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The Rescission Doctrine: Everything Old Is New Again

Allen Sparkman

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ARTICLES

THE RESCISSION DOCTRINE: EVERYTHING OLD IS NEW AGAIN

ALLEN SPARKMAN*

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

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I. CURRENT INTERNAL REVENUE SERVICE POSITION

Since 1980, the Internal Revenue Service ("IRS") has approved rescission treatment for certain transactions that unwind earlier transactions. Revenue Ruling 80-58¹ considers two situations.

In Situation 1, in February 1978, A, a calendar year taxpayer, sells a tract of land to B and receives cash for the entire purchase price. The contract of sale obligated A, at the request of B, to accept reconveyance of the land from B if at any time within nine months of the date of sale, B is unable to have the land rezoned. In October 1978, B determines that it is not possible to have the land rezoned and notifies A of its intention to reconvey the land pursuant to the terms of the contract of sale. B reconveys the land to A during October 1978, and B receives back all amounts that B expended² in connection with the transaction.

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

Revenue Ruling 80-58 explained its holdings as follows:

The legal concept of rescission refers to the abrogation, canceling, or voiding of a contract that has the effect of releasing the contracting parties from further obligations to each other and restoring the parties to the relative positions that they would have occupied had no contract been made. A rescission may be effected by mutual agreement of the parties, by one of the parties declaring a rescission of the contract without the consent of the other if sufficient grounds exist, or by applying to the court for a decree of rescission.

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

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

2. This is the language used in Revenue Ruling 80-58. B may have expended various amounts in connection with the land from A, for example, attorney fees, realtor commissions, documentary fees, title company fees, etc. Presumably, Revenue Ruling 80-58 requires only that B receive back what he paid to A for the land.

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

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

In *Situation 1* the rescission of the sale during 1978 placed *A* and *B* at the end of the taxable year in the same positions as they were prior to the sale. Thus, in light of the *Penn* case, the original sale is to be disregarded for federal income tax purposes because the rescission extinguished any taxable income for that year with regard to that transaction. See Rev. Rul. 74-501, 1974-2 C.B. 98, which holds that there is no adjustment to the basis of the old stock where a shareholder exercised stock rights and paid the subscription price for the new stock, which subscription price was later returned to the shareholder in the same taxable year in which the rights were issued because the market price of the stock had depreciated to a price below the subscription offer.

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

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

subsequent events.³

More recently, the IRS restated its view of rescissions in Private Letter Ruling (“PLR”) 200923010⁴:

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

The legal concept of rescission refers to the abrogation, canceling, or voiding of a contract that has the effect of releasing the contracting parties from further obligations to each other and restoring the parties to the relative positions that they would have occupied had no contract been made. A rescission may be effected by mutual agreement of the parties, by one of the parties declaring a rescission of the contract without the consent of the other if sufficient grounds exist, or by applying to the court for a decree of rescission.⁵

The PLR states that there are at least two conditions that must be satisfied for the remedy of rescission to apply to disregard a transaction for federal income tax purposes. First, the parties to the transaction must return to the status quo ante; that is, they must be restored to “the relative positions they would have occupied had no contract been made.”⁶ Second, this restoration must be achieved within the taxable year of the transaction.⁷

The IRS applies the two stated conditions somewhat differently. The first, that the parties be restored to the relative positions they would have occupied had no contract been made, appears to be satisfied upon material compliance.⁸ The second condition, that the restoration be achieved within

3. *Id.*

4. See I.R.S. Priv. Ltr. Rul. 200923010 (2009).

5. *Id.*

6. *Id.*

7. *Id.*

8. See I.R.S. Priv. Ltr. Rul. 200613027 (2006) (holding that a valid rescission of the conversion of a partnership to a corporation occurred even though corporate employees who received stock and were redeemed before the rescission were not parties to the ruling and presumably were not required to pay back the redemption proceeds); see also I.R.S. Priv. Ltr. Rul. 2009520036 (2009) (discussing a situation where a partnership converted to a corporation and, upon learning that the business purpose it had thought it would achieve if it were a corporation would not be realized, the corporation converted to a limited liability company. The corporation converted to a limited liability company because of a change in the state’s franchise tax that caused partnerships no longer to enjoy an advantage over limited liability companies. Both conversions occurred in the same taxable year, and the IRS ruled that a valid rescission had taken place even though the former general and limited partners of the partnership were members of a limited liability company).

the taxable year of the transaction, appears to be an either/or proposition; that is, either the condition is satisfied or it is not. If the multiple parties to a contract have different taxable years, the original transaction and the rescission apparently have to occur in the same taxable year with respect to each party. For example, if A purchases Blackacre on March 31, 2014, from Fiscal Year Corp, which has a taxable year ending March 31, it does not appear that this sale could be rescinded effective for federal tax purposes other than on the day of closing because otherwise the rescission would be in a different taxable year for Fiscal Year Corp.⁹ Interestingly, in Revenue Ruling 80-58, the IRS stated that taxpayer A was a calendar year taxpayer, but made no statement about the tax year of taxpayer B.¹⁰

Note that Revenue Ruling 80-58 states that “rescission refers to . . . voiding of a *contract*.”¹¹ The IRS apparently does not apply the rescission doctrine to transactions that do not involve the reversing or undoing of a contract. Consider, for example, PLR 200925044.¹² A taxpayer was receiving distributions from an Individual Retirement Account (“IRA”) that were intended to be a series of substantially equal periodic payments per I.R.C. Section 72(t)(2)(A)(iv), in order to avoid a 10% penalty on early distributions. The taxpayer converted part of the IRA to cash and had it transferred to a new IRA via a trustee-to-trustee transfer. The IRS concluded that the partial conversion and transfer of the IRA constituted a modification of the payment stream, making the penalty applicable.¹³ PLR 200925044 held, without any discussion of rescission theory or whether the retransfer had occurred in the same taxable year, that the consequences of the modification could not be avoided by causing the transferred amount to be transferred back to the original IRA.¹⁴ Where there is a contract, such as a subscription agreement that is cancelled, the IRS has granted rescission treatment without a formal rescission designation in the cancellation.¹⁵ In PLR 2009520036,¹⁶ the IRS required the taxpayer to represent that “under the laws of State A the Plan of Conversion constituted a contract between and among the parties thereto.”¹⁷

More recently, for 2012 and 2013, “whether a completed transaction can

9. See I.R.S. Priv. Ltr. Rul. 201211009 (2012); I.R.S. Priv. Ltr. Rul. 201021002 (2010).

10. See Rev. Rul. 80-58, *supra* note 1.

11. *Id.* (emphasis added).

12. See generally I.R.S. Priv. Ltr. Rul. 200925044 (2009).

13. *Id.*

14. *Id.*

15. See Rev. Rul. 74-501, 1974-2 C. B. 98, Situation 2.

16. Priv. Ltr. Rul. 2009520036, *supra* note 8.

17. *Id.*

be rescinded for Federal income tax purposes” was listed as one of the issues under study for which rulings would not be issued until the IRS resolved the issue through publication of a revenue ruling, a revenue procedure, regulations or otherwise.¹⁸ Rescissions are not so listed in Revenue Procedure 2014-3, but in late June 2013, William Alexander, IRS Associate Chief Counsel, Corporate, announced that the IRS was abandoning the guidance project *and* that the no-ruling policy would stay in place:

We’ve put a lot of time, effort, thought into looking at all sorts of aspects of the rescission doctrine—its history, its fingerprints, its scope, its relationship to other similar phenomena in the [C]ode And at the end of this, it appears that where we’re going to wind up is where we are now. And so I would expect that Rev. Rul. 80-58 [1980-1 C. B. 181] will be the Service’s guidance on the subject for the indefinite future, that rescission will remain a no-rule area for the indefinite future, and that next year’s guidance plan will not show a project on the topic.¹⁹

II. DEVELOPMENT OF THE ANNUAL ACCOUNTING CONCEPT

Revenue Ruling 80-58’s rationale included its statement that “the annual accounting concept requires that one must look at the transaction on an annual basis using the facts as they exist at the end of the year.”²⁰ The annual accounting concept developed after the adoption of the Sixteenth Amendment to the U.S. Constitution in 1913.²¹ In *Burnet v. Sanford & Brooks Co.*,²² the taxpayer operated a dredging business and from 1913 to 1915, acted as a subcontractor for another company that had a contract with the United States for dredging the Delaware River.²³ On its income tax returns for 1913-1916, the taxpayer included for each year the payments received under its subcontract and deducted the expenses it paid each year for performing under the subcontract. The taxpayer reported net income for 1914, but the other returns reported net losses.²⁴

Difficulties arose in the dredging work, and the prime contractor successfully sued the United States for breach of warranty of the character of the material to be dredged. From the prime contractor’s recovery, the

18. Rev. Proc. 2012-3, 2012-01 I.R.B. 113; Rev. Proc. 2013-3, 2013-01 I.R.B. 113.

19. IRS Ends Rescission Study, Leaving No-Rule in Effect, 2013 TNT 127-1 (July 2, 2013).

20. Rev. Rul. 80-58, *supra* note 1.

21. U.S. CONST. amend XVI (“The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.”).

22. 282 U.S. 359 (1931).

23. *Id.* at 361.

24. *See id.* at 361.

taxpayer in 1920 received \$192,577.59, representing the \$176,271.88 by which the taxpayer's expenses under the contract had exceeded its receipts, plus \$16,305.71 of accrued interest. The taxpayer did not report the \$192,577.59 it received in 1920 for tax purposes, and in its argument before the Court asserted that the Sixteenth Amendment and the Revenue Act of 1918 plainly contemplated taxes only on net income or profits and could not be applied to tax a transaction from which the taxpayer realized no profit.²⁵

The Court noted that even if the taxpayer's contention was accepted:

[T]he question remains whether the gain or profit which is the subject of the tax may be ascertained, as here, on the basis of fixed accounting periods, or whether, as pressed upon us, it can only be net profit ascertained on the basis of particular transactions of the taxpayer when they are brought to a conclusion.²⁶

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

All revenue acts which have been enacted since the adoption of the Sixteenth Amendment have uniformly assessed the tax on the basis of annual returns showing the net result of all the taxpayer's transactions during a fixed accounting period, either the calendar year, or, at the option of the taxpayer, the particular fiscal year which he may adopt.²⁷

A taxpayer may be in receipt of net income in one year and not in another. . . . The net result of the two years, if combined in a single taxable period, might still be a loss; but it has never been supposed that that fact would relieve him from a tax on the first, or that it affords any reason for postponing the assessment of the tax until the end of a lifetime, or for some other indefinite period, to ascertain more precisely whether the final outcome of the period, or of a given transaction, will be a gain or a loss.²⁸

The Sixteenth Amendment was adopted to enable the government to raise revenue by taxation. It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation.²⁹

25. *See id.* at 361–62.

26. *Id.* at 362–63.

27. *Id.* at 363.

28. *Id.* at 365.

29. *Id.*

In *Security Flour Mills Co. v. Commissioner*,³⁰ the Court cited and quoted from *Burnet v. Sanford & Brooks Co.* in holding that Security Flour Mills could not deduct on its income tax return for 1935 payments made by it in 1936, 1937, and 1938.³¹ In 1953, the Court again cited *Burnet v. Sanford & Brooks Co.* in holding that an individual taxpayer was not entitled to reduce his salary compensation received in one year because of repayment of a portion of the salary in a later year.³²

The Internal Revenue Code now contains exceptions to the annual accounting concept, such as installment sale treatment,³³ and the percentage of completion method of reporting for certain contracts that will not be completed during the year that they were entered into.³⁴ In addition, the Internal Revenue Code affords other relief, such as deductions for carrybacks and carryovers of net operating losses,³⁵ averaging income from farming and fishing operations,³⁶ mitigation of limitations,³⁷ and special computation of tax when a taxpayer restores more than \$3,000 held under a claim of right.³⁸ Apart from special rules like these, the annual accounting concept remains fundamental to the income tax system in the United States.³⁹

III. SUGGESTIONS FOR IMPROVEMENT AND ALTERNATIVES

Commentators and the Tax Section of the New York State Bar Association (“NYSBA”) have looked at the rescission doctrine as it has developed and been applied by the courts and the IRS. On August 11, 2010, the NYSBA Tax Section submitted a report (the “NYSBA Report”),⁴⁰ urging greater certainty with respect to rescission, and specifically making the following four recommendations:

30. 321 U.S. 281 (1944).

31. *See id.* at 286, n. 9.

32. *See Healy v. Commissioner*, 345 U.S. 278, 284 (1953) (stating “Congress has enacted an annual accounting system under which income is counted up at the end of each year”).

33. *See* I.R.C. § 453 (2012) (Allowing reporting of income as payments are received under qualifying installment sales).

34. *See* I.R.C. § 460 (2012).

35. *See* I.R.C. § 172 (2012).

36. *See* I.R.C. § 1301 (2012).

37. *See* I.R.C. §§ 1311-14 (2012).

38. I.R.C. § 1341 (2012).

39. *See* Treas. Reg. § 1.441-1(b)(3) (2002): “Annual accounting period means the annual period (calendar year or fiscal year) on the basis of which the taxpayer regularly computes its income in keeping its books.”

