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ANDERSON v. COMMISSIONER—TAX STATUS OF PAYMENTS IN SATISFACTION OF LIABILITY UNDER SECTION 16(b) OF THE SECURITIES EXCHANGE ACT OF 1934

During 1962 and 1963, James E. Anderson, a vice president of Zenith Radio Corporation, purchased 1,000 shares of Zenith common stock, pursuant to a company stock option plan, for $14,038.90. In April of 1966 Anderson sold these shares for $162,923.21, resulting in a profit of $148,884.31. Subsequent to the sale, Anderson repurchased, on April 11, 1966, 750 shares of Zenith common stock, also pursuant to a company stock option plan.

Advised by Zenith's legal department that the sale and subsequent purchase fell within section 16(b)1 of the Securities Exchange Act of 1934,2 and that Zenith must demand payment of the profit realized on the sale and purchase, Anderson, in 1966, paid Zenith $51,259.14.3

1. Section 16(b) provides as follows:
   For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.


3. Although normally the liability formula is the sale price less the lowest purchase price, where, as here, the purchase is made under an option acquired more than six months prior to its exercise, the amount of liability is calculated by subtracting from the sales proceeds the lowest market price of any security of the same class within six months before or after the date of the sale. See 17 C.F.R. § 240.16(b)-6(a) and (b) (Supp. 1973). See also Kornfeld v. Eaton, 327 F.2d 263, 265 (2d Cir. 1964).
In his 1966 tax return, Anderson treated the $148,884.31 profit realized on the sale of the 1,000 shares of Zenith stock as a long-term capital gain.\(^4\) He also deducted the $51,259.41 he paid to Zenith under section 16(b) as an ordinary and necessary business expense.\(^5\) However, the Commissioner of Internal Revenue determined that the payments to Zenith should be treated as long-term capital losses\(^6\) rather than as ordinary losses, resulting in a deficiency in the amount of $21,897.64. However, the Tax Court made an ultimate finding of fact that the payments to Zenith were made to preserve Anderson's employment with Zenith and to avoid injury to his business reputation. It held that the payments were an ordinary and necessary business expense, deductible under section 162(a) of the Internal Revenue Code of 1954.\(^7\)

On appeal, the Seventh Circuit reversed, holding that the rule of Arrowsmith v. Commissioner\(^8\) applied to require that the payments in satisfaction of section 16(b) liability be characterized in the same terms as the profit realized on the sale of the stock, namely as a long-term capital transaction. Anderson v. Commissioner, 480 F.2d 1304 (7th Cir. 1973).

The significance of the decision in Anderson is that, for the first time, the courts have adopted a precise test for determining the tax status of payments made in satisfaction of section 16(b) liability—a test which is

\(^4\) A "long-term capital gain" is any gain resulting from the "sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income." 26 U.S.C. § 1222(3) (1970). "In the case of a taxpayer other than a corporation, if for any taxable year the net long-term capital gain exceeds the net short-term capital loss, 50 percent of the amount of such excess shall be a deduction from gross income. . . ." 26 U.S.C. § 1202 (1970).

\(^5\) "In general. There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . . ." 26 U.S.C. § 162(a) (1970).

\(^6\) A "long-term capital loss" is incurred "from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such loss is taken into account in computing taxable income." 26 U.S.C. § 1222(4) (1970).

In the case of a taxpayer other than a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges, plus (if such losses exceed such gains) whichever of the following is smallest:

- (A) the taxable income for the taxable year.
- (B) $1,000, or
- (C) the sum of—
  - (i) the excess of the net short-term capital loss over the net long-term capital gain, and
  - (ii) one-half of the excess of the net long-term capital loss over the net short-term capital gain.


\(^7\) James E. Anderson, 56 T.C. 1370 (1971).

\(^8\) 344 U.S. 6 (1952).
both equitable and consistent with the notion of strict liability implicit in section 16(b). In so doing, the Seventh Circuit took a major step toward resolving this long-standing conflict between the Internal Revenue Code and the Securities Exchange Act of 1934, without frustrating the purpose of either.

