

# THE FABRICATED UNWIND DOCTRINE: THE TRUE MEANING OF *PENN V.* *ROBERTSON*<sup>†</sup>

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## I. INTRODUCTION AND OVERVIEW

Taxpayers routinely rely on the unwind doctrine found in Internal Revenue Service Revenue Ruling 80-58<sup>1</sup> when they discover that their transactions have unwanted tax consequences. Nowadays, “unwinding” has become a “common if not ubiquitous feature of tax practice.”<sup>2</sup> 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*.<sup>3</sup>

Also referred to as the “rescission doctrine,”<sup>4</sup> a tax “do-over,”<sup>5</sup> or a “tax mulligan,”<sup>6</sup> 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

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1. Rev. Rul. 80-58, 1980-1 C.B. 181.

2. David Hasen, *Unwinding Unwinding*, 57 EMORY L.J. 871 (2008).

3. 115 F.2d 167 (4th Cir. 1940).

4. David H. Schnabel, *Revisionist History: Retroactive Federal Tax Planning*, 60 TAX LAW 685, 686 (2007).

5. Richard W. Bailine, *Rescission: A Federal Income Tax ‘Do-Over’*, CORP. TAX’N, Nov.–Dec. 2005, at 32, 33.

6. Todd B. Reinstein, *IRS OKs a Mulligan: Expands the Rescission Doctrine in Recent PLRs*, PEPPER HAMILTON LLP TAX UPDATE (May 3, 2007), <http://www.pepperlaw.com/pdfs/Tax0407.pdf> (discussing an analogy to the golfing practice that allows a golfer to retake a shot if she does not like the outcome of the first attempt; the analogy is apt in the tax situation only where there is an unwind plus a re-try, rather than simply unwinding a transaction without then attempting a similar transaction).

of the tax year. In *Unwinding Unwinding*, Hasen explains that “in a successful unwind, parties to a prior transaction or arrangement back out of it by means of a later transaction and are treated for tax purposes as having engaged in no transactions at all.”<sup>7</sup> Schnabel illustrates the effect of the doctrine with the example of a rescinded stock sale:<sup>8</sup>

. . . if A sells 100 shares of stock to B for \$100 and, during the same taxable year and before any dividends have been declared on the stock, the transaction is rescinded such that A receives the stock back from B and B receives the \$100 back from A, A and B will generally be taxed as though A held the stock for the entire time.

The Internal Revenue Code, Treasury Regulations, case law, and IRS rulings do not refer to any unwind doctrine or rescission doctrine by name. Commentators coined the appellation to describe the effect of rulings, including many private letter rulings, in which the IRS has allowed taxpayers to take the unwind approach. 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,<sup>9</sup> but also tax effects such as changes in entity status,<sup>10</sup> the liquidation of a company,<sup>11</sup> and a company’s exit from a consolidated group.<sup>12</sup> It has allowed unwind treatment when the economic reversal was motivated by changes in business conditions,<sup>13</sup> and also in circumstances where the reversal was motivated by tax outcomes that the parties later came to regret.<sup>14</sup> 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,<sup>15</sup> 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.<sup>16</sup>

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 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

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7. Hasen, *supra* note 2, at 871.

8. Schnabel, *supra* note 4, at 687.

9. Rev. Rul. 80-58, 1980-1 C.B. 181.

10. I.R.S. Priv. Ltr. Rul. 05-33-002 (Aug. 19, 2005).

11. I.R.S. Priv. Ltr. Rul. 07-01-019 (Jan. 5, 2007).

12. I.R.S. Priv. Ltr. Rul. 09-23-010 (June 5, 2009).

13. I.R.S. Priv. Ltr. Rul. 05-33-002 (Aug. 19, 2005).

14. I.R.S. Priv. Ltr. Rul. 07-01-019 (Jan. 5, 2007).

15. Rev. Rul. 80-58, 1980-1 C.B. 181.

16. I.R.S. Priv. Ltr. Rul. 07-01-019 (Jan. 5, 2007).

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.

The IRS private letter rulings and consequent tax practice rely on Revenue Ruling 80-58 as the source of the unwind doctrine.<sup>17</sup> In turn, Revenue Ruling 80-58 claims to find authority for its result in *Penn v. Robertson*.

Despite many IRS rulings and despite taxpayers regularly adopting the unwind doctrine, the authors know of no analysis of *Penn v. Robertson* that convincingly shows that the case indeed supports the unwind doctrine. Published analyses of unwinding focus on Rev. Rul. 80-58. When commentators mention *Penn v. Robertson* at all, it is simply assumed to be authority for the unwind doctrine, without any consideration of the alternative interpretation of the case that this article argues is correct.<sup>18</sup>

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*.<sup>19</sup>

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.

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.

These mistakes came about because Revenue Ruling 80-57 and subsequent private letter rulings made the classic error of confusing the timing question of *when* a particular outgoing is deductible with the

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17. Sheldon I. Banoff, *New I.R.S. Rulings Approve Rescission Transactions That Change an Entity's Status*, 105 J. TAX'N 5, 5 (2006) (“[N]either the Code nor the Regulations give guidance as to when a second (unwinding or rescission) transaction will be given effect, such that neither the first nor the second transaction will be deemed to have ever occurred for federal income tax purposes.”); see also Joseph I. Graf ed., *Application of the Rescission Doctrine to Issued Stock*, 111 J. TAX'N 58, 58 (2009) (“The rescission doctrine is not part of the Code. The doctrine is derived from case law and rulings, such as Rev. Rul. 80-58. . .”).

18. E.g., Hasen, *supra* note 2, at 897–902 (examines whether any principled normative basis exists for unwinding but does not question whether the doctrine exists in law).

19. See *infra* Parts III and IV.

substantive question of *whether* the outgoing is deductible at all.

*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 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.

In contrast, the IRS’ misunderstanding of *Penn v. Robertson* does matter for practical purposes in cases where the unwind is not a true rescission, but simply a situation where two parties voluntarily reach a fresh agreement to reverse the effects of a completed and legally independent transaction.<sup>20</sup> These are cases where the unwind doctrine may lead to an outcome that cannot be achieved under ordinary principles of tax law (which is, as noted above, is the very attraction of unwinding for taxpayers). In such cases, a taxpayer may derive taxable income under the first transaction, but the reversal transaction where he repays that taxable income will not necessarily result in a deduction under ordinary principles.

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20. Rescissions are often voluntary, certainly they are often so for one party to the agreement rescinded (such as the promisee in case of breach). In many cases even the promisor may unwind an agreement “voluntarily” rather than run the risk that the promise will prevail in a dispute. The authors thank David Hasen for suggesting this point. See also *infra* Part IV.C below for a discussion of the various uses of the term “rescission.”

Under ordinary principles of tax law, the taxpayer faces the unhappy result of paying net tax on the transactions. The unwind doctrine however allows both transactions to be ignored for income tax purposes, leading to no income tax consequences whatsoever.

One such case of a bare reversal and its tax consequences gained media attention in 2009. This was the case of Mr. Douglas Poling, an executive of American Insurance Group (AIG) (a beneficiary of the Troubled Asset Relief Programme), who received a bonus from AIG, but voluntarily repaid it in the same tax year.<sup>21</sup> Under ordinary principles of tax law, the bonus was taxable income, and the repayment was a non-deductible gift.<sup>22</sup> Under ordinary principles, Mr. Poling would pay net income tax on a repaid bonus, but under the unwind doctrine in Rev. Rul. 80-58, he may treat both the bonus and repayment as having never occurred for income tax purposes.

Part II of this article outlines Mr. Poling's case to illustrate why it is important to discern the correct ratio of *Penn v. Robertson*. Part III is a close reading of *Penn v. Robertson*. We find that *Penn v. Robertson* is not authority for the unwind doctrine that the IRS, taxpayers, and commentators routinely ascribe to it. Part IV explains how Rev. Rul. 80-58 and other IRS private letter rulings, as well as practitioner and academic commentaries, have misunderstood *Penn v. Robertson*. Part V shows that the case law has not in fact made the same mistakes in interpreting *Penn v. Robertson* as the IRS. Not only is *Penn v. Robertson* not good authority for the unwind doctrine, but no other cases have authoritatively asserted that it is. Part VI briefly considers whether taxpayers can nevertheless rely on the unwind doctrine, despite there being no basis for it in case law. Part VII briefly considers what should be done about the misunderstanding of *Penn v. Robertson*.

## II. THE ILLUSTRATIVE CASE OF MR. DOUGLAS POLING

The following elements of Mr. Douglas Poling's case are relevant to this article's analysis of the precise meaning of *Penn v. Robertson*, and the issue of whether Rev. Rul. 80-58 correctly reflects that meaning:

Mr. Poling is a taxpayer who receives a sum that, following ordinary principles, is taxable income;

The taxpayer pays back that sum within the same tax year, reversing the economic effect of the first transaction. However, the repayment is not—we assume for sake of argument—deductible in its own right under ordinary tax principles; and

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21. The authors assume as such; *see infra* Part II.

22. Here, the authors do not use a technical tax meaning of "gift," but rather, the common law meaning of a transfer of property with no or inadequate consideration.

The taxpayer wishes to rely upon the special principle set out in Rev. Rul. 80-58, so as to treat both transactions as if they had never occurred, leading to no tax consequences.

#### A. BACKGROUND OF MR. POLING'S CASE

President George W. Bush signed the Emergency Economic Stabilization Act into law on October 3, 2008. This Act authorized the Troubled Assets Relief Programme, or "TARP," by which the United States government endeavoured to stabilize the finance sector, and thus the economy as a whole, which had been thrown into turmoil by the subprime crisis. TARP involved the United States Treasury investing in financial institutions by purchasing poor quality securities and other "troubled assets" and by investing in shares of institutions that were illiquid.

TARP provoked controversy on many fronts. One such front was that of the so-called "TARP bonuses." Typical of workers in the financial sector, employees of many beneficiaries of TARP funds were accustomed to receiving large proportions of their remuneration in the form of bonuses. Perhaps rashly, TARP-assisted banks, insurance companies, and others continued the practice in early 2009, in effect using taxpayers' funds supplied by the Treasury via TARP.<sup>23</sup> This action triggered a public outcry.<sup>24</sup>

Notoriously, Douglas Poling received a bonus in 2009 of \$6.4 million,<sup>25</sup> said to be the largest of all bonuses from TARP-assisted companies that year.<sup>26</sup> Mr. Poling was a senior executive at AIG, which TARP had rescued from bankruptcy. Mr. Poling gained some fame among tax practitioners and scholars, his case was widely reported, and protestors picketed his home in Fairfield, Connecticut.<sup>27</sup>

Mr. Poling received attention for reasons other than the unmatched sum of his bonus. As General Counsel and Chief Administrative Officer in AIG's Financial Products Unit, Poling was a senior executive for a particularly troubled part of the chronically troubled institution: His unit had been responsible for the credit derivative trades that had "sank the company."<sup>28</sup> Mr. Poling "oversaw legal work on the contracts that sat at

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23. Randall Smith & Liam Plevin, *Some Will Pay Back AIG Bonuses*, WALL ST. J., Mar. 19, 2009, at A1, available at <http://online.wsj.com/article/SB123743055512280701.html>.

24. *Id.*

25. Smith & Plevin, *supra* note 23.

26. *Id.*

27. See Deborah Cassens Weiss, *AIG Lawyer Offers to Return \$6.4M Bonus, Stations Guards at His Home*, A.B.A. J. LAW NEWS NOW (Mar. 20, 2009), [http://www.abajournal.com/news/article/aig\\_lawyer\\_offers\\_to\\_return\\_6.4m\\_bonus\\_stations\\_guards\\_at\\_his\\_home](http://www.abajournal.com/news/article/aig_lawyer_offers_to_return_6.4m_bonus_stations_guards_at_his_home); James Taranto, *Give Back That Bonus!*, WALL ST. J. (March 26 2009), <http://online.wsj.com/article/SB123807922595548325.html>.

28. Deborah Solomon & Serena Ng, *Fresh Pay Skirmish Erupts at AIG*, WALL ST. J., Dec. 7,

the core of the unit's business . . . [but] the terms of such contracts . . . crippled AIG, required a massive \$173.3 billion in government support and imperilled the soundness of the world financial system."<sup>29</sup> Nevertheless, AIG scheduled \$475 million in bonuses to be paid between March 2008 and March 2010 to the 400 employees of the Financial Products Unit.<sup>30</sup> The fact that Poling was a former Wall Street lawyer, a member of the New York Bar, and graduate of Yale Law School also received media attention.<sup>31</sup>

The public outcry about the TARP bonuses caused a number of Democratic members of the United States House of Representatives to sponsor bills to impose special taxes on the bonuses.<sup>32</sup> On March 19 the House passed H.R. 1586 (The TARP Bonus Act of 2009), that stipulated a 90 per cent tax on TARP bonuses.<sup>33</sup>

While these bills were being proposed, people were thinking of another possibility: recipients of TARP bonuses might simply repay them. Apart from the public opprobrium of being a TARP bonus recipient, repayment was an attractive option in the face of the effective tax rates that the legislative bills would have produced.

The problem was that cities and states in the United States use the federal income tax base for calculating their own income tax. Since a TARP bonus was also income for city and state purposes, with a special federal TARP bonus tax of (for example) 90 per cent in force, a resident of Manhattan would suffer federal, state, and city tax of over 100 per cent on a TARP bonus, and on top of that the Medicare levy.<sup>34</sup> In the face of a potential effective tax rate on TARP bonuses of over 100 per cent, returning one's bonus had appeal.

Many recipients of bonuses from TARP-funded companies waived their bonuses, repaid them, or announced that they intended to do so.<sup>35</sup> An

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2009, at A1, available at <http://online.wsj.com/article/SB126015238193279485.html>.

29. Randall Smith & Liam Plevin, *Lawyer at Center of Troubled Unit Got Top Bonus*, WALL ST. J., Mar. 20, 2009, at A6, available at <http://online.wsj.com/article/SB123750761751290337.html>.

30. OFFICE OF THE SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, SIGTARP-10-002, EXTENT OF FEDERAL AGENCIES' OVERSIGHT OF AIG COMPENSATION VARIED, AND IMPORTANT CHALLENGES REMAIN (Oct. 14, 2009), available at [http://www.sig tarp.gov/reports/audit/2009/Extent\\_of\\_Federal\\_Agencies'\\_Oversight\\_of\\_AIG\\_Compensation\\_Varied\\_and\\_Important\\_Challenges\\_Remain\\_10\\_14\\_09.pdf](http://www.sig tarp.gov/reports/audit/2009/Extent_of_Federal_Agencies'_Oversight_of_AIG_Compensation_Varied_and_Important_Challenges_Remain_10_14_09.pdf) [hereinafter SIGTARP].

