



Podcast Transcript

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

Date: July 1, 2024

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Run Time: 27:04

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Rubenking: Andrew Grossman and Jeff Paravano served as counsel in *Moore v. United States*, which some have described as the most important constitutional tax case in the last century. The case challenged the Ninth Circuit Court of Appeals' determination that realization is not required for federal taxation of income and also challenged the constitutionality of the Mandatory Repatriation Tax enacted as part of the Tax Cuts and Jobs Act of 2017 that raised over \$340 billion in taxes for the federal government. I'm Randall Rubenking, and you are listening to BakerHosts.

To provide us with insight on the Supreme Court decision for the *Moore v. United States* case, we have Andrew Grossman, co-leader of the Appellate and Major Motion team in BakerHostetler's Litigation Group, and Jeff Paravano, lead tax counsel on the *Moore* case, who serves as firmwide chair of BakerHostetler's

Tax Group and managing partner of the firm's D.C. office. Welcome, Andrew and Jeff.

Grossman: Thanks, Randall.

Paravano: Yeah, thanks for having us.

Rubenking: Jeff, you're the tax lawyer in the room. Could you give us some background, and tell us why the case was brought and what exactly the case is about?

Paravano: Thanks, Randall. Some background regarding the facts of the case, our clients, Charles and Kathleen Moore, in 2017 owned about 13% of KisanKraft, a controlled foreign corporation operating in India focused on manufacturing low-cost farm equipment. The Mandatory Repatriation Tax, or MRT, deems undistributed earnings and profits reinvested in the business abroad going all the way back to 1986 to be income in 2017 and treats certain shareholders as receiving a deemed distribution of property in 2017, in proportion to their percentage ownership on a date in 2017.

We spotted the constitutional problem with the Mandatory Repatriation Tax immediately upon passage of the Tax Cuts and Jobs Act in 2017. When I served at the Office of Treasury in the Office of Tax Policy, I never thought for a minute that we could tax shareholders on E&P earned long ago and reinvested abroad without an actual or constructive distribution of property. In fact, several earlier versions of tax reform, including the version proposed by the administration when I served at Treasury from 2001 through 2003, provided an election. Taxpayers could elect to pay the tax currently at a lower rate, or later at a higher rate, when property was actually distributed or deemed distributed.

The version of the MRT passed in 2017 did not take that approach. After our clients paid the tax, we filed an administrative claim for refund and then a refund claim in federal district court in Washington State. Five years later, we ended up at a two-hour oral argument at the Supreme Court. Andrew did a great job arguing the case. The question that the Supreme Court granted cert. on in *Moore* is as follows: whether the 16th Amendment authorizes Congress to tax unrealized sums without apportionment among the states.

A few interesting items about the MRT. First, it taxes shareholders who own shares of a CFC on a certain date in 2017, even if they did not own shares at the time the corporation previously earned the income. So, a shareholder could have bought shares on day one in 2017, and then the very next day been subject to tax by the MRT based on a deemed property distribution valued by undistributed, reinvested E&P going all the way back to 1986. The 16th Amendment, which is the source of Congress's power to tax income, states that Congress shall have the power to lay and collect taxes on incomes from whatever source derived, without apportionment among the states, and without regard to any census or enumeration. So, taxes on property are not taxes on income, and federal taxes on property must be apportioned among the states. That is one reason why there is no federal property tax.

Interestingly, Tax Code Section 61 says the same thing as the Constitution. Section 61 defines gross income as all income from whatever source derived. And the Supreme Court, going all the way back to 1940, has held that Section 61 fully implements the 16th Amendment and encompasses the full measure of Congress's taxing power. So, if it is taxable under the Constitution, it is taxable under Section 61. The district court in Washington ruled against our clients, and we appealed to the Ninth Circuit. The Ninth Circuit also denied our clients' refund, and as part of that opinion, the Ninth Circuit abandoned 100 years of Supreme Court precedent by stating that realization is not a requirement for federal taxation of income.

