

# Notes

## Federal Income Tax Treatment of Payments Pursuant to § 16(b) of the Securities Exchange Act of 1934

For the past eight years the Tax Court has feuded with various United States courts of appeals over the tax deductibility of payments in satisfaction of alleged liability under § 16(b) of the Securities Exchange Act of 1934.<sup>1</sup> The Tax Court has consistently held that payments made pursuant to § 16(b) are ordinary and necessary business expenses deductible under § 162 of the Internal Revenue Code of 1954.<sup>2</sup> The Commissioner has appealed each of these decisions, and the various courts of appeals have consistently found that the § 16(b) payments are not deductible under § 162 of the Code, but are capital losses.<sup>3</sup> The significance of this judicial confrontation for the taxpayer is that the tax benefit is potentially much greater if § 16(b) payments are characterized as fully deductible ordinary and necessary business expenses rather than capital losses with limited deductibility. This Note will examine the alternative approaches to the problem of the tax treatment of § 16(b) payments.

### I. BACKGROUND

Section 16(b) is designed to discourage the unfair use of information that may be obtained by an officer, director, or beneficial owner

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1. 15 U.S.C. 78p(b) (1970):

For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

2. I.R.C. § 162(a) provides in pertinent part: "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . ." This deduction will hereinafter be referred to as the "business expense deduction."

3. I.R.C. § 165(f).

of more than ten percent of the stock of a corporation. It provides, in part, that any profit realized by such an "insider" from any purchase and sale or any sale and purchase of any equity security of the corporation within a period of less than six months is recoverable by the corporation. In 1951 the Tax Court initially tangled with the problem of characterizing a § 16(b) liability payment in *Davis v. Commissioner*.<sup>4</sup> In that case the Tax Court reasoned that the obligation imposed by § 16(b) was penal in nature and thus the deduction should be disallowed; otherwise the deduction would lessen the financial sanction and defeat the purpose of the securities statutes. This rationale was consistent with the Internal Revenue Service's position that deduction for payments of fines and penalties should be disallowed as contrary to defined public policy.<sup>5</sup> The Commissioner later acquiesced in the *Davis* holding.<sup>6</sup>

Five years later the Tax Court reached a different result in *Marks v. Commissioner*.<sup>7</sup> The taxpayer's partnership in *Marks* dealt in shares of stock of a corporation in which taxpayer was both director and shareholder. Later, taxpayer became suspicious of a § 16(b) violation and, in order to avoid injury to his business reputation and costly litigation, he paid the full amount of his possible liability to the corporation. No determination of liability was ever made by the Securities Exchange Commission. Faced with these facts, the court was persuaded that public policy would not be frustrated by allowing Mark a deduction for the amount of the payment pursuant to § 23(a) of the Internal Revenue Code of 1939.<sup>8</sup> In turn, the Internal Revenue Service agreed, stating that § 16(b) liability is not a penalty, but merely means to return the benefit derived from the stock dealings to the issuing corporation. Thus, the public policy of the securities statute would not be hindered by allowing a deduction for the amount returned to the corporation.<sup>9</sup>

Once it was established that a deduction would be allowed, the question became which deduction was to be allowed—a business expense deduction or the more limited capital loss deduction.<sup>10</sup> The Revenue Ruling following *Marks* addressed the issue only briefly. It indicated that the loss was to be characterized as ordinary or capital depending upon the characterization of the stock dealings giving rise to the § 16(b) payments.<sup>11</sup>

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4. 17 T.C. 549 (1951).

5. Ct. D. 1819, 1958-1 C.B. 502.

6. I.T. 4069, 1952-1 C.B. 28.

7. 27 T.C. 464 (1956).

8. Current version at I.R.C. § 162(a).

9. Rev. Rul. 61-115, 1961-1 C.B. 46.

10. In *Marks*, taxpayer was a securities dealer and the gain from his stock dealings was ordinary income. Thus, the nature of the deduction was not in question.

11. Rev. Rul. 61-115, 1961-1 C.B. 46.

## II. RECENT CASES

A. *Mitchell v. Commissioner*

The Tax Court's next encounter with the issue of the characterization of a § 16(b) payment came in *Mitchell v. Commissioner*.<sup>12</sup> Taxpayer in that case was a vice president in charge of styling for General Motors. Unaware of § 16(b), he apparently violated the provision when in October 1962 he sold 2,736 shares of GM common stock and within the prohibited six month period purchased 2,130 shares of GM stock under an employee stock option. Although no determination of liability was ever made and despite one possible defense,<sup>13</sup> Mitchell was advised by legal counsel to pay his potential liability to GM. Accordingly, he paid GM \$17,939.29 but maintained that he had not violated § 16(b). Had Mitchell refused to pay this alleged liability, GM would have been required to report the alleged violation in its annual proxy statement,<sup>14</sup> which was circulated to over one million stockholders. Moreover, GM or one of its stockholders would almost certainly have instituted a suit against taxpayer.

Mitchell claimed a business expense deduction for the payment to GM. The Commissioner disallowed the more favorable business expense deduction and characterized the payment as a long-term capital loss. The Tax Court held that the taxpayer was in the business of being a corporate officer, that the payment was made to avoid expensive litigation and injury to his business reputation, and thus that he had properly claimed an ordinary business deduction. The Court of Appeals for the Sixth Circuit reversed,<sup>15</sup> finding the business purpose for the payment irrelevant because of the precedent of *Arrowsmith v. Commissioner*<sup>16</sup> and *United States v. Skelly Oil Co.*<sup>17</sup>

In *Arrowsmith* the taxpayer had received payments in 1937-1940 pursuant to liquidation of a jointly owned corporation, and had reported this income as a capital gain. In 1944 a judgment against the corporation was satisfied by the taxpayer as transferee of the corporation. Taxpayer claimed ordinary business deductions on his income tax return for this expenditure. The Commissioner argued that the payment was a part of the original liquidation and should therefore be treated as a capital loss.<sup>18</sup>

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12. 52 T.C. 170 (1969), *rev'd*, 428 F.2d 259 (6th Cir. 1970), *cert. denied*, 401 U.S. 909 (1971).

