No. 22-800

IN THE

Supreme Court of the United States

CHARLES G. MOORE, ET UX.,
Petitioners,

v.

UNITED STATES,
Respondent.

On Writ of Certiorari to the
United States Court of Appeals
for the Ninth Circuit

BRIEF OF *AMICI CURIAE* REUVEN AVI-YONAH, CLINTON G. WALLACE & BRET WELLS IN SUPPORT OF RESPONDENT

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INTEREST OF THE *AMICI*

Amici are professors of tax law. *Amici* join this brief solely on their own behalf and not as representatives of their universities.[1]

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[1] None of the parties or their counsel authored any part of this brief in whole or in part or made any monetary contribution to fund the preparation or submission of the brief, and no person or entity other than *amici* and their counsel made such a monetary contribution to the preparation or submission of this brief.

SUMMARY OF THE ARGUMENT

Reversing the *Moore* decision would invalidate or at the very least cast considerable doubt over many sections of the Internal Revenue Code. Rules that call for taxation without realization ("Nonrealization Rules") and their predecessors can be traced back to the earliest iterations of the income tax after the Sixteenth Amendment was ratified. Although the section 965 transition tax ("Transition Tax") is a single-application provision that has no ongoing import, it is fashioned in the same manner as Nonrealization Rules that are critically important to the effectiveness of the income tax.

Nonrealization Rules are essential to prevent tax sheltering and create a level playing field for all taxpayers. Importantly, these rules are *not* at odds with inclusion of income at the time of realization. Rather, these Nonrealization Rules have been carefully integrated into the income tax. Congress enacted intricately calibrated basis adjustments so that income taxed on a nonrealization basis is not taxed again when a distribution or other realization event occurs. Nonrealization Rules are also embedded in U.S. tax treaties, reflected in longstanding regulations used to implement the Internal Revenue Code, and have been embraced in Supreme Court and lower court precedents that have widely been treated as settled law until this case. These rules are essential to the broader scheme of income taxation envisioned by the Sixteenth Amendment—to ensure comprehensive and consistent taxation of all income across varied sources despite taxpayer attempts to escape the reach of the income tax through complex tax planning.

Imposing a constitutional realization requirement will allow taxpayers, for the first time in many decades, to shield significant categories of income from U.S. taxation. Creating this new requirement would break with history and would have severe practical consequences to the administration of the income tax that Congress has authority to implement under the Sixteenth Amendment. Indeed, without the authority to determine when realization is required and when it can be disregarded, Congress would lose the power to lay and collect taxes on *all* incomes.

ARGUMENT

I. EXCEPTIONS TO REALIZATION ARE ESSENTIAL TO A FUNCTIONING FEDERAL INCOME TAX

Although the receipt of money or other property is generally recognized to constitute a realization event, *see* 26 U.S.C. § 1001(b) (defining "amount realized"), there is no Constitutional requirement for realization and Congress has regularly enacted rules that do not require a realization event as a precondition for the imposition of an income tax. It is necessary and proper for Congress to have such authority in order to effectuate the goal of the Sixteenth Amendment to allow Congress to tax "incomes[ ] from whatever source derived." U.S. CONST. amend. XVI.

The integrity of the income tax depends on preventing taxpayers from manipulating realization to avoid tax. Many rules that operate without realization are responses to taxpayer planning to manipulate clear reflections of income or business arrangements that have the effect of manipulating clear reflections of income. While it is completely

legitimate for taxpayers to plan their financial affairs to reduce tax, it is also imperative that Congress retain authority to safeguard the income tax in response to the quickly evolving global economy, new financial products, and taxpayer ingenuity. Otherwise, the individual income tax will be reduced to a tax on wages and gains by those without the means to avoid them, subverting the purpose of the Sixteenth Amendment.

Between the Sixteenth Amendment's ratification in 1913 and the Moores' filing of this lawsuit in 2019, Congress enacted at least a dozen provisions that call for the inclusion of income without realization. The Transition Tax is one of the most recent, but it is far from extraordinary in its treatment of unrealized gains. Constitutionalizing a realization requirement to strike down the Transition Tax will likely invalidate many other Nonrealization Rules. At the very least, a ruling in favor of the Moores would create authority that taxpayers can and will use to ignore other Nonrealization Rules when they file their tax returns, which would take years of litigation to sort out. The resulting uncertainty by itself would wreak havoc on the fair and consistent application of the income tax.

This section details some current features of the federal income tax that operate without realization in one of two ways. The first set of examples tax unrealized income. The second set of examples tax income that is realized, just not by the particular taxpayer subject to tax or not when the realization event occurs. The Transition Tax falls into the latter category, taxing U.S. shareholders on income realized by a controlled foreign corporation. 26 U.S.C. § 965(a).

