Fordham Urban Law Journal

Volume 14 | Number 1 Article 5

1986

Tax Shelter as a Security: the Use of Tax Returns in a 10b-5 Action

Risa A. Levine

Fordham University School of Law

TAX SHELTER AS A SECURITY: THE USE OF TAX RETURNS IN A 10b-5 ACTION

I. Introduction

For many investors, the reduction in tax liability during the early years of a tax shelter investment[1] is the primary motivation for choosing this type of investment over others that merely offer the promise of future profits.[2] This reduction in tax liability represents an immediate "tangible economic benefit"[3] to the investor despite the delay in the return of profits on the investment.[4]

Where the investment fails to produce the promised return in later years, and the failure can be traced to fraud in the offering memorandum or prospectus, the investor has a right to relief under the

---

1. A tax shelter is "a transaction which accelerates tax benefits into current periods and defers the burden of tax repayment as far into the future as possible." R. HAFT & P. FASS, 1984 TAX SHELTERED INVESTMENTS HANDBOOK 2-2 (1983) [hereinafter cited as HAFT & FASS]. In addition, it is hoped that the investment will generate profits in later years. B. BITTKER, L. STONE, & W. KLEIN, FEDERAL INCOME TAXATION 648 (6th ed. 1984) [hereinafter cited as BITTKER & STONE]; *see* Weisner, *Tax Shelters—A Survey of the Impact of the Tax Reform Act of 1976*, 33 TAX L. REV. 5, 6-8 (1977) [hereinafter cited as Weisner]. "The common characteristic of a tax shelter is the generation of tax losses which are available as deductions under the present tax laws, not only against the income from the tax shelter, but also against the taxpayer's income from other sources." Weisner, *supra*, at 6. In a real estate tax shelter, the taxpayer can create even greater losses through the use of leveraging, that is, nonrecourse financing which increases the amount of his deductions far above his initial investment. See *id.* at 54-56 for a discussion of real estate tax shelters under the 1976 Tax Act.

The purpose of deferral is to "[push] income into the future by incurring costs that are currently deductible and receiving the corresponding return from the investment in some future year." BITTKER & STONE, *supra*, at 648. Conversion allows the taxpayer to convert ordinary income into capital gains, which are taxed at a more favorable rate. Ordinary income becomes capital gain upon sale or exchange of the tax shelter interest if held for over six months. I.R.C. § 1222(4) (1985). The portion of the gain attributable to accelerated deductions which reduced ordinary income is taxed as capital gains. Weisner, *supra*, at 7. This is highly favorable to the taxpayer because 60% of the amount of the net capital gain is a deduction from gross income. I.R.C. § 1202(a) (1985). Thus, although income from the investment may not be recognized for some time, *see* HAFT & FASS, *supra*, at 2-2, the investor receives a "tangible economic benefit." Austin v. Loftsgaarden, 675 F.2d 168, 182 (8th Cir. 1982).

2. Austin v. Loftsgaarden, 675 F.2d 168, 173-74 (8th Cir. 1982).

3. *Id.* at 182.

4. HAFT & FASS, *supra* note 1, at 2-2. "[A] tax benefit dollar is worth just as much as an investment return dollar, and tax benefits can make an investment financially attractive where plainly it would not be but for those benefits." BITTKER & STONE, *supra* note 10, at 653; *see also* Weisner, *supra* note 1, at 6 ("Many

federal securities laws.[5] Nevertheless, an injured tax shelter investor remains in a better financial position than victims of other types of securities fraud.[6] An individual who purchases securities in anticipation of later profits, and subsequently discovers that he has been defrauded, gains nothing of value from the investment.[7] In contrast, a tax shelter investor, while having no prospects of future income from the investment, has achieved something in the short run: he has reduced his tax liability by the amount of his investment.[8] In addition, like other securities investors, he still retains the option to sue for damages caused by the fraudulent sale of securities.[9] Although this difference has been given judicial recognition,[10] the amount of consideration that the trier of fact should allocate to this benefit during the course of a lawsuit remains in dispute.[11] In such a cause of action for fraudulent sale of a tax shelter investment, the investor's tax status is relevant[12] in determining whether he has a valid cause of action[13] and whether he has sustained any actual damages.[14] If the defendant can prove that because of the unique aspects of a tax shelter the tax benefit outweighed any losses, the plaintiff will have failed to establish grounds for relief. This in-

investors enter into tax shelters to reduce the tax liability on their unrelated income").

5. A tax shelter is viewed as a security. *See infra* note 20. Individuals who are injured as a result of securities laws violations are granted the right to relief via the private cause of action under the federal securities laws. *See infra* notes 26-29 and accompanying text.

6. Austin v. Loftsgaarden, 675 F.2d 168, 182 (8th Cir. 1982).

7. *Id.* at 182.

8. *Id.* at 182; *see* Note, *Real Estate Limited Partnerships and Allocational Efficiency: The Incentive to Sue for Securities Fraud*, 63 VA. L. REV. 669, 672-73 (1977) [hereinafter cited as *Incentive to Sue*].

9. See *infra* notes 25-34 and accompanying text for a discussion of the right to a private cause of action for securities fraud.

10. William Z. Salcer v. Envicon Equities Corp., 744 F.2d 935 (2d Cir. 1984); Austin v. Loftsgaarden, 675 F.2d 168 (8th Cir. 1982); Smith v. Bader, 83 F.R.D. 437 (S.D.N.Y. 1979); Bridgen v. Scott, 456 F. Supp. 1048 (S.D. Tex. 1978).

11. *See* Austin v. Loftsgaarden, 768 F.2d 949 (8th Cir.), *cert. granted*, 106 S. Ct. 379 (1985) (*Austin II*); Freschi v. Grand Coal Venture, 767 F.2d 1041 (2d Cir. 1985); William Z. Salcer v. Envicon Equities Corp., 744 F.2d 935 (2d Cir. 1984); Austin v. Loftsgaarden, 675 F.2d 168 (8th Cir. 1982) (*Austin I*) (allowing deduction of tax benefit from damages award, remanding for determination of damages). *But see* Burgess v. Premier Corp., 727 F.2d 826 (9th Cir. 1984) (denying deduction of tax benefit from the damage award); Western Federal Corp. v. Davis, 553 F. Supp. 818 (D. Ariz. 1982) (disallowing deduction).

12. *See infra* notes 70-105 and accompanying text.

13. See *infra* notes 43-69 and accompanying text for a discussion of the elements of the cause of action.

14. See *infra* notes 111-33 and accompanying text for a discussion of actual damages under the securities laws.

formation, in its clearest form, is contained in the individual's tax returns.[15] Compelling an individual to disclose his tax returns, however, conflicts with the public policy favoring confidentiality.[16] The qualified privilege resulting from the public policy can be overcome in "appropriate circumstances,"[17] that is, when a party has put income at issue.[18]

This Note will explore the relevant policy considerations indicating that use of the plaintiff's tax returns in determining whether a cause of action has been established and, if so, the amount of damages incurred, if any, serves the purpose underlying the creation of the private cause of action for securities fraud under federal law.[19] This Note will proceed by examining the elements of a cause of action under Rule 10b-5,[20] the liberal discovery rules which favor allowing use of plaintiff's tax returns,[21] and the theories of damages under

---

15. William E. Salcer v. Envicon Equities Corp., 744 F.2d 935 (2d Cir. 1984); Austin v. Loftsgaarden, 675 F.2d 168, 182-84 (8th Cir. 1982); Dupuy v. Dupuy, 551 F.2d 1005, 1025 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); Beaty v. Basic Resources Int'l, No. 81 Civ. 6189 (S.D.N.Y. June 19, 1985) (available on LEXIS, Genfed library, Cases file).