I don't need to tell you, Randall, that if the Ninth Circuit is right, the implications of that holding are staggering. For example, under the Ninth Circuit's holding, appreciation in the value of stock or other assets is already subject to tax. We've been told by the Supreme Court that Code Section 61 taxes all income from whatever source derived, fully implementing the 16th Amendment to the Constitution. So if realization is not required for taxation, then you're subject to tax annually on the appreciation of any stock or property you own outside of retirement accounts.

Fortunately, Judge Bumatay offered a thoughtful dissent to the Ninth Circuit's denial of our petition for rehearing *en banc*. To quote Judge Bumatay, he said, we are 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. He continues, 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. And he said, divorcing income from realization opens the door to new federal taxes on all sorts of wealth and property without the constitutional requirement of apportionment.

His cautionary words are already a reality on Capitol Hill and at the White House and Treasury. A number of proposals coming out of Washington existed even before the Ninth Circuit's decision in *Moore* to tax unrealized income. For example, the President's budget released in March of 2022 proposed a tax on unrealized income and a tax on appreciated property. Various proposals introduced in the House and Senate _____ to tax built-in gains on stock and other assets, and the White House budget proposal, released just this past March, contains a so-called minimum tax of 25% on total income, and I quote, inclusive of unrealized capital gains for wealthy taxpayers.

Professor Erik Jensen, who penned a terrific op-ed in the Wall Street Journal after oral argument at the Supreme Court, said it best, I think, when he said, and I'll quote him, although the MRT deemed the distribution of property valued by reference to the corporation's post-1986 accumulated E&P, which might sound like income, that figure includes earnings that long ago became property of the corporation. He goes on to say, 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 is crazy, he says. The corporation itself had no income in 2017 for mere ownership of property, and if there is no income to the corporation,

there is no income to attribute to shareholders. He closes by saying, no other provision in the Tax Code, including those governing partnerships as corporations in 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's power to tax income does not, according to Professor Jensen, permit calling reinvested capital property, income. So, that is what the case is about.

Rubenking: Well, that is quite a far-reaching thing. Andrew, tell us what the Court ruled.

Grossman: Well, Jeff explained what the question was that the Court agreed to address. It was a question about the meaning of income in the 16th Amendment. That's not, however, the question the court actually answered. Instead, the Court sort of took a left turn and addressed the question of whether Congress may attribute an entity's realized and undistributed income to the entities, shareholders, or partners and then tax those shareholders or partners on their pro rata portions of that income. And it answered that question in the affirmative.

The general idea of the opinion in *Moore* is that, at least of the majority opinion, is that it is not going to address this question of realization, whether the taxpayer actually has to receive something for it to be income that can be taxed as such. Instead, the way the Court looked at it was that, well, the corporation, it indisputably received some income. And so, the question is, can that income be attributed to its shareholders? And the Court's answer to that was yes, so long as Congress has treated the corporation as what it called a pass-through entity. In other words, a corporation that Congress has not taxed at the entity level. So, there is no tax that applies directly to the corporation in this instance because it is a foreign corporation. And so, the Court's view is, well, if it is a pass-through entity, and Congress has treated it that way, then it can go ahead and tax the shareholders on their pro rata share of the income in the same way that Congress for many years has treated partnerships as well as S corporations. Those are generally closely held corporations where, traditionally, the shareholders are viewed effectively from a tax point of view as if they were partners and treated in that fashion.

It is a very narrow holding. The majority opinion goes ahead and says that three or four different times, and it really tries to distinguish basically anything else that Congress might ever think about doing with respect to income taxes from the actual holding of the case. And so, it suggests very strongly that a wealth tax, for example, is off the table. The Court's not talking about that. As noted, the majority is very clear that it is not talking about the constitutional issue of realization. It also says that it has doubts, or at least it suggests that there are doubts, that Congress could tax a corporation at the entity level, in other words, impose a tax directly on the corporation and then also tax the shareholders on undistributed income of the corporation. In other words, in that instance, the Court suggests very strongly, Congress would have to wait until there is actually a distribution made to the shareholders, and then they could be taxed on that.