40. New York State Bar Association Tax Section Report No. 1216 (August 11, 2010) available at http://www.nysba.org/AM/Template.cfm?Section=Tax_Section_Reports1&TEMPLATE=/CM/ContentDisplay.cfm&CONTENTID=43022.

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

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

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

4. Finally, we recommend that the Service clarify the scope of the rescission doctrine in the compensation context, identifying in particular the extent to which common law remedies may be available to supplement the specific corrections procedures provided in various administrative pronouncements to correct plan document or operation “failures” under Section 409A of the Code.⁴¹

In addition to the clarifying recommendations made by the NYSBA Report,⁴² notwithstanding the annual accounting principle, it has been argued that rescission should be allowed (if otherwise proper) so long as the statute of limitations for the taxable year of the original transaction remains open. In addition, and sometimes in the alternative, commentators have argued that the validity of a rescission should not depend on whether it falls within the same taxable year as the original transaction, or some other period, but rather on whether the rescission is entered into because of, for example, the failure of the parties’ expectations for the original transaction. For example, Donald Hasen commented:⁴³

[I]f unwinding is viewed as an appropriate remedy, there is no reason to

41. *Id.*

42. *Id.*

43. See generally Donald Hasen, *Unwinding Unwinding*, 57 EMORY L.J. 871 (2008).

limit it in the ways that it is limited under current law. [Allowing] unwinding relief along the lines available under the claim of right doctrine and the [tax benefit rule] would seem to do no more violence to the annual accounting principle or to tax administration more generally than it does in these areas. Thus, one would hope for both a narrowing of the rule that permits unwinds for rescissions no matter what the reason as long as the rescission occurs in the same taxable year, and relaxation of the rule that limits any unwind to the same taxable year. Any reversal, to merit unwind treatment, ought to be allowed only if the mistake or error giving rise to it is justified. When the error is justified, however, it does not seem that the same-year rule should limit the relief, though it might modify it. Thus, unwinding presumably could extend both to reversals that constitute modifications and to reversals in donative situations or other non-arm's length arrangements under the income tax, such as tax elections; it would not be limited *a priori* to rescissions. The same-year rule might continue to have an effect, however, on the nature of the relief. Under this partly narrower and partly broader standard, a same-year reversal that merits unwind treatment could simply result in complete disregard of both transactions, as under current law. A later-year reversal meriting unwind treatment could be treated much as a deduction under the claim of right doctrine or an inclusion under the [tax benefit rule].⁴⁴

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

IV. RECENT CRITIQUE OF RESCISSION DOCTRINE

A. Introduction

In Revenue Ruling 80-58, the IRS based its analysis in part on *Penn v. Robertson*,⁴⁵ stating that "the facts of the *Penn* case are similar to those in

44. *Id.* at 943-44 (footnote omitted).

45. See 115 F.2d 167 (4th Cir. 1940); see also Sheldon I. Banoff, *Unwinding or Rescinding A Transaction: Good Tax Planning or Tax Fraud?*, 62 TAXES 942, 960 (Dec. 1984) (discussing Rev. Rul. 80-58 and *Penn v. Robertson*).

Situation 1 and Situation 2."⁴⁶ Two commentators have mounted an attack on Revenue Ruling 80-58 and the rescission doctrine it articulates in *The Fabricated Unwind Doctrine: The True Meaning of Penn v. Robertson* (hereinafter, "*Fabricated Doctrine*").⁴⁷ John Prebble and Chye-Ching Huang assert that the entire rescission analysis in Revenue Ruling 80-58 lacks any real basis in precedent, that the rescission doctrine is a "fabrication" by the IRS, that the IRS, practitioners, and academic commentators have all misunderstood *Penn v. Robertson*, and that the case, as analyzed by them, provides no authority for Revenue Ruling 80-58.⁴⁸ Prebble and Huang⁴⁹ take the position that the court in *Penn v. Robertson*, far from holding that the taxpayer was entitled to treat the benefit received from his employer's stock benefit fund in 1931 as "extinguished" when the establishment of the fund was rescinded in 1931, actually articulated a rationale based on allowing the taxpayer's return in 1931 to treat the repayment of the benefit received from the fund as a deductible payment offsetting the receipt of a taxable benefit from the fund earlier in 1931. *Fabricated Doctrine* recommends that Revenue Ruling 80-58 be revoked and offers scant comfort to taxpayers who might be disadvantaged as a result.⁵⁰

This Article demonstrates that the authors of *Fabricated Doctrine* have completely misread *Penn v. Robertson*, and their conclusions should be ignored on that basis alone. *Penn v. Robertson* in fact provides ample legal support for the rescission doctrine as announced in Rev. Rul. 80-58. Moreover, this Article argues that, even if *Penn v. Robertson* had never been decided, the annual accounting concept provides an ample legal and policy basis for Revenue Ruling 80-58. The annual accounting concept is a fundamental principle of United States income tax law established by the Supreme Court in the cases discussed *supra* in Part II. Revenue Ruling 80-58 cites the annual accounting concept as one of the two grounds (*Penn v. Robertson* being the other) for its holdings.⁵¹

46. Rev. Rul. 80-58, *supra*, note 1.

47. John Prebble and Chye-Ching Huang, *The Fabricated Unwind Doctrine: The True Meaning of Penn v. Robertson*, VICTORIA U. OF WELLINGTON LEGAL RES. PAPERS, No. 17/2011 (Sept., 2011), available at <http://ssrn.com/abstract=1781269>.

48. *Id.* at 121.

49. Professor Prebble and Ms. Huang have also written a shorter piece, based in part on an earlier version of *Fabricated Doctrine*. John Prebble and Chye-Ching Huang, *The Rescission Doctrine: Clothes Without an Emperor?*, TAX ANALYSTS TAX NOTES TODAY (May 16, 2011) (hereafter "*Tax Notes Paper*"). Some of the material in the *Tax Notes Paper* now appears in the current version of *Fabricated Doctrine*. This Article discusses only the current version of *Fabricated Doctrine*.

50. *Fabricated Doctrine*, *supra* note 47, at 163.

51. Rev. Rul. 80-58, *supra*, note 1.

Fabricated Doctrine begins its analysis by making the following statements:

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

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

...

The Internal Revenue Code, Treasury Regulations, case law, and IRS rulings do not refer to any unwind doctrine or rescission doctrine by name.⁵² The IRS has allowed taxpayers to use unwind treatment to erase from tax history not only tax effects, such as the derivation of income from a sale of property but also tax effects such as changes in entity status, the liquidation of a company, and a company’s exit from a consolidated group. It has allowed unwind treatment when the economic reversal was motivated by changes in business conditions, and also in circumstances where the reversal was motivated by tax outcomes that the parties later came to regret. It has allowed unwind treatment not only when the unwind was legally connected with the original transaction, such as a contractual payment rescinded for mistake, but also where the two transactions were legally independent, such as when two parties voluntarily reached a fresh agreement to reverse the economic effects of a completed and legally independent transaction.⁵³

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

52. *Fabricated Doctrine*, *supra* note 47, at 117–18. (footnotes omitted)

53. *Id.* at 118.

in the second transaction will offset the tax effect of the first *only if* it is deductible in its own right. If the outgoing is not deductible in its own right, the taxpayer will owe tax as a result of the two transactions, even though she has economically returned to the status quo ante. By contrast, under the unwind doctrine, both transactions would be treated as if they had never occurred, regardless of whether the second outgoing is deductible.⁵⁴

Just in these few statements, *Fabricated Doctrine* advances questionable positions. Although this author has not tried to undertake (or to even see if it is possible) to determine the frequency of taxpayers' use of rescission, a Westlaw search disclosed only two private letter rulings since 2012 dealing with rescissions.⁵⁵ Thus, it appears questionable whether Prebble and Huang had objective evidence that the use of rescissions is routine, common, or ubiquitous. On the other hand, anecdotal evidence suggests that taxpayers and their advisors are comfortable enough with the rescission doctrine that they are willing to undertake uncomplicated rescissions without seeking a private letter ruling. For example, if one party has sold real estate to another party within the same taxable year and the parties unwind the transaction, either because a condition in the contract has not been satisfied, or by mutual agreement because of economic changes, with the buyer conveying the real estate back to the seller and the seller returning the purchase price to the buyer, many if not most experienced tax practitioners would be comfortable advising the parties that it would be appropriate to take a return position that this was a valid rescission, i.e., the transaction would not be reported on either party's return for the applicable year.

Fabricated Doctrine also implies that these "routine" rescission transactions are undertaken only when taxpayers "discover that their transactions have unwanted tax consequences[,]"⁵⁶ and that the effect of the availability of rescissions is that "if you change your mind about a transaction, you can avoid its income tax consequences by returning to the status quo ante, so long as you do so by the end of the tax year."⁵⁷ Contrary to *Fabricated Doctrine*, many private letter rulings⁵⁸ describe situations where the parties entered into a rescission transaction for what appeared to be substantial business reasons. Moreover, saying that one can rescind a transaction for tax purposes upon a change of mind about a transaction⁵⁹ is

54. *Id.* at 118–19.

55. This is unsurprising in light of the developments discussed earlier at notes 18–19, *supra*, and accompanying text.

56. *Fabricated Doctrine*, *supra* note 47, at 117.

57. *Id.* at 117–18.

58. See, e.g., I.R.S. Priv. Ltr. Rul. 2009520036, *supra* note 8.

59. *Fabricated Doctrine*, *supra* note 47, at 117–18.

a correct statement only if the authors of *Fabricated Doctrine* are using the word “you” as a plural noun; the situations described in Revenue Ruling 80-58 involve a sale by one party to another pursuant to a contract that allowed the buyer to rescind if desired zoning was not achieved. The sales were rescinded only because both parties had agreed to do so in their original contracts. However, Revenue Ruling 80-58 states that another way in which a valid rescission may occur is by mutual agreement.⁶⁰ Presumably, this mutual agreement to rescind may occur after the initial sale and does not have to be included in the original contract. If A sells Blackacre to B in January 2014, and B decides in July 2014 that he doesn’t like Blackacre and wishes he’d never bought it, there’s nothing he can do if A responds negatively to B’s request to rescind the sale. If B has grounds for alleging that A defrauded him, he might bring a suit for rescission, but even if he is successful and obtains a judgment that the sale, was void because it was fraudulently induced, he may not receive rescission treatment for federal tax purposes if the court-ordered rescission does not occur in 2014.⁶¹

As discussed above,⁶² Revenue Ruling 80-58 contains this statement: “The legal concept of rescission refers to the abrogation, canceling, or voiding of a contract that has the effect of releasing the contracting parties from further obligations to each other and restoring the parties to the relative positions that they would have occupied had no contract been made”.⁶³

So far as the authors of *Fabricated Doctrine* are concerned, this statement does not amount to a reference to the “rescission doctrine” by name.⁶⁴ Would they have thought differently if the ruling had stated “The legal concept of the rescission doctrine . . .”? Perhaps not, as they assert, without citing any authority, that “commentators coined the appellation.”⁶⁵ Is not Revenue Ruling 80-58, in fact, a statement of the rescission doctrine, at least as to Situation 1, in which the rescission took place in the same taxable year as the original sale?

Fabricated Doctrine’s litany of situations in which the IRS has approved rescission treatment⁶⁶ is apparently an attempt to show, from a policy

60. Rev. Rul. 80-58, *supra*, note 1.

61. See, e.g., Banoff, *supra* note 45 at 967–68 (discussing the rare instances, all involving adversarial court action, in which an original transaction has been declared void *ab initio* and rescission treatment allowed for an unwinding in one year of a transaction that occurred in a prior year).

62. Rev. Rul. 80-58, *supra*, note 1.

63. *Id.*

64. *Fabricated Doctrine*, *supra* note 47, at 118.

65. *Id.*

66. *Id.*

standpoint, that the rescission treatment allowed by Rev. Rul. 80-58 is overbroad. It is difficult to be sure what the point is, because *Fabricated Doctrine* does not offer any analysis other than its statements quoted above,⁶⁷ which conclude, in part, with the statement that, absent the rescission treatment allowed by Rev. Rul. 80-58, “transactions that cancel each other’s economic effects will not necessarily . . . have tax effects that also cancel each other.”⁶⁸ Saying that taxpayers have better results under Revenue Ruling 80-58 than they would have in its absence does not seem to an argument against the validity of the ruling. To illustrate its point, *Fabricated Doctrine* states: “For example, a taxpayer might derive taxable income, but then pay that amount back later in the year. Without the unwind doctrine, the outgoing in the second transaction will offset the tax effect of the first *only if* it is deductible in its own right.”⁶⁹ This statement by *Fabricated Doctrine* ignores authorities discussed below⁷⁰ that would allow a taxpayer who receives income and repays later in the same year to exclude the repaid amount from the taxpayer’s reportable taxable income—authorities that do not rely on Revenue Ruling 80-58.

