

priation theory of insider trading, a violation occurs when a person misappropriates confidential information for securities trading in breach of a duty owed to the source of the information. The Ninth Circuit held that, although the District Court had correctly concluded that Talbot owed no duty to Lending Tree, it should not have granted summary judgment because the allegations reflected a breach of a duty to Fidelity. Specifically, Talbot allegedly had learned the information on which he traded in the course of his service as a Fidelity director; and as a director, Talbot owed a fiduciary duty to Fidelity with respect to all confidential information he learned in that capacity. Hence, if he had traded on confidential information entrusted to him in his capacity as a director (as alleged by the SEC), Talbot would have breached that duty. The court further held that, as a matter of law, the nature of the information allegedly obtained by Talbot was confidential, that there was sufficient evidence to show that the need for confidentiality was conveyed to Talbot and the other Board members, and that Talbot's trading resulted in harm to the general public. Finally, the court found that a genuine issue of fact existed as to the materiality of the information and remanded the case for determination of whether the information was material.

**COMMENT:** This case illustrates that a misappropriation theory can stand against one who trades on material non-public information learned through a fiduciary relationship, even if the information does not pertain to the entity to which the trader owes fiduciary duties. Accordingly, the Ninth Circuit will not require any showing of a continuous chain of fiduciary relationships between the original source of the confidential information and the one who trades based on that information. As long as the information is confidential and the trader receives that information via a fiduciary duty, the SEC may pursue a claim for insider trading.—J.A.S. ♦

## Federal Taxation

Marilyn Barrett

### Stock Options

**Alternative minimum tax capital losses are subject to the limitations of IRC §§172(d) and 1211(b) and are not deductible as alternative tax net operating losses under IRC §56(d).**

*Kadillak v Commissioner* (9th Cir 2008) 534 F3d 1197

Anthony Kadillak had been granted incentive stock options (ISOs) by his employer. In 2000, he purchased 32,000 shares of stock by exercising some of his ISOs. His ISOs included 14,667 nonvested shares, which were held in an escrow account and were subject to the employer's right of repurchase on termination of Kadillak's employment. Kadillak's employment was "at will."

Kadillak avoided regular income tax in 2000 when he exercised his vested ISOs, even though the fair market value of the stock exceeded the option price by over

\$3 million. However, he was subject to AMT on this amount. Kadillak also filed a voluntary election under IRC §83(b) to report income in 2000 on his nonvested shares. On these, he realized \$680,000 of income for AMT purposes.

Kadillak was terminated from his employment in 2001 and his employer repurchased his remaining nonvested shares. He realized an AMT capital loss of \$680,000 from this repurchase.

Kadillak also sold his remaining 25,333 vested shares to a third party in 2002. For regular tax purposes, this caused him to realize a capital gain on the vested shares of \$60,000. For AMT purposes, his basis had been increased by the realization of AMT income in 2000, which caused him to realize an AMT capital loss of over \$2.5 million in 2001.

Kadillak filed 2000 and 2001 tax returns on the assumption that his §83(b) election was valid and, in 2000, reported AMT of \$932,309, total tax liability of \$1,099,388, and a balance owing of \$936,597, of which he paid only \$25,000 with his return. For 2001, he reported no gain or loss on the forfeiture of shares for either regular tax or AMT. He later amended his 2000 and 2001 tax returns. For his 2000 return, he claimed his §83(b) election was *invalid* and reduced his AMT income accordingly by excluding any shares that were still unvested at year end. He also claimed alternative tax net operating loss (ATNOL) carryback deductions based on the AMT capital losses realized in 2001 from the forfeiture and in 2002 from the third party sale. These amendments reduced his AMT liability for 2000 from \$932,309 to \$16,712 and reduced his total tax liability from \$1,099,388 to \$183,524. His amended 2001 return reported \$340,213 in AMT income for the nonvested shares that vested in 2001, \$100,845 in AMT liability, and total tax liability in the same amount.

The IRS did not accept Kadillak's amended returns. The IRS issued a notice of federal tax lien for 2000 and notice of intent to levy for 2001. After exhausting his administrative remedies, Kadillak petitioned the Tax Court to challenge the lien and levy. The Tax Court granted summary judgment in favor of the Commissioner, determining that the taxpayer's §83(b) election to recognize AMT income on the nonvested shares in 2000 was valid and that he was not entitled to a "claim of right" deduction when they were subsequently forfeited to his employer. See IRC §1341. Because the sale of the remaining shares in 2002 did not result in any ATNOL under IRC §56(d)(2)(A)(i), the Tax Court concluded that the taxpayer could not claim an ATNOL carryback deduction to reduce AMT income for 2000.