13. 428 F.2d at 261. Mitchell felt that he was not an "officer" within the meaning of § 240.3b-2 of the General Rules and Regulations, Securities Exchange Act of 1934, 17 C.F.R. § 240.3b-2 (1976).

14. General Rules and Regulations of the Securities Exchange Act of 1934, 17 C.F.R. § 240-14a-101, Item 7e, Instruction (4) (1976).

15. *Mitchell v. Commissioner*, 428 F.2d 259 (6th Cir. 1970).

16. 344 U.S. 6 (1952).

17. 394 U.S. 678 (1969).

18. 344 U.S. at 8.

The Supreme Court reasoned in *Arrowsmith* that if the satisfaction of the judgment had occurred during the liquidation proceedings instead of after the liquidation, the payment would be properly classified as a capital loss rather than a business loss, and the fact that the payment was made after liquidation did not transform the capital loss into a business expense.<sup>19</sup> The Court stated that this reasoning did not violate the annual accounting principle, which divides each year into a separate taxable unit. Rather, the Court said, it was not attempting to reopen the prior taxable years, but was merely examining these prior taxable years to characterize a transaction that had occurred in the latter taxable year.<sup>20</sup>

A majority of the Tax Court had found the facts in *Mitchell* distinguishable from *Arrowsmith* and its progeny.<sup>21</sup> According to the Tax Court, the sale of GM stock that produced a long-term capital gain and the purchase that allegedly created a § 16(b) liability were separate and distinct transactions, while the receipt of the liquidation proceeds and payment of the judgment by the transferee of the corporation in *Arrowsmith* were integrally connected. The Tax Court came to this conclusion by reasoning that while the sale of securities had tax consequences because it completed a capital gain transaction, the follow-up purchase had only securities law significance in that it created a possible liability to GM. The Tax Court considered it noteworthy that actual profit or loss from the sale-purchase occurrence might in some transactions differ in amount from the "§ 16(b) profit" as calculated pursuant to the securities regulations.<sup>22</sup> For example, an insider might buy stock at twenty dollars and one year later sell the same stock at ten dollars, incurring a loss. But if within the statutory period of six months the insider purchases other stock of the same corporation at five dollars, he has a § 16(b) profit of five dollars. Further separating the payment from the stock transaction, the Tax Court found that Mitchell's payment was not made in concession of liability, but to avoid injury to his business reputation.

Judge Drennen, joined by Judge Tietjens in a concurring opinion in *Mitchell*, cautioned against dismissing *Arrowsmith* so summarily and suggested that if it were not for the ultimate determination that the payment was for business reasons, *Arrowsmith* might require the payment to be treated as a capital loss deduction. Judge Drennen also suggested a third possible treatment for the payment which was no

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19. *Id.*

20. *Id.* at 8-9.

21. For cases that have followed *Arrowsmith*, see *Rees Blow Pipe Mfg. Co.*, 41 T.C. 59 (1964), *aff'd*, 342 F.2d 990 (9th Cir. 1965); *Estate of Shannonhouse*, 21 T.C. 422 (1953); *Alvin E. Lowe*, 44 T.C. 363 (1953).

22. See generally L. LOSS, *SECURITIES REGULATION* 1062-64 (2d ed. 1961).

urged by either party: that the amount of the payment be considered as additional cost of the newly purchased stock.

According to the court of appeals, the reason for the Tax Court's reluctance to apply *Arrowsmith* was that the recent case of *United States v. Skelly Oil Co.*<sup>23</sup> was not brought to its attention. The court of appeals explained: "From our study of *Skelly Oil* this Court is convinced that if the Tax Court had considered *Skelly Oil* it would have applied the *Arrowsmith* doctrine in the present case and held that the amount paid by the taxpayer to GM must be treated as a capital loss deduction."<sup>24</sup>

In *Skelly Oil* the defendant was an Oklahoma producer of natural gas. Prior to 1938, taxpayer had adjusted its prices in compliance with a minimum price order of the Oklahoma Corporation Commission. After that minimum price order was overturned by the Supreme Court in 1958,<sup>25</sup> the defendant was forced to settle with a number of its customers for overcharges. Taxpayer claimed ordinary business deductions for the full amount of these refunds, totaling \$505,536.54. The Commissioner disallowed the deduction for the full amount of refunds because originally the overcharge income of \$505,536.54 was subject to an oil depletion allowance of 27.5%, which resulted in taxation on only \$366,513.99, or 72.5% of this income. The Commissioner argued that taxpayer should not be allowed a \$505,536.54 deduction for a refund to customers of only \$366,513.99 of taxable income.

The Supreme Court agreed, holding that the taxpayer should not be allowed "the practical equivalent of double deduction."<sup>26</sup> To hold otherwise, the Court added, would allow the corporation a deduction for refunds to customers that were not taxed when received.<sup>27</sup> Significantly, the majority found this reasoning parallel with that of *Arrowsmith*: "The rationale for the *Arrowsmith* rule is easy to see; if money was taxed at a special lower rate when received, the taxpayer would be accorded an unfair tax windfall if repayments were generally deductible from receipts taxable at the higher rate applicable to ordinary income."<sup>28</sup> Also, as in *Arrowsmith*, the majority defended its decision as not violative of the annual accounting concept because prior tax years were not reopened, but simply examined to determine the nature of later deductions.<sup>29</sup>

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23. 394 U.S. 678 (1969).

24. 428 F.2d at 262.

25. Michigan-Wisconsin Pipe Line Co. v. Corporation Comm'n, 355 U.S. 425 (1958).

26. 394 U.S. at 684 (citing *Charles Ifield Co. v. Hernandez*, 292 U.S. 62, 68 (1934)).

27. 394 U.S. at 685.

