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SHOULD TAXPAYERS SUBSIDIZE THE PERFECT FRAUD?

A CLOSER LOOK AT RANDALL V. LOFTSGAARDEN

AND THE "TAX-OFFSET RULE"

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Joseph A. Grundfest
Commissioner
U.S. Securities and Exchange Commission
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The views expressed herein are those of Commissioner Grundfest and do not necessarily represent those of the Commission, other Commissioners, or Commission staff.

SHOULD TAXPAYERS SUBSIDIZE THE PERFECT FRAUD?

A CLOSER LOOK AT RANDALL V. LOFTSGAARDEN

AND THE "TAX-OFFSET RULE"[1]

For centuries, man has searched for the perfect fraud--a fraud so pure in conception and effective in execution that, even if discovered, the perpetrator is free to enjoy the ill-gotten fruits of his labor.[2] To date, the perfect fraud has remained an elusive dream. Recent decisions by the Second and Eighth Circuits have, however, brought the perfect fraud closer to reality.

The Second and Eighth Circuits have interpreted the securities laws and tax code so as to permit promoters of fraudulent tax shelters to deduct from damage awards the tax benefits claimed by defrauded shelter investors. This damage calculation, often called the "tax-offset rule," may so severely reduce a plaintiff's recovery that, even if a promoter concedes he defrauded the investor, no damages will be awarded.[3]

1/This address was prepared by Commissioner Grundfest with the assistance of Gerald J. Laporte and Ronald A. Schy, Counsel to the Commissioner.

2/See e.g., 1 Street, Foundations of Legal Liability 374-76 (1906). (Fraud is traceable in English law to the writ of deceit, well established by A.D. 1201. Fraud is traceable further to an action for dolus under Roman law.)

3/In Salcer v. Envicon Equities Corp., 744 F.2d 935 (2d Cir. 1984), petition for cert. filed, 53 U.S.L.W. 3688 (U.S. March 13, 1985) (No. 84-1447), the Second Circuit adopted the tax-offset

(Footnote continues on next page.)

A savvy securities law violator can take advantage of this rule by structuring fraudulent tax shelters so that the amount of the fraud is less than or equal to the value of the investors' sustainable tax benefits.[4] Voila! Structure a deal so that the dollar value of the fraud is less than the value of the tax benefit to the investors and you have a perfect federal securities

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rule in a case involving a claim for rescissionary relief. The Second Circuit applied the tax-offset rule to the computation of out-of-pocket damages in Freschi v. Grand Coal Venture, 767 F.2d 1041 (2d Cir. 1985), petition for cert. filed, 54 U.S.L.W. 3154 (U.S. Sept. 6, 1985) (No. 85-377), but refused to extend the rule to allow a plaintiff to recover his expected tax benefits.

The Eighth Circuit adopted the tax-offset rule in Austin v. Loftsgaarden, 768 F.2d 949 (8th Cir. 1985) (en banc), cert. granted sub nom. Randall v. Loftsgaarden, 54 U.S.L.W. 3328 (U.S. Nov. 8, 1985) (No. 85-519). The Western District of Oklahoma has also adopted the tax offset rule. Feldman v. Pioneer Petroleum Inc., 606 F.Supp. 916, (W.D. Okla. 1985), appeal pending, No. 85-1432 (10th Cir. 1985).

The tax-offset rule has, however, been rejected by the Ninth Circuit in Burgess v. Premier Corp., 727 F.2d 826 (9th Cir. 1984) and Western Federal Corp. v. Erickson, 739 F.2d 1439 (9th Cir. 1984).

4/For example, if an investor buys a sufficiently leveraged tax shelter, his investment tax credit and accelerated depreciation can exceed his out-of-pocket costs after only a year or two. In Freschi, the plaintiff's tax benefits were not even from the tax shelter; he wrote off his investment in the fraudulent scheme as a theft loss. Nonetheless, the court deducted the $188,682 tax benefit of the write-off from the recovery of his $266,500 investment. 767 F.2d at 1051.

Some frauds may be structured so that they do not diminish the tax benefit aspect of the transaction. In these frauds a fraudulent seller might totally insulate himself under the tax-offset rule.
(Footnote continues on next page.)

fraud.[5] Even if investors discover the fraud and file an ironclad complaint the fraudulent seller has no reason to fear a civil damage award under the federal securities laws because he will never be forced to disgorge the proceeds of his fraud.

