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A Taxing Mistake

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ABSTRACT

Citibank made front page news for reasons it would rather have avoided when it mistakenly transferred $900 million of its own money to creditors of Revlon. When Citibank discovered the error the next day, it asked (initially politely then less so) for the creditors to return the mistaken payment. Several creditors refused and Citibank was forced to initiate litigation to attempt to get the money returned. This litigation is ongoing, but the first round of the battle was won by the lenders when a federal district court ruled that they had a legal right to retain Citibank's mistaken payment under the "discharge for value" defense. This Article briefly reviews the facts and the opinion of that case. On appeal, the Second Circuit reversed that decision and held for Citibank thereby requiring the lenders to return Citibank's money. This piece also reviews that opinion. The primary and original contribution of the piece, however, is to discuss the tax aspects of all the possible outcomes. While some tax consequences are straightforward, there are several interesting and less certain tax results that could apply to all three parties (Citibank, Revlon, and the lenders). This Article will explain those possibilities and review the tax doctrines that will apply once Citibank's litigation has concluded.

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INTRODUCTION

To err is human, but the Internal Revenue Service is not divine, so it does not forgive.[1] While everyone makes mistakes, the tax treatment of a transaction generally does not change whether the transaction was done purposely or accidentally or under a mistaken belief.[2] For example, assume Alvin owed a debt to Barbara, but that debt had expired so there is no longer a legal obligation for Alvin to pay the debt. Alvin, however, is under the mistaken belief that he still is required to pay, and therefore he makes the payment. The tax treatment to both Alvin and Barbara of that transaction does not change whether Alvin was under a mistaken impression or not. In either case, the transaction will merely be treated as Alvin satisfying his debt and the appropriate tax consequences will apply.[3]

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1 With apologies to the spirit of Alexander Pope.

2 One small caveat to this is that if a taxpayer engages in a transaction (purposely), but with the principal purpose of obtaining beneficial tax treatment rather than a genuine business purpose, courts may ignore the form of the transaction and instead apply the appropriate tax results to the substance. *See* Gregory v. Helvering, 293 U.S. 465 (1935). That is to say that the tax results of a transaction can change based on whether there is an actual business purpose to that transaction.

3 In this example, there is no income to Barbara (she is merely receiving back what she loaned out) and no deduction to Alvin. This treatment mirrors the tax treatment of the initial loan, which also provides no income to the recipient of the loan and no deduction for the lender. Since there is no accession of wealth for either the person receiving the loan or the creditor when the loan is paid off, there is no income. Commissioner v. Glenshaw Glass, 348 U.S. 426, 431 (1955) (defining income as "accessions to wealth, clearly realized, and over which the taxpayers have complete

Many mistakes are harmless, but sometimes they are so large that they end up in the news, in court, or both. In Part I, this Article will review the $900 million mistake that Citibank made in 2020.[4] Not surprisingly, a mistake involving that much money led to both news coverage and litigation, the latter of which this piece will review. In Part II, this Article will discuss the possible income tax consequences (at both the time of the mistake and once the litigation is completed) for all of the parties involved in the Citibank transaction. As most of the commentary has focused on the corporate and contract law elements of the Citibank mistake, the important income tax consequences have so far been ignored. This is the first piece to review and comment on the tax elements of the transaction and its fallout.

I. IN RE CITIBANK

A. *Facts*

In 2016, Revlon, Inc., a U.S. cosmetics corporation, borrowed $1.8 billion.[5] Citibank served as "administrative agent" for that loan. One of its duties as administrative agent was to receive payments from Revlon and pass those on to the lenders of the loan.[6] In 2020, Citibank, still acting as Revlon's administrative agent, made a gigantic and costly error. It wired not only the funds that Citibank had received from Revlon (around $7.8 million), but it also wired $900 million of its own money to the lenders.[7] Apparently, Citibank had intended to send the $7.8 million it received from Revlon to Revlon's creditors and transfer $900 million or so of its own money to an internal Citibank "wash account."[8] These types of accounts were used internally to safeguard against the money leaving the bank. When approving the transfer, Citibank's employees believed that the $900 million was being transferred to these Citibank internal

dominion"). While this conclusion has never been codified, common law has consistently followed such treatment. *See* DOUGLAS A. KAHN & JEFFREY H. KAHN, FEDERAL INCOME TAX—A GUIDE TO THE INTERNAL REVENUE CODE 141 (8th ed. 2019).

4 Stacy Cowley, *Citi Loses Its Bid to Reclaim Cash from a $900 Million Mistake*, NY TIMES (Feb. 16, 2021), https://www.nytimes.com/2021/02/16/business/citibank-revlon-loan.html [https://perma.cc/XF3M-26B2].

5 *In re* Citibank August 11, 2020 Wire Transfers, 520 F.Supp.3d 390, 397 (S.D.N.Y 2021), *vacated and remanded sub nom*. Citibank, N.A. v. Brigade Cap. Mgmt., LP, 49 F.4th 42 (2d Cir. 2022). The loan enabled Revlon to purchase Elizabeth Arden, Inc., another cosmetics company, for $900 million cash. Eric Talley, *Discharging the Discharge-For-Value Defense*, 18 N.Y.U. J.L. & BUS. 147, 157 (2021).

