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SECURITIES LAW—CONSIDERATION OF TAX BENEFITS IN PRIVATE DAMAGE ACTIONS UNDER RULE 10b-5—SALCER v. ENVICON EQUITIES, 744 F.2d 935 (2d CIR. 1984)

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SECURITIES LAW—CONSIDERATION OF TAX BENEFITS IN PRIVATE DAMAGE ACTIONS UNDER RULE 10b-5—Salcer v. Environ Equities, 744 F.2d 935 (2d Cir. 1984).

The role of tax benefits in securities law tax shelter fraud litigation has received substantial attention in the courts. In Salcer v. Environ Equities, the Court of Appeals for the Second Circuit ruled that

1. Some have considered tax benefits relevant: Salcer v. Environ Equities, 744 F.2d 935, 943 (2d Cir. 1984) (Rule 10b-5 real estate tax shelter fraud action, court held tax benefits must be considered); Hayden v. McDonald, 742 F.2d 423, 440 (8th Cir. 1984) (state law securities fraud action; court held tax benefits may be relevant to damage computation); Austin v. Loftsgaarden, 675 F.2d 168, 181 (8th Cir. 1982 rehearing en banc 768 F.2d 949 (1985)(suit brought under Rule 10b-5 for a fraudulent tax shelter; held that when applying a rescissionary measure of damages, tax benefits should be considered); Dupuy v. Dupuy, 551 F.2d 1005, 1025 (5th Cir.) (suit brought under Rule 10b-5 for misrepresentation in sale of stock; held tax benefits should be considered in the calculation of damages), cert. denied, 434 U.S. 911 (1977); Gardner v. Surnamer, 608 F. Supp. 1385, 1389 n.3 (E.D. Pa. 1985) (action under Rule 10b-5 for misrepresentation, court stated tax benefits are relevant when considering damages); Smith v. Bader, 83 F.R.D. 437, 439 (S.D.N.Y. 1979) (action for rescission under the federal securities laws where tax benefits are relevant and plaintiffs have placed their incomes in issue, court ordered production of returns for consideration); Houlihan v. Anderson Stokes, Inc., 78 F.R.D. 232, 234 (D.D.C. 1978) (Rule 10b-5 suit where an adversary sought to use the amount of tax losses taken by a party; held such evidence was relevant, and ordered production); Bridgen v. Scott, 456 F. Supp. 1048, 1061-63 (S.D. Texas 1978) (Rule 10b-5 action for rescission of a real estate investment; held evidence of tax consequences relevant and admissible); Berg v. Xerxes-Southdale Office Bldg. Co., 290 N.W.2d 612, 615 (Minn. 1980) (action under state securities law for fraud in a commercial real estate investment, court stated income tax considerations may preclude recovery).

Others have excluded evidence of tax benefits: Burgess v. Premier Corp., 727 F.2d 826, 837-38 (9th Cir. 1984) (action under state and federal securities law for fraud in a cattle tax shelter investment, court excluded evidence of tax benefits); Freschi v. Grand Coal Venture, 588 F. Supp. 1257, 1259-60 (S.D.N.Y 1984) (action for damages under state law and Rule 10b-5; held an investor's tax savings should not be deducted from his damage recovery); Western Federal Corp. v. Davis, 553 F. Supp. 818, 820 (D. Ariz. 1982) (action for rescission under federal securities law; held that the defendants were not entitled to a credit for tax benefits); Rhode v. Hershberger Explorations, Inc., 349 F. Supp. 993, 994 (D. Minn. 1972) (Rule 10b-5 action for a fraudulent oil well tax shelter promotion, court excluded evidence of tax benefits received); Wiesenberger v. W. E. Hutton & Co., 35 F.R.D. 556, 558 (S.D.N.Y. 1964) (action for rescission or damages under federal securities laws; held the defendants were not entitled to a reduction in damages for taxes saved); Cooper v. Hallgarten & Co., 34 F.R.D. 482, 485-86 (S.D.N.Y. 1964) (federal securities law action for rescission; held that the plaintiffs' income tax returns were not relevant to the subject of damages).

2. 744 F.2d 935 (2d Cir. 1984).
any recovery in a Rule 10b-5 real estate tax shelter fraud case, where rescission is impossible, must be reduced by the amount of tax benefits accrued to the plaintiffs. This note, in Part I, will define the operative law which must be considered in any Rule 10b-5 real estate tax shelter litigation. Part II will consider the specific arguments raised in *Salcer*. Finally, in Part III, the note will consider the result reached by the court in *Salcer* and postulate a more expedient one.

I. THE OPERATIVE LAW

Three areas of substantive law affect litigation involving real estate tax shelters: income tax law, partnership law, and securities law. The Joint Commission on Internal Revenue Taxation has defined a real estate tax shelter as an “investment in which a significant portion of the investor’s return is derived from the realization of tax savings on other income as well as the receipt of tax-free cash flow from the in-

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3. The plaintiffs brought suit under SEC Rule 10b-5, 17 C.F.R. § 240.10b-5:
   It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
   (a) To employ any device, scheme, or artifice to defraud,
   (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
   (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.


MANIPULATIVE AND DECEPTIVE DEVICES
   It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange, or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.