16. Premier Service Corp. v. Sperry & Hutchinson Co., 511 F.2d 225, 229 (9th Cir. 1975). "[A] public policy against unnecessary public disclosure arises from the need, if the tax laws are to function properly, to encourage taxpayers to file complete and accurate returns." *Id.* at 229; *see also* Smith v. Bader, 83 F.R.D. 437 (S.D.N.Y. 1979); Wiesenberger v. W.E. Hutton & Co., 35 F.R.D. 556 (S.D.N.Y. 1964). "If the statements [contained in the tax returns] may be used against the reporters, they may in some degree be discouraged from making full and true reports." McCormick on Evidence 273 (3d ed. 1984). In recognition of this policy, unauthorized disclosure of tax return information is prohibited by federal law. 26 U.S.C. § 7213(a)(1), (2), (3). Unauthorized disclosure of tax returns and return information by federal and state employees and other persons is a felony punishable upon conviction by a fine in any amount not exceeding $5,000 or imprisonment of not more than 5 years or both, together with the costs of prosecution. *Id.*

Courts, while acknowledging the importance of this interest in confidentiality, have refused to grant tax return information a "general privilege" against disclosure. Premium Service Corp. v. Sperry & Hutchinson Co., 511 F.2d 225, 229 (9th Cir. 1975); Eastern Auto. Distribs., Inc. v. Peugeot Motors of Am., Inc., 96 F.R.D. 147, 148 (E.D. Va. 1982); Smith v. Bader, 83 F.R.D. 437, 438 (S.D.N.Y. 1979); Wiesenberger v. W.E. Hutton & Co., 35 F.R.D. 556, 557 (S.D.N.Y. 1964); Cooper v. Hallgarten & Co., 34 F.R.D. 482, 483 (S.D.N.Y. 1964). Instead, tax returns are entitled to a "qualified privilege." Eastern Auto. Distribs., Inc. v. Peugeot Motors of Am., Inc., 96 F.R.D. 147, 148 (E.D. Va. 1982).

17. Eastern Auto. Distribs., Inc. v. Peugeot Motors of Am., Inc., 96 F.R.D. 147, 148 (E.D. Va. 1982).

18. Where income is at issue, tax returns are both relevant and the best source of information. *Id.*

19. *See infra* notes 70-164 and accompanying text.

20. *See infra* notes 43-69 and accompanying text.

21. *See infra* note 74 and accompanying text.

the securities laws.[22] After weighing the relevant policy considerations on both sides,[23] this Note will recommend that returns be admitted during discovery and during the damages determination.[24]

II. The Right to a Private Cause of Action Under the Securities Laws

A tax shelter is a "security" for purposes of section 2(1) of the Securities Act of 1933 (1933 Act).[25] While a promoter or offeror of a tax shelter may seek an exemption from the registration requirement set forth in section 5 of the 1933 Act,[26] this exemption does not relieve the promoter or offeror from civil liability under the antifraud provisions[27] of the 1933 Act[28] and the Securities Exchange Act of 1934 (1934 Act).[29] The judicially created private cause of action under federal law provides relief to investors in a tax

---

22. *See infra* notes 113-33 and accompanying text.

23. *See infra* notes 165-79 and accompanying text.

24. *See infra* Section VI.

25. "Security" includes any "certificate of interest or participation in any profit sharing agreement [or] . . . investment contract." 48 Stat. 77 (1933) (codified at 15 U.S.C. § 77(b) (1982)) [hereinafter referred to as the 1933 Act]. The term investment contract is not defined by either the 1933 Act or the legislative reports. However, the Supreme Court has defined the term as "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party . . . ." SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946). With respect to a tax shelter, "[i]f the promoters of a tax shelter deal offer investors the opportunity to share in the profits . . . the promoters are . . . offering a security." HAFT & FASS, *supra* note 1, at 3-2.

26. The offeror or promoter may seek, for example, the private offering exemption under § 4(2) of the 1933 Act or one of the exemptions contained in Regulations A or D, promulgated by the Securities Exchange Commission (17 C.F.R. §§ 230.251-.262 (1984) and 17 C.F.R. §§ 230.504-.505 (1984), respectively).

27. "[Exempted] transactions are not exempt from the antifraud, civil liability, or other provisions of the federal securities laws." Preliminary notes to Regulation D, 17 C.F.R. § 230.501 (1984).

28. 15 U.S.C. § 77*l* (1982). Section 12(2) of the 1933 Act prohibits making an offer or sale "by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading . . . ." 15 U.S.C. § 77*l*(2).

29. 15 U.S.C. § 78j(b) (1982). Rule 10b-5, 17 C.F.R. § 240.10b-5 (1984), promulgated under § 10(b) of the Securities Exchange Act of 1934, Pub. L. No. 291, 48 Stat. 881 (codified at 15 U.S.C. §§ 78a-78kk (1982)) [hereinafter referred to as the 1934 Act], prohibits employment of "any manipulative or deceptive device," and applies to all transactions involving a security, regardless of their registration status under the 1933 Act. *See* HAFT & FASS, *supra* note 1, at 3-26.

shelter or other security who are injured as a result of any fraudulent misrepresentation or omission in the transaction.[30]

The right to a private cause of action under the securites laws, first recognized in 1946,[31] has been affirmed by the Supreme Court.[32] The action was created to provide plaintiffs with a mechanism to seek compensation for injuries sustained as a result of violations of the securities laws,[33] and is implied from the purpose behind the securities laws—the " 'protection of investors,' which certainly implies the availability of judicial relief where necessary to achieve that result."[34]

After the private cause of action was recognized, the federal courts formulated the elements that a plaintiff would have to prove in order to recover for a fraudulent sale of securities[35] under Rule 10b-5.[36] These can now be stated in "black letter fashion:"[37]

(1) a misstatement or omission[38]
(2) of a material fact[39]
(3) made with scienter[40]
(4) on which plaintiff relied[41]
(5) that proximately caused his injury.[42]

---

30. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976).

31. Kardon v. Nat'l Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946) (cited with approval in Superintendent of Ins. v. Bankers Life and Cas. Co., 404 U.S. 6, 13 n.9 (1971)).

32. *See, e.g.*, Ernst & Ernst v. Hochfelder, 425 U.S. 185, 196 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975); J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964).

33. The action is limited to actual purchasers and sellers of securities and does not allow recovery for "intangible economic injury such as loss of a noncontractual opportunity to buy or sell . . . ." Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 734 (1975).

34. J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964).

35. *See, e.g.*, Simpson v. Southeastern Inv. Trust, 697 F.2d 1257 (5th Cir. 1983); Huddleston v. Herman & MacLean, 640 F.2d 534 (5th Cir. 1981), *aff'd in part, rev'd in part*, 459 U.S. 375 (1983); Straub v. Vaisman & Co., 540 F.2d 591 (3d Cir. 1976); Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975).

36. While section 12(2) of the 1933 Act (15 U.S.C. § 77*l*(2)) is often asserted as a basis for a cause of action for fraud in the offer or sale of securities, most litigation centers on Rule 10b-5 as the primary basis for recovery. *See* DOBBS, HANDBOOK OF THE LAW OF REMEDIES 613 (1973). This Note will focus on Rule 10b-5, but will refer to section 12(2) where appropriate.

37. Huddleston v. Herman & MacLean, 640 F.2d 534, 543 (5th Cir. 1981).

38. *See infra* notes 43-44 and accompanying text.

39. *See infra* notes 45-47 and accompanying text.

40. *See infra* notes 49-54 and accompanying text.

41. *See infra* notes 55-67 and accompanying text.

42. *See infra* notes 68-69 and accompanying text.

A. The elements of a Private Cause of Action

1. Misrepresentation or Omission

Rule 10b-5 prohibits the misstatement of a material fact or the omission of a material fact which tends to make the statement misleading.[43] Although either a misrepresentation or omission triggers liability, the standard of proof necessary to sustain a cause of action is greater for a misrepresentation than for an omission.[44]

2. Materiality

To give rise to a cause of action for fraud under the securities laws, the misrepresentation or omission must be of a *material* fact.[45] A material fact is defined as one which "a reasonable [investor] would consider . . . important."[46] The fact need not be the determinative factor in making the investment decision but rather one which "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[47]

3. Scienter

After reviewing Congressional intent in the legislative history of the 1933 and 1934 Acts, the Supreme Court in *Ernst & Ernst v.*

---

43. See *supra* note 29 for the text of Rule 10b-5. Section 12(2) also prohibits a misstatement or omission of a material fact in registration statements. See *supra* note 23 for the text of section 12(2).

44. In 10b-5 cases involving a material omission, positive proof of reliance is not a prerequisite to recovery. Affiliated Ute Citizens v. United States, 406 U.S. 128, 153 (1972). If the omission is material, reliance is presumed. *Id.* at 153-54. See *infra* notes 55-59 and accompanying text for a discussion of reliance. *See also* Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 HARV. L. REV. 584 (1975) (discussion of *Affiliated Ute* and its effect on the elements needed to prove fraud under Rule 10b-5).

