectively credited because received by him under a claim of right and without restriction as to their disposition, and (2) as the year 1931, the rescission of the transaction voluntarily made by Penn's executors after his death, although in 1931, could not properly affect Penn's individual income taxability. On the other hand the taxpayer's contention is that (with the exception of the 1931 item of $31,498.14) Penn never actually received any money or benefit from the credits, and is not chargeable with their constructive receipt, in view of the invalid and executory nature of the transaction; and as the cash item of $31,498.14 was returned during the calendar year upon the rescission of the plan, it was not taxable as income. 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.75

Where in the above quoted statement from the opinion in *Penn v. Robertson* is there any suggestion that the court was applying a deduction rationale? Judges and practitioners who are discussing whether a transaction by a taxpayer results in a deduction for income tax purposes do not generally use words like “whether the rescission in 1931 extinguished what otherwise would have been taxable income.”76 More typically, judges and practitioners would use language such as “as an offset [or reduction] in taxable income” when discussing a possible deduction.

Fabricated Doctrine continues to argue its assertion as follows:

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 large. [sic] 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.

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74 Id. at 127-128. (emphasis supplied)
75 115 F. 2nd at 172-173.
76 Id. at 175.
Thus, it is important to examine closely how the judges in *Penn v. Robertson* both presented the material facts and reached their decision based on those facts. While the outcome of *Penn v. Robertson* may be consistent with the conflation rationale, the way that the judges presented the facts and their decision show the deduction rationale to in fact be the ratio of that case.77

The reference to Goodhart is to Arthur L. Goodhart, “Determining the *Ratio Decidendi* of a Case,” 40 *Yale L. J.* 161 (1930). Fabricated Doctrine cites Goodhart as though his views establish the gospel for interpretation of case law. In fact, just a year after its publication, Karl Llewellyn described Goodhart’s article as an “indiscretion.”78 Discussion and criticism of Goodhart’s views has continued.79 Llewellyn believed that Oliphant failed to see enough guidance in a precedent and that Goodhart saw too much.80 Scofield presents an argument that the author finds persuasive that in many common fact patterns, “no matter which of the two theories of *ratio decidendi* one adopts, it does not appear that there is clearly one *ratio* that states the law. Given the vagueness, *ratio decidendi* is a metaphysical concept.”81

It is beyond the scope of this paper, and of the author’s interest, to undertake an analysis of the best way to parse a court opinion. Suffice it say that, even if Goodhart’s views are applied, Fabricated Doctrine’s misreading of *Penn v. Robertson* is astonishing. Fabricated Doctrine asserts that “for Judges Parker and Chestnut it was material that the payment was deductible” and “in terms of the court’s reasoning, deductibility of the repayment was a material

77 Fabricated Doctrine, note 32, supra, at 130.
81 Scofield, note 79, supra, at 325.
82 It is not apparent why Fabricated Doctrine claims knowledge of the state of mind of only Judges Parker and Chestnut. Judge Chestnut wrote the majority opinion in *Penn v. Robertson*, in which Judge Dobie joined. 115 F. 2nd at 169. Judge Parker wrote a concurring opinion in which he stated he concurred with the result and “also in the reasoning of the court, except with respect to grounds upon which the dividends credited in the year 1930 are taxable income.” 115. F. 2nd at 177.
These assertions are unsupportable in light of the court’s actual use of the term “deduction.”

Despite the lack of explicit clarity in the judgment, close reading reveals four indicators that their Honours 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. 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.”

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. 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).

Yes, the Commissioner did argue that a deduction arising after Mr. Penn’s death could not offset income realized while he was alive, but the court rejected this argument, stating, inter alia, that the Commissioner’s contention was “based on the erroneous assumption that Penn’s tax accounting period ended with his death on October 22, 1931, and was not for the full calendar year.” Given the way appellate arguments are presented, the Commissioner may not have had the opportunity to present an alternative argument after the court rejected the argument that 1931 involved two tax years. If he had been able to, why would the Commissioner have thought that an argument that a “conflation” could not “jump back” would be any more successful? Surely this tells us nothing.

Fabricated Doctrine continues:

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 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. 89

The court in Penn v. Robertson used the terms “deduction” and “such deduction” only in its discussion of the Commissioner’s contention, as those are the terms the Commissioner used in his argument. How this indicates the rationale of the court is not readily apparent. The court in Penn v. Roberson uses the term “deduction” only in the following paragraphs:

A minor part of the tax controversy related to deductions from income made by the taxpayer in the amount of $14,725 for the year 1930, and $12,271 for 1931, for travel and entertainment expenses. The district judge determined that these items were properly allowable as deductions for the respective years, and the Collector does not now further question them.91

The market value of the stock on the date of the decedent’s death was $1,798,562.50; the amount then still due on the note amounted to $1,347,631.48. The equity in Penn's favor at current market price was then $451,931.02. It may also be noted that in subsequent income tax accounting the Tobacco Company claimed deductions for the amounts credited to Penn on the note which, however, were disallowed by the Commissioner and his ruling was acquiesced in by the Company.92

But in view of practical necessities, income tax accounting with the Government must be on an annual basis, Burnet v. Sanford & Brooks Co., 282 U. S. 359, 51 S. Ct. 150, 75 L. Ed. 383; Heiner v. Mellon, 304 U.S. 271, 58 S. Ct. 926, 82 L. Ed. 1337; and, therefore, moneys received by a taxpayer as his own under a claim of right and without restriction as to their disposition are taxable for the year in which they are received and retained even though in a later year the taxpayer is obliged to refund them in whole or in part, in which event he would have a claim for deduction in the later year.93

89 Fabricated Doctrine, note 32, supra, at 131-132. (emphasis supplied)
90 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 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 such deduction was only $108.65. (emphasis supplied)
91 115 F. 2nd at 167. (emphasis supplied)
92 115 F. 2nd at 171-72. (emphasis supplied)
93 115 F. 2nd at 173. (emphasis supplied)
The more serious contention made by counsel for the Collector on this point is that, although Penn's tax accounting was on the cash basis and for the calendar year, his taxable period ended with his death on October 22d, and what was subsequently done by his executors, even though done in the same calendar year, cannot affect the matter. To support this contention, reliance is placed on the provisions of the income tax law that an individual taxpayer and his estate are separate taxable entities; and it is argued therefrom that nothing can be done by executors to affect income chargeable to their decedent within his lifetime, and therefore 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. 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 such deduction was only $108.65. No authority is cited in support of the Commissioner's contention in this respect, and we do not consider it sound.94

As one can see, the first time the court in Pennsylvania v. Roberson uses the term “deduction,” it is in the course of discussing an issue that is no longer in the case. The second time, the court is discussing a disallowed deduction of American Tobacco Company that has been conceded by the company. The third time, the court discusses the tax rules that apply when a taxpayer receives income in one year under a claim of right and is required to repay the income in a later year—not applicable to the court’s decision with regard to 1931 because in that year, which was considered one taxable year of Mr. Penn notwithstanding his death during the year, the receipt and repayment of the income happened in the same year. The fourth and final time the court uses the term “deduction,” it is in the context solely of describing the Commissioner’s position. These four instances say nothing about the court’s thinking and, accordingly it is not possible rationally to state that the court in Pennsylvania v. Robertson was operating “under the deduction rationale” on the basis of the court’s use of the term “deduction” in its opinion.95

What the court in Pennsylvania v. Robertson did say was:

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 for that year.96

The authors of Fabricated Doctrine acknowledge that the court in Pennsylvania v Robertson did use rescission language, such as describing the repayment of the 1931 payment by the taxpayer

94 115 F. 2nd at 176. (emphasis supplied)
95 Fabricated Doctrine, note 32, supra, at 131-132.
96 115 F. 2nd at 175 (emphasis supplied)
as a rescission that “extinguished” the entire stock fund transaction for 1931. Moreover, the authors of Fabricated Doctrine, in a paragraph in which they characterize the actions of American Tobacco Company and Penn’s executors as creating a deduction, nevertheless state: “Therefore, the reversal in 1931, although undertaken by Penn’s executors after Penn’s death, was nevertheless Penn’s. This reasoning had the effect of cancelling the 1931 credit, both economically and for tax purposes.”97 Saying that the 1931 credit was cancelled, economically and for tax purposes sounds as though they are describing a rescission. However, Fabricated Doctrine, without any support at all, goes on to assert that “Rev. Rul. 80-58 uses the term ‘extinguished’ to mean ‘ignore both transactions.’ But the judges in Penn v. Robertson were using ‘extinguished’ to mean ‘completely set off.’” The outgoing on the rescission in Penn gave rise to a deduction that completely set off the income. That outgoing was taken into consideration in the tax year of the 1931 credit because the rescission happened before the taxable period closed at the end of that year, in short, in the same tax year. Rev. Rul. 80-58, subsequent IRS rulings, and commentaries reject this possible interpretation of Penn v. Robertson by ignoring it entirely.98