28. *Id.*

29. *Id.*

### B. *Anderson v. Commissioner*

The Tax Court proved the Sixth Circuit's prediction wrong with its decision in *Anderson v. Commissioner*.<sup>30</sup> Faced with facts almost identical to those in *Mitchell*, the Tax Court allowed Anderson, a vice president of Zenith Corporation, a business expense deduction for payment of an alleged § 16(b) liability, instead of limiting him to a capital loss deduction as urged by the Commissioner. The court came to this holding despite *Skelly Oil*, again deciding that the sale of stock giving rise to a capital gain and the subsequent purchase giving rise to § 16(b) liability were not sufficiently related to satisfy the "integral relationship" test of *Arrowsmith* and its progeny.<sup>31</sup>

In addition, the Tax Court argued that the taxpayer received his gain from the sale in the capacity of a stockholder, but was allegedly liable under § 16(b) for the subsequent purchase as an insider. This distinguished *Arrowsmith*, in which the corporate liquidation produced a capital gain for the taxpayer in his role as a stockholder, and his subsequent payment, satisfying a judgment against the corporation, was also made in the capacity of a stockholder. Similarly, the Tax Court considered the taxpayer in *Skelly Oil* as having both earned the income and refunded the overcharges in the capacity of a supplier of gas. Thus, in *Arrowsmith* and *Skelly Oil* respectively, the tax gains and losses were incurred in identical capacities, while in *Anderson* the gain was achieved as a stockholder and the loss was incurred because of taxpayer's status as an officer of Zenith. Acknowledging that *Skelly Oil* forbade unfair tax windfalls and "the practical equivalent of double deduction,"<sup>32</sup> the Tax Court contended that *Skelly Oil* applied only in the narrow context of a taxpayer receiving and surrendering money in the same capacity.

Accordingly, the Tax Court held that while taxpayer believed that he had not violated securities law, he reasonably foresaw that his failure to comply with Zenith's demands for payment would jeopardize his business reputation and position. Thus, his claim of a business expense deduction under § 162(a) of the Code was proper.

Judge Dawson of the Tax Court, joined by Judge Quealy, dissented in *Anderson*. They disagreed with the majority's finding that the payment of the alleged § 16(b) liability was not integrally related to the original stock sale. Nor were the dissenters impressed by their colleagues' analysis of the different capacities of the taxpayer in *Anderson*. They concluded that *Arrowsmith* and *Skelly Oil* were applicable. The dissenters further criticized the majority for leaving unresolved

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30. 56 T.C. 1370, *rev'd*. 480 F.2d 1304 (7th Cir. 1973).

31. See cases cited note 21 *supra*.

32. 394 U.S. at 684 (citing *Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62, 68 (1934)).

the question of treatment of two other classes of "insiders,"<sup>33</sup> emphasizing the obvious inequity of allowing a business expense deduction to an officer-insider for the protection of his career, while granting the limited capital loss deduction to a director or ten-percent stockholder-insider because in those capacities they have no "trade or business"<sup>34</sup> reputation to protect.

The Commissioner appealed the decision of the Tax Court in *Anderson* to the Court of Appeals for the Seventh Circuit.<sup>35</sup> The court of appeals disagreed with the Tax Court's determination that the sale of stock resulting in capital gain for the taxpayer was not directly tied to the § 16(b) payment to Zenith. As the majority opinion expressed it: "Bifurcating the sale and payment smacks of artificiality."<sup>36</sup> The court of appeals supported this view by explaining that the amount of § 16(b) liability to the corporation is determined by subtracting the purchase price from the sales price.<sup>37</sup> The court also noted that in some cases interest, calculated from the sales date, could be demanded of a § 16(b) violator.<sup>38</sup>

The court of appeals concluded that because the sale resulting in a capital gain and the payment of the alleged liability were integrally connected, the *Arrowsmith* doctrine was applicable. Thus, the deduction for the payment should have been limited to a capital loss because the gain, to which the payment was so closely tied, was taxed as a capital gain. The court made little mention of the *Skelly Oil* interpretation of *Arrowsmith*, saying only that *Arrowsmith* was relevant to *Anderson* with or without the "double deduction" interpretation of *Skelly Oil*.

The court of appeals also attacked the Tax Court's distinguishing *Arrowsmith* from *Anderson* on the basis of the capacities of the taxpayer. The court substituted its own capacity analysis, reasoning that the taxpayer had sold the stock as an insider and payment was demanded of him in the identical capacity of an insider.

Perhaps the strongest argument advanced by the court was based upon the purpose and operation of § 16(b). The majority explained

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33. 15 U.S.C. § 78p(a) (1970).

34. I.R.C. § 162(a). See *Higgins v. Commissioner*, 312 U.S. 212 (1941). *But cf. Cummings v. Commissioner*, 60 T.C. 91, *aff'd on rehearing*, 61 T.C. 1 (1973), *rev'd*, 506 F.2d 449 (2d Cir. 1974), *cert. denied*, 421 U.S. 913 (1975) (the Tax Court allowed a business expense deduction to a director).

35. *Anderson v. Commissioner*, 480 F.2d 1304 (7th Cir. 1973).

36. *Id.* at 1307.

37. Normally, the § 16(b) liability is calculated by subtracting the purchase price from the sales price. However, when the purchase is made pursuant to an option acquired more than six months prior to exercise, the § 16(b) liability is calculated by subtracting the lowest market price of any security of the same class within six months before or after the date of the sale from the sales price. 17 C.F.R. § 240.16b-6(a) and (b). See, e.g., *Kornfeld v. Eaton*, 327 F.2d 263, 265 (2d Cir. 1964) (purchase made pursuant to an option acquired more than six months prior to its exercise).

38. See, e.g., *B. T. Babbit, Inc. v. Lachner*, 332 F.2d 255, 258 (2d Cir. 1964).

that if an insider-officer engaged in short-swing trading in obvious violation of § 16(b), realizing a capital gain, and then was allowed a business deduction for the full payment in satisfaction of the securities law violation, the effectiveness of § 16(b) would evaporate. In *Anderson*, if the taxpayer was allowed a full business expense deduction, he would enjoy a tax benefit of \$21,897.64 more than if he was limited to a capital loss deduction. Essentially, the court of appeals criticized the Tax Court approach because the taxpayer could, by entering a short-swing securities transaction and taking advantage of information available to him as an insider in the corporation, end up with a "profit"<sup>39</sup> at the expense of the Treasury. In effect the Government would subsidize the § 16(b) violator in the amount of the deduction.

