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Certiorari Granted in *Connelly*

January 16, 2024

A. Introduction

The *certiorari* application in *Connelly v. Internal Revenue Service*, 70 F.4th 412 (8th Cir. 2023), was granted by the Supreme Court on December 13, 2023. It commences as follows:

QUESTION PRESENTED

Closely held corporations often enter into agreements requiring the redemption of a shareholder's stock after the shareholder's death in order to preserve the closely held nature of the business. Corporations that enter such agreements often purchase life insurance on the shareholder in order to fund the transaction. The question presented is:

Whether the proceeds of a life-insurance policy taken out by a closely held corporation on a shareholder in order to facilitate the redemption of the shareholder's stock should be considered a corporate asset when calculating the value of the shareholder's shares for purposes of the federal estate tax.

The Eighth Circuit answered this question in the affirmative despite the fact that in earlier cases two other circuit courts had ruled to the contrary. *Estate of Cartwright v. Comm'r*, 183 F.3d 1034 (9th Cir. 1999); *Estate of Blount v. Comm'r*, 428 F.3d 1338 (11th Cir. 2005).

B. Treasury Regulation

Treas. Reg. §20.2031-2(f), dealing with valuation, states:

Where selling prices or bid and asked prices are unavailable. If the provisions of paragraphs (b), (c), and (d) of this section are inapplicable because actual sale prices and bona fide bid and asked prices are lacking, then the fair market value is to be determined by taking the following factors into consideration:

(1) In the case of corporate or other bonds, the soundness of the security, the interest yield, the date of maturity, and other relevant factors; and

(2) In the case of shares of stock, the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors.

Some of the "other relevant factors" referred to in subparagraphs (1) and (2) of this paragraph are: The good will of the business; the economic outlook in the particular industry; the company's position in the industry and its management; the degree of control of the business represented by the block of stock to be valued; and the values of securities of corporations engaged in the same or similar lines of business which are listed on a stock exchange. However, the weight to be accorded such comparisons or any other evidentiary factors considered in the determination of a value depends upon the facts of each case. In addition to the relevant factors described above, consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such nonoperating assets have not been taken into account in the determination of net worth, prospective earning power and dividend-earning capacity.

Complete financial and other data upon which the valuation is based should be submitted with the return, including copies of reports of any examinations of the company made by accountants, engineers, or any technical experts as of or near the applicable valuation date.

The Eighth Circuit concluded that "an obligation to redeem shares is not a liability in the ordinary business sense." The language from the Treasury regulation does not specifically answer the question regarding inclusion.

C. Facts

Thomas and Michael Connelly were the owners of a closely-held building-materials company [Crown]. With the company, they entered into an agreement providing that the company would redeem the shares of whichever brother died first. Crown purchased $3.5 million in life insurance on each brother. After Michael died, his son and Thomas negotiated an agreed upon redemption price of $3 million for Michael's stock.

The parties in the case entered into stipulations during the District Court proceedings. First, they stipulated that under the agreement the brothers intended for Crown (rather than the surviving brother) to purchase the deceased brother's shares. They also stipulated that if the life insurance proceeds were not added to the total value of Crown, the fair market value of the estate's shares would be $3.1 million.

D. Reasoning of *Connelly*

The *Blount* decision cited above and relied on by the Eighth Circuit in *Connelly* said:

To establish the fair market value of BCC, the Tax Court blended the analyses of the experts to arrive at a value of $6.75 million. The IRS and the Taxpayer, albeit alternatively, agree that this is the base value for the assets and liabilities of BCC as of the date of Blount's death. We accept the accuracy of this value as not clearly erroneous. The Tax Court then added the insurance proceeds that BCC would receive on Blount's death to the value of the company, concluding that the value of BCC would have been $9.85 million. In doing so, the Tax Court erred.

In valuing the corporate stock, "consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent that such nonoperating assets have not been taken into account in the determination of net worth." Treas. Reg. §20.2031-2(f)(2). The limiting phrase, "to the extent that such nonoperating assets have not been taken into account," however, precludes the inclusion of the insurance proceeds in this case. In *Cartwright v. Commissioner*, the Ninth Circuit approved deducting the insurance proceeds from the value of the organization when they were offset by an obligation to pay those proceeds to the estate in a stock buyout. 183 F.3d 1034, 1038 (9th Cir. 1999)[5]; see also *Huntsman v. Comm'r*, 66 T.C. 861, 875 (1976)[6].

The rationale in *Cartwright* is persuasive and consistent with common business sense. BCC acquired the insurance policy for the sole purpose of funding its obligation to purchase Blount's shares in accordance with the stock-purchase agreement. Even when a stock-purchase agreement is inoperative for purposes of establishing the value of the company for tax purposes, the agreement remains an enforceable liability against the valued company, if state law fixes such an obligation.[7] Here the law of Georgia required such a purchase. Thus, we conclude that the insurance proceeds are not the kind of ordinary nonoperating asset that should be included in the value of BCC under the treasury regulations. To the extent that the $3.1 million insurance proceeds cover only a portion of the Taxpayer's 83% interest in the $6.75 million company, the insurance proceeds are offset dollar-for-dollar by BCC's obligation to satisfy its contract with the decedent's estate. We conclude that such nonoperating "assets" should not be included in the fair market valuation of a company where, as here, there is an enforceable contractual obligation that offsets such assets. To suggest that a reasonably competent business person, interested in acquiring a company, would ignore a $3 million liability strains credulity and defies any sensible construct of fair market value.

E. Asserted Errors of Eighth Circuit Decision

The brief's analysis of why the decision is incorrect is as follows:

In this case, the court of appeals held that, despite an undisputed contractual obligation for a closely held corporation to use the proceeds of a life-insurance policy on one of its owners for the redemption of the owner's stock, those proceeds should be considered additional assets of the corporation for purposes of determining the fair market value of the stock. That decision was incorrect.

1. As this Court has explained, "a necessary first step in calculating the taxable estate for federal estate tax purposes is to determine the property included in the gross estate, and its value." *Commissioner v. Estate of Hubert*, 520 U.S. 93,99-100 (1997). In order to determine the value of stock held as part of the gross estate, courts must apply the "willing buyer-willing seller test." *United States v. Cartwright*, 411 U.S. 546, 551 (1973). Under that test, a court considers a hypothetical buyer who operates without compulsion and who possesses "reasonable knowledge of relevant facts." *Ibid*, (citing 26 C.F.R. 20.20314(b)).

In applying that test, a court considers not only a corporation's assets, but also its liabilities. See, e.g., *Estate of Jelke v. Commissioner*, 507 F.3d 1317,1331-1333 (11th Cir. 2007); *Eisenberg v. Commissioner*, 155 F.3d 50, 57 (2d Cir. 1998). Accordingly, as the relevant regulations confirm, a company's non-operating assets must be considered only to the extent they are not yet accounted for as part of the company's "net worth." 26 C.F.R. 20.2031-2(f)(2). Indeed, even the court of appeals appeared to accept the premise that nominal assets that are "directly offset" by a corresponding liability should not be considered when establishing the value of a corporation for estate-tax purposes. App., *infra*, 13a-15a.

If the court of appeals had properly applied those principles, it would have rejected the IRS's attempt to categorize the insurance proceeds as an additional corporate asset relevant to the valuation of Michael Connelly's estate. The court acknowledged that Crown obtained life insurance on Michael for the purpose of ensuring that, when he died, "the corporation could use the proceeds to redeem his shares." App., *infra*, 1a. The court also acknowledged that the corporation in fact used $3 million in insurance proceeds to purchase the estate's shares. See *id*. at 3a. And it acknowledged that, excluding consideration of the insurance proceeds, the estate's shares were worth approximately $3 million. See *id*. at 4a n.2.

In light of those undisputed facts, the court of appeals should have concluded that $3 million of the insurance proceeds was offset by the contractual obligation to use those proceeds to redeem Michael's stock. Put differently, because $3 million of the insurance proceeds were spoken for, the court should have held that those funds constituted a funding vehicle, rather than a genuine asset.

