Tax Shelter Litigation and Securities Law: Should Tax Benefits Be Used to Reduce Plaintiff Awards?

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INTRODUCTION

For people in high tax brackets, tax shelters can be an extremely attractive form of investment.1 Designed to provide tax losses,2 they can be used to offset other taxable income, thereby reducing the investor's overall tax liability. For some investors, however, tax shelters have failed to provide the desired tax benefits, usually one of three reasons. First, because tax shelters are often structured primarily around tax advantages, often too little consideration is given by promoters to the economic fundamentals of the underlying investment.3 The past decade's recessionary economy, combined with the structural weaknesses of some of these investments, has caused a high failure rate among them.4

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1. The government estimates that $11 billion was invested in tax shelters in 1983, a projected increase over actual investments of $9 billion in 1982 and $8 billion in 1981. Investments in tax shelters registered with the Securities and Exchange Commission (“SEC”) in the first quarter of 1983 increased 53% over registrations for the same period in 1982. STAFF OF JOINT COMM. ON TAXATION, 98TH CONG., 1ST SESS., BACKGROUND ON TAX SHELTERS 5 (Jt. Comm. Print 1983) [hereinafter cited as BACKGROUND ON TAX SHELTERS]. See also infra note 15.

2. A tax loss is the amount by which deductible expenses exceed income generated during a tax year. In tax shelters, unlike most investments, the object is to generate the largest possible amount of deductible expenses and the smallest possible amount of income, thereby producing the greatest possible tax loss. Such losses are one of the primary tax benefits derived from tax shelters. See generally J. BRODSKY, A PRACTICAL GUIDE TO TAX SHELTER LITIGATION § 2.01(1) (rev. ed. 1982). See infra text accompanying notes 21-29.

3. Where investors are primarily concerned with tax advantages, they are often willing to invest in ventures that no reasonable investor would consider but for the tax advantages. Many of these investments do not survive on a long term basis. Additionally, tax shelter investors often do not monitor the business affairs of the investment which may be inefficiently or even fraudulently managed. J BRODSKY, supra note 2, § 1.01.

4. For example, in the real estate area, inflation and high interest rates caused cost overruns in construction ventures which became difficult to finance. The energy crisis...
Second, many tax shelters are designed to take advantage of specific provisions of the Internal Revenue Code. These investments are premised on the assumption that the Code provisions will not change.\(^5\) Beginning in 1969, however, Congress took an increased interest in tax shelters and closed loopholes that formed the basis for many shelters.\(^6\)

Finally, the Internal Revenue Service has taken an aggressive stand against "abusive" tax shelters. The IRS has greatly increased the number of investigations and audits of the tax returns of tax shelter investors.\(^7\) Illegitimate deductions are disallowed, leaving the investor liable for additional taxes.

Investors whose tax shelter investments fail or whose tax deductions are disallowed by the IRS are turning to the courts for redress. Because most tax shelter investments are securities,\(^8\) investors are afforded the protections of the federal securities laws.\(^9\) Relief under these laws is somewhat limited, however, because the remedies available are strictly compensatory.\(^10\) Within the context of a tax shelter investment, this fundamental principle of securities law raises the issue of whether the successful plaintiff's award should be reduced by any tax benefits received from the investment.\(^11\) Judicial response to the tax benefit issue has been inconsistent.\(^12\)

This issue is of critical importance in this area of increasing litigation. Consideration of the tax benefits problem by the courts has led to inconsistent applications of the federal securities laws. Reducing plaintiff awards deters private parties from bringing

\(^5\) R. HAFER & P. FASS, TAX SHELTERED INVESTMENTS Intro.-7 (rev. 3d ed. 1983).
\(^6\) See infra notes 30-38 and accompanying text.
\(^7\) See infra notes 32-33 and accompanying text.
\(^8\) See infra notes 39-70 and accompanying text.
\(^10\) Austin v. Loftsgaarden, 675 F.2d 168, 183 (8th Cir. 1982).
\(^11\) Where an investor paid $50,000 for a tax shelter which generated an additional $50,000 of tax savings while he held it, should he be awarded damages of $45,000 because the investment was really only worth $5,000 when it was bought? Conversely, if the investor's purpose was to shelter income from taxes and the expected tax benefits don't materialize because of the promoter's fraud, should the investor be compensated for the non-availability of the tax savings? J. BRODSKY, supra note 2, § 16.01.
\(^12\) See infra notes 71-107 and accompanying text.
actions and undermines the policies of the securities laws.\textsuperscript{13} As a matter of public policy, the government has a strong interest in recovering tax revenues lost to questionable tax deductions. This governmental interest is subverted when the plaintiff's award is reduced because his tax benefits are credited to the defendant instead of being returned to the government via the plaintiff's amended tax return.\textsuperscript{14}

This note will discuss the nature of tax shelter investments and the tax benefits that make them attractive to investors. It will analyze the remedies available to investors under the federal securities laws and the purposes they serve. This note will then examine the various judicial approaches to the issue and discuss the problems engendered by using tax benefits to reduce plaintiff awards in light of the competing interests at stake. Finally, a uniform approach to devising a strictly compensatory remedy where the plaintiff has received tax benefits from his investment will be recommended.

**BACKGROUND**

*The Mechanics of Tax Shelters*

Tax shelters\textsuperscript{15} are investments which accelerate tax benefits into current tax periods and defer the burden of tax repayment as far into the future as possible.\textsuperscript{16} The primary attraction of a

\begin{enumerate}
\item See *infra* text accompanying notes 123-26.
\item See *infra* text accompanying notes 127-30.
\item Because of its nature, a precise definition of the term "tax shelter" is difficult to formulate. Nevertheless, a number of different definitions of the term have been offered. The American Bar Association, for example, defines a tax shelter as: An investment which has as a significant feature for federal income or excise tax purposes either or both of the following attributes: (i) deductions in excess of income from other sources in that year, and (ii) credits in excess of the tax attributable to the income from the investment being available in any year to offset taxes on income from other sources in that year. ABA Comm. on Ethics and Professional Responsibility, Formal Op. 346, n.1 (1982) (tax shelters).
\item Another commonly used definition is as follows: An investment which allows the investor to offset certain artificial losses (that is, non-economic losses but 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 its regular business or professional activity.
\item OVERVIEW OF TAX SHELTERS, *supra* note 4, at 1.
\item 4 R. HAFT & P. FASS, *supra* note 5, at Intro.-4.
\end{enumerate}
tax shelter is its ability to generate tax losses. Losses are achieved by matching a large number of deductible expenses with a business that is unlikely to produce much income initially. Tax shelters take many different forms, and the tax benefits to the investor depend on the underlying investment. Tax benefits can range from deductions for non-recourse loans to various kinds of congressionally legislated investment credits.