In a dissent in *Anderson*<sup>40</sup> Judge Campbell recognized the major thrust of the majority's opinion to be that it was unfair to allow an apparent violator of § 16(b) to lessen the financial sanction of that section at the expense of the federal government. But he countered that this effect was irrelevant and that the judiciary was not responsible for insuring fairness and symmetry between the Code and other statutes.<sup>41</sup> For Judge Campbell the logic was simple: § 162 allows deductions for business expenses and the taxpayer made the payments to Zenith for business purposes. Thus, he agreed with the holding of the Tax Court allowing taxpayer an ordinary business deduction rather than a capital loss deduction.

### C. *Cummings v. Commissioner*

The third confrontation between the Tax Court and the courts of appeals over the deductibility of § 16(b) liability payments was *Cummings v. Commissioner*.<sup>42</sup> Taxpayer in this case was a director for Metro-Goldwyn-Mayer (MGM) who made a sale and purchase of

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39. "Profit" here means tax profit in the sense that the taxpayer is taxed at the lower capital rate upon receiving his gain, but is allowed a full deduction for disgorgement of part of that gain. It cannot be said that the taxpayer profits, in the ordinary sense of the word, from his § 16(b) transaction because he must return the difference between the sale price and the repurchase price to the corporation. A taxpayer faced with the choice of violating § 16(b) by making a transaction within six months of a prior transaction or avoiding § 16(b) by waiting for the six months to expire before making a subsequent transaction should always choose to avoid § 16(b). The wise taxpayer would escape the statutory requirement of returning the § 16(b) profits to the corporation. Although the unwise taxpayer would obtain a deduction, he has lost a profit which he would otherwise enjoy if he had avoided § 16(b) by waiting. The unwise taxpayer's deduction, even if allowed as a full business expense deduction, could not equal the benefit of the wise taxpayer's profit unless his tax rate was one hundred percent or greater. The unwise taxpayer's deduction will soften his loss, but it will not eliminate it. Thus, a taxpayer would not knowingly violate § 16(b) to obtain this tax treatment, whether it be a full business expense deduction or a capital loss.

40. 480 F.2d 1304, 1309 (7th Cir. 1973).

41. *Id.* at 1309 (citing *Lewyt Corp. v. Commissioner*, 349 U.S. 237, 240 (1955); *United States v. Shirah*, 253 F.2d 789, 800 (4th Cir. 1958)).

42. 60 T.C. 91, *aff'd on rehearing*, 61 T.C. 1 (1973), *rev'd*, 506 F.2d 449 (2d Cir. 1974), *cert. denied*, 421 U.S. 913 (1975).



MGM stock within the statutory period of six months. In January 1962 the Division of Corporate Finance of the Securities Exchange Commission wrote a letter to MGM advising it that the Securities Exchange Act of 1934 required that any profit made by taxpayer as a result of his short-swing stock dealings in the previous year be reported in MGM's annual proxy statement.<sup>43</sup> Immediately upon receiving this information MGM advised taxpayer of his probable liability of \$53,870.81 to the corporation and of the requirement that this liability be reported in the proxy statement. Taxpayer on the following day satisfied the alleged liability and the proxy statement was published without mention of it. Taxpayer never sought counsel, nor was any determination of liability made.

The Tax Court refused to yield to the reversal of *Mitchell*, reiterating its contention that the sale of stock and the payment of alleged liability were not sufficiently intertwined to require application of the *Arrowsmith* doctrine. It stated that taxpayer was acting in the capacity of a stockholder as he sold the stock and in the capacity of a director when he paid the liability. Furthermore, the Tax Court argued that the payment was not made simply to satisfy the probable liability, but primarily to prevent the alleged liability from being published in the proxy statement to the injury of his business reputation; hence the taxpayer did not have time to engage counsel to advise him of his legal position before the publication of the proxy statement. The Tax Court concluded that taxpayer's payment was for a business purpose and thus was properly claimed as a business expense deduction.

Upon the reversal of the Tax Court's opinion in *Anderson*, the Commissioner was granted a rehearing of *Cummings*.<sup>44</sup> Since an appeal of *Cummings* would go to the Second Circuit, the Tax Court was not bound by either the decision of the Sixth Circuit in *Mitchell* or that of the Seventh Circuit in *Anderson*. The Tax Court remained unpersuaded by the arguments of the courts of appeals, and held steadfast to its opinion that the sale and payment were not inextricably intertwined and that the taxpayer was in the capacity of stockholder when he realized the gain and in the capacity of an insider when he made the payment.

In response to the court of appeals' contention in *Anderson* that the purpose of § 16(b) was relevant to the determination of the tax treatment to be given the payment for alleged § 16(b) liability, the Tax Court emphasized that in the instant case, as in *Anderson*, no determination of liability had been made. Payment was made promptly after the taxpayer learned that the alleged violation would be published

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43. General Rules and Regulations of the Securities Exchange Act of 1934, Item 7(e) of Schedule 14A, Information Required in Proxy Statement. 17 C.F.R. § 240-14a-101, Item 7c, Instruction (4) (1976).

44. 61 T.C. 1 (1973), *rev'd*, 506 F.2d 449 (2d Cir. 1974), *cert. denied*, 421 U.S. 913 (1975).

in the MGM proxy statement to avoid embarrassing delay in the publication and to prevent the proliferation of the news through the business community. Taxpayer had no time to engage counsel to determine his legal standing. The Tax Court maintained that the payment was primarily for the protection of taxpayer's business reputation and had little to do with the actual liability under § 16(b).

