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Securities Fraud: The Tax Benefit Offset Rule of Damages in Securities Litigation

Roger Austin, Thomas Anderson, Myrel Neumann, and William Randall invested $157,500 in a limited partnership organized in 1973 by B.J. Loftsgaarden. The partnership was organized for the purpose of financing the building and operation of a hotel in Rochester, Minnesota. The offering memorandum prepared by Loftsgaarden described the limited partnership as a “tax shelter” promising investors substantial tax benefits during the early years of the partnership and participation in the hotel’s projected profits in later years.

The hotel opened in 1974, several months behind schedule and at costs substantially in excess of those projected. It immediately incurred significant operating losses. An investigation initiated by the investors revealed that Loftsgaarden had knowingly made several fraudulent misrepresentations. The

1. The four plaintiffs in this action were among a total of 22 limited partners investing in the limited partnership. Austin v. Loftsgaarden, 675 F.2d 168, 172 (8th Cir. 1982) (Austin I), aff’d on rehearing, 768 F.2d 949 (8th Cir. 1985), cert. granted, 54 U.S.L.W. 3328 (U.S. Nov. 12, 1985) (No. 85-519).

2. The court defined “tax shelters” as investments allowing the investor to offset certain “artificial losses”—noneconomic losses 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 regular business or professional activity. Austin v. Loftsgaarden, 768 F.2d 949, 951 n.1 (8th Cir. 1985) (Austin II), cert granted, 54 U.S.L.W. 3328 (U.S. Nov. 12, 1985) (No. 85-519).

3. Real estate limited partnerships are accorded a unique tax treatment permitting the deduction of losses in excess of the amount initially invested. See I.R.C. §§ 701, 702 (1985); Note, Real Estate Limited Partnerships and Allocational Efficiency: The Incentive to Sue for Securities Fraud, 63 Va. L. Rev. 669, 673 (1977).

4. Austin II, 768 F.2d at 951; Austin I, 675 F.2d at 175.

5. These losses were primarily due to Loftsgaarden’s inability to obtain the permanent financing on time, resulting in an additional six months of high interest charges to the partnership. Austin I, 675 F.2d at 175.

6. The offering memorandum specifically indicated that Loftsgaarden could obtain interim construction financing at an interest rate of 9 1/2%; that the construction loan interest would amount to $130,000; that the land lease would run for 40 years; that construction would begin in May of 1973; that the promoter would receive $103,000 for “overhead and profit;” that the furniture and fixtures loan would be at a rate of 8%; and that long-term financing had been firmly committed. Id. at 174-75. The district court found each of these representations to be false. Id. at 175. Additionally, Loftsgaarden omitted any
partnership ultimately defaulted and the hotel was sold in fore-
closure in 1978.7

In 1976, the four investors filed a securities fraud action
against Loftsgaarden in federal district court. The jury found
Loftsgaarden liable under section 12(2) of the Securities Act of
1933,8 section 10(b)9 and Rule 10b-510 of the Securities Ex-
change Act of 1934, the antifraud provisions of the Minnesota
securities laws,11 and common-law fraud.12 The district court
applied a rescissory measure of damages,13 awarding the plain-
tiffs the consideration paid, prejudgment interest, and attor-
neys’ fees.14 Loftsgaarden appealed the award, arguing that the
district court committed reversible error in excluding any evi-
dence of tax benefits realized by the plaintiffs as a result of
their participation in the limited partnership. Loftsgaarden ar-
gued that such evidence was necessary to determine the plain-
tiffs’ actual damages.15

The Eighth Circuit affirmed the district court’s finding of
liability but vacated the damages award, holding that evidence
of any tax benefits received by the investor must be admitted to
reduce potential rescissory damages in a private securities fraud
action involving a tax shelter investment.16 On remand the
district court awarded the plaintiffs damages in the amount of
their initial investment, with interest, less tax benefits re-
ceived.17 Both sides appealed. The Eighth Circuit, en banc, in

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7. Id. at 176.
advisory verdict. The district court concurred in the jury’s finding. See Aus-
tin I, 675 F.2d at 172.
12. The jury found that Loftsgaarden had knowingly made material mis-
representations and omissions in the offering memorandum upon which the
plaintiffs relied. The plaintiffs’ claim, therefore, satisfied all of the necessary
elements of Rule 10b-5, the antifraud provisions of the Minnesota securities
laws, and common-law fraud. The parties agreed that the elements of these
various claims are identical. Austin I, 675 F.2d at 176 n.15.
13. Id. at 172; see infra notes 32-35 and accompanying text.
14. According to the district court’s computation, the plaintiffs’ recoveries
were as follows: Austin, $64,610; Anderson, $64,787; Neumann, $96,385; Ran-
dall, $67,973. See Austin II, 768 F.2d at 957. Only plaintiffs Randall and Neu-
mann were awarded attorneys’ fees. Id. at 952.
15. Austin I, 675 F.2d at 180.
16. Id. at 181-84.
17. On remand, the district court determined the amount of permanent
Austin v. Loftsgaarden (Austin II),\textsuperscript{18} upheld the Austin I panel's holding.\textsuperscript{19}

This Comment examines whether the tax benefit offset rule can be reconciled with the applicable damages provisions of the federal securities laws as applied by the courts. The Comment also addresses the effect of the tax benefit offset rule in light of the Government's role in tax shelter investments as well as its effect on certain public policy goals embodied in the tax benefits received by each of the plaintiffs as follows: Austin, $33,330; Anderson, $29,015; Neumann, $57,014; Randall, $36,404. The parties did not contest these findings. The district court then determined that each plaintiff was entitled to prejudgment interest at the rate of eight percent simple interest. Each plaintiff's damages were calculated as the original amount invested, plus eight percent simple interest from the date of purchase, less the amount of tax benefits received. The plaintiffs' damages, thus calculated, were as follows: Austin, $31,177; Anderson, $35,172; Neumann, $39,371; Randall, $31,569. Austin II, 768 F.2d at 952, 957.\textsuperscript{18}

19. The Eighth Circuit developed a different formula for computing the measure of plaintiffs' rescissory damages under § 12(2) in light of the offset rule, finding the district court, on remand, had erred in its formulation of damages by awarding prejudgment interest on the total amount of consideration paid by each plaintiff from the date of investment rather than awarding interest only on the amount of money that each plaintiff was "out-of-pocket" during each year of the investment. Id. at 958. The court further determined that the district court had failed to take into account the tax consequences of the plaintiffs' recovery. Id. at 960. The court "assume[d] that each plaintiff [was] still in the fifty percent tax bracket and thus must receive twice the . . . amount of damages and net interest cost" so that each plaintiff's after-tax recovery would equal the actual damages sustained. Id. at 959-61. The final formula adopted by the court thus required that each year's tax benefits be subtracted from the plaintiffs' original investment on an annual basis to allow the prejudgment interest to be based on an annually declining balance. The court then doubled the final figure in order to account for the tax consequences of the plaintiffs' recovery, assuming a fifty-percent tax bracket. Id. at 959-61. The result of applying this tax-offset formula was to reduce considerably the damage awards granted by the district court on remand. See supra note 17. The final recoveries awarded plaintiffs were as follows: Austin, $7,666; Anderson, $18,790; Neumann, $1,984; Randall, $506. Austin II, 768 F.2d at 961.

