Randall v. Loftsgaarden: Demise of the Tax Benefit Defense in Tax Shelter Securities Fraud Litigation - A Return to Judicial "Never-Never Land"

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NOTES

RANDALL v. LOFTSGAARDEN: DEMISE OF THE TAX BENEFIT DEFENSE IN TAX SHELTER SECURITIES FRAUD LITIGATION—A RETURN TO JUDICIAL "NEVER-NEVER LAND" 1

Courts generally do not consider the impact of federal income taxes when awarding civil damages. 2 In personal injury and wrongful death litigation, this practice is followed whether the issue involves the effect of income taxation upon future earnings in computing damages, 3 or the admissibility of evidence regarding the tax treatment of the damage award itself. 4 The courts defend this approach based on several public policy arguments including: the speculative nature of an individual's future income

1. "Requiring the jury or this Court to try this case without reference to the tax consequences of the transaction would be requiring the jury and the Court to live in an artificial 'never-never land'... and is tantamount to requiring this Court and the jury to try this case blindfolded." Bridgen v. Scott, 456 F. Supp. 1048, 1061 (S.D. Tex. 1978).

2. "Most courts have refused to deduct the income tax savings from the award [for personal injury], and likewise have refused to instruct the jury that the award is not taxable." D. Dobbs, HANDBOOK ON THE LAW OF REMEDIES § 8.8, at 576 (1973) (citations omitted). "Most appellate courts which have been confronted with the issue of the effect of income taxes on awards have upheld refusals to admit evidence or to instruct the jury on such issues." 4 M. Minzer, C. Kimball & D. Axelrod, DAMAGES IN TORT ACTIONS §§ 38.31, 38-64 (1987) (citations omitted) [hereinafter DAMAGES IN TORT ACTIONS].

3. "The amount of an award of tort damages is ordinarily not diminished because of the fact that although the award is not itself taxed, all or a part of it is to compensate for the loss of future benefits that would have been subject to taxation." RESTATEMENT (SECOND) OF TORTS § 914A(2) (1977). See, e.g., Rueter v. United States, 534 F. Supp. 731, 733 (W.D. Pa. 1982) ("Under present Pennsylvania tort law, loss of future earnings or earning power... is to be awarded in full without reduction for putative income tax thereon."); Draisma v. United States, 492 F. Supp. 1317, 1327 (W.D. Mich. 1980) (under Michigan law, damages awarded for a decrease in earning capacity should not be reduced by the proportion the plaintiff would normally have paid in federal, state, and local income taxes); Seely v. McEvers, 115 Ariz. 171, 174, 564 P.2d 394, 397 (1977) ("We adopt the majority rule and hold that the gross pay and not the net or 'take home' pay is the proper basis for computing loss of future earnings, and that the evidence of income taxes or deductions should not be allowed for the purpose of reducing the amount of damages.").

4. "The amount of an award of tort damages is not augmented or diminished because of the fact that the award is or is not subject to taxation." RESTATEMENT (SECOND) OF TORTS § 914A(1) (1977). See, e.g., Anunti v. Payette, 268 N.W.2d 52, 55 (Minn. 1978) (lower court was correct in refusing to instruct the jury in negligence action that any damages award would not be subject to taxation); Hall v. County of New Madrid, 645 S.W.2d 149, 151-52 (Mo. App. 1982) (trial court, in personal injury action, was correct in refusing to instruct the jury that any award made to the plaintiff would not be subject to federal or state income taxes); Salsgiver v. E.S. Ritter Co., 42 Or. App. 547, 550, 600 P.2d 951, 952 (1979) (jury instruction that any damages, awarded in a personal injury action, would be tax exempt is not required in cases which do not involve federal substantive law).
tax liability;\(^5\) the allowance of discovery regarding tax matters which results in evidence that is too complicated for the court to consider;\(^6\) the nature of plaintiff's tax liability which involves the plaintiff and the government and does not concern the defendant;\(^7\) and the exemption of damage awards from taxation which, if taken into account by the jury, might cause the plaintiff not to realize the intended tax benefit.\(^8\) Courts ignore the impact of income taxes in commercial litigation because such damages are usually subject to taxation and this prevents the plaintiff from receiving an undeserved windfall.\(^9\) Until recently, the circuit courts of appeal have been divided on the issue of whether rescission or rescissionary damages awarded in an action for tax shelter\(^10\) fraud, pursuant to the federal securities laws,

5. See, e.g., McWeeny v. New York, N.H. & H. R.R., 282 F.2d 34, 37 (2d Cir. 1960) (larger damage award because tax consequences were ignored was likely to be offset by attorneys' fees and the impact of inflation); Oddo v. Cardi, 100 R.I. 578, 585, 218 A.2d 373, 377 (1966) (effect of federal income taxes on gross earnings should not be considered in computing damages for lost wages "on the ground that the quantum of such taxation is of necessity in the realm of conjecture").

6. See, e.g., Highshew v. Kushto, 235 Ind. 505, 507, 134 N.E.2d 555, 556 (1956) ("Such subject matter would involve intricate instructions on the tax and non-tax liabilities with all the regulations pertinent thereto. No court could, with any certainty, properly instruct a jury without a tax expert at its side."); Hinzman v. Palmanteer, 81 Wash. 2d 327, 333, 501 P.2d 1228, 1232 (1972) ("[T]o introduce an income tax matter into a lawsuit for damages would be unduly complicating and confusing.").

7. See, e.g., Hall v. Chicago & N.W. Ry., 5 Ill. 2d 135, 151, 125 N.E.2d 77, 86 (1955) ("Whether the plaintiff has to pay a tax on the award is a matter that concerns only the plaintiff and the government. The tortfeasor has no interest in such question.").

8. Section 104 of the Internal Revenue Code excludes from gross income "the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injury or sickness." I.R.C. § 104(a)(2) (1982). See Norfolk & W. Ry. v. Liepelt, 444 U.S. 490 (1980). The Supreme Court held that evidence and jury instructions relating to the tax free treatment of certain wrongful death awards were allowed. The Court was concerned that a jury, in such cases, might over-compensate the plaintiff based on the mistaken assumption that the award would be fully taxable. Id. at 496-97. For a detailed discussion of Liepelt, see Note, Jury Review of Tax Consequences of FELA Damage Awards Now Considered Appropriate, 26 Loy. U. Chi. L.J. 409 (1980); Note, Income Taxation and the Calculation of Tort Damage Awards: The Ramifications of Norfolk & Western Railway v. Liepelt, 38 Wash. & Lee L. Rev. 289 (1981).

9. For example, damages recovered for the loss of profits are includable in gross income since business profits are includable in gross income. 1 J. Mertens, Law of Federal Income Taxation § 6A.21 (rev. ed. 1986). Damages for the destruction of property or for an injury to the goodwill of a business are taxable to the extent that the award exceeds the adjusted basis of the property. Id. The IRS has asserted that damages for wrongful death are includable in gross income where the state courts have labeled the damages as punitive in nature. Rev. Rul. 84-108, 1984-2 I.R.B. 32. However, this position has not been consistently followed by the courts. See, e.g., Burford v. United States, 642 F. Supp. 635, 636 (N.D. Ala. 1986) ("The court is of the opinion that Revenue Ruling 84-108 constitutes an unwarranted administrative amendment of the clear language of the Internal Revenue Code and cannot stand."). See supra note 8 (relevant Internal Revenue Code text).

should be reduced by the amount of the tax benefits realized by the plaintiff-investor. The Second\textsuperscript{11} and Eighth Circuits\textsuperscript{12} have held that the defendant should be allowed to reduce his payment for damages by asserting this tax benefit defense, while the Ninth Circuit\textsuperscript{13} has held that such a reduction in damages is inappropriate. The Securities and Exchange Commission (SEC) and the Internal Revenue Service (IRS) support the latter view.\textsuperscript{14} A division, however, exists in the lower courts as to both allowing\textsuperscript{15} and denying\textsuperscript{16}

\textsuperscript{11} Owners of tax shelters, for example, may want to avoid disclosing losses to the IRS and thus reduce the tax benefits they receive from the shelters. Owners of tax shelters may therefore be encouraged to maximize their chances of avoiding assessments of liability by reducing the amount of restitutionary recovery that is awarded to plaintiffs. The tax benefit defense has been recognized by the SEC as an essential tool for protecting taxpayers from being `second-class citizens.' The SEC has consistently argued that `the tax benefit defense is a central part of the tax system, and ... it is important that it remain in place.'

\textsuperscript{12} The tax benefit defense was first recognized by the Court of Appeals for the Ninth Circuit in Western Fed. Corp. v. Davis, 571 F.2d 168 (9th Cir. 1978). Since then, the defense has been recognized by a number of courts, including the Second Circuit in Smith v. Bader, 818, 820-21 (2d. Ariz. 1982), aff'd sub nom. Western Fed. Corp. v. Erikson, 739 F.2d 1439 (9th Cir. 1984) (defendants should not be given any credit for the tax benefits received by the plaintiffs); Spatz v. Borenstein, 513 F. Supp. 571, 586 (N.D. Ill. 1981) ("The fact that plaintiffs may be better off vis-a-vis the government does not warrant the discarding of a remedy specifically enumerated by the Securities Act."); and the Department of Justice on behalf of the IRS in Salcer v. Envicon Equities, Corp., 744 F.2d 935 (2d Cir. 1984), vacated and remanded, 106 S. Ct. 3325 (1986). See infra notes 62-88 and accompanying text.

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The tax offset issue is critical in securities litigation since it can have a tremendous impact on the amount of damages awarded and may even determine whether an investor decides to bring suit at all. In *Randall v. Loftsgaarden*, the United States Supreme Court evaluated the viability of the tax benefit defense in light of the statutory language of section 12(2) of the Securities Act of 1933 and section 28(a) of the Securities and Exchange Act of 1934, as well as the general policy considerations behind the federal securities laws.

This Note will discuss the circuit court decisions and their divergent positions on the tax benefit defense. The Supreme Court's holding in


18. For example, the defendants' liability in *Burgess* was determined to be $496,000 before the tax benefits were considered and only $157,000 after the tax offset. 727 F.2d at 838. The defendants' liability in *Austin* was determined to be $294,000 before the tax benefits were considered and only $29,000 after the offset. Brief for Petitioners at 7-8, *Randall v. Loftsgaarden*, 106 S. Ct. 3143 (1986) (No. 85-519) [hereinafter Brief for Petitioners].


20. Section 12(2) of the Securities Act of 1933 reads as follows:

   Any person who . . .
   (2) offers or sells a security . . . by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest therein, less the amount of any income received thereon upon the tender of such security, or damages if he no longer owns the security.