4. See infra notes 71-127 and accompanying text.

5. The tax shelter has come under increasing attack in recent years, with one commentator stating: “Tax shelters will be the Achilles heel of the federal income tax if the Administration and the Congress do not move promptly to bring them under control.” Calkins and Updegraft, Tax Shelters, 26 TAX LAW. 493, 519 (1973); see generally Comment, Auditing Partnership Tax Shelters: IRS Procedures and Taxpayer Liability, 60 NEB. L. REV. 564, 564-65 (1981).
investment itself." A tax shelter investor seeks to benefit from a venture through cash flow, tax benefits, and appreciation in equity value, which results in conversion of ordinary income into capital gain.7

The real estate tax shelter normally arises in the partnership context. The partnership is of particular interest to highly compensated individuals because losses may be passed through the partnership and used to offset each partner's individual income.8 Each partner may take his or her share of the partnership losses to the extent of his or her adjusted basis in the partnership interest.9 In real estate shelters, these artificial losses may be greatly increased by the partner's share of nonrecourse financing.10 Utilizing this method, a partner may be able

6. STAFF OF JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, 94TH CONG., 1ST SESS., TAX SHELTERS: REAL ESTATE (1975) [hereinafter cited as TAX SHELTERS].
7. Id. at 2.
8. Section 701 of the Internal Revenue Code provides: "A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities." I.R.C. § 701 (1982). Profit or loss is first determined jointly at the partnership level. This profit or loss is then distributed to the individual partners, and finally included in each partner's individual taxable income. The type of profit or loss is defined further by § 702(b). It provides that the character of any item required to be separately stated by paragraphs (1) through (7) of § 702(a) must be the same as if it were realized by the partner directly from the source from which it was realized by the partnership. I.R.C. § 702(b) (1982).
9. A partner's share of the partnership losses is determined by the partnership agreement. I.R.C. § 704(a) (1982). It provides: "A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this chapter, be determined by the partnership agreement." Id. Section 704(d) limits the amount of losses a partner may take to his adjusted basis in the partnership interest; "[a] partner's distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership . . . " I.R.C. § 704(d) (1982). A further limitation is imposed by § 704(b) which requires the distributive share allocation to have "substantial economic effect." I.R.C. § 704(d) (1982); see A. WILLIS, J. PENNELL & P. POSTLEWAITE, PARTNERSHIP TAXATION chs. 82-83 (1985).
10. Section 465(a)(1) generally permits a partner to take losses "only to the extent of the aggregate amount with respect to which the taxpayer is at risk." I.R.C. § 465(a)(1) (1982). A taxpayer is considered "at risk" with respect to amounts including "(A) the amount of money and the adjusted basis of other property contributed by the taxpayer to the activity, and (B) amounts borrowed with respect to such activity (as determined under paragraph (2))." I.R.C. § 465(b)(1) (1982). A taxpayer is considered "at risk" for amounts borrowed only to the extent he "(A) is personally liable for the repayment of such amounts, or (B) has pledged property, other than property used in such activity, as security for such borrowed amount . . . ." I.R.C. § 465(b)(2) (1982). Therefore, a nonrecourse loan (a loan for which the borrower is not personally liable) generally cannot increase a taxpayer's adjusted basis for the purpose of generating losses, because the amount of the loan is not "at risk." However, real estate borrowings, by virtue of § 465(c)(3)(D), are not subject to the "at risk" limitations. I.R.C. § 465(c)(3)(D) (1982). Thus, a real estate limited partnership investment can still generate extensive artificial losses without the risk of personal liability.
to deduct losses well in excess of his or her personal investment. Because limited partners are generally not personally liable for obligations of the partnership, the majority of real estate tax shelters are limited partnerships. It is the combination of substantial income tax benefits and personal gain coupled with limited personal liability that makes the real estate limited partnership investment so attractive.

The third operative area of law to consider in tax shelter litigation is securities law. For purposes of federal securities law, the Supreme Court has defined a security as any "contract, transaction or scheme whereby a person invests his money in a common enterprise and is lead to expect profits solely from the efforts of a promoter or third party. . . ." Because a real estate limited partnership investor is led to expect profits solely through the activities of the general partner, and limited partners are generally prohibited from interfering with

11. The following example shows how such a scenario might operate:
A hypothetical real estate partnership might show a $50,000 loss in one year. Assume that this loss was obtained by taking the difference between $60,000 of deductible depreciation and $10,000 of gross rents in excess of operating expenses and interest. If the mortgage amortization, a nondeductible expense, were $2,000, then the partnership would have a positive cash flow of $8,000. If under the partnership agreement one limited partner were entitled to 50% of partnership losses and 37.5% of the cash flow, that partner would receive $3,000 in cash, but his tax return would reflect only his share of the partnership's net loss, or $25,000.

12. U.L.P.A. §§ 1 & 7; R.U.L.P.A. § 303. Practitioners should note that an organization which may appear to be a partnership to the parties involved may not be a partnership to the IRS. The Service defines partnership as a "syndicate, group, pool, joint venture or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation." I.R.C. § 7701(a)(2) (1982); see also § 761(a) (1982).

On the other hand, a corporation is defined to include "associations, joint-stock companies, and insurance companies." I.R.C. § 7701(a)(3) (1982). For further clarification the regulations provide six characteristics of a pure corporation: (1) associates; (2) an objective to carry on business; (3) continuity of life; (4) centralization of management; (5) limited liability; and (6) transferability of interest. Treas. Reg. § 301.7701-2 (1984). In deciding whether an organization is a corporation or a partnership, the first two of these are eliminated because they are common to both, and the judgment is made on the basis of the four subsequent characteristics. So long as an enterprise does not have more than two of these four corporate characteristics, the regulations state the enterprise is a partnership for income tax purposes. Id. For further consideration see Zuckman v. United States, 524 F.2d 729 (Ct. Cl. 1975); Commissioner v. Larsen, 66 T.C. 159 (1976); and Rev. Rul. 79-106, 1979-1 C.B. 448.


partnership operations,15 the limited partnership interest is a security,16 and therefore is subject to federal securities laws.17 Rule 10b-5 gives substantial protection to investors in securities.18 It broadly pro-

15. Under § 7 of the Uniform Limited Partnership Act, which has been enacted in 28 states and the District of Columbia, a limited partner's liability remains limited to his investment unless he takes part "in the control of the business." UNIF. LIMITED PARTNER­SHIP ACT § 7, 6 U.L.A. 582 (1969). Section 10(1) provides several very limited activities that a limited partner may perform without participating "in the control of the business":

(a) Have the partnership books kept at the principal place of business of the part­nership, and at all times inspect and copy any of them.

(b) Have on demand true and full information of all things affecting the partnership affairs whenever circumstances render it just and reasonable, and

(c) Have dissolution and winding up by decree of court.

