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Tax — Treatment of Alleged Violations of Section 16 (b) of the Securities Exchange Act of 1934 — Cummings v. Commissioner

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original results, to become established. It could even drive the most creative young scientists into other fields. It is therefore submitted that while *Washington Research* may have been correctly decided as a matter of statutory interpretation, the result of the decision is erroneous in view of the policies behind the exemption.[113] It is recommended that Congress amend the Freedom of Information Act to correct the source of the error.

One possible amendment would simply add another exemption for

> confidential, technical or scientific data or research designs or other information submitted in or with an application for a research grant or in or with a report while research is in progress.

This suggested amendment is narrow, and thus may leave unconsidered interests which need to be protected. However, given the policy of the FOIA in favor of disclosure, it is better that exemptions be narrowly designed to protect areas where protection is clearly necessary, as it is here. At the same time, this amendment would protect the private interest of the scientist and would in the long run protect the public interest in a healthy and vigorous scientific community.

MARION KATZ LITTMAN

Tax–Treatment of Alleged Violations of Section 16(b) of the Securities Exchange Act–Cummings v. Commissioner[1]—In designing section 16(b) of the Securities Exchange Act of 1934 (the Act),[2] Congress clearly intended to curb the abuses of "insider"[3] trading by divesting insiders of

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[113] *See* text at notes 84-100, *supra,* particularly with reference to the policy of protecting one required to submit information to a government agency from the "substantial harm" to his competitive position which could be the result of public disclosure of that information.

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[1] 506 F.2d 449 (2d Cir. 1974), *rev'g* 60 T.C. 91 (1973).

[2] Section 16(b), 15 U.S.C. § 78p (1970) provides in pertinent part:

> 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 an equity security of such issuer . . . within any period of less than six months . . . 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.

[3] "A person who has special access to information concerning a corporation, because of financial interest or a role in management is referred to as an 'insider.' Such persons are subject to special restrictions in using such data in trading in securities." D. VAGTS, BASIC CORPORATION LAW 784 (1973). For purposes of § 16(b), an insider is any

the profits obtained from certain types of transactions.[4] Thus, where an insider realizes a profit from a purchase and sale or sale and repurchase of stock within a six month period he is required by the Act to repay his profits to the corporation.[5] However, where an insider attempts to deduct this section 16(b) repayment as a business expense,[6] the policies of the tax system interact and may conflict with the security law provisions requiring repayment of insider profits. The question of whether a section 16(b) repayment should be deductible, therefore, must be viewed from the perspective of both the goals of the tax system and the intent of section 16(b). From a tax standpoint, the well-established principle that Congress intended only to tax net income[7] has resulted in a general willingness to allow legitimate business expense deductions.[8] On the other hand, the primary concern of the security laws is whether the impact of the section 16(b) repayment would be diminshed by permitting a business deduction of the fine.[9] An additional problem arising from the interplay of section 16(b) and the tax laws stems from the judicially developed tax policy that where a loss, such as that suffered in repayment of a section 16(b) fine, is integrally related to an earlier capital gains transaction, the loss must be characterized in the same manner as the gain,[10] *i.e.*, as a capital loss.[11] This characterization of a section 16(b) violation in terms of a capital

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officer or director, or a shareholder who is directly or indirectly the beneficial owner of more than 10 percent of any equity security which is registered under § 12, 15 U.S.C. § 781 (1970) of the Act. 15 U.S.C. § 78p(a) (1970).

[4] The statutory language is cited in note 2 *supra*. For pertinent legislative history, *see generally* H.R. REP. NO. 1383, 73d CONG., 2d SESS. (1934); SEN. REP. NOS. 792, 1455, 73d CONG., 2d SESS. (1934); Nelson, *Tax Deductibility of Insider Profit Repayments: Resolving An Apparent Conflict*, 24 CASE W. RES. L. REV. 330, 341-42 (1973).

[5] *See* note 2 *supra*.

[6] A business expense deduction would be available under § 162(a) of the Code, which 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." INT. REV. CODE OF 1954, § 162(a). The § 162(a) test, set forth in Nathan Cummings, 60 T.C. 91, 93, 95-96 (1973), stipulates: (1) that the taxpayer must be in the business or trade of being a corporate executive or officer; and (2) that the payment made pursuant to section 16(b) must be undertaken to preserve his business reputation. This test has been the principal rationale used by the Tax Court in justifying such deductions. *See, e.g.*, Charles I. Brown, 32 CCH Tax Ct. Mem. 1300, 1301-02 (1973); Nathan Cummings, 60 T.C. 91, 93-96 (1973); James E. Anderson, 56 T.C. 1370, 1373-74 (1970); William L. Mitchell, 52 T.C. 170, 175-76 (1969); Laurence M. Marks, 27 T.C. 464, 467 (1956).

[7] Commissioner v. Tellier, 383 U.S. 687, 691-92 (1966); Commissioner v. Sullivan, 356 U.S. 27, 29 (1958).

[8] Commissioner v. Tellier, 383 U.S. 687, 691-92 (1966); Commissioner v. Sullivan, 356 U.S. 27, 29 (1958).

[9] The deduction would reduce gross income, and therefore the taxes which would otherwise have to be paid.

[10] United States v. Skelly Oil Co., 394 U.S. 678, 684-85 (1969); Arrowsmith v. Commissioner, 344 U.S. 6, 8-9 (1952); *Cummings*, 506 F.2d at 451.

[11] The tax treatment of capital losses under § 1211 (b)(1) of the Internal Revenue Code is as follows:

(b) Other taxpayers. (1) In general. In the case of a taxpayer other than a

gain-capital loss transaction has provoked considerable judicial conflict.[12]

The most recent circuit court pronouncement in this area is *Cummings v. Commissioner.*[13] Plaintiff Cummings, a director of Metro-Goldwyn-Mayer, Inc., (MGM) sold 3,400 MGM shares and paid capital gains tax on the profit from this sale. However, within a six month period, he repurchased 3,000 shares. Pursuant to section 16(b) of the Act, Cummings was then notified that he was required to pay any "profits"[14] resulting from his sale-purchase transactions to MGM. Failure to pay would cause his indebtedness to be noted in the forthcoming MGM proxy statement[15] and a suit to be brought against him by MGM.[16] Cummings, maintaining his innocence,[17] nevertheless remitted his "profits" to MGM claiming that the remission was made to prevent delay in the issuance of the proxy statement and to protect his business reputation, which would be damaged by either notation of his indebtedness in the proxy statement or his involvement in a section 16(b) liability suit.[18] Cummings subsequently deducted from his gross income an amount equal to his repayment to MGM, as an ordinary and necessary business expense under section 162 of the Internal Revenue Code.[19]

The Internal Revenue Commissioner denied the business expense deduction, instead limiting the deduction to capital loss treatment under section 1211(b).[20] Thereafter, Cummings instituted suit in the

> corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges, plus (if such losses exceed such gains) whichever of the following is smallest: (A) the taxable income for the taxable year, (B) $1,000, or (C) the sum of—(i) the excess of the net short-term capital loss over the net long-term capital gain, and (ii) one-half of the excess of the net long-term capital loss over the net short-term capital gain.

