Tax Treatment of Section 16(b) Repayments: Tax Court Again Reversed

Cummings v. Commissioner, 506 F.2d 449 (2d Cir. 1974)

Taxpayer, a director of Metro-Goldwyn-Mayer, Inc. (MGM), sold 3400 shares of MGM stock. Profit from the sale was reported in 1961 as long term capital gain. Within six months he purchased 3000 MGM shares at a lower price.[1] When notified of his potential liability under section 16(b) of the Securities Exchange Act of 1934,[2] which prohibits "short-swing" trading by corporate insiders and makes "profits" on such trading recoverable by the corporation,[3] taxpayer remitted the sale

1. Taxpayer was a successful food corporation executive, member of the boards of a number of corporations, and investor. MGM approached him to interest him in a directorship and the purchase of a large number of shares. Taxpayer accepted and became very active in the corporate business. On April 17, 1961, taxpayer sold some of his MGM shares, and within six months purchased a like amount at a lower price. Although he believed the potential liability under § 16(b) to be the result of inadvertence, taxpayer immediately paid the appropriate amount, $53,807.86, to MGM both to avoid delaying the issuance of an MGM proxy statement which would have had to reveal the potential § 16(b) liability, and to avoid damaging his business reputation. Nathan Cummings, 60 T.C. 91, 92-93 (1973).

2. 15 U.S.C. § 78p(b) (1970) provides:

> For the purpose of preventing the unfair use of information which may have been obtained by . . . [a ten percent] beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not purchasing the security sold for a period exceeding six months . . . .

See generally 2 L. Loss, Securities Regulation 1037-1132 (2d ed. 1961); Cook & Feldman, *Insider Trading Under the Securities Exchange Act*, 66 Harv. L. Rev. 385 (1953); Yourd, *Trading in Securities by Directors, Officers and Stockholders: Section 16(b) of the Securities Exchange Act*, 38 Mich. L. Rev. 133 (1939); Note, *Section 16(b) Insider Trading*, 1974 Wash. U.L.Q. 872; 1973 Wash. U.L.Q. 213, 214-15.

3. "Short-swing" trading is the purchase and sale or sale and purchase of a security within a period of less than six months. *See* Note, *supra* note 2, at 883-84; *cf.* Park & Tilford, Inc. v. Schulte, 160 F.2d 984, 987-88 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947). An "insider" is an officer, director, or ten percent beneficial owner. *See* 2 L. Loss, *supra* note 2, at 1037; Note, *supra* note 2, at 879-83. "Profit" under § 16(b) may result from the investor's improved economic position after selling at a high price and

price—purchase price difference to MGM. Taxpayer deducted the payment on his 1962 return as an ordinary and necessary business expense,[4] a deduction against ordinary income. The Commissioner treated the payment as a long term capital loss[5] and assessed a deficiency. The Tax Court held[6] that the taxpayer had properly characterized the payment as an ordinary and necessary business expense.[7] The

later purchasing at a low price. The investor, while not truly realizing a profit, avoids a loss. The amount of this "profit" is the difference between the sale price and purchase price. For example, if T sold 100 shares of X corporation for $1000 and within six months purchased 100 shares for $600, his "profit" under § 16(b) would be $400. This amount would be recoverable by the corporation. *See* 2 L. Loss, *supra* note 2, at 1062-63; Note, *supra* note 2, at 890-92.

4. INT. REV. CODE OF 1954, § 162(a) provides: "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 . . . ." *See generally* 4A J. MERTENS, LAW OF FEDERAL INCOME TAXATION §§ 25.01-.137 (rev. ed. 1972).

The taxpayer's status as a director and his right to a deduction in that capacity for ordinary and necessary business expenses was not at issue. Nathan Cummings, 60 T.C. 91, 95 (1973); 4A J. MERTENS, *supra*, at § 25.08. *See* note 25 *infra*.

5. Long term capital loss means loss from the sale or exchange of a capital asset held for more than six months. INT. REV. CODE OF 1954, § 1222(4). Long term capital loss is netted against long term capital gain to arrive at net long term capital gain or loss within a given tax year. *Id.* §§ 1222(7), (8). If a taxpayer has a net long term capital gain that exceeds his net short term capital loss, if any, then 50 percent of the excess is deducted from the taxpayer's gross income. *Id.* § 1202. The effect of these provisions has been concisely summarized: "[T]wo dollars of net long-term capital loss is required to offset one dollar of ordinary income." 3B J. MERTENS, *supra* note 4, at § 22.06.

