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INCOME TAXATION

TAX TREATMENT ACCORDED SURRENDER OF SHORT-SWING PROFITS

Cummings v. Commissioner

Section 16(b) of the Securities Exchange Act of 1934¹ is part of a comprehensive legislative scheme designed to protect the investing public by ensuring a fair and open market.² Specifically, section 16(b) requires a corporate insider³ to surrender to the issuer any profit realized by him on a short-swing transaction.⁴ It is firmly established that the insider is permitted an appropriate tax deduction to reflect his 16(b) liability.⁵ The nature of this deduction,

¹ Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (1970), provides in pertinent part:

For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer . . . within any period of less than six months . . . shall inure to and be recoverable by the issuer

² See Cook & Feldman, *Insider Trading Under the Securities Exchange Act*, 66 HARV. L. REV. 385 (1953) [hereinafter cited as Cook & Feldman]. The authors, discussing the "sure thing" speculation practiced by corporate insiders prior to the passage of § 16(b), point out that § 16, and particularly § 16(b), is Congress' answer to such insider abuse.

³ The class of persons liable under § 16(b), commonly referred to as insiders, consists of "[e]very person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of equity security . . . or who is a director or an officer of the issuer of such security" Securities Exchange Act of 1934 § 16(a), 15 U.S.C. § 78p(a) (1970).

⁴ As described in § 16(b) of the Act, a short-swing transaction includes "any purchase and sale, or any sale and purchase, of any equity security . . . within any period of less than six months . . ." 15 U.S.C. § 78p(b) (1970). An action to recover short-swing profits may be brought by, or, in certain circumstances, on behalf of, the corporation. See *id.* In bringing the action, the corporation need only prove that the insider's transactions occurred within the statutory 6-month period. *Smolowe v. Delendo Corp.*, 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943). According to the court in *Smolowe*, since the statute is essentially one of strict liability there is no need to show an insider's intent to profit from unfair use of inside information. 136 F.2d at 236. Additionally, the application of § 16(b) is not conditioned upon actual misuse of inside information. *Feder v. Martin Marietta Corp.*, 406 F.2d 260, 262 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1970). Employment of this objective standard has been viewed as mandated by congressional intent. See, e.g., *Reliancé Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418 (1972); *Adler v. Klawans*, 267 F.2d 840 (2d Cir. 1959). See generally Comment, *Section 16(b): Judicial Inconsistency in Application of the Pragmatic Approach*, 5 TEXAS TECH L. REV. 731 (1974).

⁵ Courts have little difficulty in treating a 16(b) payment as taxable income to the receiving corporation. See, e.g., *General Am. Investors Co. v. Commissioner*, 348 U.S. 434 (1955); *Deitz, A Practical Look at Section 16(b) of the Securities Exchange Act*, 43 FORDHAM L. REV. 1, 36-37 (1974). As will be discussed herein, the more complex question has been how the corporate insider should report his expenditure in satisfaction of a sale-purchase violation.

Initially, a 16(b) obligation was deemed a penalty. As a result, it was feared that allowance of any deduction would frustrate the policy of the statute. See *Lehman v. Commissioner*, 25 T.C. 629 (1955); *Davis v. Commissioner*, 17 T.C. 549 (1951); *Dempsey v. Commissioner*, 10 CCH Tax Ct. Mem. 936 (1951). In *Marks v. Commissioner*, 27 T.C. 464 (1956), however, the Tax Court, in reconsidering its position, allowed a deduction for a

however, is unsettled.⁶ In *Cummings v. Commissioner*,⁷ the Second Circuit, facing the problem of whether the deduction should be treated as a long-term capital loss⁸ or as an ordinary and necessary business expense,⁹ held that in the case of a sale-purchase violation,¹⁰ the former treatment is appropriate.¹¹

In 1959, plaintiff, Nathan Cummings, became a member of the board of directors of Metro-Goldwyn-Mayer, Inc. (MGM). In connection with his election, in the same year, he purchased 51,500 shares of MGM's common stock. On April 17, 1961, Cummings earned a substantial profit on the sale of 3400 of these shares, which he reported on his 1961 income tax return as a long-term capital gain. Approximately 5 months later, he repurchased 3000 shares at a price below that of his April sales. The Securities and Exchange Commission notified MGM that Cummings was in apparent violation of section 16(b) and that this fact would have to be reported in its proxy statement.¹² Although Cummings disputed his liability, he remitted his short-swing profit to MGM, claiming that he desired to protect his business reputation¹³ and that he