45. See *supra* note 23 for the text of section 12(2) of the 1933 Act (15 U.S.C. §77*l*(2)). *See* TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976); Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972); Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975); Rogen v. Ilikon Corp., 361 F.2d 260, 266 (1st Cir. 1966).

46. TSC Industries, Inc. v. Northway, Inc., 426 U.S. at 449. This case was brought for fraud in a proxy statement under Rule 14a-9 (17 C.F.R. § 240.14a-9). However, the test for materiality stated by the Supreme Court is the one used in all actions brought under the securities laws. Loss, FRAUD: AND CIVIL LIABILITY UNDER THE FEDERAL SECURITIES LAWS 11 (1983) [hereinafter cited as Loss]; *see* Simpson v. Southeastern Inv. Trust, 697 F.2d 1257 (5th Cir. 1983).

47. TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976); *see*

Hochfelder[48] held that since section 10(b) was addressed to transactions involving some element of scienter,[49] a private cause of action brought under section 10(b) and Rule 10b-5 would not lie absent an allegation of scienter.[50] To establish scienter, the plaintiff must show that the defendant had knowledge that his statements were false or misleading[51] or that he acted recklessly.[52] Negligence alone, however, is not sufficient.[53] In determining whether the defendant should be charged with scienter, the test is whether the information necessary to make the statement true reasonably could have been obtained.[54]

4. *Reliance*

For a plaintiff to recover in a Rule 10b-5 action, he must prove that he either relied on the fraudulent statement,[55] or exercised due diligence[56] in researching the investment offer. The reliance requirement prevents the cause of action from being merely an enforcement mechanism against violations of the securities laws[57] by requiring

---

Project, *Recent Developments in Securities Law: Causes of Action under Rule 10b-5*, 26 BUFFALO L. REV. 505, 516-23 (1976) (discussion of materiality) [hereinafter cited as *Recent Developments*].

48. 425 U.S. 185 (1976).

49. *Id.* at 201.

50. *Id.* at 202; *see also*, Aaron v. SEC, 446 U.S. 680, 695 (1980) (scienter is necessary element of cause of action for violation of § 10(b) and Rule 10b-5).

51. "The term 'scienter,' as applied to conduct necessary to give rise to an action for civil damages under [the] Securities Exchange Act of 1934 and rule 10b-5 refers to a mental state embracing intent to deceive, manipulate, or defraud." BLACK'S LAW DICTIONARY 1207 (5th ed. 1979); *see* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

52. Keirnan v. Homeland, Inc., 611 F.2d 785, 787 (9th Cir. 1980).

53. Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). "[T]he judicially created private damages remedy under § 10b . . . cannot be extended, consistently with the intent of Congress, to actions premised on negligent wrongdoing." *Id.* at 210.

54. Kiernan v. Homeland, Inc., 611 F.2d 785, 788 (9th Cir. 1980); *see* Loss, *supra* note 46, at 19-21; *see also Recent Developments*, *supra* note 47, at 543-52.

55. Dupuy v. Dupuy, 551 F.2d 1005, 1016 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977).

56. *Id.* at 1014.

57. *Id.* at 1016; Straub v. Vaisman & Co., 540 F.2d 591, 596 (3d Cir. 1976). Rule 10b-5 was promulgated by the Securities Exchange Commission in the exercise of its broad enforcement powers and it allows the Commission to bring an action against the perpetrator of fraud and punish him appropriately, but it does not establish prerequisites for recovery of damages by victims of stock fraud. Dupuy v. Dupuy, 551 F.2d at 1013. The private cause of action was established for the purpose of compensating victims for losses resulting from violations of the securities laws. *Id.* at 1013; *see* J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964).

the plaintiff to prove that the fraudulent statement, which is the subject of the litigation, was a causal link in the chain of injury.[58] Without positive proof that the plaintiff's injury resulted directly from the fraud, any recovery would serve only to punish the defendant and to provide a windfall to the plaintiff. The plaintiff must prove that he invested in reliance on the statement, thus making it the proximate cause of his injury.[59]

The plaintiff's duty of due diligence, sometimes treated as a separate element,[60] was added in recognition of the "policies underlying the federal securities laws, and the judicially created causes of action, where encouragement of watchfulness in the marketplace has obvious benefits."[61] If, in the exercise of due care, the plaintiff fails to discover the fraud and continues to invest, he has established grounds upon which a court can award a recovery.[62]

The due diligence requirement is highly subjective in nature.[63] The standard of care imposed on the plaintiff is that of the reasonable person with the attributes of the *plaintiff*.[64] Courts readily acknowledge that different parties, with varying investment experience, should be held to different levels of care when investigating investment offers.[65] "The principle consideration should be whether the plaintiff,

58. Dupuy v. Dupuy, 551 F.2d at 1016. If the fraudulent statement induced the plaintiff to invest where he ordinarily would not have, there is a sufficient causal link to prove reliance. Marbury Management, Inc. v. Kohn, 629 F.2d 705, 708 (2d Cir.), *cert. denied*, 449 U.S. 1011 (1980). "[If] the misrepresentation was such as to induce both their purchases and their holding of the securities, their holding and its duration determined the extent of their losses." *Id.* at 708; *see also Recent Developments*, *supra* note 47, at 523.

59. Marbury Management, Inc. v. Kohn, 629 F.2d at 708; *see also Recent Developments*, *supra* note 47, at 531-42 (discussion of causation).

60. The Fifth Circuit treats due diligence as a separate requirement. Dupuy v. Dupuy, 551 F.2d at 1014; *see* Clement A. Evans & Co. v. McAlpine, 434 F.2d 100 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971); *accord* Bird v. Ferry, 497 F.2d 112 (5th Cir. 1974), Vohs v. Dickson, 495 F.2d 607 (5th Cir. 1974); *see also* Note, *The Due Diligence Requirement for Plaintiffs under Rule 10b-5*, 1975 DUKE L.J. 753, 760-61 [hereinafter cited as *Due Diligence*].

61. Straub v. Vaisman & Co., Inc., 540 F.2d 591, 597 (3d. Cir. 1976).

62. Dupuy v. Dupuy, 551 F.2d at 1014. "[G]eneral principles of equity suggest that only those who have pursued their own interests with care and good faith should qualify for the judicially created private 10b-5 remedies." *Id.* at 1014.

63. *Id.* at 1016, 1023.

64. *Id.* at 1017. Among the attributes considered are: (1) the existence of a fiduciary relationship; (2) concealment of the fraud; (3) opportunity to detect it; (4) position in the industry; (5) sophistication and expertise in the financial community; and (6) knowledge of related proceedings. *Id.* at 1016.

65. *Id.* at 1017; Straub v. Vaisman & Co., Inc., 540 F.2d 591, 598 (2d Cir. 1976); *see Due Diligence*, *supra* note 60, at 779.

by virtue of his position, has access in fact to the particular information needed to uncover the fraud."[66] This "floating standard" was introduced to implement the securities laws' goal of promoting investor responsibility in making investment decisions.[67]

5. *Injury*

As a precondition to sustaining a cause of action under Rule 10b-5, the plaintiff must also prove that he was injured in fact, or suffered actual harm as a result of the defendant's misrepresentation or omission.[68] This requirement is in keeping with the primary purpose of the cause of action: to provide compensation for injury.[69]

III. Defendant's Need for Plaintiff's Tax Returns to Refute the Elements of the Cause of Action

The plaintiff's tax returns would prove to be highly useful to the defendant at the discovery stage in refuting the plaintiff's assertions relating to the elements of a cause of action. Specifically, they would enable the defendant to undercut the plaintiff's claims of materiality,[70] reliance[71] and due diligence.[72]

Discovery rules appear to favor granting a party's request for discovery of tax returns.[73] However, social policy interests favor

---

66. Dupuy v. Dupuy, 551 F.2d at 1022.

67. *See* TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 448 (1976). The broad remedial purpose of the Securities Acts is to "ensure disclosures by corporate management in order to enable the shareholders to make an informed choice." *Id.*

68. Shapiro v. Midwest Rubber Reclaiming Co., 626 F.2d 63, 69 (8th Cir. 1980), *cert. denied*, 449 U.S. 1079 (1981). "[D]amages for securities fraud are determined in accordance with the extent to which false and misleading information actually harmed the complaining party." *Id.*

69. The compensatory nature of the action is clearly evidenced from the fact that the damage is measured by fair market value of what plaintiff received and what would have been received absent fraudulent conduct. *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 155 (1972); Dupuy v. Dupuy, 551 F.2d 1005, 1024-25 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977).