6. Nathan Cummings, 60 T.C. 91, *aff'd on rehearing*, 61 T.C. 1 (1973). The rehearing was granted to review the decision in light of Anderson v. Commissioner, 480 F.2d 1304 (7th Cir. 1973), *rev'g* 56 T.C. 1370 (1971), a case with virtually identical facts. Since venue for appeal in *Nathan Cummings* was in the Second Circuit, the Tax Court was not required to follow the result of the Seventh Circuit in *Anderson*. 61 T.C. at 2, *citing* Jack E. Golsen, 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir.), *cert. denied*, 404 U.S. 940 (1971).

7. 61 T.C. at 3; 60 T.C. at 95. Evidence that taxpayer made the payment to protect his business reputation consisted of the taxpayer's statements to that effect, and his payment the day after notification of potential liability, which precluded the possibility he had received legal advice. 60 T.C. at 94-95. In *Anderson* the taxpayer stated that the payments were made to avoid jeopardizing his position with the corporation and damaging his business reputation. The Tax Court found these beliefs to be "reasonable." 56 T.C. at 1372-74. The Tax Court made a similar finding in William L. Mitchell, 52 T.C. 170, 176 (1969), *rev'd*, 428 F.2d 259 (6th Cir. 1970), *cert. denied*, 401 U.S. 909 (1971). In *Cummings* the Tax Court also found that the taxpayer made the payment to avoid delay in the issuance of an MGM proxy statement. 61 T.C. at 3; 60 T.C. at 95. Proxy statements must include information about "short-swing" profits by insiders if such amounts are uncollected by the corporation. *See* 17 C.F.R. § 240.14a-101, Item 7(e), Instruction 4 (1975); *cf.* 45 TEMPLE L.Q. 278, 280 (1972).

Court of Appeals for the Second Circuit reversed and *held*: A payment made in satisfaction of potential liability under section 16(b) of the Securities Exchange Act of 1934 is properly treated as a long term capital loss.[8]

Characterizing an expenditure for federal income tax purposes may involve looking to a prior transaction to which the expenditure is related.[9] In the leading case of *Arrowsmith v. Commissioner*,[10] the

8. Cummings v. Commissioner, 506 F.2d 449 (2d Cir. 1974), *cert. denied*, 421 U.S. 913 (1975). The court in dicta raised another argument. The court stated that the policy of § 16(b) supported long term capital loss treatment for § 16(b) payments, since the section was intended to squeeze all possible profits from stock transactions within its purview. *Id.* at 452; *see* L. Loss, *supra* note 2, at 1063. This purpose must not be frustrated. Anderson v. Commissioner, 480 F.2d 1304, 1308 (7th Cir. 1973), *citing* United States v. Skelly Oil Co., 394 U.S. 678 (1969); Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958); L. Loss, *supra*, at 1085. See Note, *Tax Treatment of 16(b) Payments*, 27 STAN. L. REV. 143 (1974), and 34 OHIO ST. L.J. 917 (1973) for the argument that public policy alone supported the result reached by court of appeals in *Anderson*.

In early cases the Tax Court denied all loss treatment to § 16(b) payments to avoid frustration of public policy. Robert Lehman, 25 T.C. 629 (1955); William F. Davis, Jr., 17 T.C. 549 (1951), *appeal dismissed*, 48 Am. Fed. Tax R. 1406 (9th Cir. 1953). The Tax Court later held that the policy of the 1934 Act was not frustrated by allowing a § 162(a) deduction for § 16(b) payments. Laurence M. Marks, 27 T.C. 464 (1956); Charles I. Brown, 32 CCH Tax Ct. Mem. 1300 (1973). *See* Rev. Rul. 115, 1961-1 CUM. BULL. 46; *cf.* 45 TEMPLE L.Q. 279, 289 (1972).

The basis for this change was apparently the fact pattern in *Marks*, in which a highly reputable businessman made a § 16(b) payment even though the potential violation was very likely inadvertant. *See* Joseph P. Pike, 44 T.C. 787 (1965); Note, *Tax Treatment of Payments for Apparent Violations of Section 16(b) of the Securities Exchange Act of 1934*, 36 ALBANY L. REV. 736 (1972). Inadvertance is not relevant in § 16(b) cases. *See* note 46 *infra*.