6 *In re* Citibank, 520 F. Supp. 3d at 397.

7 *Id.* at 396.

8 *Id.* at 401.

accounts but instead it was sent to Revlon's lenders.[9] This mistaken transfer ended up paying off the entirety of the remaining 2016 loan[10] (the original loan agreement was set to mature in September of 2023).[11]

After it discovered the error the next day, Citibank contacted the lenders (several times) to notify them of the mistake and asked for them to return the extra payments. The first email was fairly polite: "[p]lease return the principal portion of the payment you received . . . as soon as possible."[12] The third email sent a few days later was less friendly:

> To be clear, these funds belong solely to Citibank; they are not borrower or Revlon 2016 Term Loan facility funds. In view of this mistaken transfer, you are legally obligated to return those funds and, as is standard industry practice when fund transfers occur mistakenly, we expect that you will return those funds to Citibank immediately.[13]

Although some of the funds were returned, several of the lenders refused to send anything back to Citibank.[14] Apparently, the lenders themselves were "hours away from launching a long-shot lawsuit of their own against Revlon and Citibank, seeking to recover the precise sum that had just (miraculously) fallen into their laps."[15] Several of the lenders believed that certain transactions engaged in by Revlon violated the terms of the initial loan agreement and thus caused that loan to be in default.[16] In their opinion, this alleged default required Revlon to accelerate the repayment of their loan.[17]

In late 2020, Citibank began litigation to force those lenders to return the money that Citibank paid from its own funds. At issue in the case was more than $500 million of the original $900 million payment.[18] Citibank had a fairly simple argument—the money was sent by mistake. It does not belong to the lenders; it belongs to Citibank and therefore the lenders were required to return it to Citibank. Legally, Citibank argued "conversion, unjust enrichment, money had and received, and payment by mistake."[19] Essentially, Citibank's arguments under all four legal claims boiled down to equity—the defendants received a benefit that they

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9 *Id.* at 400–04.

10 *Id.* at 405.

11 *Id.* at 398.

12 *Id.* at 405 (alteration in original).

13 *Id.*

14 The lenders who refused held approximately $500 million of the mistaken payment. *Id.* at 396.

15 Talley, *supra* note 5, at 150. The lenders likely could not believe their luck in recovering the entire loan amount as the loans were trading at a sixty percent discount in March 2020. *Id.* at 159.

16 *Id.* at 160–62.

17 *In re* Citibank, 520 F. Supp. 3d at 409.

18 *Id.* at 398.

19 *Id.* at 413.

did not deserve and therefore they needed to give it back. There was no dispute about the facts; it was clear that this was Citibank's money and it was sent in error. Without something else, the case seemed fairly cut and dry.[20]

Still, to the surprise of many, Judge Jess Furman of the United States District Court for the Southern District of New York held for the lenders, ruling that they were allowed to keep the funds.[21] Judge Furman used the State of New York's "discharge for value" defense to provide the lenders a win.[22] The court held this defense was valid to offset each of Citibank's legal claims.

B. *Discharge-for-Value Defense*

The "discharge for value" defense is an exception to the general equitable rule that a person must return what does not belong to them. The general rule of having a duty to return what does not belong to you applies even when the payor was negligent in making the mistaken payment.[23] Courts, again following general rules of equity, carved out some exceptions to this general principle. Essentially, courts asked whether there was an equitable justification to allow the payee to keep the mistaken payment. That is, would it be even more "unfair" to force the return? For example, if the recipient was reasonably unaware that the payment was a mistake and had changed its position in reliance on the payment, a court might find that it was not required to return the funds.[24]

If this is where the exception to the general equitable rule remained, it is unlikely that the lenders in the Citibank case would have won. There

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20 The lenders attempted to argue that they did not have control over or benefit from the transferred funds and therefore the legal elements of conversion or payment by mistake were not met. *Id.* at 414. As discussed in more detail in Section II.B–II.C, the court did not make a determination on this (seemingly weak) argument because it used the affirmative defense of discharge-for-value to decide the case in favor of the lenders.

21 *Id.* at 396.

22 *Id.* at 397.

23 RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 6 (AM. L. INST. 2011) ("As in other cases of benefit conferred by mistake, the fact that the claimant may have acted negligently in making a mistaken payment is normally irrelevant to the analysis of the claim.").

24 Paramount Film Distrib. Corp. v. State, 285 N.E.2d 695, 697–98 (N.Y. 1972); *see also* Mayer v. New York, 63 N.Y. 455, 457 (1875) ("The general rule that money paid under a mistake of a material fact may be recovered back [sic], although there was negligence on the part of the person making the payment, is subject to the qualification that the payment cannot be recalled when the position of the party receiving it has been changed in consequence of the payment, and it would be inequitable to allow a recovery. The person making the payment must, in that case, bear the loss occasioned by his own negligence."). This general rule does not appear to apply to the Internal Revenue Service. *See* Robert W. Wood, *IRS Can Issue Tax Refunds, Then Demand Them Back with Interest*, FORBES (June 1, 2017) https://www.forbes.com/sites/robertwood/2017/06/01/irs-can-issue-tax-refunds-then-demand-them-back-with-interest [https://perma.cc/2DSP-VANU].