The Merriam-Webster online dictionary offers several definitions of “extinguish,” including “to bring to an end,” “to make an end of,” “to cause to be void,” and “to get rid of.”99 It seems likely that both Rev. Rul. 80-58 and Penn v. Robertson were using “extinguished” in its commonly-accepted meaning rather than a meaning conjured up to support Fabricated Doctrine’s argument. Moreover, Rev. Rul. 80-58 and subsequent rulings and commentaries had good reason to ignore Fabricated Doctrine’s “possible interpretation.” As discussed earlier, judges and practitioners who are discussing whether a transaction by a taxpayer results in a deduction for income tax purposes do not generally use words like “whether the rescission in 1931 extinguished what otherwise would have been taxable income.”100 More typically, judges and practitioners would use language such as “as an offset [or reduction] in taxable income” when discussing a possible deduction. Fabricated Doctrine’s assertion that the court in Penn v. Robertson employed a deduction rationale is a fantasy based on imagined language not used by

97 Fabricated Doctrine, note 32, supra, at 128. (emphasis supplied)
98 Id. at 140. (emphasis supplied)
100 Note 76, supra, and accompanying text.
the court in the way asserted by Fabricated Doctrine. In addition, as discussed previously, Rev. Rul. 80-58 did not use the term “extinguished” to mean “ignore both transactions.” Rev. Rul. 80-58 states that “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.”

Moreover, if “the conflation rationale treats the two transactions as a nullity,” is not that what the court in Penn v. Robertson did when it stated that “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 for that year”? However, on facts like those in Situation 1 of Rev. Rul. 80-58, it is incorrect to assert that the “conflation rationale” treats the two transactions together as a nullity. In Situation 1 of Rev. Rul. 80-58, the reconveyance of the property by B to A in October 1978 extinguishes the taxable gain to A from the sale by A to B in February 1978. The sale in February 1978 is disregarded for tax purposes, but the reconveyance is what makes the rescission work. The reconveyance is not a nullity. Nor is the February 1978 sale a nullity for state law purposes. B may have some potential liability (e.g. under environmental laws) arising from his period of ownership.

Fabricated Doctrine also tells us that “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.”

Counsel for taxpayer in Penn v. Robertson made several arguments:

- That, with the exception of $31,498.41 in 1931, Mr. Penn never actually received any money or benefit from the credits, and should not be charged with constructive receipt;
- That there was no constructive receipt of income by Mr. Penn because the stock

101 Note 66, supra.
102 Note 1, supra, and accompanying text.
103 115 F. 2nd at 175. (emphasis supplied)
104 Fabricated Doctrine, note 32, supra, at 132. (emphasis supplied)
105 115 F. 2nd at 172-73.
allotment plan of 1929 was wholly invalid and void ab initio; \(^{106}\)

- That, with the exception of the $31,498.41 in cash in 1931, the whole plan remained executory until it was finally abandoned and, therefore, Mr. Penn didn’t have constructive income; \(^{107}\)

- That a credit of $90,702.80 should be taxed, if at all, in 1929, not 1930, and that a credit of $181,708.12 should be taxed, if at all, in 1930, not 1931. \(^{108}\)

Based on the foregoing description from the opinion in *Penn v. Robertson* of the arguments made by taxpayer’s counsel, the assertion that taxpayer’s counsel “was satisfied to argue the case as one of a deduction offsetting an earlier receipt” is untenable. If possible, there is even less support for this assertion of Fabricated Doctrine that for the assertions that deductibility was material to the court, as taxpayer’s counsel did not use the term “deduction” at all in his arguments. Indeed, when the court framed the issues before it for decision, it reported taxpayer’s position as:

> [T]he taxpayer’s contention is that (with the exception of the 1931 item of $31,498.14) Penn never actually received any money or benefit from the credits, and is not chargeable with their constructive receipt, in view of the invalid and executory nature of the transaction; and as the cash item of $31,498.14 was returned during the calendar year upon the rescission of the plan, it was not taxable as income. \(^{109}\)

Where in this, or in the earlier quote of the court’s summary of both parties’ positions, \(^{110}\) is there any word remotely suggesting that the court or taxpayer’s counsel was operating under a deduction rationale?

Fabricated Doctrine offers additional arguments:

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. \(^{111}\)

There were two transactions relevant to this particular issue: the crediting transaction, the 1931 credit to Penn in his lifetime, and the repayment transaction,

\(^{106}\) 115 F. 2nd at 173.

\(^{107}\) 115 F. 2nd at 174.

\(^{108}\) 115 F. 2nd at 177.

\(^{109}\) 115 F. 2nd at 172-173.

\(^{110}\) Note 75, *supra*, and accompanying text.

\(^{111}\) Fabricated Doctrine, note 32, *supra*, at 132.
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.”

The court in *Penn v. Robertson* 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. Moreover, Fabricated Doctrine’s assertion that income tax works on net results is correct only if it is understood to mean “net results within a taxable year.” The taxpayer in *Burnet v. Sanford & Brooks Company* argued that the Sixteenth Amendment prohibited taxation of a transaction on which there was no net profit, but the Court held that net profit must be computed on the basis of the annual accounting period, even if that produces a taxable profit in one or more tax years from a transaction that does not produce a profit overall.

Fabricated Doctrine continues:

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.

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112 Id.
113 115 F.2nd at 173. (emphasis supplied)
114 115 F. 2nd at 173.
115 Notes 9 to 15, supra, and accompanying text.
116 Fabricated Doctrine, note 32, supra, at 133.
It appears likely that the court did not think it was adopting an innovation. The cases discussed above under Annual Accounting Concept support the proposition that taxable income for each tax year is determined by computing net results at the end of the year. Moreover, although Fabricated Doctrine ignores it, Rev. Rul. 80-58 included in its legal analysis the statement that “the annual accounting concept requires that one must look at the transaction on an annual basis using the facts as they exist at the end of the year. That is, each taxable year is a separate unit for tax accounting purposes. See Security Flour Mills Co. v. Commissioner, 321 U.S. 281, 88 L. Ed. 725, 64 S. Ct. 596, 1944-1 C.B. 526 (1944), Ct. D. 1603, 1944 C.B. 526.”

Again, from Fabricated Doctrine:

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,. . . [c]onstructively received income 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.

It is entirely unclear what point the authors of Fabricated Doctrine are trying to make with certain of their statements quoted above. 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 no sense can be said be to part of each other. What can the

117 Notes 8-24, supra, and accompanying text.
118 Note 1, supra, and accompanying text.
119 Fabricated Doctrine, note 32, supra, at 133.
120 Notes 116 and 119, supra, and accompanying text.
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? Is not tax law part of whatever general law is? Moreover, rescission is recognized in other areas of the law, see, e.g., 15 U. S. C. § 1635, providing a right of rescission in certain credit transactions. If rescission is an invention of tax law, why has it been defined by Black’s Law Dictionary and discussed by treatises such as Corbin on Contracts as though it is part of everyday contract and other areas of law? The authors of Fabricated Doctrine know this because they discuss that leading contract treatises disagree about the precise definition of the term “rescission.”

Fabricated Doctrine attempts to buttress its argument by the following:

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. (“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 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.