So really, I think zooming out a little bit, the way to look at the Court's opinion in *Moore*, it is basically saying everything that Congress has done in this area, the way that it generally treats corporations, that it generally treats partnerships and other sorts of entities, that is all fine. If Congress tries to do something new, that would present different issues, and it seems like the Court would look askance at that. But, at least so far as this kind of statute, the Court suggests that, well, that is kind of what Congress has been doing for a while, and there doesn't seem to be a barrier to it.

Rubenking: Okay. Well now, Jeff, given that Andrew says this is a fairly narrow decision of sorts, how would you describe the Court's opinion? And what do you think the Supreme Court opinion means?

Paravano: Thanks, Randall. I'll answer that in two parts. You know that feeling when you walk into a museum? You know what you're looking at is important, but the first time through, you don't really see or appreciate the full value of what the art is all about. I think it is similar when you look at the Supreme Court's opinion. So, the first time I read it and was going through it, you sort of just focus on the words.

So, the majority opinion, which was 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. And to quote the Court, it says, we emphasize that our holding today is narrow. It is limited to, one, taxation of the shareholders of an entity, two, on the undistributed income realized by the entity, three, which has been attributed to the shareholders, and four, when the entity itself has not been taxed on that income. To finish the quote, they say, in other words, our holding applies when Congress treats the entity as a pass-through. And the majority opinion also states in footnote two, and I'll quote, our analysis today does not address the distinct issues that would be raised by one, an attempt by Congress to tax both the entity and the shareholders or partners on the entity's undistributed income, two, taxes on holdings, wealth, or net worth, or three, taxes on appreciation.

So, those are the words, and I will say though, as you sort of see, think about the opinion, let it sink in. Like in a museum, you go back a second time, a third time. I have couple of thoughts. First, although the five-justice majority determined that it need not resolve the issue of realization in *Moore* and in fact stated that it would visit some of those issues on another day, it also specifically noted that the Supreme Court in *Macomber*, and I quote, stated that income requires realization. So, the Supreme Court in *Moore* cited its own Supreme Court precedent and stated that that precedent, part of that decision, the important part of the decision, is that income requires realization.

Next, Justice Barrett's concurrence in the judgment, which was joined by Justice Alito, states, and I quote, realization may take many forms, but our precedent uniformly holds that it is required before the government may tax financial gain without apportionment. So, they talk about realization may take many forms, that it is not a black or white test, that it is substance rather than form. But once you

ask, is realization required even though it is not a black and white rule, what Justice Barrett said is, absolutely it is required before the government may tax financial gain without apportionment. And then Justice Thomas' dissent, which was joined by Justice Gorsuch, states that the 16th Amendment incomes include only income realized by the taxpayer.

So, the majority opinion recognizes that prior Supreme Court precedent requires realization, and four justices in the *Moore* case recognized that realization is a requirement for federal taxation of income without apportionment. The opinion goes on and notes that nothing in that opinion should be read to suggest that Congress could tax both an entity and its owners on the same income and then notes that due process, the due process clause, prescribes arbitrary attribution, which gives tax practitioners food for thought about whether any current taxes or perhaps future situations might violate that holding regarding due process.

Rubenking: All right. My quick question is, did the Moores win?

Grossman: The Moores did not win. The majority opinion held that the corporation's income going back over the years could be attributed to them. So, their claim was a claim for a refund, and the bottom line of the Court's decision is that they don't get the refund.

Rubenking: What about, Andrew, you mentioned the wealth tax and taxation of asset appreciation. I'll get the take from both of you, starting with you, Andrew. Does *Moore* open the door to that?

Grossman: No, not an inch. The majority opinion tries to shy away from addressing broader issues. But it does note that the government has conceded that just an outright tax on property, whether you want to call that wealth or something else, would be in conflict with the 16th Amendment. Congress would have to apportion it among the states according to population, and I think everybody recognizes, as a practical matter, that that is effectively impossible.

The more difficult question involves a federal tax on asset appreciation, say, for example, the appreciation in the value of one's home or one's investment holdings over a period of time. The government had argued in its briefing that it believes that that sort of appreciation can be treated as income and taxed as if it were income, even if there is no sale. In other words, even if the homeowner or an investment holder never sells those assets and so doesn't actually get their hands on the money. The mere fact that the value has gone up means the government could tax them on that.

