BakerHostetler

Implications of the Supreme Court's Tax Decision in *Moore v. United States*

Jeffrey H. Paravano

Andrew M. Grossman

June 24, 2024

Presenters

Jeffrey H. Paravano
T +1.202.861.1770
JParavano@bakerlaw.com

Andrew M. Grossman
T +1.202.861.1697
agrossman@bakerlaw.com

Moore v. United States

BakerHostetler

The question on which the Supreme Court granted review was:

- "Whether the 16th Amendment authorizes Congress to tax unrealized sums without apportionment among the states"

Moore v. United States

BakerHostetler

- The Mandatory Repatriation Tax (MRT) was enacted as part of the Tax Cuts and Jobs Act of 2017 (TCJA).
- It targets U.S. shareholders who own 10 percent or more (by value or voting power) of foreign corporations that are primarily owned or controlled by U.S. persons. 26 U.S.C. § 965; see also § 957 (defining subject corporations).
- In 2017, Charles and Kathleen Moore owned about 13 percent of KisanKraft, an Indian manufacturing corporation doing business in India.
- Prior to the MRT, generally except with respect to certain narrow categories of current CFC income, such shareholders were taxed when the foreign corporation distributed (for example, a dividend) or was deemed to have distributed (for example, if shareholders obtained a loan guaranteed by a CFC) property to shareholders.
- The MRT, however, deems the corporations' earnings and profits reinvested abroad going back to 1986 to be the "income" of their U.S. shareholders in 2017 in proportion to their ownership stakes in 2017. 26 U.S.C. § 965(a).
- Thus, taxation turns on the ownership of a specified asset at a specified time.
- As a factual matter, it is clear the Moores realized nothing.

Moore v. United States

BakerHostetler

- Pursuant to the MRT, the shareholders are taxed on that deemed "income"—a deemed property distribution which, by definition, has not been distributed to them—at a rate based on how the corporation held the retained earnings in 2017: 15.5 percent for earnings held in cash or cash equivalents and 8 percent otherwise. Id. § 965(a), (c); see also § 951(a).
- 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 irrespective of whether they could force the corporation to make a distribution of cash or property. All that matters is that a given shareholder owned the requisite number of shares in 2017. §§ 965(a), 951(a).
- Earlier versions of tax reform provided an election to be taxed currently at a lower tax rate or later, when property was actually distributed (or deemed distributed), at a higher tax rate.

Moore v. United States

BakerHostetler

- The 16th Amendment to the U.S. Constitution provides:
  - "Congress shall have the power 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."
  - Direct taxes, such as taxes on property, must be apportioned among the states.
- Code Section 61 defines "gross income" as "all income from whatever source derived"
  - The Supreme Court has held that Code Section 61 fully implements the 16th Amendment and *encompasses "the full measure of [Congress's] taxing power," United States v. Burke*, 504 U.S. 229, 233 (1992) (quoting *Helvering v. Clifford*, 309 U.S. 331, 334 (1940))

Moore v. United States

BakerHostetler

- The 9th Circuit Court of Appeals stated realization is not a requirement for federal taxation of income
  - Implications of the 9th Circuit's decision are staggering:
    - Appreciation in the value of stock and other assets is already subject to tax (because Code Section 61 taxes all income from whatever source derived; fully implementing the 16th Amendment to Constitution) and the IRS has been administering the Tax Code incorrectly for more than 100 years.
    - If amounts earned by a corporation operating in Germany, asked the Moores, and reinvested in plant and equipment in 1987 may be called "income" of an individual who purchased shares in 2017, is there anything Congress would be precluded from calling "income"?
    - Absent the MRT, there generally needs to be an actual or constructive distribution of cash or property to shareholders from a CFC for shareholder "income" (generally other than certain current year moveable income) to exist.