On appeal to the Ninth Circuit, Kadillak again raised these three arguments: (1) his §83(b) election was invalid; his acquisition of property was not a transfer of property because the shares were held in an escrow account; (2) even if the §83(b) election was valid, he was entitled to a "claim of right" deduction under IRC §1341

because the nonvested shares acquired in 2000 were forfeited in 2001 at an AMT capital loss; and (3) the AMT capital losses sustained in 2001 and 2002 were ATNOL deductions that could be carried back to 2000.

The Ninth Circuit dismissed his argument that his §83(b) election was invalid by noting that the very purpose of a §83(b) election is to realize income on assets that are still subject to a substantial risk of forfeiture and without the election would not currently be subject to tax. Moreover, Treas Reg §1.83-3(e) provides that "property" includes property set aside from creditors' claims in escrow accounts. In this case, the nonvested shares were set aside in escrow.

The Ninth Circuit further ruled that Kadillak misapplied §1341, since it only applies if "a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item." 534 F3d at 1202. Because §83 expressly provides that no deduction is allowable when a §83(b) election is made and the stock is later forfeited, §1341 did not apply.

The court also denied Kadillak the right to carry back his AMT capital losses as an ANTOL. The court held that the capital loss limitations under IRC §§172(d) and 1211(b) apply to AMT capital losses. These provisions provide that capital losses can be used only to reduce capital gains plus \$3000 of ordinary income and they cannot be carried back.

**COMMENT:** This case documents the perils that employees face in exercising stock options, particularly when there is no immediate liquidity event for the employee.

This is the way stock options work. If an employee is given a nonqualified stock option, he or she is taxed at ordinary income rates on the spread between the fair market value of the stock and the exercise price at the time the option is exercised. The employee's basis in the stock is the amount paid for the stock plus the amount of income triggered on the exercise. If the employee holds the stock for at least 12 months after he or she exercised the option and acquired the stock, the employee will realize capital gain or loss on any difference between the sales price and the employee's basis in the stock. If the employee is granted an incentive stock option (ISO), the employee realizes no compensation income on exercise for regular income tax purposes. However, the difference between the exercise price and the fair market value of the stock on the date of exercise is a tax preference for AMT purposes and can cause the employee to be subject to AMT. On a subsequent sale of the stock, the employee will realize capital gain as long as the sale does not occur prior to the later of (a) 2 years from the date of grant of the ISO, or (b) 1 year from the date the ISO was exercised and the stock acquired.

Many tax advisors caution their clients against exercising stock options until a liquidity event is imminent. *Kadillak* is a textbook case for why that advice is sound. Although many employees are tempted to exercise their options even when there is no liquidity event in sight so that they can secure the 12-month holding period and

long-term capital gains rate on a later sale, they do so at the substantial risk that the value of the stock may plummet and, while they recognize substantial ordinary income on exercise, they end up with nothing more than capital losses on sale. In addition, too many employees do not understand the tax consequences of exercising stock options. On exercise of a nonqualified stock option, compensation is realized if the fair market value of the covered stock exceeds the employee's exercise price. ISOs are often viewed as a preferred form of option, because regular tax is not triggered on exercise. However, far too many people fail to realize that the spread on exercise is a tax preference and can subject the employee to significant AMT.

*Note:* On August 29, 2008, the Commissioner of the Internal Revenue Service agreed to temporarily suspend collections of alternative minimum tax liabilities owed by individuals on their ISOs until September 30. The purpose of the suspension is to give Congress time to enact pending legislation, HR 3861, that will abate interest and penalties attributable to ISO AMT liabilities for years prior to January 1, 2007, and permit taxpayers to apply the full amount of future AMT refundable tax credits toward their entire current ISO AMT liabilities.—M.B.

### Refunds

#### Innocent spouse is not eligible for a refund under IRC §6015 of payments made from community property on husband's tax debt.

*Ordlock v Commissioner* (9th Cir 2008) 533 F3d 1136

The taxpayer and her spouse lived in California, a community property state, and filed joint federal income tax returns. The IRS made deficiency assessments for the 1982, 1983, and 1984 tax years. Except for one payment of approximately \$2500 made from the taxpayer's separate property, all payments and credits applied to the couple's tax debt were made from community property. The taxpayer filed a request under IRC §6015(b) for "innocent-spouse" relief from joint and several liability on the tax debt. The IRS granted relief for the three years in a stated amount, and notified the taxpayer. The notice indicated that the couple had no remaining tax liability for the subject years, but did not address whether the taxpayer was eligible for any refund of any amounts previously paid. The taxpayer sought review of the IRS notice.

The parties agreed to submit the case to the Tax Court to resolve the issue of whether the taxpayer was entitled to a refund of the payments made from community property. The taxpayer argued that §6015 requires that the payments she made from community property be allocated between herself and her husband despite the continued existence of the marital community. The IRS argued that §6015 did not preempt community property law for purposes of calculating refunds and that she was ineligible for a refund for payments on her husband's tax debt paid from their community property. The Tax Court ruled in favor of the IRS and the taxpayer appealed.