The purpose of this note is, therefore, to reexamine this conflict, and to assess what impact the Anderson decision may have upon its eventual resolution in the Supreme Court.

In attempting to resolve the tax questions associated with payments made by corporate insiders\(^9\) in satisfaction of section 16(b) liability, the courts were initially faced with the issue of whether any deduction against ordinary income in the year of the payment should be allowed. In William F. Davis, Jr.,\(^10\) the first case to examine the issue, the deduction was denied.

Davis, a director of United Drug, Inc., sold 1,000 shares of United Drug stock for $25,441.50. Within six months he purchased 2,000 shares of United Drug, thereby incurring liability to the company under section 16(b).\(^11\) Davis then paid $12,659.00 to the corporation, the difference between the proceeds from the sale and the cost of 1,000 of the 2,000 shares he later purchased,\(^12\) and subsequently claimed a federal income tax deduction equal to the entire amount of the repayment.\(^13\)

The Commissioner disallowed the deduction contending that section

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\(^9\) Section 16(a) of the Securities Exchange Act of 1934 defines an insider as: "[e]very person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered pursuant to section 12 of this title, or who is a director or an officer of the issuer of such security. . . ." 15 U.S.C. § 78p(a) (1970).

\(^10\) 17 T.C. 549 (1951).

\(^11\) Liability under section 16(b) is incurred when an insider, in this case a director, sells and then subsequently repurchases within six months, securities of the company with which he is employed.

\(^12\) 17 T.C. at 554.

\(^13\) Davis' claim for deduction was based on section 23(a)(1) of the Internal Revenue Code of 1939, now section 162(a) of the 1954 Internal Revenue Code, which allows a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . . ." 26 U.S.C. § 162(a) (1970). It has long been judicially recognized that an individual, when acting as an employee, officer, or director of a corporation, is engaged in a trade or business, separate from that of the corporation within the meaning of section 162(a). Hochschild v. Commissioner, 161 F.2d 817 (2d Cir. 1947), rev'g 7 T.C. 81 (1946); Joseph P. Pike, 44 T.C. 787 (1965); William L. Butler, 17 T.C. 675 (1951). Each of the taxpayers in the Hochschild, Butler, and Pike cases, was engaged in the business of being an officer and/or director of a corporation; each made payments to his corporation by reason of an apparent breach of a fiduciary duty and/or to protect his business reputation; and in each case, the payment in question was held to be deductible as a business expense.
16(b) liability was in the nature of a penalty.\textsuperscript{14} The Tax Court affirmed, stating that allowance of the deduction, "would weaken an effective method of enforcing the sharply defined policy expressed in section 16(b). . . ."\textsuperscript{18}

Shortly after Davis, the United States Supreme Court decided Arrowsmith v. Commissioner.\textsuperscript{16} The taxpayers in Arrowsmith had received distributions in complete liquidation of a corporation in which they were the sole shareholders, which they subsequently claimed as long-term capital gains. In a later year, after being required as transferees of the liquidated corporation's assets to pay a judgment rendered against the corporation, they attempted to treat the payment as an ordinary business loss. Stating that characterization of the deduction as a business loss rather than a capital loss would result in a much larger deduction, the Court held the loss was capital, saying:

I.R.C., § 23(g)\textsuperscript{18} treats losses from exchanges of capital assets as "capital losses" and I.R.C., § 115(c)\textsuperscript{19} requires that liquidation distributions be treated as exchanges. The losses here fall squarely within the definition of "capital losses" contained in these sections. Taxpayers were required to pay the judgment because of the liability imposed on them as transferees of liquidation distribution assets. And it is plain that their liability as transferees was not based on any ordinary business transaction of theirs apart from the liquidation proceedings.\textsuperscript{17}

Although the court in Arrowsmith did not address itself directly to tax questions associated with section 16(b) liability, it clearly indicated that if a transaction in the year in which the deduction is sought is integrally related to a prior sale or exchange, then the subsequent transaction, for tax purposes, will be characterized in terms of the prior transaction. In other words, if a prior sale or exchange produced a profit taxable as a long-term capital gain, and that sale or exchange was integrally related to a subsequent transaction in which the taxpayer was required to repay the profit, then the repayment of that profit would be deductible only as a long-term capital loss.