16(b) payment and expressed the belief that such a deduction would not frustrate public policy. Case law which characterizes § 16(b) as a nonpenal, remedial statute supports this view. *See, e.g.*, *Western Auto Supply Co. v. Gamble-Skogmo, Inc.*, 348 F.2d 736 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1966); *Booth v. Varian Associates*, 334 F.2d 1 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965); *Smolowe v. Delendo Corp.*, 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943). Thus, the *Marks* court seems to have correctly concluded that allowance of a tax deduction would more closely reflect the intended purpose of § 16(b). In light of *Marks*, the Internal Revenue Service promulgated Rev. Rul. 115, 1961-1 CUM. BULL. 46, wherein it expressed the view that deduction of a 16(b) payment does not frustrate public policy.

⁶ While Rev. Rul. 115, 1961-1 CUM. BULL. 46, clearly permits the taxpayer to deduct a 16(b) payment, it fails to define the proper treatment of such a deduction, stating only that "[t]he income tax significance of the capital stock dealings giving rise to the payment determines whether it is deductible as an ordinary loss or as a capital loss."

⁷ 506 F.2d 449 (2d Cir. 1974), *cert. denied*, 421 U.S. 913 (1975), *rev'g* 61 T.C. 1 (1973) (rehearing), *aff'g* 60 T.C. 91 (1973).

⁸ INT. REV. CODE OF 1954, § 1222(4) defines a long-term capital loss as a "loss from the sale or exchange of a capital asset held for more than 6 months"

⁹ *Id.* § 162(a) provides in pertinent part: "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business"

¹⁰ In a sale-purchase violation, a long-term capital gain may have been recognized when the stock sold had been held for a 6-month period. *Id.* § 1222(4). This raises the question whether the 16(b) payment should be treated as a long-term capital loss or as an ordinary business deduction. In a purchase-sale situation this problem does not exist since the securities must be sold within a 6-month period for a 16(b) violation to result. The income realized must therefore be reported as an ordinary gain. *Id.* § 1222(1).

¹¹ 506 F.2d at 449.

¹² Alleged violations of § 16(b) must be publicly disclosed in the corporation's proxy statement. *See* 17 C.F.R. § 240.14a-101, Item 7(e), Instruction 4 (1975).

¹³ Cummings advanced several reasons in support of his contention that his business reputation would be protected by settling the claim immediately. Not only would it be embarrassing and dangerous to his position with MGM if litigation ensued, but mention of

wanted to avoid any delay in the issuance of MGM's proxy statement.¹⁴ Cummings treated this 16(b) repayment as an ordinary and necessary business expense on his 1962 income tax return.¹⁵ The Commissioner of Internal Revenue, however, assessed a deficiency, contending that the payment should properly be deducted as a long-term capital loss. Cummings subsequently instituted an action in the Tax Court seeking a determination that a payment to an issuer made in satisfaction of a sale-purchase violation of section 16(b) should be treated as an ordinary and necessary business expense.

The Tax Court upheld plaintiff's claim.¹⁶ The court reasoned that since Cummings was in the business of being a corporate executive, the 16(b) payment was necessary to protect his reputation and that of MGM and therefore qualified as an ordinary and necessary business expense. The Commissioner, however, moved for a rehearing based upon a subsequent case in which the Seventh Circuit reached the opposite conclusion.¹⁷ Nevertheless, upon reconsideration, the Tax Court reaffirmed its view, finding the Seventh Circuit's interpretation not in conformity with established tax principles.¹⁸

his 16(b) violation on the corporation's proxy statement would invite potentially damaging publicity. 60 T.C. at 94.

¹⁴ *Id.*

¹⁵ Although the long-term capital gain realized by Cummings was reported on his 1961 tax return, the 16(b) payment which was made the following year was properly reported on the 1962 return. See *United States v. Lewis*, 340 U.S. 590 (1951); *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931). The "claim of right" doctrine, established in *North Am. Oil Consol. v. Burnet*, 286 U.S. 417 (1932), gives finality to each accounting period. Thus, if a deduction in future years becomes necessary, the prior year's tax return is not amended. Instead, the deduction is applied in the year of payment. See, e.g., *Healy v. Commissioner*, 345 U.S. 278 (1953); *Walet v. Commissioner*, 31 T.C. 461 (1958), *aff'd per curiam*, 272 F.2d 694 (5th Cir. 1959).