31. *Lawyer Gives Up \$6.4M AIG Bonus*, LAW SHUCKS (Mar. 23, 2009), <http://lawshucks.com/2009/03/lawyer-gives-up-64m-aig-bonus>; see also Smith & Plevin, *supra* note 29.

32. See H.R. 1586, 111th Cong. (as introduced on March, 18 2009).

33. *Id.* (passed by a vote of 328—including 243 Democratic and 85 Republican yeas—to 93).

34. This article ignores the impact of the Alternative Minimum Tax. The article is more concerned to isolate and determine income tax consequences of a reversal under general legal principles and the special concept of an "unwind" than it is to determine the exact tax position of Poling or other similar taxpayers.

35. Jack Lynch, *Cuomo Says Most Huge A.I.G. Bonuses Were Returned*, N.Y. TIMES DEALBOOK BLOG, (Mar. 23, 2009, 6:05 PM), <http://dealbook.blogs.nytimes.com/2009/03/23/cuomo-says-many-big-aig-bonuses-were-returned/>.

AIG spokesperson announced on March 19, 2009, that Mr. Poling intended to repay his bonus “because [Poling] thought it was the correct thing to do,”<sup>36</sup> but there has been no public confirmation that Poling in fact repaid his bonus. This article assumes that Poling repaid his bonus in 2009, the same year that he received it.<sup>37</sup>

In the end, no TARP Bonus Bill was enacted, seemingly because the threat of the legislative bills had to some extent done their job without becoming law. One week after H.R. 1586 was introduced to the House, House majority leader Steny Hoyer said, “I think apparently the House bill had its effect. They are giving it back,” and gave his view that Congress may not need to act at all if AIG employees continued to return the payments.<sup>38</sup>

#### B. POLING’S ISSUE: PAYING TAX ON A RETURNED BONUS?

The question that may have vexed Mr. Poling’s tax advisers when they prepared Poling’s tax return for 2009: what is the aggregate income tax effect<sup>39</sup> for someone in Mr. Poling’s position of (a) receiving a bonus and (b) (presumably) repaying it within the same tax year (for most TARP bonus recipients, during 2009)?<sup>40</sup> The question depends on Rev. Rul. 80-58, and the correct meaning of the ruling’s purported authority, *Penn v. Robertson*.

#### C. POLING’S INCOME TAX POSITION

The analysis starts with ordinary tax law principles. Setting aside any unwind doctrine, what are the tax consequences of the two transactions at issue?

The transfer of the bonus from AIG to Poling, is taxable as remuneration for Mr. Poling’s services as an employee of AIG.<sup>41</sup>

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36. Weiss, *supra* note 27.

37. SIGTARP, *supra* note 30, at 17.

38. Dierdre Walsh, *Top House Dem says taxing bonuses may no longer be needed*, CNN POLITICS POLITICAL TICKER (Mar. 24, 2009, 12:50 PM), <http://politicalticker.blogs.cnn.com/2009/03/24/top-house-democrat-says-taxing-bonuses-may-no-longer-be-needed>; Laura Litvan & Alison Vekshin, *Senate Reconsidering Employee-Bonus Tax Proposal*, BLOOMBERG (Mar. 25, 2009 12:17 PM), <http://www.bloomberg.com/apps/news?pid=20601087&sid=aWCMJXvucIM&refer=home>.

39. Again, gift tax implications are beyond the scope of this article, as are the corporate income tax implications for AIG.

40. See Michael Doran, Comment to *Tax Problems of AIG Employees Who Repay Their Bonuses*, TAXPROF BLOG (Mar. 27, 2009), [http://taxprof.typepad.com/taxprof\\_blog/2009/03/tax-problems-of-aig-.html#comments](http://taxprof.typepad.com/taxprof_blog/2009/03/tax-problems-of-aig-.html#comments) (suggesting that *Penn v. Robertson* may prevent executives who return their TARP bonuses from facing a net tax impost); see also John W. Lee, *Tax TARP Needed for Year One and Year Two Returns of Executive Bonus to TARP Recipient: A Case Study of Year One Rescission/Exclusion From Income and Year Two Deduction Under Section 1341*, 1 WM. & MARY BUS. L. REV. 323, 330 (2010).

41. The finance industry colloquially uses the word “bonus” in both its legally correct meaning (a

The transfer from Mr. Poling to AIG—the bonus repayment—can be best characterized as an entirely voluntary payment from Mr. Poling to AIG, which, although economically connected to the bonus payment from AIG to Mr. Poling, is, we assume, in ordinary contract law, unconnected to the bonus payment.<sup>42</sup>

The Internal Revenue Code allows in section 162(a) deductions for “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.” An employee is treated as being in the business of earning income through the provision of services.<sup>43</sup> *Noland v. Commissioner*<sup>44</sup> suggests that under ordinary tax principles, Poling cannot claim a deduction for a bonus repayment to AIG that is, under ordinary law, a gift that was neither legally mandatory nor connected in law to the original receipt of the bonus. *Noland* is authority for the principle that when an employee voluntarily transfers value to his or her employer these outlays are not generally deductible to the employee.<sup>45</sup> Lee,

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gift for good work) and also in a meaning that is a contradiction in terms: extra remuneration for meeting targets. It is unclear from media reports whether the “bonuses” received by AIG executives were of the first or the second kind, and indeed it seems that AIG itself is unsure of the correct position: see SIGTARP, *supra* note 30, at 17. The difference is immaterial for this article. We assume that the bonus is received under an absolute right rather than a claim of right. By contrast, Lee, *supra* note 40, at 340, argues for a claim of right approach, based on the fact that when the bonus payment was made both parties had knowledge of circumstances that might necessitate a repayment. In our view this reasoning is incorrect because the circumstances that “necessitated” repayment were business and social circumstances (moral outrage and the threat of the TARP bonus bills that were not in the end enacted) rather than any legal compulsion to repay the bonuses. We do not discuss this issue in detail here, but assume that the bonus was received under an absolute legal right.

42. Reports portrayed Mr. Poling’s pledge to repay his bonus as a completely voluntary response to requests from AIG (and to public outrage). See Weiss, *supra* note 2727; SIGTARP, *supra* note 30, at 17. The conclusion that neither AIG’s employment contracts nor any special contractual conditions attached to the bonuses required that bonuses be repaid is consistent with a report that AIG was able to extract from its employees pledges to repay only \$45 million of the \$168 million in bonuses that AIG paid or was scheduled to pay in March 2008. As of October 2009, AIG has been able to collect only \$19 million of the \$45 million pledged. SIGTARP, *supra* note 30, at 17.

43. *Noland v. Comm’r*, 269 F.2d 108 (4th Cir.1959).

44. *Id.*

45. Mr. Noland was an employee and stockholder of the Noland Company. He personally claimed deductions for expenses that he had incurred for the Noland Company’s benefit, including the cost of an elaborate company Christmas party. The company did not reimburse Mr. Noland for the expenses. The court found that Mr. Noland’s contractual relationship with the Noland Company did not require him to incur the expenses for which he had claimed deductions. The issue was whether Mr. Noland could deduct the expenses under the I.R.C. §23(a) (1) (1939) (the predecessor to section 162). The court disallowed the deductions claimed by Mr. Noland on the following basis:

The business of a corporation, however, is not that of its officers, employees or stockholders. Though the individual stockholder-executive, in his own mind, may identify his interest and business with those of the corporation, they legally are distinct, and, ordinarily, if he voluntarily pays or guarantees the corporation’s obligations, his expense may not be deducted on his personal return.

*Id.* at 111. Furthermore, the court in *Noland* found “a corporate executive is normally expected to be responsive to his social obligations and to discharge his civic and community responsibilities. . . . They are, nonetheless, his obligations and responsibilities, and the expense their recognition imposes upon

however argues, that:<sup>46</sup>

. . . while there is ample precedent that a repayment of a bonus [in the same tax year] pursuant to an agreement entered into in 2009 after the receipt of a bonus is “voluntary” i.e. not legally required and hence not deductible, the better reasoned view is that if the 2009 repayment is an ordinary and necessary expense of the employee’s business in 2009, such as protecting his or her business reputation, it should be deductible in 2009.

If Lee is correct, in some circumstances a bonus repayment in situations of AIG executives like Mr. Poling may be deductible (even in absence of the unwind doctrine).

We do not dwell on this question. This article is not primarily concerned with whether the repayment is deductible under ordinary income tax principles (an issue in itself addressed by Lee). We are instead interested in the question of what is the correct income tax treatment of Mr. Poling’s repaid bonus, assuming that the repayment is not deductible.<sup>47</sup>

Therefore, for the purposes of this article we simply assume that the repayment is not deductible under ordinary principles.

We also note, as Lee does, that even if the bonus were deductible under ordinary income tax principles, such a deduction may be disallowed under the Alternative Minimum Tax.<sup>48</sup> Alternatively, under the ordinary income tax, the benefit of any deduction may be restricted by the limitation on deductions for miscellaneous individual expenses and the phase-out of itemized deductions, and personal exemptions for higher-income

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him is personal, not business expense.” *Noland*, 269 F.2d at 112.

Although TARP bonus repayments might be described as being in fulfillment of a social obligation, *Noland* suggests this is insufficient to make them deductible. *Noland* is also consistent with cases that suggest that “generally, completely voluntary expenses are not ‘necessary’ expenses for the purposes of deductibility under section 162. Voluntary expenses are not deductible even if the expenses are helpful to the taxpayer’s business.” JACOB MERTENS, JR, MERTENS LAW OF FEDERAL INCOME TAXATION 25:18 (2010) (citing *Tesar v. Comm’r*, 73 T.C.M. (CCH) 2709 (1997)).

46. Lee, *supra* note 40, at 340.

47. This question would have arisen even if the TARP Bonus Bills had become law. For example H.R. 1586 addresses the possibility of repayment of bonuses in section 1(b)(2)(C):

Waiver or return of payments- Such term [“disqualified bonus payment”] shall not include any amount if the employee irrevocably waives the employee’s entitlement to such payment, or the employee returns such payment to the employer, before the close of the taxable year in which such payment is due. The preceding sentence shall not apply if the employee receives any benefit from the employer in connection with the waiver or return of such payment.

To impose an additional tax on bonuses received from certain TARP recipients, H.R. 1586, 111th Cong. (1st Sess. 2009).

Thus, H.R. 1568 would have ensured that returned bonuses would escape the 90 per cent TARP bonus levy imposed by H.R. 1568. However, it does not explicitly exclude a returned bonus from a taxpayer’s adjusted gross income or taxable income. If H.R. 1568 had become law, a returned bonus would not have been subject to the 90 per cent levy imposed by the bill, but the question would remain whether a returned bonus is taxable income subject to usual federal, state, and local taxes.

48. Lee, *supra* note 40, at 340–341.

taxpayers.<sup>49</sup> Thus, even if the return of a bonus by a taxpayer like Mr. Poling were deductible under ordinary income tax principles, the unwind doctrine, if available, may allow the taxpayer to reach a tax result that is for the taxpayer more favourable.

#### D. THE ISSUE THAT POLING'S SITUATION DRIVES US TO EXAMINE

It has been asserted<sup>50</sup> 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.

Because Poling's bonus payment and repayment economically cancelled each other and occurred in the same year, Rev. Rul. 80-58 arguably has the effect that the two transactions can be treated, for tax purposes, as if they had not occurred, resulting in no tax implications for Poling. Indeed, this is what was speculated during the controversy surrounding Mr. Poling.<sup>51</sup>

As noted above, Rev. Rul. 80-58 cites *Penn v. Robertson* as authority for its outcome.<sup>52</sup>

The sections below explain 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.

### III. *PENN V. ROBERTSON* DOES NOT SUPPORT UNWINDING

This section is a close reading of *Penn v. Robertson*, and it finds no support in that case for the unwind doctrine ascribed to it.

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.)

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:

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49. Lee, *supra* note 40, at 340–341.

50. The authors again thank unnamed United States colleagues who suggested that reliance on Revenue Rulings would lead to the result that Poling would pay no net tax.

51. Doran, *supra* note 40.

52. Rev. Rul. 80-58, 1980-1 C.B. 181.

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?

A. FACTS AND HOLDINGS OF *PENN V. ROBERTSON*

Penn was a senior executive of the American Tobacco Company, a corporation registered in New Jersey. In 1929, the company sold shares to Penn at an under value as part of an employee share purchase scheme. Penn paid for the shares by giving the company notes that acknowledged his indebtedness for the price. In 1930, the company credited Penn with a sum that reduced the amount outstanding on the notes. It did the same in March 1931. Penn died on October 22, 1931. This article focuses mainly on the credits that transferred value from the company to Penn and calls them “the 1930 credit” and “the 1931 credit.”

The American Tobacco Company had omitted to seek shareholder approval for the employee share purchase scheme. As a result, the scheme was forbidden by Chapter 175 New Jersey Laws 1920. Thus, the share issue and the crediting of part of the price to Penn were void.<sup>53</sup> Rogers, a stockholder, challenged the scheme in the courts.<sup>54</sup> The directors resolved to reverse all transactions with employees who were willing to return to the status quo ante. Penn was so willing, but died in October 1931 before executing the reversal. After his death, his executors undertook the necessary transactions.

Circuit Judge Parker and District Judge Chestnut held that both the 1930 credit and the 1931 credit were taxable to Penn in their respective years of derivation as income received under a claim of right, following *North American Oil Consolidated v. Burnet*,<sup>55</sup> even though Penn’s right to the income was subject to challenge. As it happened, Penn escaped tax on the 1930 credit because he failed to report the gain as income and a limitation ran against the Commissioner.<sup>56</sup>

In respect of the 1931 credit, the American Tobacco Company’s reversal of the transaction, with the agreement of the executors, created a deduction. The issue was whether the deduction inured to Penn (despite his prior death) or to his executors. Parker and Chestnut held that for tax purposes Penn’s tax accounting period did not end with his death, but ran the full calendar year in which his death occurred. 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.

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53. Rev. Rul. 80-58, 1980-1 C.B. 181.

54. *Rogers v. Guaranty Trust Co.*, 288 U.S. 123, 124 (1933).

55. *N. Am. Oil Consol. v. Comm’r*, 286 U.S. 417 (1932).

56. *Penn v. Robertson*, 115 F.2d 167, 177 (4th Cir. 1940).

## B. RATIONALE FOR THE RESULT IN *PENN V. ROBERTSON*

There were two relevant transactions in 1931. The crediting transaction was the American Tobacco Company's transfer of value to Penn by crediting his account. The repayment transaction was the executors' transfer of value back to the company, (which, as the court held, counted for tax purposes as a transfer by Penn himself). The repayment transaction, being a reversal of the whole share purchase scheme and of the scheme's concomitant credits, involved much more value than the crediting transaction, which constituted the 1931 credit alone; so the repayment transaction more than set off the whole value of the crediting transaction, both economically and for tax purposes. In short (and somewhat loosely), the repayment transaction cancelled the crediting transaction, with the result that Penn had no tax to pay on the 1931 credit. There are two possible rationales for this result.