As explained above, nothing in the opinion in Penn v. Robertson supports Fabricated Doctrine’s assertions in the paragraph quoted immediately above. The words of the opinion provide absolutely no indication that the court was acting under a deduction rationale or that the deductibility of the repayment was material. Moreover, to speak of the repayment being

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121 Banoff, note 30, supra, at 957.
122 Fabricated Doctrine, note 32, supra, at 141.
123 As noted earlier, at note 82, supra, and accompanying text, it is not apparent why Fabricated Doctrine claims knowledge of the state of mind of only Judges Parker and Chestnut. Judge Chestnut wrote the majority opinion in Penn v. Robertson, in which Judge Dobie joined. 115 F. 2nd at 169. Judge Parker wrote a concurring opinion in which he stated he concurred with the result and “also in the reasoning of the court, except with respect to grounds upon which the dividends credited in the year 1930 are taxable income.” 115 F. 2nd at 177.
124 Fabricated Doctrine, note 32, supra, at 132.
125 Notes 73-102, supra, and accompanying text.
extinguished and that “extinguishment of the second of a pair of transactions is crucial to the unwind doctrine” is nonsense. As discussed earlier, the authors of Fabricated Doctrine do not appear to understand the meaning of “extinguished,” and the rescission could not be extinguished or disregarded if it was to have the effect of causing the transaction to be disregarded for tax purposes.126

Fabricated Doctrine’s Examination of TARP Bonuses

Having presented what can be seen as a Pollyannaish analysis of “true rescissions,”127 and an egregious misreading of Penn v. Robertson,128 Fabricated Doctrine then attempts to illustrate the policy short-comings of Rev. Rul. 80-58 by examining what it views as 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.129 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.”130 The authors of Fabricated Doctrine assume for purposes of their paper that Poling’s repayment would not be deductible,131 and state that, if Poling repaid his bonus in 2009, the year of receipt, the preparer of Poling’s tax return would have to determine the correct income tax treatment of the receipt of the bonus and its repayment and that the answer to this “depends on Rev. Rul. 80-58, and the correct meaning of the ruling’s purported authority, Penn v. Robertson.”132

Actually, Mr. Poling undoubtedly would have engaged a competent return preparer, who, being competent, would not have spent any time worrying about Rev. Rul. 80-58 and whether it is in fact supported by Penn v. Robertson but would have excluded the bonus from Poling’s reported taxable income on the authority of Rev. Rul. 79-311.133 Rev. Rul. 79-311 holds that if an employee repays compensation in the year of receipt the amount repaid is “excludible from [the employee’s] gross income in the year of repayment. Couch v. Commissioner, 1 B. T. A. 103 (1925), acq., IV-I C. B. 1 (1925).” Although the repayments in Rev. Rul. 79-311 were required

126 Notes 96-103, supra, and accompanying text.
127 Note 71, supra, and accompanying text.
128 Notes 73-126, supra, and accompanying text.
129 Fabricated Doctrine, note 32, supra, at 122.
130 Fabricated Doctrine, note 32, supra, at 123-124.
131 Id.
132 Fabricated Doctrine, note 32, supra, at 124.
by the relevant employment contract, the IRS views Rev. Rul. 79-311 as extending to voluntary repayments. In addition, IRS Publication 525, “Taxable and Nontaxable Income,” also states that “if you repay unearned commissions or other amounts in the same year you receive them, reduce the amount included in your income by the repayment.” Publication 525 does not treat a repayment in the year of receipt as a deduction. Moreover, Mr. Poling would be able to exclude from income any portion of his TARP bonus repaid in the year of receipt under Fender Sales, Inc. v. Commissioner, where the court held that petitioner C. Leo Fender was not taxable on bonus payments received in 1956 and 1957 to the extent he voluntarily repaid such bonuses to his employer in the year of receipt, stating:

This Court has adopted and consistently followed the legal proposition that where prior to the close of the taxable year there has been an adjustment of the contract or obligation and a repayment of a portion of the amount received, the tax liability is to be determined on the basis of such adjusted amount.

Fabricated Doctrine does not discuss Fender Sales in connection with its consideration of Mr. Poling’s tax situation, but does discuss it with the cases discussed below under Fabricated Doctrine’s Examination of Other Cases by stating that the result in that case “seems superficially consistent with the mistaken interpretation of Penn v. Robertson,” but “it is not …compelling” and, “the court in Fender cites, but does not rely on, Penn v. Robertson,” instead appearing to create “a special rule when a reversal transaction will be considered deductible in its own right: namely in circumstances where both transactions involve a company and a principal shareholder in that company who is also an employee.”

The court in Fender Sales cited previous decisions of the United States Tax Court and its predecessor, the Board of Tax Appeals, as direct authority for its statement quoted above. The court cites Penn v. Robertson in a citation of opinions that are described by the court as “adher[ing] to a similar position.” It would seem at least arguable that this is “reliance” on Penn v. Robertson. The court in Fender Sales certainly gave no indication in its opinion that it thought

135 22 TCM (CCH) 556 (1963), rev’d on other grounds, 338 F. 2nd 924 (9th Cir. 1964).
136 Notes 150-179, infra, and accompanying text.
137 Fabricated Doctrine, supra, note 32 at 149.
it was creating a special rule, particularly one that would apply only where the taxpayer in effect was on both sides of the unwinding.\textsuperscript{138}

In addition, Mr. Poling’s tax return preparer could rely on \textit{Bishop v. Commissioner}.\textsuperscript{139} In that case, the petitioner was a shareholder in Pendleton Woolen Mills. Another shareholder had asserted a claim against the petitioner and other shareholders who were diverting business from the corporation and using its name in partnerships that petitioner and the other shareholders had formed. The shareholder’s claims against petitioner and the other shareholders involved in the partnership were settled in an agreement entered into on December 31, 1946 and approved by the corporation’s board of directors on that date. Also on December 31, 1946, pursuant to the agreement, the partnerships were terminated and all of their 1946 income was transferred to the corporation. The Tax Court held for the petitioner, agreeing that all of the partnerships’ 1946 income was taxable to the corporation, stating:

\textsuperscript{138} \textsc{See}, John W. Lee, “Tax TARP Needed for Year One and Year Two Returns of Executive Bonuses to TARP Recipient: A Case Study of Year One Rescission/Exclusion from Income and Year Two Deduction Under Section 1341,” \textit{Wm. & Mary L. Rev.} 323, 376-377 (2010); there Mr. Lee states:

\begin{quote}
By the 1940s the Tax Court had come to flatly stating the rule as follows:

\[\text{Compensation for services of officers of corporations for any period is subject to modification either by corporate action or by agreement at any time and from time to time during the taxable year and the amount at which compensation is finally adjusted at the close of the taxable year is the amount which the officer must report as compensation or the corporation may deduct as ordinary and necessary business expense.}\]

\textsc{citing, at note 245, McEwen v. Commissioner, 6 T. C. 1018, 1025 (1946).}\]
\end{quote}

The Tax Court has applied this exception to modifications where the payment of compensation was neither in error nor subject to conditions subsequent.[\textsc{citing, at note 246, Fender Sales}.]

Similarly, the Service often flatly states the rule to be that a taxpayer’s gross income includes the amount of compensation set forth in a renegotiated employment contract rather than the amount of compensation set forth in an original employment contract where the renegotiated employment contract is bona fide and legally binding on the parties. Furthermore, the Board of Tax Appeals, the Tax Court, and the Service are generally in agreement that the renegotiated employment contract must be executed and the resulting salary adjustments must be implemented prior to the close of the taxpayer’s taxable year.[\textsc{citing, at note 247, I. R. S. Field Serv. Adv. Mem., 1994 FSA LEXIS 5 (Oct. 18, 1994).}

The Service reasoned that,

\begin{quote}
[w]here both the initial receipt of funds and the repayment of some portion thereof take place in the same year, there cannot very well be a serious question about the overall propriety of excluding the amount so repaid from the taxable income of the party who has thus effectively relinquished or disavowed any claim thereto.[\textsc{citing, at note 248, I. R. S. Gen. Couns. Mem. 33,602 (Aug. 25, 1967).}
\end{quote}

\textsuperscript{139} \textbf{25 T. C. 969} (1956).
We recently considered the application of the claim of right doctrine in Michael Phillips, 25 T. C. 767. Briefly, the petitioners assert that the directors of a corporation cannot retain income gained personally from a deal with the assets of the corporation, citing Enyart v. Merrick, 148 Ore. 321, 34 P.2d 629, and that under the facts here Pendleton was entitled to this partnership income. The next step in petitioner's argument is that where the alleged income is restored to the rightful owner in the same taxable year it is received, then the income is not taxable to the original recipient.

The petitioners' contention is supported by authorities. The ‘claim of right’ doctrine had its origin in North American Oil Consolidated v. Burnet, 286 U.S. 417. In general, it charges the recipient with the receipt of income when he asserts a claim it is his even though his claim later proves to be invalid. There is no need to go into a general discussion of the claim of right doctrine for actually here the question is as to the tax consequences when in the year of receipt the claim of right is renounced and the income repaid to its rightful owner. The applicable rule was recently stated in the following quotation from United States v. Merrill, 211 F.2d 297:

We are not aware that the rule has ever been applied where, as here, in the same year that the funds are mistakenly received, the taxpayer discovers and admits the mistake, renounces his claim to the funds, and recognizes his obligation to repay them. Cf. Carey Van Fleet, 2 B. T. A. 825; Curran Realty Co. v. Commissioner, 15 T. C. 341. We think there is no warrant for extending the harsh claim of right doctrine to such a situation. In such case the Internal Revenue Bureau is not faced with the problem of deciding the merits of the claim to the funds received, for the question has been resolved by the interested parties.