18. 768 F.2d 952 (8th Cir. 1985), cert. granted, 54 U.S.L.W. 3328 (U.S. Nov. 12, 1985) (No. 85-519).

19. It is interesting to note that each plaintiff's individual tax situation was considered in computing the historical tax benefits received, but in doubling the award to take account of tax effects, the court simply assumed, without any evidence, that each plaintiff was then in the fifty percent bracket. This approach was criticized by the dissent in Austin II as demonstrative of "how speculative and inaccurate the consideration of tax consequences can be in a suit involving rescissionary damages." Id. at 963. Moreover, the assumption that the award is taxable at ordinary income rates supports the view that, absent the application of the offset rule, the tax benefit rule would apply. See infra notes 44-48 and accompanying text.
The Comment concludes that the result of the tax benefit offset rule is to unfairly shift the economic consequences of securities fraud to the Government, and ultimately to the taxpayers, while allowing defrauding promoters to escape the full consequences of their actions.

I. MEASURING DAMAGES IN SECURITIES FRAUD CASES

An investor defrauded in a securities transaction may sue for recovery under both the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act). The specific remedy available under the Securities Act is rescission. Section 12(2) of the Act provides a defrauded purchaser the option to sue either for a full refund of the purchase price on tender of the security or for damages if the plaintiff no longer owns the security. Under either option, however, the recovery is reduced to the extent the plaintiff has received any income from the security.

Unlike section 12(2) of the Securities Act, neither section 10(b) of the Exchange Act nor Rule 10b-5 promulgated thereunder, provides an express remedy for a defrauded purchaser of securities. As a result, federal courts have necessarily fashioned appropriate remedies as cases have arisen.

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21. Section 12(2) of the Act provides:

[A purchaser] 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, or for damages if he no longer owns the security.


Predictably, this exercise of judicial discretion has led to significant variation in the determination of remedies and damages available under Rule 10b-5. The measure of damages traditionally applied, and most favored by courts, however, is the "out-of-pocket" rule. Pursuant to this rule, courts award the defrauded purchaser the difference between the price paid for the security and the actual value received in the transaction. This allows the plaintiff to retain the security and sue for any actual loss sustained. The purpose of the measure is to determine the amount actually lost and not what the plaintiff might have gained. The out-of-pocket rule therefore precludes the plaintiff from seeking expected profits.

Although the out-of-pocket measure is the usual standard for recovery in a Rule 10b-5 action, most courts recognize that a plaintiff may instead choose rescission or a money judgment representing the financial equivalent of rescission. The differ-

the Exchange Act on a general theory that the court may fashion any appropriate remedy for violation of a federal right; see also Garantz v. Stifel, Nicolaus & Co., 559 F.2d 1357, 1360 (8th Cir. 1977) (stating that courts should "fashion the remedy best suited to the harm"); Thompson, supra note 23, at 355 (asserting that courts are free to tailor the measure of recovery to comply with the remedy selected).


27. See Madigan, Inc. v. Goodman, 498 F.2d 233, 238-39 (7th Cir. 1974); Estate Counseling Serv., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527, 533 (10th Cir. 1962); see also D. Dobbs, Handbook on the Law of Remedies § 9.2 (1973) (describing the out-of-pocket measure as the difference between what the plaintiff gave and received).

28. For example, a buyer paying $11 for a security worth $7 on the date of purchase has suffered damages of $4. See D. Dobbs, supra note 28, § 9.2.


30. The measure is designed to put the plaintiff back in the same financial position as before the transaction occurred but not to award any benefit of the bargain. D. Dobbs, supra note 28, § 9.2. One court has stated that the plaintiff is therefore not entitled to "the expectant fruits of an unrealized speculation." Estate Counseling Serv., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527, 533 (10th Cir. 1962) (citing Smith v. Bolles, 132 U.S. 125, 130 (1889)). This rule is derived from the tort action of deceit. See Harris v. American Inv. Co., 523 F.2d 220, 224-25 (8th Cir. 1975), cert. denied, 423 U.S. 1054 (1976).

31. See In re LTV Securities Litigation, 88 F.R.D. 134, 148-49 (N.D. Tex. 1980); see also L. Loss, Securities Regulation 1794 (1961) (stating that the
ence between these two measures is that the out-of-pocket rule allows the defrauded plaintiff to affirm the transaction, keep what was received, and sue for damages, whereas a rescissory remedy voids the transaction and requires the plaintiff to return the securities purchased upon receipt of the original consideration paid.\textsuperscript{33} If the securities have been disposed of and cannot be returned, the plaintiff may recover damages based on a rescissory measure.\textsuperscript{34} The result of rescission, therefore, is to divest the plaintiff of any interest in the transaction and return the parties to the status quo ante.\textsuperscript{35}

Regardless of the remedy sought, section 28(a) of the Exchange Act limits recovery under Rule 10b-5\textsuperscript{36} to “actual damages [suffered] on account of the act complained of.”\textsuperscript{37} The purpose of section 28(a) is to limit a plaintiff’s recovery to the “actual damages” sustained, thereby eliminating any profits the plaintiff might have received, or expected to receive, from the transaction.\textsuperscript{38}

The goal of the rescission remedy, to return the parties to the status quo ante,\textsuperscript{39} is difficult to achieve in the complex circumstances created by tax-advantaged limited partnerships. This is particularly true for real estate limited partnerships because they are accorded a unique tax treatment.\textsuperscript{40} Current tax

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\textsuperscript{33} See Jacobs, The Measure of Damages in Rule 10b-5 Cases, 65 GEO. L. J. 1093, 1110-14 (1977); Thompson, supra note 23, at 365 (“most courts recognize that a plaintiff may instead choose rescission”); Note, supra note 3, at 672 (a limited partner may sue either for rescission or damages).


\textsuperscript{35} See Note, supra note 3, at 676.

\textsuperscript{36} The Supreme Court, in Affiliated Ute Citizens v. United States, 406 U.S. 128, 155 (1972), affirmed the developing consensus of the lower courts that § 28(a) should provide guidance for 10b-5 actions. See, e.g., Richardson v. MacArthur, 451 F.2d 35, 45 (10th Cir. 1971) (finding the § 28(a) limitation on 10b-5 recovery clear and binding); Green v. Wolf Corp., 406 F.2d 291, 302 (2d Cir. 1968) (§ 28(a) prohibits punitive damages); Myzel v. Fields, 386 F.2d 718, 748 (8th Cir. 1967) (stating that the only effect of the “actual damages” language in § 28(a) is to prohibit punitive damages), cert. denied, 390 U.S. 951 (1968).