INT. REV. CODE of 1954, § 1211(b)(1).

[12] Cummings v. Commissioner, 506 F.2d 449 (2d Cir. 1974), *rev'g* 60 T.C. 91 (1973); Anderson v. Commissioner, 480 F.2d 1304 (7th Cir. 1973), *rev'g* 56 T.C. 1370 (1971); Mitchell v. Commissioner, 428 F.2d 259 (6th Cir. 1970), *rev'g* 52 T.C. 170 (1969), *cert. denied*, 401 U.S. 909 (1971); Charles I. Brown, 32 CCH Tax Ct. Mem. 1300 (1973), *appeal docketed* 10th Cir.

[13] 506 F.2d 449 (2d Cir. 1974).

[14] Insider "profits" are calculated for purposes of § 16(b) as the difference between the purchase and sale price according to the principle of "lowest-in/highest-out." This calculation requires a matching of the lowest purchase against the highest sale, the next lowest purchase against the next highest sale, etc. Smolowe v. Delendo Corp., 136 F.2d 231, 239 (2d Cir. 1943), *cert. denied*, 320 U.S. 751 (1943); Painter, *The Evolving Role of Section 16(b)*, 62 MICH. L. REV. 649, 652 (1964).

[15] Notation in the proxy statement of any indebtedness is required by Schedule 14A, Item 7, 17 C.F.R. § 240.14a-101, Item 7(e), Instruction 4 (1974).

[16] 506 F.2d at 450. In accordance with the Act, such suit could be commenced by the corporation if repayment was not made. 15 U.S.C. § 78p(b) (1970).

[17] Cummings claimed that if any violation of § 16(b) had occurred, it had been inadvertent. 506 F.2d at 450.

[18] *Id.* at 450.

[19] *See* note 6 *supra* for the provisions of § 162(a) of the INT. REV. CODE OF 1954.

[20] *See* note 11 *supra* for provisions of § 1211(b) of the INT. REV. CODE OF 1954.

Tax Court.[21] After exploration of the facts, the Tax Court, concluding that plaintiff's role as a director constituted a business and that the expenses were incurred to protect plaintiff's business reputation, permitted a business expense deduction[22] under section 162.[23] The distinction between these two types of deductions is important because a business loss can be used to offset ordinary income[24] while a capital[25] loss permits a less generous allowance.

The Court of Appeals for the Second Circuit reversed the Tax Court's decision,[26] and in agreement with the Commissioner HELD: payment of the apparent liability under section 16(b) should be treated as a long term capital loss and not as a business expense deductible from ordinary income.[27] The court noted that Cummings had been given favorable capital gains treatment when his stock was sold.[28] Therefore, allowance of an ordinary deduction for his section 16(b) repayment, presumably paid from profits of the earlier sale, would improperly permit him favorable tax treatment twice[29] in violation of settled principles established by the Supreme Court.[30] In addition, the court supported its decision by pointing out that the tax advantage Cummings would receive if an ordinary deduction were granted would frustrate the purpose of section 16(b).[31]

This note will discuss the fundamental policy concerns which underlie the judicial treatment of the section 16(b) tax deduction

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[21] Nathan Cummings, 60 T.C. 91 (1973).

[22] *Id.* at 93-96.

[23] *See* note 6 *supra* for provisions of § 162(a) of the INT. REV. CODE OF 1954.

[24] INT. REV. CODE OF 1954 § 62(1).

[25] *See* note 11 *supra*. *See also* Nelson, *supra* note 4, at 340.

[26] 506 F.2d at 449. A Tax Court decision is appealable to the appropriate circuit court. If the circuit which will hear the case has already ruled on the issue, the Tax Court feels bound to accept that circuit's rationale even if the Tax Court itself would disagree with the reasoning. When the relevant circuit has not spoken, however, the Tax Court feels free to disregard rulings made by other circuits. *See* Jack E. Golsen, 54 T.C. 742, 756-57 (1970).

[27] 506 F.2d at 449.

[28] *Id.* at 451.

[29] *Id.* at 451-52.

[30] United States v. Skelly Oil Co., 394 U.S. 678, 685 (1969); Arrowsmith v. Commissioner, 344 U.S. 6, 7-9 (1952).

[31] 506 F.2d at 452. For example, if in a *Cummings* type sale-repurchase set of transactions, the insider

> sold stock for $20 and within six months thereafter purchased an equal number of shares of the stock for $10, he would pay no tax at the time of purchase. Assuming that he is in a 50-percent tax bracket [an ordinary loss] deduction in the amount of the repayment, $10 would save him $5, so that the net repayment to the corporation would amount to merely $5 instead of the full profit of $10 required by section 16(b).

Nelson, *Tax Deductibility of Insider Profit Repayments: Resolving an Apparent Conflict*, 24 CASE W. RES. L. REV. 330, 346 n.62 (1973). Assuming that Congress designed the § 16(b) penalty to exact a fine precisely calculated to deter insiders from engaging in certain short-term trading, the deduction of this fine as an ordinary loss would reduce the impact of the loss suffered from the repayment which, in turn, would diminish the deterrent effect of the fine.

issue. Toward that end, primary attention will be focused upon isolating the various considerations which have influenced the circuit and tax courts in their decisions regarding this issue.[32] Examination of these considerations, it is submitted, will indicate that although the courts have available the necessary rationales to adequately resolve the repayment-deduction issue, the structuring of these rationales into a logical and coherent standard has not yet occurred. In conclusion, this note will summarize several proposals to modify the present tax treatment of section 16(b) repayments and discuss the feasibility of each alternative.

Since a discernable pattern[33] in the opposing Tax Court-circuit court treatment of the deductibility of section 16(b) repayments has emerged, an in-depth examination of the different treatment accorded taxpayer Cummings by the Second Circuit and the Tax Court should provide an adequate basis for determining the merit of the current judicial approaches to the deductibility problem. In deciding *Cummings,* the three judge circuit court panel relied heavily upon two Supreme Court decisions — *Arrowsmith v. Commissioner*[34] and *United States v. Skelly Oil Co.*[35] Because of the emphasis placed upon these decisions, a brief review of the facts of each case is essential. *Arrowsmith* involved a situation where, upon liquidation of a corporation, the two sole shareholders received distributions which were taxed at capital gains rates. In a subsequent year, these former shareholders became liable for and paid a judgment rendered against the now dissolved corporation.[36] Although the taxpayers attempted to write off this payment as an ordinary business expense, the Supreme Court disallowed the deduction,[37] emphasizing that since their loss was related to the prior distributions which had received favorable capital gains treatment, allowance of an ordinary deduction would provide these taxpayers with a windfall.[38] In addition, the Court rejected the ordi-

[32] Three principles have had a dominant role in determining deductibility: (1) the principle that a loss should be characterized in the same terms as an earlier related gain if allowing the deduction of the loss would bestow favorable tax treatment on the same amount twice, *see* text at notes 34-76 *infra*; (2) public policy concerns, including the frustration doctrine and the policy against supplementing statutory fines through the tax system, *see* text at notes 75-108 *infra*; and (3) the business expense argument premised on § 162(a) of the Code, *see* note 6 *supra.*

[33] Since 1956, the tax court has continually allowed the taxpayer a § 162(a) deduction for the repayment of his insider fine. *E.g.*, Charles I. Brown, 332 CCH Tax Ct. Mem. 1300 (1973). On appeal, however, every circuit to consider the question has reversed, limiting the deduction to capital loss treatment. *See* Cummings v. Commissioner, 506 F.2d 449 (2d Cir. 1974), *rev'g* 60 T.C. 91 (1973); Anderson v. Commissioner, 480 F.2d 1304 (7th Cir. 1973), *rev'g* 56 T.C. 1370 (1971); Mitchell v. Commissioner, 428 F.2d 259 (6th Cir. 1970), *rev'g* 52 T.C. 170 (1969), *cert. denied*, 401 U.S. 909 (1971).