¹⁶ 60 T.C. at 91.

¹⁷ *Anderson v. Commissioner*, 480 F.2d 1304 (7th Cir. 1973), *rev'g* 56 T.C. 1370 (1971).

¹⁸ 61 T.C. at 1 (rehearing).

In *Lawrence v. Commissioner*, 27 T.C. 713 (1957), *rev'd per curiam on other grounds*, 258 F.2d 562 (9th Cir. 1958), the Tax Court had discussed "what to do when an issue came before it again after a Court of Appeals had reversed its prior decision on that point." 27 T.C. at 716. While the *Lawrence* court regarded an opinion of a circuit court highly persuasive, it did not consider an expression of one of the circuits binding on the Tax Court. The basis for this view was that the Tax Court, as a court of national jurisdiction, strives for uniformity. In light of the possibility of conflict among the circuits, such uniformity, it was believed, could not be achieved if circuit court precedent were binding.

Also worthy of consideration, however, was the avoidance of unnecessary appeals. For this reason, the *Lawrence* decision was criticized by many who contended that the Tax Court should follow the rule of the circuit to which an appeal might be taken. See, e.g., Comment, *Heresy in the Hierarchy: Tax Court Rejection of Court of Appeals Precedents*, 57 COLUM. L. REV. 717 (1957); Note, *Controversy Between the Tax Court and Court of Appeals: Is the Tax Court Bound by the Precedent of Its Reviewing Court?*, 7 DUKE L. J. 45 (1957). In fact, some circuit courts found any contrary policy extremely objectionable. See *Sullivan v. Commissioner*, 241 F.2d 46 (7th

On appeal, the Second Circuit, with Chief Judge Kaufman speaking for the court,¹⁹ reversed the holding of the Tax Court and ruled that the 16(b) payment should be treated as a long-term capital loss. In reaching its conclusion, the court was required to wrestle with the confusing interplay of the Securities Exchange Act of 1934 and the Internal Revenue Code. It is submitted that the position taken by the Second Circuit, while in accord with the decisions of three other circuits²⁰ and amply supported by securities law,²¹ reflects a strained interpretation of tax principles to achieve a result not mandated by such tax precedent.

The *Cummings* court, relying primarily upon tax law and finding additional support in securities law, expounded a two-pronged argument. The tax justification for long-term capital loss treatment was found in *Arrowsmith v. Commissioner*²² and *United States v. Skelly Oil Co.*²³ In *Arrowsmith*, the Supreme Court enunciated the doctrine that when income is taxed in one year at a reduced rate, expenditures related to the earlier transactions should be deducted at a comparable reduced rate.²⁴ Thus, where income derived from a corporate liquidation was initially reported as a long-term capital gain, the subsequent payment by the taxpayer of a judgment against the liquidated corporation was deemed a long-term capital loss as opposed to an ordinary and necessary business expense.²⁵ *Arrowsmith* was followed and clarified in *Skelly Oil*, where the Court held that the allowable deduction for the refund of income, which when initially reported was given a

Cir. 1957), *aff'd on other grounds*, 356 U.S. 27 (1958); *Stacey Mfg. Co. v. Commissioner*, 237 F.2d 605 (6th Cir. 1956) (per curiam). In light of such criticism, the Tax Court ultimately modified the opinion it expressed in *Lawrence* and will now consider itself bound by the rule of the circuit to which its decision would be appealable. See *Golsen v. Commissioner*, 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir.), *cert. denied*, 404 U.S. 940 (1971).

¹⁹ Judge Timbers joined in the Chief Judge's opinion. Judge Smith, concurring in the result, authored a separate opinion.

²⁰ See *Brown v. Commissioner*, CCH 1976 STAND. FED. TAX REP., U.S. TAX CAS. (76-1, at 83,339) ¶ 9191 (10th Cir. Jan. 26, 1976), *rev'g* 32 CCH Tax Ct. Mem. 1300 (1973); *Anderson v. Commissioner*, 480 F.2d 1304 (7th Cir. 1973), *rev'g* 56 T.C. 1370 (1971); *Mitchell v. Commissioner*, 428 F.2d 259 (6th Cir. 1970), *cert. denied*, 401 U.S. 909 (1971), *rev'g* 52 T.C. 170 (1969), *analyzed in* 1971 TOLEDO L. REV. 559. The material facts in these cases are virtually identical to those in *Cummings*.