Returning to Fabricated Doctrine, the authors tell us that Poling’s situation drives them to examine whether Rev. Rul. 80-58 would allow Poling to exclude his TARP bonus from income if he repays it. They state that now they will:

[E]xplain what Penn v. Robertson does and does not stand for, and show how Rev. Rul. 80-58 misinterprets Penn v. Robertson. On a correct interpretation of the law, taxpayers like Mr. Poling would owe tax on a bonus even if they had returned it. The bonus receipt would be taxable, the repayment we assume is not deductible, and no special tax rule would apply to allow the transactions to nullify each other for tax purposes.\footnote{Fabricated Doctrine, note 32, supra, at 127.}
Fabricated Doctrine is probably correct in its assumption that Poling’s repayment of his bonus would not be deductible, because, as explained above,\textsuperscript{141} the amount repaid in the year of receipt would be excluded from his income on the basis of authorities other than Rev. Rul. 80-58, authorities either not discussed at all by Fabricated Doctrine or not discussed in connection with Mr. Poling’s situation.

In its discussion of the potential tax treatment of Douglas Poling, Fabricated Doctrine assumes away any potential deductibility of a repayment by Mr. Poling of his TARP bonus, fails to discuss the authorities discussed above\textsuperscript{142} that show that if Mr. Poling did repay his TARP bonus in the year of receipt, he would be allowed to exclude the repaid bonus from his taxable income for that year, and wrongly states that Mr. Polling would likely be entitled to treat repayment as a rescission under Rev. Rul. 80-58. Fabricated Doctrine states “It has been asserted that the unwind doctrine in Rev. Rul. 80-58 saves Poling from a net tax impost in respect of his returned bonus, even if under ordinary tax principles the receipt of the bonus is taxable and its return not deductible.”\textsuperscript{143} For its statement that that “it has been asserted that … Rev. Rul. 80-58 saves Poling,” Fabricated Doctrine states “The authors again thank unnamed United States colleagues\textsuperscript{144} who suggested that reliance on Revenue Rulings would lead to the result that Poling would pay no net tax.”\textsuperscript{145} It is unfortunate that Fabricated Doctrine could not name these colleagues so that others could know just what Revenue Rulings they were referring to. As discussed earlier, there are cases and a published Revenue Ruling that are not rescission authorities but are based on the annual accounting concept that indicate that Mr. Poling would be entitled to exclude his TARP bonus from income if he repaid it in the year of receipt.

Fabricated Doctrine states:

If the IRS continues to follow and apply Rev. Rul. 80-58 as it has, both Poling’s receipt of the bonus and his return of it to AIG would be treated for tax purposes as if they had not occurred. He would not have to acknowledge either transaction on his income tax returns. This is a far more attractive result for Poling than that reached under ordinary tax principles, which would require him to pay tax on a bonus that he does not keep.\textsuperscript{146}

\textsuperscript{141} Notes 133-139, supra, and accompanying text.
\textsuperscript{142} Id.
\textsuperscript{143} Fabricated Doctrine, note 32, supra, at 127.
\textsuperscript{144} Fabricated Doctrine did thank certain colleagues by name for reviewing the article. Id. at 117 and note 1.
\textsuperscript{145} Id. at 127 and note 50.
\textsuperscript{146} Fabricated Doctrine, note 32, supra, at 147-148. (footnotes omitted)
Despite Fabricated Doctrine’s concern that Rev. Rul. 80-58 would save Mr. Polling, this paper has demonstrated that several authorities not discussed in Fabricated Doctrine would give Mr. Polling his desired tax treatment without application of Rev. Rul. 80-58. Moreover, because Mr. Polling’s repayment of his TARP bonus likely would not be considered the undoing of a contract, there exists considerable doubt whether the IRS would apply Rev. Rul. 80-58 to his situation because of the IRS requirement that rescission means the rescission of a contract. Fabricated Doctrine apparently goes on at such length about Mr. Poling’s situation because the authors viewed Mr. Poling as the poster child for the inappropriate relief (in their view) that Rev. Rul. 80-58 would afford him when “ordinary tax principles” would not save him. Of course, as this paper explains, ordinary tax principles other than Rev. Rul. 80-58 would very likely have provided Mr. Poling the tax treatment he presumably desired.

Fabricated Doctrine’s Examination of Other Cases

From its misanalysis of Douglas Poling’s tax situation, Fabricated Doctrine moves on to a discussion of other cases and makes much of the point that they could find no subsequent case that the authors believed clearly cited Penn v. Robertson or relied on it to treat an unwinding as a rescission. In the minds of the authors of Fabricated Doctrine, this indicates that Penn v. Robertson isn’t really a rescission case. They fail to discuss the possibility that there are no such cases because the IRS didn’t challenge cases that involved unwwindings in the same tax year. Cases involving taxpayer’s attempts to reduce income in one year because of events in a later year are decided as claim of right cases, not rescission cases. Fabricated Doctrine discusses the following cases, apparently on the theory that if they show that the later cases didn’t directly rely on Penn v. Robertson, that helps their argument.

This paper has already discussed Fender Sales, Inc. v. Commissioner. There the court held that petitioner C. Leo Fender was not taxable on bonus payments received in 1956 and 1957 to the extent he returned such bonuses to his employer in the year of receipt, stating:

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147 Notes 133-139, supra, and accompanying text.
148 Notes 3-5, supra, and accompanying text.
149 Notes 133-139, supra, and accompanying text.
150 22 TCM (CCH) 556 (1963), rev’d on other grounds, 338 F. 2nd 924 (9th Cir. 1964). See, notes 135-138, supra, and accompanying text.
This Court has adopted and consistently followed the legal proposition that where prior to the close of the taxable year there has been an adjustment of the contract or obligation and a repayment of a portion of the amount received, the tax liability is to be determined on the basis of such adjusted amount.

Although certainly not literally a rescission case, *Fender Sales* nevertheless is completely consistent with the rescission doctrine that has developed since *Penn v. Robertson*. Fabricated Doctrine discusses *Fender Sales* by stating that the result in that case “seems superficially consistent with the mistaken interpretation of *Penn v. Robertson*,” but “it is not …compelling” and, “the court in Fender cites, but does not rely on, *Penn v. Robertson*,” instead appearing to create “a special rule when a reversal transaction will be considered deductible in its own right: namely in circumstances where both transactions involve a company and a principal shareholder in that company who is also an employee.” The court in *Fender Sales* cited previous decisions of the United States Tax Court and its predecessor, the Board of Tax Appeals, as direct authority for its statement quoted above. The court cites *Penn v. Robertson* in a citation of opinions that are described by the court as “adher[ing] to a similar position.” It would seem at least arguable that this is “reliance” on *Penn v. Robertson*. The court in *Fender Sales* certainly gave no indication in its opinion that it thought it was creating a special rule, particularly one that would apply only where the taxpayer in effect was on both sides of the unwinding.

Fabricated Doctrine discusses three opinions that were reversed by the Court in *United States v. Lewis*, a claim of right case which unsurprisingly held that a taxpayer who received a $22,000 bonus in 1944 was taxable on the full amount in 1944 even though he was required to pay back $11,000 of the bonus in 1946. The taxpayer’s repayment in 1946 was deductible in 1946. Inasmuch as there exists no legal authority holding that an unwinding that spans two or more taxable years can normally be treated as a rescission for federal income tax purposes, *Lewis* hardly represents a case that rejects the rescission doctrine, and *Lewis* is consistent with the holding of *Penn v. Robertson* as to the tax year 1930.

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151 Fabricated Doctrine, supra, note 32 at 149.
152 See, John W. Lee, note 138, supra.
154 Banoff, note 30, supra, at 967-68 discusses the rare instances, all involving adversarial court action, in which an original transaction has been declared void *ab initio* and rescission treatment allowed for an unwinding in one year of a transaction that occurred in a prior year.
lower court opinions, *Gargaro v. United States*,155 *Lewis v. United States*,156 and *Haberkorn v. United States*.157 All three cases involved employees who had received bonuses in one year and were required to return a portion of the bonus in a later year. The United States Court of Federal Claims in *Gargaro* and *Lewis* allowed the taxpayer to reopen his tax return for the year of receipt of the bonus. *Haberkorn*, following *North American Oil Consolidated v. Burnet*,158 held that the taxpayer could only deduct the repayment in the year of the repayment. The Court, in its opinion in *United States v. Lewis*, reversed the Court of Federal Claims decisions and affirmed *Haberkorn*. None of this is remarkable—all this flowed from the claim of right doctrine that was established by *North American Oil Consolidated* and followed in several later cases, including *Penn v. Robertson* as to the tax year 1930 in that case. As the Court stated in *United States v. Lewis*:

In the *North American Oil* case we said: “If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.”