To add insult to injury, it is worthwhile to observe that the perfect fraud results because the tax-offset rule results in the Government generating a subsidy in the form of a "fraud shelter"--a protection against civil recovery of ill-gotten gains under the securities laws. In essence, the tax-offset rule says that the promoter of a fraudulent shelter has a claim to the

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For example, the seller could understate his management fee and take assets from other similarly treated accounts.

Other frauds may partially affect a purchaser's tax benefits. For example, a seller may understate the useful life of depreciable assets. If the fraud causes total loss of the tax benefits, then the tax-offset rule should in theory be inapplicable because there are no tax benefits to offset. This may not be the case in practice, however, if, as in Freschi, the ability to write off the investment as a bad debt or a theft loss is a sufficient tax benefit to justify offset.

5/Defrauded purchasers may, of course, be able to sue under state law or bring other federal causes of action that would not be subject to the limitations of the tax-offset rule. The tax-offset rule also does not preclude state or SEC actions seeking injunctions or disgorgement, criminal proceedings, or the imposition of IRS penalties. The tax-offset rule can, however, effectively vitiate the deterrent effect of private civil remedies under the federal securities laws. It thereby creates a fraud that is perfect with respect to private rights of action under the federal securities laws. See pp. 12-13, infra.

tax benefits that the law grants the defrauded purchaser, at least to the extent that the promoter can use these tax benefits to "shelter" the proceeds of his fraud. Needless to say, serious questions can and should be asked about any damage calculation that interprets the securities laws and the tax code so as to provide a Government subsidy that encourages fraudulent conduct.

The Supreme Court has granted a writ of certiorari in the Eighth Circuit tax-offset decision, Randall v. Loftsgaarden.[6] The Court also has pending before it two Second Circuit decisions upholding the tax-offset rule.[7] Supreme Court review of these cases presents an opportunity to resolve the difficult issues the tax-offset rule presents.

The United States and the Securities and Exchange Commission have filed a brief *amici curiae* urging that the Eighth Circuit's decision in Randall be reversed.[8] The brief argues that reversal is necessary to correct serious misinterpretations of both the securities and tax laws. In this address, I review some of the arguments presented in that brief and explore some of the consequences that might follow if the Supreme Court upholds the decision in Randall.

6/54 U.S.L.W. 3328 (U.S. Nov. 8, 1985) (No. 85-519).

7/Salcer v. Envicon Equities Corp., 53 U.S.L.W. 3688 (U.S. March 13, 1985) (84-1447); Freschi v. Grand Coal Venture, 54 U.S.L.W. 3154 (U.S. Sept. 6, 1985) (No. 85-377).

8/See Brief for the United States and the Securities and Exchange Commission Amicus Curiae in Support of Petitioners, Randall v. Loftsgaarden, No. 85-519 (U.S. Jan. 6, 1986).

Randall v. Loftsgaarden: The Facts

In Randall, plaintiffs purchased limited partnership interests in a Ramada Inn in Rochester, Minnesota. The investment was marketed as a tax shelter and was structured so that the investors could deduct from their taxes a multiple of their initial $35,000 investment.[9] The promoter made material misrepresentations regarding the financing commitments for the venture. The Ramada Inn also opened several months behind schedule and was subject to substantial cost overruns. Moreover, lower-than-predicted occupancy rates combined with higher-than-budgeted operating expenses to cause sizable operating losses. The partnership ultimately defaulted on its obligations and foreclosure proceedings were instituted in 1978.

9/The following items are the actual deductions or credits (or if, in parentheses, the amount of recapture) taken by plaintiff Randall on his tax return as a result of his investment for the years 1973-1978:

Randall	Sched. D.	Sched. E.	Form 4797	Inv. Credit	Cr. Recap.	Total
1973	-	$21,119	-			$21,119
1974	-	30,107	-	$2,451		32,558
1975	-	23,023	-	75		23,098
1976	-	17,700	70	52	(36)	17,786
1977	-	14,716	627		(1,323)	14,020
1978	($30,075)	(1,963)	79			(31,959)
Total	($30,075)	$104,702	$776	$2,578	(1,359)	$76,622

Joint Appendix at 208, Randall v. Loftsgaarden, No. 85-519 (U.S. Jan. 6, 1986).

The limited partners sued the promoter, alleging violations of section 12(2) of the Securities Act of 1933,[10] section 10(b) of the Securities Exchange Act of 1934,[11] and Rule 10b-5 thereunder.[12] After a seven-day trial, the jury found that the promoters knowingly made material misrepresentations in the offering memorandum and violated section 10(b) and Rule 10b-5. The jury also rendered an advisory opinion, adopted by the court, that the promoters were liable under section 12(2).