The Ninth Circuit affirmed, concluding that the taxpayer was ineligible for a refund for payments on her

husband's tax debt made from their community property. The question before the court was whether Congress, in enacting IRC §6015, intended to preempt California's community property law with respect to an innocent spouse's right to a refund. The answer depends on the construction of certain language in §6015(a) and (g), the refund provision.

The court observed that the issue of whether §6015 preempts community property law for purposes of calculating innocent-spouse refunds is one of first impression that depends on statutory construction. The court remarked that federal law supplants community property law only when congressional intent to preempt is clear and unequivocal.

The court found that nothing in §6015 clearly preempts California community property law with respect to an innocent spouse's entitlement to a refund for a community property payment on the noninnocent spouse's federal income tax liability. The last sentence of §6015(a), providing that any determination under the section be made without regard to community property laws, did not reveal congressional intent to preempt community property law with respect to all subsections of §6015. Rather, the plain language of the provision applies only to "determinations" made under §6015, and the only "determination" within §6015's meaning was the initial decision that the taxpayer was an innocent spouse. Whether that innocent spouse is then eligible for a refund is a separate question governed by the applicable law of the state where the innocent spouse resides. In other words, the allowance of a refund is not a "determination" and is not affected by the directive found in §6015(a) to disregard community property laws.

Regarding the phrase "notwithstanding any other law or rule of law" in §6015(g)(1), the court thought it unlikely that Congress intended the phrase to broadly preempt all state property laws for the purposes of calculating refunds. Rather, context and statutory history suggested that Congress intended to avoid the "law" of res judicata while respecting other limits on refunds throughout the Internal Revenue Code.

**COMMENT:** Lois Ordlock and her husband Bayard lived in California. They filed joint federal income tax returns for three years for which the Internal Revenue Service found they had understated their income tax liabilities. The IRS assessed additional tax, penalties, and interest. In succeeding years, Lois and Bayard made payments on the tax debt from community property, except for one payment made from Lois's separate property.

Lois later requested innocent-spouse relief from joint and several liability on the tax debt. The Internal Revenue Service granted that relief for the three years but did not address the issue of whether she was eligible for any refund of the amounts she had previously paid.

Lois sought a refund of the taxes previously paid from community property, arguing that the payments made from community property had to be allocated between her and Bayard even though they remained married.

Although the IRS did refund the payment made from her separate property, it did not agree to refund payments made from her share of community property. The parties agreed to submit the issue to the Tax Court. The Tax Court ruled in favor of the IRS and Lois appealed to the Ninth Circuit.

The Ninth Circuit acknowledged that the question of whether IRC §6015, the innocent-spouse provision, preempts state community property law for purposes of calculating innocent-spouse refunds was an issue of first impression. The court noted that federal law supplants community property laws only when congressional intent to do so is clear and unequivocal. Because IRC §6015 provides that any determination made under that section would be made without regard to community property laws, the court concluded that the answer would lie in the meaning of the word "determination." The word "determination" appears five times in §6015, but the court noted that the term is absent in §6015(g)(1), the refund provision of the statute, which states that a "credit or refund shall be allowed or made to the extent attributable to the application of this section." The court found that this was a significant distinction and concluded that if Congress had intended that §6015(g)(1) preempt state community property laws, it would have made sure that the issue of a refund or credit was a "determination" within the meaning of the statute. The court further concluded that the word "determination" in §6015 referred only to the issue of whether a taxpayer was entitled to relief from joint and several liability. Because California community property law provides that community property is available to satisfy not only the joint debts of the married couple, but also the separate liabilities of each spouse, Lois was not entitled to a refund.

This is an unusual innocent-spouse case, because Lois and Bayard remained married. Lois's attempt to gain innocent-spouse relief may have been a joint effort on the part of both of them to protect one-half of their property. If Bayard's share of community property had been substantial enough to pay all of the taxes due, the Internal Revenue Service could have collected only against his community property, because he and Lois were jointly and severally liable for all taxes on their joint tax return. A more typical case follows a divorce when the couple has divided their property and the IRS has assessed additional tax on a joint return filed when they were still married.—*M.B.* ♦

## Intellectual Property

Surjit P. Singh Soni

### Lanham Act

**Lanham Act and state tort law claims based on defendant's representation of patent infringement require proof that defendant's representation was made in bad faith.**

*Fisher Tool Co. v Gillet Outillage* (9th Cir 2008) 530 F3d 1063

Gillet Outillage, a French manufacturer of hose clamp pliers, owned French and U.S. patents on the pliers' design. After discovering that Fisher Tool Co. (plaintiffs),