Income taxes must be paid on income received (or accrued) during an annual accounting period. [citation omitted] and see *Burnet v. Sanford & Brooks Co.*, 282 U. S. 359, 363. The “claim of right” interpretation of the tax laws has long been used to give finality to that period, and is now deeply rooted in the federal tax system. See cases collected in 2 Mertens, Law of Federal Income Taxation, § 12.103. We see no reason why the Court should depart from this well-settled interpretation merely because it results in an advantage or disadvantage to a taxpayer.159

The claim of right doctrine applies differently when the repayment occurs in the same taxable year as receipt. See *Bishop v. Commissioner*, discussed earlier.160

Fabricated Doctrine tells us that “the principles of general justice applied in cases such as *Gargaro* and *Lewis* discussed above do not extend to all cases to which the unwind doctrine has been applied.”161 It goes on to suggest that a court might be sympathetic to Mr. Poling (and

156 91 F. Supp. 1017 (Ct. Cl. 1950).
157 173 F. 2d 587 (6th Cir. 1949).
158 286 U. S. 417 (1932).
159 340 U. S. at 591-592.
160 Note 139, *supra*, and accompanying text.
161 Fabricated Doctrine, note 32, *supra*, at 164.
other taxpayers similarly situated) because of the argument that he returned his bonus because of the strong public feeling that this was the correct thing to do morally, and he shouldn’t face a negative tax consequence because of this. Further, “Appeals to general notions of justice are unlikely, however, to be sustained in other cases to which the unwind doctrine has applied, such as cases where the reversal has been precipitated by unwise management decisions or the taxpayer’s regret about the tax consequences of the original transaction. Considerations of justice in Gargaro and Lewis would seem to allow unwind treatment only in cases only where the unwind has moral value.”

As discussed earlier, the opinions referred to here by Fabricated Doctrine are opinions of the United States Claims Court in two cases that were reversed by the United States Supreme Court in United States v. Lewis—an unremarkable claim of right case. This author is not clear on what value these Claims Court opinions have at all. Generally, lower court opinions reversed because they are in clear conflict with United States Supreme Court precedent would be considered minimally persuasive, if at all. Fabricated Doctrine appears to be suggesting that some pro-unwinding arguments might benefit if an appeal could be made to “justice” and it could be argued that the desired unwinding “had moral value.” As explained below, this paper asserts that there is ample legal and policy support for the rescission doctrine as articulated by Rev. Rul. 80-58, and it is not believed that any appeal to abstract notions of justice or morality are necessary.

Fabricated Doctrine next considers two cases, In re Trico Marine Services and Scallen v. Commissioner, that it describes as “cases that mention Penn v. Robertson in dicta, and at best provide weak dicta support for unwinding.” In Trico Marine Services, the court was considering plaintiff’s motion to set aside the confirmation order. In discussing the practical feasibility of unwinding the bankruptcy plan that had been confirmed and carried out, the court stated:

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162 Id.
163 Notes 153-159, supra, and accompanying text.
164 Id.
165 Fabricated Doctrine, note 32, supra, at 164.
166 Notes 209-219, infra, and accompanying text.
168 54 T. C. M. (CCH) 177 (1987).
169 Fabricated Doctrine, note 32, supra, at 148.
Where property is sold or conveyed, and the transaction is then rescinded, the rescission does not undo the tax effect of the initial transaction unless two factors are present. First, the rescission must occur in the same tax year as the initial transaction. *Penn v. Robertson*, 115 F.2d 167, 175 (4th Cir.1940); Rev. Rul. 80-58; 33A AM.JUR. 2d Federal Taxation ¶ 10079, available at Westlaw, AMJUR FEDTAXN P 10079 (2006 Thomson/West); 2 MERTENS LAW OF FED. INCOME TAX’N § 12A:173 available a Westlaw, MERTENS § 12A:173 (2006 Thomson/West). The rule is one of practicality, based on the annual accounting principle that "requires the determination of income at the close of the taxable year without regard to the effect of subsequent events." *Penn*, 115 F.2d at 175; accord *Security Flour Mills Co. v. C.I.R.*, 321 U.S. 281, 286, 64 S.Ct. 596, 88 L.Ed. 725 (1944). Second, the parties to the transaction must be returned to the status quo ante. *Hutcheson v. C.I.R.*, T.C. Memo.1996-127, 1996 WL 111325 (U.S.Tax Ct.); 33 AM.JUR. 2d Federal Taxation ¶ 10079.

As one can see, the court in *Trico Marine Services* cited *Penn v. Robertson* as authority for one of the basic requirements for a valid rescission. However, the court in *Trico Marine Services* held that no rescission had occurred in that case because it was impossible to return the parties to the status quo ante.

In *Scallen*, a corporation controlled by the taxpayer, Blue Ridge Properties Corporation in January, 1979, sold a hotel and apartments (the “Property”) to Gerald R. Hansen. The next day, Hansen sold the Property to Bradley A. Herman. On November 19, 1979, Herman sold the Property to Campus Realty Corporation, another corporation controlled by the taxpayer. The Commissioner argued that these transactions resulted in a rescission of the January sale, that taxpayer therefore had no capital gain or loss from that sale and had his historic basis in the Property. The court noted that no gain would “be recognized, however, if in the year of sale, the sale is rescinded and the taxpayer accepts reconveyance of the property and returns the buyer’s funds. *Penn v. Robertson*, 115 F.2d 167 (4th Cir. 1940). We agree with respondent’s statement of the law, but we do not agree that a rescission occurred on these facts.”170 The court disagreed with the Commissioner because it was unwilling to disregard the corporate form of Blue Ridge Properties Corporation or Campus Realty Corporation. The court also stated that there was no agreement for rescission and characterizing the transactions as a rescission would require disregarding the sale on February 1, 1979 from Hansen to Herman, and the Commissioner had offered no argument that that should be done. Once again, the court in *Scallen* cites *Penn v. Robertson* as authority but holds that no rescission had occurred on the facts before it.

170 54 T. C. M. at 205.
In *Hutcheson v. Commissioner*, taxpayer sold Walmart stock in January 1989 and repurchased an equivalent amount if stock in December, 1989. While the court applied the principles of Rev. Rul. 80-58, the court unremarkably held that no rescission had taken place because the stock acquired in December was not the same stock that was sold in January.

In *Estate of L. E. Crellin v. Commissioner*, the directors of a California personal holding corporation, based on erroneous advice received from a CPA that the corporation would otherwise be subject to the personal holding company surtax, declared and distributed to the corporation’s shareholders a dividend approximately equal in amount to a capital gain it had received earlier in the year the dividend was paid. Later in the same year, the directors learned that the advice they had received was erroneous and passed a resolution purporting to rescind the dividend and directing that a demand be sent to the shareholders for return of the amounts paid to them. All of the shareholders did return the dividends. All these events occurred in the same year. As Sheldon Banoff demonstrates in his seminal article on rescissions, except in the case of dividends mistakenly paid because of a scrivener’s error, taxpayers cannot avoid dividend income by voluntarily repaying the dividends. In this case, the corporation had no right to enforce its demand that the shareholders repay the dividends, and the court held for the Commissioner. However, in so holding, the court noted, by contrasting the case of a compelled repayment of a dividend, “when payment and return of the dividend occur within the same taxable year, it is reasonable to view the transaction as involving no increment to gross income, rather than an increment to gross income plus a deduction.” Although this statement is plainly dicta, it suggests that the court would not be unfriendly to a taxpayer arguing for rescission treatment on facts like those in 1931 in *Penn v. Robertson*, and that the court would not be applying a deduction rationale to a same year unwinding.

In *Branum v. Campbell*, pursuant to a contract effective April 1, 1948, the taxpayer sold a 50% interest in a brokerage business to C. T. Green for $15,000. The contract provided that taxpayer and Green were to operate the business as a partnership for an indefinite term unless terminated by operation of law or by agreement of the parties. On September 30, 1948, the taxpayer and Green entered into a second contract providing for the dissolution of the

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171 71 T. C. M. (CCH) 2425 (1996).
172 203 F.2nd 812 (1953).
173 Banoff, note 30, supra, at 980-82.
174 211 F. 2nd 147 (5th Cir. 1954).
partnership and the payment by taxpayer to Green of $15,000 for Green’s interest in the partnership.