## C. THE TWO POSSIBLE RATIONALES

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

*The conflation rationale* is that, being self-cancelling, the crediting transaction and the repayment transaction were conflated into a single transaction, a transaction that was in effect a nullity and ignored for income tax purposes. That is, for tax purposes both transactions became in law as if they had never occurred, with neither assessable income derived nor a deductible expense incurred.<sup>57</sup>

The understanding that *Penn v. Robertson* stands for treating two transactions as a nullity is the basis of the unwind doctrine. The IRS, practitioners, and commentators have built a large structure upon that understanding that the conflation rationale explains the result in *Penn v. Robertson*.

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57. One must emphasise the words "for tax purposes." There is no suggestion that the conflation concept means that the conflated transactions become a nullity for all purposes. No doubt, for instance, if a transaction amounted to a criminal offence by one or both parties it would not usually make any difference to guilt to reverse the transaction by a later one.

In the authors' view, *Penn v. Robertson* does not support the weight of this structure. As argued below, the decision in fact employed the deduction rationale.

Both the deduction rationale and conflation rationale can apply only in the circumstances of 1931, when the repayment transaction (the rescission) occurred in the same year as the crediting transaction (the 1931 credit). By virtue of the rule in *Saunders v. Commissioner*,<sup>58</sup> the repayment could not have had retrospective effect under the hypothesis of either rationale if the repayment had been delayed until 1932. With regard to the deduction rationale, had the rescission been delayed until 1932, *Saunders v. Commissioner* would have prevented the allowable deduction in 1932 from leaping over the barrier between the 1931 and 1932 tax years to be netted against the credit assessable in 1931. Similarly, in regards to the conflation rationale, the repayment could not bounce back into 1931 over the hurdle of the end of the fiscal year to cancel the 1931 credit, had the repayment been delayed until 1932.

#### D. ONLY ONE RATIONALE IS THE RATIO OF *PENN V. ROBERTSON*

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.<sup>59</sup> 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.<sup>60</sup>

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.

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58. *Saunders v. Comm'r of Internal Revenue*, 101 F.2d 407 (10th Cir. 1939) as explained in *Penn*, 115 F.2d at 173.

59. Arthur L. Goodhart, *Determining the Ratio Decidendi of a Case*, 40 YALE L. J. 161 (1930) (quoting Sir John Salmond, *JURISPRUDENCE* 201 (7th ed. 1924)).

60. *Id.* at 169. In some cases a court may pursue two parallel lines of argument, both of which are independently sufficient to reach a result. Cross on Precedent states that "[w]hat happens in such a case is that the judge says, in effect, 'Though I could reach my conclusion on either of two grounds, I base it on both of them.'" RUPERT CROSS, *PRECEDENT IN ENGLISH LAW*, 87 (3rd ed. 1977) (quoting *Comm'r of Taxation for New South Wales v. Palmer* (1907) A.C. 179, 184 (Austl.)). However, we argue below that it is clear from the judgments in *Penn v. Robertson* that their Honours did not pursue two parallel lines of argument, only one. The question is whether that line of was the deduction rationale, or the conflation rationale.

#### E. JUDGES' EXPLANATION OF THE RATIONALE

Judges Parker and Chestnut did not explain as explicitly as they might have done whether they adopted the deduction rationale or the conflation rationale. In the part of the case relevant to this issue their main focus was whether Penn, though dead, could take advantage of the executors' outgoing in reversing the 1931 credit, or whether Penn's death on October 22, 1931 closed his tax year on that date.

As explained, the answer was that the deceased Penn could take advantage of the expense in his tax return. However, their Honours did not explicitly address whether this result came about by virtue of subtraction of a deduction from a gain (the deduction rationale) or by virtue of conflation and consequent extinction of transactions (the conflation rationale). They framed the issue in these words: "whether the rescission in 1931 extinguished what otherwise would have been income to Penn in that year."<sup>61</sup> To the judges, the point was "obvious," stating, "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."<sup>62</sup>

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."<sup>63</sup>

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"<sup>64</sup> and "such deduction."<sup>65</sup> 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

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61. *Penn*, 115 F.2d at 173.

62. *Id.*

63. *Id.* at 176.

64. *Id.*

65. *Id.*

two transactions together as a nullity.

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.

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).

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.

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.

There were two transactions relevant to this particular issue: the crediting transaction, the 1931 credit to Penn in his lifetime, and the repayment transaction, the outgoing that the executors incurred months later. Both events were relevant for income tax purposes. To treat the credit as a receipt and the repayment as a deduction requires no magic, no new law. That is how income tax works: on net results. Indeed, the court used the expression, "net profit."<sup>66</sup>

On the other hand, to conclude that the court adopted the conflation rationale one has to assume that for some reason their Honours believed

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66. *Penn*, 115 F.2d at 173.

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.

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:<sup>67</sup>

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.

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

#### F. HOW THE JUDGES MAY HAVE CONTRIBUTED TO THE SUBSEQUENT MISUNDERSTANDING

The misunderstanding appears to have occurred because of the manner in which the Court of Appeals addressed the 1930 credit to Penn. As explained, their Honours held that even though this credit was void, Penn had to pay tax on it (or would have done so had he reported it as income).<sup>68</sup> In respect of the 1930 credit, Penn could take no account of the outgoing from the rescission that occurred in 1931. If that outgoing were no more

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67. *Penn*, 115 F.2d at 174–175.

68. *Id.* at 177.

than a deduction resulting from an independent transaction (say a trading loss in an independent business belonging to Penn) this answer would have been obvious. Of course Penn could not set a 1931 outgoing against a 1930 receipt.

The answer was not so obvious with respect to the 1930 credit to Penn, which Penn had a legal duty to repay, though no one recognised that duty in 1930. In respect of the 1930 credit to Penn and of Penn's 1931 outgoing, the court's point was that Penn could not set the outgoing off against the 1930 credit *even though* the outgoing had been latent in the credit from the moment that Penn derived the credit.

In a lapse of logic, people led themselves to believe that if a credit and an outgoing do occur in the same year, and if the outgoing was always latent in the credit, what is happening is not a receipt set off by a deduction, but two linked transactions that cancel one another and that by that cancellation conflates to a nullity for fiscal purposes. *Penn v. Robertson* contains no support for that proposition.

In short, the unwind doctrine has been fabricated: All subsequent authority for the doctrine relies on *Penn v. Robertson*, but that case does not provide support for the doctrine.

#### G. MISTAKEN USE OF THE TERM 'RESCISSION'

In most cases it does not matter which of the deduction rationale or the conflation rationale is correct. The analytical frameworks of conflated fiscal nullity and the receipt set off by a deduction of the same (or greater) amount both produce a tax liability of zero in the year in question. In some cases, however, the choice of rationale does matter. These are cases under ordinary tax principles (in the absence of any unwind doctrine) where the receipt in the crediting transaction counts for tax purposes, but where the outgoing in the repayment transaction is not deductible in its own right: Cases like the illustrative example of Mr. Poling set out above.

If the receipt is taxable, but the outgoing is not deductible, the taxpayer's result will not be zero, but will instead be assessable income in the amount of the credit. This result is unlikely in cases where the outgoing is, from the start, latent in the credit. In that event, if the credit is assessable, it would be odd for the taxpayer to be denied a deduction for the outgoing. After all, on these assumed facts the origin of the outgoing is in the taxpayer's attempt to earn the income that he or she derived as the receipt. That is, the outgoing flows from the income-earning process, usually a sure touchstone of deductibility. The facts of *Penn v. Robertson* and the reversal of the real estate sale in Rev. Rul. 80-58, to be discussed below at Part IV, are examples.

The result is different, however, where the outgoing comprising the repayment transaction is not deductible in its own right: The position in Mr.

Poling's case. The mistake arises from careless use of the term "rescission." Where the repayment transaction is truly a rescission<sup>69</sup> its deductibility will almost automatically be a corollary of the assessability of the credit. That is, where the repayment transaction is a true rescission, it will exemplify the operation of a proposition that is wholly unexceptionable: that when a deductible outgoing follows (or, indeed, precedes) an assessable credit in the same tax year the taxpayer may net one against the other. This rule is so fundamental and commonplace in a system that assesses net, not gross, receipts that it has no name. For present purposes, call it, "the netting rule." We observe the netting rule in operation when the transactions in question are an unlawful payment and a rescission, but the rule's operation does not depend on the existence of a connection between the two. All that is required is that the receipt should be assessable and the outgoing deductible.

Nevertheless, when focusing on the case of an assessable receipt and an allowable deduction that happen to be legally connected because they constitute together an unlawful payment and a rescission, as in the case of *Penn v. Robertson*, it is a short step to say that transactions rescinded in the same tax year are cancelled for tax purposes. This statement, however, is correct only for true rescissions, being rescissions that undo payments that are voidable or otherwise legally reversible.<sup>70</sup> There is no authority to apply the netting rule stated in the previous paragraph in cases where "rescission" is used colloquially to mean "economic reversal."

Judges Chestnut and Parker inadvertently contributed to the misunderstanding when they said, "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."<sup>71</sup> In context, it is clear that they did not mean that the rescission converted what might have been a nondeductible outgoing into a deductible one, nor did they mean that the recession converted a constructive derivation of income into something that never happened. They assumed that the outgoing was deductible, and, as has been explained, they labeled it as a "deduction" one page later.<sup>72</sup> When they agreed that the rescission extinguished taxable income they were making a point as to the timing of the extinguishing. It happened in "that year." They were not saying that the fact that the transaction was a rescission made the outgoing deductible; it already was deductible.

Indeed, they were not entirely sure that the transaction was correctly categorized as a rescission. They said, "The only possible doubt as to

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69. As explained *infra* Part IV.

70. And even then, to repeat, only correct in the sense that the tax effects of the two transactions cancel, not in the sense that for tax purposes, the two transactions themselves are extinguished.

71. *Penn*, 115 F.2d at 175.

72. *Id.* at 176, *see* text at *supra* note 63.

whether it was properly called a rescission flows from the intrinsic invalidity of the original transaction; in view of which, the so-called rescission might possibly more properly be called an abandonment of an invalid executory contract with a restoration.”<sup>73</sup> This passage indicates that, whatever else their Honours intended, they did not see themselves as making a statement of law about any and all transactions that people might call “rescissions.” They took it for granted (and reasonably so) that where a contract is of a kind that results in taxable income, and that where that contract is later rescinded due to some legal infirmity in the original transaction, outgoings in respect of the rescission of that contract are deductible.

#### IV. THE IRS’ MISINTERPRETATION OF *PENN V. ROBERTSON* IN REV. RUL. 80-58

To summarize the foregoing Part III, *Penn v. Robertson* was a case that was solely about timing. The only issue about deductibility was as to when the 1931 outgoing was deductible. In relation to the 1930 credit to Penn was Penn’s 1931 outgoing deductible? Certainly not. In relation to the 1931 credit to Penn, could the executors post mortem, in a tax period that started at Penn’s death (or retrospectively, as it were, in Penn’s final tax return) claim the 1931 outgoing as deductible in a return that they filed for Penn himself? The court found yes.

The IRS appears to have missed these points in Rev. Rul. 80-58, 1980-1 CB 181, and instead, assumed that the issue in *Penn v. Robertson* related to substantive deductibility. This is the first of two mistakes made by Rev. Rul. 80-58: it mistakenly understands the judgment in *Penn v. Robertson* as treating two transactions as a nullity when in fact, as explained above, the court simply recognized and allowed a deduction to offset a taxable gain. The result of this mistake is a doctrine of rescission that the case law cited as authority does not support.

The ruling also makes a second important mistake. It appears to extend the application of this fabricated unwind doctrine to transactions—unlike those in *Penn v. Robertson*—where the reversal transaction is legally unrelated to the original transaction.

The sum of these two mistakes means that Rev. Rul. 80-58 appears to allow tax consequences, that have no basis in case law, for taxpayers in situations akin to that of Mr. Poling.

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73. *Penn*, 115 F.2d at 175.

### A. HYPOTHETICAL FACTS OF REV. RUL. 80-58

Rev. Rul. 80-58 gives an example, that it calls “Situation 1,” of a sale of land on revenue account in 1978 with the purchaser having a put option to return the land to the seller and to have the price back, that is, to “rescind” the contract of sale. The ruling states that if the rescission occurs before the end of 1978 the profit on the sale is “extinguished.” As authority for this result, Rev. Rul. 80-58 cites *Penn v. Robertson*, in which, according to the ruling, “the rescission in 1931 extinguished what otherwise would have been taxable income for that year.”<sup>74</sup>

### B. THE FIRST MISTAKE: MISUNDERSTANDING THE RATIONALE IN *PENN V. ROBERTSON*

In Situation 1, the sale of land during the 1978 tax year and the rescission of that sale before the end of the tax year, Rev. Rul. 80-58 states that the rescission “extinguished any taxable income for that year with regard to that transaction.”

By itself, this phrase could be read as supporting either the deduction rationale (the subtraction of a deduction against a gain) or the conflation rationale (treating the sale and rescission as if they had not occurred).

Perhaps, consistent with the deduction rationale, the ruling means that the *effects* of the original sale are disregarded, because the tax effects of the rescission cancel (or “extinguish”) them.

Or, perhaps, consistent with the conflation rationale, “extinguished” means that the transactions themselves for tax purposes are treated as null. That is, the taxable income from the hypothetical sale of land no longer exists, and the deduction from its reversal does not arise (as opposed to simply being set off against each other).

Contextual clues in Rev. Rul. 80-58 suggest that the drafter in fact (incorrectly) interpreted *Penn v. Robertson* as standing for the conflation rationale. The phrase preceding the statement about “extinguishment” indicates that Rev. Rul. 80-58 expresses the conflation rationale (emphasis added): “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.”<sup>75</sup>

The original sale of the land is the thing said to be “disregarded” for tax purposes. By itself, this phrase is a clear statement of the conflation rationale (the extinction of the rescinded transaction itself). This suggests that the ambiguity present in the final clause of the quoted sentence should be resolved in favour of the conflation rationale.<sup>76</sup>

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74. Rev. Rul. 80-58, 1980-1 C.B. 181.