²¹ See notes 30-32 and accompanying text *infra*.

²² 344 U.S. 6 (1952).

²³ 394 U.S. 678 (1969).

²⁴ Since *Arrowsmith*, the general rule has been that the tax treatment accorded a transaction occurring in one year may control the tax treatment accorded a related expenditure in a subsequent year. See, e.g., *United States v. Skelly Oil Co.*, 394 U.S. 678 (1969); *Kimbell v. United States*, 490 F.2d 203 (5th Cir.), *cert. denied*, 419 U.S. 833 (1974); *Commissioner v. Adam, Meldrum & Anderson Co.*, 215 F.2d 163 (2d Cir. 1954), *cert. denied*, 348 U.S. 913 (1955); *Rees Blow Pipe Mfg. Co. v. Commissioner*, 41 T.C. 598 (1964), *aff'd per curiam*, 342 F.2d 990 (9th Cir. 1965); *Estate of Shannonhouse v. Commissioner*, 21 T.C. 422 (1953).

²⁵ 344 U.S. at 8.

27½ percent depletion allowance, should similarly be reduced by the amount of the depletion allowance.²⁶ In *Cummings*, Chief Judge Kaufman justified his reliance on the *Arrowsmith* rule by reasoning that the 16(b) repayment “‘had its genesis’” in the earlier sale and therefore should be accorded tax treatment similar to that of the reported gain.²⁷ The *Arrowsmith* decision was prompted by the desire to prevent the taxpayer from recognizing a “tax windfall” through deduction of the expenditure at a tax rate greater than that applied to the reported gain.²⁸ It was the desire to prevent a similar tax windfall which led the Second Circuit to treat *Cummings*’ 16(b) payment as a long-term capital loss.²⁹

In relying on securities law as additional support for its position, the *Cummings* court cited its longstanding interpretation that section 16(b) is intended to “‘squeeze all possible profits out of stock transactions’”³⁰ in order to “remove the incentive for short-term trading by corporate insiders.”³¹ To allow full deduction of the 16(b) payment as a business expense would, in the court’s opinion, permit the taxpayer to profit from his illegal transaction by the application of differing tax rates. Thus, the court concluded that only by treating the liability as a long-term capital loss could it effectuate the statutory policy.³²

²⁶ 394 U.S. at 685-87.

²⁷ 506 F.2d at 451, quoting *Mitchell v. Commissioner*, 428 F.2d 259, 261 (6th Cir. 1970). The *Cummings* court observed: “The nexus between the § 16(b) repayment and the earlier capital gains is apparent. . . . Thus, for tax purposes, [Cummings’] payment of \$53,870.81 profit from the sale and purchase may appropriately be regarded as an adjustment to the amount of the capital gain.” 506 F.2d at 451.

²⁸ Commenting upon its earlier decision in *Arrowsmith*, the Supreme Court stated: The rationale for the *Arrowsmith* rule is easy to see; if money was taxed at a special lower rate when received, the taxpayer would be accorded an unfair tax windfall if repayments were generally deductible from receipts taxable at the higher rate applicable to ordinary income. The Court in *Arrowsmith* was unwilling to infer that Congress intended such a result.

United States v. Skelly Oil Co., 394 U.S. 678, 685 (1969).

²⁹ 506 F.2d at 454. Avoidance of tax windfalls and possible double deductions is a basic objective of tax law. *See, e.g.*, *Commissioner v. Heininger*, 320 U.S. 467 (1943); *Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62 (1934). Courts, dealing with the tax treatment of certain expenditures, have consistently recognized this to be Congress’ intent. *See, e.g.*, *Deputy v. du Pont*, 308 U.S. 488 (1940).

³⁰ 506 F.2d at 452, quoting *Smolowe v. Delendo Corp.*, 136 F.2d 231, 239 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943). To reflect the remedial nature of § 16(b), *see* note 5 *supra*, rectifying a violation has been interpreted as requiring that the transaction is ultimately profitless, not resulting in a windfall or penalty. *See Cook & Feldman, supra* note 2, at 385. Essentially, this necessitates restoring the insider to the position he occupied prior to the violation. *See Lokken, Tax Significance of Payments in Satisfaction of Liabilities Arising Under Section 16(b) of the Securities Exchange Act of 1934*, 4 GA. L. REV. 298 (1970); 23 DEPAUL L. REV. 590 (1973).