\textsuperscript{38} See supra note 31; L. Loss, supra note 27, at 1132-34.

\textsuperscript{39} See supra notes 33-35 and accompanying text. If rescission is awarded in a securities fraud case, the investor returns the investment and receives the original consideration paid for that investment. See Nelson v. Servold, 576 F.2d 1332, 1340 (9th Cir.), cert. denied, 439 U.S. 970 (1978); D. Dobbs, supra note 28, § 9.4, at 618-20.

\textsuperscript{40} See infra note 42 and accompanying text. The benefits from a profitable real estate tax shelter investment are two-fold, offering tax savings to the
law allows the income and losses of a partnership to pass directly through to its partners. Only in real estate limited partnerships are the partners allowed to deduct more losses than they have actually invested or placed “at risk.” As a result, a partner’s deductions in the first year can, in some cases, be higher than the initial capital outlay. Therefore, an investor who rescinds a transaction involving a real estate limited partnership is likely to have received substantial tax benefits. A rescissory award in such circumstances would constitute a windfall to the extent an investor is able to both recoup the original investment and to retain the entire tax benefit resulting from the earlier deductions.

The Internal Revenue Service (IRS) has, however, consistently characterized a rescission as an independent taxable limited partner in its early years and generating income in later years. Unlike a corporate shareholder, even if the enterprise fails to become profitable, the investment’s unique tax treatment may still allow a limited partner to fare quite well.

A limited partner who has been misled into investing in an unprofitable real estate venture may be in a better position than a shareholder in an unprofitable corporation. By use of depreciation, real estate limited partnerships can generate a substantial tax loss while actually taking in sufficient cash to cover partnership expenses. This tax loss can be passed through to the partners as a shelter for other taxable income. In the extreme case where the partnership’s gross rents are exactly equal to its expenditures, the tax loss continues to make the partnership an attractive investment. On the other hand, the stock of a corporation having no profit or prospects of profit would be worthless, and a shareholder in that corporation would value any recovery in a civil suit more than his investment.

Note, supra note 3, at 672-73 (footnotes omitted).

41. See I.R.C. § 701 (1985) (“A partnership . . . shall not be subject to the income tax . . . .”). A partnership is thus taxed only at the partner level.

42. I.R.C. § 704(d) (1985) (“A partner's distributive share of the partnership loss . . . shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership . . . .”). In real estate partnerships, a partner’s basis will include not only the original amount invested but also any non-recourse loans the partnership, as an entity, has obtained. See I.R.C. § 752(a) (1985); Treas. Reg. § 1.752-1(e) (1956). Accordingly, partners today are able to deduct losses in excess of their capital contributions. In Austin, for example, the plaintiffs were able to take deductions not only up to the $35,000 that each invested but also up to their proportionate share of the mortgage loan obtained by the partnership. This is permitted because the “at risk” provisions of the tax laws do not apply to real estate limited partnerships. See I.R.C. § 465(c)(3)(D) (1985).

transaction,\textsuperscript{44} which will trigger one or several mechanisms for dealing with the potential windfall to the plaintiff. Although the exact tax treatment of a rescissory recovery varies in each case, a substantial number of commentators and courts have indicated that the IRS would most likely attempt to invoke the tax benefit rule in such a transaction.\textsuperscript{45} The rule generally requires that when a deduction is taken in one year for an amount subsequently recovered in a later year that amount

\textsuperscript{44} The reasons for this characterization are administrative efficiency and the integrity of the annual accounting system. See Littenberg & Reinstein, Deconglomeration—Tax and Business Problems Associated with the Divestiture of a Recently Acquired Business, 24 U. So. Cal. L. Center Tax Inst. 101, 117 (1972); Note, Tax Consequences of Rescission, supra note 20, at 579.

\textsuperscript{45} See Burgess v. Premier Corp., 727 F.2d 826, 838 (9th Cir. 1984); Western Fed. Corp. v. Davis, 553 F. Supp. 818, 820 (D. Ariz. 1982), aff'd sub nom. Western Fed. Corp. v. Erickson, 739 F.2d 1439 (9th Cir. 1984); Holbrook v. Commissioner, 34 T.C.M. (CCH) 1283, 1286 (1975); Bittker & Kanner, The Tax Benefit Rule, 26 UCLA L. Rev. 265, 272-73 (1978). I.R.C. § 111 is a partial codification of the tax benefit rule, see infra note 46 and accompanying text. The regulations thereunder give as an example of the “other items subject to the rule”—requiring inclusion in income—the analogous situation of a taxpayer who deducts a loss on selling stock and subsequently recoups the loss in whole or in part from the person who sold the taxpayer the property—for example, for misrepresenting its value or breaching a warranty. Treas. Reg. § 1.111-1(a)(1) (1956); see also Note, supra note 20, at 576-79 (asserting that the IRS has the option of recapturing the purchaser’s tax benefits either as ordinary income under the tax benefit rule or by means of capital gains treatment); Note, supra note 3, at 677 n.31 (interpreting Holbrook as indicating that the IRS will seek tax benefit rule treatment for rescission awards with respect to real estate limited partnerships). But see Salcer v. Environ Equities Corp., 744 F.2d 935, 943 (2d Cir. 1984). In Salcer, the court found that the tax benefit rule did not apply to rescissory damages, although it conceded that the rule might apply in a case of actual rescission, apparently on the theory that once the court applied the offset rule, any remaining rescissory damage recovery would no longer be inconsistent with the plaintiff’s prior tax return. The court reasoned that to apply the tax benefit rule, as the Burgess court did, see infra notes 133-135 and accompanying text, would be to “put the cart before the horse.” Id. The Austin II court, apparently following Salcer, also concluded that the tax benefit rule did not apply but gave no reason for its conclusion. Austin II, 768 F.2d 955-56. The Salcer court’s analysis, however, begs the question of whether the tax benefit rule applies to the full rescissory award in the absence of the offset rule. The question is not whether the tax benefit rule applies once the offset has occurred, but rather whether the tax benefit rule applies to a rescissory award. See supra note 44 and accompanying text and infra notes 46-50 and accompanying text. In dismissing the tax benefit rule as inapplicable, the Salcer court makes the same mistake in reasoning that it ascribes to the Burgess court. Even if the tax benefit rule were not to apply, the IRS would still treat the rescissory award as an independent taxable event that would be taxed either as ordinary income under some similar tax provision, or at preferential capital gains rates. See supra note 44 and accompanying text; Raytheon Prod. Corp. v. Commissioner, 144 F.2d 110, 114 (1st Cir.), cert. denied, 323 U.S. 779 (1944).
must be included in gross income in the year of recovery.\textsuperscript{46} The IRS applies this rule whenever a later event is deemed fundamentally inconsistent with the basis for the original deduction.\textsuperscript{47} Thus, if a successful plaintiff in a securities fraud action recovers the original purchase price, that sum is subject to taxation as ordinary income in that year's return, to the extent the plaintiff received tax benefits resulting from the investment in earlier years.\textsuperscript{48} Application of the tax benefit rule to such a plaintiff/investor may substantially, or totally, eliminate any tax savings\textsuperscript{49} realized from the investment.\textsuperscript{50}