Investments can shelter income in any of three ways. First, tax shelters can defer tax liability. Deferral relates to the investor's ability to "bunch" deductions in the early years of the investment, instead of matching the deductions against the income eventually generated. By the time the investment generates income or is sold, both of which events are taxable, the investor has been able to take deductions in an amount at least equal to the amount of his investment. Deferral is, in effect, an interest-free loan from the federal government, repayable when the investment either produces income or is sold. Through deferral, the investor also benefits from the time value of money.

17. See supra note 2.
18. Some examples of potential tax shelter investments include apartment buildings, shopping centers, rehabilitation of low income housing, cattle (or other livestock) feeding or breeding, raising certain plants, shell eggs, Christmas trees, vineyards, thoroughbred horseracing syndicates, oil and gas drilling, coal leases, equipment (computers, airplanes barges, railroad car) leases, motion picture production or purchase, and professional sports franchises. 4 R. HAFT & P. FASS, supra note 5, passim. Because Congress and the IRS have moved to slow or halt objectionable tax shelter practices, promoters have either found ways around the "roadblocks" or found new areas in which tax shelters are feasible. Abusive Tax Shelters: Hearing Before the Subcomm. on Oversight of the House Comm. of Ways and Means, 97th Cong., 2d Sess. 6 (1982) [hereinafter cited as Abusive Tax Shelters]. For a thorough discussion of the mechanics of investments in many of these specific areas, see generally 4 R. HAFT & P. FASS, supra note 5.
19. Non-recourse loans are those for which the investors are not personally at risk. Prior to 1976, investors were allowed deductions with respect to their equity (amount invested) and on the borrowed funds. Investors could thus deduct expenditures in excess of the equity for which they were at risk. Under the Tax Reform Act of 1976, 26 I.R.C. §§ 1-9602 (1982), however, Congress eliminated the use of non-recourse financing for most tax shelters. Deductions are limited to the amount at risk for all businesses except real estate and certain equipment leases of closely held corporations. 26 I.R.C. § 465 (1982).
20. These investment credits include provisions such as the Accelerated Cost Recovery System, deductions for intangible drilling costs or for research and development, depreciation deductions, and production payments on oil and gas. J. BRODSKY, supra note 2, § 2.01(2).
21. For a thorough discussion of the elements of tax shelters, see Overview of Tax Shelters, supra note 4. See also Background on Tax Shelters, supra note 1, at Part II; J. BRODSKY, supra note 2, at ch. 2; 4 R. HAFT & P. FASS, supra note 5, at Intro.
22. Background on Tax Shelters, supra note 1, at 3.
Tax Shelters

(i.e., money in hand invested to earn interest). When a tax obligation is deferred, the investor can temporarily invest the money until the obligation is repaid.

Second, tax shelters can convert the investor's ordinary income into tax-favored income. Deductions provided by the tax losses from the shelter are taken against ordinary income. The income eventually generated by the investment, however, may be taxable at a lower rate. For example, the underlying investment may be sold and the gain from the sale then taxed at capital gains rates which are lower than ordinary income rates. Alternatively, the investor may be in a lower tax bracket in the year in which the tax shelter generates income.

Third, most tax shelters are highly leveraged, using borrowed money to finance the investment. This provides the investor with several potential benefits. By using borrowed money to fund his investment, the investor can use his own money for other purposes. Interest payments on the debt are deductible. Additionally, taxpayers are allowed deductions for expenditures made with borrowed funds.

Although tax shelter investments are made in different kinds of businesses, most tax shelters are structured as limited partnerships. The partnership form is attractive for tax shelters because, unlike a corporation, a partnership is not a taxable entity under the Internal Revenue Code. Instead, partnership income and losses are passed through to the partners individually. Investors are thus taxed on their share of partnership income and can deduct their share of partnership losses.

Allocations of profits and losses among partners are provided for in the partnership agreement. As long as there is a legitimate business reason to do so, loss allocations can be made disproportionate as to the limited partners. Allocation of a greater share of loss deductions attracts investors to the limited partnership as does the fact that limited partners have limited liability for debts

23. Id. at 16.
24. Id. at 4. See also J. Brodsky, supra note 2, § 2.03(2).
25. BACKGROUND ON TAX SHELTERS, supra note 1, at 4.
26. Id. at 24. Some tax shelters also take the form of S corporations. See J. Brodsky, supra note 2, § 2.01(3)(c).
27. For a thorough discussion of the tax aspects of limited partnerships, see 4 R. Hapf & P. Fass, supra note 5, § 4.06.
28. Id.
of the partnership. Because of these features the vast majority of tax shelters take the limited partnership form.

The Government and Tax Shelters

Declining tax revenues and a perception by taxpayers that the tax system is inequitable have focused governmental interest on tax shelters. Beginning in 1969, Congress passed a series of tax reform bills designed to close the loopholes that enabled tax shelter promoters to abuse the tax laws. Additionally, in 1980, the IRS initiated an audit program to combat abusive tax shelters, and is vigorously investigating and auditing post-1980 taxpayer returns under the program to find and disallow illegit-

29. BACKGROUND ON TAX SHELTERS, supra note 1, at 24.
30. The IRS recognizes that some of the existing tax laws are structured to encourage legitimate investments in certain businesses. It has also stated, however, that because the viability of the tax administration system depends on taxpayer perceptions that the system is both equitable and fairly administered, the promotion of abusive tax shelters undermines public confidence in the tax system, leading to reduced revenues and less voluntary compliance. Abusive Tax Shelters, supra note 18, at 5 (statement of Roscoe L. Egger, Jr., Comm’r of IRS).
31. For a comprehensive summary of the provisions in the tax reform laws affecting tax shelters, see 4 R. HAFT & P. FASS, supra note 5, at Intro. See also BACKGROUND ON TAX SHELTERS, supra note 1, at 6-15.
32. Abusive Tax Shelters, supra note 18, at 5. Abusive tax shelters are characterized by extreme interpretations of the tax laws or the use by promoters of incomplete and misleading facts to secure tax benefits that are clearly disproportionate to the economic benefits of the investment. Abusive tax shelters are entered into with the sole expectation of evading taxes rather than any expectation of positive financial outcome. In contrast, non-abusive tax shelters seek to defer or minimize taxes. They involve transactions with legitimate economic reality where the economic benefits outweigh the tax benefits. Id.