Six judges dissented in the Tax Court's rehearing of *Cummings* for the same reasons given by Judge Dawson in his dissenting opinion in *Anderson*. Again Judge Drennen suggested that the § 16(b) payment simply be added to the basis of the newly purchased stock. Thus, the taxpayer would incur less capital gain upon the eventual sale of the stock and consequently would pay less tax. Although admitting that this solution has no relevance to situations like *Arrowsmith* and *Skelly Oil*, in which no subsequent purchase is involved, he advocated that it be applied to the problem of characterizing payment for probable § 16(b) sale-purchase liability.

Undaunted by the Tax Court's refusal to change its characterization of the payments for possible § 16(b) liability, the Commissioner again appealed.<sup>45</sup> The Court of Appeals for the Second Circuit determined that the sale of securities and the payment were sufficiently linked to require application of the *Arrowsmith* doctrine. It also found the *Skelly Oil* rationale of preventing tax windfalls relevant. Additionally, the court considered the policy behind § 16(b)—“to squeeze all possible profits out of stock transactions within its purview”<sup>46</sup>—and reasoned that it would frustrate the purpose of the securities law to allow an insider to profit from the prohibited short-swing stock transaction by taxing the proceeds of his sale at the favorable capital gain rate while allowing him to deduct at the higher ordinary income rate. The court maintained that such an “anomalous result” should be avoided.<sup>47</sup>

*Cummings* contended that the statutory policy behind § 16(b) was not relevant to the court's determination of tax treatment because he had not been found officially liable under § 16(b) and had some possible defenses to a § 16(b) action.<sup>48</sup> The court rejected this contention by labeling his § 16(b) defenses “frivolous” and maintaining that § 16(b) was designed for easy application and clear liability. The court added that no proof of intent or knowledge of actual inside information is necessary for liability under the provision.<sup>49</sup> Cum-

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45. *Cummings v. Commissioner* 506 F.2d 449 (2d Cir. 1974), cert. denied, 421 U.S. 913 (1975).

46. 506 F.2d at 452 (citing *Smolowe v. Delendo Corp.*, 136 F.2d 231, 239 (2d Cir. 1943)).

47. 506 F.2d at 452 (citing *Anderson v. Commissioner*, 480 F.2d at 1308, which in turn cites *United States v. Skelly Oil Co.*, 394 U.S. 678 (1969), and *Tank Truck Rentals, Inc. v. Commissioner*, 356 U.S. 30 (1958)).

48. 506 F.2d at 452.

49. 15 U.S.C. § 78p(b) (1970).

mings had contended that his liability was unclear based on relevant precedent<sup>50</sup> and on the discretion allowed the MGM board in regard to demanding repayment. The court answered that the authority cited by Cummings was probably inapplicable to the ordinary sale-purchase transaction and that, even assuming corporate reluctance to demand repayment of the profit from the prohibited transaction, § 16(b) provides for a derivative suit by any stockholder of the issuing corporation. The court added that in a corporation such as MGM, whose stock is so widely held, a derivative suit was almost inevitable. In any event, the court refused to interpret the Code so as to subvert a statutory scheme as lucid as § 16(b) simply because liability had not been judicially declared. It reasoned that to allow a business expense deduction for the payment to the corporation for obvious liability not officially declared would offer an easy escape for the violator and render § 16(b) ineffective.

The majority specifically refused to determine the feasibility of the alternative suggested by Judge Drennen of the Tax Court and one commentator.<sup>51</sup> The court suggested that in some cases adding the repayment to the basis of the purchase price of the stock might better effectuate the purpose of § 16(b). But it declined to address the issue since neither party urged adoption of this approach.

A concurring opinion filed by Judge Joseph Smith<sup>52</sup> expressed his view that *Arrowsmith* and *Skelly Oil* were not applicable to *Cummings*. Judge Smith felt that both *Arrowsmith* and *Skelly Oil* dealt with situations in which income previously received was expended in satisfaction of a liability integrally connected with such previous income. In Judge Smith's opinion this was simply not the situation in *Cummings*, since a gain was made as a result of a sale of stock and a payment was made in satisfaction of an apparent liability resulting from a subsequent repurchase. He emphasized that the § 16(b) payment to MGM, which was calculated by subtracting from the sale price the 1961 repurchase price, did not in any way represent a part of the prior income from the sale of MGM stock, which was roughly the difference between the sales price and the 1954 purchase price. He added that it is even possible to suffer a capital loss calculated from the original purchase and the sale while having a § 16(b) profit as determined from the sale and subsequent purchase.<sup>53</sup> Furthermore, Judge Smith pointed out, the latter purchase has no tax

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50. Brief of Appellee at 23 (citing *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582 (1973)).

51. Lokken, *Tax Significance of Payments in Satisfaction of Liabilities Arising Under Section 16(b) of the Securities Exchange Act of 1934*, 4 GA. L. REV. 298 (1970).

52. *Cummings v. Commissioner*, 506 F.2d 449, 453 (2d Cir. 1974), *cert. denied*, 421 U.S. 913 (1975).

53. See L. Loss, *supra* note 22, at 1063-64..

significance until the newly purchased stock is sold. He concluded that without the necessary connection between the § 16(b) payment and the prior income, *Arrowsmith* could not apply. While conceding that the majority's characterization of a repayment as part of a capital gain would be appropriate to a purchase-sale violation of § 16(b), he concluded that such a characterization in a sale-purchase situation was inaccurate.

Judge Smith also questioned the relevance of precedent concerning the dilution of punitive fines through tax law.<sup>54</sup> He contended that, as stated in *Commissioner v. Tellier*, the "public policy doctrine" is applicable only in a "sharply limited and carefully defined category" of cases.<sup>55</sup> He reasoned that since § 16(b) was remedial rather than punitive in nature,<sup>56</sup> a doctrine aimed at avoiding the softening of punitive sanctions through tax law was not relevant. Judge Smith concluded by adopting the approach suggested by Judge Drennen of the Tax Court<sup>57</sup> and Professor Lokken<sup>58</sup>—that payment in satisfaction of an apparent liability under § 16(b) should be treated as an addition to the basis of the subsequently purchased stock.