70. *See supra* notes 45-47 and accompanying text.

71. *See supra* notes 55-59 and accompanying text.

72. *See supra* notes 60-67 and accompanying text.

73. Rule 26(b)(1) of the Federal Rules of Civil Procedure, FED. R. CIV. P. 26(b)(1), states: "*In General.* Parties may obtain discovery regarding any matter not privileged, which is relevant to the subject matter involved in the pending action, whether it relates to the claim or defense of the party seeking discovery or to the claim or defense of any other party. . . . " The policy is to provide discovery into a broad range of matters that will assist a party in preparing a case for litigation. *See* 8 C. WRIGHT & A. MILLER, FEDERAL PRACTICE AND PROCEDURE § 2007, at 37-38 (1970) [hereinafter cited as WRIGHT & MILLER]; *see also* General

recognizing the need for privacy of tax return information.[74] Although courts have declined to grant an absolute privilege against disclosure of tax returns,[75] they "have recognized that interests in privacy may call for a measure of extra protection."[76] This may be accomplished, in each case, by examining the purpose for which the returns are sought and by determining whether this policy will be thwarted. Another method of protecting the returns has been to recognize a "qualified privilege,"[77] which requires the party seeking discovery to prove not only relevance, but that the information sought is not readily obtainable from any other sources.[78]

An analysis of the need for income tax returns in an action for damages against the offeror or promoter of a tax shelter for fraud

---

Tel. & Elecs. Laboratories, Inc. v. National Video Corp., 297 F. Supp. 981, 984 (N.D. Ill. 1968) ("Federal Rules of Civil Procedure provide for the broadest possible discovery and courts have consistently so maintained"). In fact, courts have construed this rule as "envision[ing] generally unrestrictive access to sources of information." Horizons Titanium Corp. v. Norton Co., 290 F.2d 421, 425 (1st Cir. 1961); *see also* Grauer v. Schenley Products Co., 26 F. Supp. 768 (S.D.N.Y. 1938) (providing that the information sought is relevant to the subject matter of the litigation). In defining what the requirements of relevancy entail, Wright & Miller state that "it is not too strong to say that a request for discovery should be considered relevant if there is any possibility that the information sought may be relevant to the subject matter of the action." WRIGHT & MILLER, *supra*, § 2008, at 46-47.

One limitation to this extensive grant of accessibility, stated in the rule itself, is that privileged information is outside the scope of discovery ("any matter, not privileged . . ."). FED. R. CIV. P. 26(b)(1). Confidential information, however, is not given this statutory protection. Luey v. Sterling Drug, Inc., 240 F. Supp. 632, 636 (W.D. Mich. 1965) (matters must be privileged to be outside the scope of discovery, confidential matters are not excluded). Those seeking to deny disclosure of particular information must turn to the judiciary for protection. *See* FED. R. CIV. P. 26(b) 1970 Amendment Advisory Committee Notes ("Rule 26(c) [FED R. CIV. P. 26(c)] confers broad powers on the courts to regulate or prevent discovery even though the materials sought are within the scope of 26(b), and these powers have always been freely exercised."); *see also* WRIGHT & MILLER, *supra*, at 47 ("If protection [from disclosure] is needed, it can better be provided by the discretionary powers of the court . . .").

74. Premium Service Corp. v. Sperry & Hutchinson Co., 511 F.2d 225, 229 (9th Cir. 1975); Eastern Auto. Distribs., Inc. v. Peugeot Motors of Am., Inc., 96 F.R.D. 147, 148 (E.D. Va. 1982); Smith v. Bader, 83 F.R.D. 437, 438 (S.D.N.Y. 1979); Wiesenberger v. W.E. Hutton & Co., 35 F.R.D. 556, 557 (S.D.N.Y. 1964); Cooper v. Hallgarten & Co., 34 F.R.D. 482, 483 (S.D.N.Y. 1964).

75. Smith v. Bader, 83 F.R.D. 437, 438 (S.D.N.Y. 1979); Houlihan v. Anderson-Stokes, Inc., 78 F.R.D. 232, 234 (D.D.C. 1978); Cooper v. Hallgarten & Co., 34 F.R.D. 482, 483 (S.D.N.Y. 1964).

76. FED R. CIV. P. 26(b) 1970 Amendment Advisory Committee Notes.

77. Eastern Auto. Distribs., Inc. v. Peugeot Motors of Am., Inc., 96 F.R.D. 147, 148 (E.D. Va. 1982).

78. *Id.* at 148-49.

under Rule 10b-5 entails balancing the factors favoring their use against the plaintiff's interest in confidentiality. If the returns are found to be uniquely relevant to the cause of action or, alternatively, disclosure in this instance does not thwart the policy upon which confidentiality is based, the returns should be disclosed.

The plaintiff's tax returns are vital to the defendant's efforts to refute the allegations against him. The returns provide valuable information regarding the plaintiff's level of sophistication as an investor, which is relevant to the issues of due care[79] and materiality of the fraud.[80] By revealing what plaintiff's tax liability would be without any methods of sheltering income, the tax returns may also reveal plaintiff's motivations for investing, which is relevant to the reliance element.[81]

In addition, the returns will indicate the effect the investment had on the plaintiff's tax liability, which will impact on the injury issue.[82] Withholding the tax returns would result in an incomplete understanding of the transaction in question. As one court aptly stated: "[r]equiring the jury or this Court to try this case without reference to the tax consequences of the transaction would be requiring the jury and the Court to live in an artificial 'never-never land'. . . . [It would be] tantamount to requesting this Court and the jury to try this case blindfolded."[83]

A study of the plaintiff's tax returns would provide information as to the extent of his experience as an investor.[84] Congress promulgated the securities laws to protect innocent investors against injury resulting from uninformed investment decisions.[85] Consequently, there are rigorous registration[86] and reporting[87] requirements

---

79. *See supra* notes 60-67 and accompanying text.

80. *See supra* notes 45-47 and accompanying text.

81. *See supra* notes 55-59 and accompanying text.

82. *See supra* notes 63-64 and accompanying text.

83. Bridgen v. Scott, 456 F. Supp. 1048, 1061 (S.D. Tex. 1978).

84. Smith v. Bader, 83 F.R.D. 437, 439 (S.D.N.Y. 1979).

85. "The basic objective of the Securities Act is the protection of the public and securities investors by requiring . . . full disclosure of information thought necessary to informed investment decisions. . . . A further objective of the Act is to protect honest enterprise . . . from the competition of securities offered to the public pursuant to misrepresentations and fraudulent promotion . . . ." 69 AM. JUR. 2D *Securities Regulation—Federal* § 13 (1964); *see also* SEC v. Ralston Purina Co., 346 U.S. 119 (1953); SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946).

86. For registered offerings under section 5 of the Act, 48 Stat. 77 (1933) (codified at 15 U.S.C. § 77e(c) (1982)), the offeror must comply with the stringent requirements set out in Schedule A.

87. The 1934 Act, 48 Stat. 881 (1934) (codified at 15 U.S.C. § 78 (1982)),

for publicly-held securities and less stringent requirments for private companies[88] and limited offerings.[89] Underlying these distinctions, which take into consideration the relative sophistication of the investor,[90] is the recognition by the Securities Exchange Commission (SEC) that a sophisticated investor needs less protection than a novice.[91]

In determining whether the allegedly injured investor was afforded the degree of disclosure appropriate for his level of experience, the trier-of-fact should examine all evidence relating to the investor's experience, including information contained within the tax returns. A sophisticated investor would be aware of the types of claims made by promoters, be able to assess the degree to which they could be trusted, and know the means by which claims could be investigated, and, therefore, should be held to a higher level of care.[92] The more sophisticated the investor, the more likely it is that he at least had constructive knowledge of the fraud, that is, with reasonable investigation he could have uncovered the fraud, and the less likely it is that he will be able to establish a cause of action.[93] If the investor invests in a project with knowledge that a statement in the prospectus or offering memoranda is fraudulent, the element of materiality is undercut.[94] Similarly, where a party has constructive knowledge of the fraud, he should be denied a recovery for failure to exercise due diligence.[95] Furthermore, if the returns provide evidence suggesting that the investor has extensive experience with tax

---

regulates the trading of securities on the market and requires continuous reporting of information necessary to keep investors informed.