[34] 344 U.S. 6 (1952).

[35] 394 U.S. 678 (1969).

[36] 344 U.S. at 7.

[37] *Id.* at 9.

[38] *Id.* at 7-9. The windfall results from the fact that the amount was originally taxed at a lower capital gains rate, but would be deducted from income to be taxed at a

nary business deduction argument on the ground that the loss was not the result of any separate business venture, but was incurred because of the taxpayers' status as shareholders — the same status which had earlier netted the taxpayers a gain.[39] To prevent the taxpayers from becoming unjustly enriched, the Court characterized the second transaction in the same terms as the earlier transaction.[40] Such a characterization resulted in the loss being deducted as a capital loss because the initial asset distribution was subject to capital gain treatment.[41]

The *Arrowsmith* principle was subsequently applied in *Skelly Oil.* In 1957, the taxpayer corporation, Skelly Oil, set prices in accordance with the order of a state commissioner. These prices resulted in income to the corporation which was permitted the benefit of a 27.5 percent oil depletion allowance. When the state's price order was subsequently vacated, Skelly was required to make repayments to two of its customers for previous overcharges.[42] Thereafter, Skelly Oil attempted to deduct these payments refunded to customers as an ordinary business expense.[43] The Supreme Court held, however, that the corporation was not entitled to a full deduction for the payments refunded in 1958, but rather must subtract from this deduction the amount earlier received as a tax benefit accruing from the depletion allowance.[44] Paralleling the reasoning of *Arrowsmith,* the Court stated that permitting both an oil depletion allowance and a later full deduction would result in a windfall to the taxpayer.[45]

In order to demonstrate the applicability of the *Arrowsmith-Skelly* rationale to the instant fact situation, the majority in *Cummings* reasoned that the section 16(b) liability had a logical nexus not only with the later purchase but also with the earlier sale.[46] The court asserted that this interrelationship between sale and repurchase was ap-

normal higher rate. For example, a taxpayer who is in a 50% tax bracket in year one receives a sum, $12,000, which is taxed as a long-term capital gain. He therefore pays tax on 1/2 of $12,000 at 50% or $3,000. In year two, if the taxpayer has repaid the $12,000 and is allowed to deduct it from ordinary income subject to the full 50% rate, he will realize a tax savings of $6,000. That is, the taxpayer will not only have recouped his earlier $3,000 tax payment, but will have gained a windfall profit of an additional $3,000 as well. If the deduction were limited to a capital loss, the taxpayer would be allowed to subtract the $12,000 only from capital gains, INT. REV. CODE OF 1954, § 1211(b). Therefore, if he had $12,000 capital gain in year two from which he subtracted his loss, his savings would be only $3,000, the long-term capital gain tax for his bracket. If there were not capital gains, however, the taxpayer could deduct the capital loss from ordinary income only to the extent of $1,000 a year. INT. REV. CODE OF 1954, § 1211(b) with a carry-over provision, INT. REV. CODE OF 1954, § 1212.

[39] 344 U.S. at 9.

[40] *Id.* at 7-8.

[41] *Id.*

[42] 394 U.S. at 685.

[43] *Id.* at 679.

[44] *Id.* at 684.

[45] *Id.* at 684-85.

[46] 506 F.2d at 451.

parent from the essential nature of a section 16(b) repayment, because without the initial sale, no section 16(b) violation would have occurred.[47] Once an interrelationship between sale and repurchase is shown, then by analogy to *Arrowsmith,* the loss incurred as a result of the section 16(b) repayment could be viewed as arising from the profit or financial gain the taxpayer had received by repurchasing the stock at a lower price.[48] The court asserted that the amount of the repayment, calculated as the difference in price between the sale and repurchase, is, in essence, a recognition of the monetary gain accruing to the taxpayer as a result of the interaction of these two transactions.[49] Since the same set of transactions which provided the taxpayer with a gain resulted in a subsequent loss, the court reasoned that the loss can be characterized in the same manner as the profits.[50] Therefore, because the profits from the earlier sale had been taxed at a capital gains rate, the majority in *Cummings* held that the section 16(b) repayment should be limited to capital loss treatment.[51] In support of this conclusion, the court noted that an ordinary deduction of the same money that was earlier taxed at a preferential rate would unjustly enrich the defendant by allowing him to receive an undeserved windfall.[52] Thus, in addition to providing the Second Circuit with a means of characterizing a loss transaction which is not expressly identified in the Internal Revenue Code,[53] but which is closely related to an earlier gain, the *Arrowsmith* and *Skelly* cases also provided a policy reason which the court used to support its characterization.

In a concurring opinion, Judge Smith contended that *Arrowsmith* and *Skelly* should not have been controlling in the *Cummings* situation, because the touchstone of both earlier cases is "the repayment of an amount which had previously been included in income."[54] In contrast, the amount required to be repaid by Cummings under section 16(b) was not the same amount which had previously been included in income.[55] The only amount that had been treated as income and taxed was the profit from the initial sale, which was taxed at capital gains rates.[56] No tax was levied upon the "financial gain" that allegedly accrued to the taxpayer as a result of the sale-repurchase

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[47] *Id.*

[48] 344 U.S. at 8-9.

[49] 506 F.2d at 451. In addition, the court also suggested that a § 16(b) repayment could be characterized as an adjustment upward of the original sales price to take into account the profits gained. *Id.*

[50] *Id.* at 451; Anderson v. Commissioner, 480 F.2d 1304, 1307 (7th Cir. 1973). *See Arrowsmith,* 344 U.S. at 8.

[51] 506 F.2d at 449.

[52] *Id.* at 451. *See Skelly Oil,* 394 U.S. at 684-86. *See generally Arrowsmith,* 344 U.S. at 7-9.

[53] 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, 306 (1970).

[54] 506 F.2d at 453 (concurring opinion).

[55] *Id.* at 454.