Taxpayer contended that he had no gain or loss on the transaction. He claimed that he had initially sold the business with the understanding that, if the partnership arrangement proved unsatisfactory, he would reimburse Green, as he claimed to do. The IRS did not accept this explanation. In concluding that a completed sale, separate and distinct from the partnership dissolution, had occurred, the court reasoned:

The words and the tenor of the contract are definite. There is no reservation of title and no indication of a conditional or provisional agreement between the parties . . . . There is no mention of an oral agreement [to unwind] . . . in the contract . . . . We think the evidence amply supports the findings by the court below that there was a completed sale . . . .

One wonders what the result in Branum would have been had the taxpayer and Green entered into a contract rescinding the sale of taxpayer’s 50% interest in his brokerage business to Green instead of, as they did, agreeing to dissolve the partnership. Indeed, the IRS views Branum as a case which, “while on the facts not holding that a rescission has taken place, has acknowledged the principle that rescission in the year of sale will extinguish otherwise taxable gain.”

Fabricated Doctrine has the following observation about Branum:

Commentary has implied that the taxpayer’s argument might have fared better had the unwind transaction been “styled as a rescission.” However, Crellin’s Estate above suggests that even if the taxpayer in Branum v. Campbell had labeled the repurchase of his partnership interest a “rescission” of the original sale, the court would have looked beyond the label to the substance which in this case was not a true rescission but, as the court noted, “separate and distinct.”

What the court in Branum said were “separate and distinct” were the taxpayer’s sale of one-half of his business and the later dissolution of his partnership with the purchaser. If, instead of dissolving their partnership, the taxpayer and Green had agreed that Green would return the one-half of the brokerage business sold to him by taxpayer and that the taxpayer would return Green’s purchase price, the taxpayer might have been able to argue successfully for rescission.

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175 In Technical Advice Memorandum 7802003.
176 The author acknowledges relying on Banoff’s description of Branum for the discussion above. Banoff, note 30, supra, at 968-69.
177 Fabricated Doctrine, note 32, supra, at 160.
One difficulty, given the nature of the business, would have been whether the parties could have been put back in the status quo ante. Another difficulty might be whether the applicable partnership law would have allowed the transaction to be a rescission of the sale of the brokerage business. In any event, such a recasting of the transaction would have been more than a different styling like that dismissed above by Fabricated Doctrine. Moreover, Fabricated Doctrine’s reference to Crellin’s Estate is improvident—as discussed above, voluntary repayment of dividends is always ineffective to avoid taxation. The rules are different for other types of voluntary unwindings, e. g., repayment of bonus.

Policy Analysis in Fabricated Doctrine

In its last four pages, Fabricated Doctrine states its conclusion and discusses some policy issues. First, it states:

The IRS should revoke its mistaken ruling, or to the extent that any ambiguity in the ruling allows it to be applied in ways that are not legally correct, should correct that ambiguity. The Treasury Regulations state that “the purpose of publishing revenue rulings . . . is to promote correct and uniform application of the tax laws by Internal Revenue Service employees and to assist taxpayers in attaining maximum voluntary compliance.” Rev. Rul. 80-58 currently violates this regulation because it promulgates an incorrect interpretation of the tax law set out in Penn v. Robertson.

For its second sentence in the above quotation, Fabricated Doctrine cites Treas. Reg. § 601.601(d)(2)(iii)—correctly, so far as it goes. However, Fabricated Doctrine should have also considered Treas. Reg. § 601.601(d)(2)(i)(a), which states: “A Revenue Ruling is an official interpretation by the Service that has been published in the Internal Revenue Bulletin. Revenue Rulings are issued only by the National Office and are published for the information and guidance of taxpayers, Internal Revenue Service officials, and others concerned.” (emphasis supplied). Therefore, the question isn’t just whether Rev. Rul. 80-58 is a correct interpretation of Penn v. Robertson, although this author submits that it is, the question is whether Rev. Rul. is a correct interpretation of the law. As this paper summarizes below, there are other legal and policy bases for Rev. Rul. 80-58. In this connection, it should be noted that Fabricated Doctrine

178 Note 173, supra, and accompanying text.
179 Notes 133-138, supra, and accompanying text.
180 Fabricated Doctrine, note 32, supra, at 163. (footnotes omitted).
181 Id. note 184.
182 Notes 209-219, infra, and accompanying text.
also makes an incorrect statement in its footnote to the last sentence of the above quote: “While section 7805 gives the I. R. S. some discretion in enforcing the code, Rev. Rul. 80-58 does not purport to rely on discretion.”183 It is elementary that an official need not refer to his or grant of discretion to take action based on that grant. Moreover, if Rev. Rul. 80-58 is viewed as a statement by the I. R. S. that it will not challenge taxpayers who take the position on facts substantially similar to those in Situation 1 of Rev. Rul. 80-58 that they have engaged in valid rescissions for tax purposes, Rev. Rul. 80-58 could be viewed as an agency non-enforcement decision that is not subject to judicial review.184

Momentarily, it appears that Fabricated Doctrine is on the right tract when it states that:

Perhaps the most promising principled basis for the unwind doctrine is the idea that tax law should follow economic substance, coupled with the tax year accounting principle in Saunders v. Commissioner. Perhaps tax law should strive, where possible, to base legal outcomes on the net change in taxpayers economic positions during the tax year, ignoring interim changes in legal and economic position. A uniform application of this principle however would have implications somewhat more radical than allowing taxpayers to claim unwind treatment at their discretion; it would require that treatment in every relevant case, and would further indicated a broader move towards reporting of net tax positions only at year end.185

The reference to Saunders is to Saunders v. Commissioner, 101 F. 2nd 407 (10th Cir. 1939). Saunders is a very short opinion in a claim of right case and does not mention a “tax year accounting principle” or any other accounting principal or concept. The remainder of the quoted paragraph could only be written by persons who have no understanding of the annual accounting concept as it has developed in United States Federal Income Tax law. Moreover, Fabricated Doctrine shows its misunderstanding of the federal tax system by stating that taxpayers are now allowed “to claim unwind treatment at their discretion.” If a taxpayer’s sale was rescinded on facts that would come within Situation 1 of Rev. Rul. 80-58, the taxpayer’s failure to treat the sale as rescinded would no doubt be challenged by the IRS if the taxpayer was audited.186 Also, when do the authors of Fabricated Doctrine think taxpayers report their taxable income if not as of the end of each year? Fabricated Doctrine also proceeds immediately to undercut its own

183 Id. note 185.
185 Fabricated Doctrine, note 32, supra, at 164-165.
186 See, the argument made by the Commissioner in Scallen v. Commissioner, note 170, supra, and accompanying text.
suggestion by discussing Hasen’s comprehensive but highly theoretical article.\textsuperscript{187} “Furthermore, it is not clear that an economic substance approach would necessarily support the unwind doctrine. Hasen, in \textit{Unwinding Unwinding}, created a theoretical framework for analyzing “unwind” cases. Hasen attempted to derive from the Haig-Simons economic income concept principles for whether and when unwinding should be allowed.”\textsuperscript{188}

Hasen’s discussion of the Haig-Simons conception of income is, in part, as follows:

The Haig-Simons conception of income, named after the two theorists who are credited with having articulated it, defines income as the net change in a taxpayer’s wealth (including wealth spent on consumption) during the tax period. The occurrence or not of transactions is irrelevant to the amount of the taxpayer’s income or loss and, therefore, to the amount of income tax liability the taxpayer has during the tax period. Thus, the Haig-Simons definition takes into account the net appreciation and depreciation of assets held during the tax period, without regard to whether the assets are retained or sold. For example, whether or not $A$ sells \textit{Blackacre} on December 31, her tax liability for the year ending on that date is the same, because the increase or decline in value of \textit{Blackacre} is definitive of whether she has taxable income or loss.\textsuperscript{189}

Most readers will note right away that our income tax system is not based on Haig-Simons, as Hasen notes:

\begin{quote}
[T]he Haig-Simons concept does not, in fact, supply the normative definition of income under the actual income tax. For one thing, the actual tax has always incorporated a realization requirement for most forms of income, and likely always will. Moreover, the historical justification for the income tax has more to do with practical ability-to-pay concepts than with the ideal of taxing Haig-Simons income. Actual ability to pay hinges in some measure on liquidity and valuation, two problems for a Haig-Simons tax that a realization-based income tax largely solves.\textsuperscript{190}
\end{quote}

And further:

From a Haig-Simons perspective, the non-taxation of accrued but unrealized gain or loss represents an accommodation of the income tax to other exigencies, principally the problems of valuation, liquidity, and political acceptability.\textsuperscript{191}

Hasen points out that rescission would be irrelevant in a Haig-Simons system of taxation.\textsuperscript{192} But, as Hasen also notes in the above quoted portions of his article, we don’t live in

\begin{flushright}
\textsuperscript{187} Note 27, \textit{supra}.
\textsuperscript{188} Fabricated Doctrine, note 32, \textit{supra}, at 165.
\textsuperscript{189} Hasen, note 27, \textit{supra}, at 897-898.
\textsuperscript{190} Id. at 899.
\textsuperscript{191} Id. at 898.
\end{flushright}
a Haig-Simons tax world. Accordingly, rescission’s irrelevance in a Haig-Simons system is irrelevant to whether the current rescission doctrine of Rev. Rul. 80-58 is good policy.