88. The private offering exemptions are contained in section 4(2) (15 U.S.C. § 77(d)(2)), section 4(6) (15 U.S.C. § 77(d)(6)) and Rule 506 (17 C.F.R. § 230.506) (1985).

89. Limited offering exemptions are contained in Regulations A, 17 C.F.R. § 230.251-.263, and Regulation D. 17 C.F.R. § 230.504-.506.

90. "Actually, no cases appear to have arisen involving the duty of sophisticated plaintiff investors to apply their common sense in interpreting information supplied to them in a securities transaction. Undoubtedly, however, placing such a burden on sophisticated investors would be reasonable." *Due Diligence*, *supra* note 60, at 779, n.132.

91. The exemptions contained in Regulation A and Regulation D for small or private offerings recognize that registration of certain types of offerings are not necessary to protect investors in these types of offerings since the offering or sale of securities is limited to the type of investor who has a greater level of sophistication and experience in making investment decisions or who has particular knowledge in the specific area of securities being offered. 69 AM. JUR. 2D *Securities Regulation—Federal* § *49*.

92. *See supra* notes 64-67 and accompanying text.

93. *See* Straub v. Vaisman & Co., 540 F.2d 591, 596-97 (3d Cir. 1976).

94. *Id.* at 596. See *supra* notes 45-47 and accompanying text for a discussion of materiality.

95. *Straub*, 540 F.2d at 596-97; *see supra* notes 60-67 and accompanying text.

shelters, a court could find that the investor actually knew that the transaction would fail to produce any future income and that the investor invested merely to reduce his tax liability.[96] Such investments constitute "abusive tax shelters," an abuse of the tax laws that the Internal Revenue Service seeks to prevent.[97]

While an individual's tax returns cannot provide conclusive evidence of tax shelter abuse, a pattern of unsuccessful investments could alert a court to the possibility of abuse and lead to prosecution. An investor should not be able to assert the privilege of confidentiality to shield wrongful investments. Moreover, an investor who has entered into an investment with dubious belief in the probability of it generating any income should be precluded from claiming damages when the investment actually fails to produce income.

One court argues that by furnishing data on the plaintiff's income level and tax bracket, tax returns also indicate the usefulness of the particular tax shelter to the plaintiff.[98] This information could be used to establish plaintiff's motivation in making the investment.[99] If the defendant were able to prove that the plaintiff's primary motivation for making the investment was to obtain tax benefits,[100] he would succeed in defeating plaintiff's cause of action; the causal link between the fraud and the injury would be eradicated, and the plaintiff would have failed to prove reliance.[101]

In order to recover any money damages, plaintiff must show positive proof of injury resulting from the fraud.[102] The first measure of the investment's success is the amount of the deductions created by losses in the venture.[103] Here, too, tax returns are relevant since

96. *See* New York Times, October 1, 1984, at D1, col. 1.

97. *Id.* at D1, col. 1 ("The Government regards as abusive the shelters that promise immediate deductions . . . especially if the venture seems to have little prospect of earning profits").

98. Smith v. Bader, 83 F.R.D. 437, 439 (S.D.N.Y. 1979).

99. Burgess v. Premier Corp., 727 F.2d 826, 836 (9th Cir. 1984); Bridgen v. Scott, 456 F. Supp. 1048, 1062 (S.D. Tex. 1978).

100. The value to an investor of a tax deduction is so great that damages are recoverable under the securites laws, where, because of fraud by the offeror, tax write-offs, taken by the investor, are disallowed by the Internal Revenue Service. *See* Sharp v. Coopers & Lybrand, 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982).

101. If, because of the fraud, plaintiff is denied the tax benefits, he will be able to recover since the statement that was fraudulent was relied upon when making the purchase. *See supra* notes 55-59 and accompanying text.

102. *See supra* notes 45-47 and accompanying text.

103. Because of the expectancy of this type of benefit, "the investor normally pays a higher price for a tax shelter investment than for one involving simply future growth or income." William Z. Salcer v. Envicon Equities Corp., 744 F.2d 935, 940 (2d Cir. 1984).

they will show what the net outcome of the transaction was.[104] If the benefits from the reductions outweighed the losses, no injury occurred, and therefore, no recovery can be awarded.[105]

Once the relevance of the tax returns has been established, the party seeking disclosure of the returns must show that there is a compelling need for the returns to be produced, i.e., that the information contained within them is not readily obtainable from other sources.[106] In an early case, the court held that the plaintiff's availability for questioning about the information contained in his tax return precluded forcing disclosure of the returns.[107] The efficacy of such interrogation is questionable. As indicated by later cases, questioning the taxpayer is clearly inferior to gleaning the information directly from the source, that is, the tax returns.[108] Tax returns would furnish the court with relevant data relating to the issues under consideration. Moreover, producing the tax returns would not thwart the public policy against disclosure. This policy was instituted to encourage accurate reporting of all income.[109] The purpose of disclosure in this instance is to examine the amount of the deduction. The incentive to show this deduction is not discouraged by disclosure.[110]

IV. The Need for Tax Return Information to Determine Damages

Assuming that the information contained in the plaintiff's tax returns was insufficient to defeat his cause of action, damages[111] for

104. Smith v. Bader, 83 F.R.D 437, 439 (S.D.N.Y. 1979).

105. There must be some out-of-pocket loss, i.e., injury, for plaintiff to recover. *See infra* notes 129-33 and accompanying text.

106. Eastern Auto. Distribs., Inc. v. Peugeot Motors of America, Inc., 96 F.R.D. 147, 148 (E.D. Va. 1982); Smith v. Bader, 83 F.R.D. 437, 438 (S.D.N.Y. 1979).

107. Cooper v. Hallgarten & Co., 34 F.R.D. 482, 484-85 (S.D.N.Y. 1964).

108. Bridgen v. Scott, 456 F. Supp. 1048, 1061-62 (S.D. Tex. 1978); Smith v. Bader, 83 F.R.D. at 439.

109. *See supra* note 66 and accompanying text; Smith v. Bader, 83 F.R.D. at 439.

110. Houlihan v. Anderson-Stokes, Inc., 78 F.R.D. 232, 234 (D.D.C. 1978); Smith v. Bader, 83 F.R.D. at 439.

111. "[T]he main purpose of the damages award is some rough kind of compensation for the plaintiff's loss." D. DOBBS, HANDBOOK OF THE LAW OF REMEDIES 136 (1973) [hereinafter cited as DOBBS]. Any opportunity the plaintiff has to minimize his losses should be reflected in the damage award so that all economic waste is avoided. Application of this rule has the "further effect of excluding any recovery that would be deemed economically wasteful." *Id.* at 189. Thus, "[w]here the defendant's tortious misconduct causes damages, but also operates directly to confer

plaintiff's losses must be determined.[112] Since the award for damages for fraud under the securities laws is discretionary and a definitive formula for damages for fraudulent tax shelters has not been established,[113] plaintiff's tax returns present issues of material fact and should be admitted.[114]

---

some benefit upon the plaintiff, the plaintiff's claim for damages may be diminished by the amount of the benefit received." *Id.* at 181. A caveat to this is that reducing the damage award should be "done, however, only where it is 'equitable.' " *Id.*

112. "The question of liability and relief are separate. Therefore, a finding that the defendant is liable does not resolve the issue of the proper remedy." 5B A. JACOBS, THE IMPACT OF RULE 10B-5, § 259, at 11-5 (1980) [hereinafter cited as JACOBS].