2. Rather than applying the foregoing analysis, the court of appeals concluded that the $3 million in insurance proceeds increased Crown's value (and thus the value of the estate's shares) by nearly 80%, even though Crown's net assets remained unchanged. In reaching that counterintuitive conclusion, the court of appeals committed multiple errors.

b. The court of appeals first erred by applying a distorted version of the willing-buyer/willing-seller test based on a speculative transaction.

Rather than imagining an investor seeking to purchase some portion of the actual stock at issue (*i.e*., that held by the estate), the court of appeals posited a buyer seeking to "own Crown outright" in order to reap the benefit of the insurance proceeds. App., *infra*, 14a. Such a prospective buyer, the court asserted, could capture the insurance proceeds by obtaining *both* Michael's and Thomas' shares before redemption. The buyer could then "extinguish the stock-purchase agreement or redeem the shares from himself," thus ending up with full ownership of Crown *and* the full amount of the life-insurance proceeds. In light of that potential windfall, the court of appeals concluded, a buyer would be willing to "pay up to $6.86 million" for the entire company. *Ibid*, (emphasis omitted).

That analysis badly distorts the willing-buyer/willing seller test because it is predicated on the hypothetical purchase of the entire company, rather than the shares at issue. To be sure, a hypothetical buyer that successfully purchased all of Crown's shares could reap a windfall. But the fair market value of individual stock is not assessed based on the price an investor would be willing to pay for the company as a whole. To the contrary, bids that seek control of an entire company generally offer a substantial premium above the fair market value of individual stock. See, *e.g.*, *Katz v. Gerardi*, 655 F.3d 1212,1215 (10th Cir. 2011). What is more, a hypothetical purchaser of the *estate's* stock would not pay an elevated price based on the hope of "own[ing] Crown outright" because such a purchaser could not be certain that Thomas would sell *his* shares. As a result, a hypothetical buyer would not count on obtaining the insurance proceeds before they exit the company, and he would acquire the estate's stock for a price that disregards them.

b. The court of appeals also erred by misapprehending the financial significance of a contractual redemption obligation. Although the court appeared to acknowledge that a nominal asset directly offset by a liability should not be considered for purposes of estate valuation, it reasoned that a contractual obligation to redeem shares "is not a liability in the ordinary business sense." App., *infra*, 14a. In the court's view, the "redemption of stock is a reduction of surplus, not the satisfaction of a liability." *Ibid*, (citation omitted).

The court appears to have confused the redemption of stock *in general* with redemption of *stock pursuant to a contractual obligation*. It is true, of course, that a stock redemption is not in and of itself a "satisfaction of liability." But the question here is whether a redemption pursuant to a contractual obligation constitutes a "satisfaction of liability." The answer to that question is yes. Under traditional accounting principles, "[a] demand of any sort against a corporation, even though contingent, unliquidated, or disputed, such as a damage claim or a guaranty of another's obligation, is still characterized as a liability." Cox & Hazen §19:5, at 463.

Nor does it matter that the redemption of an estate's stock produces a corresponding benefit for the surviving shareholders. App., *infra*, 14a-15a. The question for purposes of the estate tax is the fair market value of the estate's stock if it were sold to a third party, not the effect of such a sale on preexisting shareholders. In any event, when assessing the value of a company, it is the *corporation's* assets, not those of the shareholders, that drives the analysis. And from the perspective of the corporation, the reacquisition of stock is no benefit at all. A company's own equity is "not an asset to the corporation," *Strovgo v. Bassini*, 282 F.3d 162, 175 n.10 (2d Cir. 2002), which is why corporate redemptions result in a net loss to the corporation. See *T.J. Enterprises, Inc. v. Commissioner*, 101 T.C. 581,591 (1993), *aff'd*, 76 F.3d 976 (9th Cir. 1995). Indeed, the court of appeals seemed to recognize as much when it generally described the redemption of stock as a "reduction of surplus." App., *infra*, 14a (citation omitted). Like a dividend, the redemption of stock benefits shareholders at the expense of the corporation.

c. The court of appeals compounded those errors through its interpretation of the applicable regulations. Those regulations provide that, when "actual sale prices and bona fide bid and asked prices are lacking," then the fair market value of shares of stock should "be determined by taking * * * into consideration * * * the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors," including the "good will of the business," "the economic outlook in the particular industry," and "the company's position in the industry and its management." 26 C.F.R. 20.2031-2(f). The regulations further provide that, in addition to those factors, "consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such nonoperating assets have not been taken into account in the determination of net worth, prospective earning power and dividend-earning capacity." *Ibid*. At the same time, the regulations caution that "the weight to be accorded" to any particular factor "depends upon the facts of each case." *Ibid*.

The regulations thus limit consideration of life-insurance proceeds in valuing stock for estate-tax purposes in two distinct ways. *First*, the regulations specifically restrict consideration of insurance proceeds to the extent they have already been taken into account elsewhere in the valuation. *Second*, the regulations require that, like all of the relevant regulatory factors, insurance proceeds should be assigned only the weight due to them under the facts of the particular case.

Although the court of appeals purported to acknowledge the first limitation, it seems to have entirely missed the second. Even if the court were correct that life-insurance proceeds designated for a stock redemption are not excludable on the ground that they have been "taken into account," the court should still have assigned minimal "weight" to those proceeds on the ground that they were simply passing through the company. Indeed, before reversing positions in *Estate of Blount* (and this case), the IRS acknowledged as much in its brief to the Ninth Circuit in *Estate of Cartwright*, explaining that, because "the regulation also states, 'the weight to be accorded * * * evidentiary factors considered in the determination of a value depends upon the facts of each case,'" contractual liabilities "would offset the value" of designated insurance proceeds. Br. at 40-41, *Estate of Cartwright*, *supra* (No. 97-70032).

d. Nor was the court of appeals correct that adopting petitioner's approach would result in a "windfall" for surviving shareholders. The proceeds of a life-insurance policy are not a "windfall," because the policy is purchased by insurance premiums (often over many years). Nor is there anything untoward about life-insurance proceeds being received tax-free. Indeed, life-insurance proceeds are not subject to estate tax as long as the decedent did not possess "any of the incidents of ownership" in those policies or as long as the proceeds are owned and "payable to the corporation." 26 U.S.C. 2042; 26 C.F.R. 20.2042-1(c)(6). The IRS has never disputed that those provisions preclude subjecting the life-insurance proceeds to estate tax here.

The court of appeals' concern about a windfall also makes little sense on its own terms, because it would subject only Michael's estate to increased federal tax. If, as the court of appeals reasoned, the agreement resulted in a "windfall to Thomas," who retained his Crown stock after Michael's death, App., *infra*, 14a, one would expect Thomas to bear the accompanying tax consequences. But the court of appeals' rule does not affect Thomas at all, instead subjecting Michael's estate to tax consequences in his place. The court of appeals' rule thus amounts to a backdoor attempt to impose liability on one taxpayer for the gains of another. This Court should grant review and reverse the court of appeals' counterintuitive decision.

F. Government's Brief

The response by the Solicitor General to the estate's brief contains the following discussion:

Petitioner renews his contention (Pet. 15-21) that, for purposes of the federal estate tax, the value of Michael Connelly's shares in a closely held corporation must exclude the value of the life-insurance proceeds to which the corporation was entitled on the date of Michael's death. The court of appeals correctly rejected that contention, which is contrary to the text of the relevant regulations [quoted above] and defies customary valuation principles. And although petitioner contends that the decision below conflicts with decades-old decisions of the Ninth Circuit and Eleventh Circuit, he overstates the extent of any disagreement in the lower courts. Any disagreement, moreover, is of limited practical significance. Owners of closely held corporations have multiple options for limiting the taxability of life-insurance proceeds under circumstances like these—including options that Michael and petitioner were aware of but chose not to pursue. No further review is warranted.