Moore v. United States

BakerHostetler

- 9th Circuit Judge Bumatay, dissenting to 9th Circuit's denial of taxpayer's petition for rehearing en banc:
  - "We become the first court in the country to state that an "income tax" doesn't require that a "taxpayer has realized income" under the 16th Amendment."
  - "Instead, we conclude that the 16th Amendment authorizes an unapportioned tax on unrealized gains because the "realization of income is not a constitutional requirement.""
  - "…[W]e allow a direct tax on the ownership interest of a taxpayer – even when the taxpayer has yet to receive any economic gain from the interest and has no ability to direct distribution of gain from the interest."
  - "While the Supreme Court has allowed flexibility in identifying "incomes," it has never abandoned the core requirement that income must be realized to be taxable without apportionment under the 16th Amendment."
  - "Divorcing income from realization ***opens the door*** to new federal taxes on all sorts of wealth and property without the constitutional requirement of apportionment."

Moore v. United States

BakerHostetler

- Proposals have existed even before the 9th Circuit's decision in Moore to tax unrealized income
- White House Budget Proposal (March 28, 2022):
  - "President's Budget Rewards Work, Not Wealth with new Billionaire Minimum Income Tax," candidly described as a tax on "unrealized income" and as a tax on appreciated property.
- House and Senate Wealth Tax Proposals Include:
  - H.R. 1459, 117th Cong. Section 2901(a) (2021) and S.510 ("In the case of any applicable taxpayer, a tax is hereby imposed on the net value of all taxable assets of the taxpayer on the last day of any calendar year…")
  - Senate Finance Chair Wyden's proposal to tax annual built-in gains on stockholdings and other "tradeable assets" (October 27, 2021)
- White House Budget Proposal (March 11, 2024)
  - "Minimum tax of 25 percent on total income, generally inclusive of unrealized capital gains," for wealthy taxpayers
  - "***Opening the door***": Compare - proposal to increase the tax rate on corporate stock repurchases to 4 percent

Moore v. United States

- Petition for Writ of Certiorari (filed by BakerHostetler in February of 2023)
- *Eisner v. Macomber*, 252 U.S. 189 (1920)
  - Stock dividend to all shareholders in proportion to existing interests without altering ownership stakes.
  - The total dividend amount arguably was "measured [by] gains accumulated by the corporation;" *i.e.*, the corporation kept its profits to reinvest but issued shares reflective of the amount of profit to its shareholders, which, presumably, they could sell if they so desired.
  - The Supreme Court held that shareholders had no income and that only income "derived from property" and "received or drawn" by the shareholder would be "income."
- *Helvering v. Horst*, 311 U.S. 112 (1940) makes clear that constructive realization is sufficient ("pay interest on bonds to my child").
- *Comm'r v. Indianapolis Power & Light*, 493 U.S. 203 (1990) makes clear that refundable customer deposits are not taxable income because the utility never obtained "complete dominion" over them.

Moore v. United States

- 43 amicus briefs filed
  - 22 in support of the Moores
  - 18 in support of the government
  - 3 in support of neither party
- News articles estimated to have reached over 2 billion readers worldwide
- Two hours of lively Supreme Court oral argument December 5, 2023

Moore v. United States: Taxpayer Arguments

BakerHostetler

- The Sky is not Falling; Other Income Taxes Rest on Theories of Taxpayer Realization:
  - Constructive realization occurs when income is “unqualifiedly subject to demand of taxpayer … whether or not received in cash;” and where a taxpayer has “command over… the actual benefit for which the tax is paid. *Ross v. Comm’r*, 169 F.2d 483, 490 (1st Cir 1948); and *Corliss v. Bowers*, 281 U.S. 376, 378.
  - Subpart F taxation is overwhelmingly focused on constructive realization (control, current-year moveable income, actual or constructive distributions of prior-year reinvested profits (*i.e.*, shareholder loans guaranteed by a CFC), etc.).
  - Partners and S corporation shareholders are taxed on current-year entity income under statutes that make clear that the annual operational income of the entity is not entity taxable income but owner taxable income.
  - Neither partnership taxation nor S corporation taxation nor Subpart F purport to tax owners on previously reinvested entity earnings (*i.e.*, non-current-year income) absent an actual or constructive distribution to owners of cash or property.