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

The Supreme Court explained the annual accounting concept as follows:

Congress has enacted an annual accounting system under which *income is counted up at the end of each year*. It would be disruptive of an orderly collection of the revenue to rule that the accounting must be done over again to reflect events occurring after the year for which the accounting is made.⁷¹

Revenue Ruling 80-58 states a similar view in explaining the rationale for its holdings: “The annual accounting concept requires that one look at the transaction on an annual basis *using the facts as they exist at the end of*

67. *Id.* at 118–19.

68. *Id.* at 118.

69. *Id.* at 118 (emphasis in original).

70. See *infra* Part IV Subsection C Fabricated Doctrine’s Examination of TARP Bonuses.

71. Healy v. Commissioner, 345 U. S. 278, 284–85 (1953) (emphasis added).

the year.”⁷²

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

Fabricated Doctrine does not analyze the applicability of the annual accounting concept or, indeed, even mention it.⁷³ Nowhere do Prebble and Huang note that the annual accounting concept was one of the two grounds (*Penn v. Robertson* being the other) cited by the IRS for its holdings in Revenue Ruling 80-58. *Fabricated Doctrine*’s failure to analyze the applicability of the annual accounting concept may explain why it ignored authorities discussed *infra* in Part IV Subsection C⁷⁴ that would allow a taxpayer who receives income and repays later in the same year to exclude the repaid amount from the taxpayer’s reportable taxable income—authorities that do not rely on Revenue Ruling 80-58.

Fabricated Doctrine analyzes *Penn v. Robertson* by attempting to show that the court applied only a deduction rationale in the analysis that led to its holding.⁷⁵ *Fabricated Doctrine* then takes a detour to examine the potential tax results of voluntary repayment of a bonus in the same year as its receipt, but its analysis is flawed because it assumes deductibility of the bonus and fails to discuss relevant authorities suggesting that the taxpayer would get to exclude (not deduct) the bonus from income if the taxpayer were to repay the bonus in the year of receipt.⁷⁶ *Fabricated Doctrine* then applies this flawed analysis to argue that the taxpayer might be afforded rescission treatment under Rev. Rul. 80-58 because of the repayment, even though it is unlikely that Rev. Rul. 80-58 would be applicable.⁷⁷ This is another instance in *Fabricated Doctrine* where the authors describe supposedly likely or possible results of the rescission doctrine of Revenue Ruling 80-58 in apparent attempts to demonstrate that Revenue Ruling 80-

72. Rev. Rul. 80-58, *supra* note 1 (emphasis added).

73. *Fabricated Doctrine*, *supra* note 47 at 164 refers to the “tax year accounting principle in *Saunders v. Commissioner*.” The reference is to *Saunders v. Commissioner*, 101 F.2d 407 (10th Cir. 1939). *Saunders* is a very short opinion in a claim of right case and does not mention a “tax year accounting principle” or any other accounting principle or concept.

74. See *infra* Part IV Subsection C *Fabricated Doctrine’s Examination of TARP Bonuses*.

75. See *infra* Part IV Subsection B *Fabricated Doctrine’s Analysis of Penn v. Robertson*.

76. See *infra* Part IV Subsection C *Fabricated Doctrine’s Examination of TARP Bonuses*.

77. See *Fabricated Doctrine*, *supra* note 47, at 122; *infra* Part IV Subsection C.

58 leads to inappropriate results.⁷⁸

B. Fabricated Doctrine's Analysis of *Penn v. Robertson*

Fabricated Doctrine states that it has undertaken a close reading of *Penn v. Robertson*, and found no support in that case for the unwind doctrine ascribed to it.⁷⁹

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*.⁸⁰

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.⁸¹

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.⁸²

...

These mistakes came about because Revenue Ruling 80-57[sic] and subsequent private letter rulings made the classic error of confusing the timing question of *when* a particular outgoing is deductible with the substantive question of whether the outgoing is deductible at all.⁸³ *Penn v. Robertson* was a “when” case. The issue was whether a certain outgoing, undeniably deductible in its own right if incurred by the

78. *Fabricated Doctrine supra* note 47 at 118 (“... if A sells 100 shares of stock to B for \$100 and, during the same taxable yeat 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.”).

79. *Fabricated Doctrine, supra* note 47, at 127–28.

80. *Id.*

81. *Id.*

82. *Id.*

83. *Fabricated Doctrine, supra* note 47 at 119–20.

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.⁸⁴ 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.⁸⁵

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.⁸⁶

Fabricated Doctrine defines "true rescissions" as:

that category of unwinds [(any transaction that places the parties in the economic status quo ante economically)] [sic] in which the unwind transaction has some legal connection to the original transaction of which it undoes the economic effect. True rescissions include both judicially imposed rescissions and unwinds conducted to vindicate a legal claim embedded in the original agreement between the parties.⁸⁷

...

Any "transactions that simply reverse the economic effect of an earlier transaction, but which are not legally connected to the relevant earlier

84. Actually, that's not exactly what Revenue Ruling 80-58 says happens. As to Situation 1, Revenue Ruling 80-58 states that "the original sale is to be disregarded for federal income tax purposes because the rescission extinguished any taxable income for that year with regard to that transaction." See Rev. Rul. 80-58, *supra* note 1.

85. *Fabricated Doctrine*, *supra* note 47, at 120.

86. *Id.*

87. *Id.* at 141.

transaction” are referred to by *Fabricated Doctrine* as “reversals.”⁸⁸

As noted above, *Fabricated Doctrine* asserts that in its view, Revenue Ruling 80-58’s incorrectness generally does not matter practically in the case of a true rescission. *Fabricated Doctrine* also views Situation 1 in Revenue Ruling 80-58 as a “true rescission” because the unwinding was “conducted pursuant to a legal right embedded in the original agreement.”⁸⁹ At several points, *Fabricated Doctrine* asserts that it does not matter whether a transaction like the one in Situation 1 of Revenue Ruling 80-58 is treated as a rescission because

[a]t 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. . . . Ordinary principles of tax law operate to allow the deduction to offset the taxable gain if the two transactions occur in the same year.⁹⁰

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

Fabricated Doctrine continues:

The theme of the following sections is that the holdings in *Penn v. Robertson* were wholly concerned with matters of timing, not with

88. *Id.* at 143.

89. *Id.* at 142.

90. *Id.* at 120; *see also id.* at 142.

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.)⁹¹

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: 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?⁹²

Next, one must analyze the assertion that “all parties, and the Court of Appeals, agreed that the outgoings were deductible.” The court in *Penn v. Robertson* framed the case as follows:

The Government’s present contention is (1) that all the credits on Penn’s note, both for dividends and share of profits, were taxable income in the years in which they were respectively credited because received by him under a claim of right and without restriction as to their disposition, and (2) as the year 1931, the rescission of the transaction voluntarily made by Penn’s executors after his death, although in 1931, could not properly affect Penn’s individual income taxability. On the other hand the taxpayer’s contention is that (with the exception of the 1931 item of \$31,498.14) Penn never actually received any money or benefit from the credits, and is not chargeable with their constructive receipt, in view of the invalid and executory nature of the transaction; and as the cash item of \$31,498.14 was returned during the calendar year upon the rescission of the plan, it was not taxable as income. Thus two questions are presented for our determination; one, whether the credits on Penn’s notes constituted income constructively received by him for both years, and if so, second, whether the rescission in 1931 extinguished what otherwise would have been income to Penn in that year.⁹³

Where in the above quoted statement from the opinion in *Penn v. Robertson* is there any suggestion that the court was applying a deduction rationale? Judges and practitioners who are discussing whether a transaction by a taxpayer results in a deduction for income tax purposes do not generally use words like “whether the rescission in 1931 extinguished what otherwise would have been taxable income.”⁹⁴ More typically, judges and practitioners would use language like “as an offset [or reduction] in taxable income” when discussing a possible deduction.

91. *Id.* at 127.

92. *Id.* at 127–28 (emphasis added).

93. 115 F.2d 167, 172–73 (4th Cir. 1940).

94. *Id.* at 175.

Fabricated Doctrine continues to argue its assertion as follows:

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

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.⁹⁵

The reference to Goodhart is to Arthur L. Goodhart's article entitled, *Determining the Ratio Decidendi of a Case*.⁹⁶ *Fabricated Doctrine* cites Goodhart as though his views establish the gospel for interpretation of case law. In fact, just a year after its publication, Karl Llewellyn described Goodhart's article as essentially an indiscretion.⁹⁷ Discussion and criticism of Goodhart's views has continued since Llewellyn's disapproval.⁹⁸ Llewellyn believed that Herman Oliphant failed to see enough guidance in precedent and that Goodhart saw too much.⁹⁹ Robert G. Scofield presents a persuasive argument that in many common fact patterns, "no matter which of the two theories of *ratio decidendi* one adopts, it does not appear that there is clearly one *ratio* that states the law. Given the vagueness, *ratio decidendi* is a metaphysical concept."¹⁰⁰

95. *Fabricated Doctrine*, *supra* note 47 at 130.

96. See generally Arthur L. Goodhart, *Determining the Ratio Decidendi of a Case*, 40 YALE L.J. 161 (1930).

97. See Karl N. Llewellyn, *Legal Tradition and Social Science Method: A Realist's Critique*, in ESSAYS ON RES. IN THE SOCIAL SCI., THE BROOKINGS INST. 89, 98 (1931).

98. See, e.g., Robert G. Scofield, *Goodhart's Concession: Defending Ratio Decidendi from Logical Positivism and Legal Realism in the First Half of the Twentieth Century*, 16 KING'S C. L.J. 311 (2005); H. K. Lücke, *Ratio Decidendi: Adjudicative Rationale and Source of Law*, 1 *Bond L. REV.* 36 (1989); Julius Stone, *The Ratio of the Ratio Decidendi*, 22 *THE MODERN L. REV.* 597 (1959); Arthur L. Goodhart, *The Ratio Decidendi of a Case*, 22 *THE MODERN L. REV.* 117 (1959). Before Goodhart's 1930 article was published, Herman Oliphant published an article taking a contrary position. Herman Oliphant, *A Return to Stare Decisis*, 14 *AM. B. ASS'N J.* 71 (1928).

99. Karl N. Llewellyn, *THE COMMON LAW TRADITION: DECIDING APPEALS* 14 n. 9 (1960).

100. Scofield, *supra* note 98, at 325.

It is beyond the scope of this Article to undertake an analysis of the best way to parse a court opinion. Suffice it to say that, even if Goodhart's views are applied, *Fabricated Doctrine's* misreading of *Penn v. Robertson* is astonishing. *Fabricated Doctrine* asserts that "[f]or Judges Parker and Chestnut¹⁰¹ it was material that the payment was deductible" and "in terms of the court's process of reasoning, deductibility of the repayment was a material fact."¹⁰² These assertions are unsupportable in light of the court's actual use of the term "deduction."¹⁰³ *Fabricated Doctrine* attempts to explain its assertions as follows:

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.¹⁰⁴

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."¹⁰⁵

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).¹⁰⁶

Yes, the Commissioner did argue that a deduction arising after Mr. Penn's death could not offset income realized while he was alive, but the court rejected this argument, stating, *inter alia*, that the Commissioner's

101. It is not apparent why *Fabricated Doctrine* claims knowledge of the state of mind of only Judges Parker and Chestnut. Judge Chestnut wrote the majority opinion in *Penn v. Robertson*, in which Judge Dobie joined. 115 F.2d 167, 169 (4th Cir. 1940). Judge Parker wrote a concurring opinion in which he stated he concurred with the result and "also in the reasoning of the court, except with respect to grounds upon which the dividends credited in the year 1930 are taxable income." 115. F.2d at 177 (Parker, J., concurring).

102. *Fabricated Doctrine*, *supra* note 47, at 132.

103. Notes 106-114, *infra*, and accompanying text.

104. *Fabricated Doctrine*, *supra* note 47, at 131.

105. *Id.*

106. *Id.* at 132 (emphasis in original).

contention was “based on the erroneous assumption that Penn’s tax accounting period ended with his death on October 22, 1931, and was not for the full calendar year.”¹⁰⁷ Given the way appellate arguments are presented, the Commissioner may not have had the opportunity to present an alternative argument after the court rejected the argument that 1931 involved two tax years. If he had been able to, then why would the Commissioner have thought that an argument that a “conflation” could not “jump back” would have been any more successful? Surely, this tells us nothing.

Fabricated Doctrine continues:

The court rejected this submission of the Commissioner by holding that Penn himself, though dead, could take advantage of the loss that emerged from the rescission. The judges did not explicitly address the question of whether the loss was a deduction or a cancellation that had to be conflated with the 1931 credit to make the credit a nullity. *Their Honours did however call the outgoing from the rescission, “a deduction” and “such deduction.”* This indicates that the court was operating under the deduction rationale (the subtraction of an allowable deduction from a derived gain) because, under the conflation and extinction rationale, a deduction would not in fact arise, since the conflation rationale treats the two transactions together as a nullity.¹⁰⁸

The court in *Penn v. Robertson* used the terms “deduction” and “such deduction” only in its discussion of the Commissioner’s contention,¹⁰⁹ as those are the terms the Commissioner used in his argument. How this indicates the rationale of the court is not readily apparent. The court in *Penn v. Robertson* uses the term “deduction” only in the following paragraphs:

A minor part of the tax controversy related to *deductions* from income made by the taxpayer in the amount of \$14,725 for the year 1930, and \$12,271 for 1931, for travel and entertainment expenses. The district judge determined that these items were properly allowable as *deductions* for the respective years, and the Collector does not now further question them.¹¹⁰

...