[56] *Id.*

combination and which constituted the amount of the section 16(b) repayment.[57] Therefore, to equate the sales profit with the section 16(b) profit was inaccurate.[58] The set of transactions which gave rise to the profit which had previously been included in income[59] was not the same set which gave rise to the loss, *i.e.*, the repayment.[60] Under these circumstances Judge Smith reasoned that *Arrowsmith* should be inapplicable.[61]

Judge Smith further argued that since the section 16(b) "profits" in the *Cummings* fact situation never had any significance as profits for tax purposes, it was difficult to maintain that allowing their deduction would be equivalent to permitting favorable tax treatment twice.[62] This contention could be maintained only by viewing the section 16(b) repayment as being paid from the profits of the earlier sale, which were taxed at capital gain rates. However, such an assertion is erroneous because section 16(b) liability may result even if no profits were realized from the initial sale.[63]

The Tax Court, in rejecting the *Arrowsmith-Skelly* rationale, relied not only on similar arguments, but also noted that unlike *Arrowsmith*, the loss suffered by the taxpayer in a section 16(b) violation is not incurred in the same capacity or status as the gain.[64] More specifically, in *Arrowsmith*, the taxpayers' liability for corporate debts arose out of their shareholder status, the same status which had earlier entitled them to gains when the corporation was liquidated.[65] The gains and losses were thus suffered in the same capacity. By comparison, the court stated, in a section 16(b) violation, the taxpayer acquires his gains in the market in his capacity as an investor, while his liability

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[57] *Id. See also* William L. Mitchell, 52 T.C. 170, 174-75 (1969); Nelson, *supra* note 31, at 335.

[58] 506 F.2d at 454 (concurring opinion). *See also* William L. Mitchell, 52 T.C. 170, 174-75 (1969); Nelson, *supra* note 31, at 335.

[59] The first set of transactions was the original purchase and sale which resulted in a profit and was taxable.

[60] The set of transactions which resulted in the § 16(b) loss was the sale-purchase combination. The confusion here centers upon the fact that the sale-purchase combination can result in a financial gain for the taxpayer, *i.e.*, if the taxpayer sold 10 shares for a total of $20 and later purchases 10 shares at a total of $10, he not only has his 10 original shares but he has also pocketed $10. This financial gain is the "profit" that § 16(b) is designed to eliminate. But, it should be noted that these "profits" have no tax significance. *See* Nelson, *supra* note 31, at 335.

[61] 506 F.2d at 453-54 (concurring opinion). *Arrowsmith* requires that the transaction which gave rise to the taxable profits be the same transaction which resulted in the loss. Here the purchase-sale gave rise to taxable profits, while the sale-repurchase resulted in a "loss" through § 16(b) repayment. *Id.*

[62] *Id.* at 453-54.

[63] *See* William L. Mitchell, 52 T.C. 170, 174-75 (1969). For example, if a taxpayer bought at $20, held the stock for a year, sold at $10 and purchased at $8 within the next 6 months, the net result would be a $10 loss ($20-$10). However, the § 16(b) "profit" would be $2 ($10-$8).

[64] Nathan Cummings, 60 T.C. 91, 94-95 (1973). The same reasoning was used by the Tax Court in James E. Anderson, 56 T.C. 1370, 1374-75 (1971).

[65] 344 U.S. at 8-9.

under section 16(b) is predicated on his insider status.[66] Since the gains are acquired in a different capacity than the losses, the court decided that the nexus between the transactions was insufficient to bring the *Arrowsmith* rationale into play.[67]

The conclusion that the taxpayer acquires his gains in the market solely as an investor, however, is in some instances questionable.[68] It appears that the substance of the *Arrowsmith* holding is directed primarily toward the relationship of the loss to the earlier favorably treated gains,[69] not toward the status of the taxpayer during these transactions.[70] Therefore, the Tax Court's attempt to use the change in status argument as a measure of the applicability of *Arrowsmith* has justifiably been criticized[71] and rejected by the circuit courts which have considered the matter.[72]

It is submitted that an *Arrowsmith* analogy should not be applied to a section 16(b) situation. Application of *Arrowsmith* appears to be contingent upon the existence of a certain type of factual pattern,[73] namely one in which the taxpayer, while maintaining the same status, is involved in two taxable and *integrally related* transactions — a gain

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[66] Nathan Cummings, 60 T.C. 91, 94-95 (1973); *See also* James E. Anderson, 56 T.C. 1370, 1374-75 (1971); Note, 9 HOUSTON L. REV. 841, 848 (1972).

[67] Nathan Cummings, 60 T.C. 91, 94-95 (1973). *See also* James E. Anderson, 56 T.C. 1370, 1374-75 (1971); Note, 9 HOUSTON L. REV. 841, 848 (1972).

[68] For instance, in Anderson v. Commissioner, 480 F.2d 1304 (7th Cir. 1973), where Anderson sold his stock in order to raise money to purchase shares under an employment stock purchase agreement, it would appear that the Seventh Circuit could also argue that the taxpayer had the same employee status when he received both his financial gains and his § 16(b) losses. It is submitted, however, that the I.R.S.' allowance of favorable tax treatment for bonus employment compensation plans, INT. REV. CODE OF 1954, §§ 422, 423, 424, indicates sanctioning of some insider trading. The taxpayer could then posit that the selling of stock solely to raise funds for entering into an employment compensation program is not likely to lead to the speculative abuse which § 16(b) attempts to discourage. Therefore, in the above circumstances, the standard set forth in Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 601-03 (1973), would operate to carve out an exemption from § 16(b) liability. *Kern County* involved a rather "unorthodox" stock transaction whereby stock was acquired through a tender offer and then, under the terms of a binding merger agreement, exchanged within a six month period. In holding that the stock dealings in question were not violative of § 16(b) the Court suggested a possible § 16(b) defense, *i.e.*, exemption of stock transactions which do not afford "measurable possibilities for speculative abuse" through the use of insider information. *Id.* at 602. Cummings' attempt to utilize this defense in the instant case, however, was unsuccessful. 506 F.2d at 452.

[69] *See* Rabinovitz, *Effect of Prior Year's Transactions on Federal Income Tax Consequences of Current Receipts or Payments*, 28 TAX L. REV. 85, 106-09 (1972).

[70] *See* Kimbell v. United States, 490 F.2d 203, 204-05 (5th Cir. 1974); James E. Anderson, 56 T.C. 1370, 1378 (1971) (dissenting opinion). *See also* Lokken, *supra* note 47, at 306; Note, 9 HOUSTON L. REV. 841, 848-49 (1972).

[71] Anderson v. Commissioner, 480 F.2d 1304, 1307 (7th Cir. 1973).

[72] *Id.* It can be assumed that the Second Circuit found the Tax Court's argument less than convincing, as evidenced by its continuing application of the *Arrowsmith* approach. *Cummings*, 506 F.2d at 450-51.

[73] Lokken, *supra* note 53, at 306.

followed by a loss.[74] Thorough examination of the *Cummings* situation indicates a wide discrepancy between the facts of *Arrowsmith* and those of *Cummings,* in which the subsequent loss is a result of the application of *external* statutory requirements to a single occurrence — a purchase/sale combination within a six month period, without primary reference to the individual economic aspects of either transaction. These factual differences cast serious doubts upon the propriety of applying *Arrowsmith* principles to deny an ordinary business expense deduction to a section 16(b) violator. Furthermore, *Arrowsmith*'s only concern was with the windfall which results from the difference between allowance of an ordinary loss as compared to allowance of a capital loss.[75] The windfall in a section 16(b) situation, however, is entirely different, as it arises from repayment of a statutory fine. As such, the capital nature of the stock transactions involved is in many instances irrelevant.