#### D. *Brown v. Commissioner*

The latest skirmish concerning the characterization of a payment in satisfaction of alleged § 16(b) liability is *Brown v. Commissioner*.<sup>59</sup> Brown was vice president and treasurer of Western Nuclear, Inc. (Western). Between January 6 and May 5, 1966, he sold 3,000 shares of Western common stock, and in March of the same year bought 16,000 shares of the same stock, in apparent violation of § 16(b). Although Brown was aware of § 16(b), he did not believe that the statute applied to restricted stock options. In March 1968, a Western stockholder began a derivative suit against Western and Brown for the "profits" made by Brown from his short-swing trading. When Brown became aware of the suit, he consulted two attorneys affiliated with Western who informed him that they could not represent or advise him because they represented Western. The attorneys suggested that he seek independent counsel. Brown decided that it would be im-

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54. *E.g.* *Tank Truck Rentals, Inc. v. Commissioner*, 356 U.S. 30 (1958).

55. *Commissioner v. Tellier*, 383 U.S. 687, 694 (1966).

56. 506 F.2d at 454 (citing *Feder v. Martin Marietta Corp.*, 406 F.2d 260, 266 (2d Cir. 1969); *Adler v. Klawans*, 267 F.2d 840, 844 (2d Cir. 1959)). See SEC, REPORT ON PROPOSALS FOR AMENDMENTS TO THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934, H.R. Doc. 77th Cong., 1st Sess. 38 (1941), quoted in Darrell, *The Tax Treatment of Payments under Section 16(b) of the Securities Exchange Act of 1934*, 64 HARV. L. REV. 80, 91 (1950).

57. *Mitchell v. Commissioner*, 52 T.C. 170, 176 (1969), *rev'd*, 428 F.2d 259 (6th Cir. 1970), *cert. denied*, 401 U.S. 909 (1971); *Cummings v. Commissioner*, 60 T.C. 91, *aff'd on rehearing*, 61 T.C. 1, 14 (1973), *rev'd*, 506 F.2d 449 (2d Cir. 1974), *cert. denied*, 421 U.S. 913 (1975).

58. Lokken, *supra* note 51.

59. ¶ 73,275 P-H Tax Ct. Mem., *rev'd*, 529 F.2d 609 (10th Cir. 1976).

possible to contest the suit and continue in his position with Western, and so he paid the corporation \$37,795.52, the full amount of the alleged liability. On his 1966 tax return taxpayer reported capital gains from his sales of stock during that year, and on an amended 1968 tax return he claimed a business expense deduction for the payment to Western, which the Commissioner disallowed.

The Tax Court, as expected, maintained its position that if the taxpayer was in the trade or business of being a corporate executive and made the payment to protect his employment and business reputation, the payment was fully deductible as an ordinary and necessary business expense. Despite the three previous reversals in the courts of appeals, the Tax Court held for the taxpayer. Again the Commissioner appealed.<sup>60</sup>

The Court of Appeals for the Tenth Circuit agreed with the Tax Court's finding that the taxpayer's motivation in making the payments was his fear that litigation would damage his business reputation. But the court found this motivation irrelevant against the backdrop of the tax benefit doctrine articulated in *Arrowsmith* and *Skelly Oil*. A unanimous court determined that the nature of the payment and the prior tax treatment of the proceeds from the sale of the Western common stock were controlling in the characterization of the payment. The court determined that the sale resulting in a capital gain was closely linked with the payment of the alleged liability to Western because of Brown's statement that he had sold the stock in order to fund the subsequent repurchase. The court was not persuaded that the payment and sale were separate, nor that the transactions were made in different capacities.

The court of appeals was similarly unimpressed with Brown's contention that he should be allowed a business expense deduction because he had never been found liable under § 16(b). Brown felt that the business purpose of the payment was controlling. But the court concluded that the event that had triggered the payment was the derivative suit, and that the payment was tied to the sale of the stock, which had previously been given favorable capital gains treatment. In light of the close relationship between the payment and sale, the business purpose of the payment was made irrelevant by *Arrowsmith* and *Skelly Oil*. Thus, the court of appeals held that the tax benefit should be limited to a capital loss deduction.

### III. RESOLVING THE CONFLICT

#### A. *The Public Policy Approach*

In a leading article concerning the deductibility of payments for alleged § 16(b) liability, Robert M. Nelson suggests an approach based

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60. *Brown v. Commissioner*, 529 F.2d 609 (10th Cir. 1976).

upon the policy of § 16(b).<sup>61</sup> Nelson concludes that § 16(b) is designed to deter insider trading by taking the § 16(b) "profit" from the insider. He recognizes that § 16(b) simply destroys any economic incentive for insider trading, and is not intended to be penal in nature.<sup>62</sup>

Based upon the policy of § 16(b), Nelson offers a flexible system designed so that the amount of the deduction would vary according to the tax cost of the § 16(b) transaction. For example, if a taxpayer engaged in a purchase-sale violation of § 16(b), he would have to pay a capital gain tax and return his profit to the corporation. According to Nelson's formula, the taxpayer should deduct an amount equal to the capital gain tax for his § 16(b) liability payment. This system is designed to eliminate tax law interference with § 16(b) and would apply to all varieties of § 16(b) violations.<sup>63</sup>

Nelson's approach is conceptually sound, albeit difficult to operate. Calculations of tax cost change with differing types of § 16(b) violations. Among the types that he considers are purchase-sale violations, sale-purchase violations, "short sale"-purchase violations, "sale against the box"-purchase violations and multiple purchase-sale transactions. Nelson also considers the effect on calculation of § 16(b) payments made in a year subsequent to the stock transactions when the taxpayer is under a different tax bracket.<sup>64</sup> He demonstrates his awareness of the possible complexity of the calculation when he adds:

It is beyond the scope of this article to examine in detail all of the situations that might arise where special care must be taken to precisely calculate the actual tax cost of an insider profit because the insider has other short-term gains or losses, for [*sic*] long-term gains or losses. It is sufficient to point out that in these situations very careful analysis is required to insure that the amount allowed as a deduction will *exactly* offset the actual tax cost to the insider.<sup>65</sup>

When Nelson's calculations result in zero tax cost, the deduction is to be disallowed. The rationale for disallowing the deduction is to preserve the public policy underlying § 16(b).<sup>66</sup> Prior to 1969, arguments concerning public policy limitations on deductions were based on *Tank Truck Rentals, Inc. v. Commissioner*<sup>67</sup> as limited by *Commissioner v. Tellier*<sup>68</sup> and *Commissioner v. Sullivan*.<sup>69</sup> These and other cases developed a "common law" test of deductibility that focused

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61. Nelson, *Tax Deductibility of Insider Profit Repayments. Resolving An Apparent Conflict*, 24 CASE W. RES. L. REV. 330 (1973).