75. *Id.*

76. As noted *infra* Part IV.C, some subsequent commentary and rulings have focused exclusively

The ruling concludes by explaining how the hypothetical taxpayer should fill out the tax return for the 1978 tax year in each of the two situations it set out (Situation 2 was one in which the rescission transaction happened in 1979, after the close of the tax year in which the original sale of land took place, with the ruling stating that “in light of the *Penn* case, the rescission in 1979 is disregarded with respect to the taxable events occurring in 1978”). The filing positions were to be: in Situation 1, no gain on the sale will be recognized by A under section 101 of the Code; in Situation 2, A must report the sale for 1978.

The ruling is unequivocal that in Situation 2 the original sale must be reported in the 1978 tax return. However, there is no equivalent statement for Situation 1; by implication, the taxpayer in Situation 1 does not report the original sale on the 1978 tax return. This is indeed the implication that commentators have taken from the ruling, i.e. Bailine explaining that: “Federal income tax returns of A and B included nothing regarding the land sale (or as it turned out, the nonsale).”<sup>77</sup>

Such a filing position is consistent only with the conflation rationale, where the original sale and the rescission transaction are both treated as having not occurred, and therefore do not need to be reported in a tax return. Under the deduction rationale, because both transactions would be recognized as having independent tax effects, both the gain from the sale and the outgoing from the rescission transaction would be reported (and then netted against each other). In this light, the ruling’s statement that “[no] gain on the sale will be recognized” for Situation 1 is not a statement regarding the net tax position (after netting the gain against the deduction from the rescission transaction), but an absolute statement made in reference to the sale transaction itself: It is ignored with the result that no gain can come of it.

Finally, it would be strange for the IRS to issue a revenue ruling if its intent was merely to proclaim the deduction rationale: The unoriginal proposition that a taxable gain can be offset by a deductible outgoing in the same tax year.

On the face of it, Rev. Rul. 80-58, therefore, seems to stand for the conflation rationale. This is how subsequent private letter rulings have interpreted Rev. Rul. 80-58. Many private letter rulings cite Rev. Rul. 80-58 to reach results that can be explained *only* by the conflation rationale. In these private letter rulings, the parties rely on Rev. Rul. 80-58 to avoid the very tax results that would be produced if both of the relevant transactions were given their independent tax effects (the deduction rationale) because these are situations in which (unlike those in Rev. Rul. 80-58 and *Penn v. Robertson*) those tax effects would not net to nothing, but would still leave

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on the statement that the original sale is to be “disregarded,” without reference to the second, more ambiguous part of the sentence.

<sup>77</sup> Bailine, *supra* note 5, at 33.

some tax impact that the parties did not desire.<sup>78</sup>

For example, in both IRS Priv. Ltr. Rul. 98-29-044 (Jul. 17, 1998) and Priv. Ltr. Rul. 05-33-002 (Aug. 19, 2005), Transaction 1 was the transfer of stock in a company, Transaction 2 was the unwind of that transfer. Had each transaction been given its independent tax effect, Transaction 1 would have caused the company to lose its S Corporation status. Transaction 2 (the unwind) would not have regained the company its S corporation status.<sup>79</sup>

Relying on Rev. Rul. 80-58, the IRS held in Priv. Ltr. Rul. 05-33-002 (Aug. 19, 2005) that “the legal doctrine of rescission applies to (1) disregard the . . . issuance of . . . stock to the partnerships, and (2) to prevent the termination of [the company’s] S corporation status.” Similarly, in IRS Priv. Ltr. Rul. 98-29-044 (Jul. 17, 1998) the IRS held, citing Rev. Rul. 80-58, that the transactions themselves were “abrogated” or “disregarded,” preventing the termination of the company’s S corporation status. That is, in each case, Transaction 1—the event that would have caused the company to terminate its S Corporation Status—was treated as if it had never occurred.<sup>80</sup>

In sum, Rev. Rul. 80-58 has been routinely understood to stand for the conflation rationale, and to reach results that are possible only under that rationale.<sup>81</sup> Yet only one of the private letter rulings that relies on Rev.

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78. See I.R.S. Priv. Ltr. Rul. 07-01-019 (Jan. 5, 2007) discussed at text accompanying *infra* note 101. Further, in I.R.S. Priv. Ltr. Rul. 05-33-002 (Aug. 19, 2005), an LLC taxed as a partnership undertook a statutory conversion in order to be taxed as a corporation (the conversion was made in anticipation of an initial public offering). Later in the year the taxpayer filed a certificate of conversion to convert back into an LLC taxable as a partnership (done because the IPO was cancelled when market conditions deteriorated). If both transactions had been given their independent tax effects, the entity would have been treated as a company for part of the tax year, and the reconversion into a partnership treated as a company liquidation. However the I.R.S. held:

Based [on] the parties’ restoration, by December 31 . . . of the relative positions that they would have occupied if the Incorporation Transaction had not occurred (Rev. Rul. 80-58), we rule that, for federal income tax purposes: (1) the Taxpayer will be treated as a partnership at all times during the calendar year. . . (2) Owner 1 and Owner 2 will be treated as partners of the Taxpayer during such tax period; and (3) the conversion of the Taxpayer from a corporation into a limited liability company taxable as partnership pursuant to the Rescission Transaction will not be treated as a liquidation. . . .

In I.R.S. Priv. Ltr. Rul. 09-23-010 (Jun. 5, 2009), Transaction 1 was distribution of stock, and Transaction 2 was its reversal. Had both transactions been given their independent tax effect, the companies involved in the transaction would have ceased to be members of the same wholly owned group. Citing Rev. Rul. 80-58, the I.R.S. held that both transactions would be disregarded, and all of the parties would be treated as being members of the same consolidated group throughout the tax year.

79. In I.R.S. Priv. Ltr. Rul. 05-33-002 (Aug. 19, 2005), the problem was the five year waiting period that must elapse following the termination of an S election before a new S election can be made.

80. Bailine, *supra* note 5, at 33 (discussing Priv. Ltr. Rul. 05-33-002 (Aug. 19, 2005)).

81. In citing Rev. Rul. 80-58, the letter rulings also tend to emphasize the statement in Rev. Rul. 80-58 that a transaction that is rescinded later in the tax year can be “disregarded” (*see*, for example, PLR 9141048). As discussed above, this part of Rev. Rul. 80-58 is relatively less ambiguous than the phrase that speaks of “extinguishment” of income. The source of any ambiguity in Rev. Rul. 80-58 is simply ignored.

Rul. 80-58 cites *Penn v. Robertson* directly,<sup>82</sup> and none of the private letter rulings sets out in detail what the IRS believes to be the rationale of *Penn*. Instead, the rulings either assume that *Penn v. Robertson* stands for the conflation rationale or cite Rev. Rul. 80-58 as justification for applying the unwind doctrine, simply assuming it is correct in law.<sup>83</sup> As argued above, this assumption is mistaken.

Like the IRS private letter rulings, academic and practitioner commentary also routinely states that Rev. Rul. 80-58 stands for the conflation rationale, and assumes that this is a correct reflection of the meaning of *Penn v. Robertson*.<sup>84</sup> None of this commentary analyzes in depth the purported ultimate authority of this “unwind doctrine,” *Penn v. Robertson*, to see whether it supports the doctrine. When *Penn v. Robertson* is mentioned at all, the commentary assumes that the result in the case was reached via the conflation rationale and does not consider the possibility that a deduction offsetting taxable income could have explained the case.<sup>85</sup>

In concluding (or assuming) that *Penn v. Robertson* stands for the conflation rationale, Rev. Rul. 80-58, and the subsequent private letter rulings and commentaries are mistaken. 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.

### C. THE SECOND MISTAKE: BLURRING TRUE RESCISSIONS AND BARE REVERSALS

The second mistake Rev. Rul. 80-58 makes is that it appears to adopt a very broad definition of rescission, allowing the unwind treatment to apply in cases not only of true rescissions (of which *Penn v. Robertson* is an example) but also in cases of a bare reversal of a transaction.

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82. I.R.S. Priv. Ltr. Rul. 91-04-039, (Jan 25, 1991).

83. Although incorrect, the assumption may not be inappropriate, considering the uncertainty as to whether the I.R.S. is bound by its own incorrect public rulings. See *infra* Part VI.

84. E.g., Hasen, *supra* note 2, at 880, stating that in *Penn v Robertson*, “[the] Fourth Circuit held that amounts received in respect of the 1931 contributions were treated as though they were never contributed in the first place,” but with no analysis of the case in support of this conclusion. E.g., Lee at *supra* note 40, at 374, in his recent analysis of the case of executives repaying TARP bonuses seems to assume that the interpretation of *Penn v. Robertson* in Rev. Rul. 80-58 is correct. See also Schnabel, *supra* note 4, at 688 n.4.

85. See *supra* text accompanying note 84.

The term “rescission” by itself is unhelpful when trying to understand the class of transactions to which Rev. Rul. 80-58 and *Penn v. Robertson* attach. This is because the term is employed in many different ways, colloquially and legally; even two seminal contract treatises disagree about its correct use.<sup>86</sup>

Fortunately, the IRS in Rev. Rul. 80-58 did not simply use the term rescission without defining it. The ruling explained that it understood that the principle in *Penn v. Robertson* applied to rescissions defined in this fashion:<sup>87</sup>

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.

Unfortunately, however, this definition of rescission appears to go beyond the type of transaction involved in *Penn v. Robertson*. *Penn v. Robertson* involved a transaction of the class that we will call a “true rescission.” Rev. Rul. 80-58 however defines rescissions in a way that encompasses both “true rescissions” and another category of transaction that we will call “bare reversals.”

In this article, true rescissions are that category of unwinds<sup>88</sup> 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.

Judicially imposed rescissions are “a cause of action through which a contract was disaffirmed due to some infirmity in its formation, such as

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86. RICHARD A. LORD, A TREATISE ON THE LAW OF CONTRACTS BY SAMUEL WILLISTON § 68.3 51 (4th ed. 2002) is emphatic that rescission both in colloquial and legal contexts refers the *outcome* of an agreement being abrogated or annulled, regardless of how that outcome is reached: “When and how transactions may be rescinded is not part of the definition of the resulting rescission . . . whether a contract is spoken of as terminated, abrogated, annulled, avoided, discharged, or rescinded is not in itself important.” JOSEPH M. PERILLO, CORBIN ON CONTRACTS BY ARTHUR LINTON CORBIN § 67.8 (Rev. ed. 1993) takes an equally emphatic contrary position that the general legal meaning of rescission is a “mutual agreement by two contracting parties to terminate the legal relations created by their previous contract.” That is, the term rescission conveys some meaning about both the end result (an abrogation or annulment of an agreement) *and* about the way that the outcome is reached (by mutual agreement). Perillo at section 1105 finds any use of the term rescission to refer to the repudiation of a contract upon vital breach as an “unfortunate,” “secondary” meaning. Perillo prefers to restrict the use of the term “rescind” to situations involving the mutual assent of both parties, and does so throughout the treatise.

87. Rev. Rul. 80-58, 1980-1 C.B. 181.

88. Where an “unwind” is any transaction that places the parties in the economic status quo ante economically.

fraud, mistake, or incapacity.”<sup>89</sup> In the case of judicially imposed rescissions, the legal connection between the original transaction and its subsequent unwind is some legal infirmity latent in the original transaction. *Penn v. Robertson* involved an unwind of this type: the court in *Penn v. Robertson* accepted the finding of the district court judge that the case was one involving a rescission arising from infirmity in the original transaction, namely that the original transaction was *ultra vires*.<sup>90</sup>

Another type of “true rescission” comprises unwinds where “parties agree upfront that an agreement will be rescinded at some future time upon the occurrence of a specified condition.”<sup>91</sup> In these cases, “for one party to exercise its contractual right to rescind, the rescinding party must strictly follow the requirements of the original contract’s rescission provision.”<sup>92</sup> Again, there is a legal connection between the original transaction and the unwind transaction, in this case because the unwind transaction is conducted pursuant to a legal right embedded in the original agreement. The hypothetical situation described in Rev. Rul. 80-58 is a rescission of this type because the unwind of the land sale contract is pursuant to an option embedded in the original sale and purchase agreement.

In the case of “true” rescissions, the unwind doctrine in Rev. Rul. 80-58 based on the IRS misinterpretation of *Penn v. Robertson* as standing for the conflation rationale remains incorrect, but that mistake generally does no practical mischief, because it leads to the same result as ordinary principles of tax law. Where a taxpayer receives taxable income, then later unwinds that receipt under a “true” rescission, the legal connection between the unwind transaction, the outgoing in the second transaction is likely to be deductible in its own right under section 162(a) as an ordinary or necessary expense paid or incurred during the tax year in earning the taxpayer’s income. This is because if the original receipt is taxable because it is part of the taxpayer’s trade or business, and if the receipt is joined causatively to the repayment, then it follows that the repayment is also part of the taxpayer’s trade or business, and therefore generally deductible.

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89. See LORD, *supra* note 86, § 68.2. Note that Lord argues at section 68.3 that “rescission” in cases where a party disaffirms a contract due to the material breach or repudiation of another is not in fact a rescission: in these cases, the contract is not annulled or abrogated, it is simply that one party has a valid and effective defense for nonperformance. It is not necessary for this article to reach a conclusion as to whether such “rescissions” should be categorized as “true” rescissions or as “bare reversals.” Indeed, terminology is not in the end crucial, so long as legal categories are clearly defined. For purposes of this article, the relevant categories are what we have defined as “true rescissions” and “bare reversals.”

90. Counsel for Penn argued that the stock allotment plan had been void *ab initio*, and the Court accepted that “the transaction was *ultra vires* of the directors and therefore void in the sense that it had no legal force and effect . . . rather than merely voidable.” *Penn*, 115 F.2d at 173. However, the Court was willing to treat the reversal as a rescission. *Id.*

91. Schnabel, *supra* note 4, at 699 citing Corbin § 67.8.

92. *Id.*

However, Rev. Rul. 80-58 appears to extend unwind treatment not only to true rescissions, but also to transactions that simply reverse the economic effect of an earlier transaction, but which are not legally connected to the relevant earlier transaction. We call such transactions simply “reversals.”

An example of a bare reversal is what Schnabel labels “contractually agreed rescissions,”<sup>93</sup> where the parties make a fresh agreement to reverse the economic results of an earlier set of transactions. An agreement to reverse an existing contract in this way is “subject to the same rules (and flexibility) as applies to contract formation in general”<sup>94</sup>:

Contractual rescission is simply a second contract by which parties change the obligation entered into by the first contract. Although parties were traditionally required to restore each party to status quo ante even when voluntarily rescinding a contract, newer contracts principles do not require this. Accordingly, parties today can agree to rescind for any reason and are essentially afforded the same freedom of contract to rescind an agreement as they have to enter into an agreement.