The features that make tax shelters abusive from the point of view of the IRS also affect investors. The IRS notes that many of the abusive tax shelters currently sold are not tax shelters at all, but “fraud euphemistically referred to as tax shelters.” Id. These investments are characterized by backdated documents, fictitious notes, false affidavits, inflated appraisals, rigged transactions, and forged trading records, among other mechanisms. Id. For the investor, the existence of these fraudulent devices makes liability easy to prove under the antifraud provisions of the securities laws once the investment has soured. See infra notes 40-42 and accompanying text.

Since 1976, the IRS has continually attempted to audit tax returns of investors using tax shelters. The initial focus was on returns that reflected deductions relating to oil and gas drilling, farm operations, real estate, and movies. The 1980 Abusive Tax Shelter Audit Program selects returns on the basis of the following criteria: (1) large net loss, (2) low gross income, (3) a non-operating entity, (4) a first year return of an entity formed late in the year, (5) a year end negative capital account or 50% reduction in capital assets, or (6) a low ratio of noncash capital contributions to total asset cost and mischaracterization of capital items. See 4 R. HAFT & P. FASS, supra note 5, at Intro.-1832. There are also new audit procedures for partnerships and S corporations effective for taxable years beginning after 1982. See BACKGROUND ON TAX SHELTERS, supra note 1, at 13.
imate deductions. The IRS is also using civil sanctions provided in the 1981 and 1982 tax laws against tax shelter promoters.\(^{33}\)

The Securities and Exchange Commission ("SEC") also maintains an enforcement position in the tax shelter area because of the opportunities it sees in tax shelters for potential securities fraud. Enforcement is selective. A major consideration is the probable deterrent effect of injunctions and penalties on those involved and on others considering involvement.\(^{34}\)

Successful marketing of tax shelters is somewhat dependent on the participation of professional tax advisors. In an attempt to curtail the proliferation of questionable tax shelters, the Treasury Department has focused its attention on these advisors. In 1980, the Department issued proposed amendments to Circular 230\(^{35}\) relating to the standards for providing opinions in tax shelter offerings.\(^{36}\) The American Bar Association refused to approve the proposed amendments and instead issued its own standards in Formal Opinion 346.\(^{37}\) The Treasury Department then revised the proposed amendments to adopt a modified version of the guidelines issued by the ABA. Among other things, these guidelines require tax counsel to give an opinion on the

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\(^{33}\) The civil penalties are variously directed against investors and promoters and involve fines and injunctions. For a thorough discussion of the civil sanctions enacted since 1976, see 4 R. HAFT & P. FASS, supra note 5, at Intro.-64, 68. The IRS has summarized its position on abusive tax shelters as follows: "Caution—Participating in abusive tax shelters can be hazardous to your wealth." Abusive Tax Shelters, supra note 18, at 9 (statement of Roscoe L. Egger, Jr., Comm'r of IRS).

\(^{34}\) The SEC is committed to investigating and prosecuting tax shelter enterprises, their promoters, and principals for failure to comply with the registration and antifraud provisions of the federal securities laws. The commission is also proceeding against securities professionals, attorneys, and accountants who participate in fraud in the sale of tax shelters or failures to meet the registration requirements. Abusive Tax Shelters, supra note 18, at 47-49 (statement of John M. Fedders, Dir., Div. of Enforcement of the SEC).

The SEC faces particular difficulty in trying to prevent fraud in the tax shelter area. It has found that in tax shelter prosecutions, unlike other fraud prosecutions, investor cooperation is limited. The commission attributes this to investor concern that cooperation will lead to disallowance of tax benefits, particularly where it is already clear that the tax shelter will not be profitable. Id. at 50.


\(^{37}\) ABA Comm. on Ethics and Professional Responsibility, Formal Op. 346 (1982) (tax shelters). The bar felt that self-regulation was preferable and objected to the due diligence requirements and strict sanctions (disbarment/suspension from practice before the IRS) contained in the proposed amendments. See Special Comm. on the Lawyer's Role in Tax Practice, Ass'n of the Bar of the City of N.Y., The Lawyer's Role in Tax Practice, 36 TAX LAW. 865 (1983) [hereinafter cited as Lawyer's Role].
merits with respect to each material tax issue in the offering materials, including an evaluation of the extent to which the tax benefits are likely to be realized.\textsuperscript{38}

This increased governmental scrutiny may stop the proliferation of questionable tax shelters. Those who have already invested in them, however, suffer a dual loss. First, investors are robbed of expected returns on their investments. Second, the promised tax benefits fail to materialize when deductions are disallowed. Disappointed investors in this position are turning to the courts for redress against those involved in promoting and selling the shelters.

\textit{Tax Shelters As Securities}

Under the Supreme Court’s test in \textit{SEC v. W.J. Howey},\textsuperscript{39} limited partnership interests are investment contracts; investment contracts are, in turn, securities. Thus, investors in tax shelters can avail themselves of the provisions of the federal securities laws. Most tax shelter litigation is brought under section 12 of the Securities Act of 1933,\textsuperscript{40} section 10(b) of the Secluir-

\textsuperscript{38} 47 Fed. Reg. 56,144 (1982). \textit{See generally ABA Section on Taxation, Statement on Revisions to Proposed Rule Amending Circular 230 with Respect to Tax Shelter Opinions, 36 Tax Law. 861 (1983); Lawyer’s Role, supra note 37.}

\textsuperscript{39} 328 U.S. 293 (1946). “The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.” Id. at 301. In \textit{SEC v. Murphy}, the court held that limited partnership interests satisfied the \textit{Howey} test. 626 F.2d 633, 640-41 (9th Cir. 1980).

\textsuperscript{40} Section 12(2) provides:

Any person who—

(2) offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraph (2) of subsection (a) of said section), 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 the 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 thereon, less the amount of any income received thereon, upon the tender of such security for damages if he no longer owns the security.

15 U.S.C. § 77(1)(2) (1982). A statement or omitted fact is material under all of the securities statutes if it is substantially likely that a reasonable investor would consider the
ties and Exchange Act of 1934, and rule 10b-5 promulgated thereunder.

The 1933 Act

The Securities Act of 1933 ("1933 Act") was designed to regulate the original issue of securities. Its purpose is to ensure that investors are provided adequate information with which to make a reasoned investment decision. Under the 1933 Act, offerings of securities must either be registered with the Securities and Exchange Commission or made pursuant to a valid exemption.


Section 10b provides:

Section 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

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


Rule 10b-5 makes it unlawful:

for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme, or artifice to defraud,
(2) 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 the light of the circumstances under which they were made, not misleading, or
(3) 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.