21. Section 28(a) of the Securities Exchange Act of 1934 reads as follows:

   The rights and remedies provided by [the Securities Exchange Act of 1934] shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of [the Securities Exchange Act of 1934] shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of.


22. In 1933, President Roosevelt appealed to Congress and sought passage of the Securities Act of 1933: “This proposal adds to the ancient rule of caveat emptor, the further doctrine, ‘Let the seller also beware.’ It puts the burden of telling the whole truth on the seller. *It should also give impetus to honest dealing in securities . . . .*” 77 CONG. REC. 937 (1933) (emphasis added). The Preamble to the 1933 Securities Act states that its purpose is to: “Provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof . . . .” 47 Stat. 74 (1933) (emphasis added). Both quotes were included in Brief for Petitioners, supra note 18, at 32.
Randall will then be analyzed and its potential impact evaluated. This Note proposes that the Supreme Court misconstrued section 12(2) of the 1933 Act and section 28(a) of the 1934 Act, as well as the direct product and collateral source rules when it excluded the consideration of tax benefits when calculating damages. Such tax benefits, as well as the tax treatment of the damage award, must be considered if the courts are to make a realistic attempt to return the plaintiff-investor to the status quo ante which is the measure of damages provided under the law. While it may be argued that this form of damages is too lenient and therefore inadequately insures the realization of the public policy goals behind the federal securities laws, Congress, and not the courts, must provide for a harsher measure of damages.

Finally, this Note concludes that the Randall Court’s failure to address the tax consequences of rescissionary damages has allowed confusion surrounding the tax treatment of such awards to continue and Congress and the IRS have no incentive to clarify the law.

I. BACKGROUND

During the past few years, tax shelter investments have been subjected to tighter restrictions under the federal tax laws, and have been closely monitored by the IRS and the courts. In addition, tax shelter limited partnership interests are generally treated as securities under the provisions of the federal securities law and are subject to regulation by the


24. For example, the 1984 Tax Reform Act imposed strict requirements on promoters of “potentially abusive tax shelters” as defined by I.R.C. § 6112(b) (Supp. 1985). Promoters who market such tax shelters are required to register the investments with the IRS, I.R.C. § 6111(a)(1) (Supp. 1985), and maintain a list of clients. Id. § 6112(a). Promoters are also required to furnish each investor who purchases such a shelter with its IRS identification number. Id. § 6111(b)(1). This number must be included in the investor’s return. Id. § 6111(b)(2). Penalties are imposed for failing to meet these requirements. See id. §§ 6707, 6708. Harsher penalties are imposed under sections 1532-1534 of the Tax Reform Act of 1986 which amended these provisions.

25. In November 1983, the Justice Department’s Tax Division created a special litigation unit to deal with cases under the injunctive penalty provisions of the Internal Revenue Code which was created to stop illegal tax shelter promotions. Rollins, Patton, & Friedman, IRS Freeze On "Abusive Tax Shelter" Refunds; How It Works and Who Will Be Affected, 34 TAX’N FOR ACCTS. 270 (1985). See Deegan v. Comm’r, 787 F.2d 825 (2d Cir. 1986) (disallowed deductions and tax credits generated by limited partnership investments in two film productions that were not activities engaged in “for profit”). Honodel v. Comm’r, 722 F.2d 1462 (9th Cir. 1984) (disallowed depreciation deductions for an investment in residential real estate that were computed according to the “economic useful life” of the investment rather than the Internal Revenue Code standards).

26. Section 2(1) of the Securities Act of 1933 reads as follows:

The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transfer-
Consequently, a defrauded tax shelter investor may sue for recovery of their share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or in general any interest or participation in temporary or interim certificate for, receipt for, guarantee of, warrant or right to subscribe to or purchase, any of the foregoing.


Under the Federal Securities Laws, an offering of a limited partnership interests and interests in joint or profit-sharing real estate ventures generally constitutes an offer of a "profit sharing agreement" or "an investment contract" which is security within the meaning of section 2(l) of the Securities Act of 1933. The Supreme Court has said that an "investment contract" is a contract, transaction or scheme whereby a person invests money in a common enterprise and is led to expect profits from the efforts of the promoter and or a third party.

Securities and Exchange Commission v. W.J. Howey, 328 U.S. 293, 298, 299 (1946). In other words, the investor provides the capital and shares the risk and the profits; the promoter or third party manages, operates, and controls the enterprise, usually without active participation on the part of the investor. See also United Hous. Found., Inc. v. Forman, 421 U.S. 837, 852 (1975) (defining a security as "an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others").

27. Tax shelter investments have become increasingly popular in the past few years. "In a recent year, about two-thirds of the 15,000 private offerings made under SEC Regulation D, 17 C.F.R. § 230.501 (1986) were limited partnerships and thus presumably tax shelter ventures." SEC Directorate of Economic and Policy Analysis, An Analysis of Regulation D, at i-ii (May, 1984) (cited in Brief of U.S. and SEC as Amici Curiae at 1, Randall v. Loftsgaarden, 106 S. Ct. 3143 (1986) (No. 85-519)) [hereinafter Brief of Amici Curiae]. The total invested in limited partnerships in 1984 is estimated to be $19 billion. R. HAFT & P. FASS, TAX SHELTERED INVESTMENTS vii (3d ed. 1985). Consequently, a substantial amount of litigation has involved tax shelters. At the present time, over 30,000 cases, 40% of the Tax Court's docket, involve tax shelters. Brief of Amici Curiae, supra at 30. Most tax shelters are organized as limited partnerships because a partnership is not taxed as a separate entity but rather its income and losses pass through directly to the partners. P. GOLDSTEIN, REAL ESTATE TRANSACTIONS 830-31 (2d ed. 1985). See I.R.C. § 701 (1982).

Under I.R.C. § 465 (1982), the individual partners may deduct losses from certain partnership activities only to the extent they are "at risk" with respect to the activity. W. McKee, W. Nelson & R. Whitmore, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS, v.1 § 10.11[1] (1986). The amount "at risk" is generally composed of three components:

1. The partner's cash contributions to the partnership,
2. The adjusted basis of the other property contributed to the partnership, and
3. Amounts borrowed by the partnership for which the partner is personally liable.


More importantly, losses from trade or business activities in which the taxpayer does not materially participate (e.g., limited partnerships) may not offset other income such as salary, interest, dividends and active business income. Tax Reform Act of 1986, H.R. No. 841, 99th Cong., 2d Sess. H7633 (Sept. 18, 1986). In the case of real estate rental activities, in which the taxpayer does actively participate, up to $25,000 of these losses may be used to offset "non-passive" income. Id. These provisions are effective for taxable years beginning after December
under both section 12(2) of the Securities Act of 1933\(^\text{28}\) and Rule 10b-5, promulgated pursuant to the Securities and Exchange Act of 1934.\(^\text{29}\) The Supreme Court has held that section 28(a) of the 1934 Act should be used for guidance in determining damages under Rule 10b-5.\(^\text{30}\)

The recognized standard for measuring damages under Rule 10b-5 is the "out-of-pocket rule" by which courts award the plaintiff-investor the difference between the purchase price of the securities and their actual value.\(^\text{31}\) Section 12(2) of the 1933 Act\(^\text{32}\) specifically provides for rescission or rescissionary damages and a majority of courts have held that such damages are also recoverable under Rule 10b-5.\(^\text{33}\) The initial contract, therefore, is rendered void and the investor recovers his consideration.

\(^{28}\) See supra note 20 (text of statute).

\(^{29}\) Rule 10b-5 states:

\begin{verbatim}
It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce, or of the mails or any facility of any national securities exchange, to employ any device, scheme, or artifice to defraud,

a) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading,

b) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.
\end{verbatim}

\(^{30}\) See Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972) (damages for violations of Rule 10b-5 by bank employees were computed in accordance with section 28(a)); supra note 21 (text of section 28(a)).

\(^{31}\) See Harris v. American Inv. Co., 523 F.2d 220, 225 (8th Cir. 1975), cert. denied, 423 U.S. 1054 (1976); L. Loss, FUNDAMENTALS OF SECURITIES REGULATION 1133-34 (1983); D. Dobbs, supra note 2, § 9.2, at 595. This was the method of computing damages applied by the courts in common law fraud cases prior to Erie R.R. v. Tompkins, 304 U.S. 64 (1938). L. Loss, supra at 1133. To the extent the value of the securities is not readily determinable, reasonable inferences may be made. Id. at 1134.

\(^{32}\) L. Loss, supra note 31, at 1022 ("Section 12(2) can be best analyzed and evaluated by comparing it with common law or (equitable) rescission, from which it was adapted."); Wigand v. Flotek, 609 F.2d 1028, 1035 (2d Cir. 1979) (under section 12(2) a plaintiff is entitled to rescission if he still owns the stock and damages if he does not).

which was given in exchange for the securities purchased, i.e., the parties are returned to the status quo ante.34

Returning the investor in a tax shelter limited partnership to the status quo ante upon rescission of the investment, however, is difficult because the investor is likely to have received substantial tax benefits.35 If these tax benefits are permanent and the investor recovers his consideration, the investor will be placed in a better position than he was prior to the transaction.36 If the investor's damages are reduced by the amount of tax benefits realized and the previous benefits are completely or partially disallowed by the IRS, the investor will be placed in a worse position than he was prior to the transaction.

In 1964, two district court decisions, Cooper v. Hallgarten37 and Weisenberger v. W.E. Hutton & Co.,38 held that tax benefits realized from investment losses could not be used to offset the investor's subsequent award for damages.39 In Cooper, the court reasoned that the offset should not be allowed because any recovery by the plaintiff-investor would be subject to taxation and the benefits previously recognized would be eliminated.40 In addition, the court noted the inequity of awarding different amounts of damages to plaintiffs who sustained the same loss but happened to be in different tax brackets.41 In Weisenberger, the court stated that "it would be great 'injustice' to [the] plaintiff to reduce such damages for

34. Myzel v. Fields, 386 F.2d 718, 742 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968). "Rescission calls for cancellation of the bargain and the return of the parties to the status quo ante; where this is impossible because of the disposal or retirement of the stock, then the equivalent value of the stock at the time of resale . . . or at the time of judgment . . . should be the proper measure of damages." Id. (citations omitted).

This measure of damages is actually composed of two steps. First, the rescission is granted in order to void the contract. Jacobs, The Measure of Damages in Rule 10b-5 Cases, 65 GEO. L. J. 1110 (1977). Then, restitution is permitted to return the property or money taken from the plaintiff. D. DODDS, supra note 2, § 4.1, at 222. See generally 3 H. BLACK, RESCISSION OF CONTRACTS AND CANCELLATION OF WRITTEN INSTRUMENTS § 616, at 1482 (2d ed. 1929); C. MCCORMICK, LAW OF DAMAGES § 121, at 448 (1935).