9. United States v. Skelly Oil Co., 394 U.S. 678 (1969); Arrowsmith v. Commissioner, 344 U.S. 6 (1952); *see* Rees Blow Pipe Mfg. Co., 41 T.C. 598 (1964), *aff'd per curiam*, 342 F.2d 990 (9th Cir. 1965) (amount paid by seller in satisfaction of judgment for misrepresentation in the sale of a building held capital loss); Estate of James M. Shannonhouse, 21 T.C. 422 (1953) (amounts paid by seller of realty to purchaser in discharge of liabilities for breach of covenant of title held capital loss).

Receipts may also be classified by looking to prior transactions. *See* Merchants Nat'l Bank v. Commissioner, 199 F.2d 657 (5th Cir. 1952) (income on sale of worthless notes held ordinary income); Commissioner v. Carter, 170 F.2d 911 (2d Cir. 1948) (income from contracts following distribution to shareholder held capital gain); Stephen H. Dorsey, 49 T.C. 606 (1968) (income from participating certificates following liquidation distribution to shareholder held capital gain); Alvin B. Lowe, 44 T.C. 363 (1965) (down-payment retained after default held capital gain); *cf.* INT. REV. CODE OF 1954, § 1001 (adjusted basis of property used to determine gain thereon); *id.*, § 1016 (adjustments to basis); *id.*, § 1341 (tax computation for loss of unrestricted right on an item previously included in gross income).

10. 344 U.S. 6 (1952).

transferees of the assets of a liquidated corporation satisfied a judgment against the corporation.[11] The individuals deducted the amount of the judgment as an ordinary loss.[12] The Supreme Court held that, since the taxpayers' liability for the judgment was based on their status as transferees, it was necessary to look back to the transfer in order to characterize the payment. Because the earlier transfer resulted in capital gain,[13] the payment was treated as a capital loss.[14]

In *United States v. Skelly Oil Co.*,[15] the Supreme Court expanded the *Arrowsmith* rule to "forbid an unfair tax windfall" to the taxpayer.[16] The company had overcharged customers. In a later year, the company refunded the amounts overcharged[17] and deducted the total repayment from ordinary income.[18] Since the income resulting from the overcharge had been reduced by the 27½ percent depletion allowance before payment of income taxes,[19] the full deduction of the refund

11. Transferees are liable for judgments against a corporation following liquidation and distribution of corporate assets. Phillip-Jones Corp. v. Parmley, 302 U.S. 233, 235-36 (1937).

12. 344 U.S. at 7. A corporation may deduct as a business expense the amount of a judgment for which it is liable. *See, e.g.*, Caldwell & Co. v. Commissioner, 234 F.2d 660 (6th Cir. 1956); Mulgrew Blacktop, Inc. v. United States, 311 F. Supp. 570 (S.D. Iowa 1969).

In *Arrowsmith*, the corporation would have deducted the judgment from ordinary income had the judgment been rendered before liquidation and transfer of assets. Taxpayers argued that the same procedure, *i.e.* deduction from ordinary income, should apply following liquidation. The Court reasoned, however, that the liquidation changed the procedure. That is, had the judgment occurred in the year of the liquidation, corporate income and corporate assets would have been reduced by the amount of the judgment. The amount of the taxpayers' long term capital gains upon liquidation would, therefore, have been diminished. Thus the postliquidation judgment payment should be characterized as a long term capital loss.

13. 344 U.S. at 7. For federal income tax purposes the final liquidation and distribution of corporate assets is treated as the sale or exchange of a capital asset. INT. REV. CODE OF 1954, § 331(a).

14. 344 U.S. at 8.

15. 394 U.S. 678 (1969).

16. *Id.* at 685.

17. The refunds were required by a decision of the Supreme Court reversing a state corporation commission rate order. Michigan Wis. Pipe Line Co. v. Corporation Comm'n, 355 U.S. 425 (1958).

18. There was a question whether to apply the business expense deduction or the business loss deduction. *See* INT. REV. CODE OF 1954, §§ 162, 165. It was unnecessary to decide the issue since the Commissioner has always allowed one of the two. *See* 394 U.S. at 683 n.3.