113. In a common law action for fraud in a bargaining transaction, two general principles of damages are in use. The most common is the benefit of the bargain rule, entitling the plaintiff to recover the difference between the actual value of the property, and the value he would have received absent the misrepresentation. This rule puts him in the same position he would have been in had the fraudulent misrepresentations actually been true. DOBBS, *supra* note 111, at 594-95. The second measure, which is a restitutionary measure, allows the plaintiff to recover the difference between the amount paid for the item and its actual value. This approach is designed to return the plaintiff to the same financial position he was in before the transaction occurred, and is called the "out-of-pocket" measure. *Id.* at 595. This approach is generally used in securities fraud litigation because recovery is keyed to plaintiff's injury rather than to disgorge defendant's benefit. JACOBS, *supra* note 112, § 260.03[a], at 11-15 (1980). A third approach, enabling a court to accomplish substantial justice, allows for flexibility in the measuring of damages by permitting the court to examine the specific facts of the case at bar. DOBBS, *supra* note 111, at 596. This is the approach that should be taken in securities litigation because courts should have discretion to choose the remedy best suited to the harm. This method is most likely to yield results consistent with the purpose of the securities laws, which is to protect individuals from loss in the securities market. SEC v. Ralston Purina Co., 346 U.S. 119 (1953). Furthermore, "overwhelming liability [that may accompany a benefit of the bargain remedy] may adversely affect members of the very class to be protected, that is, innocent investors." DOBBS, *supra* note 111, at 615. For this reason, even where a rescissionary measure of damages is applied, "[t]he actual damages principle requires that a rescissional . . . award be 'reduced by any value received as a result of the fraudulent transaction.' " Austin v. Loftsgaarden, 675 F.2d 168, 181 (8th Cir. 1982); *see also* JACOBS, *supra* note 102, § 260.03[a], at 11-15 (1980). Courts have applied different methods to arrive at the damage figure. *See infra* notes 115-18 and accompanying text. The inconsistency in the cases stems from the fact that the whole area of damages under Rule 10b-5 is in dispute. In fact, "there has been so much variation in the cases that it is tempting to conclude that '[t]here is no law of damages under Rule 10b-5,—that the courts have taken an *ad hoc* approach and that, broadly using the common law out-of-pocket measure as an initial reference point, the appellate courts have exercised the discretion traditionally left to the trial courts in finding damages appropriate to the facts of the case." 2 Federal Securites Code 789 (quoting Note, *Measurement of Damages in Private Actions Under Rule 10b-5,* 1968 WASH. U.L.Q. 165, 179).

114. Austin v. Loftsgaarden, 675 F.2d 168 (1982). The defendant's argument, that "the evidence [of tax benefit is] crucial to the issue of whether plaintiffs, regardless of whether they had been defrauded, suffered any actual damages," was

The compensatory theory[115] of recovery for fraud[116] under the securities laws[117] limits the plaintiff's recovery to the extent defendant's violation "actually harmed" him.[118] Once the plaintiff establishes that the defendant knowingly[119] made a material[120] misrepresentation or omission[121] upon which plaintiff relied[122] and which injured him,[123] the question of damags must be considered. In fraud cases under the securities laws, where a party sues for rescissionary damages,[124] the plaintiff's recovery is limited to his net economic loss[125] in the transaction.[126]

---

accepted by the court, and the case was remanded for further hearings on the issue of damages. *Id.* at 182. Plaintiffs/Investors had sued the individual and corporate defendants for fraud in the offering memorandum under Rule 10b-5 and section 12(2) of the 1933 Act and state anti-fraud laws. The individual defendant was the offeror of a partnership interest in a real estate venture which would "operate as a tax shelter leading to significantly greater returns for persons in relatively high income brackets." *Id.* at 173.

115. "One who suffers a legally recognized injury is usually entitled to an award of damages . . . . The damages award is substitutionary relief, that is, it gives the plaintiff money mainly by way of compensation, to make up for some loss that . . . ordinarily may be measured in money." DOBBS, *supra* note 111, at 135.

116. A fraudulent representation "invades the economic interests of the deceived person." *Id.* at 591.

117. The statutory liability for fraud in the prospectus or offering statement is contained in section 12(2) and provides for recovery of "the consideration paid for such security with interest thereon, less the amount of such security, or for damages if he no longer owns the security." 48 Stat. 77 (codified at 15 U.S.C. § 77*l* (1982)). This provision contemplates rescission and restitution as the basic remedy and limits the recovery of damages to situations where the purchaser no longer owns the security. DOBBS, *supra* note 111, at 613. Section 28(a) of the 1934 Act, ch. 404, § 28, 48 Stat. 903 (1934) (codified at 15 U.S.C. § 78bb(a) (1982)), provides relief for actual damages suffered by an investor as a result of wrongs committed in violation of the 1934 Act. The purpose is to compensate civil plaintiffs for economic loss. Osofsky v. Zipf, 645 F.2d 107, 111 (2d Cir. 1981).

118. Shapiro v. Midwest Rubber Reclaiming Co., 626 F.2d 63, 69 (8th Cir.), *cert. denied*, 449 U.S. 1079 (1980).

119. *See supra* notes 48-54 and accompanying text.

120. *See supra* notes 45-47 and accompanying text.

121. *See supra* notes 43-44 and accompanying text.

122. *See supra* notes 55-59 and accompanying text.

123. *See supra* notes 68-69 and accompanying text.

124. *See, e.g.,* Austin v. Loftsgaarden, 675 F.2d 168, 172 (8th Cir. 1982).

125. "Net economic loss is defined as that loss stemming from the substance of the fraud, not including those losses arising from non-fraud related factors. This definition is consistent with the purpose of these measures—'to calculate the amount of damages based upon [those] losses that are truly attributable to the fraud.' " Note, *Rule 10b-5 Damage Computation: Application of Financial Theory to Determine Net Economic Loss*, 51 FORDHAM L. REV. 838, 850 (1981).

126. Marbury Management, Inc. v. Kohn, 470 F. Supp. 509, 516 (S.D.N.Y. 1979), *aff'd in part, rev'd in part*, 629 F.2d 705 (2d Cir.), *cert. denied*, 449 U.S. 1011 (1980).

In determining the plaintiff's net economic loss, the court should consider all benefits received as a result of the transaction[127] in addition to all expenses and losses.[128] In securities fraud cases, the out-of-pocket measure[129] is used to arrive at net economic loss[130] because of the policy of compensating for injuries sustained,[131] rather than awarding the expectancy interest[132] of the investor. Damages are measured by the difference between the purchase price of the security and its actual value on the date of purchase.[133]

An investor in a tax shelter clearly may have something of value in the form of deductions because of the investment's unique tax treatment[134] even where the transaction fails to generate profits.[135] If the investor has a cause of action against the offeror or promoter for fraud, the actual damages view of damage recovery will allow the court to factor in this benefit in determining the amount of the recovery.[136] The argument that the benefit derives from a collateral

127. Austin v. Loftsgaarden, 675 F.2d 168, 181 (8th Cir. 1982); Garnatz v. Stifel, Nicolaus and Co., 559 F.2d 1357, 1361 (8th Cir. 1977), *cert. denied*, 435 U.S. 951 (1978); *see* JACOBS, *The Measure of Damages in Rule 10b-5 Cases*, 65 GEO. L.J. 1093, 1159-60 (1977).

128. Marbury Management, Inc. v. Kohn, 629 F.2d 705 (2d Cir.), *cert. denied*, 449 U.S. 1011 (1980).

129. *See infra* note 133 and accompanying text.

130. *See supra* note 125, for a definition of net economic loss.

131. Osofsky v. Zipf, 645 F.2d 107, 111 (2d Cir. 1981).

132. See *supra* note 113, for a defintion of the benefit of the bargain, which is the expectancy interest.

133. Harris v. American Inv. Co., 523 F.2d 220, 225 (8th Cir. 1975), *cert. denied*, 423 U.S. 1054 (1976); Bonime v. Doyle, 416 F. Supp. 1372, 1384 (S.D.N.Y.) (Sneed, J., concurring in result in part), *aff'd*, 556 F.2d 554 (2d Cir. 1976); Green v. Occidental Petroleum Corp., 541 F.2d 1335, 1345 (9th Cir. 1976), *cert. denied*, 434 U.S. 924 (1977). "The traditional measure of damages in 10b-5 actions is the out-of-pocket measure. It has been classified as a restitutionary measure." JACOBS, *supra* note 112, § 260.03[c][ii], at 11-23.

134. Austin v. Loftsgaarden, 675 F.2d 168, 182 (8th Cir. 1982); *see Incentive to Sue, supra* note 8, at 672-73.

135. Austin v. Loftsgaarden, 675 F.2d at 182. The value to an investor of a tax deduction is so great that damages are recoverable under the securities laws where because of fraud by the offeror, tax write-offs taken by the investor are disallowed by the Internal Revenue Service. *See* Sharp v. Coopers & Lybrand, 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982). The benefit that inures to real estate tax shelter investors is even greater than other investments. Because the "at risk" rules of a real estate tax shelter are generous, the investor is not limited to the amount of his investment in deducting losses. Rather, he may include the amount of the financing in his basis, and may create deductions far exceeding his initial investment. This acts as an incentive to choose real estate tax shelters over other types of shelter investments when making investment decisions. Austin v. Loftsgaarden, 675 F.2d at 173-74; *see also* BITTKER & STONE, *supra* note 1, at 649; *Incentive to Sue, supra* note 8, at 672-73 (1977).