G. Comments

We disagree with the statement that the case is "of limited practical significance." It affects many small businesses where life insurance has been used to "buy out" one owner of the business.

A decision by the Supreme Court will hopefully create a clear and concise reason for the result reached.

A related provision of the Code, IRC Sec. 2703, states that "the value of any property for tax purposes is determined without regard to any option, agreement, or other right to acquire. . . the property at a price less than the fair market value." IRC Sec. 2703(b) creates an exception if the agreement (1) is a bona fide business agreement, (2) is not a device to transfer property to members of the decedent's family for less than full and adequate consideration, and (3) has terms that are comparable to other similar arrangements entered into in arms'-length transactions, In *Connelly* the court determined that the agreement did not provide a fixed or determinable mechanism to value the stock by a fair and objective measure.

The estate's reply brief makes the obvious point that a primary purpose of Supreme Court review is to resolve differences between circuit courts. Deciding *Connelly* would do so. The brief then points out that the issue involved is important to "small business".

The Connelly estate relied upon the decision of the Eleventh Circuit in *Estate of Blount* which used a balance sheet approach – the life insurance proceeds of a policy paid by a closely-held business are an asset directly offset by a liability to redeem a stockholder's shares with the result that no increase in the company's value occurs. The *Connelly* court agreed with the IRS contention that an obligation to redeem shares is not a liability in the ordinary business sense. Where a corporation purchases its own stock, it is depleting its assets by the amount used in exchange for the stock. The result is an increase in the proportional interest of a non-selling shareholder in the remaining assets of the corporation. The life insurance proceeds were an asset that increased the value of the stock.

More on *Moore;* Supreme Court Briefs and Other Matters

A. Introduction

The Moore case was discussed in issue 2023-2. Taxpayers' brief has been filed contending that the Sixteenth Amendment to the Constitution requires income to be realized. Tax Notes Doc. No. 2023-25256. It commences with the following introduction:

The Sixteenth Amendment empowers Congress "to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States." The Constitution originally required apportionment of all "direct taxes," which the Court in *Pollock v. Farmers' Loan & Trust Co*., 158 U.S. 601, 637 (1895), held to include taxes on "the income of real estate, and of personal property," such as rents and dividends. The Amendment's framers drafted its text to overrule that holding while retaining the apportionment requirement for other direct taxes, including taxes on property. That is why its reach is limited to "taxes on incomes." Then, as now, income was understood to refer to gains realized by a taxpayer through payment, exchange, or the like, not mere increase in the value of property. Appreciation in the value of a home or other asset is not income — at least, not until it is sold and the gain is realized. Realization is not only what distinguishes income from property in general, but what makes income income.

That was the holding of the Court's Sixteenth Amendment landmark, *Eisner v. Macomber*, 252 U.S. 189 (1920). The "characteristic and distinguishing attribute of income" is that "a gain, a profit, something of exchangeable value" is "*received* or *drawn* by the recipient (the taxpayer) for his *separate* use, benefit and disposal." *Id*. at 207 (emphases in original). "Nothing else answers the description." *Id*. Accordingly, mere "enrichment through increase in value of capital investment is not income in any proper meaning of the term." *Id*. at 214–15. The Court has never retreated from *Macomber's* core holding on realization; to the contrary, its precedent from that era to the modern day consistently observes the necessity of realization to income. Congress, too, has accepted that understanding, structuring federal income taxes to turn on taxpayer realization.

With one recent exception. Enacted to offset the cost of a 2017 corporate tax reform, the Mandatory Repatriation Tax was designed to achieve a one-time windfall in tax revenue from earnings that had been accumulated by foreign corporations with U.S. owners over the preceding three decades. Rather than encourage those corporations to make distributions with a favorable tax rate, as Congress had previously done, the MRT simply deems their accumulated earnings to be the "income" of whoever happened to own the requisite number of shares on an arbitrary date in 2017. Unlike with other income-attribution schemes, MRT liability does not turn on constructive realization of income by those being taxed; instead, it turns on ownership of a specified asset at a specified time. It is a tax on property, not income in any sense of the word. Petitioners Charles and Kathleen Moore were hit with MRT liability because they are minority shareholders in a foreign corporation that reinvested its earnings to grow its business, without distributing a penny to them — and it may well never. Yet the MRT tagged them with $132,512 in 2017 "income" and taxed them on it.

Because it was undisputed that the Moores had realized nothing, to uphold their tax liability the Ninth Circuit was compelled to hold that "realization of income is not a constitutional requirement" for an income tax under the Sixteenth Amendment. Pet.App.12. That radical notion stands in conflict with the Amendment's original meaning, this Court's longstanding precedent, and a century of constitutional practice. Worse, it renders the Constitution's apportionment requirement a dead letter, opening the door to unapportioned taxation of anything that Congress might deem a person's "income," from property to growth in retirement investments to uncertain or even fictional gains. The Constitution's Framers were wary of direct taxation because they knew it could be used to work "partiality or oppression" against disfavored persons and places. The Federalist No. 36 (Hamilton). Their solution was to align this dangerous mode of taxation with representation, ensuring that its burdens would be shared broadly, not imposed according to political power or caprice. The Sixteenth Amendment's framers retained that vital protection, being no less wary than their predecessors of federal taxation of property.

The Ninth Circuit's decision upends the careful balance of power and accountability that the Framers struck and the Sixteenth Amendment preserved, solely to uphold a novelty of a tax enacted without any consideration of its constitutional validity. That decision should be reversed.

An article supports the position that at the time of the Sixteenth Amendment, no clear meaning of the term "incomes" existed. Thorndike, Moores Lean on 1916 Tax Expert to Argue No Realization Means No Income, Tax Notes Federal, Volume 181, November 20, 2023, p.1356.

B. Possible Avoidance of Decision as to Realization

On page 21 of Issue 2023-2, we noted that a possibility existed the Supreme Court might decide the *Moore* case without getting involved in whether realization of income was required. An amicus brief filed on behalf of Professor Hank Adler deals with this possibility. See Tax Analysts Doc. No. 2023-2585. His theory is that the right structure of the Mandatory Repatriation Act is an unconstitutional direct tax. See also, Adler and Spach, More on *Moore*, Tax Notes Federal, Vol. 180, September 18, 2023, p. 2079; Letters to the Editor, More is Less: Holding Must Be Limited to Individual Shareholders, Tax Notes Federal, Vol. 180, September 11, 2023, p. 1963; Velarde, Transaction Tax Drafter, Quit It With 'Mandatory Repatriation Tax', Tax Notes, Doc. 2023-31677.

C. Support for Government

An amicus brief of 33 pages has been filed by Calvin H. Johnson of the University of Texas School of Law supports the position of the Ninth Circuit in *Moore*. On page 2 in a section captioned SUMMARY OF THE ARGUMENT, he states:

This Court should overrule *Pollock v. Farmers' Loan & Trust Co*., 157 U.S. 429; 158 U.S. 601 (1895) explicitly to return to the Founders' understanding that apportionment of direct tax by population is required only when apportionment is constructive and yields a uniform tax rate across the states. A tax that does not have an equal per-capita base is not a direct tax. *Hylton v. United States*, 3 U.S. 171 (1796).

Pollock was inconsistent with the original meaning of the Constitution when decided, later confined to its facts before the Sixteenth Amendment, and finally abrogated in its last redoubt by the Amendment. It now should be overruled explicitly and without remnant. With the fall of *Pollock*, *Eisner v. Macomber*, 252 U.S. 189 (1920), should be overruled automatically and explicitly. Petitioners would then have no basis for challenging the Code section 956 tax, and the decision below should be affirmed.

Later his brief provides:

C. After the adoption of the Sixteenth Amendment, *Eisner v. Macomber* inappropriately found that a poorly conceived tax passed by the majority of the people was unconstitutional with unstated reliance on use of apportionment as a killing requirement when killing apportionment was no longer available.