62. *Id.* at 341-43.

63. *Id.* at 340.

64. *Id.* at 343-54.

65. *Id.* at 354 (emphasis in original).

66. *Id.* at 346-47.

67. 356 U.S. 30 (1958).

68. 383 U.S. 687 (1966).

69. 356 U.S. 27 (1958).

on the "severity and immediacy of the frustration resulting from the allowance of the deduction."<sup>70</sup> However, a 1961 Revenue Ruling<sup>71</sup> contended that deductions for liability payments would not frustrate the nonpenal § 16(b).<sup>72</sup> More importantly, the Tax Reform Act of 1969<sup>73</sup> added § 162(c), (f), and (g), which specifically list payments for which § 162 deductions are to be denied on the basis of public policy. The legislative history of the Act indicates that the statutory coverage "is intended to be all inclusive" and that "[p]ublic policy, in other circumstances, generally is not sufficiently clearly defined to justify the disallowance of deductions."<sup>74</sup> This probably is the death knell for the "common law" of public policy in terms of § 162.<sup>75</sup> Nelson argues that the lucid public policy of § 16(b) is the exception to the general rule as stated in the Senate Report. Whether a court would agree remains to be seen, but Nelson's approach is unlikely to gain wide acceptance due to its great complexity.

### B. Purchase-Sale Violations

The *Arrowsmith* doctrine stands for the proposition that when a person is taxed at the favorable capital gain rate and later is forced to surrender a portion of that gain, the deduction for that payment is limited to a capital loss deduction. *Arrowsmith* prevents the tax windfall that would result if the taxpayer were taxed at the limited capital gain rate when he received the earnings but allowed a full deduction for relinquishing the same income. While there are no cases so holding, *Arrowsmith* should clearly apply to a purchase-sale violation of § 16(b), since the § 16(b) payment is accurately characterized as part of the prior capital gain.

One might argue, however, that *Arrowsmith* is inapplicable when repayment to the issuing corporation occurs before official determination of § 16(b) liability. A taxpayer could cite the Tax Court opinions in *Mitchell*, *Anderson*, *Cummings*, and *Brown* in support of the contention that his payment was made to protect his business reputation rather than to satisfy any § 16(b) liability. Thus, the taxpayer would be allowed a full business expense deduction. Judicial acceptance of such an argument in cases involving taxpayers with business reputations would significantly narrow the application of *Arrowsmith*. A clever taxpayer could escape the clutches of *Arrowsmith* by quickly satisfying his obvious § 16(b) liability before official determination, pur-

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70. 356 U.S. at 35.

71. Rev. Rul. 61-115, 1961-1 C.B. 46.

72. See authorities cited in note 56 *supra*.

73. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487.

74. Senate Comm. on Finance, Tax Reform Act of 1969, S. Rep. No. 552, 91st Cong., 1st Sess. 274 (1969).

75. *But cf.* Raymond Mazzei, 61 T.C. 497 (1974) (concerning § 165 of the Code).

portedly in order to protect an endangered business reputation. Hence, the taxpayer would have what *Arrowsmith* forbids—a gain taxed at the favorable capital gain rate and a relinquishment of that gain deductible at the favorable ordinary income rate. Whether courts would allow this remains to be seen, but it is highly unlikely given the judicial adherence to *Arrowsmith* in the less appropriate area of a sale-purchase violation. Although this blanket application of *Arrowsmith* would sacrifice the good faith protector of a business reputation, such a person would rarely be encountered since § 16(b) is designed for easy application and clear liability.<sup>76</sup> In addition, the consistent application of *Arrowsmith* to both clever and good faith taxpayers would save the courts from making this very difficult determination of subjective motivation. Thus, the nets of *Arrowsmith* would spread over the sly taxpayer who simply pays his apparent liability early.

### C. Sale-Purchase Violations

*Arrowsmith's* applicability to a sale-purchase violation of § 16(b) is less clear. In a sale-purchase violation, the § 16(b) payment does not represent a portion of the gain. The capital gain results from the earlier purchase and sale, while the § 16(b) liability payment is made because of the sale and later purchase. The sale completes a capital gain transaction, while the later purchase begins a separate capital transaction which itself has no tax significance until ultimate sale. In a sale-purchase violation the sale results in income, and the later purchase, which begins a separate transaction, results in § 16(b) liability. Thus, the § 16(b) payment does not logically represent a portion of the sale proceeds. As Judge Smith concluded in *Cummings*, “the fact that one kind of violation of § 16(b) leads to *Arrowsmith-Skelly Oil* treatment does not require that all kinds of violations of § 16(b) be so treated.”<sup>77</sup>

The Tax Court agrees with Judge Smith. Its approach to a sale-purchase violation of § 16(b) is to distinguish *Arrowsmith* and allow the taxpayer a business expense deduction for the protection of his business reputation. This approach weakens the deterrent effect of § 16(b).<sup>78</sup> More importantly, the Tax Court approach leaves in doubt the tax treatment to be given other insiders, that is, ten percent stockholders and low paid directors of corporations. These insiders may lack a “trade or business” in that capacity under § 162 of the Code.<sup>79</sup>

76. See *Cummings v. Commissioner*, 506 F.2d at 452-53.

77. *Cummings v. Commissioner*, 506 F.2d 449, 454 (2d Cir. 1974).

78. This is probably no longer a valid criticism in light of § 162(c), (f), and (g) of the Code and the accompanying legislative history. See notes 74 & 75 *supra* and accompanying text.