The district court found that the limited partnership interests were worthless by the time the investors learned of the fraud. The court awarded the investors rescissionary damages under section 12(2) in the amount of the purchase price originally paid, plus prejudgment interest. The promoters, however, urged the court to reduce the damage award by the amount of the tax benefits plaintiffs allegedly received. The court rejected this tax-offset argument as "sophistic malarkey."[13]

But what the district court saw as "sophistic malarkey" made perfect sense to the Eighth Circuit. A panel of that court agreed that "misrepresentations so permeated" the offering memorandum

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10/U.S.C. 77l(2).

11/5 U.S.C. 78j(b).

12/17 C.F.R. 240.10b-5.

13/Austin v. Loftsgaarden, No. 4-76-Civ. 82 (D. Minn. Aug. 15, 1980), reprinted in Petitioners' Appendix, Randall v. Loftsgaarden, No. 85-519, slip op. at F8 (U.S. Sept. 23, 1985).

as to render its forecasts unreasonable and misleading. The panel further concurred that Loftsgaarden, the fraudulent promoter, understated by more than 50% the compensation his closely-held corporations received in the venture. But when it came to calculating damages, the court held that the investors' recovery had to be reduced by the amount of the tax benefits they received in connection with the fraudulent transaction.

The court reasoned that, under section 28(a) of the Exchange Act, recovery of damages for violations of section 10(b) cannot exceed "actual damages" suffered "on account of the act complained of." 17 U.S.C. 78bb(a). "The actual damages principle," the court said, "requires that a rescissionary or restitutionary award be 'reduced by...value received as a result of'" the tax deductions generated by the investment.[14] As for recovery under section 12(2) the court observed that plaintiffs were by statute limited to "the consideration paid for [the] security with interest thereon, less the amount of any income received."[15] The court reasoned that the tax deductions constituted "income received" that by statute must be offset from damages caused by the fraud.

On remand to establish the measure of damages, the district court calculated each petitioner's recovery as the amount paid for the investment, plus 8% simple interest from the date of purchase, minus the amount of his net tax benefits.[16]

14/675 F.2d 168, 181 (1982), modified, 768 F.2d 949 (8th Cir. 1985), cert. granted sub nom. Randall v. Loftsgaarden, 54 U.S.L.W. 3328 (U.S. Nov. 8, 1985) (No. 85-519).

15/15 U.S.C. 77l(2)

16/768 F.2d at 957.

Not willing to let matters lie, the parties then cross-appealed from the judgment setting damages. The Eighth Circuit ordered reconsideration *en banc* and upheld the original panel's decision that the tax-offset rule applied to the transaction. However, the court modified the damage calculation by adopting an elaborate formula for computing recoveries under section 12(2). The Eighth Circuit ruled that, for each year, tax benefits should be deducted from the amount invested. Prejudgment interest should then be calculated on the annually declining balance. For years in which the petitioners' cumulative tax benefits exceeded their original investment, the defrauded investors were in effect required to credit the fraudulent promoter with the prejudgment interest value of their net tax benefits.

The court then assumed that each plaintiff was in the 50% tax bracket, and that each investor's recovery would be taxed as ordinary income. Accordingly, the court found it was necessary to gross-up the damage award by a factor of two so that the amount left to the investors after tax equalled the after-tax "actual damages" suffered by investors. In other words, the Eighth Circuit held that the measure of rescissionary damages prescribed by section 12(2) is, for investors in the 50% bracket, twice the aggregate of the plaintiff's original investment, minus tax benefits, plus prejudgment interest at 8% on the original investment, less prejudgment interest on the tax benefits.[17]

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[17]/The Eighth Circuit's damages formula is thus:

$$D = 2(I - TB + \sum_{t=1}^{T} I_t(1 + i)^t - \sum_{t=1}^{T} TB_t(1 + i)^t)$$

(Footnote continues on next page.)

This convoluted damage rule had a dramatic effect on plaintiffs' recoveries. Without the tax-offset rule, Randall would have recovered $67,973. After application of the rule, Randall's recovery was reduced to $506. Other investors had their recoveries reduced from $96,385 to $1,984; from $64,610 to $7,666; and from $64,787 to $18,790. Needless to say, the promoter was quite pleased by this damage rule because it allowed him to retain a substantial portion of his ill-gotten gains.