An example is a contract for sale of goods where both delivery and payment are complete. Certainly, buyer and retailer may agree to *reverse the effect* of the contract, as where a buyer who has changed her mind returns goods to a shop for a refund, without any right to do so, but relying on the shop’s goodwill. In these circumstances, where the shop has no obligation to allow such return and refund, the transactions constitute a new contract, in effect a re-sale from customer to shop. Economically, the parties return to the status quo ante, but there is nothing latent in the original, executed contract that leads to this result. The original contract has been completed leaving no residual obligation upon either party or legal right upon which they can rely to require the reversal.

Another example of a bare reversal is Mr. Poling’s situation of voluntarily returning a bonus. As discussed above at Part II, we assume that Poling’s voluntary repayment is not connected in law to the original receipt of his bonus, but is legally a fresh, unconnected gift transaction.

*Penn v. Robertson*, however, was certainly not a case of a bare reversal. It can therefore provide no authority for applying unwind treatment to bare reversals (setting aside the more fundamental objection that it provides no authority for unwind treatment *at all*). Indeed the judges in *Penn v. Robertson* were very explicit in pointing out that the facts in that case did not constitute a re-sale, but were in fact a true rescission.<sup>95</sup>

The IRS in *Penn* had indeed asserted that the case was one of a re-sale. Penn, before his death, “appreciated the possible or probably infirmity of his right to the stock and was willing to surrender it,” and his

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93. Schnabel, *supra* note 4, at 699.

94. *Id.*

95. *Penn*, 115 F.2d at 175, 176.

executors had “agreed to the rescission.” But this assent to the rescission did not mean that Penn (via his executors) was entering into a fresh, “mutual agreement” with American Tobacco Company to sell back to the company any benefits that had been received under the share plan. The executors were merely agreeing to recognize that they had no legal right to the share plan in the first place. Indeed, a re-sale would not be possible because of the infirmity in the original share agreement. Penn could not sell rights to benefits that he had not validly received without infirmity. The judges explicitly rejected the IRS’ contention that Penn had agreed to a re-sale, stating that, “[w]e have no doubt that the parties intended a genuine rescission. Certainly what was done was entirely consistent therewith . . . in no sense could it properly be termed a re-sale.”<sup>96</sup>

Although *Penn v. Robertson* was not a case of a re-sale, Rev. Rul. 80-58 appears to apply to re-sales and other bare reversals. This is not because the hypothetical example in Rev. Rul. 80-58 is a bare reversal; it was in fact as noted above a case of a true rescission, in which a land sale was reversed subject to an option in the original sale contract. However, the ruling stated that that “rescission may be effected by mutual agreement.” Practitioners and the IRS have taken that statement to mean that the unwind doctrine fabricated in Rev. Rul. 80-58 applies to bare reversals in which the parties agree to reverse the economic effects of fully executed contracts and other completed transactions.

When applying Rev. Rul. 80-58 in private letter rulings, the IRS has played down the “rescission” requirement in a way that makes it clear that the Service regards the “restoration” of economic positions as the key to Rev. Rul. 80-58, irrespective of whether that restoration came about because of what the authors call a bare reversal, or because of what the authors call a true rescission. For example, IRS Priv. Ltr. Rul. 98-29-044 (July 17, 1998) stated a formulation of the requirements of Rev. Rul. 80-58 that has been repeated in a number of subsequent letter rulings (emphasis added):

According to [Rev. Rul. 80-58], 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.

This formulation requires only that the parties be “restored” to the same positions that they would have otherwise occupied had no contract been made. No mention is made of any requirements as to how restoration must come about. It does not specify that the restoration must come about via a “rescission,” and leaves open the possibility that the restoration may

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96. *Penn*, 115 F.2d at 176.

be achieved by a bare reversal.

The formulation avers that there are “*at least*” two conditions required by Rev. Rul. 80-58, leaving open the possibility that there are others (perhaps including that the restoration must come about via a “rescission” for the ruling to apply). None of the private letter rulings that use the formulation mention any further requirements for the form of the restoration.<sup>97</sup>

In addition to downplaying the “rescission” requirement of Rev. Rul. 80-58, the Service has in fact applied the unwind doctrine in Rev. Rul. 80-58 in many cases where the so-called rescission is a bare reversal. This observation is undoubtedly what led Schnabel to advise:<sup>98</sup>

. . . if the parties to a transaction collectively agree to rescind the transaction, the transaction can be disregarded for federal tax purposes under the rescission doctrine even if the decisions to rescind was triggered by a change in circumstances rather than by some sort of infirmity in the original transaction . . . the rescission in Private Letter Ruling 2006-13-027 was triggered by a “precipitous and unexpected deterioration in market conditions.”

[. . .]

Taxpayers wishing to disregard a transaction under the rescission doctrine would clearly be well advised to use one of three approaches. First, the taxpayer and the other parties to the original agreement can enter into a new agreement that has the word “rescission” in the title and that provides for the rescission of the original agreement and the transactions undertaken pursuant to the original agreement. . . . The first approach is obviously the more important, as pre-negotiated rescission rights are very uncommon as a commercial matter. . . . In virtually all published and private rulings where the Service held the rescission doctrine to be available, the unwinding of the original transaction was effected to some sort of rescission agreement (or a right included in the original agreement)

That is, Rev. Rul. 80-58 extends unwind treatment to bare reversals, so long as the parties are careful enough to use the word “rescission” when describing the reversal transaction. It matters not that the reversal is not a true rescission, having no legal connection to the original transaction.

One example of a letter ruling that applies the unwind doctrine to a bare reversal is IRS Priv. Ltr. Rul. 91-040-39 (Jan. 25, 1991). In that ruling, a company transferred shares to employees along with cash bonuses sufficient to pay the employees’ taxes on those shares. The company subsequently discovered that true value of the transferred shares was much higher than its accountant had estimated. Had the transfer stood, it would have resulted in an unwanted change to company earnings 655 per cent higher than originally estimated. The company, “with full agreement” of

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97. See, e.g., I.R.S. Priv. Ltr. Rul. 05-33-002 (Aug. 19, 2005); see also 07-52-035 (Dec. 27, 2007); see also 08-43-001 (Oct. 24, 2008); see also 09-23-010 (June 5, 2009).

98. Schnabel, *supra* note 4, at 699–702.

the affected employees, wished to “rescind the agreements with the employees and require them to transfer the shares back to the company. In addition, Company does not intend to pay the cash bonus originally agreed upon.” The Service cited Rev. Rul. 80-58 in holding that the employees would not recognize any federal income in relation to the transactions.

Unlike in *Penn v. Robertson*, there was no contention that the transfer of shares and cash bonuses was *ultra vires*. There was no alleged legal infirmity in the original transaction. The reason for unwinding was that it was simply a poor financial decision viewed in hindsight with knowledge of the more accurate valuation of the shares transferred. There was no suggestion that the original transfer involved any reservation allowing the employees or company to require the return of the shares and cash. Thus, although the Service referred to the unwind transaction as a “rescission” in the letter ruling, under the terminology set out in Part III above the unwind transaction was a bare reversal.<sup>99</sup>

Another example of the IRS applying the unwind doctrine to a bare reversal is IRS Priv. Ltr. Rul. 07-010-19 (Jan. 5, 2007). In this ruling, the parties did not even attempt to label the unwind as a rescission. The ruling involved a parent company merging a subsidiary into its business, thereby liquidating it. The parent then experienced “unexpected and significant weakness”<sup>100</sup> in its business, and its managers realized that liquidating the subsidiary, thereby forfeiting the subsidiary’s tax basis, had been imprudent. The parties tried to reverse the transactions by incorporating a new subsidiary, with the same assets, liabilities, articles of incorporation, and bylaws of the old subsidiary.

The taxpayer made no representation that anything other than a change of circumstances and the benefit of hindsight motivated the attempted unwind. No legal infirmities in the original transactions were suggested; the parties simply regretted the tax consequences of the original transaction. As Schnabel noted the parties in this case did not style the fresh reversal transaction as a rescission.<sup>101</sup>

Citing Rev. Rul. 80-58, the IRS allowed unwind treatment, with the new subsidiary being treated for tax purposes as if it was the old subsidiary. The ruling focused on the fact that the parties had been restored before the end of the tax year to the same position that they would have occupied had the merger transaction not occurred. No mention of rescission is made in

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99. See also I.R.S. Priv. Ltr. Rul. 09-23-010 (June 5, 2009) (in which the I.R.S. allowed the parties to ignore the distribution and redemption of stock and its attempted reversal. The parties did not suggest any legal infirmity in the original redemption and distribution, but were instead very explicit that the unwind was a voluntary reversal motivated by a change in the management of all of the companies involved. The new management thought the merger was for business reasons unsound in the new business environment.).

100. I.R.S. Priv. Ltr. Rul. 07-010-19 (Jan. 5, 2007).

101. Schnabel, *supra* note 4, at 700. See also I.R.S. Priv. Ltr. Rul. 09-15-031 (Apr. 10, 2009) (a similar situation involving the amalgamation of two companies).

the ruling at all, perhaps because it would have been a stretch to call a fresh incorporation a rescission of a liquidation, even colloquially.<sup>102</sup> A true rescission occurs between parties to an original agreement or transaction, but statutory incorporations, liquidations, or other entity status changes blessed by statute or a regulatory body cannot be regarded as “rescinded” as between two parties in a legal sense.

In summary, Revenue Ruling 80-58 can be, and has been interpreted as applying the rescission doctrine (derived from a misunderstanding of the ratio in *Penn v. Robertson*) to cases of true rescissions, and also to cases of bare reversals. This is despite the fact that in *Penn v. Robertson* itself, the judges were careful to point out that the case was not one of a re-sale (i.e., a bare reversal), but a “genuine rescission.”<sup>103</sup>

As noted earlier, adopting the “rescission doctrine” in cases of true reversals applies an incorrect interpretation of *Penn v. Robertson*, but does no practical mischief in that the same results can be reached under ordinary principles of tax law. However, in the case of bare reversals, applying the “rescission doctrine” leads to novel results that are impossible under ordinary tax principles or the correct interpretation and application of *Penn v. Robertson*. This is surely the attraction that Rev. Rul. 80-58 holds for many taxpayers who rely on it, including many who obtained private letter rulings such as those mentioned above.

#### D. HOW THE MISTAKES IN REV. RUL. 80-58 COMBINE TO SAVE POLING

Taxpayers like Mr. Poling can take advantage of the two mistakes in Rev. Rul. 80-58 to save themselves from tax consequences that are for them undesirable.

Mr. Poling’s situation is, we assume, that of a bare reversal, and the cumulative effect of the mistakes in Rev. Rul. 80-58 has been for the IRS to allow unwind treatment in cases of a bare reversal.

So, although Poling’s return of his bonus to AIG is (we assume) a gift that is not deductible in its own right, because it puts Poling in the economic status quo ante within the tax year, under Rev. Rul. 80-58, Poling can be treated for income tax purposes as having never received a bonus and never returned it because it puts Poling in the economic status quo ante in the same tax year. Rulings indicate that this treatment is available even though the original bonus receipt was not *ultra vires*, and had been completed.<sup>104</sup> Rulings also indicate that that it should not matter that Poling was motivated to return the bonus by potential undesirable tax

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102. Although in some letter rulings, the I.R.S. has “somewhat awkwardly” painted a statutory conversion of an LLC into a corporation pursuant to state law as being effected pursuant to contract, Schnabel, *supra* note 4, at 701; I.R.S. Priv. Ltr. Rul. 06-13-027 (Mar. 31, 2006).

103. *Penn*, 115 F.2d 167 at 175.

104. See I.R.S. Priv. Ltr. Rul. 91-04-039 (Jan. 25, 1991).

consequences from the spectre of the TARP bonus bills.<sup>105</sup>

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.

Of course, as we have shown, this is not the outcome sanctioned by *Penn v. Robertson*. When the second transfer is not deductible in its own right there is no principle in *Penn v. Robertson* that can cause the second transfer to offset tax on the derivation of the first transfer. If the second transfer *is* deductible such a set-off can occur, but this happens according to ordinary principles of deductibility (so long as the second gift happens before the end of the tax year), without needing help from *Penn v. Robertson*.

#### V. THE CASE LAW DOES NOT MAKE THE SAME MISTAKES AS REV. RUL. 80-58 IN INTERPRETING *PENN V. ROBERTSON*

In Parts III and IV we have found that Revenue Ruling 80-58 misinterpreted *Penn v. Robertson* and that this mistake allows taxpayers to achieve tax results that are not sanctioned by that case. We now show, for completeness, that this misinterpretation is a mistake that has been made only by the IRS, practitioners, and commentators, but not to date by judges. We survey the cases since *Penn v. Robertson*, and find that there is no compelling judicial authority that misinterprets *Penn v. Robertson*. The relevant case law falls into four groups.

The first group of cases—*Fender*,<sup>106</sup> *Gargaro*,<sup>107</sup> and *Lewis*<sup>108</sup>—reach results that are superficially similar to the result that would be reached under the unwind doctrine. However, examination of these cases reveals that they were decided on the basis of different legal principles.

The second group—*Trico*<sup>109</sup> and *Scallen*<sup>110</sup>—are cases that mention *Penn v. Robertson* in dicta, and at best provide weak dicta support for unwinding.

The third group consists of one case, *Hutcheson*,<sup>111</sup> a case that again provides at best weak dicta support for unwinding, but does not mention

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105. See I.R.S. Priv. Ltr. Rul. 07-01-019 (Jan. 5, 2007).

106. *Fender Sales, Inc. v. Comm'r*, 22 T.C.M. (CCH) 550 (1963).

107. *Gargaro v. United States*, 73 F. Supp. 973 (Ct. Cl. 1947).

108. *Lewis v. United States*, 91 F. Supp. 1017, 1019 (Ct. Cl. 1950), *rev'd*, 340 U.S. 590 (1951).

109. *In re Trico Marine Services, Inc.*, 343 B.R. 68 (Bankr. S.D.N.Y. 2006).

110. *Scallen v. Comm'r*, 54 T.C.M. (CCH) 177 (1987).

111. *Hutcheson v. Comm'r*, 71 T.C.M. (CCH) 2425 (1996).

*Penn v. Robertson* and instead discusses only Rev. Rul. 80-58.

The fourth group of cases—*Crellin's Estate*<sup>112</sup> and *Branum v. Campbell*<sup>113</sup>—indicate that the interpretation of *Penn v. Robertson* in Part III above is correct: in these two cases the court rejected a taxpayer's request to apply unwind treatment to a bare reversal. These cases do not, however, mention *Penn v. Robertson*.