³¹ 506 F.2d at 452.

³² *Id.* Deduction of the 16(b) payment as a long-term capital loss from the long-term capital gain realized on the stock’s sale nullifies the net gain or loss (including any tax

Judge Smith concurred in the reversal, but rejected the Chief Judge's conclusion that long-term capital loss treatment is proper.³³ Instead, in accordance with Judge Drennen's dissent in the Tax Court,³⁴ he urged a third alternative as the proper tax treatment. Judge Smith argued that the court's reliance on *Arrowsmith* and *Skelly Oil* as dispositive was erroneous. Whereas the payment claimed as a tax deduction in those decisions was essentially an offsetting expense related to an item previously included in income,³⁵ the 16(b) payment in *Cummings*, which arose from the repurchase of the stock, was never included in plaintiff's income and was unrelated to the reported gain from the original purchase and sale.³⁶ In the Judge's opinion, the transaction which gave rise to the 16(b) liability, *i.e.* the repurchase of the stock, should have no tax significance at all until the stock is sold. Accordingly, he recommended that the 16(b) payment be capitalized, thereby increasing the basis of the repurchased stock and deferring tax consequences until subsequent sale.³⁷

The continuing conflict between the Tax Court and the circuit courts³⁸ is understandable in light of the confusing interrelation between the relevant tax and securities law provisions. While the Tax Court's analysis may be justified solely on tax grounds, it appears to ignore the intent of section 16(b). On the other hand, the Second Circuit, by attempting to promote the purpose of section 16(b), seems to have adopted a strained extension of *Arrowsmith*. Judge Smith's third alternative is a logical compromise, but finds little support in either tax or securities law.

It is well established in tax law that a payment made to protect a taxpayer's business reputation from a business-related claim is deductible as an ordinary and necessary business expense.³⁹ The

benefits) as a result of the 16(b) violation. Thus, the taxpayer will be restored to the position he occupied prior to the offending transactions, thereby satisfying the remedial intent of § 16(b).

³³ *Id.* at 453-54 (Smith, J., concurring).

³⁴ 61 T.C. at 4-5 (Drennen, J., dissenting) (rehearing).

³⁵ See note 47 *infra*.

³⁶ The amount of Cummings' 16(b) liability was determined in accordance with the rule established in *Smolowe v. Delendo Corp.*, 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943), by taking the difference between the price at which Cummings sold the stock and the cost of the repurchased shares. Cummings recognized a gain on the sale only because the stock increased in value during the period in which he owned it. Had the value of the stock decreased and Cummings sold at a loss, while he still would have incurred 16(b) liability for the difference between the sale and repurchase price, he would have recognized no capital gain against which the 16(b) expenditure could be offset.

³⁷ 506 F.2d at 454 (Smith, J., concurring).

³⁸ See note 20 *supra*.

³⁹ See, *e.g.*, *Helvering v. Community Bond & Mortgage Co.*, 74 F.2d 727 (2d Cir. 1935); *Pike v. Commissioner*, 44 T.C. 787 (1965); *Old Town Corp. v. Commissioner*, 37 T.C. 845

Second Circuit itself has said that "almost any trade or business will give rise to claims, many invalid but some valid; resisting such claims, paying judgments on some and settling others, is thus an 'ordinary and necessary' expense of 'carrying on any trade or business.'"⁴⁰ Therefore, in light of the Tax Court's finding that protection of his business reputation was Cummings' purpose in settling the 16(b) claim with MGM,⁴¹ tax law would appear to support plaintiff's contention.

Further, although less compelling, tax support for this view is found in the "origin and character of the claim" test established in *United States v. Gilmore*.⁴² There, the Supreme Court held that the controlling factor in determining whether an expenditure is deductible as an ordinary and necessary business expense is the "'origin of the liability out of which the expense accrues' or 'the kind of transaction out of which the obligation arose.'"⁴³ More specifically, "the determinative question" is whether the claim arose "in connec-

(1962); *Marks v. Commissioner*, 27 T.C. 464 (1956); *Howard v. Commissioner*, 16 T.C. 157 (1951), *aff'd*, 202 F.2d 28 (9th Cir. 1953).