19. INT. REV. CODE OF 1954, § 613 allows taxpayers to deduct a fixed percentage of certain receipts to compensate for the depletion of natural resources from which they derive income.

resulted in the "equivalent of a double deduction."[20] The Court disallowed 27½ percent of the deduction,[21] restating the *Arrowsmith* rule: If income was taxed at a special lower rate when received, the taxpayer would be accorded an unfair tax windfall if repayments were fully deductible from ordinary income.[22]

In *William L. Mitchell*[23] and *James E. Anderson*,[24] the Tax Court found the *Arrowsmith* rule inapplicable to section 16(b) payments. Reasoning that the payments were made to protect the insiders' business reputations and were therefore "ordinary and necessary expenses" of doing business,[25] the Tax Court allowed the ordinary business expense

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20. 394 U.S. at 684. When the revenues were received, 27½ percent of the overcharge was deducted pursuant to the depletion allowance. The "practical equivalent of a double deduction" resulted when 100 percent of each refund dollar, each equal to one dollar of overcharge, was also deducted as a loss in a later year, equalling an overall deduction of $1.275 for each dollar of refund. *Id.*

21. The parties in *Skelly Oil* stipulated that if the full deduction claimed by the company was disallowed, the proper deduction should equal the full deduction minus "the percentage depletion allowance . . . claimed . . . in the years of receipt . . . ."

22. 394 U.S. at 685. Although similar to the tax benefit doctrine under INT. REV. CODE OF 1954, § 111, which accords beneficial tax treatment to recovery of bad debts, prior taxes, and delinquent amounts, the *Arrowsmith* rule usually is applied to situations in which payments are made after receipt of income, rather than cases in which income is received after payment. *See* Note, *The Tax Benefit Rule, Claim of Right Restorations, and Annual Accounting: A Cure for the Inconsistencies*, 21 VAND. L. REV. 995 (1968). The leading case explaining the application of § 111 is Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399 (Ct. Cl. 1967), *noted in* 66 MICH. L. REV. 381 (1967).

The *Skelly Oil* approach has been criticized as not following the *Arrowsmith* rule. In *Arrowsmith* the Court looked to the tax *character* of the first of two integrally related transactions to determine the character of the second. In *Skelly Oil* the Court looked to the end result—avoidance of a double deduction. *See* Casey, *Aftermath of* Skelly, 20 TUL. TAX INST. 400, 416-17 (1971); McLane, *Supreme Court Raises More Questions Than It Answers in* Skelly Oil *Decision*, 31 J. TAX. 66 (1969); Rabinovitz, *Effect of Prior Year's Transactions on Federal Income Tax Consequences of Current Receipts or Payments*, 28 TAX L. REV. 85 (1972). *Cf.* Pacific Transp. Co. v. Commissioner, 483 F.2d 209, 215 (9th Cir. 1973).

23. 52 T.C. 170 (1969), *rev'd*, 428 F.2d 259 (6th Cir. 1970), *cert. denied*, 401 U.S. 909 (1971).

24. 56 T.C. 1370 (1971), *rev'd*, 480 F.2d 1304 (7th Cir. 1973).

25. It is well settled that expenses incurred to protect the taxpayer's business reputation are "ordinary and necessary expenses." William L. Mitchell, 52 T.C. 170 (1969); *rev'd on other grounds*, 428 F.2d 259 (6th Cir. 1970), *cert. denied*, 401 U.S. 909 (1971) (taxpayer was a corporate officer); Joseph P. Pike, 44 T.C. 787 (1965) (stockholder); Laurence M. Marks, 27 T.C. 464 (1956) (director); Paul Draper, 26 T.C. 201 (1956) (entertainer); William L. Butler, 17 T.C. 675 (1951) (consultant, officer, director); *but cf.* P. Walter Graham, 40 T.C. 14 (1963), *rev'd on other grounds*, 326 F.2d 878 (4th Cir. 1964) (being solely a director not part of trade or business). The taxpayer's belief

deductions and distinguished *Arrowsmith* on two grounds. The court reasoned that for *Arrowsmith* to apply, the amount of the payment must be "integrally related" to the amount of the gain on the earlier sale of stock, a relationship lacking in these cases.[26] Additionally, the Tax Court reasoned that in section 16(b) cases the taxpayer acts in two capacities, as a shareholder when selling stock and as an insider when making the section 16(b) payment, while in *Arrowsmith* the taxpayers were at all times acting in one capacity.[27]