The examination so far has been limited to whether a capital deduction or an ordinary deduction is appropriate. However, a third alternative — denial of any deduction — should be considered since the loss results from a statutory fine. Since the legislature has determined that a fine should be exacted for the violation of section 16(b), should the court reduce the impact of that fine by allowing the violator to deduct the cost of his section 16(b) repayment?

The Supreme Court has established that a fine payment does not qualify for any deduction at all.[76] In fact, the argument against allowance of a deduction for payment of a fine has evolved into a well established judicial principle — the "frustration doctrine."[77] Broadly stated, this judicial principle dictates that tax deductions which would

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[74] Although the application of the *Arrowsmith-Skelly* rationale to the reverse of the *Cummings* situation—a *purchase-sale* violation of § 16(b)—has not been judicially tested, the propriety of its use was suggested by Judge Smith in his concurring opinion. 506 F.2d at 454 (concurring opinion). Unlike a sale-repurchase combination, the amount of repayment in a purchase-sale transaction is exactly equal to the amount of profits from the sale, thereby undercutting the primary defense that no correlation exists between amount of repayment and profits earned. To illustrate, assume that stock was purchased at $5 and within six months sold at $10. The amount of profits—$5—would equal the § 16(b) liability of $5 (sales price of $10 minus purchase price of $5). It is submitted, however, that the taxpayer should be allowed an ordinary business deduction to offset his tax loss rather than the more restricted capital loss deduction. Assuming that the taxpayer is in a 50 percent tax bracket, an ordinary deduction of the $5 repayment would yield a tax benefit of $2.50—an amount equal to the short-term capital gains tax earlier paid on his $5 profit. On the other hand, if only a capital loss was allowed, the taxpayer would still be losing part of the tax on his $5 profit, in addition to the loss of his insider profit. *See* Nelson, *supra* note 31, at 344-45.

[75] In *Arrowsmith*, the windfall which the Court sought to prevent was the amount of money the taxpayer would have received if the second transaction was identified as an ordinary rather than a capital loss. 344 U.S. at 7. *See* note 38 *supra.*

[76] Hoover Motor Express Co. v. United States, 356 U.S. 38, 40 (1958); Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30, 35-36 (1958).

[77] Hoover Motor Express Co., 356 U.S. 38, 39-40 (1958); Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30, 33-36 (1958).

frustrate sharply defined legislative policies should be denied.[78] In support of the doctrine, it is argued that the judiciary should guard against indirectly rewarding a taxpayer for his misdeeds.[79] This reward, taking the form of a tax deduction, would reduce the amount of the violator's repayment[80] and could very well put him in a better financial position than before the violation.[81] Either of these benefits would seem to indicate judicial condonation of present wrongdoing and encouragement of future violations.[82] To prevent this undermining effect on statutory penalties, the frustration doctrine has been applied in the past whenever congressional legislative policy would be subverted by allowance of a tax deduction.[83]

The Second Circuit in *Cummings*,[84] in accordance with at least one other circuit,[85] found the rationale of the frustration doctrine convincing and adopted this principle to justify the denial of ordinary deductions to section 16(b) violators engaged in sale-purchase transactions.[86] Although the amount deductible under capital loss provisions is less than the amount deductible under ordinary business loss provisions, the capital loss treatment is still more favorable than no deduction at all. In this sense the security laws are still frustrated by the allowance of a capital deduction.

Confusion arises from the fact that the court appears to equate the unjust enrichment[87] problem of the frustration doctrine with the unjust enrichment problem of *Arrowsmith*. The two concepts, however, are quite different. The frustration doctrine operates broadly to deny all deductions which would detract from the effective enforcement of section 16(b). Under the facts of *Cummings*, any deduction, whether capital or ordinary, could reduce the severity of the economic impact of the fine[88] and thereby unjustly enrich the taxpayer. Thus, the de-

[78] *See* Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30, 33-34, 35-36 (1958); Commissioner v. Heininger, 320 U.S. 467, 473 (1943); Jerry Rossman Corp. v. Commissioner, 175 F.2d 711, 713 (2d Cir. 1949), *rev'g* 10 T.C. 468 (1948); Darrell, *The Tax Treatment of Payments Under Section 16(b) of the Securities Exchange Act of 1934*, 64 HARV. L. REV. 80, 90-92 (1950); Lokken, *supra* note 53, at 300-04.

[79] Anderson v. Commissioner, 480 F.2d 1304, 1307-08 (7th Cir. 1973); Lokken, *supra* note 53, at 312, 321.

[80] Anderson v. Commissioner, 480 F.2d 1304, 1307-08 (7th Cir. 1973).

[81] *Id.*

[82] Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30, 36 (1958).

[83] Anderson v. Commissioner, 480 F.2d 1304, 1307-08 (7th Cir. 1973); Lokken, *supra* note 53, at 321. *See* note 31 *supra* for an example of how a tax deduction would allow the taxpayer to repay less than his full § 16(b) fine, thereby frustrating the operation of § 16(b).

[84] 506 F.2d at 449-50.

[85] *See* Anderson v. Commissioner, 480 F.2d 1304, 1307-08 (7th Cir. 1973).

[86] *See* note 31 *supra* for an example illustrating the need for withholding a deduction in a sale-purchase situation.

[87] Enrichment results from any deduction which either puts the violator in a better financial condition than before the violation or reduces the amount of the violator's repayment.

[88] The *Cummings* court acknowledged that an ordinary business deduction would

nial of any such deduction would be required by the frustration doctrine. On the other hand, the only enrichment problem presented in *Arrowsmith* is how to eliminate the tax benefits gained from the characterization of a loss as ordinary rather than capital where the same amount had previously been taxed at capital gains rates.[89] Although the *Cummings* court condemns the windfalls described in both *Arrowsmith* and the frustration doctrine cases,[90] the majority acts only to prevent the *Skelly-Arrowsmith* type windfall.[91] The ultimate result flowing from the characterization of the section 16(b) repayment as a capital loss is that the taypayer is still able to avoid the full impact of a section 16(b) fine, albeit to a lesser extent than if an ordinary loss was allowed.[92] To avoid this result, it is submitted that a better approach would be to give force to the frustration doctrine by denying a deduction whenever its allowance would reduce the taxpayer's section 16(b) fine.[93]

This suggestion, however, should be qualified in at least one respect. The frustration doctrine should not operate automatically to deny a deduction in every case in which a statutory fine is exacted. For example, where a taxpayer has suffered additional losses beyond that of his statutory fine, it appears that allowance of an ordinary deduction to offset these secondary expenses[94] would neither decrease the effective operation of the statute nor suggest judicial approbation of wrongdoing.[95] On the contrary, "to deny the deduction [in the above situation] would be, in effect, to multiply the penalty beyond what Congress intended."[96] Therefore, it is desirable both to deny a deduction where its allowance would frustrate public policy and, con-

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frustrate the operation of § 16(b). 506 F.2d at 452. It is submitted that the same result will follow if a capital loss is allowed, although the fine will be reduced to a lesser extent. *See* Nelson, *Tax Deductibility of Insider Profit Repayments: Resolving an Apparent Conflict*, 24 CASE W. RES. L. REV. 330, 340 (1973). Although lack of information makes it impossible to calculate the amount of reduction Cummings received through allowance of a capital loss, elaboration of the example in note 38 *supra*, may illustrate how allowing even a capital loss will violate the frustration doctrine. Assume the loss in the note 38 hypothetical is the result of a fine payment. The ordinary loss deduction would in effect be a partial rebate, because the taxpayer could offset $12,000 of income and reduce the taxes he would otherwise have to pay by $6,000. Thus, the net effect is that his § 16(b) fine only amounts to $6,000. The tax savings from a capital loss, $3,000, however, is also a partial rebate, lessening the impact of the fine repayment. Assuming that the statutorily determined amount of the fine was calculated to discourage recidivism, a lessening of that amount could increase the likelihood of recurring violations.