107. *Penn v. Robertson*, 115 F.2d 167, 176 (4th Cir. 1940).

108. *Fabricated Doctrine*, *supra* note 47, at 131–32 (emphasis added).

109. *Robertson*, 115 F.2d at 176 (discussing the Commissioner’s argument the court stated that the Commissioner contends that “the loss to Penn by the rescission or re-sale could only serve as a *deduction* against income received by his executors after his death during the calendar year”) (emphasis added).

110. 115 F.2d at 167 (emphasis added).

The market value of the stock on the date of the decedent's death was \$1,798,562.50; the amount then still due on the note amounted to \$1,347,631.48. The equity in Penn's favor at current market price was then \$451,931.02. It may also be noted that in subsequent income tax accounting the Tobacco Company claimed *deductions* for the amounts credited to Penn on the note which, however, were disallowed by the Commissioner and his ruling was acquiesced in by the Company.¹¹¹

...

But in view of practical necessities, income tax accounting with the Government must be on an annual basis, *Burnet v. Sanford & Brooks Co.*, 282 U. S. 359, 51 S. Ct. 150, 75 L. Ed. 383; *Heiner v. Mellon*, 304 U.S. 271, 58 S. Ct. 926, 82 L. Ed. 1337; and, therefore, moneys received by a taxpayer as his own under a claim of right and without restriction as to their disposition are taxable for the year in which they are received and retained even though in a later year the taxpayer is obliged to refund them in whole or in part, in which event he would have a claim for *deduction* in the later year.¹¹²

...

The more serious contention made by counsel for the Collector on this point is that, although Penn's tax accounting was on the cash basis and for the calendar year, his taxable period ended with his death on October 22d, and what was subsequently done by his executors, even though done in the same calendar year, cannot affect the matter. To support this contention, reliance is placed on the provisions of the income tax law that an individual taxpayer and his estate are separate taxable entities; and it is argued therefrom that nothing can be done by executors to affect income chargeable to their decedent within his lifetime, and therefore the loss to Penn by the rescission or re-sale could only serve as a *deduction* against income received by his executors after his death during the calendar year. In the instant case the tax assessed by the Commissioner against Penn for 1931 was about \$80,000, while the tax payable by the executors for the balance of the calendar year without *such deduction* was only \$108.65. No authority is cited in support of the Commissioner's contention in this respect, and we do not consider it sound.¹¹³

As one can see, the first time the court in *Penn v. Roberson* uses the term

111. 115 F.2d at 171-72 (emphasis added).

112. 115 F.2d at 173 (emphasis added).

113. 115 F.2d at 176 (emphasis added).

“deduction,” it is in the course of discussing an issue that is no longer in the case. The second time, the court discusses a disallowed deduction of the American Tobacco Company that had been conceded by the company. The third time, the court discusses the tax rules that apply when a taxpayer receives income in one year under a claim of right and is required to repay the income in a later year; this discussion is not applicable to the court’s decision with regard to 1931 because in that year, which was considered one taxable year of Mr. Penn notwithstanding his death during the year, the receipt and repayment of the income happened in the same year. The fourth and final time the court uses the term “deduction” is in the sole context of describing the Commissioner’s position. These four instances say nothing about the court’s perspective; accordingly, it is not rationally possible to state that the court in *Penn v. Robertson* was operating “under the deduction rationale” on the basis of the court’s use of the term “deduction” in its opinion.¹¹⁴

What the court in *Penn v. Robertson* did say was: “But we agree with the district judge that the rescission in 1931 before the close of the calendar year, *extinguished* what otherwise would have been taxable income to Penn for that year.”¹¹⁵

The authors of *Fabricated Doctrine* acknowledge that the court in *Penn v. Robertson* did use rescission language, such as describing the repayment of the 1931 payment by the taxpayer as a rescission that “extinguished” the entire stock fund transaction for 1931. Moreover, the authors of *Fabricated Doctrine*, in a paragraph in which they characterize the actions of the American Tobacco Company and Penn’s executors as creating a deduction, nevertheless state: “Therefore, the reversal in 1931, although undertaken by Penn’s executors after Penn’s death, was nevertheless Penn’s. *This reasoning had the effect of cancelling the 1931 credit, both economically and for tax purposes.*”¹¹⁶ Explaining that the 1931 credit was cancelled, “economically and for tax purposes” sounds as though they are describing a rescission. However, *Fabricated Doctrine*, with no support at all, goes on to assert that:

Rev. Rul. 80-58 uses the term “extinguished” to mean “ignore both transactions.” But the judges in *Penn v. Robertson* were using “extinguished” to mean “completely set off.” The outgoing on the rescission in *Penn* gave rise to a *deduction* that completely set off the income. That outgoing was taken into consideration in the tax year of the 1931 credit because the rescission happened before the taxable period closed at the end of that year, in short, in the same tax year. Rev. Rul.

114. *Fabricated Doctrine*, *supra* note 47, at 131–32.

115. 115 F.2d at 175 (emphasis added).

116. *Fabricated Doctrine*, *supra* note 47, at 128 (emphasis added).

80-58, subsequent IRS rulings, and commentaries reject this possible interpretation of *Penn v. Robertson* by ignoring it entirely.¹¹⁷

The Merriam-Webster online dictionary offers several definitions of “extinguish,” including “to bring to an end,” “to make an end of,” “to cause to be void,” and “to get rid of.”¹¹⁸ It seems likely that both Revenue Ruling 80-58 and *Penn v. Robertson* were using “extinguished” in its commonly-accepted meaning rather than a meaning conjured up to support *Fabricated Doctrine*’s argument. Moreover, Revenue Ruling 80-58 and subsequent rulings and commentaries had good reason to ignore *Fabricated Doctrine*’s “possible interpretation.” As discussed earlier, judges and practitioners who are discussing whether a transaction by a taxpayer results in a deduction for income tax purposes do not generally use words like “whether the rescission in 1931 extinguished what otherwise would have been [taxable] income to Penn in that year.”¹¹⁹ More typically, judges and practitioners would use language such as as an offset, or reduction, in taxable income when discussing a possible deduction. *Fabricated Doctrine*’s assertion that the court in *Penn v. Robertson* employed a deduction rationale is a fantasy based on imagined language not used by the court in the way asserted by *Fabricated Doctrine*. In addition, as discussed previously,¹²⁰ Revenue Ruling 80-58 did not use the term “extinguished” to mean “ignore both transactions.” Revenue Ruling 80-58 states that “the original sale is to be disregarded for federal income tax purposes because the rescission extinguished any taxable income for that year with regard to that transaction.”¹²¹

Moreover, if “the conflation rationale treats the two transactions as a nullity,” is that not what the court in *Penn v. Robertson* did when it stated that “we agree with the district judge that the rescission in 1931 before the close of the calendar year, *extinguished* what otherwise would have been [taxable] income to Penn for that year”?¹²² However, on facts like those in Situation 1 of Revenue Ruling 80-58, it is incorrect to assert that the “conflation rationale treats the two transactions together as a nullity”. In Situation 1 of Revenue Ruling 80-58, the reconveyance of the property by B to A in October 1978 extinguishes the taxable gain to A from the sale by A to B in February 1978. The sale in February 1978 is disregarded for tax purposes, but the reconveyance is what makes the rescission work. The

117. *Id.* at 140. (emphasis added).

118. Merriam Webster Dictionary <http://www.merriam-webster.com/dictionary/extinguish>.

119. 115 F.2d at 173.

120. *Fabricated Doctrine*, *supra* note 47, at 119–20.

121. Rev. Rul. 80-58, *supra* note 1.

122. 115 F.2d at 175 (emphasis added).

reconveyance is not a nullity. Nor is the February 1978 sale a nullity for state law purposes. B may have some potential liability (for example under environmental laws) arising from his period of ownership.

Fabricated Doctrine also tells us that:

[H]ad 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.¹²³

Counsel for taxpayer in *Penn v. Robertson* made several arguments: (1) with the exception of \$31,498.14 in 1931, Mr. Penn never actually received any money, or benefit from the credits, and should not be charged with constructive receipt;¹²⁴ (2) there was no constructive receipt of income by Mr. Penn because the stock allotment plan of 1929 was wholly invalid and void *ab initio*;¹²⁵ (3) with the exception of the \$31,498.41 in cash in 1931, the whole plan remained executory until it was finally abandoned, and therefore, Mr. Penn didn't have constructive income;¹²⁶ and (4) a credit of \$90,702.80 should be taxed, if at all, in 1929, not 1930, and a credit of \$181,708.12 should be taxed, if at all, in 1930, not 1931.¹²⁷

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

[T]he taxpayer's contention is that (with the exception of the 1931 item of \$31,498.14) Penn never actually received any money or benefit from the credits, and is not chargeable with their constructive receipt, in view of the invalid and executory nature of the transaction; and as the cash item of \$31,498.14 was returned during the calendar year upon the rescission of the plan, it was not taxable as income.¹²⁸

Where in this, or in the earlier quote of the court's summary of both

123. *Fabricated Doctrine*, *supra* note 47, at 132 (emphasis added).

124. 115 F.2d at 172-73.

125. *Id.* at 173.

126. *Id.* at 174.

127. *Id.* at 177.

128. *Id.* at 172-173.

parties' positions,¹²⁹ is there any word remotely suggesting that the court or taxpayer's counsel was operating under a deduction rationale?

Fabricated Doctrine offers additional arguments:

The third reason for concluding that *Penn v. Robertson* did not involve the conflation rationale is that this interpretation would require accepting that the judges chose to make new law, even though they could have reached the same result via the established and perfectly ordinary route of subtracting a deduction from income.¹³⁰

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."¹³¹

...

The court in *Penn v. Robertson* uses the term "net profit" as follows:

At the outset of the discussion it should be noted that the tax controversy exists only because the stock allotment plan was initiated in 1929 and abandoned in a subsequent tax year. If the plan had been terminated during Penn's lifetime in the same tax year that it originated, it is obvious that there would have been no tax, as there was no *net profit*. On the items in controversy the Commissioner has made tax assessments of about \$90,000, which the taxpayers have paid, and the Government contends may not be recovered although the transaction resulted in no *net profit*.¹³²

It is hard to see how the court's use of the term "net profit" in this context has any relevance to the argument asserted by *Fabricated Doctrine*. Moreover, in 1929, the value of the stock allotted to the directors of the American Tobacco Company exceeded the cost price to the recipients by close to \$2,000,000.¹³³ If the plan terminated in 1929, saying that there would be "no net profit" sounds as though one would be describing a rescission. Moreover, *Fabricated Doctrine's* assertion that income tax works on net results is correct only if it is understood to mean "net results

129. *Fabricated Doctrine*, *supra* note 47, at 127–28.

130. *Id.* at 132.

131. *Id.*

132. 115 F.2d at 173 (emphasis added).

133. *See* 115 F.2d at 173.

within a taxable year.” The taxpayer in *Burnet v. Sanford & Brooks Co.*¹³⁴ argued that the Sixteenth Amendment prohibited taxation of a transaction on which there was no net profit, but the Court held that net profit must be computed on the basis of the annual accounting period, even if that produces a taxable profit in one or more tax years from a transaction that does not produce a profit overall.

Fabricated Doctrine continues:

On the other hand, to conclude that the court adopted the conflation rationale one has to assume that for some reason their Honours believed that it was necessary for the court to hold innovatively that some alchemy had operated to conflate the two transactions and to leave them a fiscal nullity as well as being an economic nullity. This conclusion also requires one to believe that the court would have adopted this innovation without explicitly noting that it had done so.¹³⁵

It appears likely that the court did not think it was adopting an innovation. The cases discussed *supra* in Part II support the proposition that taxable income for each tax year is determined by computing net results at the end of the year. Moreover, although *Fabricated Doctrine* ignores it, Revenue Ruling 80-58 included in its legal analysis the statement that “the annual accounting concept requires that one must look at the transaction on an annual basis using the facts as they exist at the end of the year. That is, each taxable year is a separate unit for tax accounting purposes.”¹³⁶

Again, from *Fabricated Doctrine*:

Fourthly, if the conflation rationale is correct it is an invention of tax law that has no counterpart in the general law. Ordinarily, tax law is part of and reflects the rest of the law. Where tax creates its own special rules the courts point this out. For instance, Judges Parker and Chestnut took care to explain that Penn was taxable on the 1930 credit to him, and why this was so, even though the credit to him was void. They summarized the reason in these terms:

But while we regard the [share purchase] plan as void... [c]onstructively received income is taxable when the amount is definitely liquidated and available to the taxpayer without restriction. The circumstances under which the credits were made met these conditions. The credits were precise in amount and were absolutely made as reductions of the notes.

It would have been much more radical for their Honours to say that for tax purposes a rescission makes a nondeductible expense deductible.