35. Note, Securities Fraud: The Tax Benefit Offset Rule of Securities Litigation, 70 MUNN. L. REV. 1185, 1190 (1986). This is particularly true with real estate tax shelters. See supra note 27 (benefits realized through investments). If the rescission occurs after the first few years of the investment, it is likely that the total tax benefits realized by the defrauded investor will exceed his initial consideration paid. See W. DROLLINGER, supra note 10, at 21.

36. The benefit that accrues to the investor, however, will be reduced if his damage award is subject to taxation. See infra notes 57-60 (discussion of tax benefit rule).

37. 34 F.R.D. 482 (S.D.N.Y. 1964).


39. For a detailed analysis and critique of these two cases, see Note, Tax Consequences of Rescission: The Interplay Between Private and Public Law, 42 U. Chi. L. Rev. 562, 565-70 (1975).

40. 34 F.R.D. at 486. See infra notes 57-60 and accompanying text (discussion of tax benefit rule).

41. 34 F.R.D. at 486.
extraneous reasons wholly unconnected with the acts of [the] defendants."

Eventually, some courts did allow discovery regarding tax benefits, in securities fraud litigation, because such information could be relevant to issues other than damages, such as valuation of the investment, misrepresentation of the potential tax benefits, sophistication of the investors, and reliance. Finally, in the 1982 case of *Austin v. Loftsgaarden*, the Eighth Circuit ruled that the tax benefit defense could be successfully asserted, in an action for tax shelter fraud, to reduce the investor's award of rescissionary damages.

The *Austin* court found that the tax savings generated by a real estate limited partnership was a tangible economic benefit and the actual damages principle of federal securities law required that a rescissionary award for fraud "be reduced by any value received as a result of the fraudulent transaction." The court found that the required calculation was no more

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42. 35 F.R.D. at 558. See infra notes 168-79 and accompanying text (discussion of collateral source rule).


44. Dupuy v. Dupuy, 551 F.2d 1005, 1025 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977) (trial court properly considered tax benefits in valuing investment in closely-held corporation); Berg v. Xerxes-Southdale Office Bldg. Co., 290 N.W.2d 612, 615 (Minn. 1980) ("On remand, evidence will have to be received as to the market value of the limited partnership interest, assuming the disclosure of the negative cash flow. It may well be that because of income tax considerations, the evidence will reveal that the selling price equaled the market value of the property.").


46. Smith v. Bader, 83 F.R.D. 437, 439 (S.D.N.Y. 1979) ("The plaintiffs' investments in other partnerships and their investments in other tax shelters may shed light on their sophistication as investors.").

47. Sharp v. Coopers & Lybrand, 83 F.R.D. 343, 352 (E.D. Pa. 1979), *rev'd on other grounds*, 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982) ("[A]n investor's 1971 tax return could reveal information relevant to the issue of reliance, since for example, an investor in a comparatively 'low' tax bracket might not have needed the type of tax shelter the defendant's opinion letters represented these investments to be.").

48. 675 F.2d 168 (8th Cir. 1982), *aff'd en banc*, 768 F.2d 949 (8th Cir. 1985), *cert. granted sub nom.* Randall v. Loftsgaarden, 106 S. Ct. 379 (1985) (hereinafter *Austin I*).

49. The plaintiffs in *Austin I* were investors in a real estate limited partnership explicitly marketed as a tax shelter. 675 F.2d at 173. The promoters of the investment were found guilty of violating Rule 10b-5 because they knowingly made material misrepresentations in the offering memorandum. *Id.* at 176. In addition, the district court allowed the jury's advisory verdict which stated that the defendant was liable under section 12(2) because he "knowingly made material misrepresentations or omissions of which plaintiffs were unaware, and because there was some causal connection between the Loftsgaarden's wrongful conduct and the plaintiffs' purchases." *Id.* In determining the appropriate award for damages, the Eighth Circuit ruled that the tax benefit defense should be allowed and that the plaintiffs' recovery should be reduced by the amount of tax benefits realized. *Id.* at 183.

50. *Id.* at 180-81.

51. *Id.* at 181 (citing Garnatz v. Stifel, Nicolaus & Co. 559 F.2d 1357, 1361 (8th Cir. 1977), *cert. denied*, 435 U.S. 951 (1978)).
uncertain or complex than that already made in determining future earnings. Therefore, the Eighth Circuit held that evidence of any ongoing IRS audits and expert opinion as to the likely results would be admissible at retrial. The jury would then determine whether and to what extent the previous deductions would be disallowed.

Two years later, in Burgess v. Premier Corporation, the Ninth Circuit Court of Appeals rejected the tax benefit defense. The court determined that any previous tax savings enjoyed by tax shelter investors, who received rescissionary damages, would be displaced by virtue of the tax benefit rule. The tax benefit rule provided that a taxpayer who claimed a deduction in one taxable year had to recognize as income any recovery or repayment of the deduction which arose in a subsequent year. Since the damages were fully taxable, the court reasoned that once the plaintiffs

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52. Id. at 183 (citing Norfolk & W. Ry. Co. v. Liepelt, 444 U.S. 490 (1980)).
53. 675 F.2d at 183.
54. Id. The court defines a "tax shelter" as "investments which allow the investor to offset certain 'artificial losses' (that is, non-economic losses which are available as deductions under the present tax laws) not only against the income from those investments but also against the [investor's] other income, usually from his regular business or professional activity." Id. (quoting STAFF OF JOINT COMM. ON INTERNAL REVENUE TAXATION, 94th Cong., 1st Sess. (Comm. Print 1975)). The Eighth Circuit limited the impact of its holding in Austin I in Hayden v. McDonald, 742 F.2d 423 (8th Cir. 1984). In Hayden, the plaintiffs were investors who had undivided working interests in oil and gas leases located in Texas. Id. at 425. Suit was brought against the venture's promoter for rescission and restitution under the Minnesota Blue Sky Act for failing to register the interests as securities in the state of Minnesota. Id. See MINN. STAT. ANN. § 80A.23(1) (West Supp. 1984). Although the Minnesota statute used the same language as section 12(2) of the Securities Act of 1933, the court held that tax benefits realized should not reduce an award for rescissionary damages under the Minnesota law. Id. at 440-41. Since Minnesota courts had not interpreted the words "income received" under the Minnesota statute, the court deferred to the district court's interpretation that the phrase did not include tax benefits. However, in Austin v. Loftsgaarden, 768 F.2d 949 (8th Cir. 1984) [hereinafter Austin II], the Eighth Circuit explicitly overruled its decision in Hayden, even though the state issue was not presented, because the court wanted "to bring consistency" to the law. Id. at 953 n.6. For a discussion of the Hayden case, see Note, Tax Shelter Schemes and Damages in the Eighth Circuit — Hayden v. McDonald, 18 CREIGHTON L. REV. 1307 (1985).
55. 727 F.2d 826 (9th Cir. 1984).
56. Id. at 837-38. The plaintiffs in Burgess were five doctors from the Seattle, Washington area who purchased tax shelter investments in cattle herds from Premier Corporation. Id. at 830. The promoters were found guilty of common law fraud, negligent misrepresentation, and violating Rule 10b-5. Id. at 831.
57. Id. at 838.
58. 1 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 7.34 (rev. ed. 1986). This rule is not expressly stated in the Internal Revenue Code but is judicially created. Id. See, e.g., Hillsboro Nat'l Bank v. Comm'r, 460 U.S. 370 (1983) (previous tax deduction of property taxes placed in escrow pending litigation was includable in income when the escrow amount was refunded). The Internal Revenue Code restricted the general rule by excluding recovery of previous deductions which did not reduce the income subject to taxation. I.R.C. § 111 (Supp. 1985). For a detailed discussion of the tax benefit rule, see Bittker and Kanner, The Tax Benefit Rule, 26 UCLA L. REV. 265 (1978).
paid their tax liability, they would be returned to the status quo ante. In addition, the Ninth Circuit refused to recognize the Eighth Circuit's holding in Austin because the government would be the "banker" for the fraudulent tax shelter activity.

In Salcer v. Envicon Equities, Inc., the Second Circuit Court of Appeals was also faced with the issue of whether rescission damages should be reduced by realized tax shelter benefits. Both the SEC and the IRS submitted amicus curiae briefs which asserted that the tax benefits should not offset an award for damages.

The SEC's argument included three points. First, the Commission agreed with the Ninth Circuit's holding in Burgess that the tax benefit rule would recapture all of the previous tax benefits realized and would prevent a windfall to the plaintiffs. Second, the SEC asserted that the tax savings

59. The court found that the plaintiffs would have to file amended returns for each of the tax years in which the tax benefits were realized. 727 F.2d at 838. Most practitioners find this statement to be incorrect. See, e.g., Fijolek & Banoff, Do Tax Shelter Benefits Offset Rescission Damages? The Courts Disagree, 5 REAL EST. SEC. J. 70, 75 (1984) ("The Ninth Circuit wrongly assumed that the "tax benefit" rule would apply to the rescission award and would require a plaintiff to file amended tax returns for his prior tax years to remove his claimed tax losses from the rescinded investment."). Instead, income is recognized on the plaintiff's tax return for the year in which the damages are received. Id.

60. 727 F.2d at 838. This is the reasoning followed by the district court in Cooper v. Hallgarten in 1964. See supra notes 37-41 and accompanying text.

61. Id. The plaintiffs also argued that Burgess should be distinguished from Austin II because the investors in Burgess were motivated primarily by their desire to purchase a valuable investment in a cattle herd, with only secondary tax benefits. Brief for Plaintiffs-Appellees at 31, Burgess v. Premier Corp., 727 F.2d 826 (9th Cir. 1984) (Nos. 82-3064 & 82-3090). The court, however, did not address this distinction. For additional discussion of this opinion, see Note, Securities: Tax Shelter Investment Fraud—Should Tax Savings Be Considered in Determining Amount of Recovery?, 38 OKLA. L. REV. 334, 341-42 (1985). The Ninth Circuit has consistently applied its holding in Burgess to actions brought under the federal securities laws, see Western Fed. Corp. v. Erickson, 739 F.2d 1439 (9th Cir. 1984), as well as its state securities statute, see Hall v. Johnston, 758 F.2d 421 (9th Cir. 1985) (interpreting Oregon's securities laws).

62. 744 F.2d 935 (2d Cir. 1984), vacated and remanded, 106 S. Ct. 3324 (1986).