UNIF. LIMITED PARTNERSHIP ACT § 10(1), 6 U.L.A. 590 (1969). Section 303(a) of the Revised Uniform Limited Partnership Act, which has been enacted in 22 states, also restricts a limited partner from taking part "in the control of the business." REVISED UNIF. LIMITED PARTNERSHIP ACT § 303(a), 6 U.L.A. 245-46 (Supp. 1985). Section 303(a) permits a limited partner to participate in several well-defined activities of the partnership without participating in the control of the partnership, and thus without losing his limited partner status. *Id.*

16. SEC regulations and judicial decisions support this conclusion. 17 C.F.R. § 240.3a11-1 (1985)("The term 'equity security' is hereby defined to include any stock or similar security, certificate of interest or ... limited partnership interest. . . ."); SEC v. Holschuh, 694 F.2d 130, 137 (7th Cir. 1982)("There is no dispute that the limited partnership interests constituted securities."); SEC v. Murphy, 626 F.2d 633, 640-41 (9th Cir. 1980)("a limited partnership generally is a security, . . . because, by definition, it involves investment in a common enterprise with profits to come solely from the efforts of others."); Goodman v. Epstein, 582 F.2d 388, 406-07 (7th Cir. 1978)("the very legal requirements for a limited partnership necessitate its including all of the attributes of a 'security' in the interest bestowed upon one of limited partners.").


18. The Securities Exchange Act of 1934 had as a primary purpose full disclosure. See S. REP. No. 47, 73rd Cong., 1st Sess. 1 (quoted in Wilko v. Swan, 346 U.S. 427, 431 (1953)). Rule 10b-5 is based on the expectation that all investors should have "relatively equal access to material information." SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968). The rule has been called the most important securities provision in the United States securities laws. 5 A. JACOBS, THE IMPACT OF RULE 10b-5, § 1 at 1-4 (1980). Courts have traditionally sought to interpret the rule broadly. Because this note considers Rule 10b-5 only peripherally as a fraud provision through which an injured investor may seek damages, its requirements for recovery and other applications will not be considered. These issues have been discussed in great detail by others. See, e.g., 5 A. JACOBS, THE IMPACT OF RULE 10b-5 (1980) (contains a general discussion of the Rule 10b-5 action, its possible applications, and recognized remedies); Ruder & Cross, Limitations on Civil Liability Under Rule 10b-5, 1972 DUKE L.J. 1125 (considers the limiting elements of a Rule 10b-5 civil action); Cox, Fraud Is in the Eyes of the Beholder: Rule 10b-5's Application to Acts of Corporate Management, 47 N.Y.U. L. REV. 674 (1972) (discusses Rule 10b-5's role as a regulator of corporate management); Leader, Threshold Prerequisites to Securities Fraud Class Actions, 48 TEX. L. REV. 417 (1970) (applies federal class action requirements to Rule 10b-5 and other securities fraud provisions); Note, Retributive or Remedial: What is
hibits using the mails or interstate commerce to engage in fraudulent acts "in connection with the purchase or sale of any security," and thus it provides safeguards well in excess of those provided for by common law fraud protections.

II. SALCER

A. The Facts

In Salcer, the plaintiffs were limited partners in Greenspoint Associates, a limited partnership established to construct and manage an apartment complex. The defendants were the general partners of Greenspoint Associates, a 308-unit apartment complex located outside the city of Houston. Plaintiffs purchased their interests based on sales literature developed by the defendants. The literature indicated that the investment would be appropriate only for persons subject to high rates of taxation.

Problems arose when the city of Houston annexed the land involved in September 1981. As a result, there was a forced sale of the property, and each of the purchasers received a substantial loss on the investment.

At this point, the plaintiffs commenced an action in the district court for the Southern District of New York under section 10(b)(5) of the Securities Exchange Act of 1934 and SEC Rule 10b-5. The

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19. See supra note 3.
20. Salcer, 744 F.2d at 937.
21. Id.
22. Id. The purchase price of each unit of the limited partnership was $77,500. The literature provided to the plaintiffs included an October 1977 private placement memorandum and a financial analysis sheet dated October 19, 1977. The literature stated that the Greenspoint Project was to be a 308-unit complex in Harris County Texas, just outside the Houston City limits. Id.
23. Id. Specifically, the memorandum stated:

[Investment in the Units is suitable only for persons of adequate financial means who have no need for liquidity with respect to their investment. Only persons whose income is subject to high rates of income taxation will derive the full economic benefit of the intended tax benefits of this offering.]

Id.
24. Id. at 938.
25. Id. From the sale, each plaintiff received $30,000 per unit, $47,500 short of their investment. Id.
26. See supra note 3.
plaintiffs alleged that the defendants knew or should have known, and failed to disclose, that the city of Houston was planning to annex the land on which the Greenspoint Project was to be built. As a result, costs should have been expected to rise substantially.

The defendants answered, claiming affirmatively that each plaintiff had realized tax benefits in excess of his loss on the investment. In August 1983, the plaintiffs made a motion pursuant to Federal Rule of Civil Procedure 12(c), 12(f) and/or 56 to strike these affirmative defenses. At the close of oral argument, the district court judge granted the 12(f) motion. The defendants then sought an interlocu-