Fabricated Doctrine also notes:

“Hasen argued that “the substantive case for unwinding treatment is comparatively weak” in situations where income tax consequences are being unwound, as compared to situations where transactional taxes are being unwound. The crux of his thesis is that:

. . . the existence of the thing that is taxed—income—does not depend on the fact of a transaction. Rather, the transaction provides the occasion for imposing the tax now rather than at some other time; the income (or loss), however, will generally be taken into account eventually. Hence the availability of the unwind treatment should not depend, even in the abstract, on the mere return to the status quo ante, because such a return does not mean that nothing giving rise to a tax has occurred. Hasen concludes that “any reversal, to merit unwind treatment, ought to be allowed only if the mistake or error giving rise to it is justified.”193

Hasen makes other interesting statements:

The “rightness” of any given rule in the abstract, however, is not the only consideration relevant to shaping a well-conceived unwinding doctrine. A further and equally significant consideration is consistency.194

This paper submits that the annual accounting concept as applied in Rev. Rul. 80-58 and the claim of right cases brings consistency to tax law. Moreover, although Fabricated Doctrine is correct that Hasen views the justification for allowing rescission treatment in income tax cases as comparatively weaker than for transactional tax cases, he nowhere attempts to quantity the difference and concludes his article by stating that rescissions will very likely continue to be allowed on some basis in income tax cases.195 However, Hasen also discuss tax benefit rule cases and claim of right cases in connection with rescission and makes the following observation:

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192 Id. at 898.
193 Fabricated Doctrine, note 32, supra, at 165.
194 Hasen, note 27, supra, at 904. (emphasis supplied)
195 Id. at 942, where Hasen states:

These considerations do not imply that unwinding should be unavailable under an income tax. They only indicate that the case for income tax unwinding is weaker than the case for transactional taxes. The possibility of evasion or avoidance may be a cost worth bearing, especially if the contexts in which unwinding is deemed a permissible remedy are sufficiently salient to the tax authority that the worry about evasion is minimal, the options for avoidance are minimized, or both.
If the compulsory nature of a reversal is considered one of the necessary conditions of unwind treatment, then Revenue Ruling 80-58 is overbroad in permitting unwinds in the same taxable year as the original transaction, regardless of whether the reversal is a product of the taxpayer’s choice. On the other hand, if the sanctity of the annual accounting principle provides the basis for according or denying unwinding relief, it is unclear why the principle does not also govern claim of right and TBR cases, at least where the error giving rise to the later-year adjustment concerns the taxpayer’s knowledge of underlying facts that themselves have not changed.

The tax benefit rule (TBR in Hasen) provides that if a taxpayer recovers an expense or loss that was written off against a previous year’s income, the recovered amount must be included in income in the year of recovery. Frequently recurring tax benefit situations are the inclusion of a prior bad debt deduction upon the unexpected repayment of the debt and the inclusion in income of amounts previously deducted as losses under § 165 when the amounts have been unexpectedly recovered. The claim of right cases hold that if a taxpayer receives income in one year without any restriction on the taxpayer’s use of the income, the full amount of the income is includible in the year of receipt notwithstanding a possibility that the taxpayer might be required to repay some or all of the income in the future.

It is unclear why application of the annual accounting concept should change the treatment of tax benefit cases or claim of right cases. The annual accounting concept provides that a taxpayer’s income for a taxable year is computed on the basis of the facts at the end of the year. If the facts existing at the end of a taxpayer’s tax year support the taking of a loss deduction or require the inclusion of income received under a claim of right, then that is the mandated result, and a taxpayer is not permitted to reopen a prior year on the ground that the relevant facts have changed since the end of that year. On the other hand, the rescission treatment allowed by Rev. Rul. 80-58 is consistent with the annual accounting concept in that the rescission must take place in the same tax year as the transaction that is being rescinded; thus the facts at the end of the tax year include the fact of the rescission. In connection with his argument that the annual accounting principle, if applied to tax benefit cases and claim of right cases in the same way it is applied to rescissions, would change the treatment of those cases, Hasen states:

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196 Id. at 906. See Treas. Reg. § 1.165-1(d)(2)(iii), which specifies that the rule applies to unexpected recoveries of losses that were reasonably but erroneously deducted in a prior taxable year.

197 Notes 153-160, supra, and accompanying text.

198 Id.
“For example, it is not clear why a deduction should be available in the later year on the taxpayer’s discovery that she never received an item that she included in a prior year.”

This statement seems incorrect. If the taxpayer in a prior year included as income an amount the taxpayer didn’t actually receive, the annual accounting principle would say that that amount should not have been included in income in the prior year and the taxpayer’s remedy should be limited to filing an amended return that would report taxable income correctly for the prior year based on the facts existing at the end of that year (although misapprehended by the taxpayer).

Fabricated Doctrine then refers to Banoff’s discussion of policy arguments both for and against permitting retroactive unwinding, including the argument against that “approval of retroactive unwindings that are tax motivated permits taxpayers to play the audit lottery: If you are audited, only then do you unwind to avoid adverse tax results.”

With respect to Banoff, the author does not see under the present state of authority on rescission how one could play the audit lottery. If a taxpayer waits until he or she is audited, it will be impossible to carry out an unwinding in the same year as the transaction desired to be unwound.

Fabricated Doctrine continues:

The unwind doctrine may similarly dilute the deterrent effect of the codified economic substance doctrine in section 17709(o) [sic] by allowing taxpayers to undertake transactions that may risk falling foul of that doctrine knowing that they can be rescinded later in the tax year if they receive advice that it would certainly fall foul of section 17709(o) [sic].

Fabricated Doctrine’s references to “section 17709(o)” [sic] appear to be intended to be references to I. R. C. § 7701(o), which defines the “economic substance doctrine” as “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.”

Penalties are imposed by I. R. C. § 6662. I. R. C. § 6662(a) imposes a penalty of 20% of the portion of any underpayment attributable to any of various defined actions, including any disallowance because a transaction lacks economic substance “within the meaning of section

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199 Hasen, note 27, supra, at 923, note 213.
201 Id. at 166.
If a transaction that does not have economic substance is not disclosed in the taxpayer’s return, the penalty increase to 40%. This author believes that almost all unwinding transactions will have economic substance because the very nature of an unwinding transaction that comes within Rev. Rul. 80-58 is that the parties will have changed their economic position in a meaningful way—whether by undoing a sale of property or by giving up the right to income. Also, it appears unlikely that a taxpayer who enters into a transaction lacking economic substance would see the light, if at all, within the period during which a valid rescission can be undertaken in compliance with Rev. Rul. 80-58. In any case, the purpose of I. R. C. §§ 7701(o) and 6662 would appear to be to deter taxpayers from entering into transactions that lack economic substance. Accordingly, if a taxpayer were to rescind a transaction because the taxpayer feared that the transaction would be found to lack economic substance, it would seem that I. R. C. §§ 7701(o) and 6662 would have achieved their purpose.

Fabricated Doctrine continues its argument by stating:

Hasen further notes that the ability to unwind transactions in the manner allowed by Rev. Rul. 80-58 facilitates the problem of government ‘whipsaw,’ when the property transferred subject to an ‘unwinding has depreciated or depreciated [sic] over the course of the tax year.’ Each of these effects may mean that unwinding is a drain on the revenue.