The choice of § 10b, rule 10b-5, or § 12(2) appears to be somewhat a matter of the bar's familiarity with the different provisions. For a comparison of the causes of action under these claims, see Kaminsky, An Analysis of Securities Litigation Under Section 12(2) and How It Compares With Rule 10b-5, 13 HOUS. L. REV. 231 (1976). Based on the Court's holding in Herman & MacLean v. Huddleston, 103 S. Ct. 683 (1983), an implied cause of action under § 10b will apparently lie for conduct subject to the express remedy of § 12(2). See generally Steinberg, The Propriety and Scope of Cumulative Remedies Under the Federal Securities Laws, 67 CORNELL L. REV. 557 (1982).

The rationale underlying § 12(2) is the same as that of the antifraud provisions of the securities laws in general: Full disclosure puts the buyer and seller on an equal footing in terms of their ability to make an informed decision. Kaminsky, supra note 43, at 237.

Possible exemptions have traditionally been available for private placements, intrastate offerings, and offerings that involve a relatively small amount of capital. For a
Section 12 provides an express remedy for material misstatements or omissions in the offering materials. The investor must sue for rescission unless he no longer holds the securities, in which case he can sue for damages. The measure of the award is the consideration paid for the security plus interest, less income received on the investment. One area of disagreement among the judiciary is whether tax benefits are income under the statute and should accordingly reduce the award.

The 1934 Act

The Securities and Exchange Act of 1934 ("1934 Act") regulates the securities markets. The 1934 Act mandates full disclosure to buyers and sellers of securities. It also affords remedies to injured investors for fraud and manipulation in the trading markets.

In order to effectuate the Act's purposes, courts have recognized an implied cause of action under section 10(b) and rule 10b-5 of the 1934 Act. Thus, the courts have broad discretion to fashion appropriate remedies as long as they further the remedial purposes of the Act. Plaintiffs can plead in the alter-
native, seeking either rescission or damages.\textsuperscript{52}

Rescission is the act of voiding a relationship and, by itself, is not generally a satisfactory remedy in this type of action.\textsuperscript{53} A rescissional remedy under the 1934 Act contemplates awarding the plaintiff some kind of restitution to restore him to the status quo ante.\textsuperscript{54} Typically, the buyer tenders the security to the seller and receives his purchase price in return.\textsuperscript{55}

Under section 10(b) and rule 10b-5, rescission is a discretionary remedy. The courts grant rescission only if it is equitable to do so.\textsuperscript{56} There are two theoretical underpinnings to rescission under the 1934 Act. First, as noted, courts can infer it as a remedy if it furthers the purposes of the Act. Second, section 29(b) renders void any contract made in violation of provisions of the Act.\textsuperscript{57}

The measures of damages under section 10(b) and rule 10b-5 are numerous and depend on the plaintiff's position vis-a-vis the defendant and the market.\textsuperscript{58} Two are particularly important to the tax shelter investor, who is typically a defrauded buyer. Defrauded buyers traditionally recover an out-of-pocket measure been used to supplement the Borak mandate: First, judges can use a remedy whether it was traditionally available in actions at law or suits in equity. Second, district court judges have discretion in granting legal or equitable relief while the law pertaining to remedies under the 1934 Act is in flux. 5C A. Jacobs, Litigation & Practice Under Rule 10b-5 § 259 (1983).


There are several reasons why a plaintiff might choose rescission over damages in a tax shelter action. By rescinding, the investor no longer has to continue his association with those who defrauded him. He also cuts off his exposure to the financial risk that might be precipitated by a suit for damages. See generally Note, Real Estate Limited Partnerships and Allocational Efficiency: The Incentive to Sue for Securities Fraud, 63 Va. L. Rev. 669 (1977).

53. If the transaction is executory, however, rescission alone would be a sufficient remedy. 5C A. Jacobs, supra note 51, § 260.03(c)(vi).


55. 5C A. Jacobs, supra note 51, § 260.03c(vi)[B].

56. The courts are in disagreement as to whether rescission is available when the plaintiff has an adequate remedy at law. See e.g., Baumel v. Rosen, 283 F. Supp. 128, 146 (D. Md. 1968), modified, 412 F.2d 571 (4th Cir. 1969), cert. denied, 396 U.S. 1037 (1970). Most courts require a contractual relationship with at least one defendant. Additionally, the plaintiff seeking rescission must act promptly after becoming aware of the fraud. See Bridgen v. Scott, 456 F. Supp. 1048 (S.D. Tex. 1978).

57. 5C A. Jacobs, supra note 51.

58. Some measures of damages are designed to compensate only defrauded sellers. Thus, the "cover" measure of damages allows the plaintiff to recover the value of the
of damages.\textsuperscript{59} This measure gives the plaintiff the difference between the consideration paid for the security and its actual value at the time of purchase.\textsuperscript{60} The out-of-pocket measure is a tort theory of recovery. It is designed to compensate the plaintiff for his actual loss rather than the loss of any potential gain.\textsuperscript{61}

Alternatively, defrauded buyers can recover their purchase price under a rescission measure of damages.\textsuperscript{62} Unlike the out-of-pocket measure, the value of the security is calculated as of the time of the action and not as of the time of the purchase, en-

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\textsuperscript{59} See generally 5C A. JACOBS, supra note 51, § 206.03 (e)(i).

\textsuperscript{60} Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 155 (1972). Thus, if the buyer paid $15 for a security having a fair value at the time of purchase of $10, his out-of-pocket damages will be $5.

\textsuperscript{61} Sacher, supra note 52, at 437.

\textsuperscript{62} This has prompted one commentator to note that defrauded buyers typically recover their purchase price under a rescission measure whether or not formally suing for rescission. 2 A. BROMBERG, SECURITIES LAW: FRAUD—SEC RULE 10b-5 226 (1969).

The rescission measure of damages, however, cannot restore the plaintiff to a better
abling the buyer to recover his entire purchase price.\textsuperscript{63}

Section 28 of the 1934 Act limits recovery to actual damages suffered on account of the defendant's actions.\textsuperscript{64} This section generally has been understood to preclude any award for punitive damages.\textsuperscript{65} The actual damages principle has also been invoked, however, to reduce the plaintiff's award by tax benefits he received from the investment.\textsuperscript{66}

The court's choice of an out-of-pocket measure over a rescission measure of damages may depend somewhat on the facts of the case, but the courts that have considered the tax benefits issue have not usually indicated why one measure is chosen over the other.\textsuperscript{67} The mandate that the award further the remedial purposes of the 1934 Act obviously affords the courts great leeway in formulating a remedy.