63. In Salcer, the plaintiffs were purchasers of fifteen partnership interests in Greenpoint Associates, a tax shelter limited partnership established to construct, own, and operate a residential apartment complex. 744 F.2d at 937. Suit was brought against the promoters, under Rule 10b-5, for failing to disclose material information regarding the planned annexation of the property by the city of Houston, an event that would cause a substantial increase in building costs. Id. at 937-38. The defendants asserted the "tax benefit" defense but the district court refused to allow it. Id. at 938.

64. Brief of SEC as Amicus Curiae at 2, Salcer v. Envicon Equities, Corp., 812 F.2d 713 (2d Cir. 1984) (No. 84-7183) [hereinafter Salcer SEC Brief]; Brief of United States as Amicus Curiae at 3, Salcer v. Envicon Equities, Corp., 812 F.2d 713 (2d Cir. 1984) (No. 84-7183) [hereinafter Salcer IRS Brief]. The Tax Division of the Department of Justice submitted the brief on behalf of the United States Government.

65. Salcer SEC Brief, supra note 64, at 13. See supra notes 57-60 and accompanying text. The defendants in Randall v. Loftsgaarden responded to this argument by asserting that if the plaintiffs really believed they would have to pay back all of their tax benefits, it was not clear why they were bringing suit at all. See Brief For Respondents at 20, Randall v. Loftsgaarden,
emanated from a source collateral to the defendant. Therefore, allowing the tax benefit defense would violate the common law direct product and collateral source rules which held that the plaintiffs could recover the full amount of compensatory damages from a wrongdoer even if he or she received compensation for the injury from a source entirely independent from, or collateral to, the offending party. The SEC contended that the tax benefits were conferred by the government and by other income generated by the plaintiffs and not by any action taken by the defendant. Third, the SEC contended that the plaintiffs would not receive a windfall if the government failed to recover all of the previous tax benefits realized because some compensation should be allowed for the use of the plaintiffs' money. The SEC also argued, based on public policy, that the tax benefit defense "would discourage private enforcement of the anti-fraud provisions of the federal securities laws in an area in which the SEC itself was unable to devote substantial resources."
The IRS agreed with the SEC and argued that the tax benefits previously recognized by the plaintiffs would be recaptured. If the years were still open, i.e., still subject to assessment, the IRS could challenge the original deductions and eliminate any tax benefits. If the tax years were closed, according to the Service, the tax benefit rule required that previous benefits be picked up in income in the current year. Lastly, the IRS stated

(1983). Consequently, the SEC argued that this exempt status makes the detection of fraud in limited partnership offerings extremely difficult and reduces the effectiveness of the Commission in enforcing the securities laws. Salcer SEC Brief, supra note 64, at 2. Therefore, private actions for securities laws violations are needed to supplement the enforcement activities of the SEC. Id. (citing Mills v. Electric Auto-Lite Co., 396 U.S. 375, 382 (1970)); J.J. Case Co. v. Borak, 377 U.S. 426, 432 (1964). See also Berner v. Lazzaro, 730 F.2d 1319, 1222-23 (1979) (“The resources of the Securities Exchange Commission are adequate to prosecute only the most flagrant abuses. To this end, private actions brought by investors have long been viewed as a necessary supplement to SEC enforcement actions.”) (citing Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975)), aff’d sub nom. Bateman Eichler, Hill Richards, Inc. v. Berner 472 U.S. 299 (1985).

Salcer IRS Brief, note 64, at 5.

Generally the IRS is given three years in which to assess taxpayers. I.R.C. § 6501(a) (1982). The statute of limitations begins to run on the due date of the return or on the date the return is actually filed, whichever is later. Id. § 6501(b). The courts have interpreted the word “return” to mean the original return, not a subsequently filed amended return. See Zellerbach Paper Co. v. Helvering, 293 U.S. 172 (1934); Rev. Rul. 72-311, 1972-1 I.R.B. 398. This three year period increases to six years if the taxpayer omits from gross income 25% or more of the amount of gross income shown on the return. I.R.C. § 6501(e) (1982). There is no statute of limitations on the assessment if the taxpayer files a false return, makes a willful attempt to evade taxes, or files no return at all. Id. § 6501(c)(1)-(3). In addition, the IRS and the taxpayer may extend the statute of limitations by agreement. Id. § 6501(c)(4). See generally M. GARRIS & S. STRUNTZ, TAX PROCEDURE AND TAX FRAUD 164-5 (1982); F. MODRICKER, W. DONALD & J. GILJUM, STATUTE OF LIMITATIONS: INTEREST ON UNDERPAYMENTS AND OVERPAYMENTS OF TAX (BNA) No. 28-4 (1984).

Salcer IRS Brief, supra note 64, at 6-7. See supra notes 57-61 and accompanying text (discussion of tax benefit rule).

Salcer IRS Brief, supra note 64, at 8 (citing Western Fed. Corp. v. Erickson, 739 F.2d 1439 (9th Cir. 1984)). The IRS gives three specific examples where the previous tax benefits may be subject to recapture. If the partnership interest is sold subject to debt, the investor must include the discharged indebtedness as part of the “amount realized” under I.R.C. § 1001 (1982), thereby increasing his taxable income. Id. See I.R.C. § 752(d) (1982); Crane v. Comm’r, 331 U.S. 1 (1947) (when property encumbered by debt is sold, the amount realized includes the discharged indebtedness); Millar v. Comm’r, 67 T.C. 656 (1977), aff’d sub nom. Millar v. C.I.R., 577 F.2d 212 (3d Cir.) (shareholders of a tax option corporation realized taxable gain in the form of cancellation of indebtedness upon surrender of stock in the corporation), cert. denied, 439 U.S. 1046 (1978); Parker v. Delaney, 186 F.2d 455 (1st Cir. 1950) (gain realized on discharge of mortgage from a bank upon reconveyance of a deed). See generally Adams, Exploring the Outer Boundaries of the Crane Doctrine; An Imaginary Supreme Court Opinion, 21 TAX L. REV. 159 (1966); Bittker, Tax Shelters, Nonrecourse Debt, and the Crane Case, 33 TAX L. REV. 277 (1978); Ginsberg, The Leaky Tax Shelter, 53 Taxes 719 (1975). If accelerated depreciation is taken on the partnership’s assets, and these assets are sold or otherwise disposed of, all or part of any recognized gain may be subject to the depreciation recapture provisions and thus
that the tax benefits arose because Congress determined that a favorable tax treatment should be given to encourage additional investments.\textsuperscript{75} To the extent a taxpayer was entitled to the tax benefits realized, "he, and not the [defendant] should be allowed to retain those benefits because the tax laws so provide."\textsuperscript{76}

The Second Circuit rejected the arguments of the SEC and the IRS and allowed the defendant to assert the tax benefit defense.\textsuperscript{77} The court first noted that section 28(a) of the 1934 Act limited recovery to actual damages\textsuperscript{78} and did not give the court discretionary power to increase that amount in order to encourage the filing of private actions.\textsuperscript{79} The court then rejected the notion expressed by the Ninth Circuit in \textit{Burgess} that allowing the tax benefit defense would make the government the banker for the fraudulent tax shelter activity.\textsuperscript{80} The court reasoned that because the government received the residential development, which it had hoped to encourage by offering the tax benefits taken by the plaintiffs, it was banking precisely what it had agreed to bank.\textsuperscript{81}

The Second Circuit rejected the IRS and SEC argument that the collateral source doctrine prevented the consideration of tax benefits in the determination of damages.\textsuperscript{82} The court found the tax benefits to be an inextricable part of the tax shelter offering which emanated directly from actions by the defendant.\textsuperscript{83} The court also held that the tax benefit rule did not apply since the plaintiffs sought rescissionary damages and not actual rescission.\textsuperscript{84} The court then distinguished the \textit{Burgess} holding. The court stated that because the investors in \textit{Burgess} had been awarded a rescission, i.e., were returned to the \textit{status quo ante}, they had recovered their previous deductions.\textsuperscript{85} Therefore, the tax benefit rule applied.\textsuperscript{86} Since the plaintiffs in \textit{Salcer}, however, sought rescissionary damages, a purely monetary award,
they were not returned to the status quo ante. Therefore, they did not recover their prior deductions and the tax benefit rule did not apply.

Due to the conflict among the circuit courts, lower court decisions have been equally divergent. When the Supreme Court granted the plaintiffs' petition for certiorari in Randall, it was hoped that many of the unsettled issues would be resolved, such as whether the actual damages provisions under federal securities laws required that damages be reduced by economic benefits received or merely income received, whether the tax benefit rule required recognizing as income a rescissionary damage award for recovery from a fraudulent tax shelter scheme, and whether the collateral source or direct product doctrine should apply to such awards.

II. The Randall Decision

In 1973, the four plaintiffs, along with eighteen other investors purchased interests in Alotel Associates, a limited partnership organized to construct and manage a Ramada Inn motel in Rochester, Minnesota. Defendant B.J. Loftsgaarden, president and sole shareholder of defendant Alotel, Inc., organized the venture and was to serve as a general partner along with the corporation.

The original offering memorandum stated that the limited partnership would utilize financing techniques that would generate substantial tax benefits during the initial years of the venture and would generate profits

87. 744 F.2d at 943.
88. Id. The court responded to the third argument asserted by the SEC, regarding prejudgment interest, by stating that the tax benefits realized by the investors were so disproportionate to any computation of prejudgment interest that an argument that they should be treated equivalently bordered on the frivolous. Id. at 942. For additional discussion of this opinion, see Note, Tax Benefits in Mitigation of Rule 10b-5 Damages: William Z. Salcer v. Environ Equities Corp., 21 TULSA L.J. 542 (1986). The Second Circuit reaffirmed its holding in Salcer in Freschi v. Grand Coal Venture, 767 F.2d 1041 (2d Cir. 1985), vacated and remanded, 106 S. Ct. 3324 (1986) (marketing of fraudulent coal leases as tax shelters).
89. See supra notes 15 & 16.
91. Recent articles by tax practitioners recognize the uncertainty regarding the tax consequences of these awards. See, e.g., Banoff, Unwinding or Rescinding A Transaction: Good Tax Planning or Tax Fraud?, 62 TAXES 972 (1984) ("[T]he tax consequences of the rescission award for a tax shelter interest are not certain."); McCauley, Rescissionary Awards For Securities Fraud-The Tax Benefit Defense Does Not Work, 64 TAXES 250-51 (1986) ("It may be said that the successful development of the tax benefit defense is attributable to the uncertainty relative to the proper tax treatment of rescissionary awards.").
92. Austin v. Loftsgaarden, 675 F.2d 168, 172 (8th Cir. 1982).
93. See Brief for Petitioners, supra note 18, at 13.
94. Randall v. Loftsgaarden, 106 S. Ct. 3134, 3146 (1986). Property Development and Research Company and 2361 Building Corporation were also named as defendants. Brief for Respondents, supra note 65, at 5 n.4. Property Development and Research Corporation was to acquire the property for the venture while 2361 Building Corporation was to act as general contractor for the project. Id.
in the later years.\textsuperscript{95} The project was to be financed through the use of a nonrecourse note which would support the accelerated depreciation methods that generated the partnership's tax losses.\textsuperscript{96} Alotel Associates experienced financial difficulties from the outset, and in February 1975, Loftsgaarden solicited the investors to extend additional advances to the partnership.\textsuperscript{97} The subsequent loans, however, proved insufficient. Thus, the partnership defaulted on its obligations and the mortgage lender foreclosed on the motel.\textsuperscript{98}