Not all members of the Eighth Circuit agreed with this damage rule. In a dissenting opinion, Chief Judge Lay, joined by Judge Bright, argued that the majority's interpretation conflicted with the clear language of the statute. They also argued that "[t]he tax transaction is between [the plaintiff] and the Government and should not affect the [defendants'] liability.[18]

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where: D = Damages Awarded

I = Aggregate Investment

TB = Aggregate Tax Benefits

I_t = Investment in Year t

TB_t = Tax Benefits in Year t

i = Relevant Interest Rate (Set by Court at 8%)

T = Life of the Investment

18/ 768 F.2d at 963.

Moreover, they argued that the tax-offset rule improperly allows a defendant "to escape liability, shifting the burden of the loss on the Government."[19]

Did the Eighth Circuit Err?

As set forth in the Government's amicus brief, I think it clear that Randall is wide of the mark in its interpretation of both the securities and tax laws. It is possible to identify at least six fundamental errors of law in the Court of Appeals' decision. After discussing those potential errors I would like to explore some of the consequences likely to result if the Supreme Court fails to reverse the Eighth Circuit's decision.

First, Randall misconstrues the damage limitation provision of the '34 Act. The "actual damages" formulation of section 28(a) of the '34 Act is intended to assure that recovery is limited to nonspeculative, compensatory damages; it prevents duplicative recoveries under state and federal law, awards of damages for nonpecuniary harm, and awards of punitive damages.[20] Randall construes section 28(a) to require deduction from a damage award of a speculative and arbitrary amount over which the defendant had little, if any, control. It stands logic on its head to argue that a defrauded investor did not suffer actual

19/Id. at 964.

20See American Law Institute, Federal Securities Code §§ 1722(f), 1723(b) (1980); L. Loss, Fundamentals of Securities Regulation 1139-41 (1983).

damage because the investor received tax benefits from an independent source that were never the promoter's to sell.

Second, Randall also misconstrues the statutory damage provisions of the '33 Act. In particular, the Eighth Circuit was incorrect in concluding that tax deductions and credits constitute "income received" to be offset against damages under section 12(2). Tax deductions and credits are derived from the Internal Revenue Code. The Code reflects Congress' intent to promote certain forms of investment activity. Deductions and credits thus do not arise from the investment property itself, standing in isolation; they require independent acts by the investor, their value depends in large part on the investor's tax status, and they have no economic value apart from the taxpayer's tax status. Consequently, tax benefits are not a direct product of the investment, nor do they constitute income received from the investment, as do rents, crops, or other proceeds that don't depend on Government largesse or the filing of a tax return. Tax deductions and credits are therefore benefits bestowed by the Government in connection with the purchaser's decision to invest. These tax benefits were never the seller's property to convey, could not have been claimed by the seller in the form claimed by the investor, and cannot in any meaningful sense be restored to the seller in returning the parties to the status quo ante.[21]

21/See Hanover Shoe, Inc. v. United Shoe Machinery Corp., 392 U.S. 481, 503 (1968) (antitrust damages not subject to tax-offset rule); Cf. Janigan v. Taylor, 344 F.2d 781, 787 (1st. Cir.), cert. denied, 382 U.S. 879 (1965) (an artist who acquires paints by fraud and uses them to paint a valuable portrait cannot be required to "restore" the portrait or the proceeds from its sale to the defrauded party).

Third, the Eighth Circuit made a fundamental error in analysis by assuming that the transaction was purely bilateral and that tax benefits can be shifted between buyer and seller as though the seller had an interest in the tax deductions claimed by the buyer. In reality, there are at least two transactions involving three parties--there is the transaction between the promoter and the investor, and there is the transaction between the investor and the Government, through the tax return filed with the Internal Revenue Service. The IRS has its own rules for dealing with fraudulent purchases by taxpayers. If there are problems with the Government's treatment of tax shelters, or with the IRS rules for allocating the tax consequences resulting from fraudulent tax shelters, then the Government should change the tax laws. The Eighth Circuit should not, however, distort the securities laws to correct what it may perceive as inequities in the tax code. As an aside, I might mention that if the investor has to deduct tax benefits from his recovery, there is no principled reason why the promoter's tax status shouldn't also enter into the court's calculation. Such a battle of tax returns in fraud actions could quickly degenerate into a situation where the party truly at risk in these transactions is the Government, not the fraudulent promoter.