Any potential whipsaw problem appears to be de minimus first because taxpayers do not have that much time to decide to try to rescind a transaction. Moreover, if taxpayer A sells property to taxpayer B in January, 2014, and the parties rescind the sale before the end of 2014, the sale in January, 2014, is disregarded under Rev. Rul. 80-58, and taxpayer A is treated as having owned the property all the time after the disregarded sale. Accordingly, any deductions attributable to the property would belong to taxpayer A, and taxpayer B would not be entitled to claim them. How does one determine if rescissions or any other activity is “a drain on the revenue”? Is there some knowable level of revenue that somehow can be said to belong to the Federal government that may be drained? Further, although Hasen does note that some whipsaw may occur, for him the possible whipsaw arises because taxpayers may conduct their affairs so as

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203 I. R. C. § 6662(b)(6).
204 I. R. C. § 6662(i).
205 Fabricated Doctrine, note 32, supra, at 166.
to avoid Rev. Rul. 80-58 when it is advantageous to do so, and comply when that is favorable. 206 Hasen also notes that our self-reporting system contributes to whipsaw. 207 Both of these concerns apply to our tax system generally and not peculiar disadvantages of the unwinding doctrine of Rev. Rul. 80-58. Indeed, in another part of his article, Hasen discusses that when a taxpayer successfully avoids having to report gain on a rescinded sale, the taxpayer often will have more taxable income in future years than would be the case if the rescission had not occurred. 208

The Rescission Doctrine as Currently Applied by the Internal Revenue Service is Correct and would be Correct Even If Penn v. Robertson Had Never Been Decided.

This paper has attempted to demonstrate that Penn v. Robertson in fact offers strong support for the rescission doctrine articulated by Rev. Rul. 80-58 and that the authors of Fabricated Doctrine have completely failed in their attempt to show that the IRS fabricated the rescission doctrine in Rev. Rul. 80-58 and that everyone else has misread Penn v Robertson. Penn v. Robertson clearly characterizes the income realized by Mr. Penn early in 1931 as having been extinguished by his executors’ agreeing to return his credits later in 1931. Fabricated Doctrine attempts unsuccessfully to show that the court in Penn v. Robertson was operating under a deduction rationale, but those attempts, as this paper demonstrates, were based on an incredible misreading of the opinion. 209 Nowhere in its opinion does the court in Penn v. Robertson give any indication that when it said that it agreed with the district court “the rescission in 1931 before the close of the calendar year extinguished what otherwise would have been taxable income to Penn for that year” 210 that it was really saying that what would otherwise have been taxable income to Mr. Penn was extinguished because it had been reduced to zero by a deduction. In addition to their fundamentally flawed reading of the opinion in Penn v. Robertson, the authors of Fabricated Doctrine only attempted to analyze half of the problem. Rev. Rul. 80-58 cited two grounds for its holdings—one was Penn v. Robertson and the other (cited first in Rev. Rul. 80-58) was the annual accounting principle as established by the United States Supreme Court cases discussed above under Development of the Annual Accounting Concept. Ultimately, however, even if the authors of Fabricated Doctrine were correct in their

206 Hasen, note 27, supra, at 940-942
207 Id.
208 Id. at 901.
209 Notes 63-114, supra, and accompanying text.
210 115 F. 2nd 175.
assertion that Penn v. Robertson provides no support for the rescission doctrine as currently applied by the IRS, that doctrine would be correct as a matter of policy and would be within the authority of the Treasury Department and the Internal Revenue Service. Section 7801 of the Internal Revenue Code authorizes and directs the Treasury Department to perform the “administration and enforcement” of the income and transfer tax provisions, and section 7805 authorizes and directs the prescription “of all needful rules and regulations.” Treasury has delegated this authority and direction to the Commissioner of Internal Revenue.211

In other words, assume that Penn v. Robertson had never been decided and that taxpayers were just now approaching the Internal Revenue Service with questions about the tax treatment of transactions that had been unwound. Can anyone doubt that sections 7801 and 7805 provide ample authority for the Internal Revenue Service to look at the United States Supreme Court cases defining and discussing the annual accounting concept and on the basis of the annual accounting concept promulgate a revenue ruling articulating the same rescission doctrine as Rev. Rul. 80-58?212 The Court in Burnet v. Sanford & Brooks Company observed that “all revenue acts since the adoption of the Sixteenth Amendment have uniformly assessed the basis of annual returns showing the net result of all the taxpayer’s transactions during a fixed accounting period.”213 The Court quoted this statement approvingly in 1944,214 and, in 1953, the Court stated that “Congress has enacted an annual accounting system under which income is counted up at the end of each year.”215

The annual accounting concept is the common policy thread running through Penn v. Robertson, Rev. Rul. 80-58, and the claim of right cases. As discussed earlier, the claim of right cases teach us that if a taxpayer receives income in the tax year 2014 with no restrictions of the taxpayer’s right to retain or use the income, if the taxpayer is required to repay all or a portion of the income in a later tax year, the taxpayer cannot reopen the 2014 tax year to reduce the taxpayer’s income in 2014 but will only be allowed a deduction in the year of repayment. The claim of right cases also teach us, however, that if the taxpayer in this example repays all or a portion of the income in the year of receipt, 2014, the repayment reduces the taxpayer’s

211 Treas. Reg. § 301.7805-1.
212 Indeed, just last year, the IRS reaffirmed that Rev. Rul. 80-58 is its guidance on rescissions. Notes 6-7, supra, and accompanying text.
213 282 U. S. at 363. (emphasis supplied)
215 Healy v. Commissioner, note 17, supra, 345 U. S. at 284.
reportable taxable income in 2014, whether the repayment was voluntary or involuntary—it is a reduction in reportable taxable income, not the allowance of a deduction. Fabricated Doctrine does not offer any analysis of the annual accounting concept. Indeed, in its discussion of the potential tax treatment of Douglas Poling, without any consideration of how the annual accounting concept might apply, Fabricated Doctrine assumes away any potential deductibility of a repayment by Mr. Poling of his TARP bonus, fails to discuss the authorities discussed above\textsuperscript{216} that show that if Mr. Poling did repay his TARP bonus in the year of receipt, he would be allowed to exclude the repaid bonus from his taxable income for that year, and wrongly states that Mr. Polling would likely be entitled to treat repayment as a rescission under Rev. Rul. 80-58.

A fundamental difference between this author and the authors of Fabricated Doctrine is that this author believes the annual accounting concept is an important policy concept that supports the rescission doctrine as developed by Rev. Rul. 80-58. Fabricated Doctrine does not discuss the annual accounting concept or even acknowledge that it was one ground cited by Rev. Rul. 80-58 as authority for its holdings.\textsuperscript{217} Under the annual accounting concept, what policy would suggest that, although a deductible expense paid (if the taxpayer uses the cash basis of accounting) or incurred (if the taxpayer uses the accrual method of accounting) on December 31, 2014 may reduce taxable income realized on January 1, 2014, it is inappropriate to say that a sale closed in January, 2014 that is unwound in December, 2014 does not have to reported on the taxpayer’s return for 2014, or that it is inappropriate to say that a taxpayer who receives taxable compensation in January 2014 does not have to report the income to the extent the taxpayer repays the compensation to the employer before the end of 2014? As discussed in more detail above,\textsuperscript{218} it is no answer, particularly in the case of an unwound sale of a capital asset, to assert that a deduction puts the taxpayer in the same position as an unwinding and that therefore a deduction rationale is just as likely or, as Fabricated Doctrine argues, more likely the basis for the holding with respect to the tax year 1931 in \textit{Penn v. Robertson} as is the rescission doctrine.

This paper has demonstrated that Fabricated Doctrine’s recommendation that Rev. Rul. 80-58 be revoked rests entirely on a fundamentally flawed analysis of \textit{Penn v. Robertson}. \textit{Penn v. Robertson} in fact provides ample legal support for Rev. Rul. 80-58. Moreover, Rev. Rul. 80-

\textsuperscript{216} Notes 133-139, \textit{supra}, and accompanying text.
\textsuperscript{217} Note 1, \textit{supra}, and accompanying text.
\textsuperscript{218} Note 72, \textit{supra}, and accompanying text.
58 is supported by the United States Supreme Court cases establishing the annual accounting concept, and Rev. Rul. 80-58’s permitting a rescission of a sale in the same taxable year is completely consistent with the annual accounting concept. Although the IRS has recently confirmed that Rev. Rul. 80-58 will continue indefinitely to be its position on rescissions, it would be beneficial if the IRS would relax its current no-ruling policy on rescissions and provide guidance on questions like those raised in the New York State Bar Report. If time and energy could be found, a wide-ranging discussion of the best policies to apply to rescissions, tax benefit cases, and claim of right cases, as Hasen attempted in his article, would also be beneficial. 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.

219 Notes 6-7, supra, and accompanying text.