Both categories of Nonrealization Rules face certain constitutional attacks if the Moores prevail.[2]

A. Taxes on Unrealized Income

1. Deemed Stock Distributions

The Moores contend that in the wake of *Eisner v. Macomber*, 252 U.S. 189 (1920), Congress has "observe[d] the line of taxpayer realization" in the tax treatment of stock dividends "for a century" now. Pet. Br. 39-40 (citing 26 U.S.C. § 305). That is not accurate. In section 305 itself, Congress targeted what they labeled "disproportionate distributions," whereby certain circumstances "shall be *treated as a distribution* with respect to any shareholder whose proportionate interest in the earnings and profits or assets of the corporation is increased." 26 U.S.C. § 305(b)(2), (c) (emphasis added). The statute identifies specific situations in which a shareholder must be treated as receiving a taxable stock distribution even though no stock is actually distributed and directs Treasury to issue regulations elaborating further. The statute specifically includes—in contrast with the Moores' assertion—situations in which a shareholder must include a deemed dividend simply based on other shareholders taking actions (i.e., redeeming stock) that increase the value of the remaining outstanding shares.

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[2] The Joint Committee on Taxation compiled for Congress a list of income tax provisions that could be called into question if *Moore* is reversed. *See* Letter from Thomas A. Barthold, Chief of Staff, Joint Comm. on Tax'n, to Richard E. Neal, Ranking Member, H. Comm. on Ways and Means (Oct. 3, 2023).

The legislative history to these provisions explains that "[t]he proportionate interest of a shareholder can be increased not only by the payment of a stock dividend not paid to other shareholders, but by such methods as . . . the periodic redemption of stock owned by other shareholders." S. Rep. No. 91-552, at 153 (1969), *as reprinted in* 1969 U.S.C.C.A.N. 2027, 2185. Regulations include the example of a shareholder whose interest in a corporation increases by virtue of other shareholders taking part in a plan of periodic redemption of up to five percent of shareholders' stock. Treas. Reg. § 1.305-3(e), ex. 8. The non-redeeming shareholder in this example owns 100 shares of the corporation at all times, and has not experienced any realization event, but nonetheless is treated as having received a taxable stock distribution equal to the fair market value of shares representing her increased proportionate interest in the corporation. *Id.* These deemed dividend provisions are integral to preventing the use of stock distributions to avoid dividend taxation. *See* Saul Levmore, *Recharacterizations and the Nature of Theory in Corporate Tax Law*, 136 U. PA. L. REV. 1019, 1041 n.67 (1988).

2. Original Issue Discount

When a debt instrument is issued for an amount that is less than its face amount at maturity, it creates an opportunity for taxpayers to manipulate the timing and character of income resulting from the debt. For example, consider a company that issues a bond that has an issue price of $1,000 and will pay out $1,400 in three years. Prior to 1969, a taxpayer who purchased that bond was able to treat the $400 as gain realized and taxable in Year 3, and, prior to 1954, that gain could be subject to preferential capital gains rates.

But the better view is that the $400 is accrued interest on the debt, accumulating in value over the course of the three years that the bond is held. As such, the taxpayer holding the bond should have interest income each year the debt is outstanding,

Congress enacted section 1272 to identify the difference between the issue amount and the payment at maturity as "original issue discount" ("OID"). The OID rules include a calculation to impute interest payments to the bondholder for each day that a debt instrument with OID is outstanding even though there is no realization event of such interest. Since 1982, these rules have also provided for a corresponding series of interest deductions by the borrower, calculated in the same manner. 26 U.S.C. § 163(c). These rules are a part of the fabric of taxation of debt instruments, ensuring consistent treatment in an administrable manner. *See* DAVID GARLOCK, FEDERAL INCOME TAXATION OF DEBT INSTRUMENTS Intro. (2023).

3. Mark-to-Market Rules

As the tax shelter industry grew through the 1970s, Congress became aware that individuals were using the intricacies of commodities futures trading to dodge taxes. Interrelated trades could be used to create losses to offset ordinary income, defer gains, and convert ordinary income into long-term capital gains taxed at preferential rates. STAFF OF JOINT COMM. ON TAX'N, GENERAL EXPLANATION OF THE ECONOMIC RECOVERY ACT OF 1981, JCS-71-81, at 294-96 (1981). In particular, taxpayers were structuring "straddles," i.e., economically offsetting positions, to manipulate the realization of gains and losses. These are contracts, generally purchased on credit, to buy or

to sell a commodity at a future date—or, potentially, to buy *and* sell the same commodity. *See* 26 U.S.C. § 1092(c). For example, a taxpayer can arrange to enter into contracts to buy *and* sell wheat in the future for $100 when the current price is $50, so that the taxpayer will have a gain and a precisely offsetting loss on each of the two contracts. If the taxpayer can sell the losing contract on December 31 and the winning contract on January 1, she can take a loss in the first year and delay taxation of the gain to the next year, and she can structure the trade so that she can treat the gain as capital gain subject to a lower tax rate. In this context, realization is a weapon that can be used by taxpayers to misrepresent their true economic position.