134. See *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 361–62, 365 (1931).

135. *Fabricated Doctrine*, *supra* note 47, at 132–33.

136. Rev. Rul. 80-58, *supra* note 1 (citing *Security Flour Mills Co. v. Commissioner*, 321 U.S. 281 (1944)).

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.¹³⁷

It is entirely unclear what point the authors of *Fabricated Doctrine* are trying to make with some of their statements quoted above. What does it mean to say that “[o]rdinarily, tax law is part of and reflects the rest of the law. Where tax creates its own special rules the courts point this out.”? Experienced practitioners have always believed that tax, securities, and corporate and alternative entity law all have their specific concerns, are not consistent, and in no sense can be said to be a part of one another. What can the authors of *Fabricated Doctrine* possibly mean by “if the conflation doctrine [i.e., rescission] is correct it is an invention of tax law that has no counterpart in the general law.”? What is general law? Is not tax law part of whatever general law is? Moreover, rescission is recognized in other areas of the law.¹³⁸ If rescission is an invention of tax law, why has it been defined by *Black’s Law Dictionary* and discussed by treatises such as *Corbin on Contracts* as though it is part of everyday contract and other areas of law?¹³⁹ The authors of *Fabricated Doctrine* know this because they discuss how leading contract treatises disagree about the precise definition of the term “rescission.”¹⁴⁰

Fabricated Doctrine attempts to buttress its argument by stating the following:

Now, examine the issue in terms of Goodhart’s analysis of ratio and material facts. For Judges Parker and Chestnut,¹⁴¹ 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

137. *Fabricated Doctrine*, *supra* note 47, at 133.

138. See, e.g., 15 U.S.C. § 1635 (2012) (providing a right of rescission in certain credit transactions).

139. See Banoff, *supra* note 45, at 957.

140. *Fabricated Doctrine*, note 47, *supra*, at 141.

141. As noted earlier, at note 100, *supra*, and accompanying text, it is not apparent why *Fabricated Doctrine* claims knowledge of the state of mind of only Judges Parker and Chestnut. Judge Chestnut wrote the majority opinion in *Penn v. Robertson*, in which Judge Dobie joined. Compare *Penn v. Robertson*, 115 F.2d 167, 169 (1940) with 115 F.2d at 177 (Parker, J., concurring), where Judge Parker stated he concurred with the result and “also in the reasoning of the court, except with respect to grounds upon which the dividends credited in the year 1930 are taxable income.”

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.¹⁴²

As explained above,¹⁴³ nothing in the opinion in *Penn v. Robertson* supports *Fabricated Doctrine's* assertions in the paragraph quoted immediately above. The opinion provides absolutely no indication that the court was acting under a deduction rationale or that the deductibility of the repayment was material. Moreover, to speak of the repayment being extinguished and that "extinguishment of the second of a pair of transactions is crucial to the unwind doctrine" is nonsense. As discussed earlier, the authors of *Fabricated Doctrine* do not appear to understand the meaning of "extinguished," and the rescission could not be extinguished or disregarded if it was to have the effect of causing the transaction to be disregarded for tax purposes.¹⁴⁴

C. *Fabricated Doctrine's Examination of TARP Bonuses*

Having presented what can be seen as a Pollyannaish analysis of "true rescissions,"¹⁴⁵ and an egregious misreading of *Penn v. Robertson*,¹⁴⁶ *Fabricated Doctrine* then attempts to illustrate the policy short-comings of Revenue Ruling 80-58 by examining what it views as the possible income tax treatment available to Douglas Poling, who, in 2009, received a \$6.4 million bonus from AIG, which AIG paid out of funds it had received from the Troubled Assets Relief Program ("TARP").¹⁴⁷ Following great public outcry and threatened federal legislation to impose punitive taxes on such "TARP bonuses," in March 2009, Poling announced that he would repay his bonus "because [he] thought it was the correct thing to do."¹⁴⁸ The authors of *Fabricated Doctrine* assume for purposes of their paper that Poling's repayment would not be deductible.¹⁴⁹ They state that, if Poling repaid his bonus in 2009 (the year of receipt) the preparer of Poling's tax return would have to determine the correct income tax

142. *Fabricated Doctrine*, *supra* note 47, at 132.

143. Notes 105-113, *supra*, and accompanying text.

144. *Id.*

145. *Fabricated Doctrine*, *supra* note 47 at 144.

146. See *supra* Part IV Subsection B *Fabricated Doctrine's* Analysis of *Penn v. Robertson*.

147. See *Fabricated Doctrine*, *supra* note 47, at 122.

148. *Id.* at 123-24.

149. See *id.*

treatment of the receipt of the bonus and its repayment, and that the answer to this would “depend[] on Rev. Rul. 80-58, and the correct meaning of the ruling’s purported authority, *Penn v. Robertson*.”¹⁵⁰

Actually, Mr. Poling undoubtedly would have engaged a competent return preparer, who would not have spent any time worrying about Revenue Ruling 80-58 and whether it is in fact supported by *Penn v. Robertson* but instead would have excluded the bonus from Poling’s reported taxable income pursuant to the authority of Revenue Ruling 79-311.¹⁵¹ Revenue Ruling 79-311 holds that if an employee repays compensation in the year of receipt the amount repaid is “excludible from [the employee’s] gross income in the year of repayment.”¹⁵² Although the repayments in Revenue Ruling 79-311 were required by the relevant employment contract, the IRS views Revenue Ruling 79-311 as extending to voluntary repayments.¹⁵³ In addition, IRS Publication 525: Taxable and Nontaxable Income, also states that “if you repay unearned commissions or other amounts in the same year you receive them, reduce the amount included in your income by the repayment.” IRS Publication 525 does not treat a repayment in the year of receipt as a deduction. Moreover, Mr. Poling would be able to exclude from income any portion of his TARP bonus repaid in the year of receipt under *Fender Sales, Inc. v. Commissioner*,¹⁵⁴ where the court held that petitioner C. Leo Fender was not taxable on bonus payments received in 1956 and 1957 to the extent he voluntarily returned such bonuses to his employer in the year of receipt. Specifically, the court stated:

This Court has adopted and consistently followed the legal proposition that where prior to the close of the taxable year there has been an adjustment of the contract or obligation and a repayment of a portion of the amount received, the tax liability is to be determined on the basis of such adjusted amount.¹⁵⁵

Fabricated Doctrine does not discuss *Fender Sales* in connection with its consideration of Mr. Poling’s tax situation, but it does discuss it with the cases discussed below.¹⁵⁶ *Fabricated Doctrine* asserts that the result in that

150. *Id.* at 124.

151. Rev. Rul. 79-311, 1979-2 C. B. 25.

152. *Id.* (citing *Couch v. Commissioner*, 1 B.T.A. 102 (1925)).

153. See Treasury Information Letter 2005-0146 (September 30, 2005), (stating: “The repayment results in a reduction in gross income and wages rather than a deduction. See *Couch v. Commissioner*, 1 B.T.A. 103 (1924), acq., IV-1 C. B. 1 (1925)”).

154. 22 TCM (CCH) 550 (1963), *rev’d on other grounds*, 338 F.2d 924 (9th Cir. 1964).

155. See *id.* at 560-61.

156. See *infra*, Part IV Subsection D Fabricated Doctrine’s Discussion of Other

case “seems superficially consistent with the mistaken interpretation of *Penn v. Robertson*,” but that “it is not . . . compelling.” *Fabricated Doctrine* also states that “the court in *Fender* cites, but does not rely on, *Penn v. Robertson*,” instead appearing to create “a special rule when a reversal transaction will be considered deductible in its own right: namely in circumstances where both transactions involve a company and a principal shareholder in that company who is also an employee.”¹⁵⁷

The court in *Fender Sales* cited previous decisions of the U.S. Tax Court and its predecessor, the Board of Tax Appeals, as direct authority for its statement quoted above. The court cites *Penn v. Robertson* in a citation of opinions that are described by the court as “adher[ing] to a similar position.” It would seem at least arguable that this is demonstrative of “reliance” on *Penn v. Robertson*. The court in *Fender Sales* certainly gave no indication in its opinion that it thought it was creating a special rule, particularly one that would apply only where the taxpayer in effect was on both sides of the unwinding.¹⁵⁸

Cases.

157. *Fabricated Doctrine*, *supra* note 47, at 149.

158. See John W. Lee, *Tax TARP Needed for Year One and Year Two Returns of Executive Bonuses to TARP Recipient: A Case Study of Year One Rescission/Exclusion from Income and Year Two Deduction Under Section 1341* 1 WM. & MARY L. REV. 323, 376–77 (2010); there Mr. Lee states:

By the 1940s the Tax Court had come to flatly stating the rule as follows:

[C]ompensation for services of officers of corporations for any period is subject to modification either by corporate action or by agreement at any time and from time to time during the taxable year and the amount at which compensation is finally adjusted at the close of the taxable year is the amount which the officer must report as compensation or the corporation may deduct as ordinary and necessary business expense. [citing, at note 245, *McEwen v. Commissioner*, 6 T. C. 1018, 1025 (1946).]

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

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

The Service reasoned that:

[w]here both the initial receipt of funds and the repayment of some portion

In addition, Mr. Poling's tax return preparer could rely on *Bishop v. Commissioner*.¹⁵⁹ In that case, the petitioner was a shareholder of Pendleton Woolen Mills. Another shareholder had asserted a claim against the petitioner and other shareholders who were diverting business from the corporation and using its name in partnerships that the petitioner and the other shareholders had formed. The shareholder's claims against petitioner and the other shareholders involved in the partnership were settled in an agreement entered into on December 31, 1946 and approved by the corporation's board of directors on the same day. Also, on December 31, 1946, pursuant to the agreement, the partnerships were terminated and all of their 1946 income was transferred to the corporation. The Tax Court held for the petitioner, agreeing that all of the partnerships' 1946 income was taxable to the corporation, stating:

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

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

We are not aware that the rule has ever been applied where, as here, in the same year that the funds are mistakenly received, the taxpayer discovers and admits the mistake, renounces his claim to the funds, and recognizes his obligation to repay them. Cf. *Carey Van Fleet*, 2 B. T. A. 825; *Curran Realty Co. v. Commissioner*, 15 T. C. 341. We

thereof take place in the same year, there cannot very well be a serious question about the overall propriety of excluding the amount so repaid from the taxable income of the party who has thus effectively relinquished or disavowed any claim thereto.[citing, at note 248, I. R. S. Gen. Couns. Mem. 33,602 (Aug. 25, 1967.)]

159. 25 T.C. 969 (1956).

think there is no warrant for extending the harsh claim of right doctrine to such a situation. In such case the Internal Revenue Bureau is not faced with the problem of deciding the merits of the claim to the funds received, for the question has been resolved by the interested parties.¹⁶⁰

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

[E]xplain what *Penn v. Robertson* does and does not stand for, and show how Rev. Rul. 80-58 misinterprets *Penn v. Robertson*. On a correct interpretation of the law, taxpayers like Mr. Poling would owe tax on a bonus even if they had returned it. The bonus receipt would be taxable, the repayment we assume is not deductible, and no special tax rule would apply to allow the transactions to nullify each other for tax purposes.¹⁶¹

Fabricated Doctrine is probably correct in its assumption that Poling's repayment of his bonus would not be deductible, because, as explained above,¹⁶² the amount repaid in the year of receipt would be excluded from his income on the basis of authorities other than Rev. Rul. 80-58, authorities either not discussed at all by *Fabricated Doctrine* or not discussed in connection with Mr. Poling's situation.

In its discussion of the potential tax treatment of Douglas Poling, *Fabricated Doctrine* assumes away any potential deductibility of a repayment by Mr. Poling of his TARP bonus, fails to discuss the authorities discussed above¹⁶³ that show that if Mr. Poling did repay his TARP bonus in the year of receipt, he would be allowed to exclude the repaid bonus from his taxable income for that year, and wrongly states that Mr. Poling would likely be entitled to treat repayment as a rescission under Revenue Ruling 80-58. *Fabricated Doctrine* states that “[i]t has been asserted that the unwind doctrine in Rev. Rul. 80-58 saves Poling from a net tax impost in respect of his returned bonus, even if under ordinary tax principles the receipt of the bonus is taxable and its return not deductible.”¹⁶⁴ For its statement that “it has been asserted that . . . Rev. Rul. 80-58 saves Poling,” *Fabricated Doctrine* states “The authors again thank unnamed United States colleagues¹⁶⁵ who suggested that reliance on revenue rulings would

160. *Id.* at 974.

161. *Fabricated Doctrine*, *supra* note 47, at 127.

162. Note 153, *supra*, and accompanying text.

163. Note 153, *supra*, and accompanying text.

164. *Fabricated Doctrine*, *supra* note 47, at 127.

165. *Fabricated Doctrine* did thank certain colleagues by name for reviewing the article. *See id.* at 117, n. 1.

lead to the result that Poling would pay no net tax.”¹⁶⁶ It is unfortunate that *Fabricated Doctrine* could not name these colleagues so that others could know just what revenue rulings they were referring to. As discussed earlier, there are cases and a published revenue ruling that are not rescission authorities, but are based on the annual accounting concept and indicate that Mr. Poling would be entitled to exclude his TARP bonus from income if he repaid it in the year of receipt.