do not appear to be any facts to suggest that the lenders could meet a legal requirement of detrimental reliance. The Restatement of Restitution, however, adopted a more lenient position. Instead of having to show detrimental reliance, the lender merely needed to show that it had not made any "misrepresentation and did not have notice of the transferor's mistake."[25] Well before the Citibank mishap, there had been some question whether New York had adopted the more liberal view of this exception.[26] In the 1991 *Banque Worms* case, the New York Court of Appeals (New York's highest state court) unanimously held that the "discharge for value" exception was accepted law in the state and so the more liberal version of the exception was settled law in New York.[27]

C. *Did the Lenders Have Notice?*

Therefore, the issue in *Citibank* was whether the liberal discharge-for-value doctrine applied to the lenders. Citibank attempted to argue certain technical points about the doctrine that would strengthen its case. For example, Citibank argued that (1) the doctrine only applies when the debt is "due,"[28] and (2) the question of notice is evaluated not when the payment is made but instead when the payment is credited.[29] The federal district court dismissed both of these arguments.

In the end, the ultimate determination in the case was whether the lenders had notice that the payment was a mistake. Still, before that determination could be made, the court also had to determine what the standard of notice was.[30] That is, the two sides disagreed on whether actual notice was required or if constructive notice would suffice. Not surprisingly, Citibank took the position that constructive notice was all that was required, while the lenders argued for a standard of actual

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25 RESTATEMENT OF RESTITUTION § 14 (AM. L. INST. 1937).

26 Banque Worms v. BankAmerica Int'l, 570 N.E.2d 189, 193 (N.Y. 1991) ("[O]ne may find . . . language in a myriad of cases that arguably lends support to the proposition that New York, long ago, embraced the 'discharge for value' rule' . . . . On the other hand, cases can also be cited where the language employed supports the contrary view—that New York not only eschews the 'discharge for value' rule . . . but also embraces exclusively the detrimental reliance rule-mistake of fact doctrine . . . ." (citations omitted)).

27 *Id.*

28 *In re Citibank*, 520 F. Supp. 3d 390, 419–21 (S.D.N.Y 2021). Using this argument, Citibank contended that the discharge-for-value defense could not apply to their mistake since the full payment of the loan was not due for another three years. *Id.* We will see that this argument ended up succeeding on appeal.

29 *Id.* at 421–25. Citibank contended that the appropriate time to determine whether the discharge-for-value defense applied was not upon the immediate receipt of the mistaken funds, but instead when the payment is "credited" to the debtor's account. *Id.*

30 *Id.* at 425 ("The final legal issue in dispute is what *kind* of notice prevents an assertion of the discharge-for-value defense.").

knowledge.[31] The court, reviewing both the opinions of other courts and the Restatement, held that constructive notice was the appropriate standard.[32] Since actual notice was not met in the case, the final determinative issue came down to whether the lenders had constructive notice that the large payment from Citibank was made in error.

The court held that several factors supported the contention that the lenders did not have constructive notice that the payment was in error. The court noted that no payment was due on the date of the transfer.[33] So the lenders were not expecting any payment, including a payment of a much smaller variety. It would have been a better case for Citibank if a $7–8 million payment was due and instead the much larger payment was made. This lack of payment due supported the argument that it was reasonable for the lenders to believe this was merely a prepayment of the loan principal—something that Revlon was specifically allowed to do according to the loan contract with the lenders.

The court also noted that it was reasonable for the lenders to believe that the payment was intentional because it was for the exact amount of the loan.[34] The typical "fat finger" mistake is more obvious—more than the amount due is paid or a decimal point is clearly in the wrong spot. Since it was the exact amount due, it again supported the idea that Revlon was paying off the loan early. The court also noted that a prepayment of the loan was a much more likely explanation than a mistake.[35] The lenders knew Citibank had significant and rigorous procedures to ensure this type of mistake did not occur. In fact, the court noted this was a "black swan" event.[36] It was difficult, if not impossible, to think of another mistaken transfer involving so much money. It was again more reasonable for the lenders to believe this payment was on purpose rather than some slip-up that made it through all of Citibank's verification checks.

Finally, the court noted that the lenders acted as if this was an intentional payment. All communication by the lenders, prior to the first Citibank email, suggested that the lenders believed it was an intentional full satisfaction of the loan.[37] It is only after they received the email from

31 *Id.* at 427.

32 *Id.* at 430.

33 *Id.* at 434 ("Critically, August 11, 2020, was *not* a scheduled interest payment date; the next scheduled interest payment date was not until August 28, 2020.").

34 *Id.* at 432 ("[T]he amounts received matched—to the penny—the amounts of principal and interest outstanding on the 2016 Term Loan for each Lender as of August 11, 2020.").

35 *Id.* at 433 ("[A]s surprising as an apparent early paydown from Revlon may (or should) have been . . . that explanation for the wire transfers was far more plausible than the alternative explanation (accurate though it turned out it be): that Citibank or Revlon had wired nearly $1 billion by mistake. Citibank is one of the most sophisticated financial institutions in the world.").

36 *Id.* at 434.