\textsuperscript{14} In the leading case of Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir.), cert. denied, 320 U.S. 751 (1943), the court held that "the statute was intended to be thoroughgoing, to squeeze all possible profits out of stock transactions, and thus to establish a standard so high as to prevent any conflict between the selfish interest of a fiduciary officer, director, or stockholder and the faithful performance of his duty." \textit{Id.} at 239.

\textsuperscript{15} Id. at 558.

\textsuperscript{16} 344 U.S. 6 (1952).

\textsuperscript{17} \textit{Id.} at 8.


Following *Arrowsmith*, implicit in which were equitable considerations prohibiting the manipulation of the tax laws to produce an unwarranted tax advantage, the Internal Revenue Service found that in cases involving section 16(b) liability, its policy of either allowing a deduction against ordinary income, or denying deductibility altogether, often proved to be unsatisfactory. As a result, in 1961, the Internal Revenue Service modified its earlier position by ruling that section 16(b) is not a penal provision. According to the ruling, "[t]he purpose of the statute is to place the insider in the same position he would have occupied if he had never engaged in stock dealings." The insider was held entitled to a deduction in the amount of his payment in satisfaction of the section 16(b) liability, since "the allowance of the deduction is consistent with the purpose of the statute in returning the insider to his original position." However, "[t]he income tax significance of the capital stock dealings giving rise to the payment determines whether it is deductible as an ordinary loss or as a capital loss."24

20. See Lokken, Tax Significance of Payments in Satisfaction of Liabilities Arising Under Section 16(b) of the Securities Exchange Act of 1934, 4 Ga. L. Rev. 298 (1970). The author provides the following example:

An insider, taxed at a fifty percent marginal rate, sells a share of the corporation's stock, which has a basis of $10, for $20, recognizing a long-term capital gain of $10. Within six months thereafter, he purchases another share at $10. . . . He pays the resulting 16(b) profit of $10 to the corporation. If the payment is deducted from ordinary income, the insider apparently realizes a net profit from the offending transactions of $2.50. The apparent profit increases if the insider is placed in a higher marginal bracket. However, denial of the deduction will increase the ultimate cost of the insider's encounter with section 16(b) to $12.50. Again, the net cost will vary with the insider's marginal rate bracket. Neither result seems fully consistent with the closely balanced sanction imposed by section 16(b). The enigma results, of course, because the gain on the sale is taxed at the preferential capital gains rate. The apparent conflict with section 16(b) can be resolved only by eliminating or offsetting that tax.

21. Rev. Rul. 61-115, 1961-1 Cum. Bull. 46, 48. The rationale behind this ruling appears to be that since 16(b) provides only a civil remedy to the corporation, it can be fairly inferred that criminal penalties are not necessary to accomplish the purposes of the section, thereby making the liability imposed non-penal. In Cook & Feldman, Insider Trading Under the Securities Exchange Act, 66 Harv. L. Rev. 385, 616 (1953), the authors argue that in some cases short-swing insider trading may be justified, and that such trading would not violate the provision if the insider did not benefit unfairly from inside information. Therefore, assuming the temptation to profit unfairly would be effectively deterred by making the transaction profitless, one could argue that a tax result which effects an ultimate after-tax cost to the insider in excess of the profit recoverable by the corporation would frustrate the purpose of section 16(b). Lokken, *supra* note 19, at 303.


23. *Id.*

24. *Id.*
In *William L. Mitchell*, the Commissioner of Internal Revenue argued that *Arrowsmith* demanded that the character of the insiders' deduction be determined by the nature of the transactions from which the 16(b) liability arose. Mitchell, a General Motors vice president, had reported a long-term capital gain on the sale of General Motors stock in October 1962. In January 1963, he purchased additional General Motors stock. The sale followed by the purchase within six months constituted a violation of section 16(b), the profit from which, computed as the excess of his selling price of the shares in 1962 over his purchase price for the same number of shares in 1963, Mitchell agreed to repay to General Motors.