I read the majority opinion to suggest that the Court would in very much look askance at it. The majority opinion by Justice Kavanaugh really takes a very conservative view of taxation, and it basically blesses what Congress has done up till now. While it doesn't answer the question of realization, whether you need to have that sort of sale or otherwise getting your hands on the proceeds of an increase in value, it does suggest that that would raise entirely different issues than what we're at issue with in *Moore*. And as Jeff noted, it also indicates that

such a tax would also run afoul of its realization holding in that 1920 case, *Macomber*. And so, if the government were trying to defend that sort of ploy, it would have to overcome long-standing Supreme Court precedent. And then as Jeff also noted, you've also got four of the justices who did directly address this realization question, who held that realization is absolutely required for there to be 16th Amendment income.

So, if the government is thinking that this sort of decision, if members of Congress are thinking that this sort of decision potentially opens the door to a wealth tax, my suggestion is they ought to read it a little bit more closely. Because you've got four justices saying no way on Earth, and then you have a majority opinion that suggests that, at the very least, at an absolute minimum, that the government would have to overcome Supreme Court precedent that's been on the books for over a century at this point. So, that is certainly a daunting hurdle for Congress to overcome, to undertake what would be a very novel form of federal taxation. Jeff, what do you think?

Paravano: Yeah, I agree completely with Andrew. If you read the opinion in its entirety multiple times and gain a full appreciation of what you're looking at, like it's a piece in an art museum, I think it becomes crystal clear that the wealth tax is a tax on property and impermissible under the 16th Amendment without apportionment. And I believe also that asset appreciation before an asset is sold, for example, if your home goes up in value, I think if you read the opinion in its entirety, it becomes very clear, as Andrew said, that realization is lacking, that their existing precedent going all the way back more than 100 years to *Macomber*, requires realization. Four justices stated realization is required in this opinion. Even the majority noted that *Macomber* requires it. So, if somebody took that case to the Supreme Court, they would have to be asking them to overrule the precedent that goes back more than a century. And they would have to overcome the fact that four justices have already shown their hand clearly, and the rest of the justices have recognized precedent.

Rubenking: Very good. Now let's get your personal take on this. Both of you gentlemen, what was it like taking a case up to the Supreme Court? Andrew?

Grossman: It was a roller-coaster ride. We knew we were right about this, or at least we thought we were right about this, from the get-go. But we met, I think, a lot of hostility in the low, lower courts who are reluctant to cast any question on Congress's taxing power. And then certainly, the result that we got from the Supreme Court, it wasn't what we were hoping for. But it did reaffirm some of the fundamental principles in this area. And it was a little bit of a curveball, which I think is something we saw over and over and over again in this litigation.

Ultimately, it's really gratifying to be able to identify a legal issue, to press it forward through the courts, and to get the highest court in the land to speak on it. And it's something at Baker that we've been privileged to do a few times now. We have led the litigation over the Patient Protection and Affordable Care Act, also known as Obamacare, when that was enacted. My colleagues and I were able also to bring up to the Supreme Court just two terms ago the case that

became *West Virginia v. EPA*, which gave birth to the major questions doctrine and really remade the landscape of certain areas of administrative law as well as environmental law.

And then in this case, we were able to press forward and set one of the Court's most important tax precedents in many, many years. And it was just so much fun to really learn a lot about that area of the law and work very closely with our tax colleagues and people like Jeff, who has forgotten more in this area than I will ever know. So, just really neat to be able to bring and marry our appellate expertise and issue development expertise with the firm's deep bench of tax expertise.

Rubenking: Jeff, how about you?

Paravano: Sure. Thanks, Randall. Well, the justices are brilliant, and it was an incredible honor to sit there so close to them for two hours of oral argument. It is their job to tell us what the law means, and as you sit back and read the opinion again as a whole, I think it is clear that realization is required even though the majority says that they're punting that for another day. Like I said, they cited precedent that says it clearly is. And at the same time that they were suggesting that if another case came forward, they would probably say that realization is required, they also gave quite a bit of comfort. They used the words, the Constitution does not require a fiscal calamity.