In *Eisner v. Macomber*, 252 U.S. 189 (1920), the Court held that tax on a pro rata stock dividend was unconstitutional, even after passage of the Sixteenth Amendment, on the ground that a stock dividend was not "income" within the Amendment. *Macomber* defined income as requiring a severance from capital, and a stock dividend was not such severance.

Macomber used apportionment as a fatal requirement to kill a tax when apportionment was not a constructive rule reaching uniform rates, and such use is inconsistent with the Constitution's original meaning, with the abrogation of *Pollock* by this Court's subsequent decisions, and by the Sixteenth Amendment overruling *Pollock*.

Citing neither *Pollock* nor *Hylton*, the *Macomber* Court used apportionment to destroy a legislated tax. Under *Hylton*, a tax on stock dividends is a not a direct tax because stock dividends are not the same per capita in every state; taxpayers in poorer states have fewer stock dividends per capita than in richer states. While *Pollock* ignored *Hylton*, *Pollock* was an illegitimate case when decided, inconsistent with both the Founders' meaning and a hundred years of sound precedent going back to those Founders. *Pollock* had been confined to its facts in every case before the Court by a legal fiction, "excise," and *Pollock* was killed on its only holding that an income tax was not constitutional by the overwhelming voice of the people in the Sixteenth Amendment. With the de facto death of *Pollock*, *Hylton* was and is the law of the land. Under *Hylton's* holding, toxic apportionment may not be used to defeat a tax that cannot be constructively apportioned. Notwithstanding *Macomber*, it does not matter whether a tax is on income. Congress has the general power to raise taxes. Art. I, §8, Cl. 1. With the fall of *Pollock*, *Macomber* needs fall with it, and the Moores' attack on the Code section 956 transition tax has no constitutional basis.

Macomber will not be missed when its basis is destroyed by overruling *Pollock*. The attacks on *Macomber's* specific definition of income are devastating. Governing New York law at the time defined a stock dividend as income, not belonging to the capital interest: Corporate earnings were the harvest, the income from investment in a corporation, which could not be denied to income beneficiaries by mere decision of the board to accumulate earnings. New York law treated a stock dividend as sufficient proof of earnings. *McLouth v. Hunt*, 154 N.Y. 179, 198 (1897); Edwin A. Howes, <u>The American Law Relating to Income and Principal</u> 29–30 (1905). The *Macomber* Court drew its definition of income from "brooding omnipresence," not New York law, in the days before *Erie Railroad Co. v. Tompkins*, 304 U.S. 64 (1938) told the federal courts to look to state law to determine legal rights.

Savings, moreover, are part of the economic definition of income, but they do not need to be severed from capital this year nor reduced to cash to serve the function of savings as a cushion in case needed, as the source of future consumption and as collateral for borrowing cash now. Savings are income even if not severed.

The *Macomber* requirement of severance is also inconsistent with the definitions of income required by financial reporting required for publicly traded corporations, which requires a parent corporation to include the earnings of subsidiary in parent's reported income as the money is earned even if not distributed. See, e.g., Accounting Standard Codification ("ASC") Topic 810-10-25-1; ASC Topic 323-10. Financial accounting also now "marks to market" gains on publicly traded stock during the year, even if the stock is not sold or reduced to cash. Financial Accounting Standards Board, Statement No. 115 (1993).

This Court also should not let itself be drawn into defining "income." *Macomber*, in its assumption the tax was subject to fatal apportionment unless it was on "income," implies that this Court must micromanage an area, taxation, in which it has no special inclination. For example, it is said both that the Constitution prohibits taxation of cash received before it is earned (John Nolan, *The Merit in Conformity of Tax to Financial Accounting*, 50 Taxes 761, 767–769 (1972)) and also that an earned requirement has no place in tax or nontax accounting. Johnson, *The Illegitimate 'Earned' Requirement in Tax and Nontax Accounting*, 50 Tax L. Rev. 373 (1995). Under the Constitution, these micromanagement tax issues are for Congress to decide, not the courts. But such a reorientation would require full reversal of *Pollock* and *Macomber* to allow the Democracy to get control over its own tax.

To the same effect, see Cummings, *Moore*: *Macomber* Was Wrongly Decided and Other Considerations, Tax Notes Federal, September 25, 2023, p. 2307.

D. Government's Brief

The brief for the government in the Supreme Court has been filed. See Tax Notes Document Service Doc. 2023-30016. It contains the following discussion:

3. Petitioners' congressional-practice argument lacks merit

Attempting their own congressional-practice argument, petitioners contend (Br. 37) that in "the aftermath" of the Court's 1920 decision in *Macomber*, Congress "observed the need for realization of taxable income" and has "consistently" taxed realized gains since. But any "reconfigur[ation]" (Pet. Br. 39) of income taxes after *Macomber* only confirms that *before* 1920, Congress did not view the Sixteenth Amendment as restricting its power to tax unrealized gains.

And as explained below, this Court subsequently limited *Macomber* to the stock-dividend context in which it arose. Once it became clear that *Macomber* did not create the rigid realization requirement that petitioners assert, Congress resumed enacting taxes that disregard that requirement, including Subpart F. While Congress has not "redefin[ed] the Tax Code's central 'gain or loss' provision to include unrealized appreciation in property," Pet. Br. 40, Congress's targeted decisions to tax unrealized appreciation demonstrate that it perceives no constitutional imperative—even as it often recognizes the "'administrative convenience'" of taxing gains upon realization, given the potentially "'cumbersome'" task "of valuing assets on an annual basis to determine whether the assets ha[ve] appreciated or depreciated in value." *Cottage Sav. Ass'n v. Commissioner*, 499 U.S. 554, 559 (1991) (citations omitted).

C. This Court Has Recognized Congress's Power To Tax Individuals On Their Pro Rata Shares Of Undistributed Business Earnings

Before the Sixteenth Amendment, *Hubbard*, [79 U.S.1 (1871)] held that Congress may tax individuals' shares of undistributed corporate earnings as income. 79 U.S. at 18. Following the Amendment's adoption, this Court has consistently made clear that Congress may tax "all economic gains." *Banks*, 543 U.S. at 433. And the Court has emphasized that the Amendment empowers Congress to choose "how taxes may be laid" on such gains, so long as its choice is "neither unreasonabl[e] nor arbitrar[y]." *Taft v. Bowers*, 278 U.S. 470, 481, 483 (1929).

In arguing that the Sixteenth Amendment's *grant* of power somehow stripped Congress of a preexisting authority recognized in *Hubbard*, petitioners stake their case on dictum in *Macomber* implying that shareholders must receive monetary distributions of corporate earnings before being taxed on them. But *Macomber's* dictum was poorly reasoned and has been abrogated by many later decisions. As it stands, this Court has limited *Macomber* to the stock-dividend context in which it arose.

1. *Macomber's* dictum erroneously implied that Congress cannot tax shareholders on undistributed corporate earnings

a. In *Macomber*, the Court considered whether a particular type of "stock dividend" was taxable income. 252 U.S. at 210. Standard Oil shareholders had received an additional 50% of their current number of common shares (*e.g.*, a shareholder with 2200 common shares received 1100 additional common shares). See *id*. at 200-201. As the Court explained, such a "'stock dividend'" is a "book adjustment" that "does not alter the preexisting proportionate interest of any stockholder or increase the intrinsic value of his holding." *Id*. at 210-211. "The new [stock] certificates simply increase the number of the shares, with consequent dilution of the value of each share." *Id*. at 211.