Fabricated Doctrine states:

If the IRS continues to follow and apply Rev. Rul. 80-58 as it has, both Poling’s receipt of the bonus and his return of it to AIG would be treated for tax purposes as if they had not occurred. He would not have to acknowledge either transaction on his income tax returns. This is a far more attractive result for Poling than that reached under ordinary tax principles, which would require him to pay tax on a bonus that he does not keep.¹⁶⁷

Despite *Fabricated Doctrine*’s concern that Revenue Ruling 80-58 would save Mr. Polling, this Article demonstrates that several authorities not discussed in *Fabricated Doctrine* would give Mr. Polling his desired tax treatment without application of Revenue Ruling 80-58.¹⁶⁸ Moreover, because Mr. Polling’s repayment of his TARP bonus likely would not be considered the undoing of a contract, there exists considerable doubt whether the IRS would apply Revenue Ruling 80-58 to his situation because of the IRS requirement that rescission means the rescission of a contract.¹⁶⁹ *Fabricated Doctrine* apparently goes on at such length about Mr. Poling’s situation because the authors viewed Mr. Poling as the poster child for, what they believed to be, inappropriate relief that Revenue Ruling 80-58 would afford him when “ordinary tax principles” would not save him. Of course, as this Article explains, ordinary tax principles other than Revenue Ruling 80-58 would very likely have provided Mr. Poling with the tax treatment he presumably desired.¹⁷⁰

D. Fabricated Doctrine’s Examination of Other Cases

From its misanalysis of Douglas Poling’s tax situation, *Fabricated Doctrine* moves on to a discussion of other cases and makes much of the point that they could find no subsequent case that the authors believed clearly cited *Penn v. Robertson* or relied on it to treat an unwinding as a rescission. In the minds of the authors of *Fabricated Doctrine*, this

166. *Id.* at 127, n. 50.

167. *Fabricated Doctrine*, *supra* note 47, at 148 (footnotes omitted).

168. *See* Note 153, *supra*, and accompanying text.

169. *See* Note 11, *supra*.

170. *See* Note 153, *supra*, and accompanying text.

indicates that *Penn v. Robertson* is not really a rescission case. They fail to discuss the possibility that there are no such cases because the IRS didn't challenge cases that involved unwindings in the same tax year. Cases involving a taxpayer's attempts to reduce income in one year because of events in a later year are decided as claim of right cases, not rescission cases. Prebble and Huang discuss the following cases, apparently on the theory that it demonstrates that the later cases did not directly rely on *Penn v. Robertson*, that bolsters their argument that *Penn v. Robertson* is not a rescission case.

This Article has already discussed *Fender Sales, Inc. v. Commissioner*.¹⁷¹ There, the court held that petitioner C. Leo Fender was not taxable on bonus payments received in 1956 and 1957 to the extent that he returned such bonuses to his employer in the year of receipt. The court stated:

This Court has adopted and consistently followed the legal proposition that where prior to the close of the taxable year there has been an adjustment of the contract or obligation and a repayment of a portion of the amount received, the tax liability is to be determined on the basis of such adjusted amount.¹⁷²

Although certainly not a literal rescission case, *Fender Sales*, nevertheless is completely consistent with the rescission doctrine that has developed since *Penn v. Robertson*. *Fabricated Doctrine* discusses *Fender Sales* by stating that the result in that case “seems superficially consistent with the mistaken interpretation of *Penn v. Robertson*.” *Fabricated Doctrine* then asserts that “it is not . . . compelling.” *Fabricated Doctrine* states that “the court in *Fender* cites, but does not rely on, *Penn v. Robertson*,” and appears to “create a special rule when a reversal transaction will be considered deductible in its own right: namely in circumstances where both transactions involve a company and a principal shareholder in that company who is also an employee.”¹⁷³ The court in *Fender Sales* cited previous decisions of the U.S. Tax Court and its predecessor, the Board of Tax Appeals, as direct authority for its statement quoted above. The court cites *Penn v. Robertson* in a citation of opinions that are described by the court as “adher[ing] to a similar position.” It would seem at least arguable that this is “reliance” on *Penn v. Robertson*. The court in *Fender Sales* certainly gave no indication in its opinion that it thought it was creating a special rule, particularly one that would apply

171. 22 TCM (CCH) 550 (1963), *rev'd on other grounds*, 338 F.2d 924 (9th Cir. 1964). See note 157, *supra*, and accompanying text.

172. 22 TCM (CCH) at 560.

173. *Fabricated Doctrine*, *supra* note 47, at 149.

only where the taxpayer was in effect on both sides of the unwinding.¹⁷⁴

Fabricated Doctrine discusses three opinions that were reversed by the Supreme Court in *United States v. Lewis*,¹⁷⁵ a claim of right case that unsurprisingly held that a taxpayer who received a \$22,000 bonus in 1944 was taxable on the full amount in 1944, even though he was required to pay back \$11,000 of the bonus in 1946. The taxpayer's repayment in 1946 was deductible in 1946. Inasmuch as there exists no legal authority holding that an unwinding that spans two or more taxable years can normally be treated as a rescission for federal income tax purposes, *Lewis* hardly represents a case that rejects the rescission doctrine, and is consistent with the holding of *Penn v. Robertson* as to the tax year 1930.¹⁷⁶

Fabricated Doctrine discusses three lower court opinions, *Gargaro v. United States*,¹⁷⁷ *Lewis v. United States*,¹⁷⁸ and *Haberkorn v. United States*.¹⁷⁹ All three cases involved employees who had received bonuses in one year and were required to return a portion of the bonus in a later year. The U.S. Court of Federal Claims in *Gargaro* and *Lewis* allowed the taxpayer to reopen his tax return for the year of receipt of the bonus. *Haberkorn*, following *North American Oil Consolidated v. Burnet*,¹⁸⁰ held that the taxpayer could only deduct the repayment in the year of the repayment. The Supreme Court, in its opinion in *United States v. Lewis*, reversed the U.S. Court of Federal Claims decisions and affirmed *Haberkorn*. None of this is remarkable—all of this flowed from the claim of right doctrine that was established by *North American Oil Consolidated* and was followed in several later cases, including *Penn v. Robertson* (as to the tax year 1930). As the Court stated in *United States v. Lewis*:

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

...

174. See Lee, *supra* note 157.

175. 340 U.S. 590 (1951).

176. Banoff, *supra* note 45, at 967-68 (discussing the rare instances, all involving adversarial court action, in which an original transaction has been declared void *ab initio* and rescission treatment allowed for an unwinding in one year of a transaction that occurred in a prior year).

177. 73 F. Supp. 973 (Ct. Cl. 1947).

178. 91 F. Supp. 1017 (Ct. Cl. 1950).

179. 173 F.2d 587 (6th Cir. 1949).

180. 286 U.S. 417 (1932).

Income taxes must be paid on income received (or accrued) during an annual accounting period. [citation omitted] and see *Burnet v. Sanford & Brooks Co.*, 282 U. S. 359, 363. The “claim of right” interpretation of the tax laws has long been used to give finality to that period, and is now deeply rooted in the federal tax system. See cases collected in 2 Mertens, *Law of Federal Income Taxation*, § 12.103. We see no reason why the Court should depart from this well-settled interpretation merely because it results in an advantage or disadvantage to a taxpayer.¹⁸¹

The claim of right doctrine applies differently when the repayment occurs in the same taxable year as receipt.¹⁸²

Fabricated Doctrine tells us that “the principles of general justice applied in cases such as *Gargaro* and *Lewis* discussed above do not extend to all cases to which the unwind doctrine has been applied.”¹⁸³ It goes on to suggest that a court might be sympathetic to Mr. Poling (and other taxpayers similarly situated) because of the argument that he returned his bonus due to the strong public feeling that this was the correct moral action, and that as a result, he should not face a negative tax consequence. Further:

[a]ppeals to general notions of justice are unlikely, however, to be sustained in other cases to which the unwind doctrine has applied, such as cases where the reversal has been precipitated by unwise management decisions or the taxpayer’s regret about the tax consequences of the original transaction. Considerations of justice in *Gargaro* and *Lewis* would seem to allow unwind treatment only in cases only where the unwind has moral value.¹⁸⁴

As discussed earlier,¹⁸⁵ the opinions referred to here by *Fabricated Doctrine* are opinions of the U.S. Court of Federal Claims in two cases that were reversed by the Supreme Court in *United States v. Lewis*—an unremarkable claim of right case.¹⁸⁶ It is not clear what value these U.S. Court of Federal Claims opinions have at all. Generally, lower court opinions that are reversed because they are in clear conflict with Supreme Court precedent would be considered minimally persuasive, if at all. *Fabricated Doctrine* appears to be suggesting that some pro-unwinding arguments might be beneficial if an appeal could be made to “justice” and it could be argued that the desired unwinding “had moral value.”¹⁸⁷ As

181. 340 U.S. at 591–592.

182. See 25 T.C. 969 (1956).

183. *Fabricated Doctrine*, *supra* note 47, at 164.

184. *Id.*

185. See 173 F.2d 587 (6th Cir. 1949).

186. See *id.*

187. *Fabricated Doctrine*, *supra* note 47, at 164.

explained below,¹⁸⁸ this Article asserts that there is ample legal and policy support for the rescission doctrine as articulated by Revenue Ruling 80-58, and it is not believed that any appeal to abstract notions of justice or morality are necessary.

Fabricated Doctrine next considers two cases, *In re Trico Marine Services*¹⁸⁹ and *Scallen v. Commissioner*,¹⁹⁰ describing them as “cases that mention *Penn v. Robertson* in dicta, and at best provide weak dicta support for unwinding.”¹⁹¹ In *Trico Marine Services*, the court considered plaintiff’s motion to set aside the confirmation order. In discussing the practical feasibility of unwinding the bankruptcy plan that had been confirmed and carried out, the court stated:

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. [citing *Penn v. Robertson*, 115 F.2d 167, 175 (4th Cir.1940); and Rev. Rul. 80-58; other citations omitted]. The rule is one of practicality, based on the annual accounting principle that “requires the determination of income at the close of the taxable year without regard to the effect of subsequent events.” *Penn*, 115 F.2d at 175; accord *Security Flour Mills Co. v. C.I.R.*, 321 U.S. 281, 286, 64 S.Ct. 596, 88 L.Ed. 725 (1944). Second, the parties to the transaction must be returned to the *status quo ante*. [citations omitted].¹⁹²

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

In *Scallen*, a corporation controlled by the taxpayer, Blue Ridge Properties Corporation in, January 1979, sold a hotel and apartments (the “Property”) to Gerald R. Hansen. The next day, Hansen sold the Property to Bradley A. Herman. On November 19, 1979, Herman sold the Property to Campus Realty Corporation, another corporation controlled by the taxpayer. The Commissioner argued that these transactions resulted in a rescission of the January sale, and that the taxpayer, therefore, had no capital gain or loss from that sale and had his historic basis in the Property. The court noted that no gain would:

be recognized, however, if in the year of sale, the sale is rescinded and

188. See Part V, *infra* The Rescission Doctrine as Currently Applied by the IRS is Correct and Would be Correct Even if *Penn v. Robertson* had Never Been Decided.

189. 343 B.R. 68 (Bankr. S.D.N.Y. 2006).

190. 54 T.C.M. (CCH) 177 (1987).

191. *Fabricated Doctrine*, *supra* note 47, at 148.

192. 343 B.R. at 73.

the taxpayer accepts reconveyance of the property and returns the buyer's funds. *Penn v. Robertson*, 115 F.2d 167 (4th Cir. 1940). We agree with respondent's statement of the law, but we do not agree that a rescission occurred on these facts.¹⁹³

The court disagreed with the Commissioner because it was unwilling to disregard the corporate form of Blue Ridge Properties Corporation or Campus Realty Corporation. The court also stated that there was no agreement for rescission characterizing the transactions as a rescission would require disregarding the sale on February 1, 1979 from Hansen to Herman, and the Commissioner had offered no argument that that should be done. Once again, the court in *Scallen* cited *Penn v. Robertson* as authority but held that no rescission had occurred on the facts before it.

In *Hutcheson v. Commissioner*,¹⁹⁴ the taxpayer sold Wal-Mart stock in January 1989 and repurchased an equivalent amount of stock in December, 1989. While the court applied the principles of Rev. Rul. 80-58, the court unremarkably held that no rescission had taken place because the stock acquired in December was not the same stock that was sold in January.

In *Estate of L. E. Crellin v. Commissioner*,¹⁹⁵ the directors of a California personal holding corporation received erroneous advice from the corporation's Certified Public Accountant ("CPA"). The CPA advised the directors that the corporation would be subject to the personal holding company surtax unless the directors declared and distributed to the corporation's shareholders a dividend approximately equal in amount to a capital gain the corporation had received earlier in the year the dividend was paid. Later, in the same year, the directors learned that the CPA's advice was erroneous and passed a resolution purporting to rescind the dividend and directing that a demand be sent to the shareholders for return of the amounts paid to them. All of the shareholders returned the dividends. All of these events—the dividend, the resolution rescinding the dividend, and the repayment of the dividends by the shareholders—occurred in the same year.¹⁹⁶ As Sheldon Banoff demonstrates in his seminal article on rescissions,¹⁹⁷ except in the case of dividends mistakenly paid because of a scrivener's error, taxpayers cannot avoid dividend income by *voluntarily* repaying the dividends. In this case, the corporation had no right to enforce its demand that the shareholders repay the dividends, and the court held for the Commissioner. However, in so holding, the court noted, by contrasting the case of a compelled repayment

193. 54 T.C.M. at 205.