In 1976, the plaintiffs brought suit in federal district court for securities fraud and asserted federal claims under section 12(2) of the 1933 Act, section 10b of the 1934 Act, and SEC Rule 10b-5, as well as pendent state law claims.\textsuperscript{99} The jury found that Loftsgaarden had knowingly made material misrepresentations and omissions in the offering memorandum, upon which the investors relied, thereby causing their damages.\textsuperscript{100} Consequently, the defendant was liable under section 10(b), Rule 10b-5, and state law.\textsuperscript{101} In addition, the district court also accepted the jury’s advisory verdict that the defendant was liable under section 12(2).\textsuperscript{102} The trial court held that rescission was the proper award for damages under section 12(2) and awarded the plaintiffs the amount of the consideration paid for the investment, plus prejudgment interest.\textsuperscript{103} The court rejected Loftsgaarden's argument that the plaintiffs’ recovery should be reduced by tax benefits realized and stated that it wanted to avoid complex tax testimony.\textsuperscript{104} It dismissed the defendant's contention as "sophistic malarkey."\textsuperscript{105}

The defendant’s liability under the state and federal securities laws was affirmed on appeal by the Court of Appeals for the Eighth Circuit.\textsuperscript{106} However, the court of appeals ruled that the lower court was incorrect in refusing to offset the damage award by the amount of the tax benefits realized on the plaintiffs’ investment.\textsuperscript{107} The Eighth Circuit found that tax

\textsuperscript{95} Austin II, 768 F.2d 949, 951 (1985). The original offering proved unsuccessful. Consequently, Loftsgaarden revised the memorandum and proposed that the land be rented rather than purchased since this would generate another deductible expense. 106 S. Ct. at 3147. The plaintiffs subscribed to this revised offering with investments from $35,000 to $52,000 per person. \textit{Id.}
\textsuperscript{96} Id. S. Ct. at 3147.
\textsuperscript{97} \textit{Id.}
\textsuperscript{98} \textit{Id.} The foreclosure proceedings can be found in United Realty Trust v. Property Dev. & Research Co., 269 N.W.2d 737 (Minn. 1978).
\textsuperscript{99} 106 S. Ct. at 3147. For text of federal statutes, see supra notes 20-21, & 29.
\textsuperscript{100} 106 S. Ct. at 3147. The misstatements included mischaracterizing the financial resources available, the terms of the land lease, and details concerning the defendants' compensation. \textit{Id.}
\textsuperscript{101} \textit{Id.}
\textsuperscript{102} \textit{Id.}
\textsuperscript{103} \textit{Id.} The court ruled that rescission was allowed even though the investors had not attempted to return their limited partnership interests until shortly before trial. \textit{Id.}
\textsuperscript{104} \textit{Id.}
\textsuperscript{105} \textit{Id.} See \textit{Austin I}, 675 F.2d 168, 181 (8th Cir. 1982).
\textsuperscript{106} 675 F.2d 168.
\textsuperscript{107} \textit{Id.} at 183-84.
deductions had a real economic value. Consequently, the "strictly compensatory nature" of damage awards under the securities laws required that this value be considered in evaluating "whether and to what extent damages were inflicted upon [the plaintiffs]."

The court recognized that permitting evidence regarding tax matters would increase the complexity of trial proceedings but that such matters were neither too complicated nor too speculative for jury consideration. To limit the impact of its decision, the court restricted its holding "only to those cases involving investments that are expressly marketed and sold as tax shelters."

On remand, the district court calculated damages in accordance with the Eighth Circuit's holding. On appeal, the Eighth Circuit reconsidered the case en banc. The court of appeals upheld its original ruling and found that although the "actual damages" language of section 28(a) of the 1934 Act did not appear anywhere in the 1933 Act, the courts have consistently interpreted the provisions of the 1933 legislation as limiting recovery to actual damages. In addition, the court recognized that while tax benefits realized were not "a form of income in the strict accounting sense," they should be treated as income received under section 12(2) so that the goal of rescission, returning the parties to the status quo ante, could be realized. Two judges dissented, stating that the amount of tax savings was not income received. Rather, it represented only a tax deferral subject to recapture at a later date. The dissenters also stated that the majority's interpretation of the statute provided "a windfall to the defendant—the fraudulent party."

The SEC and the Department of Justice filed a joint amicus curiae brief, on behalf of the IRS with the United States Supreme Court. The government agencies again asserted the direct product or collateral source rule as

108. Id. at 182-83. "[U]nlike a corporate shareholder, . . . even if the enterprise fails to become profitable, the limited partners clearly may have something of value due to the investment's unique tax treatment." Id. at 182.

109. Id. at 183. The court referred to this notion as the "actual damages principle." Id. at 181.

110. Id. at 183.

111. Id.

112. 106 S. Ct. at 3148. The district court computed each investor's damages as the price paid for his investment plus simple interest less tax benefits realized. Id.

113. Austin II, 768 F.2d 949 (8th Cir. 1985).

114. Id. at 954. The court cited Globus v. Law Research Serv., 418 F.2d 1276, 1278, 1283-86 (2d Cir. 1969) (section 28(a) applied to bar punitive damages under section 17(a) of the 1933 Act), cert. denied, 397 U.S. 913 (1970).

115. 768 F.2d at 954-55.

116. Id. at 963 (Lay, C.J., dissenting). See supra notes 71-74 (IRS position that the tax benefits would be recaptured).

117. 768 F.2d at 963.

118. The petition for a Writ of Certiorari was filed on September 24, 1985, and was granted on November 12, 1985. Brief for Petitioners, supra note 18, at 1.
an argument against the tax benefit defense.\textsuperscript{119} They argued that the right to a tax deduction had no economic value "in and of itself," but was only valuable when used to offset the investors' other income.\textsuperscript{120} Therefore, the tax benefits were not a direct product of the investment because, for such benefits to be realized, they required "the intervention of an independent transaction by the possessor."\textsuperscript{121}

The \textit{amici} brief also asserted the position of the \textit{Burgess} court that the tax benefit rule would serve to reduce or eliminate any tax benefits realized by the plaintiffs.\textsuperscript{122} In addition, the government agencies argued that the Eighth Circuit's holding was confusing because it was only limited to "tax shelter" investments and it was difficult to determine which tax preferred investments qualified as "shelters."\textsuperscript{123} Lastly, the \textit{amici} brief argued that when an action for securities fraud was brought, the investors' relevant tax returns were often under audit so that previous tax deductions or credits might be disallowed.\textsuperscript{124} Therefore, determining the tax benefits retained by the plaintiffs "will be wholly speculative, and any effort to offset the damage award thereby will lapse into a tailspin of circular reasoning."\textsuperscript{125}

In an eight to one decision, the Supreme Court reversed the holding of the Eighth Circuit Court of Appeals.\textsuperscript{126} In an opinion written by Justice O'Connor, the Court first examined the language of section 12(2) to construe the meaning of the term income received.\textsuperscript{127} The Court found that the receipt of tax deductions or credits was not taxable under the Internal Revenue Code\textsuperscript{128} and that such benefits could not reasonably be defined as

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\textsuperscript{119} Brief of Amici Curiae, \textit{supra} note 27, at 12-14. \textit{See supra} notes 66-68 and accompanying text (SEC position regarding the collateral source rule in \textit{Salcer}); \textit{infra} notes 168-79 and accompanying text (discussion of direct product and collateral source rules).

\textsuperscript{120} Brief of Amici Curiae, \textit{supra} note 27, at 13.

\textsuperscript{121} \textit{Id.} (quoting \textit{RESTATEMENT OF RESTITUTION} § 157 comment b (1937)).

\textsuperscript{122} Brief of Amici Curiae, \textit{supra} note 27, at 22-27. \textit{See supra} notes 57-60 and accompanying text (discussion of tax benefit rule).

\textsuperscript{123} Brief of Amici Curiae, \textit{supra} note 27, at 27-28.

\textsuperscript{124} \textit{Id.} at 29.

\textsuperscript{125} \textit{Id.}

\textsuperscript{126} 106 S. Ct. 3143 (1986).

\textsuperscript{127} \textit{Id.} at 3150 (citing Santa Fe Indus. v. Green, 430 U.S. 462 (1977)). \textit{See text of section 12(2), supra} note 20.

\textsuperscript{128} 106 S. Ct. at 3150 (referring to I.R.C. § 61 (1982)).

\textbf{GENERAL DEFINITION} — Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items: (1) Compensation for services, including fees, commissions, fringe benefits, and similar items; (2) Gross income derived from business; (3) Gains derived from dealings in property; (4) Interest; (5) Rents; (6) Royalties; (7) Dividends; (8) Alimony & separate maintenance payments; (9) Annuities; (10) Income from life insurance and endowment contracts; (11) Pensions; (12) Income from discharge of indebtedness; (13) Distributive share of partnership gross income; (14) Income in respect of a decedent; and (15) Income from an interest in an estate or trust.

I.R.C. § 61(a).
income. Therefore, the damages award should not be offset by the tax benefits realized.

The Court then stated that even at common law, tax benefits would not be considered in computing a rescissionary remedy due to the direct product or collateral source rule. The Court agreed with the SEC and the IRS and held that tax benefits were probably not a direct product of the security since they were only realized if the deductions or credits generated by the investment offset the investors' other income or their total tax liability.

The Court then interpreted the meaning of actual damages under section 28(a). The Court examined the law at the time section 28(a) was enacted and found that section 12(2) stood as "a conspicuous example of a rescissionary remedy" and that such damages should not be reduced by realized tax benefits. Therefore, the Court held that section 28(a) required the same result where rescissionary damages were obtained under section 10(b).