[89] 344 U.S. at 7-9. *See also* note 38 *supra*.

[90] 506 F.2d at 451-52.

[91] *See* text at notes 45-54 *supra*.

[92] *See* Nelson, *supra* note 88, at 340. *See also* note 88 *supra*.

[93] 506 F.2d at 452; Anderson v. Commissioner, 480 F.2d 1304, 1307-08 (7th Cir. 1973).

[94] *See* note 74 *supra*.

[95] Laurence M. Marks, 27 T.C. 464, 468-69 (1956).

[96] *See* Darrell, *supra* note 78, at 92.

versely, to allow a deduction where its denial would only supplement a legislative fine. These two considerations can be integrated into one standard by asking, in every repayment-deduction situation, whether a deduction would "enrich"[97] the taxpayer. If the answer is yes, then a deduction should be denied under the frustration doctrine.[98] Conversely, if the answer is no, the denial of a deduction would merely impose additional hardship on the taxpayer beyond that dictated by the statute[99] and the judicial policy against allowing the tax system to further sanction the individual for his wrongdoing would require the allowance of the deduction.[100]

This approach not only encompasses the concerns of both the frustration doctrine and the policy against judicial supplementation of legislative sanctions but also, and more importantly, it takes into consideration the overlapping of congressional policies by balancing the interest of the tax system in imposing taxes only on net income[101] with the policy against frustrating the legislative intent in setting the section 16(b) fine.[102] Where the effective enforcement of a "clearly defined statutory scheme" would be subverted by allowing a tax deduction, then the statutory interest is paramount to that of the tax system.[103] On the other hand, if denial of a deduction only increases the penalty above that prescribed by the legislature, the policy against frustration of legislative intent is served "imperfectly, if at all."[104] The interests of the tax system are subverted by taxation of money which is not net income.[105] Since neither objective is furthered whenever a denial of the deduction would exact a fine greater than that required by statute,[106] a deduction should be allowed in such cases[107] under section 162(a).[108]

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[97] *See* note 87 *supra.*

[98] *Cummings*, 506 F.2d at 452; Anderson v. Commissioner, 480 F.2d 1304, 1307-08 (7th Cir. 1973).

[99] Nelson, *supra* note 88, at 343. For a detailed analysis of transactional combinations which deserve special tax treatment, *see* Nelson, *supra* note 88, at 343-54.

[100] Commissioner v. Tellier, 383 U.S. 687, 691, 694-95 (1966).

[101] Commissioner v. Tellier, 383 U.S. 687, 691-92 (1966); Commissioner v. Sullivan, 356 U.S. 27, 29 (1958).

[102] Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30, 35-36 (1958).

[103] *See* 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, 301-02.

[104] *Id.* at 302.

[105] *See generally* Lokken, *supra* note 103, at 301-02.

[106] Indeed, assuming that Congress intended § 16(b) to be precisely tailored to the culpability of the insider's violation, then any court action which either increases or decreases the amount of the fine would be judicial interference with legislative intent. *See* Nelson, *supra* note 88, at 343.

[107] Laurence M. Marks, 27 T.C. 464 (1956), is unique in that it is the only case to date in which the violation resulted from a purchase and sale rather than a sale and repurchase. This distinction between the sale-repurchase and purchase-sale combinations is crucial. *See* Nelson, *supra* note 88, at 344-48, for an extensive treatment of the significance of the differences between these two transactional arrangements.

[108] *See* note 6 *supra.* Of course, when the insider involved is merely a shareholder rather than an officer or director, a different statutory basis for the deduction may be

Where a section 162(a) deduction in the year of repayment would be insufficient to offset the amount of capital gains tax previously paid on a purchase-sale transaction,[109] the tax consequences of the section 16(b) violation conceivably could be determined under section 1341(a) of the Code.[110] This section is designed to alleviate the inequities which result when a taxpayer, who has received income and paid a tax on it, subsequently discovers that his right to such income is incomplete and repayment must be made. Since a deduction in the amount of the tax paid in the previous year would be less valuable if the taxpayer is in a lower income bracket in the subsequent year, section 1341(a) affords the taxpayer the option of taking a credit in the year of repayment.[111]

The Service, however, has held that section 1341(a) is not applicable where money was received because of a mistake in fact; that is, where the taxpayer had access to all the facts which would have established that he was not entitled to the fund at the time the sum was received.[112] Although the money from insider trading could be considered money received under a mistake in law rather than in fact, it

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necessary. Section 212 of the INTERNAL REVENUE CODE OF 1954, a provision designed to afford a deduction to a person who is not in business but who has incurred expenses similar to those enumerated in § 162(a) may, however, provide the shareholder with the tax treatment desired. *See* Nelson, *supra* note 88, at 354-56.

[109] Such situations occur when income decreases, repayment is in a different year than the violation, and the violative transactions were a purchase and sale. *See* Nelson, *supra* note 88, at 349-50. Conversely, given the same circumstances as above except that income increases, the deduction taken in the later year will be worth more than if it was taken in the year of violation. A Revenue Ruling requiring the § 16(b) fine be paid as soon as possible after the violation may be necessary to prevent taxpayers from attempting to schedule their repayments in a later year.

[110] The section provides:

> If (1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item; (2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and (3) the amount of such deduction exceeds $3000, then the tax imposed by this chapter for the taxable year shall be the lesser of the following: (4) the tax for the taxable year computed with such deduction; or (5) an amount equal to (A) the tax for the taxable year computed without such deduction, minus (B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years) . . . .

INT. REV. CODE OF 1954, § 1341(a). Both Nelson, *supra* note 88, at 350, and Lokken, *supra* note 103, at 315-20, argue that § 1341(a) was designed to alleviate inequalities by permitting an adjustment in the present tax year for a transaction which occurred and had tax significance in a previous year. Therefore, if it can be shown that in a § 16(b) situation the initial profits from the purchase-sale appear to be a fund to which the taxpayer has an unrestricted right, then that taxpayer should be eligible for a § 1341(a) deduction. *See also* Rabinovitz, *supra* note 69, at 129, 135-52 (1972).

[111] *See* Nelson, *supra* note 88, at 350.