A. CASES SUPERFICIALLY CONSISTENT WITH UNWIND TREATMENT BUT NOT COMPELLING AUTHORITY FOR UNWINDING

*Fender*, and *Gargaro* and *Lewis*, all reach results that are superficially consistent with the unwind doctrine. But, just because the results of these case *could* be explained by the unwind doctrine, it does not follow that they are authority for that approach. As with *Penn v. Robertson* itself, the ratios of *Fender*, *Gargaro*, and *Lewis* must be determined taking account of the facts treated by the judges in these cases as material, and the judges' decisions as based on those material facts.<sup>114</sup> In that light, *Fender*, *Gargaro*, and *Lewis* were not in fact decided on the basis of the unwind rationale and therefore are not authority for that approach.

1. *Fender v. Commissioner of Internal Revenue*

Although the result in *Fender* seems superficially consistent with the mistaken interpretation of *Penn v. Robertson* in Rev. Rul. 80-58, it is not in fact compelling authority for that mistaken interpretation. The court in *Fender* cites, but does not rely on, *Penn v. Robertson*. Furthermore, rather than being a clear case where the court gave a bare reversal unwind treatment, the court appeared to instead create a special rule concerning when a reversal transaction will be considered deductible in its own right: namely in circumstances where both transactions involve a company and a principle shareholder in that company who is also an employee.

The taxpayer in *Fender* was C. Leo Fender, the founder of Fender Electric Instrument Co., Inc. ("Instrument"), and designer of such famous electric guitars as the Fender Stratocaster. Fender was the sole shareholder in Instrument, and its president, treasurer, and chairman of the board of directors.

Fender received a basic salary for his services to Instrument, and an annual bonus of five per cent of Instrument's annual sales, payable to Fender after the close of the calendar year. In the 1956 tax year, Fender derived a bonus of \$30,358. In the 1957 tax year, Fender derived a bonus of \$37,205 in 1957. However, before the end of the 1956 and 1957 tax

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112. *Crellin's Estate v. Comm'r*, 203 F.2d 812 (9th Cir. 1953).

113. *Branum v. Campbell*, 211 F.2d 147 (5th Cir. 1954).

114. Goodhart, *supra* note 59.

years, Fender returned to Instrument \$22,000 and \$25,000 of each bonus, because Fender was aware of the “precarious cash position of Instrument.” The Tax Court was asked to consider:<sup>115</sup>

Whether the full amounts of \$30,357.84 and \$37,205.04 received by C. Leo Fender as salary bonuses from Fender Electric Instrument Co. in the years 1956 and 1957, respectively, constitute taxable income, notwithstanding C. Leo Fender’s subsequent return of \$22,000 in 1956 and \$25,000 in 1957 to Fender Electric Instrument Co.

The Tax Court held that the returned amounts should not have been entered as income in Fender’s 1956 and 1957 tax returns.<sup>116</sup>

This result is superficially consistent with the application of the unwind doctrine to a voluntary, bare reversal of a completed transaction. However, the court did not in fact decide the case on that basis.

The court instead held that the return of the bonus was not, as the Commissioner argued, an outright gift, or a partial repayment of debt that Fender owed to Instrument, or a loan to Instrument or a contribution of Instrument’s capital. Fender, the court found, had intended to reduce his compensation by returning the bonuses, and it was to be treated as “an adjustment of the contract or obligation and a repayment of a portion of the amount received.”<sup>117</sup> In reaching this result, the court quoted with approval the following passage from *H C Couch*:<sup>118</sup>

Salary arrangement between corporations and their principal shareholders and managers in cases like this one, where the manager is expected by his associates to protect the interests and the future prospects of the company even at sacrifice to himself, are and must be at times subject to modification as may be made by agreement from time to time.

That is, while in most cases a voluntary return of a bonus might be treated as a fresh transaction unconnected to the original contract between the employee and his employer, a special rule applies when the employee is also a principal shareholder, such that the return of the bonus is not treated as a fresh transaction, but as an adjustment of the original contractual relationship between the employee-shareholder and the company. The rule has the effect of creating a legal connection between the original contract and the return of the bonus. In the terminology adopted in Part III above, in these special circumstances, the return of a bonus is a true rescission, legally connected to the original salary arrangement, not a fresh agreement about compensation (a bare reversal). As a consequence, the return of the bonus by a shareholder employee in these circumstances would be deductible in its own right, connected as it is to the original agreement under which the shareholder/employee derives his income. No special

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115. *Fender Sales, Inc.*, 22 T.C.M. (CCH) 550.

116. *Id.*

117. *Id.*

118. *Id.*

unwind doctrine is needed. *Fender* is therefore not good authority for the effect of Rev. Rul. 80-58 that bare reversals can be given “unwind” treatment. It is restricted to its narrow facts involving employees who are also principal shareholders.

The court in *Fender* mentioned *Penn v. Robertson* only to say: “other courts have adhered to a similar position;”<sup>119</sup> there is no further analysis of *Penn v. Robertson*. There is no indication that the court relied on *Penn v. Robertson*, and indeed the court’s discussion of *H C Couch* shows that the court was instead relying on a special principle about when company transactions with shareholder-employees will be treated as adjustments to existing contracts rather than a fresh transaction.

2. *Gargaro v. United States, Lewis v. United States, and Haberkorn v. United States*

*Gargaro, Lewis, and Haberkorn*<sup>120</sup> are three cases that each mentions *Penn v. Robertson*. In each case the taxpayer was an employee who had received a bonus. In each case the taxpayer treated the entire bonus as taxable income in his tax return in the year in which the bonus was received. In each case, the taxpayer discovered after the close of that tax year that he was in fact entitled to a smaller bonus than he had received, and repaid the overpayment to his employer.<sup>121</sup>

The Claims Court in both *Gargaro* and *Lewis* allowed the taxpayer to reopen his tax return for the tax year in which he received the bonus, and to reduce the amount of bonus income he had received in that year.<sup>122</sup> By contrast, the United States Court of Appeals for the Sixth Circuit in *Haberkorn* held that the correct tax treatment would be for the taxpayer to claim a deduction for the amount of the bonus he was required to repay in the years in which such repayments were made.<sup>123</sup> The Supreme Court heard *Lewis* because of this circuit split, and overturned the decision of the

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119. *Fender Sales, Inc.*, 22 T.C.M. (CCH) 550.

120. *Haberkorn v. United States*, 78 F.Supp. 192 (E.D. Mich. 1948).

121. In *Gargaro*, the bonus was calculated and paid to the taxpayer in 1942 as a per centage of profits as the company understood those profits to be in 1942. In 1945, the Gargaro Company’s 1942 profits were reduced under renegotiation proceedings with the Reconstruction Finance Corporation Price Adjustment Board (the company had entered contracts with governmental agencies that were subject to such proceedings). In *Lewis*, the bonus overpayment was due to the taxpayer’s error. The taxpayer was entitled to a bonus calculated as a per centage of the Accurate Spring Manufacturing Co.’s profits, but the taxpayer had erroneously ordered his bonus in 1944 to be calculated and paid as a per centage of gross profits. The company discovered this error after the close of the tax year and in 1946 obtained a judgment against the taxpayer for the return of the bonus. In *Haberkorn*, the taxpayer was paid a bonus of a per centage of the company’s net income in 1942, but in 1944 the company discovered that the accounts for 1942 contained an error and that the company’s profits had been overstated in that year.

122. 73 F. Supp. at 975; 340 U.S. at 592.

123. *Haberkorn*, 78 F.Supp. at 195.

Claims Court.<sup>124</sup>

Even aside from *Lewis* being overturned in the Supreme Court,<sup>125</sup> while the *Gargaro* and *Lewis* decisions did allow a taxpayer to ignore an original transaction (receipt of overpayment) by virtue of a later reversal transaction (repayment of overpayment), the cases do not support interpreting *Penn v. Robertson* to give rise to the “unwind doctrine” attributed it in Rev. Rul. 80-58, for the following reasons.

First, the majority in *Gargaro* and *Lewis* neither relied on *Penn v. Robertson* nor even mentioned *Penn*. Whittaker J, the dissenting judge in both *Gargaro* and *Lewis* noted this omission, and cited *Penn v. Robertson* in his dissenting judgment that the taxpayers in those cases should not be entitled to reduce the amount of bonus income originally received based on subsequent events in a future tax year.<sup>126</sup>

If I had to decide this case according to what I think the law ought to be, I might decide it as the majority has done; but our job, of course, is to decide the case according to the law as it is, and I do not think the majority has done this.

It does seem unjust that plaintiff should have to pay a tax on income he was not allowed to keep, but I think the law says he should. He took his bonus from the company believing he was entitled to it, and with the right to do so with it what he pleased. It was his absolutely and unconditionally, so far as any one knew until long after the taxable year had passed. Under all authorities this constituted income to him . . . see, among others, . . . *Penn v. Robertson*. . . . This is the law today.

The unanimous court in *Haberkorn* also cited *Penn v. Robertson* in finding that the taxpayer in that case could not adjust his income recognized in the year that he received the bonus overpayment, but could claim a deduction in the year that he repaid the excess amount.<sup>127</sup> Perhaps if the majority in *Gargaro* and *Lewis* had considered *Penn*, it would have found, as the dissent urged (and as the Sixth Circuit found in *Haberkorn*), that the close of the taxpayer’s income year prevented his income in the year he received the bonus from being retroactively reduced due to later

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124. *United States v. Lewis*, 340 U.S. 590, 591 (1951). The Court stated certiorari was granted because of the conflict between the finding of the Court of Claims in *Lewis* and the findings of the Sixth Circuit in *Haberkorn*. The courts in both *Haberkorn* and *Lewis* had acknowledged the split. The Supreme Court in a brief opinion which did not mention *Penn v. Robertson* stated that *Lewis* had taken a view in conflict with the well-settled claim of right doctrine. The Supreme Court noted that it had been suggested that the result in *Lewis* was a more “equitable approach” but that there was “no reason” to depart from a well-settled law “merely because it results in an advantage or disadvantage to a taxpayer.” *Id.* at 592.

125. However, the dissent preferred the approach of the Claims Court because under that approach, “the government would not be permitted to maintain the unconscionable position that it can keep the tax after it is shown that payment was made on money which was not income to the taxpayer. *Id.* at 523–524 (Douglas, J., dissenting).

126. *Gargaro*, 73 F. Supp. at 975–976.

127. *Haberkorn*, 78 F.Supp. at 193.

events.<sup>128</sup> In any event, because the majority in *Gargaro* and *Lewis* did not explicitly consider *Penn v. Robertson*, the cases cannot be clear judicial interpretations of *Penn v. Robertson* as creating an “unwind doctrine.”

The second reason why *Gargaro* and *Lewis* do not support the interpretation of *Penn v. Robertson* taken in Rev. Rul. 80-58 is that the majority in those cases reached their decision based on considerations of general justice wholly absent from both *Penn v. Robertson* and Rev. Rul. 80-58. In *Gargaro*, the majority stated:<sup>129</sup>

We . . . are similarly impressed here, with the injustice of the Government’s position. For the Government to insist upon keeping taxes paid to it by a taxpayer under the mistaken belief that he had received income for his own use and benefit, when in fact he received it only by reason of an honest mistake, and was obliged to and did give it back and got no benefit from it, there is nothing to be said morally.

The majority seemed to find the contrast with *Wilcox*,<sup>130</sup> in which an embezzler was found not taxable on embezzled money, as particularly egregious:<sup>131</sup>

We are asked to hold that an honest man who received money under a mistake and immediately restored it when the mistake was discovered, must pay an income tax upon it, whereas than embezzler who received money and used it (we suppose it is immaterial that he lost it gambling) and did not restore it to the rightful owner, owes the Government no tax. We would suppose that if there was to be a difference in the treatment of these two situations, the difference should be that the honest taxpayer would be treated more considerately than the embezzler.

That is, the court in *Gargaro* and *Lewis* treated as material that it would be unjust or immoral for the Government to refuse to reopen and retrospectively amend the taxpayer’s return given the circumstances. This explicit appeal to morality is entirely absent in both Rev. Rul. 80-58 and *Penn v. Robertson* itself, but as explained by Goodhart, is part of the ratio in *Gargaro* and *Lewis*.<sup>132</sup>

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128. The Harvard Law Review argued that the Court used “reasoning of doubtful validity to escape applying the claim of right doctrine” in *Gargaro*, stating that: in “cases like the present one, where the earnings or dividends are actually repaid, most courts apply the *North American* dictum in all its rigor, taxing the recipient when he obtains the funds and allowing him the cold comfort of a possible deduction when he loses them. . . . Justification for this result is found in the annual system; federal revenue cannot wait until final determination of the rights of all claimants.”; *Income Tax – What is Income – Taxpayer Allowed Refund of the Tax Paid on Profit Sharing*, 61 HAR. L. REV. 710, 711 (1948).

129. *Gargaro*, 73 F. Supp. at 974.

130. *Comm’r v. Wilcox*, 327 U.S. 404 (1946).

131. *Gargaro*, 73 F. Supp. at 975. Judge Whitaker in the minority in *Gargaro* and *Lewis v. United States*, and the Sixth Circuit in *Haberkorn v. United States* noted that the finding in *Wilcox* was that, unlike in the instant cases, the embezzler had not received the money under any claim of right because at the time he embezzled the money he was at all times under an unqualified duty and obligation to repay the money. *Id.* at 976 (Whitaker, dissenting); *Lewis*, 91 F. Supp. at 1022 (Whitaker, dissenting); *Haberkorn*, 78 F. Supp. at 194.

132. Goodhart, *supra* note 59. Conversely this means that the Supreme Court judgment overturning

Finally, both *Gargaro* and *Lewis* were cases in which the reversal transaction was legally connected to the original transaction (and gave rise to an outgoing that was deductible in its own right) so they cannot be authority for the application of the unwind doctrine to bare reversals, as apparently blessed by Rev. Rul. 80-58. In each case, there was a “definite, unconditional obligation” on the taxpayer to refund the excess part of his bonus.<sup>133</sup> A legal infirmity in the original transaction meant that the repayment was legally connected to the overpayment of the bonus itself. The repayment was not a fresh, bare reversal.

In sum, *Gargaro* and *Lewis* form a line of authority, now seemingly extinguished by the Supreme Court<sup>134</sup> distinct from the unwind doctrine in Rev. Rul. 80-58. The majority relied on a general principle of justice to find that, sometimes, when a taxpayer refunds an over payment he can reopen a past year’s assessment. The “unwind doctrine” merely requires a reversal by the end of the tax year, with no justice considerations attached and applies *only* to reversals that take place within the same tax year.

#### B. MENTIONS OF PENN V. ROBERTSON IN DICTA

In the following three cases, the courts suggest that the unwind doctrine may exist, but they are only dicta on that point because in each case the court finds as a matter of fact the parties have not been returned to the status quo ante. The dicta is only weak support for the interpretation of *Penn v. Robertson* in Rev. Rul. 80-58 because the cases are also vague about whether returning to the economic status quo ante within the tax year is the only requirement necessary to grant an unwind, or whether the return to the status quo ante must be effected by a transaction that is a true rescission. In each case the taxpayer had in fact tried unsuccessfully to argue that there had been a true rescission.