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27. See supra note 3.
28. Salcer, 744 F.2d at 937.
29. Id. Costs could be expected to rise due to (1) the imposition of water, sewer, and building permits, certificates of occupancy, taxes; (2) additional construction requirements such as water and sewer lines; (3) additional roofing, plumbing and electrical work necessary to comply with Houston's building code; and (4) a delay in completion that might jeopardize the project's financing. Id. at 937-38.
30. Id. at 938. The defendants reached this conclusion based on the assumption that each plaintiff was taxed at a marginal rate of at least 50 per cent, an assumption the plaintiffs did not challenge. Id.
31. Rule 12(c) states:
   (c) Motion for Judgment on the Pleadings. After the pleadings are closed but within such time as not to delay the trial, any party may move for a judgment on the pleadings. If, on a motion for judgment on the pleadings, matters outside the pleadings are presented to and not excluded by the court, the motion shall be treated as one for summary judgment and disposed of as provided in Rule 56, and all parties shall be given reasonable opportunity to present all material made pertinent to such a motion by Rule 56.
FED. R. CIV. P. 12(c). Rule 12(f) states:
   (f) Motion to Strike. Upon motion made by a party before responding to a pleading or, if no responsive pleading is permitted by these rules, upon motion made by a party within 20 days after the service of the pleading upon him or upon the court's own initiative at any time, the court may order stricken from any pleading any insufficient defense or any redundant, immaterial, impertinent or scandalous matter.
FED. R. CIV. P. 12(f). Rule 56 states in pertinent part:
   (c) Motion and Proceedings Thereon. The motion shall be served at least 10 days before the time fixed for the hearing. The adverse party prior to the day of hearing may serve opposing affidavits. The judgment sought shall be rendered forthwith if the pleadings, depositions, answers to interrogatories and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law.
FED. R. CIV. P. 56(c).
32. Salcer, 744 F.2d at 938. Rule 12(f) is the "primary procedure for objecting to an insufficient defense." 5 C. WRIGHT AND A. MILLER, FEDERAL PRACTICE AND PROCEDURE § 1380 (1969). Its most important application is when the parties' primary disagreement is about the legal implications of a defense, not controverted facts. Id. at § 1381.
tory appeal pursuant to 28 U.S.C. section 1292(b),\textsuperscript{33} which was granted.\textsuperscript{34}

B. The District Court’s Opinion

In granting the plaintiffs’ Rule 12(f) motion, the district court stated that although “tax considerations come into this case in determining whether there was in fact a fraud committed,”\textsuperscript{35} it would make “no sense to say that any loss to the defrauded investor and hence, any gain or recovery which he is entitled to should be reduced by the tax benefits that he realized.”\textsuperscript{36}

Judge Broderick, the district court judge, reasoned that the tax benefits would have been realized regardless of whether there was a fraud.\textsuperscript{37} The investors could have invested in a different enterprise, realized similar tax benefits, and not have suffered due to the alleged Greenspoint fraud.\textsuperscript{38} Realizing that the issue of tax benefit reduction was of critical importance to the case, Judge Broderick certified the issue as appropriate for review.\textsuperscript{39}

C. The Second Circuit’s Opinion

In the appeal to the Second Circuit, the plaintiffs were joined by the SEC and the Department of Justice Tax Division which both filed amicus curiae briefs. The arguments of each party will be considered individually.

1. The Plaintiffs

The Second Circuit rejected the plaintiffs’ argument that reduction of the award by the amount of tax benefits received would make

\[\text{\textsuperscript{33} The section reads:}
\text{When a district judge, in making in a civil action an order not otherwise appea­}
\text{lable under this section, shall be of the opinion that such order involves a controlling question of law as to which there is a substantial ground for difference of opinion and that an immediate appeal from the order may materially advance the ultimate termination of the litigation, he shall so state in writing in such order.}
\text{The Court of Appeals may thereupon, in its discretion, permit an appeal to be taken from such order. . . .}
\text{28 U.S.C. § 1292(b) (1982).}
\text{\textsuperscript{34} Salcer, 744 F.2d at 938. Since the issue of reduction of the recovery by tax benefits was critical, and the plaintiffs indicated they would drop the suit if they received an adverse ruling, the court granted the defendants’ motion. Id. at 938-39.}
\text{\textsuperscript{35} Id. at 938.}
\text{\textsuperscript{36} Id.}
\text{\textsuperscript{37} Id.}
\text{\textsuperscript{38} Id.}
\text{\textsuperscript{39} Id. See supra note 33.}\]
"the government the banker for fraudulent tax shelter activity." In *Burgess v. Premier Corp.*, the Ninth Circuit ruled that tax benefits in tax shelter fraud litigation should be ignored. The *Burgess* court reasoned that the promoters of the fraudulent investment, not the taxpayers, should bear the burden of the losses. According to *Burgess*, any double benefit to the plaintiff would be avoided by application of the tax benefit rule.

Judge Mansfield, the court of appeals judge, distinguished *Burgess* by reasoning that in *Salcer* the government had already received its end of the bargain. The residential development which the tax incentives were designed to encourage had occurred. He stated further that the court was bound by section 28(a) of the Securities Exchange Act, which limits a plaintiff's recovery to "actual damages," and therefore was compelled to consider the tax benefits the plaintiffs had bargained for and received.

2. The Securities and Exchange Commission

Joined by the plaintiffs, the SEC in its amicus brief argued that the tax benefits should not be considered because they fall within the collateral source rule. The collateral source rule prohibits consideration of benefits received from third parties as a result of separate transactions. Under Rule 10b-5, however, courts have ruled that benefits resulting directly from the transaction under scrutiny must be consid-

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40. Id. at 941, (quoting *Burgess v. Premier Corp.*, 727 F.2d 826, 838 (1984)).
41. 727 F.2d 826 (9th Cir. 1984).
42. Id. at 838.
43. Id; see infra text accompanying notes 98-111 for an explanation of the tax benefit rule.
44. *Salcer*, 744 F.2d at 941.
45. Section 28(a) of the Securities Exchange Act of 1934 reads:

    The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of. . . .

46. See infra notes 72-74 and accompanying text.
47. *Salcer*, 744 F.2d at 941.
48. Id.
49. Generally, the rule states that "[p]ayments made to or benefits conferred on the injured party from other sources are not credited against the tortfeasor's liability, although they cover all or a part of the harm for which the tortfeasor is liable." *Restatement (Second) of Torts* § 920A (2) (1979). The comments provide that the collateral source rule normally applies to insurance policies, employment benefits, gratuities, and social legislation benefits. *Restatement (Second) of Torts* § 920A comment (c)(1)-(4) (1979).
With this standard in mind, the court held that the tax benefits were too closely related to the transaction which led to the loss to be excluded by the collateral source rule. The court, concerned that the plaintiffs might receive an undeserved windfall, rejected the argument for application of the collateral source rule, finding the tax benefits an inextricable part of the real estate tax shelter investment.