Section 12 of the 1933 Act and section 10(b) and rule 10b-5 of the 1934 Act are not exclusive causes of action.\textsuperscript{68} Where the investor avails himself of both Acts, however, the courts have
not clearly distinguished remedial theories.\textsuperscript{69} Decisional law is further clouded because many tax shelter cases are remanded for new trials on the damages issue and are then apparently settled.\textsuperscript{70}

**THE COURTS' APPROACHES TO THE TAX BENEFITS ISSUE**

Courts have inconsistently analyzed what role tax benefits should play in formulating plaintiff awards. Some courts have denied the plaintiff any relief where he received tax benefits from his investment. In *Bridgen v. Scott*,\textsuperscript{71} for example, the court reasoned that rescission would restore the plaintiff to a better position than he had occupied before the transaction, and thus was not an appropriate remedy.\textsuperscript{72}

Other courts have decided that an award is not precluded by the receipt of tax benefits, but have disagreed as to what role tax benefits should play in it. The Court of Appeals for the Eighth Circuit considered the tax benefit issue in *Austin v. Loftsgaarden*.\textsuperscript{73} *Austin* involved a real estate limited partnership, formed

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\textsuperscript{69} See supra note 65. Additionally, plaintiffs often include in the pleadings a common law fraud claim. See, e.g., *Austin v. Loftsgaarden*, 675 F.2d 168 (8th Cir. 1982); *Hokama v. E.F. Hutton & Co.*, 566 F. Supp. 636 (C.D. Cal. 1983).


\textsuperscript{70} See infra text accompanying notes 75-86, 113-18.

\textsuperscript{71} 456 F. Supp. 1048 (S.D. Tex. 1978).

\textsuperscript{72} Id. at 1058-60. Because the plaintiffs had received immediate tax writeoffs and additional tax benefits the following year, as well as the chance to make a large profit from the appreciation of the investment during the time it was held, the court perceived of no way to restore the plaintiffs to the status quo ante. The court analogized plaintiffs' positions to that of a player at a roulette table who pays for a speculative chance and then wants the return of his money after he doesn't win. Further offending the court was its view that the plaintiffs had bought their chances with dollars that would otherwise have been paid as taxes. Concluding that requiring the case to be tried without reference to its tax aspects was requiring the jury and the court to live in "never never land," the court denied relief. Id. It should be noted that the plaintiffs in *Bridgen* were somewhat dilatory, first learning of the defendant's fraud in 1973, but not filing suit until 1975. See also *Mintz v. Bache, Halsey, Stuart, Shields, Inc.*, No. C-79-92, slip op. at 4-5 (S.D. Tex. Jan. 27, 1981); *Bayoud v. Ballard*, 404 F. Supp. 417, 426 (N.D. Tex. 1975).

\textsuperscript{73} 675 F.2d. 168 (8th Cir. 1982).
to build and operate a Ramada Inn motel. The plaintiff investors had bought limited partnership interests relying on the defendant developer's offering memorandum. Subsequently, the partnership defaulted and the development was foreclosed.

The jury found that the offering memorandum contained various material misrepresentations, and found the defendants liable under section 12(2) of the 1933 Act and under section 10(b) and rule 10b-5 of the 1934 Act. Applying a rescissory remedy, the district court awarded the plaintiffs their purchase prices for the limited partnership interests, prejudgment interest, and attorney's fees. The defendant appealed the district court's ruling that evidence of tax benefits accruing to the plaintiffs by virtue of their investments was inadmissible. The Eighth Circuit reversed and remanded the case for a new trial on the damages issue. The court did not dispute the district court's decision to make a rescissory award, but held that it was reversible error not to admit evidence of the tax benefits received.

74. Id. at 173.
75. The offering memorandum misrepresented the interest rates for an interim construction loan and a furniture and fixture loan, the length and terms of the land lease, the construction time, defendants' compensation, and a commitment for permanent financing. The budgets and forecasts in the offering memorandum were found to be based on unreasonable and misleading assumptions. Furthermore, the defendant had failed to explain the role in the development to be assumed by his three closely-held corporations. Id. at 174-75.
76. The defendants were also found liable under the antifraud provisions of the Minnesota Securities Act and for common law fraud. Id. at 176.
77. Id. at 172. Although the opinion is not clear on this point, both the district court and the Court of Appeals for the Eighth Circuit apparently formulated the award under § 12(2). See id. at 179.
78. The district court had disallowed the evidence and dismissed as "sophistic malarkey" defendants' argument that because of the tax benefits they had received, plaintiffs had suffered no actual damages. Id. at 181.
79. In Norfolk & Western R.R. v. Liepelt, 444 U.S. 490, 494 (1980), the Supreme Court rejected the notion that the introduction of evidence relating to future tax liability was too complex or speculative for a jury. Although Liepelt was a wrongful death action under the Federal Employers Liability Act (FELA), the Austin court held that under Liepelt, the lower court's allusion to the complexity of the evidence was not a viable reason to preclude its introduction. The Liepelt argument has been extended to other areas of the law. See, e.g., In re Airline Crash Near Chicago, Ill. v. McDonnell Douglas, 701 F.2d 1189, 1192 (7th Cir. 1983). The speculative nature of evidence relating to tax benefits has been approached in different ways. In Austin, the court stated that evidence of audits and expert opinions as to their likely outcome would be admissible at retrial. 675 F.2d at 183. Accord Dupuy v. Dupuy, 551 F.2d 1005, 1025 (5th Cir.), cert. denied, 434 U.S. 911 (1977); Smith v. Bader, 83 F.R.D. 437 (S.D.N.Y. 1979). But see G & R Corp. v. American Sec. & Trust Co., 523
The court of appeals noted that recovery in securities cases is limited to actual damages, and, relying on Garnatz v. Stifel, Nicolaus & Co., held that the actual damages principle required that a rescission award be reduced by any value received as a result of the fraudulent transaction. The court stated that this rule applied to the claims under section 10(b) and rule 10b-5 as well as to the section 12(2) claims.

The appellate court acknowledged the tangible economic value of the tax aspects in a tax shelter investment and held that such value had to be considered in determining whether and to what extent the plaintiff was damaged. The court limited the Austin holding to investments marketed as tax shelters where a "rescissory measure of damages" is applied.

In Western Federal Corp. v. Davis, however, the court took the opposite position and refused to reduce the plaintiffs' award by any tax benefits. In Western Federal, summary judgment was granted in favor of the plaintiffs for the defendants' violation of section 12(2) of the 1933 Act. The defendants argued that, because the plaintiffs had sought rescission, the judgment could only restore them to the status quo ante. Accordingly, the defendants argued, tax deductions claimed by the plaintiffs must be considered in determining the amount of the award.