The Court thus held that "the essential nature of a stock dividend necessarily prevents its being regarded as income in any true sense" under the Sixteenth Amendment. *Macomber*, 252 U.S. at 205. The Court recognized that it could have "rest[ed] the * * * case there." *Ibid*. But it proceeded to observe that "income" under the Sixteenth Amendment is "a gain, a profit, something of exchangeable value" that is "*received* or *drawn by* the recipient (the taxpayer) for his *separate* use, benefit, and disposal." *Id*. at 207. According to petitioners (Br. 17-18), that dictum bars Congress from taxing shareholders on undistributed corporate income.

b. Macomber's dictum was misconceived in multiple respects. The Court began from the premise that "[i]ncome may be defined as the gain derived from capital, from labor, or from both combined." *Macomber*, 252 U.S. at 207 (citation omitted). Citing no authority, it then read that definition of income to mean that the gain must be "*received* or *drawn* by the recipient (the taxpayer) for his *separate* use, benefit and disposal." *Ibid*. As Justice Holmes emphasized in dissent, that novel reading of income contradicted "the common understanding" of the term "'at the time of [the Amendment's] adoption.'" *Id*. at 220 (citation omitted); see *id*. at 237 (Brandeis, J., dissenting) (stating that the majority defied the "reasonable understanding" of what is fairly "regarded as income").

Petitioners err in asserting (Br. 19) that *Macomber's* definition of income "was the logical consequence" of the Court's decisions in *Brushaber* and *Lynch v. Hornby*, 247 U.S. 339 (1918). *Brushaber* never attempted to define income; it held that the Sixteenth Amendment "prevent[ed]" courts from relying on "the sources from which a taxed income was derived" when determining whether apportionment was required. 240 U.S. at 19. *Hornby* observed that "Congress was at liberty to treat [certain] dividends" as "income when they came to hand," without suggesting that Congress could tax shareholders *only* then. 247 U.S. at 344.

The *Macomber* Court also misunderstood the historical practice. It recognized that *Hubbard* had upheld taxes on shareholders' portions of undistributed corporate earnings, but it concluded that *Hubbard* "must be regarded as overruled by *Pollock*." *Macomber*, 252 U.S. at 218. That reasoning ignores that the Sixteenth Amendment overturned *Pollock* and "forbids" applying that decision to income taxes. *Brushaber*, 240 U.S. at 19. Under the *Macomber* Court's apparent view, the Sixteenth Amendment negated *Pollock's* income-tax holding *except* as applied to the income taxes at issue in *Hubbard*. Nothing in the Amendment's text or history supports that understanding. To the contrary, the Sixteenth Amendment authorized precisely those income taxes—like those taxing undistributed corporate earnings from 1864 through 1871—that "had been in actual operation within the United States before its adoption." *Burnet*, 282 U.S. at 365.

2. This Court has abrogated *Macomber's* dictum

Macomber "was promptly and sharply criticised." *Griffiths*, 318 U.S. at 373 & n.4 (citing commentary). And the Court has steadily limited its reach. *Macomber* retains vitality only in its specific stock-dividend context and when Congress has expressly invoked realization.

a. One year after *Macomber*, the Court began limiting its force even in the stock-dividend context. In *United States v. Phellis*, 257 U.S. 156 (1921), the Court held that a stock dividend issued as part of a corporate reorganization was income under the Sixteenth Amendment, *id*. at 175, over a dissent suggesting a "conflict with" *Macomber*, *id*. at 176 (McReynolds, J., dissenting). The Court later observed that *Macomber* had led to an "erroneous belief " by some (including in Congress) that "no stock dividend could be taxed." *Helvering v. Gowran*, 302 U.S. 238, 242 (1937). In fact, *Macomber* "affected only the taxation of dividends declared in the same stock as that presently held by the taxpayer," where "the preexisting proportionate interests of the stockholders remained unaltered." *Koshland v. Helvering*, 298 U.S. 441, 444-445 (1936). By contrast, a stock dividend that "gives the stockholder an interest different from that which his former stock holding represented" remained "taxable as income," *id*. at 446—even though such dividends are not "*received* or *drawn by* the recipient (the taxpayer) for his *separate* use" as *Macomber*'s dictum would have required, 252 U.S. at 207.

b. In the 1940s, the Court refused to apply *Macomber* beyond the stock-dividend context. In *Helvering v. Bruun*, 309 U.S. 461 (1940), a tenant erected a new building on a landlord's land and then defaulted on the lease. *Id*. at 462. When the government tried to tax the building's value as the landlord's income, he contended that the gain was not yet "realized within the meaning of the Sixteenth Amendment" and would become income "only upon [his] disposition of the asset." *Id*. at 467. The Court disagreed, holding that the term income was "broad enough to embrace the gain in question," even though the landlord could not "sever the improvement begetting the gain from his original capital." *Id*. at 468-469.

The *Bruun* Court reasoned that *Macomber's* "expressions" about income being a gain "received by the recipient for his separate use" were simply "used to clarify the distinction between an ordinary [cash] dividend and a stock dividend." 309 U.S. at 468-469; see *id*. at 468 n.8. The Court therefore deemed *Macomber's* understanding of income "not controlling." *Id*. at 469.

In *Helvering v. Horst*, 311 U.S. 112 (1940), the Court more directly undermined *Macomber's* dictum by deeming realization a "rule[] founded on administrative convenience" rather than constitutional imperative. Id. at 116. Thus, although *Horst* "addresses what counts as realization" in the context of a gift, Pet. Br. 42, *Horst* viewed its realization analysis as implementing statutory and administrative principles alone.

Three years later, in *Griffiths*, the Court was asked to overrule *Macomber* but avoided the question by holding that the relevant statute did not tax the type of dividends at issue in *Macomber*. 318 U.S. at 394, 404. Before reaching its statutory holding, the Court recounted *Macomber's* erosion, explaining that *Bruun* and *Horst* had "undermined * * * the original theoretical bases of the decision," *id*. at 394, leaving *Macomber* "limited * * * to the kind of dividend there dealt with," *id*. At 375.

In 1955, the Court further vitiated *Macomber* in *Glenshaw Glass*, *supra*. There, the Court held that punitive-damages awards are taxable income, emphasizing that "income" refers to "all gains except those specifically exempted" by the Code. 348 U.S. at 430. The Court thus rejected the taxpayers' reliance on *Macomber's* "characterization of income" as "the gain derived from capital, from labor, or from both combined." *Ibid*. (citation omitted). The Court explained that *Macomber* used that characterization when "determin[ing] whether the distribution of a corporate stock dividend constituted a realized gain to the shareholder, or changed 'only the form, not the essence,' of his capital investment." *Id*. at 430-431 (citation omitted). And while "the definition served a useful purpose" "[i]n that context," the Court made clear that "it was not meant to provide a touchstone to all future gross income questions." *Id*. at 431.

Petitioners emphasize (Br. 24) the statement in *Glenshaw Glass* that punitive-damages awards constituted income because they involved "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." 348 U.S. at 431. But that statement simply listed elements that sufficed to create income on the facts of that case—not necessary elements of income in every case. See *ibid*. (prefacing statement with "[h]ere we have instances of"). Having just explained that *Macomber's* conception of realization was *not* "a touchstone to all future gross income questions," the Court was not treating realization as essential. *Ibid*.

Petitioners cite (Br. 25) three cases quoting *Glenshaw Glass's* statement about realization, but none suggests that realization is a *necessary* element of income. Each involved economic gains far afield from those at issue here. See *Commissioner v. Indianapolis Power & Light Co*., 493 U.S. 203, 209-210 (1990) (customer deposits); *Commissioner v. Kowalski*, 434 U.S. 77, 83 (1977) (meal-allowance payments); *James v. United States*, 366 U.S. 213, 218 (1961) (embezzled funds). And Kowalski recognized that *Glenshaw Glass* "is squarely at odds with" *Macomber's* "definition of income." 434 U.S. at 94.

d. Finally, the Court's 1991 decision in *Cottage Savings Ass'n* reiterated that "the concept of realization is 'founded on administrative convenience.'" 499 U.S. at 559 (quoting *Horst*, 311 U.S. at 116). That realization concept—which applies only when Congress incorporates it—does not even derive from the statutory definition of "gross income." 26 U.S.C. 61(a). Instead, the Court explained, it is rooted in separate provisions, such as one defining "'the gain or loss from the sale or other disposition of property' as the difference between 'the amount realized' from the sale or disposition of the property and its 'adjusted basis.'" *Cottage Sav. Ass'n*, 499 U.S. at 559 (quoting 26 U.S.C. 1001(a)) (brackets omitted). In those provisions, the Court observed, Congress has invoked the concept of realization for the "administrative purpose[]" of streamlining income reporting. *Id*. at 565.