II. THE AUSTIN COURTS' ADOPTION OF THE OFFSET RULE

Courts determining the appropriate measure of a rescissory award in securities fraud cases have disagreed on whether to treat tax benefits as falling within the limiting language of the Securities Act ("income received") and the Exchange Act ("actual damages") and thus subject to offset, or whether to allow the plaintiff full recovery subject to subsequent taxation. A number of courts, applying the "offset rule," have construed

\textsuperscript{46} See Hillsboro Nat'l Bank v. Commissioner, 460 U.S. 370, 378-79 (1983); Bittker & Kanner, \textit{supra} note 45, at 265. The general tax benefit rule, "not expressly stated in the Code but developed through the case law, is that, if an amount deducted from gross income in one taxable year is recovered in a later year, the recovery is income in the later year." 1 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 7.34 (rev. ed. 1974) (footnotes omitted). Statutory recognition of the rule is found in § 111 of the Code, providing for exclusion from gross income of income attributable to the recovery of bad debts, prior taxes, and delinquency amounts deducted in an earlier year, but providing no tax benefit when deducted. I.R.C. § 111 (1985).

\textsuperscript{47} See Hillsboro Nat'l Bank v. Commissioner, 460 U.S. 370, 383 (1983). A typical tax benefit situation involves a taxpayer who takes a charitable deduction for a contribution that is returned in a subsequent year. See Note, \textit{supra} note 20, at 568. Although not expressly described in the Treasury Regulations under I.R.C. § 111, rescission of an investment, and its consequent restoration of the status quo ante, would probably be deemed "inconsistent" with prior deductions taken on account of that investment. See Bittker & Kanner, \textit{supra} note 45, at 265, 272-74.


\textsuperscript{49} See Note, \textit{supra} note 20, at 578 (referring to a hypothetical rescission of a limited partnership interest where application of the tax benefit rule would serve to eliminate the plaintiff's entire tax benefit).

\textsuperscript{50} See Burgess v. Premier Corp., 727 F.2d 826, 838 (9th Cir. 1984); Western Fed. Corp. v. Davis, 553 F. Supp. 818, 820 (D. Ariz. 1982), \textit{affd sub nom.} Western Fed. Corp. v. Erickson, 739 F.2d 1439 (9th Cir. 1984); Note, \textit{supra} note 20, at 578.
the statutory restrictions broadly, requiring that any economic benefit to the plaintiff, including tax benefits, be taken into account to reduce the damages awarded.\textsuperscript{51} Others have read the statutes narrowly allowing the plaintiff to retain the tax benefits received and recognizing that the plaintiff must, in turn, incur tax liability upon recovery.\textsuperscript{52} The two approaches lead to quite different results. Under the offset rule, the plaintiff's recovery may be substantially reduced or entirely eliminated.\textsuperscript{53} As a result, the IRS will be precluded from recouping the deductions previously received by the plaintiff. Under the alternative approach, the plaintiff is assured of an after-tax recovery of no less than half of the original investment and the IRS, in turn, will recapture at least some of the tax benefits granted.\textsuperscript{54}

\textit{Austin I}\textsuperscript{55} was the first circuit court case in which tax benefits were offset against a rescissory award in a securities fraud case involving a tax-advantaged investment.\textsuperscript{56} In \textit{Austin I}, the defrauded plaintiffs sought recovery of their original investment in the limited partnership. The defendant argued that despite any fraud he may have committed, the plaintiffs suffered no actual damages because they received a tangible economic benefit from the partnership in the form of large tax write-offs.\textsuperscript{57} In upholding the \textit{Austin I}\textsuperscript{58} decision requiring tax benefits to be offset against damages, the \textit{Austin II}\textsuperscript{59} court adopted a broad reading of the statutory limitations on dam-

\textsuperscript{51} See \textit{Austin II}, 768 F.2d 949, 956 (8th Cir. 1985); Freschi v. Grand Coal Venture, 767 F.2d 1041, 1051 (2d Cir. 1985); Salcer v. Environ Equities Corp., 744 F.2d 935, 941-43 (2d Cir. 1984); \textit{Austin I}, 675 F.2d 168, 183 (8th Cir. 1982).


\textsuperscript{53} In the \textit{Austin} case the plaintiffs' tax benefits came close to equaling, and for one plaintiff exceeded, the original amount invested. See supra notes 14, 17, 19; see also supra notes 42-43 and accompanying text (discussing the deductions allowed in a real estate limited partnership).

\textsuperscript{54} See supra notes 44-50 and accompanying text.

\textsuperscript{55} 675 F.2d 168 (8th Cir. 1982), aff'd on rehearing, 768 F.2d 949 (8th Cir. 1985), cert. granted, 54 U.S.L.W. 3328 (U.S. Nov. 12, 1985) (No. 85-519).

\textsuperscript{56} This issue had been addressed several times at the district court level. See, e.g., Spatz v. Borenstein, 513 F. Supp. 571, 586 (N.D. Ill. 1981); Wiesenberger v. W.E. Hutton & Co., 35 F.R.D. 556, 558 (S.D.N.Y. 1964).

\textsuperscript{57} \textit{Austin I}, 675 F.2d at 181; see supra note 17.

\textsuperscript{58} 675 F.2d 168 (8th Cir. 1982), aff'd on rehearing, 768 F.2d 949 (8th Cir. 1985), cert. granted, 54 U.S.L.W. 3328 (U.S. Nov. 12, 1985) (No. 85-519).

\textsuperscript{59} 768 F.2d 949 (8th Cir. 1985), cert. granted, 54 U.S.L.W. 3328 (U.S. Nov. 12, 1985) (No. 85-519).
ages, dismissing the contrary arguments raised in several other similar cases.\textsuperscript{60}

The two \textit{Austin} decisions are based primarily on the "actual damages" provision of section 28(a) of the Exchange Act.\textsuperscript{61} The courts interpreted this provision to require that a rescissory award\textsuperscript{62} be reduced to reflect \textit{any value} received as a result of the fraudulent transaction.\textsuperscript{63} Applying the statute in accordance with this interpretation, the \textit{Austin I} court concluded that tax benefits realized as a result of a tax shelter investment are "something of value"\textsuperscript{64} and a "tangible economic benefit"\textsuperscript{65} and, therefore, must be deducted from any damages awarded.