37 *Id.* at 435. The court cites several examples of the contemporaneous communications that occurred by the lenders including an email from an Allstate employee stating "Please see holdings

Citibank disclosing the mistake that the lenders began to remark on the uniqueness of the situation.[38] Since the appropriate time to judge whether the lenders had notice was at the time of receipt (and thus before any of the Citibank emails were received), this supported the case that the lenders did not think the payment was in error. All these factors led the court to find that the discharge-for-value defense was met.

D. *The Second Circuit Reverses*

Not surprisingly, Citibank appealed the decision of the federal district court and many believed that it would be reversed.[39] Those predictions proved to be prescient recently when the Second Circuit vacated the district court's opinion and held for Citibank.[40]

The Second Circuit began its opinion by noting that there was no factual dispute and set out the same recitation of facts as those provided by Judge Furman's district court opinion. Like that opinion, the Second Circuit agreed that the key issue in the case was whether the discharge-for-value defense applied and the key New York precedent was the *Banque Worms* case.[41]

Again, the ultimate issue for the Second Circuit to determine was whether the lenders had notice that the payment was a mistake. While at the district court the lenders argued that only actual notice would suffice, Judge Furman rejected that contention and held that constructive notice would also disqualify the discharge-for-value defense. The lenders did not challenge that portion of the lower court decision.[42] Instead, the two sides disagreed on how to define "constructive notice." The lenders argued that "constructive notice is evaluated by asking what the

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and cash received on 8/11. The cash description noted Revlon, and the amounts appear to tie to a full paydown with interest." *Id.*

38 *Id.* at 437. The court includes some of the "colorful" communications after the lenders discovered the mistake, including an HPS Investment Partners, LLC employee writing "I feel really bad for the person that fat fingered a $900mm erroneous payment. Not a great career move . . . . How was work today honey? It was ok, except I accidentally sent $900mm out to people who weren't supposed to have it . . ." *Id.* A different HPS Investment employee described it simply and succinctly as an "epic fail." *Id.*

39 *See* Talley, *supra* note 5, at 172 ("[T]here is by now no shortage of discussion among academics and practitioners about the Citibank holding—much of it critical . . . ."). Professor Talley's article not only points to several doctrinal and logic problems in the opinion, but it also reviews the response from the market to the case. Professor Talley finds an almost immediate reaction to the news of the mistake by firms in the lending space to include language rejecting the *Citibank* result. Talley, *supra* note 5, at 218.

40 Citibank, N.A. v. Brigade Cap. Mgmt., LP, 49 F.4th 42 (2d Cir. 2022).

41 Banque Worms v. BankAmerica Int'l, 570 N.E.2d 189 (N.Y. 1991).

42 *Citibank, N.A.*, 49 F.4th 42, at 61 n.11.

transferee 'knew or should have known' of the transferor's mistake."[43] Citibank, on the other hand, argued that constructive notice under New York law also required a duty of inquiry if the facts were such that a reasonable party would question whether there was a mistaken payment.[44]

The Second Circuit agreed with Citibank, citing both New York precedent and the Restatement. The lenders tried to counter that such interpretation was inconsistent with the *Banque Worms* decision.[45] The Second Circuit disagreed by holding that the standard of notice was not at issue in that case because there was "no reason whatsoever to suspect that there was a mistake. The standard of notice had no bearing on that case."[46] The court succinctly concluded that "In sum, we find it clear that inquiry notice is the applicable notice standard in adjudicating a discharge-for-value defense in New York."[47]

Under this standard, when does a lender need to make an inquiry to verify that the payments were not a mistake? The Second Circuit held that the standard is one of reasonableness.[48] If there are red flags about a payment that should raise suspicions or warnings about whether a payment was made by mistake, the standard is whether a reasonable person would make an inquiry to ensure that the payments were not a mistake. The Second Circuit, noting that the lenders have little incentive to make that inquiry since it could result in them having the return the money, instead applied the reasonableness standard to a hypothetical person who would suffer a loss if the payments turned out to be a mistake and therefore has an interest to ensure its validity.[49]

With that standard in mind, the Second Circuit reviewed whether red flags existed in the Citibank payment that should have raised suspicion or doubt thereby requiring the lenders to inquire whether it was a mistake.[50] The Second Circuit emphasized several items to support its conclusion that the lenders should have realized something was amiss. First, the court noted that there was no prior notice of a prepayment.[51] Under the loan contract, Citibank was required to provide prior notice if Revlon planned to prepay any principal of the loan.[52] Noting that Citibank was one of "the most sophisticated financial institutions in the world,"

43 *Id.* at 61.

44 *Id.*

45 *Id.* at 63.

46 *Id.*

47 *Id.* at 64.

48 *Id.*

49 *Id.*

50 *Id.* at 65–72.

51 *Id.* at 65.

52 *Id.*

something that the district court used to support its conclusion that the lenders could assume the payment was not a mistake, the Second Circuit used this fact to support the conclusion that Citibank would not have sent the payment without the appropriate and required notice.

Second, the Second Circuit noted that Revlon's well-known financial difficulties also suggested that the payment should have been viewed with suspicion.[53] The appeals court held that it should have been considered astonishing that an essentially insolvent company would find the resources to fully pay off the debt.[54] The appeals court further noted that, on account of Revlon's financial problems, the debt was trading at 20–30 cents on the dollar.[55] Why would Revlon pay the debt back in full when it could have much more cheaply purchased the debt back for a major discount? Once again, the court believed this should have raised red flags to the lenders.