The SEC argued further that the plaintiffs' recovery should not be reduced by tax benefits, because such benefits are the equivalent of pre-judgment interest. The purpose of pre-judgment interest is to compensate a party for the loss of the use of his money. Any recovery, the SEC argued, would merely be compensation for any gain the plaintiffs could have accrued with their investment had they gone elsewhere. The court quickly disposed of this argument on two grounds: (1) the tax benefits would be an unreasonably large amount of pre-judgment interest, and (2) treatment of tax benefits as pre-judgment interest was unnecessary.

3. The Tax Division

The Department of Justice Tax Division argued that tax benefits should not be considered because the tax benefits in any case may be illusory. The division relied on Burgess v. Premier Corp., and Western Federal Corp. v. Davis, which held that because amended returns may have to be filed under the tax benefit rule, any economic

51. Saicer, 744 F.2d at 941-42.
52. Id. at 942. Specifically, the court stated:
Assuming proof that the $77,500 investment per unit was induced by fraud, not only would they [the plaintiffs] retain the $97,866 already received per unit ($30,000 upon liquidation plus $67,866 tax savings) but they would gain another $47,500 (i.e., the difference between the $77,500 paid per unit and the $30,000 per unit received upon liquidation) for a total of $145,366. Id.
53. Id.
54. Id.
55. Jacobs, supra note 50 at 1160; see also Cant v. A. G. Becker & Co., 384 F. Supp. 814, 815 (N.D. Ill. 1974) (pre-judgment interest is awarded if plaintiff is denied the use of his money).
56. Saicer, 744 F.2d at 942. In the court's view, the use of the plaintiff's $77,500 investment for two years was clearly not worth the $63,866 of tax benefits the plaintiffs claimed as pre-judgment interest. Id.
57. Id.
58. Id.
59. 727 F.2d 826.
60. 553 F. Supp. 818 (D. Ariz. 1982).
benefit due to tax deductions is illusory. Judge Mansfield, writing for the Second Circuit, stated that the chance or possibility of a challenge and subsequent inclusion does not justify the proposition that those tax benefits should be ignored. Since the IRS has had ample time to act and has not done so, the court will act as though no challenge is anticipated.

Finally, the Tax Division argued that the tax benefit rule should prevent the court from considering the tax consequences. The tax benefit rule requires a taxpayer who takes a deduction and later obtains a recovery to include the amount of that recovery in ordinary income. Under this theory, the government argued that rescissionary damages recovered would amount to a recovery of the purchase price, putting the plaintiffs in the position they would have been in had they never owned the limited partnership interest. Such a recovery, inconsistent with their claimed deductions, would force them to claim the recovery as ordinary income. Actual rescission, if it had been possible in this case, would have forced the Greenspoint general partners (the defendants) to repurchase the limited partners’ (plaintiffs) shares in the project.

The court responded to this argument by noting that actual rescission was impossible in this case, because the project had already been sold. Where actual rescission is unavailable, rescissionary damages may be awarded. The court concluded that under a rescissionary damage theory, the tax benefit rule has no application.

4. The Court’s Conclusion

Although the issue was raised in the context of a motion to strike, which theoretically would not force the court to reach a particular...
decision, Judge Mansfield made it clear that any damage award the plaintiffs would recover must be reduced by any tax benefits received. The result of this holding was to force the plaintiffs to drop their action.70

III. ANALYSIS

A. Actual Damages

It is essential to begin a consideration of this case with an understanding of what damages are recoverable for fraud under the Securities Exchange Act. In a Rule 10b-5 case, the primary place to turn for guidance in determining damages is section 28(a) of the 1934 Act.71 The language of section 28(a) limits recovery to actual damages.72 At the time the Securities Exchange Act was enacted, “actual damages” had an accepted meaning.73 In Birdsall v. Coolidge, the Supreme Court stated, “Compensatory damages and actual damages mean the same thing; that is, that the damages shall be the result of the injury alleged and proved, and that the amount awarded shall be precisely commensurate with the injury suffered...”74 In Osofsky v. Ziff,75 the Second Circuit Court of Appeals stated that “the purpose of section 28(a) is to compensate civil plaintiffs for economic loss suffered as a result of wrongs committed in violation of the 1934 Act.”76 The court’s function, then, is to model a remedy best suited to fit the harm.77 This measure may include “out-of-pocket loss, the benefit-of-the-bargain or some other appropriate standard.”78

B. The Benefit-of-the-Bargain Measure

Although the benefit-of-the-bargain79 measure has been awarded

70. See supra note 34 and accompanying text.
71. See supra note 45 and accompanying text.
72. See supra note 45.
74. 93 U.S. 64, 64 (1876).
75. 645 F.2d 107 (2d Cir. 1981).
76. Id. at 111.
77. Id.
78. Id. at 111. In addition, although § 28(a) clearly does not authorize an award of punitive damages, Green v. Wolf Corp., 406 F.2d 291, 302 (2d Cir. 1968), courts have held that punitive damage awards under state law may be awarded on a pendent state claim, even when suit is brought under § 28(a). Flaks v. Koegel, 504 F.2d 702, 706-07 (2d Cir. 1974); Young v. Taylor, 466 F.2d 1329, 1338 (10th Cir. 1972).
79. The benefit-of-the-bargain measure of damages permits the plaintiff to recover the difference between the value of the securities and the value that was represented by the defendant. Note, The Measure of Damages in Rule 10b-5 Cases Involving Actively Traded Securities, 26 STAN. L. REV. 371, 381 (1974); accord Jacobs, supra note 50 at 1108-09 ("the
under section 28(a), it would be an inappropriate measure in this case. The benefit-of-the-bargain measure of damages permits the plaintiff to recover the difference between the value of the securities and the value that was represented by the defendant. An award of benefit-of-the-bargain damages is only appropriate when such damages can be proved with reasonable certainty. There is no reasonable basis to judge what amount could have been earned on the Greenspoint Project had the investors not been defrauded. Any estimate would be too speculative and cause the court to reject the benefit-of-the-bargain measure.