On appeal, however, the Sixth and Seventh Circuits disallowed the ordinary deductions, and held that when the taxpayer made a section 16(b) payment the *Arrowsmith* rule applied, rather than the deduction for ordinary and necessary business expense.[28] The courts reasoned that the payments had to be treated as long term capital losses because the earlier sales of stock were capital transactions. The sufficient relationship between the section 16(b) payments and earlier sales of stock was provided by section 16(b);[29] the taxpayer acted at all times in the capacity of an insider.[30]

In *Nathan Cummings*,[31] the section 16(b) issue arose for the third time. Noting that "venue for appeal in this case is in the Second

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that injury to his reputation will result must be reasonable. William L. Mitchell, *supra;* Joseph P. Pike, *supra;* Old Town Corp., 37 T.C. 845 (1962); Laurence M. Marks, *supra.*

26. 56 T.C. at 1374-75; 52 T.C. at 174. In *Mitchell* the Tax Court held:

> . . . there is no relationship between the amount of the capital gain realized upon the sale transaction . . . and the amount which "inures" to the stock issuer under section 16(b).

52 T.C. at 174. The circuit courts reached the opposite result by focusing on the relationship between the transactions that § 16(b) created. *See* text accompanying note 29 *infra.*

27. 56 T.C. at 1375-76; 52 T.C. at 175. The Tax Court in *Cummings* relied on United States v. Generes, 405 U.S. 93 (1972), which held that when a party might have acted in one of two capacities, it is necessary to decide in what capacity he acted to determine the nature of the deduction. The Tax Court viewed Cummings as a shareholder when he sold the stock and as a director when making the payment. 61 T.C. at 4. If, however, § 16(b) is recognized in order to apply the *Arrowsmith* rule, then the taxpayer's status as a statutory insider ought to control the *Generes* choice. The Seventh Circuit saw no need for identical capacities in the two transactions in any event. Anderson v. Commissioner, 480 F.2d 1304, 1308 (7th Cir. 1973).

28. 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).

29. 480 F.2d at 1307; 428 F.2d at 263-64. *See* notes 38 & 40 *infra* and accompanying text.

30. 480 F.2d at 1308; 428 F.2d at 263.

31. 60 T.C. 91, *aff'd on rehearing,* 61 T.C. 1 (1973).

Circuit,"[32] the Tax Court again rejected the circuit court decisions, reiterated its earlier reasoning, and added an argument distinguishing *Arrowsmith* and *Skelly Oil.* In those cases, the Tax Court reasoned, the result reached by the Supreme Court was identical to the result that would have been reached under the Internal Revenue Code had the payment and the earlier transaction occurred in the same tax year.[33] Since the Tax Court believed that a section 16(b) payment made in the same tax year as the sale of stock would not be related to the earlier capital transaction under the Code,[34] the court again refused to find the necessary "integral relationship."[35]

On appeal,[36] the Second Circuit followed the Sixth and Seventh Circuits[37] and found that section 16(b) sufficiently related the payment to the earlier sale of stock for the *Arrowsmith* rule to apply.[38] The payment "had its genesis" in the earlier sale; the sale price of the stock was a factor in determining the amount of the payment; and if a deduction against ordinary income were allowed, the taxpayer would realize a tax windfall similar to that disallowed in *Skelly Oil.*[39] The

32. 61 T.C. at 2 (footnote omitted).

33. In the *Arrowsmith* situation the liquidation would have been treated as if it had occurred on the last day of the tax year. INT. REV. CODE OF 1954, § 331. The judgment payment, if made in the same tax year, would have reduced the assets of the corporation before that date. Therefore, the transfer to the taxpayers would have been less the amount of the judgment, in effect reducing the taxpayers' capital gains.

In *Skelly Oil,* the case was simpler. If the corporation had refunded overcharges in the same tax year, it simply would have subtracted the amount of the refunds from the total income earned in the tax year, prior to applying the 27½ percent depletion allowance. INT. REV. CODE OF 1954, § 613.

34. Under the income tax statute alone the § 16(b) payment would not be related to gain or loss on the stock transaction. The long term capital gain on the sale of stock would be charged against the long term capital losses for the year, if any. INT. REV. CODE OF 1954, § 1201. The two transactions would not be combined in any manner.

35. 61 T.C. at 3.

36. Cummings v. Commissioner, 506 F.2d 449 (2d Cir. 1974), *cert. denied,* 421 U.S. 913 (1975).

37. *See* cases cited note 28 *supra* and accompanying text.