The court acknowledged that while section 12(2) mentioned only "income" as an item to be credited to the defendant, some courts consider economic benefits such as tax deductions to be income under the statute. Finding that any economic benefits were illusory, the Western Federal court refused to credit the defendants with the plaintiffs' tax deductions.

F.2d 1164 (D.C. Cir. 1975), wherein the court rejected on two grounds the defendants' suggestion that the defendants' expert calculate the plaintiffs' tax benefits. First, the burden of mitigation would shift to the plaintiff. Second, accurate valuation of tax benefits and burdens cannot be accomplished for several years and it is "unrealistic and impractical" to compute at trial what the ultimate effects of tax benefits will be. Id. at 1176.

80. 559 F.2d 1357, 1361 (8th Cir. 1977).
81. This interpretation of the actual damages principle has not been widely used. See supra text accompanying note 65. See also infra notes 112-14 and accompanying text.
82. 675 F.2d at 181.
83. Id. at 183.
84. Id. The Austin holding, therefore, arguably does not apply to a § 10(b) or rule 10b-5 suit for damages where an out-of-pocket remedy is applied.
86. Id. at 820.
87. Id.
88. Id.
Referring to the tax benefits rule, the court indicated that when the plaintiffs received the return of the funds they had invested, they would have to amend their income tax returns to report the award. The deductions taken previously would be washed out by the amended return and the net tax benefit would equal zero. The court recognized the existence of a second economic benefit in the plaintiffs' use of the money that would otherwise have been paid in taxes, but refused without discussion to credit the defendant for that benefit.

The court based its holding on the equitable nature of rescission under section 12. First, the equities did not run in the defendants' favor because they were guilty of violating the securities laws. Second, the defendants could not benefit at the expense of the government when it was the government, and not the defendants, that had provided the tax benefits to the plaintiffs. The court noted that if the plaintiffs were to receive the return of their entire purchase price, they would have to amend their income tax returns to report the award. The government would then recapture the deductions and the plaintiffs and defendants would be restored to the status quo ante.

The Court of Appeals for the Third Circuit took a different approach to the tax benefits problem in *Sharp v. Coopers & Lybrand*, which was brought under section 10(b) of the 1934 Act. The plaintiffs had invested in an oil and gas limited part-

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89. The tax benefits rule has been developed through case law and is not an express provision of the Internal Revenue Code. The rule holds that if an amount deducted from gross income in one year is subsequently recovered, the recovery is income in the later year. See generally 1 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 7.34 (1981).

90. 553 F. Supp. at 820.
91. Id. at 820, 821.
92. Id. at 821.
93. Id. For a thorough discussion of the tax ramifications to be considered in an award, see generally Banoff, To What Extent Will Benefits From Tax Shelters Be Permitted to Offset Rescission Damages?, 57 J. TAX'N 154, 155-57 (1982). See also Note, Tax Consequences of Rescission: The Interplay Between Private and Public Law, 42 U. CHI. L. REV. 562, 570 (1975).
95. 649 F.2d 175 (3d Cir. 1981). The issues of liability and damages were tried separately, liability as a class action and damages individually. This appeal was on the damages case.
nership. The defendant accounting firm had prepared a tax opinion letter used in sales presentations for the partnership. The letter stated that investors who purchase a limited partnership interest would be able to deduct both the amount of their investment and an approximately equal sum for the loan which the partnership would be taking out to finance the investment. The loan was never obtained and the “double” deduction was thus invalid. Some of the investors were audited and their deductions for the loan amount were disallowed by the IRS, leaving them liable for additional taxes.

The defendants were found guilty of violating section 10(b) and rule 10b-5. The district court chose an out-of-pocket remedy, believing that it would best compensate the investors. The court reasoned that the plaintiffs had bought an investment described as having value as a double deduction when, in fact, the investment lacked that value and was thus worth less at the time of purchase than the plaintiffs had paid for it.

The defendant objected to an out-of-pocket remedy and argued that the measure of damages should instead be tied to the tax consequences of the investment because the plaintiffs’ primary motivation in the venture was to obtain tax benefits. The district court refused to consider the plaintiffs’ motives in determining the appropriate measure of damages. The court believed that such a measure would amount to a benefit of the bargain recovery and that it would not fully compensate the plaintiffs for their entire loss.

97. Id.
98. Id.
99. The defendant argued that plaintiffs who relied on their opinion letter and purchased the investment in order to get a tax shelter were damaged only in the amount of the additional taxes they owed the IRS. Id. at 348.
100. See supra note 58 for a discussion of the benefit of the bargain measure of damages.
101. The district court refused to apply a benefit of the bargain measure because, while well-suited to contracts cases, it was not appropriate to securities fraud litigation. The court reasoned that there was no agreement between the plaintiffs and defendant whereby the defendant would provide them with a double tax deduction. Instead, the court viewed the harm as being that, because of the defendant’s fraud, the plaintiffs who relied on the tax opinion letter were induced to purchase an investment for an amount that was greater than the investment was worth. The court also objected to the defendant’s argument because allowing the plaintiffs to recover only the additional taxes they had to pay would not compensate them for the loss caused by purchasing a security worth less than they paid. 83 F.R.D. at 348.
The Court of Appeals for the Third Circuit disagreed with the district court's formulation of damages. It reasoned that because the goal in formulating a remedy must be to compensate the plaintiffs precisely for damages directly resulting from the defendants' wrongful acts, the plaintiffs' investment motives were relevant to the issue of damages. The court found that the plaintiffs in Sharp had been attracted to the venture both for the underlying investment and for tax reasons. The court used the widely accepted definition of out-of-pocket damages, and found that such a measure encompassed more than just the difference between the price paid and the value of the investment when purchased. Noting that it was important to separate concepts of investment loss from those of tax loss, the court suggested the use of special interrogatories to measure precisely the components of plaintiffs' losses. While the loss of tax benefits was compensable, the loss of the underlying investment was similarly compensable.