In reaching its decision, the Tax Court construed *Arrowsmith* as requiring an integral relation between the transaction in one year and the transaction in another. However, the court rejected the Commissioner's argument that *Arrowsmith* required the deduction to be characterized as a capital loss, holding that the crux of *Arrowsmith* was not the favorable tax treatment in the earlier year, but rather the relationship between the prior years' liquidation and the later repayment. Since the court felt this relationship was lacking in *Mitchell*, deduction of the full amount of the payment was allowed as an ordinary and necessary business expense.

On appeal, the Sixth Circuit reversed the Tax Court on the basis of


26. In sum, it appears to us that the underlying element in the *Arrowsmith* line of case law is the existence of an integral relationship between two taxable transactions in separate years, so that the characterization of the latter transaction by the earlier one is necessary in order to reflect the true taxable income of the taxpayer. Only by such reasoning does the logic of those decisions become evident.

52 T.C. at 175.

27. In the instant case in 1962, when petitioner sold General Motors stock, he reported a long-term capital gain and paid the resulting tax. That gain was then his property without a claim against it on the part of anyone. It was a completed transaction. In 1963, petitioner purchased other shares of General Motors common stock at a price fixed by stock options owned by him. Upon this latter transaction, nothing of tax consequence took place. Only upon the sale or disposition of the purchased stock could it be said that anything with tax incidence had occurred. [citations omitted.] Because the purchase of the stock in 1963 took place within 6 months of the sale transaction, however, an entirely separate and distinct statute from the Internal Revenue Code was alleged to have come into operation, i.e., section 16(b) of the Securities Exchange Act of 1934. Violation of section 16(b) has no ipso facto tax effect whatsoever but merely creates an indebtedness between an "insider" officer of a corporation and his corporate employer.

52 T.C. at 174.

United States v. Skelly Oil Co.,29 decided by the United States Supreme Court nine days after the Tax Court decision in Mitchell.

In Skelly Oil, the corporation was required to repay income which had been taxed after a 27.5 percent oil depletion allowance.30 After the Commissioner had disallowed a deduction for the full amount of the repayment as an ordinary and necessary business expense, the Supreme Court affirmed, holding that Skelly Oil was limited in the year of repayment to a deduction for the amount repaid reduced by the percentage depletion attributed to the receipt of that amount in the earlier years.

In so deciding, the Court found that permitting a deduction for the full amount of the repayment would be tantamount to allowing a double deduction, a result precluded by Arrowsmith. Writing for the majority, Mr. Justice Marshall explained:

The rationale for the Arrowsmith rule is easy to see; if money was taxed at special lower rate when received, the taxpayer would be accorded an unfair tax windfall if repayments were generally deductible from receipts taxable at the higher rate applicable to ordinary income. The Court in Arrowsmith was unwilling to infer that Congress intended such a result.31

In citing Mr. Justice Marshall's opinion,32 it is clear that the Sixth Circuit adopts the Skelly Oil interpretation of the Arrowsmith decision; specifically, that if allowing a deduction for the full amount of the repayment would have the practical effect of allowing the taxpayer a double deduction, and, therefore, an unfair tax windfall, then Arrowsmith requires that the repayment be deducted at the lower rate—the rate at which the income was originally taxed.