Although its decision was premised on the "actual damages" language of section 28(a), the \textit{Austin I} court applied this analysis not only to the Rule 10b-5 claims explicitly limited by section 28(a) of the Exchange Act, but also to claims arising under section 12(2) of the Securities Act.\textsuperscript{66} Although the Securities Act does not explicitly limit rescissory damages to "actual damages" sustained, the \textit{Austin II} court asserted that "section 12(2) implicitly incorporates the actual damages principle" by limiting a plaintiff's recovery to the consideration paid, less any income received.\textsuperscript{67} From this, the \textit{Austin II} court further found that the words "income received" should be construed as including tax benefits received as a result of a tax shelter investment.\textsuperscript{68} Thus, while recognizing that tax benefits

\begin{footnotesize}
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  \item \textsuperscript{60} Austin II, 768 F.2d at 953-54; see supra note 52.
  \item \textsuperscript{61} Austin II, 768 F.2d at 953; Austin I, 675 F.2d at 180. Both courts stated that damages for securities fraud "are determined in accordance with the extent to which false and misleading information actually harmed the complaining party."
  \item \textsuperscript{62} The \textit{Austin} courts used the terms "rescission" and "restitution" interchangeably. See Austin II, 768 F.2d at 954; Austin I, 675 F.2d at 181. Often rescission serves as a prelude to restitutionary recovery, but there is an important distinction between the two remedies. See Jacobs, supra note 33, at 1110-11. Restitution is a much broader remedy than rescission. See D. Dobbs, supra note 28, § 4.1, at 222. Rescission attempts to return the injured party to the status quo ante. The goal of restitution, however, is to avoid unjust enrichment of the defendant. See id. § 4.1, at 223-27.
  \item \textsuperscript{63} Austin II, 768 F.2d at 953; Austin I, 675 F.2d at 181.
  \item \textsuperscript{64} Austin I, 675 F.2d at 182.
  \item \textsuperscript{65} Id. See supra note 40 for the explanation that tax benefits resulting from a tax shelter investment are a "tangible economic benefit."
  \item \textsuperscript{66} Austin I, 675 F.2d at 181. "The actual damages principle . . . applies in the instant case not only to the Section 10(b) and Rule 10b-5 claims, but also to claims under Section 12(2) . . . ." Id.
  \item \textsuperscript{67} Austin II, 768 F.2d at 954.
  \item \textsuperscript{68} Id.
\end{itemize}
\end{footnotesize}
are not income in "a strict accounting sense,"\(^{69}\) the \textit{Austin II} court nevertheless interpreted the term "income" to include tax benefits. In support of its interpretation, the \textit{Austin II} court reasoned that the section 12(2) limitation reflects a general securities law policy restricting damage awards to those strictly compensatory in nature.\(^{70}\) According to the \textit{Austin II} court, therefore, "all economic benefits bargained for and received must be deducted from plaintiffs' damages."\(^{71}\)

Finally, the \textit{Austin II} court dismissed the argument that the offset rule unfairly operates to prevent the Internal Revenue Service from recovering a portion of the tax benefits received by the plaintiffs as a result of their investment.\(^{72}\) The court reasoned that because the development had met all the applicable tax code criteria, there was no justification for the Government's claim.\(^{73}\)

The \textit{Austin II} court's analysis is flawed in several respects.\(^{74}\) Its interpretation of the damage limitations in the \textit{Se-...
securities Act and the Exchange Act was overly broad. In addition, the court refused to recognize the Government's interest in the transaction. Finally, the court also failed to adequately consider important policies underlying the applicable securities laws.

III. STATUTORY INTERPRETATION

The Austin II court advanced a novel interpretation of section 12(2) of the Securities Act in classifying tax benefits received by plaintiffs as income. It found that the statutory term "income" does not mean income in a strict accounting sense but rather construed the term to encompass all economic benefit received by the plaintiffs. The court supported this interpretation by citing the general policy that damage awards in private securities actions should be strictly compensatory in nature. The term "income," however, should be interpreted in a more restrictive sense to mean profits derived directly from the investment, such as stock dividends, interest, or other distributions that are typically required to be offset in computing rescissory damages.

In contrast to the Austin courts' interpretation of income, applicable case law supports the view that tax benefits received by a plaintiff are distinguishable from income. In Johns Hopkins University v. Hutton, a Maryland district court found that payments in an oil and gas limited partnership applied to

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440-41. Nevertheless, despite this and other authority to the contrary, see Western Fed. Corp. v. Davis, 553 F. Supp. 818 (D. Ariz. 1982), aff'd sub nom. Western Fed. Corp. v. Erickson, 739 F.2d 1439 (9th Cir. 1984); Spatz v. Borenstein, 513 F. Supp. 571 (N.D. Ill. 1981); Wiesenberger v. W.E. Hutton & Co., 35 F.R.D. 556 (S.D.N.Y. 1964), the Eighth Circuit, en banc, upheld in Austin II the earlier Austin I decision adopting the offset rule. 75. Austin II, 768 F.2d at 955. 76. Id. 77. Id. ("[T]he strictly compensatory nature of damages awarded in private securities fraud actions requires that such value be taken into account ... "). 78. See, e.g., Hayden v. McDonald, 742 F.2d 423, 441 (8th Cir. 1984) (finding that the term "income" covered benefits received from the defendant such as production checks, but not the financial benefits or consequences of federal and state tax laws); see also infra notes 79-87 and accompanying text. 79. 297 F. Supp. 1165 (D. Md. 1968), aff'd in part, rev'd in part, 422 F.2d 1124 (4th Cir. 1970), on remand, 326 F. Supp. 250 (D. Md. 1971), aff'd in part, rev'd in part, 488 F.2d 912 (4th Cir.), cert. denied, 416 U.S. 916 (1974). The controversy in that case involved plaintiff's purchase of an oil and gas production payment. The plaintiff alleged that the defendant materially misrepresented and omitted facts material to the transaction in the offering circular. The court, in a complex ruling, ordered rescission of the transaction. Id. at 1236.
taxes were not "income" under section 12(2). The defendant in *Johns Hopkins* argued that despite any fraud that had been committed, the court should find the tax benefits received by the plaintiff to be income within the meaning of the statute. The court rejected the defendant's argument as an attempt to "rewrite the remedial language of the statute" and held that only payments received as the equivalent of interest could correctly be construed as income for purposes of section 12(2). The court thus refused to characterize the tax benefits received by the plaintiff as "income." More recently, the Eighth Circuit in *Hayden v. McDon ald*, decided in the period between the *Austin I* and *Austin II* decisions, construed the term "income" to cover only benefits received from the defendants, not the financial benefits or consequences of federal and state tax laws. In *Hayden*, the Eighth Circuit noted that the term "income" encompasses benefits directly attributable to the efforts of the developer and the success of the investment. The court thus distinguished tax benefits from income presumably because they flow not from the developer but are a result of a general tax program designed by the Government to encourage investment.