79. I.R.C. § 162(a). See *Higgins v. Commissioner*, 312 U.S. 212 (1941). *But cf.* *Cummings v. Commissioner*, 60 T.C. 91, *aff'd on rehearing*, 61 T.C. 1 (1973), *rev'd*, 506 F.2d 449 (2d Cir. 1974), *cert. denied*, 421 U.S. 913 (1975) (Tax Court allowed a business expense deduction to a director).



But perhaps the strongest criticism of the Tax Court approach is that it treats similar § 16(b) violators differently: while *Arrowsmith* limits the deductibility of the purchase-sale violator's payment, the sale-purchase violator's payment is fully deductible. A sale-purchase and purchase-sale are simply two different ways of violating § 16(b); the sale-purchase violator deserves no better tax treatment than the purchase-sale violator.

Judge Drennen's characterization of the sale-purchase violator's payment nearly eliminates this unwarranted discrimination. His approach is to add the amount of the § 16(b) payment to the basis of the newly acquired stock. This treatment is similar to that given expenses incurred in defense of title to property.<sup>80</sup> The payment, which is not immediately deductible, is added to the basis, thereby delaying the tax benefit until sale or exchange of the stock. The taxpayer benefits by the decrease in capital gain or increase in capital loss caused by the addition to basis. This does not insure precisely equal tax treatment of purchase-sale and sale-purchase violators because the capital gain or loss tax rate in the year of payment may be different than in the year of ultimate sale or exchange.<sup>81</sup> Also, the sale-purchase violator's tax benefit is delayed while the purchase-sale violator receives an immediate deduction. But the possible difference in tax dollars owed is minimal compared to the Tax Court approach of allowing the sale-purchase violator a full business expense deduction for the § 16(b) payment. Drennen's approach affords different treatment to § 16(b) violators because of the "unavoidable consequences of the annual accounting system."<sup>82</sup> Additionally, Drennen's approach does treat insiders alike. It is immaterial whether the § 16(b) violator has a "trade or business."

But the most appealing aspect of Judge Drennen's approach is that it accurately characterizes the § 16(b) payment in a sale-purchase situation. Unlike the *Arrowsmith* approach, his addition-to-basis approach recognizes that the § 16(b) payment is more logically linked to the subsequent purchase than to the prior purchase and sale. Like the *Arrowsmith* approach, it renders the business purpose for the payment irrelevant, and limits the deductibility of the expenditure. The *Arrowsmith* doctrine should apply to purchase-sale violations; however, the courts of appeals, in apparent attempts at uniform treatment of § 16(b) payments, have overextended *Arrowsmith* in applying the doctrine to sale-purchase violations of § 16(b). Drennen's addition-to-basis treatment accurately conceptualizes the § 16(b) payment in the case of a sale-purchase violation.

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80. See Treas. Reg. § 1.263(a)-2(c).

81. See I.R.C. §§ 1201 and 1202.

82. But see I.R.C. § 1341; Lokken, *supra* note 51, at 315-320.

## IV. CONCLUSION

If *Arrowsmith* is to remain an efficacious doctrine, it must limit the deductibility of payments made in satisfaction of obvious § 16(b) liability for purchase-sale violations. Moreover, if a taxpayer can sidestep the *Arrowsmith* doctrine by simply paying his obvious liability before official determination and claiming that the payment was made to salvage an endangered business reputation, then the doctrine's applicability will be severely limited.

In a sale-purchase violation of § 16(b) the applicability of *Arrowsmith* is doubtful. It is difficult to conceptualize the integral relation required by the *Arrowsmith* doctrine between the § 16(b) payment and the capital gain from the prior purchase and sale. The liability arises solely because the taxpayer repurchases stock within six months of the sale.

Public policy considerations should not limit deductibility in lieu of *Arrowsmith*. Limiting the deduction of a sale-purchase violator based on the judicially established "frustration of policy" doctrine<sup>83</sup> is contrary to congressional intentions as manifested by § 162(c), (f), and (g) of the Code<sup>84</sup> and the accompanying legislative history.<sup>85</sup> Congress could decisively eradicate the problem by adopting Code provisions prohibiting deductions, business or otherwise, for apparent and actual § 16(b) payments. This would provide consistent tax treatment of all § 16(b) violators and make *Arrowsmith* inapplicable. It would preserve *Arrowsmith* from the crippling effect of the Tax Court approach and the inaccurate application of the courts of appeals. Although this approach would punish the § 16(b) violator to an extent not originally anticipated,<sup>86</sup> the benefit of consistency seems well worth it.

Absent such legislation, the courts must choose among three alternative approaches for sale-purchase violations of § 16(b): the Tax Court's approach, that of the courts of appeals, or that articulated by Judge Drennen. The Tax Court unfairly favors the sale-purchase violator with a business reputation to protect. The courts of appeals' approach distorts and stretches the *Arrowsmith* doctrine in an attempt at uniform tax treatment of all § 16(b) payments. Drennen's approach is conceptually sound and equitable in its treatment of all § 16(b) violators. Although apparently inconsistent, in that the *Arrowsmith* doc-

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83. See *Commissioner v. Tellier*, 383 U.S. 687 (1963); *Commissioner v. Sullivan*, 356 U.S. 687 (1958); *Tank Truck Rentals, Inc. v. Commissioner*, 356 U.S. 30 (1958).

84. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487.

85. Senate Comm. on Finance, Tax Reform Act of 1969, S. Rep. No. 552, 91st Cong., 1st Sess. 274 (1969).

86. See SEC REPORT, *supra* note 56. See also *Feder v. Martin-Marietta Corp.*, 406 F.2d 260, 266 (2d Cir. 1969); *Adler v. Klawans*, 267 F.2d 840, 844 (2d Cir. 1959).

trine would apply to purchase-sale violations and Drennen's treatment to sale-purchase violations, both approaches produce similar results. Moreover, Drennen's approach logically links the § 16(b) payment with the repurchase in a sale-purchase violation. Thus, Judge Drennen's solution is preferable.

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