In addition to adopting the double deduction theory as the test to determine whether the Arrowsmith rule applies, the Sixth Circuit expressly rejected the Tax Court position of allowing ordinary business deductions when the payments were made to protect the taxpayer's employment and business reputation,33 as well as implicitly rejecting the Tax Court

30. In 1958, Skelly Oil was required to refund to customers $505,536 in overcharges collected in the previous six years. In its tax returns for those years, the corporation had included annual sums going to make up the $505,536 in its "gross income from the property" which section 613 of the Code makes the basis for the 27.5% depletion allowed for the production of oil and natural gas. As a result of the depletion allowance, therefore, the actual increase in taxable income was $366,513. However, in its 1958 tax return, the corporation attempted to deduct the $505,536 it was forced to return as an ordinary and necessary business expense under section 162 of the Code. United States v. Skelly Oil Co., 394 U.S. 678 (1969). The Code has since been amended to allow a 22% depletion. 26 U.S.C. § 613(b) (1) (1970).
31. 394 U.S. at 685.
32. 428 F.2d at 263.
33. Id.
decision in Mitchell, which held that the crux of Arrowsmith was the integral relation theory.\(^3\)

Despite the decision of the Sixth Circuit in Mitchell, the Tax Court, in James E. Anderson,\(^\text{34}\) adhered to its original position that payments in satisfaction of section 16(b) liability were deductible as ordinary and necessary business expenses.\(^3\) While maintaining its position that Arrowsmith does not apply because a sale and repurchase are separate transactions involving only securities law significance, and, therefore, no integral relation, the Tax Court went one step further in holding that there was also no integral relation between the transactions because the sale and purchase were made in taxpayer's capacity as a shareholder, while the repayment was made in his capacity as an employee to protect his employment and business reputation.\(^3\)

As a result of the Tax Court decision in Anderson, the Seventh Circuit was presented with three issues: First, whether the appropriate test for determining the applicability of the Arrowsmith rule was the integral relation theory\(^3\) advanced by the Tax Court, or the double deduction theory\(^3\) set forth by the Supreme Court in Skelly Oil; second, given the appropriate test, whether the Arrowsmith rule does, in fact, apply; and third, whether the taxpayer's capacity in making the payment is of any significance in determining its tax status.

Although the court does not address itself directly to the first issue, it is nevertheless clear from the majority opinion—"that Arrowsmith, with and without the benefit of its interpretation in Skelly Oil, is applicable to this case . . ."\(^4\)—that Anderson represents a significant departure from the rationale of the Skelly Oil line of case law which supports the double deduction theory. Consequently, if an integral relation exists between a prior sale and a subsequent payment, it may be fairly inferred that Arrowsmith will apply, irrespective of whether a double deduction will result.

Despite the failure of the court to stress the appropriateness of the integral relation theory, there has been support for this position in recent case law\(^4\) and commentary.\(^4\) In fact, only in viewing Arrowsmith as
requiring an integral relation between the prior sale and the subsequent payment can a result be obtained that is consistent with the notion of strict liability implicit in section 16(b). 43

An illustration of this position is demonstrated in the situation of an insider taxpayer who incurs both a capital loss and section 16(b) liability as a result of a purchase-sale transaction. Suppose, for example, a taxpayer purchased 100 shares of X Corporation ten years ago for $5,000. If, in the current year, he purchases another 100 shares for $4,000, followed by a sale for $4,600, within six months, of the shares purchased ten years ago, the result will be a $400 long-term capital loss on the sale for tax purposes, as well as a section 16(b) gain and liability of $600. Regardless of what his basis had been for tax purposes, his section 16(b) liability would still be $600. 44 Clearly, then, the absence of any connection between the amount of tax gain or loss and the amount of the section 16(b) liability is irrelevant.

Given this situation, in which a loss on the sale for tax purposes precludes a section 1202 deduction, the allowance of an ordinary loss for the amount paid in satisfaction of the section 16(b) liability would not produce a double deduction, and, therefore, the rationale of Skelly Oil would not require capital loss treatment. However, despite the absence of any double deduction, Arrowsmith should apply to produce a capital loss because of the integral relation between the liability and the sale.