194. 71 T.C.M. (CCH) 2425 (1996).

195. 203 F.2d 812 (1953).

196. 203 F.2d at 813.

197. Banoff, *supra* note 45, at 981.

of a dividend 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.” Although this statement is plainly dicta, it suggests that the court would not be unfriendly to a taxpayer arguing for rescission treatment on facts like those for 1931 in *Penn v. Robertson*, and that the court would not be applying a deduction rationale to a same-year unwinding.

In *Branum v. Campbell*,¹⁹⁸ pursuant to a contract effective April 1, 1948, the taxpayer sold a 50% interest in a brokerage business to C. T. Green for \$15,000. The contract provided that the taxpayer and Green were to operate the business as a partnership for an indefinite term unless terminated by operation of law or by agreement of the parties. On September 30, 1948, the taxpayer and Green entered into a second contract providing for the dissolution of the partnership and the payment of \$15,000 from the taxpayer to Green for Green’s interest in the partnership.

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

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

One wonders what the result in *Branum* would have been had the taxpayer and Green entered into a contract rescinding the sale of the taxpayer’s 50% interest in his brokerage business to Green instead of, as they did, agreeing to dissolve the partnership. Indeed, the IRS views *Branum* as a case that “while on the facts not holding that a rescission has taken place, acknowledges the principle that rescission in the year of sale will extinguish otherwise taxable gain.”¹⁹⁹

Fabricated Doctrine has the following observation about *Branum*:

Commentary has implied that the taxpayer’s argument might have fared better had the unwind transaction been “styled as a rescission.” However, *Crellin’s Estate* above suggests that even if the taxpayer in *Branum v.*

198. 211 F.2d 147 (5th Cir. 1954).

199. The author acknowledges relying on Banoff’s description of *Branum* for the discussion above. Banoff, *supra* note 45, *supra*, at 961.

Campbell had labeled the repurchase of his partnership interest a “rescission” of the original sale, the court would have looked beyond the label to the substance which in this case was not a true rescission but, as the court noted, “separate and distinct.”²⁰⁰

What the court in *Branum* said were “separate and distinct” were the taxpayer’s sale of one-half of his business and the later dissolution of his partnership with the purchaser. If, instead of dissolving their partnership, the taxpayer and Green had agreed that Green would return the one-half of the brokerage business to the taxpayer that Green had purchased and that the taxpayer would return Green’s purchase price, the taxpayer might have been able to argue successfully for rescission. One issue, given the nature of the business, would have been whether the parties could have been put back in the status quo ante. Another potential issue is whether the applicable partnership law would have allowed the transaction to be a rescission of the sale of the brokerage business. In any event, such a recasting of the transaction would have been more than a different styling like that dismissed above by *Fabricated Doctrine*. Moreover, *Fabricated Doctrine*’s reference to *Crellin’s Estate* is improvident; as discussed above, voluntary repayment of dividends is always ineffective to avoid taxation.²⁰¹ The rules are different for other types of voluntary unwindings, like the repayment of a bonus.²⁰²

E. Policy Analysis in *Fabricated Doctrine*

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

The IRS should revoke its mistaken ruling, or to the extent that any ambiguity in the ruling allows it to be applied in ways that are not legally correct, should correct that ambiguity. The Treasury Regulations state that “the purpose of publishing revenue rulings . . . is to promote correct and uniform application of the tax laws by Internal Revenue Service employees and to assist taxpayers in attaining maximum voluntary compliance.” Rev. Rul. 80-58 currently violates this regulation because it promulgates an incorrect interpretation of the tax law set out in *Penn v. Robertson*.²⁰³

In the second sentence of the above quotation, *Fabricated Doctrine* cites Treasury Regulation Section 601.601(d)(2)(iii) correctly. However, *Fabricated Doctrine* should have also considered Treasury Regulation Section 601.601(d)(2)(i)(a), which states: “A Revenue Ruling is an official

200. *Fabricated Doctrine*, *supra* note 47, at 160.

201. See Note 196, *supra*, and accompanying text.

202. See Note 152, *supra*, and accompanying text.

203. *Fabricated Doctrine*, *supra* note 47, at 163 (footnotes omitted).

interpretation by the Service that has been published in the Internal Revenue Bulletin. Revenue Rulings are issued only by the National Office and are published for the information and guidance of taxpayers, Internal Revenue Service officials, and others concerned.”²⁰⁴ Therefore, the question isn’t just whether Revenue Ruling 80-58 is a correct interpretation of *Penn v. Robertson*, although this Article submits that it is, the question is whether Revenue Ruling is a correct interpretation of the law. As this Article summarizes below,²⁰⁵ there are other legal and policy bases for Revenue Ruling 80-58. In this regard, it should be noted that *Fabricated Doctrine* also makes an incorrect statement in its footnote to the last sentence of the above quote which states: “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.”²⁰⁶ It is elementary that an official need not refer to his or her grant of discretion to take action based on that grant. Moreover, if Revenue Ruling 80-58 is viewed as a statement by the IRS that it will not challenge taxpayers who take the position on facts substantially similar to those in Situation 1 of Revenue Ruling 80-58 that they have engaged in valid rescissions for tax purposes, Revenue Ruling 80-58 could be viewed as an agency non-enforcement decision that is not subject to judicial review.²⁰⁷

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

Perhaps the most promising principled basis for the unwind doctrine is the idea that tax law should follow economic substance, coupled with the tax year accounting principle in *Saunders v. Commissioner*. Perhaps tax law should strive, where possible, to base legal outcomes on the net change in taxpayers economic positions during the tax year, ignoring interim changes in legal and economic position. A uniform application of this principle however would have implications somewhat more radical than allowing taxpayers to claim unwind treatment at their discretion; it would require that treatment in every relevant case, and would further indicated a broader move towards reporting of net tax positions only at year end.²⁰⁸

Saunders is a very short opinion in a claim of right case and does not mention a “tax year accounting principle” or any other accounting principal or concept. The remainder of the quoted paragraph could only be written by persons who have no understanding of the annual accounting concept as

204. Treas. Reg. § 601.601(d)(2)(i)(a) (1987) (emphasis added).

205. See Part V, *infra* The Rescission Doctrine as Currently Applied by the IRS is Correct and Would be Correct Even if *Penn v. Robertson* had Never Been Decided.

206. *Fabricated Doctrine*, *supra*, note 47, n. 185.

207. See *Heckler v. Chaney*, 470 U.S. 821 (1985).

208. *Fabricated Doctrine*, note 47, *supra*, at 164–165.

it has developed in U.S. federal income tax law. Moreover, *Fabricated Doctrine* shows its misunderstanding of the federal tax system by stating that taxpayers are now allowed “to claim unwind treatment at their discretion.” If a taxpayer’s sale were rescinded on facts that would come within Situation 1 of Revenue Ruling 80-58, the taxpayer’s failure to treat the sale as rescinded would no doubt be challenged by the IRS if the taxpayer were audited.²⁰⁹ Also, when do the authors of *Fabricated Doctrine* think taxpayers report their taxable income if not at the end of each year? *Fabricated Doctrine* also proceeds immediately to undercut its own suggestion by discussing Hasen’s comprehensive but highly theoretical article.²¹⁰ “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. Hasen attempted to derive from the Haig-Simons economic income concept principles for whether and when unwinding should be allowed.”²¹¹

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

The Haig-Simons conception of income, named after the two theorists who are credited with having articulated it, defines income as the net change in a taxpayer’s wealth (including wealth spent on consumption) during the tax period. The occurrence or not of transactions is irrelevant to the amount of the taxpayer’s income or loss and, therefore, to the amount of income tax liability the taxpayer has during the tax period. Thus, the Haig-Simons definition takes into account the net appreciation and depreciation of assets held during the tax period, without regard to whether the assets are retained or sold. For example, whether or not *A* sells *Blackacre* on December 31, her tax liability for the year ending on that date is the same, because the increase or decline in value of *Blackacre* is definitive of whether she has taxable income or loss.²¹²

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

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

209. See *Scallen v. Commissioner*, 54 T.C.M. at 205.

210. See *Fabricated Doctrine*, *supra* note 47, at 165 (citing Hasen, *supra* note 43).

211. *Id.*

212. Hasen, *supra* note 43, at 897–98.

largely solves.²¹³

And Hasen further notes: “[f]rom a Haig-Simons perspective, the non-taxation of accrued but unrealized gain or loss represents an accommodation of the income tax to other exigencies, principally the problems of valuation, liquidity, and political acceptability.”²¹⁴

Hasen points out that rescission would be irrelevant in a Haig-Simons system of taxation.²¹⁵ But, as Hasen also notes in the above-quoted portions of his article, we don’t live in a Haig-Simons tax world. Accordingly, rescission’s lack of importance in a Haig-Simons system is irrelevant to whether the current rescission doctrine of Revenue Ruling 80-58 is good policy.

Fabricated Doctrine also notes:

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

the existence of the thing that is taxed—income—does not depend on the fact of a transaction. Rather, the transaction provides the occasion for imposing the tax now rather than at some other time; the income (or loss), however, will generally be taken into account eventually. Hence the availability of the unwind treatment should not depend, even in the abstract, on the mere return to the status quo ante, because such a return does not mean that nothing giving rise to a tax has occurred. Hasen concludes that “any reversal, to merit unwind treatment, ought to be allowed only if the mistake or error giving rise to it is justified.”²¹⁶

Hasen makes other interesting statements: The “rightness” of any given rule in the abstract, however, is not the only consideration relevant to shaping a well-conceived unwinding doctrine. A further and equally significant consideration is *consistency*.²¹⁷

This Article submits that the annual accounting concept as applied in Revenue Ruling 80-58 and the claim of right cases bring consistency to tax law. Moreover, although *Fabricated Doctrine* is correct that Hasen views the justification for allowing rescission treatment in income tax cases as comparatively weaker than for transactional tax cases, he nowhere attempts to quantify the difference, and he concludes his article by stating that rescissions will very likely continue to be allowed on some basis in income

213. *Id.* at 899.

214. *Id.* at 898.

215. *See id.*

216. *Fabricated Doctrine*, note 47, *supra*, at 165.

217. Hasen, *supra* note 43, at 904 (emphasis added).

tax cases.²¹⁸ However, Hasen also discusses tax benefit rule cases and claim of right cases in connection with rescission and makes the following observation:

If the compulsory nature of a reversal is considered one of the necessary conditions of unwind treatment, then Revenue Ruling 80-58 is overbroad in permitting unwinds in the same taxable year as the original transaction, regardless of whether the reversal is a product of the taxpayer's choice. On the other hand, if the sanctity of the annual accounting principle provides the basis for according or denying unwinding relief, it is unclear why the principle does not also govern claim of right and TBR cases, at least where the error giving rise to the later-year adjustment concerns the taxpayer's knowledge of underlying facts that themselves have not changed.²¹⁹

The tax benefit rule ("TBR") provides that if a taxpayer recovers an expense or loss that was written off against a previous year's income, the recovered amount must be included in income in the year of recovery. Frequently recurring tax benefit situations are the inclusion of a prior bad debt deduction upon the unexpected repayment of the debt, and the inclusion in income of amounts previously deducted as losses under Section 165 when the amounts have been unexpectedly recovered.²²⁰ The claim of right cases hold that if a taxpayer receives income in one year without any restriction on the taxpayer's use of the income, the full amount of the income must be included in the year of receipt notwithstanding a possibility that the taxpayer might be required to repay some or all of the income in the future.²²¹

It is unclear why application of the annual accounting concept should change the treatment of tax benefit cases or claim of right cases. The annual accounting concept provides that a taxpayer's income for a taxable year is computed on the basis of the facts at the end of the year.²²² If the facts existing at the end of a taxpayer's tax year support the taking of a loss deduction or require the inclusion of income received under a claim of right, then that is the mandated result, and a taxpayer is not permitted to

218. *Id.* at 942 ("These considerations do not imply that unwinding should be unavailable under an income tax. They only indicate that the case for income tax unwinding is weaker than the case for transactional taxes. The possibility of evasion or avoidance may be a cost worth bearing, especially if the contexts in which unwinding is deemed a permissible remedy are sufficiently salient to the tax authority that the worry about evasion is minimal, the options for avoidance are minimized, or both.")

219. *Id.* at 923.

220. *Id.* at 906. See Treas. Reg. § 1.165-1(d)(2)(iii) (1977). (specifying that the rule applies to unexpected recoveries of losses that were reasonably but erroneously deducted in a prior taxable year).

221. *United States v. Lewis*, 340 U.S. 590, 591-592.