Finally, the court noted that Revlon had made an exchange offer to the lenders just four days prior to the Citibank payment.[56] The purpose of that offer was to avoid an acceleration of the principal payment due under the loan.[57] The Second Circuit considered this another red flag as it should have raised the question why Revlon would try to avoid payment acceleration if it planned to repay the entire loan four days later.

The Second Circuit stated that it believed the district court incorrectly applied the appropriate test to determine whether the lenders believed that the payment was made by mistake. The court stated:

> The test is not whether the recipient of the mistaken payment reasonably believed that the payment was genuine and not the result of mistake. The test is whether a prudent person, who faced some likelihood of avoidable loss if the receipt of funds proved illusory, would have seen fit in light of the warning signs to make reasonable inquiry in the interest of avoiding that risk of loss. In other words, when the information available to the recipient of an apparent repayment includes facts supporting a reasonable suspicion of mistake, the question is not whether the recipient reasonably believed the payment was valid. It is whether a reasonably prudent investor, focusing on all the available information (some supporting the validity, some supporting doubts) who would be at risk of an avoidable loss if the payment proved illusory, would have found the factors supporting doubt sufficiently troublesome in the mix to warrant making reasonable inquiry, in which case the recipient would be chargeable with the knowledge that such reasonable inquiry would

53 *Id.* at 65–66.

54 *Id.*

55 *Id.* at 66.

56 *Id.*

57 *Id.*

> have revealed. It is an objective test, not dependent on what the actual recipient believed.[58]

Having concluded that this collection of red flags raised enough concern that the lenders had a duty to inquire, the Second Circuit also concluded that a reasonable inquiry would have easily brought the mistake to light.[59] The court held "A payee who failed to call Citibank or Revlon, but relied instead on nothing more than ascertaining that the payment matched the debt, could not be said to have conducted a reasonable investigation."[60]

The Second Circuit made one final point supporting its decision to reverse the lenders' victory. The court held that *Banque Worms* was distinguishable from the current controversy because in *Banque Worms* the lenders were actually entitled to the money that they had received.[61] In this case, since the debt was not due for another three years, the court held that the lenders were not entitled to the payment. The Second Circuit stated that there are "significant reasons" why restitution is important when a mistaken payment is made.[62] It noted that in this case, should the court find an exception to the normal case of restitution, it would provide a large windfall to the lenders.[63] Whereas the doctrine of restitution would "leave them exactly where they contracted to be."[64]

The lenders argued that *Banque Worms* stressed the importance of "finality of wire transfers," but the Second Circuit did not believe the case stood to mean that finality should trump all other policy considerations.[65] The court noted that *Banque Worms* was an *exception* to the general rule of restitution and the importance of finality of wire transfers did not alter the fact that allowing recipients to receive mistaken payments was the exception, not the rule. Therefore, the court held that the discharge-for-value defense had an entitlement requirement and the lenders in the Citibank mistake did not meet that requirement since the loan was not due for another three years. This conclusion meant that the lenders could not use the discharge-for-value defense.

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58 *Id.* at 68.
59 *Id.* at 72.
60 *Id.* at 74.
61 *Id.*
62 *Id.* at 76.
63 *Id.* at 77.
64 *Id.*
65 *Id.* at 78.

II. TAXING THE MISTAKE

Whatever the final outcome, there are interesting questions regarding the tax results to the involved parties. This Part will review the possible federal income tax consequences to the lenders, Citibank, and Revlon whatever the final conclusion of the case is.

A. *Initial Tax Treatment*

All three of the parties involved in this dispute did not get to wait until the final conclusion of the controversy before they had to report the initial tax consequences of the mistake. Taxes are filed on an annual basis and therefore all three parties should have reported their income based on the situation as it was at the end of the tax year of the mistake. At that point, the lenders had the money and refused to return it to Citibank.

For the lenders, their initial tax position was fairly simple. Since the payments represented loan principal, the lenders merely received back what they originally loaned out. Therefore, they did not recognize any income for receiving those funds from Citibank.[66] The only possible exception to this was some small portion of the payment representing interest. That amount would be income to the lenders, even though they discovered that there was a possibility that the lenders would have to return the money if Citibank sued and a court forced them to return the mistaken payment.[67] It makes no difference for tax purposes that the payment was a mistake (or that the payor was someone other than Revlon). The funds were clearly tied to the Revlon loan and of course the lenders all took the position that they believed the funds were paying off the loan under the discharge-for-value defense.[68]

There is a bit more complexity (and some uncertainty) for the original tax treatment of Citibank and Revlon. One issue that needed resolution was the status of the debt obligation for Citibank and Revlon on account of the mistaken payment. One possible contractual result was that subrogation applied and Citibank stepped into the shoes of the lenders. Subrogation has been described as a "legal fiction through which one, who . . . pays the debt of another, is substituted to all the rights and remedies of the other, and the debt is treated in equity as still existing for

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66 *See supra* note 3.