The different approaches used in these four cases are illustrative of the difficulty courts face in deciding how best to allocate tax benefits in formulating compensatory remedies. Tax shelter litigation will surely increase, and it is imperative that courts

102. 649 F.2d 175, 190 (3d Cir. 1981).
103. The court found that the investment itself offered a speculative potential for future appreciation and income should the oil wells be productive. The tax features of the investment offered an opportunity for rapid deduction of twice as much money on the investors' tax return as had actually been invested. The court held that these motives were distinguishable and measurable. Id.
104. The correct "measure of damages is the difference between what the [buyer paid] for his stock and what he would have [paid] had there been no fraudulent conduct." Id.
105. Id. at 191.
106. Apparently, neither the court nor the defendant objected to compensating the plaintiffs for the loss of tax benefits taken and later disallowed by the IRS. Of much greater concern was measuring the loss of the speculative underlying investment. To correctly measure the plaintiffs' losses on their investment, the court found it was necessary to determine exactly what the defendant knew at the time it prepared the opinion letter. If the defendant had known that the loan was not going to be obtained, that fact would affect the speculative nature of the investment and increase the risk of no long term investment return. The measure of damages would then be the purchase price less the value the investment would have had if the defendant disclosed all it knew.
On the other hand, if the defendant had provided the plaintiffs with the most accurate information available to it, the court found the defendant should not be liable for subsequent events rendering the information invalid. To do otherwise would render a party with no connection with the investment information an effective insurer for a risk that the investors knowingly took by investing in a speculative venture. Id. at 190-91.
107. The combination of the poor economy of the last decade and the government's aggressive position should lead to a substantial number of tax shelter failures. The
adopt a uniform approach to the problem of determining the appropriate remedies.

**TAX BENEFITS: SQUARE PEGS IN ROUND HOLES**

The remedies traditionally available under the federal securities laws are ill-suited to the problems posed by the tax considerations inherent in tax shelter litigation. The theories underlying these remedies are misapplied when, as in *Austin*, the plaintiffs' award is reduced by the tax benefits received. The defrauded tax shelter investor typically brings a cause of action under section 12 of the 1933 Act or under section 10(b) and rule 10b-5 of the 1934 Act. Under both acts, the underlying purpose of the available remedies is to compensate the defrauded plaintiff. Crediting the defendant with tax benefits received by the plaintiff shifts the focus, vitiating the remedial purposes of the federal securities laws. Crediting the defendant with the plaintiffs' tax benefits also ignores the government's role in providing the original tax benefits.

The policy of rescission under section 12 of the 1933 Act is to give the purchaser full restitution of his monetary investment. He is effectively restored to the position he occupied before entering into the transaction. Thus, the remedial formula of section 12(2) requires that the consideration returned to the defrauded buyer be reduced by any income received on the security. "Income" within the context of section 12(2) is generally understood to be income produced by the underlying investment. Although other courts have considered evidence of tax benefits in establishing a remedial formula, the Eighth Circuit's equating increased likelihood of IRS audit also points to a greater number of deduction disallowances. Investors will turn to the courts to recoup the losses of both the underlying investments and the promised but unrealized tax benefits. The inevitable lag caused by the district courts' crowded dockets has meant that the majority of already existing tax shelter failures have not yet been litigated. See generally J. Brodsky, supra note 2, at Intro.

108. *See supra* notes 44, 49 and accompanying text.
109. *Note, supra* note 93, at 570.
110. *See supra* text accompanying note 47.
the value of tax benefits with income is unique. The court described the actual damages principle as requiring the award to be reduced by any value received by the plaintiff. The case relied on for this principle by the Austin court, however, is distinguishable, because the remedy in that case had to compensate the plaintiff for a loss of value due to a change in the market. The remedy applied was not strictly rescissory but a "Chasins-type" remedy. Hence, the Austin court's holding seems to be an unwarranted expansion of the meaning of income under section 12(2). The court's extension of what it viewed as the actual damages principle to the claims under the 1934 Act was similarly unwarranted. Unlike section 12, the language of section 10(b) and rule 10b-5 does not require that an award be reduced by income received.

The Austin court also clouded the tax benefits issue when it explicitly applied its formulation of the remedy to claims under section 10(b), rule 10b-5, and section 12, and then limited the holding to a "rescissory measure of damages." The court's lack of precision in expounding a remedy disregards fundamental differences in the way the tax benefits issue applies to the theories of rescission and damages.

The issue under section 12 is whether tax benefits are income under the statutory formula. In a section 10(b) or rule 10b-5 suit for rescission, the issue is whether the tax benefits are part of the consideration to be returned to the seller to restore both parties to the status quo ante. Thus, some courts have held that where tax benefits are received, the status quo ante cannot be restored. The

113. In Garnatz v. Stifel, Nicolaus & Co., 559 F.2d 1357 (8th Cir. 1977), the plaintiff had invested in a bond margin account program, and specified that he was not interested in any speculative investments. To pay the interest rate on the margin account, the defendant had to buy high yield and, thus, very speculative bonds. The market value of the plaintiff's account declined 1% in six months. The defendants urged an out-of-pocket measure of damages because there was no difference between the value of the bonds and the purchase price. The court disagreed and held that because the plaintiff got what he paid for did not mean there was no fraud, only that the fraud was not related to the price of the bonds. The Garnatz court awarded a "Chasins-type" rescissory measure of damages to return the parties to the status quo ante. The measure of the award was the purchase price less any value (e.g., interest) received as a result of owning and/or selling the bonds. Id. at 1360-61.

114. See supra note 58 for a discussion of the Chasins measure of damages. Garnatz is inapposite to the issue of tax benefits in a rescission remedy.

115. See supra notes 41-42.

116. 675 F.2d at 182-83.
Bridgen court denied rescission altogether, reasoning that the remedy cannot accommodate tax gains to the plaintiff provided by losses on the investment.\textsuperscript{117}

Alternatively, in a suit for damages, the focus is on compensating the plaintiff for harm directly resulting from the defendant's wrongful acts. Arguably, mitigation of the plaintiff's loss by tax benefits he received is wholly unrelated to the transaction between the plaintiff and defendant.\textsuperscript{118} The compensable harm is not that the defendant failed to provide tax benefits, but that he made misrepresentations about their availability or about the underlying investment. Some courts have agreed with this view and have refused to credit the defendant with tax benefits received by the plaintiff.\textsuperscript{119} For these courts, the actual damages principle limits a defendant's credits to benefits for which he was responsible, just as it limits his liability to harm directly resulting from his actions.