The critical question in determining whether a payment made to protect a taxpayer's business reputation qualifies as an ordinary and necessary business expense is whether the expenditure actually arose from the taxpayer's business. Thus, even if the expenditure is necessary to protect the taxpayer's business reputation, deduction as an ordinary and necessary business expense will not be allowed if the need for the payment arose out of the taxpayer's personal life. See *Nadiak v. Commissioner*, 356 F.2d 911 (2d Cir. 1966); *Lewis v. Commissioner*, 253 F.2d 821 (2d Cir. 1958); *Bonney v. Commissioner*, 247 F.2d 237 (2d Cir.), *cert. denied*, 355 U.S. 906 (1957). For purposes of this analysis, a trade or business has been generally defined as "all means of gaining a livelihood by work, even those which would scarcely be so characterized in common speech." *Trent v. Commissioner*, 291 F.2d 669, 671 (2d Cir. 1961) (citations omitted). As a result, a corporate officer or director may be deemed to be carrying on a trade or business. See, e.g., *Ditmars v. Commissioner*, 302 F.2d 481 (2d Cir. 1962). *But cf.* *Graham v. Commissioner*, 40 T.C. 14 (1963), *rev'd on other grounds*, 326 F.2d 878 (2d Cir. 1964) (totally inactive director not considered to be conducting trade or business).

⁴⁰ *Ditmars v. Commissioner*, 302 F.2d 481, 485 (2d Cir. 1962). So long as the claim arises directly from the taxpayer's trade or business, courts have little trouble in characterizing expenditures, be they judgments, settlements, or attorneys' fees, as ordinary and necessary business deductions. See, e.g., *Trust of Bingham v. Commissioner*, 325 U.S. 365 (1945); *Draper v. Commissioner*, 26 T.C. 201 (1956); *Butler v. Commissioner*, 17 T.C. 675 (1951); *Great Island Holding Corp. v. Commissioner*, 5 T.C. 150 (1945).

⁴¹ 60 T.C. at 95.

⁴² 372 U.S. 39 (1963). In *Gilmore*, the Court disallowed the deduction as an ordinary and necessary business expense of attorneys' fees expended by the taxpayer to protect his assets from his wife's claim for alimony. The taxpayer attempted to justify the deduction by arguing that since the property demanded by his wife was business property, its loss would damage his business and his business reputation. Rejecting this argument, the Court stated:

[T]he *origin and character* of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expense was "business" or "personal" and hence whether it is deductible or not

Id. at 49 (emphasis added). The Court concluded that the wife's claim for alimony had its origin in the taxpayer's personal life and as such did not constitute a proper business deduction.

⁴³ *Id.* at 47-48, quoting *Deputy v. du Pont*, 308 U.S. 488, 494, 496 (1940).

tion with [the taxpayer's] profit-seeking activities."⁴⁴ Although in *Cummings* the 16(b) liability resulted from the taxpayer's violation of a securities law, his status as a corporate director was an essential element of the violation. The argument might therefore be made that Cummings' expenditure was sufficiently connected with his employment as a director of MGM to warrant treatment, under the rule of *Gilmore*, as an ordinary and necessary business expense.⁴⁵

The *Cummings* court's reliance on *Arrowsmith* and *Skelly Oil* is premised upon the existence of a nexus between the 16(b) payment and the earlier capital gain.⁴⁶ Chief Judge Kaufman reasoned that since the payment would have been unnecessary but for the earlier sale, it should be regarded as an adjustment to the amount of the gain. In both *Arrowsmith* and *Skelly Oil*, however, there was more than a mere nexus between the relevant transactions. Indeed, it may be argued that in each case the realization of income and subsequent expenditure were, in effect, elements of one integrated transaction, separated only by the arrival of a new year.⁴⁷ Thus, had they occurred in the same year, there would have been no doubt as to their identical tax treatment, for the latter transaction would have simply reduced the amount of income upon which the initial assessment was made.

The relationship in *Cummings* between the 16(b) payment and the earlier capital gain is arguably remote. First, it is questionable whether Cummings acted in the same capacity in each transaction. His recognition of the capital gain was as a shareholder of MGM, while his incurrence of liability under section 16(b) was as a director of the corporation.⁴⁸ Second, as Judge Smith and the Tax

⁴⁴ 372 U.S. at 51.

⁴⁵ Cf. *Commissioner v. Tellier*, 383 U.S. 687 (1966) (attorneys' fees incurred by underwriter in defending criminal prosecution for violation of fraud provision of Securities Act of 1933 deductible as ordinary and necessary business expense).