Fourth, as a matter of tax law, the Eighth Circuit's decision is incorrect. The tax laws contain numerous means of generating offsets between tax shelter losses and later recoveries that result from the promoter's fraud. The investor retains only those tax benefits that Congress has decided he should retain, and in

no meaningful sense does the defrauded investor retain a "windfall."[22]

Fifth, as a matter of equity, it seems clear that in a dispute between a defrauded investor and a lying promoter, the investor has the more legitimate claim to the tax benefits. This principle is well established,[23] and even if it leads to a "windfall" recovery for the plaintiff--which it does not--it is far better that the victim enjoy a windfall than the perpetrator be offered absolution.[24]

Sixth, to interpret the recovery provisions of the '33 and '34 Acts so as to allow fraudulent promoters to reap the benefits of their defrauded investors' tax returns does serious violence to the deterrent purposes of civil damage actions under the securities laws. In Bateman Eichler, the Supreme Court recently

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22/ If the defrauded investor obtains rescission and restitution, some, if not all, of the award is subject to tax as ordinary income under the "tax benefit rule." If he obtains out-of-pocket damages, the damage award will reduce his basis. If he has already disposed of his investment, or if he has reduced his basis to zero by previously claimed deductions, the award will be taxed as ordinary income when received. In that event, the award may be taxed, in whole or in part, as ordinary income under the tax benefit rule or under the "recapture" provisions of the Internal Revenue Code.

23/ See Affiliated Ute Citizens v. United States, 406 U.S. 128, 155 (1972); Nelson v. Serwold, 576 F.2d 1332, 1338-39 (9th Cir. 1978); Janigan v. Taylor, 344 F.2d 781, 786 (1st Cir.), cert. denied, 382 U.S. 879 (1965); L. Loss, Fundamentals of Securities Regulation 1134 (1983).

24/ Janigan v. Taylor, 344 F.2d 781, 786 (1st Cir.), cert. denied, 382 U.S. 879 (1965).

reaffirmed that private damage actions under the federal securities laws are "a necessary supplement" to the Commission's enforcement activities.[25] The Eighth Circuit's decision would take the bite out of many private enforcement actions, and leave only the distant echo of a bark to deter promoters of fraudulent tax shelters.

Consequences

Evidently, there are many grounds upon which the Supreme Court could reverse the Eighth Circuit's decision. It is interesting, nonetheless, to consider the consequences in the event the Court fails to reverse.

Most troubling is the incentive that the tax-offset rule provides for the creation and marketing of fraudulent tax shelters. The hallmark of these transactions will be that they generate tax benefits that can withstand audit scrutiny while allowing the promoter to engage in fraud that lines his pockets. Shelter promoters will have less incentive to remain honest if they know that the tax benefits associated with the transaction will shield them from substantial civil liability under the securities laws.

If upheld, the tax-offset rule will also provide an independent incentive for the formation of deep tax shelters because the deeper the shelter the greater the Government-provided insurance

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25/ *Bateman Eichler, Hill Richards, Inc. v. Berner*, 105 S.Ct. 2622, 2628 (1985).

against recovery in an action for fraud.[26] Thus, the tax-offset rule will promote the worst of securities transactions combined with the deepest of tax shelters--hardly the incentive that should be created by a deficit-ridden Government seeking to prevent fraud and deter the appearance of unfairness in its tax system.

The administrative problems generated by application of the tax-offset rule would also be substantial. It can be extraordinarily difficult to calculate the tax benefits that result from investment transactions. A requirement that tax benefits be calculated in tax shelter fraud actions can add tremendously to the complexity and length of such proceedings. Imagine for a moment the expert testimony likely to be offered in every tax-offset case concerning the likelihood that tax benefits will or will not be sustained on audit. The simple thought of this testimony should be enough to make any judge's, lawyer's, or juror's eyes glaze over more than once.

Finally, the arguments presented in defense of the tax-offset rule are not limited to tax shelter investments. Every investment and subsequent damage recovery has tax consequences. There is no principled basis upon which the tax-offset rule can be limited to

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26/In a parallel context, the Supreme Court has observed that application of the *in pari delicto* defense in insider trading cases would deny any incentive to a defrauded tippee to bring suit, and would thus undermine private enforcement of the federal securities laws. *Bateman Eichler, Hill Richards, Inc. v. Berner*, 105 S.Ct. 2622, 2632 (1985).

tax shelter cases. Therefore, once adopted for tax shelter cases, I fear that the tax-offset rule could spread to every securities action.[27] The result will be random justice that depends on the tax status of the defrauded investor, and a significant weakening of the deterrent effects of the securities laws.

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[27]/For instance, if the Randall rule were applied in insider trading cases, the court would have to consider whether the profits gained or losses avoided were ordinary or capital gains or short- or long-term losses, and, if long-term losses, whether the taxpayer had income to offset the losses. Similarly, in pure securities fraud cases, if the victim takes a theft or casualty deduction, he could only recover the difference between his tax savings as a result of the deduction and the amount of the fraud.