The majority also stated that refusing to reduce the damage award by the tax benefits realized prevented the unjust enrichment of the defendant, an alternative goal of the securities laws. The Court reasoned that even if the tax benefits could be characterized as a windfall, the tax benefit rule would probably make the recovery taxable, and would substantially reduce the windfall. The Court maintained that its holding was consistent with the congressional intent to deter fraud and "manipulative practices in the securities markets," and would ensure "full disclosure of information

129. 106 S. Ct. at 3150.
130. Id. The majority also rejects the defendants' contention that tax benefits constitute consideration under section 12(2) and therefore should be used in a determination of damages to offset the initial consideration paid by the investor. Id. at 3151-52 (citing Brief for Respondents, supra note 65, at 29-30). The Court states that within the context of the statute, the word "consideration" means only "the money or property given by the investor in exchange for a the security." Id. Thus tax benefits are not included. Id.
131. 106 S. Ct. at 3151. See infra notes 168-79 and accompanying text (discussion of direct product and collateral source rules).
132. See Brief of Amici Curiae, supra note 27, at 9-14.
133. 106 S. Ct. at 3151.
134. Id. at 3153. See supra note 21 (text of statute).
136. 106 S. Ct. at 3153.
137. Id.
138. Id. (citing Janigan v. Taylor, 344 F.2d 781, 786 (1st Cir.), cert. denied, 382 U.S. 879 (1965)). See infra note 194 and accompanying text; Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972) ("Where the defendant received more than the seller's actual loss, . . . damages are the amount of the defendant's profit."). See generally Thompson, supra note 33.
139. 106 S. Ct. at 3154. "We are told that the 'tax benefit rule' will apply in cases of rescission, thus making the recovery taxable as ordinary income." Id. (citing Hillsboro Nat'l Bank v. Comm'r, 460 U.S. 370 (1983)); Brief of Amici Curiae, supra note 27, at 25. The Court went on to say that "[a]ny residual gains to plaintiffs thus emerge more as a function of the operation of the Internal Revenue Code's complex provisions than of any unduly generous damages standard for defrauded investors." 106 S. Ct. at 3154.
material to investment decisions.””140 Permitting an offset of tax benefits would ensure that those found guilty of securities fraud would effectively be protected from substantial liability for civil damages.141

The majority then concluded that section 28(a) did not require a complete investigation of the investors’ tax status to determine their damages.142 The Court also dismissed the defendant’s argument that failing to recognize an offset ignored “the economic reality of the tax benefits produced by tax shelters.”143 The Court stated that “[i]t is for Congress, not this Court, to decide whether the federal securities laws should be modified to comport with respondents’ version of economic reality.”144

Justice Blackmun, in a concurring opinion, stated that in an action brought solely under section 10(b) and Rule 10b-5 it might be proper to take tax benefits into account.145 As stated previously, the normal measure of damages under section 10(b) is the investor’s “out-of-pocket” loss.146 Justice Blackmun noted that an investor who received “the promised tax benefits, but not the promised income stream or appreciation,” had been injured.147 However, the injury did not extend to the tax benefits received because the investor retained the benefit of his bargain.148 Therefore, under
an out-of-pocket loss measure, the damages should not include any payment made by the investor for these tax benefits.\textsuperscript{149}

Justice Brennan, the lone dissenter, stated that he would "look for guidance in interpreting the word 'income' in the theory and goals of common law rescission and equitable restitution, rather than in the Internal Revenue Code, as the [majority] does."\textsuperscript{150} Brennan stated that if the plaintiffs could recover the full consideration they gave, pursuant to the agreement, and retain the benefits conveyed to them by the defendant, they would be better off economically than they were before the contract was made, contrary to the goal of restitution.\textsuperscript{151} Justice Brennan then concluded that the majority's interpretation of the word "income" ignored reality because it excluded valuable tax benefits.\textsuperscript{152}

III. Analysis and Impact

By failing to consider the tax aspects of the plaintiffs' tax shelter investment as well as the subsequent rescission of the agreement, the Court in Randall takes an unrealistic approach to the determination of damages under the federal securities laws. The Court avoids a discussion of the tax aspects of the transaction by narrowly interpreting key terms under the federal statutes and misapplying the collateral source and direct product rules. Consequently, courts may now effectively award the plaintiff-investor with a windfall unintended by the federal securities statutes. Although this may deter fraud in the securities marketplace,\textsuperscript{153} it is at odds with the goal of rescission which is to return the parties to the \textit{status quo ante}. If Congress intended the deterrence of fraud to be a primary goal of the federal securities civil liability provisions, it should have provided for a harsher form of damages.\textsuperscript{154}

\textsuperscript{149} Id.
\textsuperscript{150} Id. at 3157 (Brennan, J., dissenting). See supra notes 32-34 and accompanying text (discussion of rescission and restitution). Justice Brennan notes that income is commonly defined as "a gain or recurrent benefit usually measured in money that derives from capital or labor," and that this could encompass tax savings. 106 S. Ct. at 3158-59 (citing Webster's Ninth New Collegiate Dictionary 610 (1983)).
\textsuperscript{151} 106 S. Ct. at 3158.
\textsuperscript{152} Id. at 3158-59.
\textsuperscript{153} According to one Securities and Exchange Commissioner, Joseph Grundfest, deterring fraud in the securities marketplace is the primary reason for not allowing the tax benefit defense. In a recent address to the Southern Securities Institute in Miami entitled \textit{Should Taxpayers Subsidize the Perfect Fraud? A Closer Look at Randall v. Loftsgaarden and the 'Tax-Offset Rule,'} Mr. Grundfest stated that the Second and Eighth Circuits have "brought the perfect fraud closer to reality." Address by Joseph Grundfest, Sixth Annual Southern Securities Institute (Feb. 14, 1986), \textit{portions reprinted in} 18 Sec. Reg. & L. Rep. (BNA) No. 8, at 256 (1986). He stated that "[e]ven if investors discover fraud and file an ironclad complaint, the fraudulent seller has no reason to fear a civil damage award under the federal securities laws because he will never be forced to disgorge the proceeds of his fraud." Id.
\textsuperscript{154} The courts have consistently held that punitive damages are not authorized under the
In most cases, the investor's damages should not be reduced by the full amount of the tax benefits realized due to the tax treatment of the damage award. However, by holding that the tax benefits received should not even be considered in determining rescissionary damages, the Court not only allows for an inaccurate attempt to return the investor to the status quo ante, but provides Congress and the IRS with no incentive to end the confusion surrounding the tax treatment of such awards.

A. Income Received

The term income received is not defined in either the Securities Act of 1933 or the Securities and Exchange Act of 1934. The plaintiffs in Randall contend that income has a "well settled" meaning, citing section 61 of the Internal Revenue Code. The Supreme Court is quick to accept this definition for income received under section 12(2) of the 1933 Act. In the business context, however, income has many meanings. For example, there is accrual income, taxable income, and cash.
income,\textsuperscript{162} to name but a few.\textsuperscript{163} Without justification, the Supreme Court chooses to define income as gross income under section 61 of the Internal Revenue Code which does not include tax benefits realized.\textsuperscript{164}

The Court easily could have used net income as defined by Generally Accepted Accounting Principles (GAAP).\textsuperscript{165} According to Opinion No. 11 of the Accounting Principles Board,\textsuperscript{166} tax benefits associated with losses are recognized currently as an increase to net income to the extent realization is assured.\textsuperscript{167} Since a tax shelter investor recognizes a current tax benefit (one of his primary motivations for making the investment), this benefit could reasonably be characterized as income which is recognizable under section 12(2).

\textbf{B. The Collateral Source and Direct Product Rules}

The collateral source rule attempts to maintain a balance between two well established principles of the common law.\textsuperscript{168} First, with the exception of punitive damages, it is generally agreed that the plaintiff should recover no more than the actual loss he sustained.\textsuperscript{169} Second, the defendant should

\begin{footnotes}
\textsuperscript{162} "Under the cash basis of accounting, revenue is recognized only when cash is received; expenses are recorded when they are paid in cash." W. MEIGS, A. MOSICH & C. JOHNSON, supra note 160, at 24.

\textsuperscript{163} See supra note 150 and accompanying text (Justice Brennan's definition of income). See also BLACK'S LAW DICTIONARY 687-88 (5th ed. 1979) (additional types of income, e.g., earned income, imputed income, operating income, etc.).

\textsuperscript{164} 106 S. Ct. at 3150. See supra note 128 (text of I.R.C. § 61 (1982)).

\textsuperscript{165} "Although a body of generally accepted accounting principles has long been recognized by business executives, courts, and governmental agencies, as well as by professional accountants, no complete official list of such accounting principles exists." W. MEIGS, A. MOSICH & C. JOHNSON, supra note 160, at 12. "The most authoritative sources of generally accepted accounting principles in recent years have been the Statements issued by the FASB (Financial Accounting Standards Board), the Opinions issued by the APB (Accounting Principles Board), the Accounting Research Bulletins issued by the AICPA (American Institute of Certified Public Accountants) Committee on Accounting Procedure, and Accounting Series Releases issued by the SEC." Id.

\textsuperscript{166} See supra note 165 (definition of APB).

\textsuperscript{167} "When an operating loss occurs following a period of profitable operations, a corporation has a claim for a refund of past income taxes that should be recognized in the accounting records in the year in which the loss occurs." W. MEIGS, A. MOSICH & C. JOHNSON, supra note 160 at 864. See generally FASB Research Report, Accounting For Income Taxes: A Review of Alternatives 95-107 (1983).

\textsuperscript{168} DAMAGES IN TORT ACTIONS, supra note 2, at 17-6.

\textsuperscript{169} Id. See, e.g., Hudson v. Lazarus, 217 F.2d 344, 346 (D.C. Cir. 1954) ("In general the law seeks to award compensation, and no more, for personal injuries negligently inflicted.");
\end{footnotes}
be held accountable for all the losses he has inflicted. When an independent source of compensation for the plaintiff, such as insurance arises, one of these principles will be violated. The court must decide whether to ignore the independent compensation in computing the damages and allow the plaintiff to receive more than his actual loss, or offset the damage award by the amount of the independent compensation and hold the defendant responsible for less than the damages he proximately caused.

The collateral source rule adheres to the former view because tort damages are not reduced by collateral benefits received by the plaintiff, even if such benefits totally eliminate the plaintiff’s loss.

Two rationales support the collateral source rule. First, the defendant should not be given the benefit of compensation which is obtained by the plaintiff from an entirely independent source. Second, the plaintiff usually contracts for the benefits (e.g., insurance) and should not be penalized for having the foresight to protect himself against future losses. For the doctrine to apply, it is important to note that the source of compensation

Hanna v. Martin, 49 So. 2d 585, 587 (Fla. 1950) (“The fundamental principle of the law of damages is that the person injured by breach of contract or by wrongful or negligent act or omission shall have fair and just compensation commensurate with the loss sustained in consequence of the defendant’s act which give rise to the action. In other words, the damages awarded should be equal to and precisely commensurate with the injury sustained.”).