Moore v. United States: Taxpayer Arguments

BakerHostetler

- The Sky is not Falling; Other Income Taxes Rest on Theories of Taxpayer Realization:
  - Accrual accounting is about timing, not about the need for realization. *United States v. Safety Car Heating & Lighting Co.*, 297 U.S. 88, 99 (1936). Original Issue Discount is permitted by accrual accounting and also justified as an excise on purchase or sale of bonds.
  - Current Tax Code mark-to-market taxation in limited cases are easily characterized as excises on doing business in a certain way or are targeted at circumstances where assets are treated by their owners as equivalent to cash.
  - The tax on relinquishment of citizenship is best viewed as an excise tax.
- The MRT does not purport to tax any shareholder on "income" of the CFC; it deems a distribution of property valued by E&P (E&P is not property, it is a computation of prior years' earnings reinvested abroad). A deemed distribution of E&P (old and cold reinvested earnings) can only occur by a deemed distribution of cash or property. A "deemed" distribution of cash or property is an actual distribution of nothing. If an actual distribution of stock to all shareholders is not income under *Macomber* (which all agree is still good law), an actual distribution of nothing (not even a piece of paper) also is not income.

Moore v. United States

WSJ Letter to the Editor

BakerHostetler

- "Although the MRT deemed a distribution of property valued by reference to the corporation's post-1986 accumulated E&P—which might sound like income—that figure [E&P is a computation, it is not property] includes earnings that long ago became property of the corporation."
- "Characterizing reinvested E&P from 1987 as corporate income in 2017 is like calling a factory built by the corporation in 1987 as 2017 "income." That's crazy. The corporation itself had no income in 2017 from mere ownership of property, and if there is no income to the corporation, there's no income to attribute to shareholders."
- "No other provisions in the tax code—including those governing partnerships, S corporations and Subpart F—purport to tax "income" to owners of an entity when the entity itself has no current income, absent an actual or constructive distribution of property to the owner. Congress' power to tax income does not permit calling reinvested capital—property—income."

-- Professor Erik M. Jensen, Coleman P. Burke Professor Emeritus of Law, Case Western Reserve University

Supreme Court's Opinion in *Moore*

BakerHostetler

- The Supreme Court On June 20th upheld the constitutionality of the so-called mandatory repatriation tax in a narrow ruling, stating that the MRT taxes realized income — income earned by the offshore corporation — and attributes that corporate income to shareholders and taxes the shareholders on their portions of that income.

Supreme Court's Opinion in *Moore*

- In the majority opinion, authored by Justice Kavanaugh and joined by Chief Justice Roberts and Justices Sotomayor, Kagan and Jackson, the Court held that the 16th Amendment authorizes Congress to attribute income realized by an entity to its owners in certain circumstances:
  - "We emphasize that our holding today is narrow. It is limited to (i) taxation of the shareholders of an entity, (ii) on the undistributed income realized by the entity, (iii) which has been attributed to the shareholders, (iv) when the entity itself has not been taxed on that income. In other words, our holding applies when Congress treats the entity as a pass-through."

Supreme Court’s Opinion in *Moore*

BakerHostetler

- The majority opinion also states, in footnote 2, that “our analysis today does not address the distinct issues that would be raised by (i) an attempt by Congress to tax both the entity and the shareholders or partners on the entity’s undistributed income, (ii) taxes on holdings, wealth, or net worth; or (iii) taxes on appreciation.”

Supreme Court's Opinion in *Moore*

BakerHostetler

- Although the five-justice majority determined that it need not resolve the issue of realization in *Moore*, it also specifically noted that the Supreme Court in *Macomber* '"stated that income requires realization."
- Further, Justice Barrett's concurrence in the judgment, joined by Justice Alito, states that "[r]ealization may take many forms, but our precedent uniformly holds that it is required before the Government may tax financial gain without apportionment."
- And Justice Thomas's dissent, joined by Justice Gorsuch, states that 16th Amendment "incomes" include only income realized by the taxpayer."
- Thus, the majority opinion recognizes that prior Supreme Court precedent requires realization, and four Justices in *Moore* recognize that realization is a requirement for federal taxation of income without apportionment.