38. The majority in *Cummings v. Commissioner* characterized the case as involving "[t]he interplay of two distinct statutory schemes . . . ." 506 F.2d at 449. The Tax Court ignored the provisions of § 16(b) and confined its analysis to tax law. *See* 61 T.C. at 3. Because the § 16(b) payment to MGM and the earlier sale of stock were not related by tax law, the Tax Court found *Arrowsmith* inapplicable. The approach is internally coherent, if the premise that no other statutory scheme should have tax consequences is accepted. The premise, however, was rejected by the courts of appeals. *See* notes 40-46 *infra* and accompanying text.

39. 506 F.2d at 451, *quoting* Mitchell v. Commissioner, 428 F.2d 259, 261 (6th Cir. 1970).

court characterized the payment as a surrender of a portion of the proceeds on the sale of stock,[40] and reasoned that, since the sale resulted in long term capital gain, the surrender should be treated as long term capital loss.[41]

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40. 506 F.2d at 451. The existence of a sufficient relationship between the § 16 (b) payment and the earlier sale of stock does not require a tracing of proceeds from one transaction to the other; however, such a relationship is supported in three ways. First, the sale is the *sine qua non* for the payment. Second, the sale price is one factor in the equation for determining "profit" under § 16(b). *See* note 3 *supra*. Finally, since the economic advantage to the taxpayer is derived from a sale of shares at a high price and purchase of the same shares at a lower price, the payment may fairly be viewed as a return of the difference—the § 16(b) "profit." *See id.*

Of course, variations in the taxpayer's tax situation from year to year will affect the degree to which treatment of the payment as a capital loss will be equivalent to treatment of the gain on the sale of stock as a capital gain. *See* Note, *Tax Treatment of Section 16(b) Payments*, 27 STAN. L. REV. 143, 151-2, 155 (1974). These variations will occur, however, whenever an adjustment is made in one year for an event of an earlier year. United States v. Skelly Oil, 394 U.S. 678, 692 n.1 (1969); *cf.* Nelson, *Tax Deductibility of Insider Profit Repayments: Resolving Apparent Conflict*, 24 CASE W. RES. L. REV. 330 (1973) (suggests a complicated tax adjustment to reflect the "economic reality" of the taxpayer's situation); Rabinovitz, *supra* note 22, at 112.

41. 506 F.2d at 449. Judge Drennen, dissenting in *Nathan Cummings*, recommended that the amount of the § 16(b) payment be added to the basis of the purchased stock. 61 T.C. at 5. The concurring opinion in *Cummings v. Commissioner* agreed. 506 F.2d at 454. This approach combines the refusal of the Tax Court to recognize the effect of § 16(b) on the tax law and the courts of appeals' unwillingness to allow a full deduction:

> The amount of income on the sale . . . has no bearing on the calculation of the insider's profit . . . .
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> . . . [T]he transaction resulting in capital gain terminated with the sale, and the purchase was the initiation of a new transaction that should be considered entirely separate and independent for tax purposes . . . .
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> . . . [T]here is no . . . reason why [the Internal Revenue Code of 1954] must be construed *in pari materia* with the 1934 Securities and Exchange Act [*sic*].

Id. Clearly the concurring opinion would require the § 16(b) violation to have income tax significance of its own, a view similar to the position adopted by the Tax Court. *See* notes 31-35 *supra* and accompanying text. Several commentators have argued for such treatment. *E.g.*, Englebrecht, *The* Arrowsmith *Doctrine: A Review and Analysis*, 52 TAXES 686 (1974); 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); 28 SW. L.J. 625 (1974); 5 TEX. TECH. L. REV. 872 (1974). *See also* Nelson, *supra* note 40.