136. *See supra* notes 117-23 and accompanying text. Harris v. American Inv.

source[137] is incorrect. An offer to invest in a tax shelter is promoted by providing offerees with information regarding tax incentives.[138] The venture, which usually requires a greater financial outlay than other forms of securities in anticipation of the added benefit,[139] constitutes one integrated transaction.[140] Since the tax benefit does not have an independent source,[141] the loss claimed should be reduced by the amount of the benefit to arrive at net out-of-pocket loss.[142]

The tax benefit rule,[143] relied on by parties opposing consideration of deductions,[144] is inapposite.[145] The rule asserts that any funds

---

Co., 523 F.2d 220, 225 (8th Cir. 1975), *cert. denied*, 423 U.S. 1054 (1976); Bonime v. Doyle, 416 F. Supp. 1372, 1384 (S.D.N.Y. 1976), *aff'd*, 556 F.2d 554 (2d Cir. 1977).

137. Wiesenberger v. W.E. Hutton & Co., 35 F.R.D. 556 (S.D.N.Y. 1964). In this action for fraudulent sale of securities in an oil participation, the court held that consideration of the tax benefits produced to reduce the damage recovery was inappropriate. "[I]t would be a great 'injustice' to plaintiff to reduce such damages for extraneous reasons wholly unconnected with the acts of defendants." *Id.* at 558. The collateral source rule states that "benefits received by the plaintiff from a source collateral to the tortfeasor or contract breacher may not be used to reduce the defendant's liability for damages. This rule holds even though the benefits are payable to the plaintiff because of the defendant's actionable conduct and even though the benefits are measured by the plaintiff's losses." DOBBS, *supra* note 111, at 185.

138. *Austin II*, 768 F.2d at 956; Austin v. Loftsgaarden, 675 F.2d 168 (8th Cir. 1982). The Securities Exchange Commission has recognized that tax benefits are an inextricable aspect of tax shelters and requires issuers to disclose the prospective tax benefits that might be realized from the investment. William Z. Salcer v. Envicon Equities Corp., 744 F.2d 935, 942 (2d Cir. 1984).

139. William Z. Salcer v. Envicon Equities Corp., 744 F.2d 935, 940 (2d Cir. 1984); *see supra* note 103.

140. *Id.* at 941-42. The court rejected the argument that the benefits derived from a reduction in tax liability come from a collateral source. The "collateral source rule" prohibits considering benefits received from third parties as a result of "wholly separate and distinct transactions." *Id.* at 941. The essence of the rule is the independence of transactions which is not present in this case, since the benefits "emanate directy from the tax shelter sought by the plaintiffs and provided by defendants, without which plaintiffs could not have realized any tax benefits." *Id.* at 941-42.

141. The collateral source rule has no application except to collateral sources. If the benefit derives from the defendant himself, or from a source identified with him, he is entitled to credit for it. DOBBS, *supra* note 111, at 181-82.

142. *See* JACOBS, *supra* note 112, at 11-15. "Where the defendant's tortious misconduct causes damages, but also operates directly to confer some benefit upon the plaintiff, the plaintiff's claim for damages may be diminished by the benefit received." DOBBS, *supra* note 111, at 181.

143. The tax benefit rule states that "when the earlier deduction [for losses] resulted in a tax benefit the recovery is under general principles of tax law, included in gross income in the year of recovery." 1 MERTENS LAW OF FEDERAL INCOME TAXATION § 7.37, at 130 (1981) [hereinafter cited as 1 MERTENS].

144. *See, e.g.*, Western Federal Corp. v. Davis, 553 F. Supp. 818, 820 (D. Ariz. 1982); Cooper v. Hallgarten & Co., 34 F.R.D. at 482.

145. *Austin II*, 768 F.2d at 955; William Z. Salcer v. Envicon Equities Corp.,

received for losses previously deducted will be subject to taxation,[146] thus making any apparent benefit "illusory."[147] This rule assumes that the future tax treatment by the plaintiff of an undetermined damage award can be predetermined.[148] The plaintiff, in fact, has various options regarding treatment of the damages award and may have other deductions or credits to offset the income, thereby avoiding taxation altogether.[149] The possibility of future taxation is too remote to disregard the fact that tax benefits already have been received. Therefore, this possibility should be discounted.[150]

A more persuasive argument against using tax savings to reduce the damage award is that the plaintiff received a benefit at the expense of the government.[151] By allowing the investor to deduct the losses from his investment, the government is foregoing income from taxation.[152] Allowing the court to reduce the amount of the recovery by the tax benefits derived arguably provides a benefit to a defendant who ill deserves it.[153] Furthermore, one court has argued

---

744 F.2d at 943 (2d Cir. 1984).

146. 1 MERTENS, *supra* note 143, § 7.37.

147. Western Federal Corp. v. Davis, 553 F. Supp. 818, 820 (D. Ariz. 1982); *accord* Burgess v. Premier Corp., 727 F.2d 826, 838 (9th Cir. 1984).

148. There is some guidance for determining how to tax damage recoveries. "A payment in settlement of a suit for rescission of a sale of stock, on the ground that it was induced by fraud, was held to represent payment for the stock resulting in capital gain and not ordinary income." 3B MERTENS LAW OF FEDERAL INCOME TAXATION § 22.93, at 631 (1980). However, the prospective and unsecured damage recovery should not be relied on to offset a loss that has already been rightfully deducted by the taxpayer since

> [i]ncome accrues to a taxpayer when there arises in his favor a fixed and unconditional right to receive it and there is a reasonable expectation that this right will be converted into money or its equivalent. . . . Anticipated damages are not accruable in the year of breach or in the year of commencement of litigation, except in the comparatively unusual case where the taxpayer's rights are reasonably certain, the amount is ascertainable and, ordinarily, has been accrued on the taxpayer's books.

2 MERTENS LAW OF FEDERAL INCOME TAXATION § 12.65, at 243 (1983). Since the damage award may not in fact accrue to the plaintiff, it is "jumping the gun" to assume that it will offset the earlier deduction.

149. William Z. Salcer v. Envicon Equities Corp., 744 F.2d 935, 943 (2d Cir. 1984).

150. *Id.* at 943. The Eighth Circuit has noted the possibility that previous deductions may be disallowed by later audits. Austin v. Loftsgaarden, 675 F.2d 168, 183 (8th Cir. 1982). However, the court held that this does not foreclose consideration of tax benefits. "Certainly the possibility that past tax deductions will be disallowed is relevant to the determination of the extent of any benefit actually received by plaintiffs from those deductions. The jury is entitled to determine whether and to what extent there would be a disallowance of deductions." *Id.* at 183; *accord Austin II,* 768 F.2d at 955.

151. Burgess v. Premier Corp., 727 F.2d 826, 838 (9th Cir. 1984).

152. *Id.* at 838.

153. *Id.*

that subtracting the benefits would place an unfair burden on taxpayers generally, and would leave the government to absorb the cost of defendant's fraud.[154] According to this view, the government should not become "the banker for fraudulent tax shelter activity."[155] This argument, however, overlooks the purpose behind the allowance of tax shelters, which is to encourage private construction of projects that may not have been undertaken without tax inducements.[156] The project here, although perhaps unprofitable, already has been completed. Thus, the government has received what it "banked on."[157] The injury sustained by the plaintiff, not the government, was caused by the defendant. Yet it was also the defendant who provided the opportunity to profit from liberal tax laws by performing necessary research, preparation and management of the project.[158] These efforts should not be discounted when computing benefits and losses.

Courts have discretion to "fashion the remedy best suited to the harm" inflicted where a cause of action is judicially created,[159] such as the cause of action for securities fraud.[160] One federal court devised an alternative to reducing the award by the amount of the benefit.[161] While rejecting the defendant's argument that it was entitled to credit for the tax deductions claimed by the plaintiffs, the court nevertheless reduced the amount of prejudgment interest awarded to reflect the plaintiff's ability to use the money not paid to the Internal Revenue Service during the period in question.[162] Although this holding lacks internal consistency, the court's consideration of the benefit to the plaintiffs of the use of the money was appropriate.