170. “The courts were interested primarily in keeping the peace between individuals by providing a substitute for private vengeance, and the party injured was just as likely to take the law into his own hands when the injury was an innocent one. The man who hurt another by pure accident or in self-defense was required to make good the damages he inflicted.” W. PROSSER, J. WADE & V. SCHWARTZ, TORTS (1982).


172. DAMAGES IN TORT ACTIONS, supra note 2, at 17-6.


174. Overton v. United States, 619 F.2d 1299, 1306 (8th Cir. 1980).

175. Id. at 1306 (“[T]he wrongdoer does not deserve to benefit from the fortuity that the plaintiff has received or will receive compensation from a source wholly independent of the wrongdoer.”); Hudson v. Lazarus, 217 F.2d 344, 346 (D.C. Cir. 1954) (“Usually the collateral contribution necessarily benefits either the injured person or the wrongdoer. Whether it is a gift or a product of the contract of employment or of insurance, the purposes of the parties to it are obviously better served and the interests of society are likely to be better served if the injured person is benefited than if the wrongdoer is benefited.”).

176. See, e.g., Feeley v. United States, 337 F.2d 924, 928 (3d Cir. 1964) (“[O]ne can justify a double recovery where the original source was supplied by the plaintiff, himself, out of resources that would otherwise have been available to him for other purposes.”); Note, Unreason in the Law of Damages: The Collateral Source Rule, 77 HARV. L. REV. 741, 748-52 (1964) (where the collateral payment is a gift, the donee should receive the intended benefit, not the defendant; determining collateral benefits may be too speculative; legal compensation for personal injuries does not fully compensate).
must be collateral, i.e., secured from someone other than the defendant.\textsuperscript{177} Otherwise, the plaintiff would receive more than his actual loss and the defendant would be forced to pay more than the amount of the damages he actually caused.\textsuperscript{178} The equivalent concept under the law of restitution is the direct product rule, in which the plaintiff is required to credit the defendant with gains that are the direct product of, that is, not collateral to, the consideration received by the plaintiff in the transaction to be rescinded.\textsuperscript{179}

The Supreme Court, in \textit{Randall}, agreed with the SEC that the tax benefits realized should be ignored under the direct product rule.\textsuperscript{180} The Court argued that the tax benefits were not a direct product of the tax shelter investment because they were only of value when combined with other income or additional tax liability of the plaintiff.\textsuperscript{181} This argument, however, ignored the fact that the tax benefits were not only a direct product of the investment agreement, but were the primary focus of the agreement.\textsuperscript{182} The initial tax benefits were realized due to the defendant’s direct and intentional efforts in building a motel and syndicating a limited partnership in accordance with the provisions of the Internal Revenue Code.\textsuperscript{183} In addition, the defendant increased the benefits by obtaining sufficient loans to pay for the deductions taken.\textsuperscript{184} These efforts were not less direct merely because the parties assumed that the investor would generate other income that would be sheltered by the tax losses or credits.\textsuperscript{185} These tax

\textsuperscript{177} See Adams v. Turner, 238 F. Supp. 643, 644-45 (D.D.C. 1965) ("[The collateral source rule] does not apply in a situation where the collateral source is the defendant himself. Under those circumstances no one gets a windfall and if a recovery were allowed under those circumstances the result would be that the plaintiff would receive a double recovery and that the defendant would be mulcted twice for the same item of damages.")

\textsuperscript{178} Id.

\textsuperscript{179} Randall v. Loftsgaarden, 106 S. Ct. 3143, 3151 (1986) (citing \textit{RESTATEMENT OF REMNOR} § 157 comment b (1937)).

\textsuperscript{180} Id. See supra notes 119-21 and accompanying text (discussion of arguments set forth in amici curiae brief).

\textsuperscript{181} Id. See supra notes 131-33 and accompanying text (argument set forth by the court regarding the direct product rule).

\textsuperscript{182} "One of the prime motivations for investment in limited real estate partnerships is the unique tax advantage made available to high tax bracket individuals." Salcer v. Environ Equities, 744 F.2d 935, 940 (2d Cir. 1984). See supra note 27 (discussion of tax shelter investments).

\textsuperscript{183} Brief of Respondents, supra note 65, at 22.

\textsuperscript{184} Id. See supra note 27 and accompanying text (discussion of at risk provisions). The respondents obtained these funds exclusively through their own efforts. Alotel Associates' expenditure of these funds were three times the amount the investors advanced and resulted in tax benefits three times greater than what would have received without the loans. Brief of Respondents, supra note 65, at 22.

\textsuperscript{185} In an unnumbered footnote in his dissent, Justice Brennan equates a tax shelter with a rebuilt automobile engine. Randall v. Loftsgaarden, 106 S. Ct. 3143, 3159 (1986) (Brennan, J., dissenting). "We do not—at least I would not—describe the value that an engine has when placed in a car as ‘indirect’ simply because the buyer had to acquire a car in order to exploit that value." Id. The defendants supported their position with a different analogy. Brief for
benefits were bargained for and the benefits were as much a part of the transaction as the expected profits. Therefore, the direct product and collateral source rules should not exclude the tax benefits realized from the computation of damages.

C. Actual Damages

Rather than looking to the "language of the statute itself" as the Court did in interpreting "income" under section 12(2) of the 1933 Act, the Randall Court examined "the state of the law at the time the legislation was enacted" to interpret actual damages under section 28 of the 1934 Act. This is odd because income does not have a fixed definition, whereas the courts have consistently interpreted actual damages to mean compensatory damages or net economic loss such that punitive damages are clearly excluded. Thus, there is an even stronger argument to examine

Respondents, supra note 65, at 24. "Suppose that Alotel Associates took the petitioners' funds and purchased certificates of deposit from a bank. Suppose further that Alotel Associates then distributed all those certificates to the petitioners, who promptly took them to the bank and received payments equaling their investments. Meanwhile, their partnership interests became worthless and they commenced an action for fraud. It would be unthinkable that they could recover under these circumstances simply because the payments they received ultimately came from a bank rather than Alotel Associates." Id.

186. See Note, supra note 39, at 567.

187. 106 S. Ct. at 3150. See supra notes 127-30 and accompanying text (summary of the Court's discussion of income received).

188. 106 S. Ct. at 3152. See supra notes 134-37 and accompanying text (summary of the Court's discussion of actual damages).

189. See supra notes 157-67 and accompanying text (discussion of income received).

190. See, e.g., Birdsall v. Coolidge, 93 U.S. 64, 64 (1876) ("Compensatory damages and actual damages mean the same thing; that is, the damages will be the result of injury alleged and proved, and that the amount awarded will be precisely commensurate with the injury suffered, neither more nor less, whether the injury be to the person or the estate of the complaining party."); Oosfisky v. Zipf, 645 F.2d 107, 111 (2d Cir. 1981) ("[W]e believe that the purpose of section 28(a) is to compensate civil plaintiffs for economic loss suffered as a result of wrongs committed in violation of the 1934 Act, whether the measure of those compensatory damages be out-of-pocket loss, the benefit of the bargain, or some other appropriate standard."); Herpich v. Wallace, 430 F.2d 792, 810 (5th Cir. 1970) ("The gist of the Rule 10b-5 action for damages is economic injury to the plaintiff resulting proximately from the acts of the defendants which constitute a violation of the rule."); Green v. Wolf, 406 F.2d 291, 303 (2d Cir. 1968), cert denied, 395 U.S. 977 (1969) ("We do not believe that Congress intended the Securities and Exchange Act to be used as a vehicle for the recovery of damages that could often be grossly disproportionate to the harm done."). We are required to look to the courts for a definition of "actual damages" because the legislative history of the term is of little help. See H.R. REP. No. 1383, 73rd Cong., 2d Sess. 28 (1934) ("This subsection reserves rights and remedies existing outside of those provided in the act, but limits the total amount recoverable to the amount of actual damages.").

191. See, e.g., Byrnes v. Faulkner, 550 F.2d 1303, 1313 (2d Cir. 1977) ("[Section 28(a)] on its face precludes recovery of punitive damages"); Green v. Wolf, 406 F.2d 291, 303 (2d Cir. 1968), cert. denied, 395 U.S. 977 (1969) ("[P]unitive damages are not authorized in private actions under section 10(b) and Rule 10b-5.").
the language of the law under section 28(a) than there is under section 12(2).

The Court also stated that it was proper to award the plaintiffs more than their actual loss to prevent the defendant's unjust enrichment.192 This has been a goal of the federal securities laws193 because any potential windfalls should inure to the plaintiff rather than the defendant.194 Therefore, the Randall Court argued that a receipt of tax benefits by the investor, as well as full recovery under a rescissionary measure of damages, did not exceed the "flexible limits of section 28(a)."195

The Court, however, fails to recognize that the value of the tax benefits realized by the investor are not equal to the unjust enrichment enjoyed by the promoter. The investor generally pays a higher price for the tax shelter investment than he does for other investments that offer comparable cash flow and appreciation potential.196 To the extent the tax benefits fail to materialize or are realized by the victim and then lost, the defendant is unjustly enriched only when he is allowed to retain the additional price or "premium" paid for the tax shelter investment.197 Returning this premium to the victim remedies the unjust enrichment. Allowing a full recovery without considering the tax benefits realized by the investor does not.

The Supreme Court also argued that the larger award for damages in a private action served to deter prospective fraud in the securities marketplace and insured that the disclosure requirements of the federal securities laws were met.198 However, these purposes can be met adequately through enforcement of the criminal sanctions available under the securities laws.199 In addition, compensatory damages alone can have a significant deterrent effect, especially in large class action cases.200 Lastly, a larger federal

192. 106 S. Ct. at 3153.
193. See generally Thompson, supra note 33.
194. "It is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them." Nelson v. Serwold, 576 F.2d 1332, 1339 (9th Cir. 1978) (citing Janigan v. Taylor, 344 F.2d, 781, 786 (1st Cir. 1968)).
195. 106 S. Ct. at 3153.
196. 4 R. HaPT & P. FASS, TAX SHELTERED INVESTMENTS § 0.06, at 8-9 (3d ed. 1981).
197. This premium paid represents the present value of anticipated future tax savings. Salcer SEC Brief, supra note 64, at 9 n.12.
198. 106 S. Ct. at 3154. See supra notes 140-41 and accompanying text.
200. See, e.g., DeHaas v. Empire Petroleum, Co., 435 F.2d 1223, 1231 (10th Cir. 1970) ("Since [class actions and derivative actions] allow many small claims to be litigated in the same action, the overall size of the compensatory damages alone may constitute a significant deter-
rent."); Green v. Wolf, 406 F.2d 291, 303 (2d Cir. 1968), cert. denied, 395 U.S. 977 (1969) ("[C]lass actions, derivative suits and other such procedural devices provide sufficient incentive to insure that those injured by a violation of 10b-5 will have adequate opportunity to confront alleged malefactors and to have appropriate sanctions imposed upon them."). There also exists "the psychological deterrent of being branded a knowing violator of the law." Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1285 (2d Cir. 1969), cert. denied, 397 U.S. 913 (1970). See
damage award combined with pendent state claims, which allow punitive damages, may provide the plaintiff with a double recovery.\textsuperscript{201} Section 28(a) requires that the investor be awarded no more than his actual damages and section 12(2) requires that damages be reduced by income received.\textsuperscript{202} If Congress intended a stronger deterrent, it could have provided for an express measure of punitive damages\textsuperscript{203} instead of allowing recovery only for an out-of-pocket loss or rescission.\textsuperscript{204} Because such expansive language is not explicitly provided by the legislature, it is not proper for the courts to provide such expansive meaning to the language.