When applying the *statutory* "realization requirement in §1001(a)," the Court looked to *Macomber's* "treatment of realization." *Cottage Sav. Ass'n*, 499 U.S. at 563, 565. But it never suggested that that treatment flowed from the Sixteenth Amendment rather than "Section 1001(a)'s language" prescribing "realization." *Id*. at 559.

Lower courts have followed this Court's lead in recognizing that *Macomber* has been limited to the stock dividend context. See, e.g., *Commissioner v. Obear-Nester Glass Co*., 217 F.2d 56, 60 (7th Cir. 1954) ("[*Macomber*] has been limited to its specific facts."), cert. denied, 348 U.S. 982 (1955). That is how courts have regarded *Macomber* when upholding Subpart F in particular. See *Garlock*, 489 F.2d at 203 n.5.

Similarly, since *Cottage Savings Ass'n*, "[t]he scholarly consensus" is that "[t]he realization requirement is not constitutionally mandated." Cunningham & Schenk, 47 Tax L. Rev. at 741 & n.69; see, *e.g*., 1 Bittker & Lokken ¶5.2, at 5-19 (3d ed. 1999) (explaining that "realization remains largely intact as a rule of administrative convenience (or legislative generosity)" but has been "badly eroded, if not wholly undermined, as a constitutional principle"); Marvin A. Chirelstein & Lawrence Zelenak, *Federal Income Taxation* 59 (14th ed. 2018) (Chirelstein & Zelenak) ("[R]ealization is strictly an administrative rule and not a constitutional, much less an economic requirement, of 'income.'").

Even scholars cited by petitioners (Br. 37-38) agree that "[t]he view that realization is constitutionally mandated has dissipated," and "[n]ow the realization requirement is generally regarded as a concession to the administrative burdens of * * * a system taxing asset appreciation as it occurs." Jeffrey L. Kwall, *When Should Asset Appreciation Be Taxed?*, 86 Ind. L.J. 77, 80 (2011). And scholars have explained that the statutory concept of realization is laden with "ambiguities," *id*. at 100, because "the Code contains no general rule or explicit set of criteria * * * [for] determin[ing] just when a realization has taken place," Chirelstein & Zelenak 101. The amorphous nature of realization further refutes petitioners' contention that it is a bedrock constitutional requirement.

Petitioners thus err in invoking (Br. 14, 26, 36) *stare decisis*. While *Macomber* still governs whether the type of stock dividends at issue there are income and informs application of the statutory concept of realization, this Court has already abrogated its broader relevance as a constitutional precedent. Accordingly, *Macomber* is not controlling here.

In effect, the brief asserts that the *Macomber* decision should be ignored.

E. Taxpayers' Reply Brief

The reply brief of the taxpayers in the Supreme Court (Tax Notes Doc. 2023-33159) focuses on *Macomber*. It states that the Government's assertion that the case is dictum is wrong and says that "*Macomber's* realization holding was correct: precedent, text, structure, and practice all dictate that Sixteenth Amendment 'incomes' require realization."

The brief commences with a heading "REPLY BRIEF" which provides:

The 110 years since adoption of the Sixteenth Amendment have been marked by the unrelenting growth of federal spending and quest for revenue to fund it. Yet Congress has never ventured to tax families on appreciation in their homes, investors on appreciation in their investments, or ordinary shareholders on corporations' retained earnings. That omission reflects not forbearance on Congress's part but the understanding that these enormous pots of potential revenue lie beyond the reach of unapportioned taxation because they are not income.

The Government ignores that central fact in favor of focusing on narrow tax-avoidance measures tailored to target abuses of the corporate form to separate taxpayers from their otherwise-taxable income. Among those is Subpart F, whose reticulated structure can only be understood as an attempt to fit within the limits of the Sixteenth Amendment's exception to apportionment for "taxes on incomes." Yet the Government disavows that Subpart F rests on a theory of constructive realization of income to advance a more ambitious argument: that Congress may tax any "gain" as income, irrespective of taxpayer realization.

That argument is bold in its implications, which would eliminate the central restraint on the federal taxing power by nullifying the apportionment requirement as to taxation of property. Its substance is bolder. The Court rejected the same argument in *Eisner v. Macomber*, 252 U.S. 189 (1920), and its precedent has consistently recognized the necessity of realization. Unlike the last time the Government took a run at *Macomber*, it does not ask the Court to overrule the decision. Instead, it insists *Macomber's* central holding was "dictum," when the Government has always maintained the opposite, or has been overruled, when it has always been followed. *Macomber* decided the question of realization, decided it correctly, and that holding remains good law.

It controls here. Petitioners Charles and Kathleen Moore realized nothing on the investment for which they were subject to liability under the Mandatory Repatriation Tax. The MRT taxes them and others not because they realized income, but because they owned shares in certain corporations on a certain date. The Government identifies no precedent, legislative or judicial, for the MRT's income-taxation of property because of ownership.

The Court should reverse the decision below and reaffirm that unrealized gains are not income.

This is followed by a point-by-point analysis of the quotation in the first paragraph of this section. See Velarde, Moores Fires Back that *Macomber* is Controlling, Not Mere Dictum, Tax Notes Doc. 2023-33199.

F. Graetz Article

An excellent article discussing *Moore* is Graetz, To Avoid the *Moore* Morass, the Court Should DIG It —But It Probably Won't, 181 Tax Notes Federal, November 13, 2023. "DIG" means "dismiss as improvidently granted". The article refers to Chief Justice Roberts's 2012 opinion in *NFIB v. Sebelius*, 567 U.S. 519 (2012), and says:

I believe Chief Justice Roberts's dictum in the Obamacare decision calls into question the constitutionality of a wealth tax, but, of course, the Supreme Court (unlike myself) does not issue advisory opinions. Why the Court might think it needs to decide the wealth tax issue now is highly questionable, to be gentle. In summary, in the century since *Macomber* was decided, no other Supreme Court case has struck down an income tax provision as unconstitutional; there has also been no Supreme Court decision overruling *Macomber* or clearly holding whether there is any realization requirement under the Sixteenth Amendment.

G. Other Matters

Oral argument in *Moore* was held on December 5, 2023. We have read the transcript of the oral argument which is lengthy. Several lawyers have provided their views on *Moore* in an installment of The Star Forum. See *The Biggest Implications of Moore*, Tax Notes Federal, December 18, 2023 at 2147. The last article, *Moore May Be Less (Than It Might Have Been)*, by Lawrence A. Zelenak, states:

My guess is that, although the Court's opinion will neither invalidate the MRT nor cast constitutional doubt on any other provisions in the current code, the Court will make clear that the rumors of the death of *Macomber* are greatly exaggerated and signal that any congressional attempt at broad-based mark-to-market taxation, including the Biden administration's proposed billionaire's tax, would be viewed dubiously (or worse) by the Court. In terms of practical effects in the next few years, the most likely impact of *Moore* may be to discourage Congress from seriously considering enactment of a billionaire's tax.

A letter dated October 3, 2023 from the Joint Committee on Taxation to Ranking Member Neal responded to his request for a discussion of provisions in the federal tax code that could be affected by a ruling for the petitioners in *Moore*. A copy of this letter is in Appendix A.

Appendix A.

118TH CONGRESS, 1ST SESSION

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October 3, 2023

Honorable Richard E. Neal

U.S. House of Representatives

372 Cannon House Office Building

Washington, D.C.20515

Dear Ranking Member Neal

This letter responds to your request for a delineation of present law provisions of the Internal Revenue Code of 1986, as amended (the "Code"), that could be affected by a ruling for the petitioners in *Moore*,[1] which is currently before the Supreme Court. The question presented in *Moore* is whether the one-time transition tax imposed under section 965 (referred to in the petition for writ of certiorari as the "mandatory repatriation tax" or "MRT")[2] is unconstitutional because it is an unapportioned direct tax and is not an income tax under the meaning of the Sixteenth Amendment.