80. *Id.* at 1232.
81. *Id.*
82. *Id.*
83. *Id.*
84. 742 F.2d 423 (8th Cir. 1984) (decided by a panel different from the panel that decided *Austin I*); see supra note 74.
85. *Id.* at 440-41.
86. *Id.*
87. *Id.* Other courts have similarly refused to reduce a defendant's liability under § 12(2) by the amount of tax benefits a plaintiff has received and so have implicitly refused to interpret the term "income" to include tax benefits. In *Wiesenberger v. W.E. Hutton & Co.*, 35 F.R.D. 556 (S.D.N.Y. 1964) the District Court for the Southern District of New York denied the defendant's request that the plaintiff's income tax returns be produced in order to show that the plaintiff had received a tax savings. The *Wiesenberger* court characterized the argument that plaintiff's damages should be reduced by the amount of taxes saved as a result of the investment as "without merit." *Id.* at 558. The court also noted that it seemed "wide of the mark to argue an 'injustice' to [the] defendant... if it cannot reduce the amount of the claim against it by the amount of taxes saved by [the] plaintiff through deductions for his losses, depletion, etc. The claim is for damages caused to plaintiffs by [the] defendants." *Id.* More recently, the District Court for the Northern District of Illinois, in *Spatz v. Borenstein*, 513 F. Supp. 571 (N.D. Ill. 1981) dismissed the argument that tax benefits could be used to reduce a defendant's damages under § 12(2), regarding it as "wholly unpersuasive." *Id.* at 586. The court reasoned that the fact that the plaintiff may be better off vis-a-vis the Government did not warrant the application of the offset rule. *Id.*
The Austin courts' interpretation of section 28(a) is similarly flawed. As noted above, the Austin courts based their adoption of the offset rule primarily on the "actual damages" limitation of section 28(a) of the Exchange Act. Section 28(a), however, does not dictate the results reached in the Austin cases. There is substantial authority to the effect that the purpose of the "actual damages" language in section 28(a) is to prevent double recovery by plaintiffs asserting both state and federal law claims arising out of the same facts and to prohibit recovery of punitive damages. In fact, the Austin II court's opinion disregards a previous Eighth Circuit case, Myzel v. Fields, which found that the only effect of the actual damages limitation is to prohibit punitive damages otherwise available in state civil actions under the Exchange Act.

Whatever the intended effect of the actual damages provision of section 28(a), the Supreme Court has made it clear that the provision does not prohibit recovery of "windfall" profits. In Affiliated Ute Citizens v. United States, which involved a defrauded seller suing under Rule 10b-5, the Court determined that the correct measure of damages was the difference between the fair value of what was actually received for the securities and the fair value of what would have been received absent the fraudulent conduct, "except . . . where the defendant received more than the seller's actual loss. In [that] case, damages would be the amount of the defendant's profit." In so holding, the Court construed the section 28(a) limitation so as not to prevent the plaintiffs from recovering more than their actual loss. It is difficult to reconcile the Supreme Court's interpretation of the section 28(a) limitation, permitting the recovery of windfall profits, with the Austin courts' inter-

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88. See supra notes 61-65 and accompanying text.
89. See Osofsky v. Zipf, 645 F.2d 107 (2d Cir. 1981); see also 3 L. Loss, supra note 27, at 1624. A narrow interpretation of the actual damages principle is also reflected in the structure of § 28(a). The first sentence provides that the rights and remedies in the Exchange Act are "in addition to any and all other rights and remedies that may exist at law or in equity." 15 U.S.C. § 78bb(a) (1982). The purpose of this sentence is to make it clear that federal remedies do not preempt remedies existing under state laws. The next sentence in § 28(a) restricts awards to actual damages. Id. Thus the second sentence is designed to prevent a plaintiff from recovering more than once for the same violation or cause of action.
90. 386 F.2d 718 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968).
91. Id. at 748; see 3 L. Loss, supra note 27, at 1624.
92. 496 U.S. 128 (1972).
93. Id. at 155 (citing Janigan v. Taylor, 344 F.2d 781, 786 (1st Cir.), cert. denied, 382 U.S. 879 (1965)).
pretation of the same provision as prohibiting a defrauded plaintiff from retaining any tax benefits realized as a result of the fraudulent transaction.

Moreover, the Eighth Circuit in *Myzel*,\(^{94}\) and, at least implicitly, the Supreme Court in *Affiliated Ute*,\(^{95}\) have recognized that it is more appropriate to give the benefit of any windfall to the defrauded plaintiff than to allow the defendant to benefit from its fraudulent conduct.\(^{96}\) The *Austin* courts, by contrast, rejected such an approach, choosing instead to apply an overly restrictive interpretation of section 28(a).

IV. THE GOVERNMENT AS AN INTERESTED PARTY

Also weighing against application of the offset rule in securities fraud litigation is that it would preclude the Government from asserting a legitimate claim to recapture tax benefits in such cases. The *Austin* courts mistakenly assumed that a tax shelter investment involves only two parties—the purchaser of the security and the seller/promoter. This assumption led the *Austin II* court to conclude that the tax benefits received by the investor were attributable to the promoter and so should have been accounted for in the calculation of a rescissory award.\(^{97}\) In arriving at any computation of a plaintiff’s recovery for losses caused by securities fraud involving a tax shelter, however, a court should acknowledge the impact of such an award on the Government as, essentially, a third party participant.\(^{98}\) Benefits received by an investor in the form of

\(^{94}\) *Myzel v. Fields*, 386 F.2d 718, 747 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968). The policy of preferring that plaintiffs rather than defendants benefit from any windfall was first articulated in *Janigan v. Taylor*, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965). The *Janigan* plaintiffs sold their stock to the corporation’s president for approximately $40,000; less than two years later, the defendant sold the stock for $700,000. *Id.* at 783. The court approved recovery of defendant’s net profit from the resale. *Id.* at 786-87.

\(^{95}\) *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972). In *Affiliated Ute*, the Supreme Court cited both *Myzel* and *Janigan* with approval. *Id.*

\(^{96}\) *See Janigan v. Taylor*, 344 F.2d 781, 786 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965). Lower courts have extended *Janigan* to include defrauded purchasers as well. *See, e.g.*, *Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 795, 801-02 (2d Cir.) (the thrust of the rationale in *Janigan* and *Ute* does not preclude windfall profits to purchasers), *cert. denied*, 414 U.S. 908 (1973); *see alsoHackbart v. Holmes*, 675 F.2d 1114, 1122 (10th Cir. 1982) (although unjust enrichment generally occurs when buyer defrauds seller, it can also occur when innocent party is induced to buy securities).