---

154. *Id.*; *see also* Freschi v. Grand Coal Venture, 588 F. Supp. 1257, 1260 (S.D.N.Y. 1984) ("[T]he losers would be the government and plaintiffs, and the only winner would be defendants").

155. Burgess v. Premier Corp., 727 F.2d 826, 838 (9th Cir. 1984).

156. *Austin II*, 768 F.2d at 956; William Z. Salcer v. Envicon Equities Corp., 744 F.2d at 941; Austin v. Loftsgaarden, 675 F.2d at 182; New York Times, October 1, 1984, at D1, col. 1.

157. William Z. Salcer v. Envicon Equities Corp., 744 F.2d 935, 941 (2d Cir. 1984).

158. *Id.* "To ignore the sizeable tax benefits actually realized by the plaintiffs [through the work of defendants] would be unrealistic." *Id.* at 941; *see also Austin II*, 768 F.2d at 956. *But see* Freschi v. Grand Coal Venture, 588 F. Supp. 1257, 1260 (S.D.N.Y. 1984). The decision in *Freschi*, to disallow evidence of tax benefits, preceded that of William Z. Salcer v. Envicon, 744 F.2d 935 (2d Cir. 1984), which came to the opposite conclusion.

159. Garnatz v. Stifel, Nicolaus & Co., 559 F.2d 1357, 1360 (8th Cir. 1977), *cert. denied*, 435 U.S. 951 (1978).

160. *Id.*

161. Western Federal Corp. v. Davis, 553 F. Supp. 818 (D. Ariz. 1982).

162. *Id.; see* New York Law Journal, April 20, 1983, at 1, col. 1 (discussion of this case).

Most importantly, mitigation conforms to the compensatory purpose of the remedy. The limitation on damages contained in section 28 of the 1934 Acts precludes recovery "in excess of [the investor's] actual damages on account of the act complained of [sic]."[163] Whatever benefits plaintiff has received as a result of the transaction, therefore, must be subtracted from the amount of the recovery to arrive at the actual damages figure.[164]

V. Policy Considerations

Several policy considerations militate against the use of tax returns to determine whether the cause of action for a fraudulent tax shelter investment has been established and, if appropriate, to calculate the appropriate measure of damages. An examination of the consequences of disclosure, however, reveals that making tax returns available promotes the applicable policy considerations.

One possible objection focuses on the confidentiality of tax returns.[165] Even though they are only protected by a qualified privilege,[166] it may be argued that this privilege should not be lightly waived in view of the underlying policy of encouraging honest filing.[167] In the case of a party bringing an action for fraud against the offeror of a tax-sheltered investment, however, disclosure will not deter that party from filing complete and accurate tax information. The specific information being examined on the return is the amount of the deduction.[168] In any circumstance, the taxpayer will want to create the greatest deduction possible and, thus, will have had no incentive to withhold relevant information.[169] Furthermore, a confidentiality stipulation can be signed which will prevent

---

163. 15 U.S.C. § 78bb(a) (1982); *see* Osofsky v. Zipf, 645 F.2d 107, 111 (2d Cir. 1981). Courts apply the actual damages concept contained in section 28(a) of the 1934 Act to 1933 Act causes of action. *See, e.g., Austin II*, 768 F.2d at 954.

164. *Austin II*, 768 F.2d at 956. The purpose is to compensate plaintiffs, not penalize defendants. *Id.*; William Z. Salcer v. Envicon Equities Corp., 744 F.2d at 940-41.

165. See *supra* notes 16-17 and accompanying text for a discussion of the social policy favoring confidentiality.

166. *See supra* note 16 and accompanying text.

167. *See supra* note 16 and accompanying text.

168. Smith v. Bader, 83 F.R.D. 437, 439 (S.D.N.Y. 1979).

169. William Z. Salcer v. Envicon Equities Corp., 744 F.2d 935, 944 (2d Cir. 1984). The purpose of a tax shelter is to offset other income with losses to reduce tax liability. The court in this type of case is looking at the amount of the deduction to mitigate the damage award. At the time of filing the returns it was in the plaintiff's interest to report the greatest deduction possible. If the plaintiff were to be deterred from accurately reporting the deduction by fear of disclosure, investing

any dissemination of the disclosed information beyond that which is necessary in the interest of justice.[170]

Another possible argument against disclosing tax returns is that innocent investors will bear a heavier burden of proof in establishing the cause of action and may not be fully compensated for their injuries. The floating nature of the due care requirement precludes this outcome.[171] Innocent and inexperienced investors who invested in good faith, believing that there was a valid economic purpose to the venture, have a lesser burden of proof to establish fraud.[172] Disclosure of their tax returns is to their advantage, since it will make it easier for them to support their claim of reliance by revealing their relative lack of expertise. Disclosure will, simultaneously help them recover the full measure of injuries sustained once they prove fraud. The defendant must reimburse the investor for the full measure of actual damages,[173] the extent of which will become manifest only by examining that party's tax returns.

Conversely, individuals who have made "sham" investments, that is, who invested in a venture strictly for the tax deductions, knowing that there was no valid economic purpose, or investors who should have been able to discover the lack of potential for profits on their investment from the outset should, in equity, be denied a recovery.[174] For this class of investors disclosure will thus serve two purposes: it will discourage investment in abusive tax shelters and it will also discourage frivolous claims. Upon learning that their tax returns will be admitted into evidence, potential plaintiffs are likely to withdraw their action if they know that the benefit received from the investment far outweighs any injury suffered, or if they suspect that their returns will expose them as sophisticated investors who were aware that their investment was made primarily to reduce their tax liability.[175]

A final objection to introducing tax returns is that, to the extent they reduce the amount of the damage award, defendants, offerors

---

in a tax shelter would have no value to him since the purpose is to create deductions. *See* Smith v. Bader, 83 F.R.D. at 439.

170. Austin v. Loftsgaarden, 675 F.2d 168 (8th Cir. 1982).

171. *See supra* notes 63-67 and accompanying text.

172. *See id.*

173. *See supra* note 115-26 and accompanying text.

174. *See* Dupuy v. Dupuy, 551 F.2d 1005 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977) (discussion of equitable nature of availability of this cause of action).

175. In fact, the plaintiff in William Z. Salcer v. Envicon Equities Corp., 744 F.2d at 938, stipulated that if he lost on defendant's motion to compel discovery of plaintiff's tax returns, he would withdraw his lawsuit. It was for this reason that the court granted a hearing on this interlocutory appeal.

of fraudulent tax shelters, will be the beneficiaries.[176] This argument is based on a misunderstanding of the nature of the private cause of action under the securities laws, which is intended not to serve as an enforcement mechanism, but to compensate for harm caused.[177] That the offeror of the fraudulent tax shelter may end up paying less does not necessarily mean that he will not be subject to any further sanctions. Such offerors are still susceptible to suit by the Securities and Exchange Commission, whose obligation it is to punish offerors or promoters of fraudulent securities within the statutory framework laid out by Congress.[178] Furthermore, it is not up to the judiciary to increase the amount of damages to punish a defrauder; rather, that is the perogative of the legislature.[179]

VI. Conclusion

The securities laws present a fertile ground for litigation by allegedly defrauded investors seeking to recover for their losses. While claims of injury are often meritorious, there are distinct possibilities for abuse of the judicially created cause of action. To the greatest degree possible, these abuses should be limited. Where a recovery is granted, however, it should not exceed the amount necessary to compensate for losses—the "actual damages" figure. In an action for a fraudulent sale of a tax shelter investment, tax returns should be discoverable in order to fully explore plaintiff's claim of fraud. Furthermore, tax returns clearly shed light on the degree to which plaintiff was injured and therefore, should be considered when determining damages. Revealing the plaintiff's tax returns in an action for fraud under Rule 10b-5 will do little harm to the purpose behind the policy of confidentiality, but will greatly assist a court in rendering a fair and just decision.

Risa A. Levine

---

176. *See supra* notes 151-58 and accompanying text.
177. *See supra* notes 115-18 and accompanying text.
178. 1934 Act, § 21(a), 15 U.S.C. § 78u(a) (1982).
179. William Z. Salcer v. Envicon Equities Corp., 744 F.2d 935, 941 (2d Cir. 1984) ("We are barred from engaging in judicial legislation by § 28(a) of the Exchange Act, which limits plaintiffs to recovery of their actual net economic loss and does not give us discretionary power to increase that amount . . .").