##### 1. *In Re Trico Marine Services*

In *Trico*, the plaintiffs alleged that a Chapter 11 bankruptcy plan had been procured by fraud, and asked the court to revoke the plan.<sup>135</sup> The court held that it was impossible to do so because bankruptcy law requires for the valid revocation of a Chapter 11 plan that all relevant parties be restored to the status quo ante, but this was impossible on the facts.<sup>136</sup> In particular, the court found that it was impossible to restore the tax positions

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the claims court in *Lewis* is not an explicit judicial rejection of the unwind doctrine interpretation of *Penn v. Robertson*, because no such doctrine or interpretation was relied upon by the Claims Court.

133. *Haberkorn*, 78 F. Supp. at 193.

134. See generally *Lewis*, 340 U.S. 590.

135. *In re Trico*, 343 B.R. 68 at 72–73.

136. *Id.*

of the parties to the status quo ante.<sup>137</sup>

The plaintiffs had argued that it was indeed possible to restore the parties' tax positions, because tax unwind treatment could and should be applied to the proposed revocation of the Chapter 11 plan.<sup>138</sup> Responding to this submission, the court cited *Penn v. Robertson* and Rev. Rul. 80-58 by way of *obiter dictum*, suggesting that it accepted that in theory tax unwind treatment may sometimes be available:<sup>139</sup>

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* . . . Rev. Rul. 80-58. . . . Second, the parties to the transaction must be returned to the status quo ante.

The court found however that it was impossible in the case before it to return the parties to the status quo ante, because doing so would require tracing all the shares issued under the Chapter 11 plan, which the plaintiff conceded would be "very difficult, if not impossible."<sup>140</sup>

Because the court did not sanction tax unwind treatment in this case, *Trico* gives no firm basis for either the unwind doctrine or its application to bare reversals. Even as dicta, *Trico* is weak support for the interpretation of *Penn v. Robertson* in Rev. Rul. 80-58 for other reasons.

The court did not unambiguously adopt the unwind doctrine, even by way of *obiter dictum*. It said that "[w]here 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."<sup>141</sup> "Undo the tax effect" could simply be a statement that the tax effect of a rescission can cancel the tax effect of the original transaction, if both tax effects are independently recognized.

The court did not analyze *Penn v. Robertson* or refer to the facts in that case. When it did refer to *Penn v. Robertson*, it simultaneously cited Rev. Rul. 80-58,<sup>142</sup> so any of the court's dicta comments about tax unwinds could just be an interpretation of Rev. Rul. 80-58 or an independent understanding by the court of *Penn v. Robertson*.

Finally, the plaintiffs sought to apply unwind treatment not to a bare reversal, but to a true rescission. The plaintiffs urged that the Chapter 11 plan be revoked because it had been procured by fraud.<sup>143</sup> That is, they argued that there was a legal infirmity in the original transactions.

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137. *In re Trico*, 343 B.R. 68 at 72–73.

138. *Id.* at 71–72.

139. *Id.* at 73.

140. *Id.* at 70.

141. *Id.* at 73.

142. *In re Trico*, 343 B.R. 68 at 73.

143. *Id.* at 70.

## 2. *Scallen v. Commissioner of Internal Revenue*

Scallen was a tax professor at the University of Minnesota who was also involved in the real estate business.<sup>144</sup> In January 1979, Blue Ridge, Inc. (controlled by the Scallen) sold the Brittany Apartments to Mr. Hansen. Hansen then sold the Brittany Apartments to Mr. Herman. In November 1979, Mr. Herman sold the Brittany Apartments to Campus Realty, Inc., another company controlled by the Scallen. Scallen argued that the November sale of the Brittany Apartments should be treated as a “rescission” of the January contract. The court said:<sup>145</sup>

Section 1001(c) provides that [e]xcept as otherwise provided in this subtitle [A], the entire amount of the gain or loss, determined under this section, on the sale or exchanged of property shall be recognized. No gain shall 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* . . . .

The court found that “we do not agree that a rescission occurred on the facts.”<sup>146</sup> Neither of the parties to the January transaction were the same as the parties to the November transaction. The court declined to disregard the corporate form to treat both Blue Ridge, Inc., and Campus Realty, Inc., as acting as agents for the Scallen, and “even assuming an agency for [Scallen] existed through both corporations, we are still addressing a different ‘other’ party in each contract, i.e., Hansen in the January contract and Herman in the November contract.”<sup>147</sup> There was no reason to disregard the transfer from Hansen to Herman.

Because the court did not apply unwind treatment, its statements suggesting that the unwind doctrine might exist are dicta. Furthermore, the court does not address, even in dicta, the question of whether any unwind treatment can be applied to pure reversals that put the parties in the status quo ante, or only true rescissions. Finally, although the court cites *Penn v. Robertson* as authority for the unwind doctrine it appears to take this authority for granted. It does not work through the judges’ reasoning in *Penn* to explain how the case can be taken for authority for the unwind doctrine, a task that would have been impossible, as this article explains.

### C. OTHER WEAK DICTA – *HUTCHESON*

*Hutcheson*<sup>148</sup> is a case that discusses the unwind treatment in Rev. Rul. 80-58 in dicta, but does not mention *Penn v. Robertson*.

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144. *Scallen*, 54 T.C.M. (CCH) 177.

145. *Id.*

146. *Id.*

147. *Id.*

148. *Hutcheson*, 71 T.C.M. (CCH) 2425.

The taxpayer in 1998 asked the broker Merrill Lynch to sell some of the taxpayer's stock in the company Wal-Mart. Merrill Lynch sold 96,600 more shares than client thought he had advised should be sold.<sup>149</sup> Later that year Merrill Lynch purchased with funds contributed by Merrill Lynch and the client 96,600 shares in Wal-Mart (the shares had in meanwhile gone up in price).<sup>150</sup>

The taxpayer argued that Rev. Rul. 80-58 applied so as to allow him to recognize no gain on the original sale of the 96,000 shares sold erroneously, because the later purchase of Wal-Mart shares had "rescinded" that sale.<sup>151</sup>

The court held that the situation did not meet the requirement of Rev. Rul. 80-58 that "both buyer and seller must be put back in their original positions."<sup>152</sup> In the first transaction Merrill Lynch was acting as agent and in the second had acted as purchaser in its own right. Furthermore, the 96,000 shares purchased were purchased from different parties, and were different shares, from the 96,000 shares sold.<sup>153</sup>

The case did not cite *Penn v. Robertson*; the taxpayer's argument appeared to be exclusively that he could rely on Rev. Rul. 80-58. The court denied that such reliance was appropriate, and did not consider whether Rev. Rul. 80-58 was correct.<sup>154</sup>

#### D. BARE REVERSALS DENIED UNWIND

None of the cases discussed above explicitly and authoritatively make the same mistakes in interpreting *Penn v. Robertson* as the IRS made in Rev. Rul. 80-58, namely pronouncing it authority for an unwind doctrine that applies to bare reversals.

By contrast, there is clear case authority consistent with the orthodox view that where there are two transactions that economically nullify each other within the same tax year, each transaction must be given its separate tax effect. *Crellin's Estate* and *Branum v. Campbell* are two cases where the courts were asked to apply unwind treatment to bare reversals that returned the parties to the economic status quo ante within the tax year. In these cases, the courts explicitly rejected the approach of ignoring both the original transaction and its reversal—as would be consistent with Rev. Rul. 80-58's misinterpretation of *Penn v. Robertson*—and instead recognized the independent tax impacts of the two separate transactions.

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149. *Hutcheson*, 71 T.C.M. (CCH) 2425 at 1–2.

150. *Id.* at 2.

151. *Id.*

152. *Id.* at 4.

153. *Id.*

154. Even if the court had thought that the ruling was incorrect, the taxpayer may have been able to rely on it nevertheless if he had been able to bring himself within the requirements of the ruling. See discussion *infra* Part VI.

In both *Crellin's Estate* and *Branum v. Campbell* the taxpayer derived income from one transaction, and later reversed that transaction. However, the outgoing in the reversal was not deductible in its own right.

In each case, the court was emphatic that each transaction would be recognized for tax purposes and given its independent tax effect, even though the taxpayer had been returned economically to the status quo ante. The transactions could not be ignored, nor was there any special rule that made the second transaction—not deductible in its own right—deductible simply because it economically reversed an earlier transaction.

Neither case mentions *Penn v. Robertson*. Perhaps this is unsurprising if *Penn v. Robertson* does simply stand for the ordinary proposition that a deduction can be set off against taxable income in the same tax year. The courts in *Crellin's Estate* and *Branum v. Campbell* may have thought this proposition so uncontroversial and established that no such citation of *Penn v. Robertson* or of any other cases was required on this point.

#### 1. *Crellin's Estate v. Commissioner of Internal Revenue*

The taxpayers in *Crellin's Estate*<sup>155</sup> were shareholders of a company that realized a capital gain. The company's accountant advised the company that the gain would be subject to the personal holding company surtax unless the gain was distributed.<sup>156</sup> On the advice of the accountant the company's directors declared a dividend in 1946 equal to the amount of the capital gain.<sup>157</sup> Later that year the directors learned that the accountant's advice had been wrong and, therefore, passed a resolution purporting to rescind the dividend.<sup>158</sup>

The IRS argued that the payment of a dividend and its voluntary return later that year should be treated as two separate transactions, with each given their independent tax effect: The dividend should be taxable because it was received under a claim of right, and the return of the dividend should be treated as an entirely voluntary, nondeductible contribution of capital.<sup>159</sup> The taxpayers' position was that the dividend payments should not form part of their gross income for the year 1946, the dividend having been both received and returned in that year.<sup>160</sup> The court stated the question before it in this way: "Did the action of the directors in attempting to rescind the dividend and the repayment of the stockholders in the year the dividends were declared and received (1946) change the character of the dividend payments so as to authorize their exclusion from

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155. 203 F.2d 812.

156. *Id.* at 813.

157. *Id.*

158. *Id.*

159. *Crellin's Estate*, 203 F.2d at 814.

160. *Id.*

the gross income of petitioners?”<sup>161</sup>

The court rejected the taxpayer’s argument and held for the IRS. The court stated that taxable income arises in the year in which a dividend is received under a claim of right, and that in this case, it was clear that the taxpayer had received the dividend under a claim of right.<sup>162</sup> The court said that a deduction arises in the year in which a dividend is repaid subject to a legal compulsion to repay.<sup>163</sup> Therefore:<sup>164</sup>

[The taxpayers’] contention that the amounts of the dividend payments were not a part of their respective gross incomes for the year 1946, the dividend having been both received and returned in that year, is therefore valid *if* the repayment could have been required. It is the year in which a legally rescindable dividend is returned that determines when the deduction from gross income may be taken.

By footnote to this passage, the court said that “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.”<sup>165</sup> However, this is a legitimate way to view the outcome if and *only if* the return of the dividend was required by law—i.e., deductible in its own right. Furthermore, this was not the court’s preferred characterization, but the characterization proposed by the taxpayers. That is, the court noted that the outcome is the same under the deduction rationale and the conflation rationale in circumstances where the outgoing is deductible in its own right.

The court was unequivocal that in cases where an outgoing is *not* deductible in its own right: Just because it economically undoes another transaction earlier in the tax year, the outgoing cannot be treated as deductible, or otherwise nullifying or “changing the character of” the original taxable receipt. “On the other hand, a so-called ‘rescission’ which does not have the force and effect in law of compelling the return of payments made under a dividend declaration, but which in reality is a voluntary act, cannot create a deduction in any year.”<sup>166</sup>

The court also made plain that in trying to determine whether an outgoing paid in reversal of an earlier transaction is deductible, it is the substance of that second transaction that matters, not the label given to it by the parties: “Substance prevails over form. The consent given by [the taxpayers] and relied upon by them as justifying ‘rescission’ was in fact no more than a voluntary payment by stockholders.”<sup>167</sup>

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161. *Crellin’s Estate*, 203 F.2d at t 813.

162. *Id.* at 814.

163. *Id.*

164. *Id.*

165. *Id.* at 814 n.1.

166. *Id.* at 814.

167. *Id.* at 815.

## 2. *Branum v. Campbell*

In *Branum v. Campbell* the taxpayer in 1948 sold a half interest in his business (forming a partnership with the purchaser) and then repurchased the half interest later that year for the same amount (dissolving the partnership).<sup>168</sup> The Commissioner treated the gain on the original sale as having given rise to net income, with the repurchase being a “separate transaction which resulted in the taxpayer’s obtaining an increased basis in one-half of his business, but which had no effect on the taxable status of the gain realized from the original sale.”<sup>169</sup> The taxpayer, by contrast, sought to report no taxable gain on the sale of the business at all. The court found that: “the words and tenor of the contract are definite. There is no reservation of title and no indication of a conditional or provisional agreement between the parties. By its terms, a sale of one-half of the business was accomplished and a partnership formed.”<sup>170</sup>

The court concluded that “there was a completed sale, which was a separate and distinct transaction . . . and that the gain realized upon the sale was properly included in the taxpayer’s gross income as a capital gain.”<sup>171</sup> Although the transactions economically cancelled each other they were legally separate, each transaction was given its independent tax effect.

Commentary has implied that the taxpayer’s argument might have fared better had the unwind transaction been “styled as a rescission.”<sup>172</sup> 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<sup>173</sup> which in this case was not a true rescission but, as the court noted, “separate and distinct.”<sup>174</sup>

## VI. TAXPAYER RELIANCE ON MISTAKEN REVENUE RULINGS

The forgoing has shown that there is no decisive judicial authority for the unwind doctrine in Rev. Rul. 80-58 or its application to bare reversals, either in *Penn v. Robertson* itself or in any subsequent case law interpreting

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168. *Branum*, 211 F.2d at 148.

169. *Id.*

170. *Id.*

171. *Id.*

172. Schnabel, *supra* note 4, at 700.

173. *Crellin’s Estate*, 203 F.2d at 814.

174. Relying on *Branum v. Campbell*, the court in *Reeves v. United States*, also treated the repurchase of the taxpayer’s business interests as a separate and distinct transaction from the original sale, nothing that in the original sale there was no “conditional or provisional agreement” and it was a transfer “without reservation.” 173 F. Supp. 779, 781 (M.D. Ala. 1959). In *Reeves* however, the court also noted that the reversal transaction did not put the taxpayer in the status quo ante, as in the second transaction, the taxpayer purchased more of the business than he had sold in the original sale transaction, and the sale price also reimbursed the taxpayer for other expenses.