⁴⁶ 506 F.2d at 451.

⁴⁷ In *Arrowsmith*, the taxpayers recognized a capital gain through liquidation of their business. In a subsequent year, a judgment rendered against the liquidated corporation was paid by the taxpayers as transferees of the corporate assets. The Court held that the expenditure was related to the prior capital gain and must be deducted at the same tax rate. 344 U.S. at 8.

The situation was similar in *Skelly Oil*. There, the taxpayer was afforded a 27½% depletion allowance against its gross income. Several years later, part of the reported income was paid out in settlement of claims brought by the taxpayer's customers. The Court held that the allowable deduction for this expenditure should be reduced by the fixed percentage of the depletion allowance, thereby according the reported income and the subsequent payout equal tax treatment. Thus, *Skelly Oil*, like *Arrowsmith*, dealt with payment of an amount previously included in the taxpayer's income.

The *Arrowsmith* rule was more recently followed and discussed in *Kimbell v. United States*, 490 F.2d 203 (5th Cir.), cert. denied, 419 U.S. 833 (1974).

⁴⁸ The distinct capacities in which Cummings acted were discussed by Judge Simpson in the Tax Court. 61 T.C. at 2-4 (rehearing), citing *Anderson v. Commissioner*, 56 T.C. 1370, 1374-76 (1971), rev'd, 480 F.2d 1304 (7th Cir. 1973).

Court each pointed out, the 16(b) payment was not, as in *Arrowsmith*, a return of an item previously included in income.⁴⁹ Cummings' realization of income resulted from his original purchase and sale, which, for tax purposes, constituted a complete transaction.⁵⁰ The 16(b) payment was of the insider's profit on the sale and repurchase, which, arguably a gain in the economic sense, is decidedly not income for tax purposes.⁵¹

While the *Cummings* court made no attempt to rebut this criticism of its reliance on *Arrowsmith*, such an attempt was made in *Anderson v. Commissioner*,⁵² wherein the Seventh Circuit arrived at a result identical to that reached in *Cummings*. There the court argued that "[b]ifurcating the sale and payments smacks of artificiality, and characterizing the sale-purchase occurrence as without tax significance could only have been done in a vacuum."⁵³ It is submitted, however, that this reasoning similarly "smacks of artificiality," for it fails to account for the distinction between the rationale of *Arrowsmith* and the factual circumstances of a sale-purchase 16(b) violation. Unlike the repayment in *Arrowsmith*, the 16(b) liability in *Cummings*, the result of the taxpayer's violation of a securities law, was not a repayment of an amount previously included in his income. Thus, reliance on *Arrowsmith* as a basis for long-term capital loss treatment is a questionable extension of that doctrine.⁵⁴

While Judge Smith and the Tax Court agree that *Arrowsmith* is inapposite, they differ on what treatment the 16(b) payment should be accorded. The Tax Court reasoned that since the payment was made to protect plaintiff's business reputation, it was deductible as an ordinary and necessary business expense.⁵⁵ The *Cummings* court rejected this approach as contrary to securities law policy: "Without good reason, we are unwilling to interpret the Internal Revenue Code so as to allow this anomalous result which severely and directly frustrates the purpose of Section 16(b)." ⁵⁶ Judge Smith,

⁴⁹ See 506 F.2d at 454 (Smith, J., concurring); 61 T.C. at 2-3 (rehearing).

⁵⁰ For tax purposes, a gain or loss is recognized only upon a sale or exchange. INT. REV. CODE OF 1954, §§ 1001, 1002.

⁵¹ See 506 F.2d at 454 (Smith, J., concurring).

⁵² 480 F.2d 1304 (7th Cir. 1973), *rev'g* 56 T.C. 1370 (1971).

⁵³ 480 F.2d at 1307.

⁵⁴ Since its first encounter with the issue of the tax treatment to be accorded the surrender of profits resulting from a 16(b) sale-purchase violation, *Mitchell v. Commissioner*, 52 T.C. 170 (1969), *rev'd*, 428 F.2d 259 (6th Cir. 1970), *cert. denied*, 401 U.S. 909 (1971), the Tax Court has consistently rejected the applicability of *Arrowsmith* notwithstanding circuit court opinion to the contrary. See cases cited note 20 *supra*.

⁵⁵ See text accompanying notes 16-18 *supra*.