The Court of Appeals for the Third Circuit recognized that an out-of-pocket measure of damages could not properly compensate the plaintiff for his loss.\textsuperscript{120} The Sharp court's decision to separate tax benefits from the underlying investment correctly differentiated the components of the plaintiffs' losses. The investor expects value from his investment as well as value from the tax benefits. The Sharp court recognized that the federal securities laws are the plaintiff's means of seeking redress for the loss attributable to the underlying investment. It remains to be seen whether it is workable to use the special interrogatories sug-

\textsuperscript{117} See supra notes 71-72 and accompanying text.
\textsuperscript{118} Note, supra note 93, at 99 n.38.
\textsuperscript{119} In Wiesenberger v. W.E. Hutton & Co., 35 F.R.D. 556 (S.D.N.Y. 1964), the court addressed the issue of whether the plaintiff's damages should be reduced by tax savings, stating that it was "wide of the mark" for the defendant to so argue, because the claim was for damages caused to plaintiff by the defendant. Id. at 558. Similarly, in Cooper v. Hallgarten & Co., 34 F.R.D. 482 (S.D.N.Y. 1964), production of the plaintiff's tax returns to show tax savings was refused by the court, which noted that the fact that the revenue laws allowed plaintiff to take certain deductions had no bearing on the issue of whether he was entitled to the return of his purchase price for interests in the venture. Id. at 485-86. In Smith v. Bader, 83 F.R.D. 437 (S.D.N.Y. 1979), however, because the plaintiffs had placed their income at issue by claiming to have suffered a loss due to the defendants' actions, production of the plaintiffs' income tax returns was allowed. The court reasoned that knowledge of the plaintiffs' tax rate and net value of their investment in the partnership might be needed to calculate any tax benefits which would mitigate damages. In such disclosure, the court saw no contravention of the public policy favoring confidentiality of tax returns. Id. at 439. See also Houlihan v. Anderson-Stokes, Inc., 78 F.R.D. 232, 234 (D.C. 1978).
\textsuperscript{120} See supra text accompanying notes 95-106.
gested by the court to precisely allocate the components of loss. The *Sharp* approach is important, however, in light of the current governmental efforts to eliminate illegitimate tax shelters. If these efforts are successful, more investors will be seeking recovery of tax benefits lost to disallowed deductions.

Even though tax benefits are measurable, they do not fit squarely into an out-of-pocket formulation of damages or into a remedy whereby the parties seek a return to the status quo ante. In part, this is because neither party to the transaction actually provides the tax benefits. Nor are they affirmatively generated by the investment as, for example, a dividend would be generated. Thus, plaintiff’s tax benefits should not affect his pursuit of a remedy for securities fraud. The policies underlying the federal securities laws are not served by reducing plaintiff awards by tax benefits.

As some courts have noted, however, it is unrealistic not to consider the tax aspects of a tax shelter investment when they are so clearly at the core of the transaction. For many investors, the tax considerations of the investment are of paramount, if not primary, importance. Clearly, when the tax benefits disappear either because the investment fails or the IRS disallows deductions, the investor’s focus shifts to redress.

Fortunately for these investors, there are available private causes of action under the securities laws. Private causes of action are traditionally important in securities law because the SEC cannot prosecute the vast numbers of fraudulent securities transactions alone. The threat of civil enforcement from private causes of action thus deters violations of the Acts. Reducing plaintiff awards by tax benefits received can only discourage plaintiffs from suing. This will diminish the use of the federal securities laws to prevent fraud in the tax shelter area.

Finally, there is a tremendous tension in tax shelter litigation between the private interests of the parties to the action and the

121. See supra text accompanying note 106. The effectiveness of the special interrogatory approach will depend on the reliability of expert testimony and on the feasibility of determining the wrongdoing attributable to each defendant and whether it should be compensable. J. Brodsky, *supra* note 2, § 16.01(2).

122. See supra notes 30-34 and accompanying text.

123. See Sharp v. Coopers & Lybrand, 649 F.2d at 190. See also supra note 79.

124. See supra notes 71 and 72.


126. See supra note 34.
government's interest in collecting tax revenues. The government has demonstrated a firm commitment to prosecuting promoters and investors in questionable tax shelters in order to retrieve some of the tax revenues lost to shelters each year.\textsuperscript{127}

Public policy therefore requires that the courts consider this governmental concern in formulating remedies in tax shelter litigation.\textsuperscript{128} When the plaintiff's entire loss is returned to him, the government can recapture the tax benefits by taxing the award.\textsuperscript{129}

The analysis in \textit{Western Federal}, which held that the defendant should not be allowed to profit at the government's expense,\textsuperscript{130} fully reflects the fact that as between the three interests involved in tax shelter litigation, the culpable defendant in a securities fraud action should be the last to prevail.

\section*{A UNIFORM APPROACH}

Courts considering the tax benefits issue when granting remedies for securities fraud will best serve the conflicting interests at stake if they recognize tax benefits as a separate aspect of the remedy. The gain from tax benefits should not be viewed as one of the traditional components in the award formulation.

Courts should be careful not to make their holdings overbroad. The issues involved in the remedial formulations under section 12, section 10(b), and rule 10b-5 are distinct. The precise formula of section 12 should not be expanded to apply to the rescissory remedies under the 1934 Act. Furthermore, the courts should carefully distinguish the remedial issues in a rescission suit from those in a suit for damages.

The dual motivation for investing in a tax shelter should also be a consideration. The loss of the underlying investment is separable from the loss of expected tax benefits. Any remedial computation should address these components separately, rather than use one component to offset the other. The courts must also consider the income tax ramifications of any award.

\begin{footnotes}
\footnote{127. See supra notes 31-34 and accompanying text.}
\footnote{128. One author favors reducing buyer awards by tax benefits received because otherwise the seller has borne the risk of the investment and has no profits to show for it. Recognizing the seller's interest, this approach favors a tax credit in the form of a deduction to the seller rather than by an offset to his contractual liability. This approach credits the government's overriding public law claim to the tax benefits. Note, supra note 93, passim.}
\footnote{129. See supra note 93.}
\footnote{130. 553 F. Supp. at 821.}
\end{footnotes}
Culpable defendants in tax shelter litigation should not be able to mitigate their liability by claiming the plaintiff's tax benefits as a credit. Instead, where deductions are illegitimate, the tax benefits should be returned to the government. Awards should be formulated so that the government can recapture the plaintiff's tax benefits through taxation. This can be achieved most consistently where plaintiff awards are not reduced in any way, since the plaintiffs will have to amend their tax returns to reflect the receipt of the award.

In this way both interests are met. The parties to the transaction will be treated fairly under equitable or actual damages principles and the governmental interest in tax revenues will be served. Furthermore, the judicial approach to the tax shelter problem will be consistent with that of the other branches of government.

CONCLUSION

The traditional remedies available under the securities laws are ill-equipped to properly handle the tax benefits problem. Reducing plaintiff awards by tax benefits deters plaintiffs from bringing causes of action, which then undermines enforcement of the federal securities laws. Furthermore, crediting the defendant with the plaintiff's tax benefits shifts the focus of the issue away from the strong governmental interest in collecting revenue. Plaintiff awards should not be reduced by tax benefits received. This will allow the government to recapture lost tax revenue by separately taxing the award. The culpable defendant will be prevented from profiting from his fraud.

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