Supreme Court's Opinion in *Moore*

- The opinion notes that nothing in the opinion should be read to suggest that Congress could tax both an entity and its owners on the same income, and that the Due Process Clause 'proscribes arbitrary attribution' — which gives tax practitioners food for thought on whether any current taxes might violate that holding.

Analysis of Supreme Court's Opinion in *Moore*

BakerHostetler

- What exactly is the rule laid down by the majority opinion?
- Practical Consequences:
  - How does that rule apply to other taxes on the books?
  - Does it open doors for Congress?
- The Court's Due Process Dicta:
  - What does it say, what does it mean, and will it matter?

Discussion of Supreme Court's Opinion in *Moore*

BakerHostetler

- Thoughts about the somewhat unexpected result?
- What might the Court say about realization in a future case?
  - Admonitions to Congress in majority opinion? "And the Court further stated [in *Macomber*] that income requires realization."
  - Hasn't realization been a dead letter constitutional requirement since *Macomber* ("derived" from any source means "realized") vs. "we do not decide that question today" vs. our precedent is long-settled and crystal clear). Remarkable sea change in the meaning of the 16th Amendment or simple judicial restraint?
- Where does the Court in *Moore* leave wealth tax proposals and proposals to tax appreciation in the value of property?

Analysis of Supreme Court's Opinion in *Moore*

- Central purpose of the 16th Amendment was to overrule one of the two holdings in *Pollack Farmers' Loan & Trust Co.*
- Solicitor General's concession at oral argument that "a federal tax on the value of someone's property" would need to be apportioned.
  - Hypothetical tax on "one's wealth or net worth."

Jeff Paravano
BakerHostetler
Washington, D.C.
T +1.202.861.1770
jparavano@bakerlaw.com

Jeff Paravano serves as firmwide Chair of BakerHostetler's Tax Group and as managing partner of the firm's Washington, D.C., office. Jeff has been the lead litigator or the key tax team member in more than 30 tax cases, and is the tax counsel of record in the *Moore v. United States* Supreme Court tax case. Jeff previously served as Senior Advisor to the Assistant Secretary, Tax Policy, at the United States Department of the Treasury. While at Treasury, Jeff was responsible for providing advice on a wide range of tax policy and technical issues, including tax legislation and corporate, partnership, REIT and financial sector tax guidance. He also was one of the primary authors of the final tax shelter regulations, is author of the Tax Management Portfolio, Tax Shelters, T.M. 798, and co-author of the Tax Management Portfolio, Reportable Transactions, T.M. 648-2nd. Mr. Paravano has a broad-based tax practice that includes buy-side M&A, international restructurings, and tax controversy and litigation.

Andrew M. Grossman
BakerHostetler
Washington, D.C.
T +1.202.861.1697
agrossman@bakerlaw.com

Andrew Grossman serves as BakerHostetler's Appellate and Major Motions team co-leader. He has appeared before the U.S. Supreme Court, nearly all the federal courts of appeals, as well as some state appellate courts, litigating high-profile and complex commercial, administrative and constitutional issues.

Andrew works with practice groups across BakerHostetler to identify and tackle complex issues, advise on administrative law and strategy, tee up issues for appeal and tackle appeals. He has developed and implemented litigation and administrative strategies for clients in several fields and industries.

BakerHostetler
bakerlaw.com

Atlanta | Chicago | Cincinnati | Cleveland | Columbus | Dallas

Denver | Houston | Los Angeles | New York | Orange County | Orlando

Philadelphia | San Francisco | Seattle | Washington, D.C. | Wilmington

These materials have been prepared by Baker & Hostetler LLP for informational purposes only and are not legal advice. The information is not intended to create, and receipt of it does not constitute, a lawyer-client relationship. Readers should not act upon this information without seeking professional counsel. You should consult a lawyer for individual advice regarding your own situation.

© 2024 BakerHostetler®