[112] Rev. Rul. 68-153, 1968-1 CUM. BULL. 371.

has been suggested that this distinction should not justify a different result as to the applicability of section 1341(a), because in either case the taxpayer had access to information defeating his claim at the time of the receipt of the money.[113] In addition, it has been argued that section 1341(a) should be applicable because: (1) the Service's interpretation of section 1341(a), as applied to section 16(b) repayments, could violate the policy against using the tax system to impose extra financial penalties on offenders;[114] and (2) congressional intent in enacting section 1341(a), as expressed in the language of the section itself, requires only that the right "appear" to be unrestricted.[115] Nevertheless, the courts have not yet recognized section 1341(a) as applicable to the section 16(b) situation and absent such judicial recognition, the taxpayer's deduction would be restricted to a section 162(a) deduction in the year of repayment.[116]

One commentator has suggested that the Code might prohibit use of the public policy argument as a basis for denying deductions to insiders.[117] The argument is premised on a 1968 amendment to section 162(f) of the Code which purports to deny deductions for the payment of any "fine or similar penalty."[118] Although this new provision was designed to codify the frustration doctrine,[119] it includes only fines payable to a government.[120] Since a section 16(b) fine is paid to the corporation, it may be outside the scope of section 162(f). Moreover, the fact that the committee report accompanying the amendment clearly states that section 162(f) is intended to be all inclusive[121] could preclude independent use of the public policy argument as a ground for denial of a deduction.[122] In summary, if a section 16(b) fine is not covered by the language of section 162(f) and a deduction cannot be denied for public policy reasons outside section 162(f), the courts may be left with no alternative but to allow a deduction.

On the other hand, there are strong arguments that support denial of a deduction where required by public policy. First, it should be

[113] Nelson, *supra* note 88, at 351. *See also* Lokken, *supra* note 103, at 319 nn.99, 100.

[114] *See* Nelson, *supra* note 88, at 351.

[115] *Id.*

[116] *Id.*

[117] *Id.* at 359-60.

[118] INT. REV. CODE OF 1954, § 162(f), amending INT. REV. CODE OF 1954, § 162. The new amendment to the Code, § 162(f), provides as follows: "No deduction shall be allowed under subsection (a) [§ 162(a)] for any fine or penalty paid to a government for the violation of any law."

[119] Nelson, *supra* note 88, at 360.

[120] *See* note 118 *supra*.

[121] "The provision for the denial of the deduction for payments in these situations which are deemed to violate public policy is intended to be all inclusive." SENATE COMM. ON FINANCE, TAX REFORM ACT OF 1969, S. REP. NO. 552, 91st Cong., 1st Sess. 274 (1969).

[122] *See generally* Nelson, *supra* note 88, at 360.

noted that the "all inclusive" language of the committee report is directly followed by the comment that "[p]ublic policy, in other circumstances, generally is not sufficiently clearly defined to justify the disallowance of deductions."[123] The public policy surrounding the enactment and enforcement of section 16(b), however, could hardly be described as not well defined.[124] Since the abuses of insider trading are widely condemned, it would seem logical to create an exception to the "all inclusive" language of section 162(a) and allow use of the frustration doctrine to deny a deduction in a section 16(b) situation.[125] Indeed, the inference that can be drawn from the committee report — that public policy is still a developing concept — indicates support for the continued use of public policy beyond that set forth in section 162(f).[126] Furthermore, the fact that section 162(f) was recently supplemented by an additional Internal Revenue Service [I.R.S.] regulation[127] argues against the total inclusive nature of the 1968 provision. Even if the supplementary regulations are regarded as explanatory rather than expansive, an argument could be made that under these new provisions the corporation, as the recipient of the insider's fine is, in essence, functioning solely as an agent or instrumentality of the government. Accepting the characterization of a corporation as a government instrument would thereby bring a section 16(b) fine within the scope of section 162(f).

Another possible interpretation of section 162(f) and the relevant legislative history is that the failure to include a section 16(b) fine within the new statutory provision was inadvertent.[128] However, even if there was no legislative oversight, it is submitted that the public policy argument should be available to deny a deduction to an insider, since allowance of a section 16(b) fine deduction would undermine clearly established public policy in the same manner as would allowance of a section 162(f) fine deduction.[129]

The application of the frustration doctrine may be affected by other considerations.[130] One pressing question is whether the fact that

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[123] SENATE COMM. ON FINANCE, TAX REFORM ACT OF 1969, S. REP. NO. 552, 91st Cong., 1st Sess. 274 (1969).

[124] SENATE COMM. ON BANKING AND CURRENCY, STOCK EXCHANGE PRACTICES, S. REP. NO. 1455, 73d Cong., 2d Sess. 55 (1934).

[125] *See* Nelson, *supra* note 88, at 360.

[126] *Id.*

[127] Treas. Regs. § 1.162-21 (1975) provides in part:

"(a) *In general.* No deduction shall be allowed under section 162(a) for any fine or similar penalty paid to (1) the government of the United States . . . (3) A political subdivision of, or corporation or other entity serving as an agency or instrumentality of, any of the above."

[128] It may be that since no court has yet attempted to deny a deduction to a § 16(b) violator under § 162(f), the § 16(b) problem has never been brought to the attention of the legislators.

[129] The allowance of both types of fine deductions would undermine clearly established public policy by subsidizing the fine which in turn would weaken the deterrent effect of the fine.

[130] Such other considerations include voluntariness of the repayment, *see* text at

a fine was paid voluntarily rather than after an adjudication of liability should have an impact on the tax treatment of a violator.[131]

The position articulated by the Second Circuit in *Cummings* is that since defenses to a section 16(b) charge are difficult to assert successfully, the statute operates almost automatically.[132] Therefore, bifurcation of the tax treatment of the section 16(b) repayment according to whether liability was judicially determined would subvert the intent of the statute.[133] Under the Second Circuit's analysis, it appears that the "[t]axpayer's subjective motive for making a settlement payment is irrelevant to the determination of its deductibility."[134]

It is suggested that if the voluntariness issue is analyzed in terms of its impact on public policy rather than in terms of its affect on deductibility, the voluntary repayment problem is more easily understood and the correctness of the circuit court's approach will become apparent. Generally, a voluntary repayment only avoids the almost inevitable judicial finding of liability.[135] Assuming that a section 16(b) fine does lessen the likelihood that a violation will recur,[136] then granting a deduction only to an insider who voluntarily repaid would undercut the deterrent effect of the section 16(b) fine by, in effect, reducing the amount of his fine.[137] This conclusion is substantiated by

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notes 132-142 *infra*, and any of a number of possible defenses to a § 16(b) charge, such as a claim that the challenged transactions came within the *Kerns County* exception, Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 601-03 (1973), *see* note 68 *supra*, or a more technical challenge that the individual does not qualify as an officer or director, Alder v. Klawans, 267 F.2d 840 (2d Cir. 1959). *See Cummings*, 506 F.2d at 452-53.

[131] Charles I. Brown, 32 CCH Tax Ct. Mem. 1300, 1302 (1973). *See Cummings*, 506 F.2d at 452; Nathan Cummings, 60 T.C. 91, 95-96 (1973); William L. Mitchell, 52 T.C. 170, 175-76 (1969); Laurence M. Marks, 27 T.C. 464, 467-70 (1956).

[132] 506 F.2d at 452-53.

[133] *Id.*

[134] Kimbell v. United States, 490 F.2d 203, 204 (5th Cir. 1974). *See Cummings*, 506 F.2d at 452.

[135] *See* Lokken, *supra* note 103 at 312-13 (1970). Of course, if there was not almost automatic enforcement of § 16(b), so that viable defenses became available, the impact of these defenses would require a reconsideration of the repayment before adjudication issue.