67 This treatment illustrates the inclusion aspect of the "claim of right" doctrine. Under that doctrine, if the taxpayer "acquired the property without a consensual recognition (express or implied) of an obligation to repay and without restriction as to his disposition of the property" then the taxpayer recognizes the receipt as income. *See* KAHN & KAHN, *supra* note 3, at 175–76.

68 *In re* Citibank, 520 F.Supp.3d 390, 396 (S.D.N.Y 2021).

his benefit."[69] Under that treatment, Revlon would owe money to Citibank under the same terms that it originally owed the lenders who were mistakenly paid off by Citibank.

If, after the mistaken payment, Revlon continued paying back the loan, just to Citibank and not the lenders, then for tax purposes there really would not be much difference to the two parties. Revlon would get a deduction for the interest payments that it accrues,[70] but not for the payment of principal.[71] Citibank would have income for the interest, but the principal payments would be return of capital and therefore not income.[72]

Of course, if Revlon has the financial wherewithal to pay back the loan, it is less clear why Citibank would go through the trouble of suing the original lenders who refused to return Citibank's mistaken payment. The interest rate on the original loan may be lower than what Citibank could earn if it had the money (not unlikely with the rate increases of late), but the more likely explanation is that Revlon does not have the financial means to fully pay back the loan. Part of the reason the lenders refused to return the money was their concern about Revlon's financial position.[73] If that was part of Citibank's justification for suing the lenders to force them to return the money, it was well founded since Revlon filed for bankruptcy under Chapter 11.[74]

So there are two possibilities here: either Revlon began to pay Citibank back what it originally owed the lenders or it did not. As noted above, if Revlon paid Citibank back, the tax consequences are simple—neither Citibank nor Revlon will have any income tax consequences for the payment of the loan principal. There will be no income to Citibank and no deduction for Revlon for those loan principal payments. Any interest payments will be income to Citibank and will be deductible by Revlon.[75]

The latter possibility (Revlon not paying Citibank anything) may have occurred for two distinct reasons. First, it is possible that Revlon does not have the financial means to pay back the loan on account of its insolvent position. Second, Revlon may take the position that it is not actually required to pay Citibank back at all. That is, Revlon may argue that subrogation does not apply. Citibank paid off Revlon's loan and that

69 Home Owners' Loan Corp. v. Sears, Roebuck & Co., 193 A. 769, 772 (Conn. 1937).

70 I.R.C. § 163.

71 *See supra* note 3.

72 *Id.*

73 Talley, *supra* note 5, at 150.

74 Jacqueline Ganun, *Revlon Files for Bankruptcy Amid Competition and Supply Chain Stress*, NPR (June 16, 2022, 11:57 AM) https://www.npr.org/2022/06/16/1105490036/revlon-bankruptcy [https://perma.cc/UFJ2-98X8].

75 I.R.C. § 163.

is the end of it. These two possible scenarios lead to more interesting tax results than if Revlon merely pays back the loan at the original terms.

Consider the second possibility—that Revlon took the position that subrogation did not apply and therefore the loan was simply wiped off the books because Citibank paid it. Was this a likely position for Citibank to take after the mistaken payment? Commentators have noted that there is not much legal precedent in this type of situation and so perhaps it is unclear whether subrogation would apply.[76] However, if Revlon took such a position, it would have to be required to recognize Citibank's payment of the loan as income.[77] Citibank paid off Revlon's liability which was clearly income to Revlon.[78] In fact, if Revlon did not report the loan payment as income when Citibank made the mistaken payment, it could diminish the strength of its position that subrogation did not apply. Citibank could point out that, for tax purposes, Revlon acted as if the loan was still valid. Assume, however, that a court sided with Revlon and ruled that subrogation did not apply. As noted above, Revlon would have income but what would be the tax results to Citibank? Citibank should have received a business deduction for the mistaken payment. Although in the past courts have denied deductions for paying off someone else's loan,[79] this should qualify for a business expense deduction under Internal Revenue Code section 162 or a deductible loss under section 165.[80]

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76 *See* Jeremy Hill & Eliza Ronalds-Hannon, *Citi's $900 Million Revlon Gaffe Risks Getting Even More Painful*, BLOOMBERG (June 16, 2022, 3:27 PM) https://www.bloomberg.com/news/articles/2022-06-16/citi-s-900-million-revlon-gaffe-risks-getting-even-more-painful [https://perma.cc/XJV3-YUUL]. The article quotes Columbia University Law Professor Eric Talley, who states that "[t]here isn't a lot of law on this." *Id.*

77 There is one possible argument to avoid income recognition. If Citibank owns Revlon stock, Revlon could argue that the payment was a nontaxable contribution of capital. I.R.C. § 118. That is, Citibank contributed the money to Revlon thereby increasing its basis in its Revlon stock. I.R.C. § 362. Revlon then used those funds to pay off the loan.

78 *See* Old Colony Trust Co. v. Comm'r, 279 U.S. 716, 729 (1929) ("The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed.").