Assuming, however, that a particular sale-payment transaction does give rise to a double deduction, it is not clear that even the Skelly Oil interpretation of Arrowsmith would require capital loss treatment. Writing for the majority in Lewyt Corp. v. Commissioner, 45 Mr. Justice Douglas stated:

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44. Id. at 240.
[The rule that general equitable considerations do not control the measure of deductions or tax benefits cuts both ways. It is as applicable to the Government as to the taxpayer. Congress may be strict or lavish in its allowance of deductions or tax benefits. The formula it writes may be arbitrary and harsh in its applications. But where the benefit claimed by the taxpayer is fairly within the statutory language and the construction sought is in harmony with the statute as an organic whole, the benefits will not be withheld from the taxpayer though they represent an unexpected windfall.]

In a dissenting opinion in Skelly Oil, Mr. Justice Stewart concurred with the majority in Lewyt, and correctly indicated that

[i]n prior decisions disallowing what truly were "double deductions," the Court has relied on evident statutory indications, not just its own view of the equities, that Congress intended to preclude the second deduction. In those cases the taxpayers sought to benefit twice from the same statute deduction. In this case, by contrast, the respondent has taken two different deductions accorded by Congress for distinct purposes.

Accepting the integral relation theory as the appropriate test for application of the Arrowsmith rule, the question then becomes whether such a relation, in fact exists. The Tax Court, in both Mitchell and Anderson, repeatedly emphasized that the sale giving rise to the capital gain was a closed transaction for tax purposes. And since the subsequent purchase was without tax significance, the payment in satisfaction of section 16(b) liability was held to lack the requisite integral relation to the prior sale.

In rejecting the Tax Court argument, the court relied implicitly on the nature of the transactions involved and their relation to section 16(b). Recognizing that both the sale and purchase were capital transactions, which together gave rise to section 16(b) liability, the court found the requisite integral relation to exist between the sale-purchase combination and the subsequent payment.

Logically, it appears that the characterization of the payment as an adjustment on the sales price is correct. This is evidenced by the fact that the amount of liability is calculated by subtracting from the sales proceeds the lowest purchase price within the six-month period, and that interest on the payments may be required from the date of the sale preceding the purchase.

Turning to the remaining issue of whether the capacity of the taxpayer in making the sale-purchase and subsequent payment is significant in

47. 394 U.S. at 695-96.
determining the type of deduction allowed, it is clear that the court correctly rejected this distinction as unpersuasive.\textsuperscript{51} One merely has to look to the language of the Securities Act to discover that section 16(b) was intended to regulate the activities of officers, directors, and shareholders owning 10\% or more of the company's stock.\textsuperscript{52} To argue, therefore, that a sale-purchase made in the taxpayer's shareholder capacity, and a subsequent payment made as an employee to protect his business reputation warrants special tax treatment, clearly places the non-employee shareholder at a disadvantage not contemplated by the statute.

In resolving this issue, the court indicated that it would be more appropriate to view the taxpayer as an insider—the capacity in which he made the sale, purchase, and payment. However, even if the Tax Court's capacity distinction was prompted by the taxpayer's desire to protect his employee status, "nothing in \textit{Arrowsmith} or \textit{Skelly Oil} suggests that the purpose of the taxpayer in satisfying the demand must be rooted in the exclusively identical capacity in which the profit was realized and the demand was made."\textsuperscript{53}

In conclusion, it appears that the court's decision in the instant case accomplished two things: First, in adopting the integral relation theory as the sole test for interpreting the applicability of the \textit{Arrowsmith} rule, the court has sanctioned a standard for determining the tax status of insider payments that clarifies an otherwise controversial area of the law; and second, it adheres to the notion of strict liability implicit in section 16(b) without frustrating the policy underlying the Internal Revenue Code. As a result, the court has eliminated a significant loophole in the tax law through which corporate insiders have effectively managed to avoid the full extent of the liability imposed by section 16(b) of the Securities Exchange Act of 1934.

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\textsuperscript{51} See James E. Anderson, 56 T.C. 1370, 1374-75 (1971), for a more complete discussion of this issue.

\textsuperscript{52} See 15 U.S.C. \textsection 78p(a) (1970).

\textsuperscript{53} Anderson v. Commissioner, 480 F.2d 1304, 1308 (7th Cir. 1973).