According to the petition for writ of certiorari, the question presented for the court is "[w]hether the Sixteenth Amendment authorizes Congress to tax unrealized sums without apportionment among the states."[3] By contrast, the brief of the United States in opposition to certiorari frames the question for the court as "[w]hether the MRT is a 'tax[] on incomes, from whatever source derived,' within the meaning of the Sixteenth Amendment."[4]

The petitioners assert that the MRT is a tax on unrealized income and that Congress for purposes of the Sixteenth Amendment cannot tax unrealized income. They rely primarily on *Eisner v. Macomber*, 252 U. S. 189 (1920), which the lower court found inapplicable to the Moores' case.[5] The Government, in turn, asserts that the Constitution "does not restrict Congress to taxing only realized gains" and that, even if it did, the MRT is a tax on realized income.[6] The Court may leave unanswered the question of whether the Constitution imposes a realization requirement if it finds that the MRT is a tax on realized income. This letter describes several types of present law provisions that may be implicated if the Court adopts certain definitions of realization suggested in the Petition or the petitioners' reply brief,[7] along with a nonexhaustive set of examples of each type.

Commentators have asked whether the MRT and other tax proposals are direct taxes and therefore (if they are not income taxes for purposes of the Sixteenth Amendment) unconstitutional because they are not apportioned among the States or, instead, excise taxes not subject to apportionment.[8] This letter focuses instead on the Sixteenth Amendment issue argued by the parties in their briefs.

The facts of the case require the Court to decide whether the MRT is unconstitutional as applied to individuals, not to corporations or other persons. If the Court were to strike down the tax as applied to individuals, a question might arise as to whether Congress would be constitutionally permitted to apply the MRT to corporate shareholders of controlled foreign corporations ("CFCs")

A. Strict Realization

The Petition includes suggestions that the realization requirement can be satisfied only by the receipt of cash or by a liquidity event without the receipt of cash.[9] This letter assumes that the Court will not apply either of these strict definitions of income for purposes of the Sixteenth Amendment,[10] but it considers the possible implications for present law if the Court were to attribute significance to a doctrine that the Petition refers to as "constructive realization."[11]

B. Look-Through Realization

Recognizing that "constructive" or "deemed" realization constitutes realization for purposes of the Sixteenth Amendment, petitioners argue that realization requires the taxpayer (not an entity in which the taxpayer holds an interest, absent special circumstances, such as "entire identity" between an entity and its owner) to participate in a transaction or to receive something of value during the relevant taxable period.[12] This requirement would call into question provisions of the Code that generally treat "look through" entities as separate from their owners for Federal tax purposes and tax each of the entity's owners on its share of the entity's income, without regard to whether the income is distributed to the taxpayer.[13]

Look-through provisions that a taxpayer might challenge if the Court finds that looking through an entity is constitutionally impermissible include the following present law rules:

• Subpart F and GILTI. Under the subpart F and global intangible low-taxed income ("GILTI") regimes,[14] United States shareholders of a CFC are subject to tax each year on certain types of income of the CFC.[15] These regimes impose U.S. taxation on United States shareholders in a taxable year even if there is no transaction or other income realization event at the level of the United States shareholder in that year. Instead, certain income earned by a CFC is deemed to be income of the United States shareholders of the CFC on a current basis.

• Subchapter K.[16] Under subchapter K,[17] partners of a partnership are generally taxed currently on their distributive shares of the partnership's income.[18]

• Subchapter S. Under subchapter S,[19] shareholders of S corporations are taxed on their pro rata share of the S corporation's items of income.[20]

• REMICs. The income of real estate mortgage investment conduits ("REMICs") is generally taxed to the holders of its residual interests.[21]

Commentators have generally not described the possible implications of a Supreme Court decision for the rules for real estate investment trusts ("REITS"), regulated investments companies ("RICs"), and other trusts, even though, as with partnerships, S corporations, and REMICs, there is generally a single level of taxation at the owner (or beneficiary) level for income derived by these entities. Unlike partnerships, S corporations, and REMICs, generally, taxation at the owner (or beneficiary) level of REITs, RICs, and other trusts occurs only when there is a distribution to the owner (often a required distribution).

C. Deemed Realization

As an alternative to the look-through approach, the petitioners suggest that the Court could conclude that the Sixteenth Amendment requires that a transaction be undertaken or something of value be received during the taxable year.[22] This framework might call into question the constitutionality of provisions that deem a taxpayer to have received an amount or to have engaged in a transaction giving rise to income.

• OID rules and below-market and short-term loans. Under the original issue discount ("OID") rules, holders of debt instruments that pay no interest until maturity, or less than a certain minimum level of yearly interest, are taxed on a deemed interest amount each year.[23] Similarly, interest payments are imputed on "below-market" loans.[24] Certain amounts are also included in income before the receipt of any payments on short-term obligations.[25]

• Mark-to-market for securities dealers. Securities held by dealers in securities are deemed to be sold for their fair market value (that is, it is "marked to market") each taxable year, and holders of these assets are taxed on the resulting gain or loss under section 475(a).[26]

• Mark-to-market for regulated futures contracts. Regulated futures contracts are similarly marked to market on the last business day of each taxable year, and holders of these contracts are taxed on the resulting gain or loss under section 1256.[27]

• Imputed rental income. Imputed rental income is taxed when a rental agreement provides for prepaid rent, deferred rent, or increasing or decreasing rent.[28]

• Subchapter L mark-to-market. Life insurance companies are similarly taxed on mark-to-market gains or losses of any segregated assets they hold each year under section 817 A.[29]

D. Deemed Realization of Income Accrued in Prior Taxable Years

The petitioners argue that, even if the Sixteenth Amendment permits taxation of shareholders on corporate earnings or unrealized appreciation in value and allows deemed realization at the end of the taxable year, income taxed under principles of "constructive" or "deemed" realization should be limited to earnings from or appreciation in value attributable to the current period.[30] If the Court were to adopt this reasoning, its decision would make present law provisions that are similar to the MRT subject to challenge. One example is the mark-to market exit tax of section 877A.

Section 877A generally taxes an individual who either renounces her United States citizenship or who loses her status as a permanent resident on a deemed sale of her property (with some exceptions).[31] This deemed sale taxes expatriating individuals on gains and losses accumulated over the holding periods of their property, not just the current taxable period.[32]

I hope this information is helpful to you. If we can of further assistance in this matter, please let me know.

Sincerely,

Thomas A. Barthold

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[1] *Moore v. United States*, No. C19-1539-JCC (unpublished, W.D. Wash. 2020), *aff'd*,36 F.4th 930 (9th Cir. 2022), *reh'g denied*, 53 F.4th 507 (9th Cir. 2022), *cert*. granted, No. 22-800 (U.S. 2023).

[2] Unless otherwise stated, all section references are to the Code.

[3] Petition for writ of certiorari, *Moore*, No. 22-800 (S. Ct. May 16,2023) (the "Petition").

[4] Brief of the United States in opposition to certiorari, *Moore*, No.22-800 (S. Ct. May 16,2023) (the "Opposition Brief') (citations omitted). The Sixteenth Amendment authorizes Congress "to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

[5] In *Macomber*, the Court ruled that the receipt of a *pro rata* stock dividend did not qualify as income under the Sixteenth Amendment because it did "not alter the pre-[e]xisting proportionate interest of any stockholder or increase the intrinsic value of each share." *Macomber*, pp.210-211. The lower court found *Macomber* inapplicable to the Moores' case because "the Supreme Court, [the Ninth Circuit], and other courts have narrowly interpreted *Macomber* and *Glenshaw Glass*," the *Macomber* definition of income was not meant to provide a "universal definition" of income, and "holding that Subpart F is unconstitutional would also call into question the constitutionality of many other tax provisions that have long been on the books." Petition, pp. App. 14-16.