C. The Out-of-Pocket Measure

The out-of-pocket measure of damages is preferable for the situation in Salcer. This is the traditional measure of damages in Rule 10b-5 cases. Under this method, the plaintiff should recover the difference between the value of what he received in the transaction and the security's purchase price. Therefore, the plaintiffs should be entitled to an amount equal to their original investment, less the amount they received on the forced sale.

Once a court determines that some recovery is warranted, the next problem is how the plaintiffs should recoup their investment. It would be naive to suggest that the tax consequences should not play some part in this decision. As the court stated in Bridgen v. Scott,
asking the jury to consider a tax shelter case without permitting them to consider the tax consequences would be “requiring the jury and the Court to live in an artificial ‘never-never land.’ ”

The Salcer and Austin courts accounted for the tax consequences by reducing any recovery by the amount of tax benefits received. To decide whether this is an expedient result, it should be considered in light of the three parties involved. First, the plaintiffs are compensated to the extent of their out-of-pocket loss. This seems just. Second, the defendants may incur no loss as a result of their fraudulent actions, a result that does not deter the defendants or others from committing similar acts. Third, the government is left to bear a portion of the cost of the defendants’ fraud through tax benefits to the plaintiffs.

Although there is merit to the court’s argument that the government has already received the benefit it bargained for, it is still inexpedient for the government to act as “the banker for fraudulent tax shelter activity.” The defendants are not paying the damages; the government is paying. One purpose of the securities acts is certainly prevention and deterrence, especially if the wrongdoer was conscious of his actions. At least one jurisdiction has ruled that deterrence is the primary motive behind the securities acts. That purpose is not being furthered by allowing government tax benefits to replace defendant liability. Considering the three parties involved, the Salcer result is inexpedient because it leaves the government to bear the cost of the defendant’s fraudulent activity.

87. Id. at 1061.
88. Austin, 675 F.2d 168; Salcer, 744 F.2d 935.
89. A central purpose behind Rule 10b-5 and the securities acts is the protection of investors through full disclosure. Tcherepnin v. Knight, 389 U.S. 332, 336 (1967). Unless the fraudulent defendants are punished, others are not deterred from similar deceptive practices. To achieve this end, any fraud provisions of the securities acts are construed broadly. Greater Iowa Corp. v. McLendon, 378 F.2d 783, 795 (6th Cir. 1967). “Of course, it is well recognized that the securities and exchange legislation has broad remedial purposes for protection of the investing public and should be liberally construed.” Id.
90. Salcer, 744 F.2d at 941.
91. Burgess, 727 F.2d at 838.
93. Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 567 (E.D.N.Y 1971); Note, Ancillary Relief in SEC Injunction Suits for Violation of Rule 10b-5, 79 HARV. L. REV. 656, 663-65 (1966). In some cases criminal penalties may be imposed. Under section 32(a) of the 1934 Act “any person who willfully violates any provision of the chapter” may be subject to criminal penalties. 48 Stat. 904 (1934)(codified as amended at 15 U.S.C. § 78ff(a) (1982)). The purpose behind section 32(a) is to punish the individual and deter others from committing similar acts. Criminal Sanctions in Section 10(b) Actions, supra note 18, at 540.
Since the *Salcer* court's measure of damages is not the most expeditious one, a more appropriate alternative should be sought. The alternative chosen by the district court in *Freschi v. Grand Coal Venture*\(^94\) was to allow recovery without regard to the plaintiff's tax benefits.\(^95\) The district court stated that such a result is equitable because under the tax benefit rule any recovery will be included in the plaintiff's income. As previously stated, the tax benefit rule requires a taxpayer who takes a deduction and later obtains a recovery to include the amount of that recovery in ordinary income for the year of recovery to the extent of the deductions taken.\(^96\) The court in *Freschi* went on to note that were the tax benefit rule to be ignored, "the losers would be the government and plaintiffs, and the only winner would be defendants."\(^97\)

### D. The Tax Benefit Rule

The court in *Salcer* maintained that the tax benefit rule would not apply to the facts of this case. The court stated that because rescissory damages are not the "same as rescission"\(^98\) and are not "inconsistent with the plaintiff's prior tax position,"\(^99\) an award of such damages would not result in application of the tax benefit rule. Under the tax benefit rule, only recoveries fundamentally inconsistent with earlier deductions must be included as income in the current year.\(^100\) A thorough examination will show the court applied the rule incorrectly.

Application of the tax benefit rule is essential in this case; without it a recovery by the plaintiffs would not be taxed. To determine whether a court award of damages is to be taxed as income, it is critical to look at the nature of the action settled.\(^101\) It has long been settled that if the basis of the recovery is an injury to capital, then the recovery is not taxed as income.\(^102\) If, however, the recovery is for loss

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\(^95\) *Id.* at 1260.
\(^96\) Although the tax benefit rule was created in the courts, it has been given the approval of Congress through the enactment of I.R.C. § 111 which limits the rule's application. I.R.C. § 111 (1982).
\(^97\) *Freschi*, 588 F. Supp. at 1260.
\(^98\) *Salcer*, 744 F.2d at 943.
\(^99\) *Id.*
\(^100\) See infra notes 106-111 and accompanying text.
\(^102\) Durkee v. Commissioner, 162 F.2d 184, 186 (6th Cir. 1947).
of profits,\textsuperscript{103} or punitive damages,\textsuperscript{104} then the recovery is taxable. The burden of proving that the settlement represents a recovery of capital rather than ordinary income rests with the taxpayer.\textsuperscript{105} Because plaintiffs' claim for damages in \textit{Salcer} is for recovery of their original capital investment, any monies received from a damage award would not be treated as income, and therefore would not be taxed.