IV. TAX TREATMENT OF DAMAGES

By holding that tax benefits are to be ignored in computing rescissionary damages in securities fraud litigation, the Randall Court does not attempt to clarify the proper tax treatment of such awards.\textsuperscript{205} The Court merely mentions the tax benefit rule\textsuperscript{206} and states that there are too many difficulties in predicting the ultimate treatment of the investor's claimed tax benefits.\textsuperscript{207} However, if an accurate measure of damages is to be made, so that the parties are returned to the status quo ante, the tax implications of the transaction cannot be ignored.\textsuperscript{208}

Tax benefits have real economic value and in some cases are readily transferable to other parties under the Internal Revenue Code.\textsuperscript{209} To the


\textsuperscript{201} "The statutory language suggests that one purpose of section 28(a) is to prevent double recovery by those who assert both state and federal claims arising out of the same conduct."

\textsuperscript{202} Osofsky v. Zipf, 645 F.2d 107, 111 (2d Cir. 1981) (citing 3 L. Loss, \textit{SECURITIES REGULATION} 1624 n.5 (2d ed. 1961)).

\textsuperscript{203} See supra notes 20-21 (text of statutes).


\textsuperscript{205} See supra note 31 and accompanying text (discussion of out-of-pocket loss).

\textsuperscript{206} The Court's statements, if anything, only added to the confusion regarding this question. See supra note 139 and accompanying text.

\textsuperscript{207} "Id. However, many tax experts believe that a reasonable estimate of the tax benefits can be made. See, e.g., Banoff, \textit{Supreme Court Holds Tax Shelter Benefits Do Not Offset Rescission Damages}, 64 J. TAX'N 210, 213 (1986) (in his discussion of the computation of damages for tax shelter fraud, the author says that "[d]espite [the existing] uncertainties and complexities, it usually will be possible to reach an approximate determination of the net tax benefits to the plaintiffs.").

\textsuperscript{208} See supra notes 32-34 and accompanying text.

\textsuperscript{209} One example is the safe harbor leasing provisions enacted under the Economic Recovery Tax Act, Pub. L. No. 97-34 (1981). Using these rules, "three party financing leases or leverage leases are often used to transfer tax benefits from users of property who do not have sufficient tax liability to absorb those benefits." 5 J. MERTENS, \textit{LAW OF FEDERAL INCOME TAXATION} § 23.65 (rev. ed. 1986). "Since Congress recognized that many businesses would not be able to completely use the increased cost recovery allowances under ACRS (Accelerated Cost Recovery System), it decided to facilitate the transfer of ACRS benefits through these types of transactions." Id.
extent tax benefits promised to an investor fail to materialize, full recovery is allowed in court. The SEC has also recognized the importance of these benefits in real estate limited partnerships because it requires the offerer to disclose information regarding potential tax write-offs that might be generated by the investment.

In some cases, such as when the investor's tax returns are subject to audit, i.e., the statute of limitations on assessments has not run, the evidence concerning tax benefits "may be so speculative as to be beyond the jury's province." If evidence as to tax benefits is allowed, the plaintiff would be forced to argue in court that the tax benefits will be recaptured while arguing before the IRS that the benefits should stand. However, in most cases, as in Randall, the statute of limitations on assessments has already run on the relevant years and it is only a matter of comparing the tax treatment of the damages award with the tax benefits already realized. If the tax liability arising from the damage award is equal to the tax benefits previously recognized by the investor, the full amount of the rescissionary damages should be paid by the defendant. In this way, the investor will be made whole after he pays the required taxes on his damage award. If the tax benefits previously realized by the investor exceed his subsequent tax liability arising from the damage award, his compensation should be adjusted downward accordingly.

Because the Supreme Court does not provide any clear statements on the tax consequences of rescission damage awards under the federal securities laws, the confusion surrounding the tax treatment of such awards still remains. It is fairly certain that the IRS will treat the rescission as a second independent transaction that will not change the parties' tax


211. See SEC Industry Guide No. 5, Preparation of Registration Statements Relating to Interests in Real Estate Limited Partnerships. See supra note 143.

212. See supra note 72 (statute of limitations on assessments).

213. 106 S. Ct. at 3154.

214. See Banoff, To What Extent Will Benefits From Tax Shelters Be Permitted to Offset Recission Damages?, 57 J. Tax'n 154, 155 (1982) ("Proof of the weaknesses of the partnership's tax shelter benefits will be of public record in the rescission litigation, and well may serve as a road map to the IRS on its ongoing audit."); Garahan, Should Tax Shelter Benefits Offset Recoveries For Securities Law Violations?, 2 J. Tax'n Inv. 302, 307 (1985) ("Here the investor is clearly caught between a rock and a hard place if the taxable years in question are still open. To reduce any offset, he must argue against the validity of his own tax return positions.").

215. Austin II, 768 F.2d 949, 955 (8th Cir. 1985) ("All of the plaintiffs' tax returns from the relevant years have already been audited and are now closed.").

216. This payment is currently deductible by the defendant under I.R.C. § 162(f) (1982). However, proposed Bill H.R. 2473, "Deduction Disallowance for Damages for Fraud Violations," would disallow any tax deduction for damage payments made pursuant to the convictions for crimes involving fraud. Banoff, supra note 207, at 214.

217. See supra notes 57-60 and notes 84-88 and accompanying text.
treatment of the original sale.218 Thus, any gain will be recognized in the current year and will not require amending returns from prior years.219 However, it is uncertain whether this independent transaction will be treated as a payment to a retiring partner,220 a sale or exchange of a partnership interest,221 or a recapture of all previous benefits realized under the tax benefit rule.222 Due to the Court's holding in Randall, neither Congress nor the IRS has any incentive to eliminate the confusion.

The rules limiting tax shelter write-offs and the reduction in personal income tax rates under the 1986 Tax Reform Act will likely decrease the popularity of these tax-motivated investments.223 Therefore, the holding in Randall v. Loftsgaarden may have a limited impact on tax shelter securities fraud litigation in the distant future. However, in the next few years as fraudulent tax shelter offerings not covered by the new tax law are litigated, the Randall doctrine will have a substantial impact on the computation of rescissionary damages. Consequently, defendants will be in a much less favorable bargaining position in structuring out-of-court settlements. In addition, the Randall Court's holding encourages the lower courts to continue the present practice of generally ignoring the tax aspects of most civil damage awards.224

Permitting the consideration of tax benefits in the calculation of damages in tax shelter securities fraud litigation, would allow courts to make a more

218. In Penn v. Robertson, 115 F.2d 167 (4th Cir. 1940), a taxpayer was credited with earnings from a corporate employee benefit fund in 1930. The plan was rescinded in 1931 as a result of suits filed by shareholders. The court held that due to the annual accounting period principle, the employee's taxable income for 1930 was to include the fund earnings and was to be determined without regard to the subsequent rescission of 1931. See also Rev. Rul. 80-58, 1980-1 I.R.B. 181 (gain on sale of land made in 1978 should be recognized in 1978 even though the property was reconveyed in 1979 pursuant to the terms of the sales contract). See generally Banoff, supra note 91, at 970-72.

219. This is contrary to the Ninth Circuit's position in Burgess. See supra note 59 and accompanying text.

220. The transaction may be treated as a payment to a retiring partner where the partnership is still in existence and solvent. Banoff, supra note 91, at 970. The partnership is viewed as reacquiring the partnership interest in return for the investor's cash. Id. Under I.R.C. section 736(b) (1982), payments to a retiring partner are taxable to the recipient as distributions in liquidation of a partnership interest which may be given either capital gain or ordinary income treatment. 2 W. McKee, W. Nelson, & R. Whitmire, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS § 15.02[1] (1986). However, if such payments are made for unrealized receivables or goodwill of the partnership, they are taxable to the recipient under section 736(a) either as a distributive share of partnership income or as guaranteed payments. Id. In either case, the retiring partner generally recognizes ordinary income. Id.

221. The payment of damages may be viewed as a sale or exchange of a partnership interest between the defrauded investor and the defendant. Banoff, supra note 91, at 971. Therefore, the transaction would probably be given capital gain or loss treatment under I.R.C. § 741 (1982). Id.

222. The investor would recognize ordinary income to the extent he deducted ordinary losses in previous years. See supra notes 57-60 and accompanying text.


224. See supra notes 2-8 and accompanying text.
accurate determination of the loss actually sustained by the investor. Jury consideration of the plaintiffs' tax benefits is no more uncertain or speculative than many other determinations made by the courts. Unfortunately, the Supreme Court's holding in *Randall* denies courts the opportunity to properly compensate defrauded investors in accordance with the federal securities laws.

**CONCLUSION**

*Randall v. Loftsgaarden* holds that courts are not to consider tax benefits realized when awarding rescissionary damages to the victims of fraudulent tax shelters, pursuant to the federal securities laws. In doing so, the Court read the securities statutes so as to exclude these benefits from any consideration of damages. Consequently, courts are not given the opportunity to further the goals of rescission, the form of recovery provided for by the securities laws.

If Congress wants to deter securities fraud and insure the veracity of the information before the investor, it should provide for a much harsher civil penalty under the law. It is not for the courts to expand the scope of the securities laws to conform to their perception of congressional intent. Because of the Court's rejection of the tax benefit defense, *Randall v. Loftsgaarden* does not provide any guidance as to the tax treatment of rescissionary damages awarded under the securities laws. Therefore, Congress and the IRS have no incentive to provide a much needed clarification of the tax law in this area.

*Paul J. Gaeto*

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225. "[T]he practical wisdom of the trial bar and the trial bench has developed effective methods of presenting the essential elements of an expert calculation in a form that is understandable by juries that are familiar with the complexities of modern life. We therefore reject the notion that the introduction of evidence describing a decedent's estimated after-tax earnings is too speculative or complex for a jury." *Norfolk & W. Ry. v. Liepelt*, 444 U.S. 490, 494 (1980).