\(^{97}\) *Austin II*, 768 F.2d at 955.

\(^{98}\) *Note*, supra note 20, at 573 (profits earned in the form of tax benefits
tax deductions result not only from the actions of the investor and promoter in the purchase and sale of the security but also from the Government's policy allowing such deductions.99 These deductions are essentially a form of subsidy in the nature of an interest-free loan,100 with the amount of the loan dependent on the investor's tax situation. Because the plaintiff subsequently recoups the original amount of the investment on rescission,101 the Government should be allowed an opportunity to recapture the tax benefits the plaintiff realized from the investment.102

The Austin II court responded to the Government's claim to tax revenues by asserting that the Government received what it had bargained for. Recognizing that the tax laws are designed to create incentives for real estate investment which would further the Government's public policy objectives,103 the court concluded that so long as the development met all of the tax code criteria for such an investment, the Government had received all of the benefits from the investment that it had bargained for and therefore its claim to any tax revenues was unfounded.104 This analysis, however, oversimplifies the Government's interest as a co-venturer in the investment.105 Absent any fraud, the Government may have received what it bargained for when the building was sold in foreclosure and certain tax benefits previously received by the investors were recaptured.106 When the investment fails due to the promoter's

cannot be treated solely as a private law issue—a court ordering rescission should always investigate the manner in which the Government will approach the rescinded transaction).

99. See, e.g., Thompson, supra note 23, at 390 (“The plaintiff who receives a tax benefit obtains his advantage from the government, not from the defendant.”).

100. See S. SURREY, PATHWAYS TO TAX REFORM 6-29 (1973); Lee, An Approach to Real Estate as a Tax Oriented Investment, 49 NOTRE DAME LAW. 477, 493 (1974) (a purchaser of a tax shelter investment is "co-venturing" with the Government); see also Ginsburg, The Leaky Tax Shelter, 53 TAXES 719, 719 (1975) (tax shelters generally provide a form of tax deferral).

101. See supra notes 22-35 and accompanying text.

102. See supra notes 44-50 and accompanying text.

103. The Government's objectives, according to the Austin II court, include creating employment, increasing the real estate tax base, and enhancing the local business climate. Austin II, 786 F.2d at 956.

104. Id.

105. See supra notes 98-102 and accompanying text.

106. Tax shelter deductions are counterbalanced in the year the investment is sold by requiring the investor to include in the "amount realized," for purposes of computing the taxable gain, the amount of debt from which the investor is thereby discharged. See Commissioner v. Tufts, 461 U.S. 300, 317
fraud, however, the terms of the bargain must be reevaluated. The *Austin II* court should have recognized that, at the very least, the Government did not agree to subsidize the fraudulent activities of the defendant. In addition, if the fraud affected the value of the development, the sale price will be depressed, and, as a consequence, the Government will necessarily recapture less than it would have in the absence of such fraud.\(^\text{107}\) If, unlike the *Austin* case, rescission occurs prior to a sale or foreclosure of the building, the offset rule will leave the plaintiff with no tax benefit to be recaptured and, because the defendant did not take the deductions, upon sale of the building the Government will be left without a party to tax.\(^\text{108}\) This result violates the basic tax doctrine that deductions are not outright grants, but rather a form of tax deferral.\(^\text{109}\) That doctrine dictates that when an investment is ultimately sold or otherwise disposed of, the tax benefits realized must be returned to the Government.\(^\text{110}\)

Regardless of whether the Government received what it bargained for, as a matter of public policy a court ordering rescission should not preempt the Government's right to recapture the tax benefits granted. If the offset rule is applied, the Government is precluded from recovering the tax liability owed

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\(^{107}\) Austin II, 768 F.2d at 963 (Lay, C.J., dissenting); see 4 R. HAFT & P. FASS, TAX SHELTERED INVESTMENTS § 0.03, at 3-4 (3d ed. 1981); Ginsburg, *supra* note 100, at 719.


by the plaintiff upon rescission. To this extent, the offset rule relieves the defendant of fraud liability at the Government's expense.

By acknowledging the Government's valid interest in the transaction, the Austin courts also would have been able to more adequately address the issue of a possible windfall to the plaintiff. Instead the courts limited their analysis of this issue to a bald assertion that a plaintiff can recover no more than his or her economic loss. What the court failed to recognize, however, is that upon rescission the Government will use the tax benefit rule to recapture, in whole or in part, any tax benefit windfall realized by the plaintiff.

Unlike the Eighth Circuit, the Ninth Circuit, in Burgess v. Premier Corp., analyzed the offset issue in terms of all three parties to the transaction. The court concluded that the plaintiff would not experience a "windfall" because the tax laws would treat any rescissory recovery in a manner that would largely wash out any prior tax savings. Thus, if, as is typical, the period of investment extends over several years and the prior tax years are closed, the tax laws will treat the rescissory award as a separate transaction and will apply the tax benefit rule to recapture at least a portion of the plaintiff's windfall.

111. See supra notes 44-50 and accompanying text.
112. Austin II, 768 F.2d at 954; Austin I, 675 F.2d at 181.
113. See supra notes 44-50.
114. 727 F.2d 826 (9th Cir. 1984).
115. See id. at 838; see also Western Fed. Corp. v. Davis, 553 F. Supp. 818, 820 (D. Ariz. 1982), aff'd sub nom. Western Fed. Corp. v. Erickson, 739 F.2d 1439 (9th Cir. 1984) ("[t]he net tax benefit will be nothing.").
116. See supra notes 44-50. It should also be noted that the tax benefit rule may not create complete transactional equivalence even where the amount of the earlier deductions equals the amount of the subsequent recovery. See Bittker & Kanner, supra note 45, at 270 ("[t]he rule by no means insures that the tax on the recovery will be equal to the tax savings attributable to the prior deduction."). The tax rates and the plaintiff's marginal tax bracket may change in the period between the transaction and rescission. The Supreme Court noted this aspect of the tax benefit rule in Hillsboro Nat'l Bank v. Commissioner, 460 U.S. 370, 380-81, n.12 (1983), stating that the purpose of the tax benefit rule is not to achieve mathematical perfection but "to achieve rough transactional parity in tax." Courts, however, have been satisfied with the resulting adjustment and have not insisted on exacting a tax equal to the amount saved by the taxpayer in the earlier year. See Bittker & Kanner, supra note 45, at 271. While this result may, as in Austin, allow an injured plaintiff to ultimately recover an amount in excess of the actual economic loss sustained, courts have traditionally viewed the result as the "most satisfactory outcome." Hanover Shoe, Inc. v. United Shoe Mach. Corp., 392 U.S. 481, 503 (1968) ("the rough result of not taking account of taxes for the year of injury but then taxing [the] recovery when received seems the most satisfactory out-
Even if under the tax benefit rule the plaintiff receives some windfall because not all prior tax savings are recaptured,\textsuperscript{117} such a result is more consistent with the policies underlying the securities laws than a result that allows a defendant to escape full liability.\textsuperscript{118} As noted above,\textsuperscript{119} in securities fraud cases it is more appropriate to grant a windfall to a defrauded plaintiff than to accord any benefit to a party guilty of fraud.\textsuperscript{120} Additionally, courts have long recognized that the federal securities laws are designed both to compensate the victim and to deter fraud.\textsuperscript{121} The best way to promote the deterrent policies of the securities laws is to hold a guilty defendant fully liable for the fraudulent conduct. The policies underlying the securities laws, therefore, are better served by rejecting the offset rule, which essentially credits the defendant's liability with the plaintiff's tax benefits.