And they mention and call out specifically that some current provisions in the Code, like 305(c), deemed stock distributions, where it is an interesting provision that the smaller percentage owned by a shareholder that redeems in a potentially abusive transaction, the bigger the deemed dividend is that goes to all the other shareholders and then gets recontributed. They cite 446 and 448, Accrual Accounting. They cite Section 701, Partnership Taxation. They cite 951 through 965, which is Subpart F. They cite 951(a), which is the pass-through tax on global intangible low-taxed income, or GILTI. They cite 1256, which deals with certain futures contracts. Sections 1272(a), which is OID, Original Issue Discount instruments. They cite 1361 through 1379, the S Corporation provisions, and even 2501 through 2524, the Gift Tax provisions.

So, they indicate that they don't think, under existing law, that realization is going to be a basis to knock any of these provisions out. They're trying to give taxpayers comfort. So, at the same time they're suggesting that realization or stating that realization is existing law, they also say that they'll consider that issue another day. They're not going to talk about it in this opinion. But they say that, seem to indicate that all these other provisions are just fine, and some of these provisions were ones that practitioners were worried about, depending on how the Supreme Court ruled here.

Rubenking: Alright, very good. Let's bring it on home for our BakerHostetler clients. Why does *Moore* matter? Andrew?

Grossman: Well, I think there are two things. First, *Moore* reaffirms that there are limitations on Congress's taxing power, and we see just increasingly complicated tax situations, and we see a lot of foment on Capitol Hill regarding all different types of developments in taxation. And so, *Moore* just adds to the tools that taxpayers potentially have to bring pressure to bear on IRS and on Treasury and to ultimately vindicate their rights and their tax positions.

Second, looking out over the long term, there are a lot of changes that are going to be coming in the near future to tax law. I mean, we've got a fiscal cliff that is coming up. There are already negotiations ongoing on the Hill as to how Congress is going to address that, and I think *Moore* does, to some extent, factor into that, those discussions on the future of tax policy. As I said, it does set limits and specifies some of those limits on what exactly it is that Congress can do.

And it also raises questions about different approaches that Congress might take, including aspects, frankly, of the budget that's been proposed by the White House and certain proposals that have been put on the table, for example, by Senator Wyden regarding market-to-market taxation for individuals and things of that nature. Things that some people refer to as a wealth tax. And these constitutional issues are going to be in the mix, and if you're a client and you're thinking about, well, how do these things affect me? It is something that really has to be part of that conversation.

Rubenking: Jeff, how about you?

Paravano: Yeah Randall, I agree. I think our clients can take a lot of comfort of reading the opinion that wealth taxes are not something that would be constitutional in this country. If they're worried about market-to-market taxation on long-term investments, I think they can take a lot of comfort from the opinion and the way it's written and justices' say about that. And then as Andrew said, next year with so many expiring provisions of the 2017 Tax Cuts and Jobs Act, Congress has said that everything is on the table.

And there is a fiscal calamity that we're facing now in this country that we haven't faced before. Even though federal revenues, tax revenues are up significantly, in part because of productivity gains because of AI and because of investments made during COVID in computers and other things, spending is up even higher. And it started with relief for COVID, but then it didn't really taper down like it should have.

So, the tax bill that we're going to see next year, Congress has said everything is on the table, and we've got real need for increasing fiscal federal revenue. We've got real needs to cut and raise revenue by cutting some provisions potentially. And having this opinion out there with all of the richness that you can get out of reading it several times, I think will be very helpful to help direct Congress and how that goes. And it'll give some clients comfort about what directions they can head in and potentially some directions where they can't go.

Rubenking: All right, very good. Well, thanks so much for talking to us today.

Grossman: Thank you for having us.

Paravano: Thank you, Randall.

Rubenking: If you have any questions for Jeff and Andrew, their contact information is in the show notes. As always, thanks for listening to BakerHosts.

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