Since the recovery would not be taxed as income, the recovery will only be taxed if the tax benefit rule is applied. In \textit{Hillsboro National Bank v. Commissioner},\textsuperscript{106} the Supreme Court stated that "[t]he basic purpose of the tax benefit rule is to achieve rough transactional parity in tax . . . and to protect the Government and the taxpayer from the adverse effects of reporting a transaction on the basis of assumptions that an event in a subsequent year proves to be erroneous."\textsuperscript{107} Although not all recoveries will justify application of the tax benefit rule,\textsuperscript{108} the recovery of a loss is the prototypical event that invokes the rule.\textsuperscript{109} In \textit{Hillsboro}, the Supreme Court stated that if a later event is "fundamentally inconsistent with the premise on which the deduction was initially based,"\textsuperscript{110} then the income from that transaction will be included as income in the current taxable year.\textsuperscript{111}

\begin{itemize}
  \item \textsuperscript{103} Sager Glove Corp. v. Commissioner, 311 F.2d 210, 211 (7th Cir. 1962). If the injury is for loss of profits, the claim also determines the nature of the income realized. Sanders v. Commissioner, 225 F.2d 629, 635 (10th Cir. 1955).
  \item \textsuperscript{104} Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955) (money received as exemplary damages or the punitive two-thirds portion of an antitrust treble damage recovery must be reported as income).
  \item \textsuperscript{105} Morse v. United States, 371 F.2d 474, 483 (Ct. Cl. 1967) (court found gain realized from the sale of a partnership interest was a gain from the sale of a capital asset, rather than ordinary income).
  \item \textsuperscript{106} 460 U.S. 370 (1983).
  \item \textsuperscript{107} \textit{Id.} at 383; see Bittker & Kanner, \textit{The Tax Benefit Rule}, 26 U.C.L.A. L. REV. 265, 270 (1978).
  \item \textsuperscript{108} As the Supreme Court stated:
    Not every unforeseen event will require the taxpayer to report income in the amount of his earlier deduction. On the contrary, the tax benefit rule will 'cancel out' an earlier deduction only when a careful examination shows that the later event is fundamentally inconsistent with the premise on which the deduction was initially based.
    \textit{Hillsboro}, 460 U.S. at 383.
  \item \textsuperscript{109} See Bittker and Kanner, \textit{supra} note 107 at 273.
  \item \textsuperscript{110} \textit{Hillsboro}, 460 U.S. at 383.
  \item \textsuperscript{111} \textit{Id.} at 389. In his dissent, Justice Stevens criticized the \textit{Hillsboro} majority for causing uncertainty in result and enlarging the tax gatherer's discretion to reexamine past transactions. \textit{Id.} at 416.
\end{itemize}
E. Rescissionary Damages\textsuperscript{112}

The question now becomes whether a recovery of rescissionary damages is inconsistent with the deductions taken by the plaintiffs. If such a recovery is inconsistent, then it would have to be included as income in the year recovered. As the Court of Appeals points out, if this were a case of actual rescission, the tax benefit rule would apply.\textsuperscript{113}

Rescission revokes the bargain between the parties and attempts to return them to their prior position.\textsuperscript{114} Rescissionary damages are awarded when actual rescission is no longer possible.\textsuperscript{115} Since the Greenspoint Project had already been sold, the option of rescission was foreclosed, and a rescissionary theory had to be employed. Generally, rescissionary damages equal the fair value paid, measured at the time of purchase, less the fair value paid at the time of sale.\textsuperscript{116} Rescissionary damages seek the same end as rescission, to place the plaintiffs in the position they would have been in had they never entered the bargain. In fact, courts use identical language in defining the two theories of damages. Both seek to return the injured parties to the "status quo ante."\textsuperscript{117}

To state that an award of rescission is fundamentally inconsistent with the plaintiffs’ deductions, and an award of rescissionary damages is not, is to elevate form over substance. Both yield the same result, for the same reasons, but utilize somewhat different means. It is a fundamental concept of taxation that substance should not be exalted over form.\textsuperscript{118} Application of the Code should never turn on “attenu-

\textsuperscript{112} This note consistently uses the term \textit{rescissionary damages}. However, courts and commentators referring to this theory have used several terms: \textit{rescissionary}, \textit{recessory}; and \textit{rescissional}; \textit{Salcer}, 744 F.2d at 943 \textit{rescissionary}; \textit{Austin}, 768 F.2d at 957 \textit{recessory}; Jacobs, \textit{supra} note 50 at 1114 \textit{rescissional}.

\textsuperscript{113} The rule could apply to \textit{Burgess}, 727 F.2d 826, where actual rescission occurred. The court in \textit{Salcer} is correct in pointing out that the court in \textit{Burgess} incorrectly applied the rule. The plaintiffs in \textit{Burgess} would not be required to amend their previous returns but would be required to include any recovery as income in the current year.

Courts that have considered the issue of rescission and the tax benefit rule have not reached consistent results; see Note, Tax Consequences of Rescission: The Interplay Between Private and Public Law, 42 U. Chi. L. Rev. 562, 575 & n.55 (1975).

\textsuperscript{114} \textit{Myzel} v. \textit{Fields}, 386 F.2d 718, 742 (9th Cir. 1967), \textit{cert. denied}, 390 U.S. 951 (1968).

\textsuperscript{115} \textit{Id.} at 742 & n.18.

\textsuperscript{116} \textit{See} Jacobs, \textit{supra} note 50 at 1118-19.

\textsuperscript{117} \textit{Garrett}, 559 F.2d at 1361; \textit{Myzel}, 386 F.2d at 742.

\textsuperscript{118} \textit{Frank Lyon Co.} v. \textit{United States}, 435 U.S. 561, 572-73 (1978); \textit{Commissioner} v. \textit{Court Holding Co.}, 324 U.S. 331, 334 (1945); \textit{Gregory} v. \textit{Helvering}, 293 U.S. 465, 470 (1935). In a myriad of factual situations, the courts, while applying the Code, have looked beyond the form of the transaction involved, and evaluated the substance to discern the
ated subtleties.”