Moreover, courts have generally viewed a plaintiff's receipt of tax benefits related to a particular investment as purely a matter between the taxpayer and the Government and not as a basis for reducing damages arising from ordinary securities transactions.\textsuperscript{122} Upon rescission, the plaintiff settles any obligations owing the Government by complying with the applicable tax provisions.\textsuperscript{123} Rescission of the investment is thereby accomplished to the greatest degree possible when dealing with a

\textsuperscript{117} See supra note 116 and accompanying text.
\textsuperscript{118} See supra notes 94-98 and accompanying text. When the tax benefit rule is employed, the recovery is treated as ordinary income if the earlier loss or expense was deducted from ordinary income. Conversely, if the earlier deduction was taken as a capital loss, the recovery will be taxed at capital gains rates. See Bittker and Kanner, supra note 45, at 276.
\textsuperscript{119} See supra notes 94-96 and accompanying text.
\textsuperscript{121} See Nelson v. Serwold, 576 F.2d 1332, 1339 (9th Cir. 1978), cert. denied, 439 U.S. 970 (1978) ("To allow violators of the Act to profit by their misconduct would undermine the deterrence that the Act was intended to effect.").
\textsuperscript{123} See supra notes 44-50.
transaction which involves the Government as well as the two parties. That the plaintiff may be better off vis-a-vis the Government does not mandate application of the offset rule. The plaintiff and the Government fare only as well under the tax laws as the Government intends.¹²⁴ There is no reason to involve the courts in what is essentially a tax matter between the plaintiff and the Government.

In addition, the Austin courts' adoption of the offset rule conflicts with the "collateral source" doctrine. According to this common-law rule, courts should not credit benefits received by an injured party from other sources—such as insurance—against the defendant's liability, even though the payments may cover all or part of the harm for which the defendant is liable.¹²⁵ The Restatement (Second) of Torts explains that a benefit directed to the injured party should not be shifted so as to create a windfall for a defendant tortfeasor if the benefit did not come from the defendant.¹²⁶ In cases such as Austin, the tax benefits conferred by the Government are essentially "collateral" and any offset should therefore be prohibited by the collateral source rule.

The Austin II court considered the collateral source rule issue but concluded that the tax benefits were not derived from a collateral source. Adopting the reasoning of the Second Circuit,¹²⁷ the court stated that the tax benefits, although conferred by the Government, emanated directly from the tax shelter organized and operated by the defendant.¹²⁸ The plaintiffs' tax savings, however, were not wholly or even primarily attributable to the defendant. The promoter of a tax shelter investment plays only a partial role in securing tax savings for the investor. Although the defendant in Austin structured and operated a bona fide real estate venture and was at least partially responsible for the tax deductions taken by the plaintiffs, the plaintiffs' tax benefits were conferred by the Government.¹²⁹ Moreover, it was the investors' tax situation that enabled them to obtain any tax savings. As one court noted, "it would be a great 'injustice' to [the] plaintiff to reduce such damages for extraneous reasons wholly unconnected with the

¹²⁴. See supra note 46.
¹²⁶. Id. § 920A comment b.
¹²⁸. 768 F.2d at 956.
¹²⁹. See supra note 99 and accompanying text.
acts of defendants.”

V. PUBLIC POLICY CONSIDERATIONS

Aside from the problems of statutory interpretation and those related to the recognition of the Government’s interest in the transaction, public policy considerations also militate against adoption of the offset rule. Because the Securities and Exchange Commission (SEC) has limited enforcement resources, the civil remedies provided by the Securities Act are important in deterring securities fraud. These remedies are particularly significant for tax shelter investment securities because these securities are usually sold in private offerings exempt from the registration requirements of the securities laws and, therefore, are not reviewed by the SEC. The offset rule of the Austin courts, however, reduces litigation incentives for victims of securities fraud. An investor with a cause of action under the securities laws will sue only when the benefits of successful litigation outweigh the costs. Under the offset rule, defrauded investors will have little incentive to bring claims in the face of securities law violations if tax deductions equal or exceed the initial investment, because the investor may recover little or nothing from the defrauding promoter. From the promoter’s perspective, as potential civil liability decreases, the incentive to make adequate disclosures concerning the investment will decrease. Moreover, in the unlikely event that an investor does sue, the fraudulent promoter will only be liable insofar as the investor’s tax benefits fail to cover the amount of the original investment. Thus, to the extent the offset rule decreases the probability of private actions and the size of potential liabilities, it undermines the deterrent provisions of the federal securities laws.


131. See J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1963) (characterizing private actions for violations of the antifraud provisions as a “necessary supplement” to the enforcement activities of the SEC); Note, supra note 3, at 670.

132. Austin II, 768 F.2d at 957 n.13. The Securities Act of 1933 exempts certain securities from its registration requirements because of the “small amount involved” or because of the limited character of the offering. See 15 U.S.C. § 77(c) (1982). The Act also exempts certain transactions because of the nature of the transactions or the participants. See 15 U.S.C. § 77d (1982).

133. Note, supra note 3, at 671.

134. Id.

135. See supra note 133 and accompanying text.
CONCLUSION

The *Austin II* court’s decision requiring the offset of tax benefits against damages in securities fraud litigation involving tax shelter investments is flawed. The court’s interpretation of the applicable statutory damage limitations was overly broad and, with respect to the Securities Act, without precedent. In addition, the court treated the tax shelter investment transaction too simplistically, failing to recognize the important interests of the Government. Finally, the decision runs counter to public policy considerations underlying the securities laws. The effect of the decision will be to unfairly shift the economic consequences of fraud to the Government. The offset rule thus results in a windfall to the defrauding defendant at the expense of the plaintiff, the Government, and, ultimately, the taxpayers.

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