222. Note 39, *supra*, and accompanying text.

reopen a prior year on the ground that the relevant facts have changed since the end of that year. On the other hand, the rescission treatment allowed by Rev. Rul. 80-58 is consistent with the annual accounting concept, in that the rescission must take place in the same tax year as the transaction that is being rescinded; thus, the facts at the end of the tax year include the fact of the rescission. In connection with his argument that the annual accounting principle, if applied to tax benefit cases and claim of right cases in the same way it is applied to rescissions, would change the treatment of those cases, Hasen states: "For example, it is not clear why a deduction should be an item that she included in a prior year."²²³ This statement seems incorrect. If the taxpayer in a prior year included as income an amount the taxpayer did not actually receive, the annual accounting principle would say that that amount should not have been included in income in the prior year and the taxpayer's remedy should be limited to filing an amended return that would report taxable income correctly for the prior year based on the facts existing at the end of that year (although misapprehended by the taxpayer).

Fabricated Doctrine then refers to another article by Banoff, in which he discusses policy arguments both for and against permitting retroactive unwinding, including the argument against, that "approval of retroactive unwindings that are tax motivated permits taxpayers to play the audit lottery: If you are audited, only then do you unwind to avoid adverse tax results."²²⁴ With respect to Banoff, under the present state of authority on rescission, it is unclear how one could play the audit lottery. If a taxpayer waits until he or she is audited, it will be impossible to carry out an unwinding in the same year as the transaction desired to be unwound.

Fabricated Doctrine continues:

The unwind doctrine may similarly dilute the deterrent effect of the codified economic substance doctrine in section 17709(o) [sic] by allowing taxpayers to undertake transactions that may risk falling foul of that doctrine knowing that they can be rescinded later in the tax year if they receive advice that it would certainly fall foul of section 17709(o) [sic].²²⁵

Fabricated Doctrine's references to "section 17709(o)" [sic] appear to be intended to be references to I.R.C. Section 7701(o), which defines the "economic substance doctrine" as "the common law doctrine under which tax benefits under Subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business

223. Hasen, note 43, *supra*, at 923, n. 213.

224. *Fabricated Doctrine*, *supra* note 47, at 165-66 (citing Sheldon I. Banoff, *New IRS Rulings Approve Rescission Transactions That Change an Entity's Status*, 105 J. TAX'N 5, 6 (2006)).

225. *Id.* at 166.

purpose.”²²⁶ I.R.C. Section 7701(o) also states rules for determining if economic substance exists. I.R.C. Section 6662 imposes penalties. I.R.C. Section 6662(a) imposes a penalty of 20% of the portion of any underpayment attributable to any of various defined actions, including any disallowance because a transaction lacks economic substance “within the meaning of section 7701(o) or failing to meet the requirements of any similar rule of law.”²²⁷ If a transaction that does not have economic substance is not disclosed in the taxpayer’s return, the penalty increases to 40%.²²⁸ It is clear that almost all unwinding transactions will have economic substance because the very nature of an unwinding transaction that comes within Revenue Ruling 80-58 is that the parties will have changed their economic position in a meaningful way—either by undoing a sale of property or by giving up the right to income. Also, it appears unlikely that a taxpayer who enters into a transaction lacking economic substance would see the light, if at all, within the period during which a valid rescission can be undertaken in compliance with Revenue Ruling 80-58. In any case, the purpose of I.R.C. Sections 7701(o) and 6662 would appear to be to deter taxpayers from entering into transactions that lack economic substance. Accordingly, if a taxpayer were to rescind a transaction because the taxpayer feared that the transaction would be found to lack economic substance, it would seem that I.R.C. Sections 7701(o) and 6662 would have achieved their purpose.

Fabricated Doctrine continues its argument by stating:

Hasen further notes that the ability to unwind transactions in the manner allowed by Rev. Rul. 80-58 facilitates the problem of government ‘whipsaw,’ when the property transferred subject to an “unwinding has depreciated or depreciated [sic] over the course of the tax year.” Each of these effects may mean that unwinding is a drain on the revenue.²²⁹

Any potential whipsaw problem appears to be de minimus because taxpayers do not have that much time to decide whether to rescind a transaction. Moreover, if taxpayer A sells property to taxpayer B in January 2014, and the parties rescind the sale before the end of 2014, the sale in January 2014, is disregarded under Revenue Ruling 80-58, and taxpayer A is treated as having owned the property all the time after the disregarded sale. Accordingly, any deductions attributable to the property would belong to taxpayer A, and taxpayer B would not be entitled to claim them. How does one determine if rescissions or any other activity is “a drain on the revenue”? Is there some knowable level of revenue belonging

226. I.R.C. § 7701(o)(5)(A) (2012).

227. I.R.C. § 6662(b)(6) (2012).

228. I.R.C. § 6662(i) (2012).

229. *Fabricated Doctrine*, *supra* note 47, at 166.

to the federal government that may be drained? Further, although Hasen does note that some whipsaw may occur, for him the possible whipsaw arises because taxpayers may conduct their affairs so as to avoid Revenue Ruling 80-58 when it is advantageous to do so, and comply when it is favorable.²³⁰ Hasen also notes that our self-reporting system contributes to whipsaw.²³¹ Both of these concerns apply to our tax system generally and not the peculiar disadvantages of the unwinding doctrine of Revenue Ruling 80-58. Indeed, in another part of his article, Hasen discusses that when a taxpayer successfully avoids having to report gain on a rescinded sale, the taxpayer often will have more taxable income in future years than would be the case if the rescission had not occurred.²³²

V. THE RESCISSION DOCTRINE AS CURRENTLY APPLIED BY THE IRS IS CORRECT AND WOULD BE CORRECT EVEN IF *PENN V. ROBERTSON* HAD NEVER BEEN DECIDED

This Article attempts to demonstrate that *Penn v. Robertson* in fact offers strong support for the rescission doctrine articulated by Revenue Ruling 80-58 and that the authors of *Fabricated Doctrine* have completely failed in their attempt to show that the IRS fabricated the rescission doctrine in Revenue Ruling 80-58 and that everyone else has misread *Penn v. Robertson*. *Penn v. Robertson* clearly characterizes the income realized by Mr. Penn early in 1931 as having been extinguished by his executors' agreeing to return his credits later in 1931. *Fabricated Doctrine* attempts unsuccessfully to show that the court in *Penn v. Robertson* was operating under a deduction rationale, but those attempts, as this Article demonstrates, were based on an incredible misreading of the opinion.²³³ Nowhere in its opinion does the court in *Penn v. Robertson* give any indication that when it said that it agreed with the district court "the rescission in 1931 before the close of the calendar year *extinguished* what otherwise would have been taxable income to Penn for that year"²³⁴ that it was really saying that what would otherwise have been taxable income to Mr. Penn was extinguished because it had been reduced to zero by a deduction. In addition to their fundamentally flawed reading of the opinion in *Penn v. Robertson*, the authors of *Fabricated Doctrine* only attempted to analyze half of the problem. Revenue Ruling 80-58 cited two grounds for its holdings—one was *Penn v. Robertson* and the other (cited first in

230. Hasen, *supra* note 43, at 940–41.

231. *Id.*

232. *Id.* at 901.

233. See *supra* Part IV Subsection B *Fabricated Doctrine's* Analysis of *Penn v. Robertson*.

234. *Penn v. Robertson* 115 F.2d 167, 175 (4th Cir. 1940).

Revenue Ruling 80-58) was the annual accounting principle as established by the Supreme Court cases discussed above in Part II. Ultimately, however, even if the authors of *Fabricated Doctrine* were correct in their assertion that *Penn v. Robertson* provides no support for the rescission doctrine as currently applied by the IRS, that doctrine would be correct as a matter of policy and would be within the authority of the Treasury Department and the IRS. Section 7801 of the Internal Revenue Code authorizes and directs the Treasury Department to perform the “administration and enforcement” of the income and transfer tax provisions, and Section 7805 authorizes and directs the prescription “of all needful rules and regulations.” The Treasury has delegated this authority to the Commissioner of Internal Revenue.²³⁵

In other words, assume that *Penn v. Robertson* had never been decided and that taxpayers were just now approaching the IRS with questions about the tax treatment of transactions that had been unwound. Can anyone doubt that Sections 7801 and 7805 provide ample authority for the IRS to look at the Supreme Court cases defining and discussing the annual accounting concept, and, on the basis of the annual accounting concept, promulgate a revenue ruling articulating the same rescission doctrine as Revenue Ruling 80-58?²³⁶ The Court in *Burnet v. Sanford & Brooks Co.* observed that “all revenue acts . . . since the adoption of the Sixteenth Amendment have uniformly assessed the tax on the basis of annual returns showing the *net* result of all the taxpayer’s transactions during a fixed accounting period.”²³⁷ The Court quoted this statement approvingly in 1944,²³⁸ and, in 1953, it stated that “Congress has enacted an annual accounting system under which *income is counted up at the end of each year.*”²³⁹

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

235. Treas. Reg. § 301.7805-1.

236. See Note 1, *supra*, and accompanying text. In 2013, the Internal Revenue Service reaffirmed that Revenue Ruling 80-58 is its guidance on rescissions—see notes 18-19, *supra*, and accompanying text).

237. 282 U.S. at 363 (emphasis added).

238. *Security Flour Mills Co. v. Commissioner*, 321 U.S. 281, 285 (1944).

239. *Healy v. Commissioner*, 345 U.S. 278, 284 (1953) (emphasis added).

right cases also teach us, however, that if the taxpayer in this example repays all or a portion of the income in the year of receipt, 2014, the repayment reduces the taxpayer's reportable taxable income in 2014, whether the repayment is voluntary or involuntary; it is a reduction in reportable taxable income, not the allowance of a deduction. *Fabricated Doctrine* does not offer any analysis of the annual accounting concept. Indeed, in its discussion of the potential tax treatment of Douglas Poling, without any consideration of how the annual accounting concept might apply, *Fabricated Doctrine* assumes away any potential deductibility of a repayment by Mr. Poling of his TARP bonus, fails to discuss the authorities discussed above²⁴⁰ that show that if Mr. Poling did repay his TARP bonus in the year of receipt, he would be allowed to exclude the repaid bonus from his taxable income for that year, and wrongly states that Mr. Poling would likely be entitled to treat repayment as a rescission under Revenue Ruling 80-58.

A fundamental difference between this Article and *Fabricated Doctrine* is that this Article believes the annual accounting concept is an important policy concept that supports the rescission doctrine as developed by Revenue Ruling 80-58. *Fabricated Doctrine* does not discuss the annual accounting concept or even acknowledge that it was one ground cited by Revenue Ruling 80-58 as authority for its holdings.²⁴¹ Under the annual accounting concept, a deductible expense paid (if the taxpayer uses the cash basis of accounting) or incurred (if the taxpayer uses the accrual method of accounting) on December 31, 2014 may reduce taxable income realized on January 1, 2014. What policy argument suggests that it is inappropriate to say that a sale closed in January, 2014 that is unwound in December 2014 does not have to be reported on the taxpayer's return for 2014? Similarly, what policy is there that would state that it is inappropriate to say that a taxpayer who receives taxable compensation in January 2014 does not have to report the income to the extent the taxpayer repays the compensation to the employer before the end of 2014? As discussed in more detail above,²⁴² it is no answer, particularly in the case of an unwound sale of a capital asset, to assert that a deduction puts the taxpayer in the same position as an unwinding and that therefore a deduction rationale is just as likely or, as *Fabricated Doctrine* argues, more likely the basis for the holding with respect to the tax year 1931 in *Penn v. Robertson* as is the rescission doctrine.

240. See *supra* Part IV, Subsection C *Fabricated Doctrine's* Examination of TARP Bonuses.

241. Rev. Rul. 80-58, *supra* note 1.

242. *Fabricated Doctrine*, *supra* note 47 at 142; see note 90, *supra*, and accompanying text.

This Article has demonstrated that *Fabricated Doctrine*'s recommendation that Revenue Ruling 80-58 be revoked rests entirely on a fundamentally flawed analysis of *Penn v. Robertson*. *Penn v. Robertson* in fact provides ample legal support for Revenue Ruling 80-58. Moreover, Revenue Ruling 80-58 is supported by the U.S. Supreme Court cases establishing the annual accounting concept, and Revenue Ruling 80-58's permitting a rescission of a sale in the same taxable year is completely consistent with the annual accounting concept. Although the IRS confirmed in 2013 that Revenue Ruling 80-58 will continue indefinitely to be its position on rescissions,²⁴³ it would be beneficial if the IRS would relax its current no-ruling policy on rescissions and provide guidance on questions like those raised in the NYSBA Report. If time and energy could be found, a wide-ranging discussion of the best policies to apply to rescissions, tax benefit cases, and claim of right cases, as Hasen attempted in his article, would also be beneficial. In an age when information abounds on the Internet and researchers face difficulties in assuring that they have thoroughly researched a topic, articles like *Fabricated Doctrine* that appear in facially creditable publications present a danger and do a disservice to scholarship in a complicated field that could benefit from thoughtful analysis.

243. Notes 18-19, *supra*, and accompanying text.