Rescissory damages attempt to return injured plaintiffs to the status quo ante. Any deductions taken by the plaintiffs must be considered fundamentally inconsistent with a recovery that places the plaintiff in a position equivalent to what they would have been in had the transaction never occurred. Interest deductions taken for loans considered to have never occurred, or depreciation deductions for projects considered to have never existed, must present a fundamental economic reality of the transaction. Commissioner v. Tower, 327 U.S. 260, 291 (1946) (court determined no real partnership existed between husband and wife, and income was properly attributable solely to husband); O'Hare v. Commissioner, 641 F.2d 83, 85 (2d Cir. 1981) (court held taxpayer was a guarantor in substance, not a joint venturer, and therefore held fees were ordinary income rather than capital gain); Republic Petroleum Corp. v. United States, 613 F.2d 518, 524 (5th Cir. 1980) (taxpayer attempted to cloak assumption of a mortgage into a promissory note, the court looked to the substance of the transaction, and held taxpayer's intention could not have been anything other than to assume the mortgage); United States v. Kennedy Construction Co. of NSB Inc., 572 F.2d 492, 496 (5th Cir. 1978) (contractor made advances to subcontractor for the specific purpose of paying wages to specific employees, court held substance of the transaction was a direct payment by contractor to subcontractor's employees, and thus contractor was liable for taxes which should have been withheld); Johnson v. Commissioner, 495 F.2d 1079, 1083 (6th Cir. 1974) (court held description of transaction as “part sale and part gift” or “net gift” had no effect on the substance of the transaction); Stahl v. United States, 441 F.2d 999, 1001 (D.C. Cir. 1970) (court determined loan of securities to a securities firm was in substance a bailment, and did not create a debtor-creditor relationship); Comtel Corp. v. Commissioner, 376 F.2d 791, 796-797 (2d Cir. 1967) (court held substance of transaction was a loan with security rather than a purchase and resale of stock, and hence taxpayer was forced to recognize ordinary income); Palmer v. Commissioner, 354 F.2d 974, 975 (1st Cir. 1965) (taxpayers transferred real property to a corporation wholly owned by them, and carried out a previously arranged sales contract, court held the sale was actually made by the taxpayers); Foxman v. Commissioner, 352 F.2d 466, 469 (3d Cir. 1965) (court determined that transaction between two partners to buy out third partner was in substance a purchase and sale for tax purposes rather than a liquidation of the retiring partner’s interest); Estate of Smith v. Commissioner, 313 F.2d 724, 730 (8th Cir. 1963) (court found substance of a partnership agreement was for employment services, and fees constituted payment for services and not a distributive share of partnership income); Garcia v. Commissioner, 80 T.C. 491, 495 (1983) (court held interim steps taken by the taxpayer did not preclude transaction from qualifying as an exchange of like kind property, when in substance the same result was intended and achieved); Brountas v. Commissioner, 73 T.C. 491, 582 (1979) (taxpayer’s characterization of payments as management fees was disallowed, because in substance payments were commissions); Johnson Investment & Rental Co. v. Commissioner, 70 T.C. 895, 903 (1978) (taxpayer claimed payments were rent, court held substance of transaction indicated payments were actually mineral royalties); Buddy Schoellkopf Products, Inc. v. Commissioner, 65 T.C. 640, 657 (1975) (court held cost of leasehold improvements had to be amortized over useful life of improvements rather than lease period, because it was apparent the length of lease term was indefinite).


120. Generally, an interest deduction is allowed for “all interest paid or accrued within the taxable year on indebtedness.” I.R.C. § 163(a) (1982).

121. Reasonable depreciation deductions are permitted as an “allowance for exhaus-
tal inconsistency. The tax benefit rule would require any rescissionary damage recovery by the plaintiffs to be included in income. In Freschi,\textsuperscript{122} the district court stated that were this application of the tax benefit rule to be ignored, "the losers would be the government and the plaintiffs, and the only winner would be the defendants."\textsuperscript{123} If a party is to benefit, "[i]t is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them."\textsuperscript{124}

Reduction of damages by the tax benefits received also has the result of discouraging defrauded investors from suing. The Supreme Court has stated that the securities acts were designed to encourage private actions.\textsuperscript{125} Furthermore, where federally secured rights are violated, courts are given wide latitude to "provide such remedies as are necessary to make effective the congressional purpose."\textsuperscript{126} Given this discretion, it would be improvident to rely on the subtle distinction between rescission and rescissionary damages. In light of these considerations, the more expedient rule would be to exclude evidence of tax benefits with the understanding that application of the tax benefit rule will result in the inclusion of the recovery in the plaintiff's income.

IV. Conclusion

In Salcer, the Second Circuit Court of Appeals held that a Rule 10b-5 damage award must be reduced by any tax benefits received by the plaintiff.\textsuperscript{127} Although this rule is a reasonable one, it is not the most expedient. If we consider the interests of the plaintiffs, the defendants, and the government, it is more appropriate to place the burden, wear and tear" on property "used in the trade or business," or "property held for the production of income." I.R.C. §§ 167(a)(1) & (2) (1982).

\begin{itemize}
\item \textsuperscript{122} 588 F. Supp. 1257 (S.D.N.Y. 1984).
\item \textsuperscript{123} Id. at 1260.
\item \textsuperscript{124} Janigan v. Taylor, 344 F.2d 781, 786 (1st Cir.), cert. denied, 382 U.S. 879 (1965) (quoted in Myzel v. Fields, 386 F.2d 718, 747 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968)).
\item \textsuperscript{125} J. I. Case Co. v. Borak, 377 U.S. 426, 432 (1964). Private actions provide "a necessary supplement" to actions by the government. "[T]he possibility of civil damages serves as a most effective weapon in enforcement. . . ." Id.
\item \textsuperscript{126} Id. at 433; the Supreme Court explained this principle: Moreover, where federally protected rights have been invaded, it has been the rule from the beginning that courts will be alert to adjust their remedies so as to grant the necessary relief. And it is also well settled that where legal rights have been invaded, and a federal statute provides a general right to sue for such invasion, federal courts may use any available remedy to make good the wrong done.
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\item \textsuperscript{127} 744 F.2d 935 (2d Cir. 1984).
\end{itemize}
den on the fraudulent parties, the defendants. Such a decision would prevent the court from reducing a damage award by the amount of tax benefits received.

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