⁵⁶ 506 F.2d at 452, *quoting* *Anderson v. Commissioner*, 480 F.2d 1304, 1308 (7th Cir. 1973).

The construction of apparently inconsistent statutes presents courts with serious problems. The majority view appears to be that the "proper approach is to ascertain the purposes

on the other hand, suggested capitalization of the 16(b) payment by adding it to the basis of the repurchased stock. He argued that since the repurchase constituted the first half of a transaction with independent tax significance, the 16(b) payment should have no tax consequences until a gain or loss is realized by sale of the repurchased securities.⁵⁷ The *Cummings* court recognized that such treatment might be preferable in certain circumstances, but, since neither party advanced its adoption, refused to resolve the issue.⁵⁸ Neither Judge Smith nor Judge Drennen, who first developed the theory in the Tax Court, offered convincing arguments.

Perhaps some tax support for Judge Smith's capitalization approach can be extrapolated from the "origin and character of the claim" test enunciated in *Gilmore*. Pursuant to this test, an expense incidental to the purchase of an asset will be characterized as a capital expenditure if it is intimately related to the taxpayer's interest in the asset. Thus, it has been held that appraisal litigation,⁵⁹ negotiation costs,⁶⁰ and expenses necessary to compel the sale of stock⁶¹ are all properly treated as capital expenditures. The propriety of reliance on *Gilmore*, however, is somewhat doubtful, for in most situations where capital expenditure treatment was deemed proper, the expenditure related exclusively to a purchase transaction.⁶² In contrast, the 16(b) liability in *Cummings* resulted from the combination of a sale and subsequent repurchase. In addition, Chief Judge Kaufman has suggested that scrutiny of Judge Smith's approach under securities analysis reveals that capitalization may be contrary to the intent underlying section 16(b).⁶³ Since the

underlying both enactments, not to dispose of the problem by a mechanical rule." *Fanning v. United Fruit Co.*, 355 F.2d 147, 149 (4th Cir. 1966). See also *Gamble v. Central of Ga. Ry.*, 356 F. Supp. 324 (M.D. Ala.), *rev'd*, 486 F.2d 781 (5th Cir. 1973); *Durand v. NLRB*, 296 F. Supp. 1049 (W.D. Ark. 1969). At least one court, however, has said that the controlling statute should be that "provision more closely associated with the specific substance of the controversy." *Bowman v. Texas Educ. Foundation, Inc.*, 454 F.2d 1097, 1101 (5th Cir. 1972). Although the conflict presented in *Cummings* is more one of underlying policy than statutory language, it would appear that the same considerations apply.

⁵⁷ 506 F.2d at 454 (Smith, J., concurring). Capitalization treatment has also been urged by a number of commentators. See *Lokken, Tax Significance of Payments in Satisfaction of Liabilities Arising Under Section 16(b) of the Securities Exchange Act of 1934*, 4 GA. L. REV. 298 (1970); 5 TEXAS TECH L. REV. 877 (1974).

INT. REV. CODE OF 1954, § 1016(a)(1) provides that "expenditures, receipts, losses, or other items, properly chargeable to capital account" may be used to adjust basis.

⁵⁸ 506 F.2d at 453.

⁵⁹ *United States v. Hilton Hotels Corp.*, 397 U.S. 580 (1970) (costs of determining value of stock).

⁶⁰ *Anchor Coupling Co. v. United States*, 427 F.2d 429 (7th Cir. 1970) (costs related to settling claim for specific performance of contract for sale).

⁶¹ *Ransberg v. United States*, 440 F.2d 1140 (10th Cir. 1971) (costs incurred in litigation over buy-sell agreement between family members).

⁶² See, e.g., cases cited notes 59-61 *supra*.

⁶³ 506 F.2d at 453.

provision is remedial, and not penal, in nature, deferring any deduction until the repurchased shares are sold could work a penalty not intended by Congress.

In the final analysis it appears that none of the three judicially discussed alternatives offers an adequate solution to the problem of determining the nature of the deduction to be afforded the type of 16(b) expenditure involved in *Cummings*. Although the long-term capital loss treatment urged by the Second Circuit rests upon questionable tax precedent, it is suggested that the court's conclusion is not entirely without sound support. Since the holding in *Cummings* is in accord with three other circuits and is consistent with securities law policy, it is urged that the decision not be disturbed absent a more appropriate solution to this perplexing problem.

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