[6] Opposition Brief, pp. 11-12.

[7] Petitioners' reply brief in Moore, No. 22-800 (S. Ct. May 30, 2023) (the "Reply Brief:)

[8] See, e.g., John R. Brooks & David Gamage, "*Moore v. United States* and the Original Meaning of Income," July 2, 2023, p.5, available at https:i/papers.ssrn.com/sol3/papers.cfln?abstract id:4491855 (arguing that the MRT, like several other taxes including the income tax, is.an excise tax, rather than a direct tax); Bruce Ackerman, "Taxation and the Constitution," *Columbia Law Review*, vol. 99, January 1999, p. I (arguing that modem caselaw has, and should continue, to narrowly interpret "direct" taxes and that neither a flat tax nor a wealth tax would be a direct tax); Calvin H. Johnson, "Apportionment of Direct Taxes: The Foul-Up in the Center of the Constitution," *William & Mary Bill of Rights Journal*, vol. 7, 1998, p. 1 (arguing that the direct taxes clause should be construed narrowly so as not to apply to a variety of types of taxes); Dawn Johnsen and Walter Dellinger, "The Constitutionality of a National Wealth Tax," *Indiana Law Journal*, vol. 93, Winter 2018, p. 111 (arguing that a wealth tax would be a constitutional indirect tax); Eric Jensen, "The Apportionment of "Direct Taxes": Are Consumption Taxes Constitutional?" *Columbia Law Review*, vol. 97, December 1997, p. 2334 (arguing that certain consumption taxes such as a flat tax or an unlimited savings allowance tax are direct taxes, whereas a VAT or a sales tax would be an indirect tax not subject to apportionment).

[9] For example, the Petition notes that the Moores "hadn't received a penny from the company and likely wouldn't for some time, if ever" and argues that the receipt of cash is required for a realization event. Petition, pp. 4-5, 17-18 (citing *Maryland Cas. Co. v. United States*, 52 Ct. Cl. 201, p. 209 (Ct. Cl. 1917) for the statement that "the word 'income'…has a settled legal meaning" which "include[s] only the receipt of actual cash as opposed to contemplated revenue due but unpaid," and *United States v. Schillinger*, 27 F. Cas. 973, p. 973 (C.C.S.D.N.Y. 1876) for the statement that "income must be taken to mean money, and not the expectation of receiving it, or the right to receive it, at a future time."). See also Petition, pp. 10-12 (citing *Macomber*, p.207 for the proposition that realization requires that the taxpayer receive "a 'gain,' 'profit,' or other thing of value" and, *Helvering v. Bruun*, 309 U.S. 461, pp. 468-69 (1940) for the proposition that "'income' requires 'realization of gain' through the 'exchange of property, payment of the taxpayer's indebtedness, relief from a liability, or other profit realized from the completion of a transaction."').

However, the petitioners concede that, in the case of a tax on what petitioners characterize as unrealized income, generally as long as a taxpayer may elect out of such tax and instead pay a tax on realized income (even subject to an interest charge and other requirements), such a tax falls within the Sixteenth Amendment and so does not violate the apportionment clause. Reply Brief, p. 8 (discussing the taxation of S corporations and section 877A, which is discussed further below).

[10] As an example of a present law provision that might be subject to challenge under a strict definition of realization, one commentator has described section 1259, which taxes constructive sales of appreciated financial positions. Robert Goulder, "SCOTUS Crystal Ball: Predicting *Moore's* Future," *Tax Notes International*, vol. 110, July 24, 2013, p. 480.

[11] Petition, p. 9; Reply Brief, p. 5. One commentator attributes petitioners' use of the term "constructive realization" to a misinterpretation of the doctrine of constructive receipt, as used to uphold a constitutional challenge to section 1256. He points out that that doctrine does not apply to many United States shareholders of controlled foreign corporations, since the threshold of ownership for United States shareholders is only 10

percent, which is generally insufficient for purposes of forcing a dividend. Reuven S. Avi-Yonah , "If *Moore* Is Reversed," *Tax Notes International*, vol. 111, June 26, 2023, p. 1728.

[12] Reply Brief, p. 5 ("… as *Macomber* recognizes, it is proper to 'look through the form of the corporation' in circumstances where shareholders have 'received income,' such as where there is 'entire identity between them and the company'… [b]ut that exception has never been thought to reach ordinary shareholders, which would swallow the general rule. It also does not support the MRT, which taxes shareholders like Petitioners irrespective of whether they realized anything.").

[13] Describing what the petitioners argue are the negative consequences of upholding the MRT and the lower court decision, the Petition argues that "… the decision below spells out what the MRT implies, holding that nothing prohibits Congress from 'attributing a corporation's income pro rata to its shareholders' and then taxing them on it." Petition, p.23.

[14] Secs. 951-960

[15] Opposition Brief, p. 10.

[16] Opposition Brief, p. 10.

[17] Secs. 702-104.

[18] There are certain exceptions to this rule, including when a partnership is treated for certain Federal income tax purposes as a separate entity, rather than as an aggregate of its partners. For example, a partnership is generally responsible for paying tax if it has underreported its income in a prior taxable period, known as an "imputed underpayment," unless the partnership meets certain requirements and makes an election.

[19] Secs. 1361-1368.

[20] The Opposition Brief asserts that, under the petitioners' argument, Subchapter S would be unconstitutional. Opposition Brief, p. 11. The Reply Brief counters that, because shareholders must unanimously elect to be taxed under subchapter S, shareholders of S corporations have "conced[ed] that its income is theirs." Reply Brief, p. 8. A question might arise regarding whether other elective look-through provisions, such as the qualified electing fund ("QEF") election rules under sections 1293-1295 and mark-to-market election under section 1296 for passive foreign investment companies ("PFICs") may also be implicated insofar as there are limitations on reversing either election.

[21] Secs. 8608 and 860C.

[22] See Reply Brief, p. 7.

[23] Sec. 1272.

[24] Sec.7872.

[25] Sec. 1281.

[26] Similar to the PFIC elections described above in note 20, a question might arise as to whether the election under section 475 for dealers in commodities and traders of commodities and securities is constitutional.

[27] Opposition Brief, p. 11. The Reply Brief counters that section 1256 is based on the theory of constructive receipt, "rely[ing] on the fact that the contracts are settled daily and give the taxpayer 'the right to withdraw cash from… his futures trading account on a daily basis,' which Congress regarded as manifesting realization." Reply Brief, p. 8.

[28] Sec.467.

[29] Opposition Brief, p. 11.

[30] Reply Brief, pp. 7, 11 ("[Subpart F]'s provisions predating the MRT all turn on events of [sic] that Congress identified as manifesting constructive realization of corporate income by shareholders, whereas the MRT simply attributes a foreign corporation's income going back thirty years to its shareholders…." and "…even if the Government is right that the decision below does not authorize an outright federal property tax without apportionment…that limitation could be trivially overcome by taxing any asset's earning capacity or year-past appreciation to achieve the same numerical result."); Petition, pp. 5, l0 ("The MRT taxes shareholders irrespective of whether they owned shares at the time the corporation made the earnings on which they're being taxed…" and "What led *Macomber* to confront the constitutional question of realization was the Government's contention–just as in this case-that the Sixteenth Amendment permits it to tax, without apportionment, ordinary shareholders on a corporation's retained earnings.").

[31] Opposition Brief, p. 11. An individual may elect to defer payment of the tax by posting security for the tax, waiving certain treaty rates, and subjecting herself to an interest charge when she eventually pays the tax. Sec. 877A(b).

[32] Even though the tax under section 877A applies to unrealized gains accumulated during taxable years preceding the expatriation, the Reply Brief argues that this tax comports with the Sixteenth Amendment because of the election permitting the taxpayer to defer the tax until a later realization date. Reply Brief, p. 8; see also Opposition Brief, p. 11.

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