79 Internal Revenue Code section 162 allows a taxpayer to deduct "ordinary and necessary expenses" incurred in a trade or business. I.R.C. § 162. In the landmark case of *Welch v. Helvering*, the Court held that it was not "ordinary" to pay off the debt of someone else. 290 U.S. 111, 114 (1933) ("Men do at times pay the debts of others without legal obligation or the lighter obligation imposed by the usages of trade or by neighborly amendities, but they do not do so ordinarily, not even though the result might be to heighten their reputation for generosity and opulence."). The Court therefore denied the taxpayer a deduction for paying off the debt of a bankrupt corporation. *Id.* at 116–17. This opinion has been criticized. *See* Conley v. Comm'r, 36 T.C.M. (CCH) 1644 (1977); *see also* KAHN & KAHN, *supra* note 3, at 506–07. Some courts have modified the *Welch* holding by ruling that payment of another's liability is deductible if it was done to promote their own ongoing business. *See* Dietrick v. Comm'r, 881 F.2d 336, 339 (6th Cir. 1989) (citing Jenkins v. Comm'r, 47 T.C.M. (CCH) 238, 246 (1983)).

80 KAHN & KAHN, *supra* note 3, at 506–07. In this situation, the argument for deduction is even stronger since there is no contention that the mistaken payment should be capitalized rather than deducted. This distinction (expense vs. capitalization) is the more proper determination to be made

On the other hand, assume subrogation kicked in but Revlon does not begin to pay Citibank back because of its bankruptcy. Under this scenario, the income tax results are slightly different. Here, normally Citibank would get a deduction for the amount not paid back from Revlon as it would qualify for a bad debt deduction.[81] However, such a deduction may have to be delayed until the lawsuit with lenders was concluded since such lawsuit would provide a reasonable possibility that Citibank would be "repaid" and it would not be bad debt.

Revlon would realize income in the amount of debt that is canceled, but it might not have to recognize the income under the exception for insolvent taxpayers or taxpayers in Chapter 11.[82] Note this treatment should apply even with the Citibank lawsuit since that lawsuit had no bearing on whether Revlon could make its debt payments, it would only affect to whom Revlon owed the money (that it still could not afford to pay). Under this treatment, although the immediate recognition of income would be avoided, Revlon would have to reduce its beneficial tax attributes to the extent of the nonrecognition of cancellation of debt income so it is not a pure exclusion.[83]

Assuming Revlon did not actually have the financial means to pay Citibank back for the loan, it is surprisingly preferable (for federal tax purposes) for Revlon to take the position that subrogation applied when Citibank mistakenly paid the lenders. As noted above, if subrogation did not apply, then Revlon had income equal to the payoff amount since Citibank paid off its loan. As this is not considered "cancellation of debt" for tax purposes,[84] there is no exclusion or nonrecognition provision that would apply and allow Revlon to avoid the immediate income recognition. Even if Revlon was insolvent or in Chapter 11 bankruptcy, if the position was that Citibank paid off the loan and Revlon did not owe anything to anyone, Revlon must include the payment in income. However, if the position was that Citibank merely stepped into the shoes of the creditors when it mistakenly paid Revlon's loan (that is, subrogation applies), then the loan still exists on Revlon's books and

when determining whether an expense was "ordinary" within the meaning of Internal Revenue Code section 162. Comm'r v. Tellier, 383 U.S. 687, 689 (1966). *See also* KAHN & KAHN, *supra* note 3, at 505–06.

81 I.R.C. § 166.

82 I.R.C. § 108(a)(1)(A)–(B). Technically, section 108 is an "exclusion" provision, not a nonrecognition provision. However, since it is possible that the excluded cancellation of debt income will reduce favorable tax attributes, it is possible the exclusion will not be an actual exclusion at all, but merely a deferral of recognizing the income which fits the nonrecognition label. Of course, if the taxpayer has no favorable tax attributes to reduce (an unlikely situation since the taxpayer will be required to reduce their basis in their assets if they do not have other favorable tax attributes) then the provision is a true exclusion. *See* KAHN & KAHN, *supra* note 3, at 159.

83 I.R.C. § 108(b); *see also* KAHN & KAHN, *supra* note 3, at 152–53.

84 This would be considered a satisfaction of the debt by another party.

there was no income effect at that moment. Instead, when the loan was canceled (or reduced) in bankruptcy, the cancellation of debt exception would kick in and Revlon would not be required to report the cancellation of the debt as income.[85] Instead, as noted above, it would have to reduce some of its favorable tax attributes.[86] Although not a pure exclusion, this is likely better than the immediate recognition and inclusion of income.

B. *Possibility 1: Citibank Victory Holds*

The next two sections review what happens for tax purposes once the Citibank litigation is concluded. The tax results are fairly simple if Citibank's Second Circuit victory holds and the lenders return the mistaken payment. Assuming the lenders have the funds to return what was paid, there would be essentially no income tax result to any of the parties for returning the money. The lenders do not get any deduction because they merely step back into their position as a creditor on the original Revlon loan. Other than any deemed interest, the claim of right rule also does not apply. The claim of right rule is a tax doctrine that requires taxpayers to include a payment in income upon receipt, but allows that taxpayer a deduction if, in a later tax year, they are required to return the payment and they do return it.[87] This doctrine is inapplicable to the lenders since they never included the mistaken payment in income (other than the amounts considered interest). Citibank does not have income since it is merely getting back what it paid out in mistake.[88]

For Revlon, the tax results depend on the position that Revlon took when the debt was mistakenly paid. If Revlon took the position that Citibank discharged the loan and subrogation did not apply, Revlon should have recognized income at the time of the payment on account of Citibank paying off its liability. If the lenders return the funds to Citibank, then Revlon is back on the hook for the loan. The returning of the money to Citibank (and the reconstitution of the loan) would appear to be a situation where the claim of right rule should apply.[89] Internal Revenue

85 I.R.C. § 108(a)(1)(A)–(B).

86 I.R.C. § 108(b).

87 *See* KAHN & KAHN, *supra* note 3, at 176.