[136] This assumption could account for the difference between the Tax and Circuit Court approaches. *See* Charles I. Brown, 32 CCH Tax Ct. Mem. 1300, 1302 (1973); Nathan Cummings, 60 T.C. 91, 95-96 (1973); William L. Mitchell, 52 T.C. 170, 175-76 (1969); Laurence M. Marks, 27 T.C. 464, 467-70 (1956). That is, if the Tax Court rejects this assumption, instead adopting the position that the imposition of a fine on an inadvertent violator probably has a minimum impact on recidivism, then allowing a deduction for the repayment seems reasonable. A problem arises, however, from the fact that the decision to fine inadvertent violators was legislative. While the wisdom of that decision may be questionable, if a change is needed it should be made directly by the legislators and not through the circuitous reasoning of the courts. Therefore, it is submitted that the better approach is that adopted by the circuit courts.

[137] In essence, a voluntary repentor would suffer less than the full amount of his fine in a sale-purchase situation regardless of his culpability. *See* Lokken, *supra* note 103, at 313. On the other hand, allowing such a deduction would place a premium on the timeliness of the repayment.

an I.R.S. ruling that denies deductions for any amount "[p]aid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil) or criminal . . . ."[138] This ruling refers to section 162(f) fines and, as yet, there has been no judicial determination whether the section 162(f) fines encompass a fine under section 16(b).[139] However, even if the section 16(b) repayment is not included, the same public policy considerations which support the I.R.S. ruling with regard to section 162(f) fines are also applicable to a section 162(a) repayment. Therefore, by analogy, no deduction should be allowed to the insider who pays a potential liability before it has been judicially determined, where the same payment, if made under judicial compulsion, would not be deductible.

It is submitted that the foregoing analysis demonstrates that the judiciary has the necessary means to equitably resolve the deduction problem. To date, the courts have not taken full advantage of the most appropriate and best reasoned of these rationales—the frustration doctrine and its correllary, the policy against supplementation of statutory fines through the tax system. Instead, the circuit courts, preoccupied with an undiscerning desire for uniformity,[140] have stretched the principles of the *Arrowsmith* and *Skelly* cases to encompass the section 16(b) situation. Concurrently, the Tax Court, motivated by a similar desire,[141] has perfunctorily employed the business expense argument to justify deductions without discriminating among different fact patterns.[142] The deficiencies in the reasoning of both the circuit courts and the Tax Court have caused concern among members of the judiciary and legal commentators and have inspired the creation of several alternative plans.

The concurring opinion in *Cummings* recommended that the section 16(b) repayment be added to the basis of the purchased stock.[143] As explained by one commentator,[144] the theory of the addition-to-basis plan is to restore the sale-purchase violator to the same position he occupied before engaging in the transactions.[145] Such a restoration serves as a compromise between the public policy interest of denying an ordinary deduction and the tax interest of allowing a full deduc-

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[138] Treas. Regs. § 162-21(b)(iii) (1975).

[139] *See* text at notes 117-130 *supra*.

[140] This desire for uniformity is evident from the fact that the court in *Cummings* heavily relied on Anderson v. Commissioner, 480 F.2d 1304 (7th Cir. 1973) and Mitchell v. Commissioner, 428 F.2d 259 (6th Cir. 1970) which are the only two prior circuit court pronouncements on the subject. 506 F.2d at 450.

[141] *See generally*, Nelson, *supra* note 88, at 339-40.

[142] *See* Nelson, *supra* note 88, at 334 n.19, 339-40.

[143] 506 F.2d at 454 (concurring opinion). This alternative, first suggested in a concurring opinion in William L. Mitchell, 52 T.C. 170, 176 (1969) (concurring opinion) has been given comprehensive treatment by Lokken, *supra* note 103, at 309-15, 320-21. *See also Cummings*, 506 F.2d at 453.

[144] Lokken, *supra* note 103, at 309-15, 320-21.

[145] *Id.* at 309-11, 311 n.69.

tion for any business expenses.[146] Since in a sale-purchase violation, the expense of the section 16(b) fine actually makes the cost of reacquiring the stock higher than is indicated by the purchase price, this increased expenditure is taken into account by adding the cost of the section 16(b) fine to the basis of the repurchased stock.[147] The result of this linking does not become apparent until the stock is again sold, at which time the addition to basis will effect a reduction in capital gains or, in some instances, a capital loss.[148] A major obstacle to adoption of this approach, however, as noted by the *Cummings* court, is that an addition to basis would exact a penalty from the violator beyond that prescribed in section 16(b) by deferring the recognition of the loss until a later date—the time of the sale of the repurchased stock.[149] In addition, the analogy between the section 16(b) repayment and the increased cost of the stock is inaccurate, because the section 16(b) fine is not a function of the cost of acquiring the stock but results from the violator's status as an insider.[150]

Another commentator, dissatisfied with both the Tax Court and circuit court approaches, recommends the use of public policy considerations as the touchstone of deductibility.[151] Of primary importance in the design of this plan for implementing the goals embodied in section 16(b) and the tax system is a case by case determination of the economic impact of the section 16(b) repayment.[152] Once the economic effect of the violation on the insider has been assessed, a deduction would be allowed only to the extent necessary to offset any tangential losses.[153] In this respect, the ultimate objective would be the creation of a system in which repayment of a section 16(b) profit would have no effect on the tax liability of the insider. After the amount of the deduction necessary to achieve a "no tax" effect has been computed, the public policy rationales, *i.e.*, the frustration doctrine and the doctrine against supplementation of statutory fines, together with Code section 162(a)[154] can be invoked to justify the treatment of the section 16(b) violator.

This "no tax" effect approach may supply the guiding principle needed for resolving the repayment-deductibility problem by placing the emphasis on the public policy concerns and the individual taxpayer's economic situation. As seen from the analysis in the *Cummings* case and the general patchwork treatment given the deduc-

[146] *Id.* at 320-21.

[147] Nelson, *supra* note 88, at 347.

[148] 506 F.2d at 453 & n.11.

[149] *Id.* at 453.

[150] Nelson, *supra* note 88, at 347-48.

[151] Nelson, *supra* note 88, at 340-61.

[152] *Id.* at 343. Such an approach is imperative because of the numerous transactional combinations which can lead to such a violation.

[153] *Id.* at 343-44.

[154] If the violation was by a shareholder, the relevant Code section would be 212. *See* Nelson, *supra* note 88, at 354.

tibility issue by other courts, the need for guidance in this area is great. Too often in the past various rationales appear to have been lumped together to justify a predetermined conclusion.[155] The inadequacies of employing the *Arrowsmith-Skelly* rationale as a primary basis for determining the tax treatment of an insider's repayments have been demonstrated.[156] While the deductibility problem eludes easy analysis, the public policy concerns and competing interests suggest an appropriate premise from which to start. It is hoped that this concept, in conjunction with a more careful examination of economic considerations, will provide the flexibility necessary to achieve a balance of the needs of both the tax system and the securities law.

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[155] *See* text at notes 71-77 *supra*. *See also* Nelson, *supra* note 88, at 338-40.
[156] *See* text at notes 71-92 *supra*.