*Penn. v. Robertson*. On the contrary, in cases like *Branum v. Campbell* where the issue has been before the court, the judges have held, in effect, that there is no unwind doctrine in the form in which Rev. Rul. 80-58 and private letter rulings present it.

This conclusion has significant practical implications. Taxpayers routinely rely on Rev. Rul. 80-58 to reach tax results that they could not otherwise attain.<sup>175</sup> Can they continue to do so, even if Rev. Rul. 80-58 is mistaken and there is no authority in the Code, Treasury Regulations, or case law for the approach that it takes? Importantly, when a taxpayer has relied upon an incorrect revenue ruling, is the Commissioner estopped from arguing that the ruling should be disregarded because it is incorrect in law? The answer is unclear.

The departure point is the frequently quoted passage from *Beneficial Foundation, Inc. v. United States*, “[so] long as a published ruling is not revoked or modified, it may be invoked by any taxpayer as if it were issued to him personally, and to the extent that it addresses issues in his case, the ruling will normally be dispositive.”<sup>176</sup>

Some commentaries on the issue begin and end with that quotation.<sup>177</sup> The case contains this comment, by way of an easily overlooked footnote to the above quotation:<sup>178</sup>

The court leaves for future consideration whether circumstances exist where it may be appropriate to overturn a published ruling favouring a taxpayer at the behest of the Service. In this case, defendant has not asked the court to overturn the published rulings in question, apparently taking the position that the court ought simply to ignore them. To ignore published rulings is, however, tantamount to overturning them because rulings can provide no guidance to taxpayers if the Service and the courts fail to give them effect in litigation.

Furthermore, the Supreme Court decision in *Automobile Club of Michigan v. Commissioner of Internal Revenue* has been interpreted by other courts to stand for a “well established rule that the Commissioner may retroactively revoke certain revenue rulings, even where taxpayers may have relied on them to their detriment.”<sup>179</sup>

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175. *Branum*, 211 F.2d at 148.

176. 8 Cl.Ct. 639, 645 (1985). See commentary in, for example, CORPUS JURIS SECUNDUM, 47A INTERNAL REVENUE, §9 n.81.

177. See CORPUS JURIS SECUNDUM, *supra* note 175.

178. *Beneficial Found.*, 8 Cl. Ct. at 645 n.7.

179. See *Estate of McLendon v. Comm’r*, 135 F.3d 1017, 1024 n.15 (5th Cir. 1998).

Note that in cases where the I.R.S. has tried in vain to argue that a Revenue Ruling *is* dispositive, the courts have clearly and repeatedly stated that Revenue Rulings:

do not have the force or effect of regulations or Treasury decisions much less that of law, are at most persuasive, and are not binding on a court. These cases state that when a court finds that the statutory interpretation embodied in a ruling is erroneous, it must substitute its judgment for that of the service.

See CORPUS JURIS SECUNDUM, 47A INTERNAL REVENUE, §9 nn. 79–80.

Another line of cases relying on *Silco v. United States*<sup>180</sup> has held that *Automobile Club of Michigan* applies only where the Commissioner revokes a ruling that is “clearly” contrary to the Code:<sup>181</sup>

*Silco* stands for the proposition that the Commissioner will be held to his published rulings in areas where the law is unclear, and may not depart from them in individual cases. Furthermore, under *Silco* the Commissioner may not retroactively abrogate a ruling in an unclear area with respect to any taxpayer who has relied on it.

The cases relying on *Silco* emphasize Treasury Regulations that had not been promulgated when *Automobile Club of Michigan* was decided.<sup>182</sup> Those Treasury Regulations (601.101(3)(92)(v)(e)) currently state:

Taxpayers generally may rely upon Revenue Rulings published in the Bulletin in determining the tax treatment of their own transactions and need not request specific rulings applying the principles of a published Revenue Ruling to the facts of their particular cases. However, since each Revenue Ruling represents the conclusion of the Service as to the application of the law to the entire state of facts involved, taxpayers, Service personnel, and others concerned are cautioned against reaching the same conclusion in other cases unless the facts and circumstances are substantially the same. They should consider the effect of subsequent legislation, regulations, court decisions, and revenue rulings.

The regulation states only that taxpayers “generally” may rely upon revenue rulings, leaving open the possibility that in some circumstances reliance is inappropriate, but without enumerating those circumstances.<sup>183</sup>

The Commissioner appears to have open to him an argument that, under *Silco*, he is entitled to ignore Rev. Rul. 80-58 on the basis that the ruling was clearly incorrect because of the Service’s misinterpretation of *Penn v. Robertson*. A case of “clear” mistake of law might be one of the circumstances in which the Treasury Regulations anticipate that on revenue rulings cannot be relied upon by taxpayers.

The authors do not attempt to resolve this issue, but it is perhaps not as easily disposed of as some may believe. Mr. Poling and others in his position should not simply assume that Rev. Rul. 80-58 saves them from a daunting tax result.

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180. 779 F.2d 282 (5th Cir. 1986).

181. *McLendon*, 135 F.3d at 1024.

182. *Id.* at 1024 n.15.

183. The Treasury Regulations are equivocal relative to, for example, the New Zealand Tax Administration Act 1994 section 91DB which has the clear effect that New Zealand taxpayers may rely upon public rulings even when the rulings are clearly wrong: “(1) Notwithstanding anything in any other Act, if — (a) a public ruling on a taxation law applies to a person in relation to an arrangement; and (b) the person applies the taxation law in the way stated in the ruling, — the Commissioner must apply the taxation law in relation to the person and the arrangement in accordance with the ruling.” Tax Administration Act 1994 § 91DB (N.Z.).

## VII. WHAT SHOULD BE DONE?

We have found that the unwind doctrine in Rev. Rul. 80-58 has no judicial authority, and the ability of taxpayers to continue to rely on the mistaken revenue ruling is uncertain.

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.”<sup>184</sup> Rev. Rul. 80-58 currently violates this regulation because it promulgates an incorrect interpretation of the tax law set out in *Penn v. Robertson*.<sup>185</sup>

If Rev. Rul. 80-58 were revoked, taxpayers could perhaps continue tax unwinding, taking the position that the Code gives implicit authority for the unwind doctrine, irrespective of whether *Penn v. Robertson* recognized it. Taxpayers and practitioners wishing to continue unwinding might further persuade the IRS to issue a new revenue ruling, or Treasury to issue an interpretive regulation to the effect that the unwind doctrine exists and may be applied to bare reversals, despite the lack of case law supporting it. This approach has two weaknesses. The first is that the case law has explicitly rejected interpreting the Code to allow unwinding. Cases such as *Crellin's Estate* and *Branum v. Campbell* discussed above rejected the application of an unwind approach to bare reversals. In the face of such cases, the courts might hold that any subsequent, contradictory regulation or rulings would be an impermissible construction of the statute.<sup>186</sup> The approach of relying on the Code as it stands to support unwinding also has the weakness that there would be no certainty until the approach is tested by the courts.

For those reasons, it would be sensible for taxpayers and practitioners who wish to continue to use unwinding to seek an explicit amendment to the Code that allows unwind treatment in the case of bare reversals.

Policymakers responding to such a request would have to decide whether to create an unwind doctrine that applies to bare reversals. Below we canvass existing principles of tax law and other policy considerations relevant to this question.

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184. Internal Revenue Statement of Procedural Rules 26 C.F.R. § 601.601(d)(2)(iii) (2009).

185. While section 7805(b) gives the I.R.S. some discretion in enforcing the code, Revenue Ruling 80-58 does not purport to rely on discretion. Rev. Rul. 80-58, 1980-1 C.B. 181.

186. Here, we do not consider in detail the validity of such a regulation considering such factors as *Chevron*. *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842–843 (1984).

## A. PRINCIPLES OF TAX LAW

When considering whether to legislatively recognize an unwind doctrine with application to bare reversals, policymakers should consider whether such a doctrine would be consistent with or required by existing principles of tax law. In the authors' view, the unwind doctrine does not seem currently tethered to existing principle.

Schnabel has claimed that the unwind doctrine is simply a "modest variation of the claim of right doctrine."<sup>187</sup> In the authors' view the unwind doctrine is not a natural extension of the claim of right doctrine. The unwind doctrine applies even in cases (such as Poling's) where there was no doubt about the legal basis of the taxpayer's right to keep the receipt,<sup>188</sup> and that the reversal of that receipt was not due to some infirmity in the taxpayer's claim to the amount received.<sup>189</sup>

Similarly, 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.<sup>190</sup> Judges may be sympathetic to the argument that Poling returned their bonuses because of the strong public feeling that this was the correct thing to do morally, and should not face a net negative tax consequence this morally laudable action. 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.<sup>191</sup> Considerations of justice in *Gargaro* and *Lewis* would seem to allow unwind treatment only in cases only where the unwind has moral value.<sup>192</sup> This would allow unwind in a narrower class of cases than the unwind doctrine, which has been applied irrespective of the motivation for the reversal.<sup>193</sup>

Perhaps the most promising principled basis for the unwind doctrine is the idea that tax law should follow economic substance,<sup>194</sup> coupled with the tax year accounting principle in *Saunders v. Commissioner*.<sup>195</sup> Perhaps tax

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187. Shnabel, *supra* note 4, at 688–689.

188. *See supra* Part II.

189. In claim of right cases section 1341 may apply; *see Lee, supra* note 40, at 330 n.21.

190. Assuming that courts could be persuaded to consider this approach at all, given the Supreme Court's rejection of it in *Lewis*, *see supra* text accompanying note 134.

191. The situations in, respectively, I.R.S. Priv. Ltr. Rul. 05-33-002 (Aug. 19, 2005) and I.R.S. Priv. Ltr. Rul. 07-01-019 (Jan. 5, 2007).

192. *See discussion supra* Part V.A.

193. Lee, *supra* note 40, canvasses a number of other approaches and principles that might result in the same outcome as the unwind doctrine, but does not argue that these approaches form the principled bases for the unwind doctrine.

194. Reflected in many attempts by tax law to follow economic substance, including judicial development of the economic substance doctrine and enactment of section 17709(o).

195. *See generally* 101 F.2d 407.

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.

Furthermore, it is not clear that an economic substance approach would necessarily support the unwind doctrine. Hasen, in *Unwinding Unwinding*, created a theoretical framework for analyzing “unwind” cases.<sup>196</sup> Hasen attempted to derive from the Haig-Simons economic income concept principles for whether and when unwinding should be allowed.<sup>197</sup> 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.<sup>198</sup> The crux of his thesis is that:<sup>199</sup>

. . . 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.”<sup>200</sup> This is again a narrow principle than the current unwind doctrine.

There may be other principles of tax law that suggest that unwinding has some basis in existing tax law approaches. We are not aware of any compelling detailed analysis that argues this is the case. Instead the basis for the unwind doctrine to date seems to be simply the assertion that *Penn v. Robertson* is authority for it.

## B. OTHER POLICY CONSIDERATIONS

Banoff canvasses a number of policy arguments both for and against permitting retroactive unwinding.<sup>201</sup> The arguments against include that “approval of retroactive unwindings that are tax motivated permits taxpayers to play the audit lottery: If you are audited, only then do you

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196. Hasen, *supra* note 2.

197. *Id.* at 895–905.

198. *Id.* at 943.

199. *Id.* at 874.

200. *Id.* at 943.

201. Banoff, *supra* note 17, at 6.

unwind to avoid adverse tax results.”<sup>202</sup> The unwind doctrine may similarly dilute the deterrent effect of the codified economic substance doctrine in section 17709(o) 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). 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 over the course of the tax year.”<sup>203</sup> Each of these effects may mean that unwinding is a drain on the revenue.

Banoff’s list of policy arguments in favour of the unwind doctrine include that “tax law should be interpreted reasonably and mirror commercial reasonableness. It is commercially reasonable for people in business to have a transaction remain ‘open’ for economic purposes. Thus the tax law should reflect flexibility to recognize unwinding as of the original transaction.”<sup>204</sup>

A further policy consideration is the transition cost of eliminating unwinding. Given the large structure of tax practice now built upon the mistaken interpretation of the unwind doctrine, perhaps now it would be too costly and difficult to eliminate the unwind doctrine. Mitigating this consideration is that any IRS or legislative clarification that there is no current basis in law for unwinding could be promulgated with prospective effect only. Because the unwind doctrine applies only to transactions that reverse each other within the same tax year, there would be no need for grandfathering or other complicated transition rules.

### C. CONCLUSIONS ABOUT POLICY RESPONSES

The brief review above of policy considerations does not unequivocally establish that the unwind doctrine should exist, even if it is not currently supported by case law. An unwind doctrine of the same scope as set out in Rev. Rul. 80-58 and subsequent practice is not clearly supported by existing principles of tax law, and policy considerations point in both directions.

## VIII. CONCLUSION

The unwind doctrine is the result of a simple mistake. The mistake was for the IRS, practitioners, and commentators to treat *Penn v. Robertson* as standing for a principle that could explain the outcome of the case, rather

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202. Banoff, *supra* note 17, at 6.

203. Hasen, *supra* note 2, at 941.

204. Banoff, *supra* note 17, at 6.

than the principle that accurately described the reasoning of the judges.<sup>205</sup>

Two rationales are consistent with the result in *Penn v. Robertson*: (1) that a taxable gain and a deduction may offset each other when they occur in the same tax year; or (2) that two transactions that cancel each other economically and occur in the same tax year may be conflated and treated as a nullity. We have found in Part III above that only the deduction rationale accurately describes the reasoning of the judges in the *Penn v. Robertson*, and is the ratio *decidendi* of the case.<sup>206</sup>

The mistake matters (and is useful for taxpayers) in cases where ordinary principles of tax law would not lead to the same result as the unwind doctrine. These are cases in which the unwind transaction is not legally connected to the original transaction, such as, under the facts we assume, the situation of some TARP bonus recipients who repaid their bonuses.<sup>207</sup>

Judges, however, have not yet made the same mistake, and taxpayers would not be wise to rely on the unwind doctrine in the face of it lacking a firm basis in case law.<sup>208</sup> Policymakers should therefore be asked to decide whether there is some tax principle or economic or policy rationale that justifies ratifying the mistaken interpretation of *Penn v. Robertson* by independently creating an unwind doctrine.<sup>209</sup> The choice for policymakers is not clear cut. Existing principles of tax law do not unequivocally support the adoption of an unwind doctrine, and policy considerations point in different directions.<sup>210</sup> While the mistake that led to the fabricated unwind doctrine becoming a part of tax practice was simple, deciding what to do about it is likely to be much more complicated.

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205. *See supra* Part III.

206. *Id.*

207. *See supra* Part IV.

208. *See supra* Parts V and VI.

209. *See supra* Part VII.

210. *Id.*

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