88 This assumes Citibank did not take an income tax deduction for the payment in the year of the mistaken payment. If Citibank did take a deduction (and assuming the deduction provided Citibank a tax benefit), it will have income for the return of the funds under the tax benefit rule. I.R.C. § 111. *See* Dobson v. Comm'r, 320 U.S. 489 (1943).

89 I use the word "appear" because this is not your typical claim of right situation. The typical claim of right scenario is where a taxpayer receives money (whether by mistake or otherwise). In a later tax year, the taxpayer has an obligation to return the money and does so. Under general tax principles, the taxpayer would have income in the year it received the money and a deduction when it returned it. *See* KAHN & KAHN, *supra* note 3, at 176. Revlon's situation is a bit unusual because

Code section 1341 should apply to provide tax relief to Revlon. Under Internal Revenue Code section 1341, Revlon would either get a credit for the amount of taxes that they paid on the income that they reported for having the debt satisfied by Citibank, or Revlon would get a deduction equal to the amount of money that is returned to Citibank.[90] The taxpayer takes whichever option produces the lower tax liability in the year of the inconsistent event.[91]

However, if Revlon did not report the mistaken loan payment as income and instead held the position that subrogation applied then, as noted above, it continues to owe money, but now it owed Citibank instead of the lenders. Under this scenario, there are no tax consequences to Revlon when the lenders return the funds to Citibank. The debt merely shifts back to the lenders instead of Citibank. This is a nonevent for income tax purposes. With Revlon declaring bankruptcy, it may not have the funds to pay off the loan. If the loan is cancelled (or reduced) during bankruptcy, that would be income to Revlon although the insolvency/bankruptcy exception may kick in to allow Revlon to avoid recognition of income, but still reduce beneficial tax attributes to the extent they avoided income.[92] The lenders would be allowed a bad debt deduction for whatever is not paid to them.[93]

C. *Possibility 2: The Supreme Court Reverses*

Although unlikely, what are the tax results if the Supreme Court reviews the case, reverses the Second Circuit, and reinstates the lenders' victory? For the lenders, there are no tax consequences. They would be entitled to keep the funds that they received from Citibank, but since those funds were payments for a loan, there was no tax consequence for their receipt (other than the amount representing interest). A court victory entitling the lenders to keep the funds would be a nonevent for tax purposes to the lenders.

For Revlon, a reversal would also be a nonevent for tax purposes. If Revlon's position was that subrogation did not apply (and therefore it had

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it never actually received any money; Citibank merely paid off its liability and then the liability returns when a court rules that the lenders have to give the money back. Still, the principle of the claim of right rule applies to this situation, and the payment of the liability is similar to receiving money, so the doctrine should apply.

90 I.R.C. § 1341(a)(4)–(5).

91 I.R.C. § 1341(a).

92 *See supra* notes 82–83 and accompanying text.

93 I.R.C. § 166. The bad debt deduction is for "debts which become worthless in whole or in part . . . " Treas. Reg. § 1.166-1(a)(1). The regulations also state that the "fact that a bad debt is not due at the time of its deduction shall not of itself prevent its allowance under section 166." Treas. Reg. § 1.166-1(c).

recognized income on account of the Citibank debt payment), a lender victory would have no bearing on that income tax position and there would be no tax consequences to Revlon for the tax year that the lenders victory is finalized. If Revlon took the position that subrogation applied and it owed the debt to Citibank at the same terms as the lenders, it still appears that a lender victory would not have any effect on Revlon's immediate income tax position. If the debt had been reduced or canceled in bankruptcy, the tax consequences of that would have already been applied. Finalizing that the debt, after the mistaken payment, was owed to Citibank, rather than lenders, would not alter those consequences, whether all or only some of the debt was canceled in bankruptcy.

Citibank is the one party that would be affected by such a reversal. Citibank may not have deducted the mistaken payment because there was a reasonable possibility that the money would be returned. A final lender victory would eliminate the possibility that Citibank would be getting any money from the lenders. Therefore, if Revlon was also not going to pay Citibank (either because subrogation did not apply or because Revlon had the debt reduced or canceled in bankruptcy) then Citibank would be entitled to deduction either as a loss, bad debt, or general business expense.[94]

CONCLUSION

Mistakes happen, but our sympathy for those that make them does not change the tax consequences. This piece has set out the possible tax consequences whichever way the courts end up ruling in the Citibank case. While corporate law scholars are watching the case with interest, the Internal Revenue Service may also be watching to see what ends up being the final tax consequences for all three of the parties involved.

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94 *See supra* notes 79–80 and accompanying text.