Although a sale followed by a purchase of stock, as in *Cummings*, has no tax significance, a purchase followed by a sale within six months, also a violation of § 16(b), will result in capital gain or loss, with resulting tax significance. 506 F.2d at 454. In such a situation the concurring opinion and the Tax Court may be more willing to relate the § 16(b) payment to the earlier transaction. *Id.*

Addition of the amount of the 16(b) payment to the basis of the stock in a sale-

The court in *Cummings v. Commissioner* correctly applied the *Arrowsmith* rule in finding that the surrender under section 16(b) was "sufficiently related" to the earlier sale of stock. While the Tax Court required this relationship to be established by the Internal Revenue Code of 1954,[42] the Second Circuit permitted the relationship to be established by section 16(b).[43] *Arrowsmith* and *Skelly Oil* support the latter view. In *Arrowsmith* the payment was made to satisfy a judgment based on corporate law.[44] In *Skelly Oil* the payment was made to satisfy a judgment in a rate case.[45] Similarly, *Cummings v. Commissioner* involved a payment made to satisfy a potential liability based on the Securities Exchange Act of 1934.[46] In each case, the relationship between the payment and the earlier capital transaction was created by law other than the Internal Revenue Code of 1954.

This pattern of cases vitiates the arguments presented by the Tax Court. First, the Court in *Arrowsmith* and *Skelly Oil* focused not on the relationship between the *amounts* of the payment and the earlier capital transaction, but rather on the relationship between the two *transactions*.[47] Second, the Tax Court's argument that in *Arrowsmith* the taxpayers acted in one capacity, as transferees, and that in *Cum-*

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purchase sequence, as suggested by the concurring opinion, is not consistent with *Arrowsmith*, which required immediate tax consequences for a payment related to an earlier transaction. *See* text accompanying notes 42-46 *infra*. Neither party, however, urged adoption of this approach. Nathan Cummings, 61 T.C. 1, 5 (1973).

42. *See* note 26 *supra* and accompanying text. The Tax Court requirement was supported in Note, *Tax Treatment of Payments For Apparent Violations of Section 16(b) of the Securities Exchange Act of 1934*, 36 ALBANY L. REV. 736 (1972).

43. *See* note 38 *supra* and accompanying text.

44. *See* notes 10-14 *supra* and accompanying text.

45. 394 U.S. at 679, *citing* Michigan Wis. Pipe Line Co. v. Corporation Comm'n, 355 U.S. 425 (1958).

46. The majority in *Cummings v. Commissioner* treated the payment as if it were mandated by a judgment despite the lack of adjudication. Their reasoning is sound. Section 16(b) consists of simple elements (a purchase and sale or sale and purchase within six months by a statutory insider). It imposes strict liability—no proof of intent is necessary. Note, *Section 16(b): Insider Trading*, 1974 WASH. U.L.Q. 872. Finally, the taxpayer's defenses to the § 16(b) violation were "frivolous." 506 F.2d at 452. There is no indication in either *Arrowsmith* or *Skelly Oil* that, had the taxpayer in those cases settled in advance of adjudication, the result would have been different.

47. *See* Casey, *supra* note 22, at 410. In *Arrowsmith*, the Court emphasized the relationship between the *payment* of a judgment and the earlier transfer of assets to taxpayers; the *amount* of the judgment against the corporation was related to an earlier violation of fiduciary duty, not the amount transferred. 344 U.S. at 8-9. In *Skelly Oil*, the Court emphasized the relationship between the corporation's refunds and earlier overcharges for natural gas. 394 U.S. at 684-85.

mings v. Commissioner the taxpayer acted in two capacities, as shareholder when selling stock and as insider when making the section 16(b) payment, completely ignores the impact of section 16(b) itself.[48] Section 16(b) makes "short-swing" trading by "insiders" unlawful. That an "insider" may also be described as a "shareholder" is of no consequence. Finally, the Tax Court's argument that the Internal Revenue Code of 1954 would not have related the payment to the earlier sale of stock if both had occurred in the same tax year disregards the effect of permitting section 16(b) to relate sufficiently the payment to the earlier sale under *Arrowsmith.* There is nothing in *Arrowsmith* to suggest that, once the sufficient relationship is established, a timing factor must be considered.

By holding that a payment by a director of a corporation for a potential section 16(b) violation must be treated as a long term capital loss rather than an ordinary deduction, the Second Circuit reversed the Tax Court for the third time. There was no indication in *Nathan Cummings* that the Tax Court will abandon its position[49] and no indication in *Cummings v. Commissioner* that the courts of appeals will abandon their position. Therefore, the Commissioner will assess deficiencies in the remaining circuits whenever taxpayers attempt to treat section 16(b) payments as ordinary deductions rather than long term capital losses.

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48. *See* note 27 *supra* and accompanying text.

49. The Tax Court has permitted an ordinary deduction in a similar case. *See* Charles I. Brown, 32 CCH Tax Ct. Mem. 1300 (1973).