There is a simple way to prevent this kind of manipulation: with publicly traded assets, a taxpayer's annual gain or loss can be determined based on market price, despite the absence of a realization event. To shut down the straddle tax shelter, Congress enacted section 1256, which uses known fair market values to impose current taxation on the increase in value of certain regulated futures contracts without regard to realization. Following the model established by commodities futures exchanges, which account for the gain or loss on each contract on a daily basis, this regime requires taxpayers to determine net gain or loss each year based on the value of their contracts at the end of each year. 26 U.S.C. § 1256(a)(1). Including amounts in income in the same manner as exchanges report net gain and loss on these types of contracts better reflects the true economics, timing and character of income and loss from these trades. *See* S. Rep. No. 97-144, at 155-57 (1981), *as reprinted in* 1981 U.S.C.C.A.N. 105, 254-56.

This is not the only mark-to-market regime currently used as part of the federal income tax. Section 475, enacted in 1993, requires dealers and traders in securities to determine gain or loss annually based on market values of the securities they are holding in inventory. Congress understood that the cost method and the lower-of-cost-or-market method provided a built-in tax shelter for securities dealers to avoid taxation on profits, even though such profits were reported in their financial statements. *See* H.R. Rep. No. 102-631, at 57 (1992). Therefore, Congress decided to require commodity and security dealers to report their profits on a mark-to-market basis in order to more clearly reflect their true income.

Congress has enacted other similar provisions as well. Section 817A, enacted in 1996, provides a mark-to-market rule for assets held by life insurance companies. Section 1259, enacted in 1997, imposes tax on appreciated financial positions where the taxpayer locks in gain by entering into an offsetting position—for example, a short sale of identical property known as a "short sale against the box." Congress understood in each of these contexts that waiting for a realization event that can be manipulated allows taxpayers to shelter certain income from taxation. Further, realization is not necessary when value can be determined otherwise, particularly for assets that are easily liquidated.

4. The Expatriation Exit Tax

In 2008, Congress introduced an exit tax based on deemed realization for wealthy U.S. citizens who give up their citizenship and move outside the United States. Under these rules, "all property" of the expatriating citizen "shall be treated as sold on the

day before the expatriation date for its fair market value." 26 U.S.C. § 877A(a)(1). For example, Eduardo Saverin, the co-founder of Facebook, expatriated to Singapore in 2011 and was taxed on his Facebook stock worth almost $4 billion as if he sold it upon expatriation. Paul O'Donnell, *Chasing Saverin's Winnings Is a Losing Battle*, CNBC.COM (Sept. 13, 2012), https://www.cnbc.com/2012/05/17/chasing-saverins-winnings-is-a-losing-battle.html.

Despite the deemed sale at expatriation, the expatriating citizen can elect to defer payment of the tax until the property is actually sold. 26 U.S.C. § 877A(b). This is not an election to defer the deemed realization of gain or loss but, instead, is merely a deferral of payment in recognition of the fact that some taxpayers face liquidity constraints. The election to defer payment is premised on (a) proper security being posted for paying the tax, (b) a waiver of any treaty-based defenses, and (c) an interest charge. In this respect, section 877A has the same structure as the Transition Tax, which provides for an immediate imposition of the tax (section 965(a)), but an election to defer payment to address liquidity issues (section 965(h)).

5. The Branch Profits Tax

Before 1986, there was a difference in the tax treatment between foreign corporations that operated in the United States through a subsidiary and those that operated through a "branch" (for example, an unincorporated office). If a foreign corporation owned a U.S. subsidiary, the subsidiary would be subject to tax on its income as a U.S. domestic corporation, and a dividend to the foreign parent would be subject to a withholding tax, in accordance with the applicable tax

treaty and sections 871 and 881. *See, e.g.*, United States Model Income Tax Convention, art. 10(2) (Feb. 17, 2016), https://home.treasury.gov/system/files/131/Treaty-US-Model-2016_1.pdf. If, however, the foreign corporation operated through a U.S. branch, it would be subject to tax on the branch's income, but a distribution from the branch to its owner would not be subject to withholding tax because they were part of the same corporation. Thus, taxpayers could structure their U.S. operations to avoid payment of the withholding tax on distributions to the foreign owner.

Congress decided to equalize the treatment of the two situations by imposing a "branch profits tax." 26 U.S.C. § 884. But because it was hard to trace actual distributions from a branch to its owner, the branch profits tax is imposed on a decrease in the net U.S. assets of the branch, without tracking actual distributions. 26 U.S.C. § 884(c). This design feature allows the branch profits tax to match the timing of what would have occurred had a U.S. subsidiary paid a dividend to a foreign parent in that year. But in order to achieve this dividend equivalency, the branch profits tax regime has been designed so that it applies to a foreign taxpayer without regard to whether or not a realization event occurs in the particular year. For example, as illustrated in Treas. Reg. § 1.884-1(b)(4) Example 3, a foreign corporation is subjected to the branch profits tax upon a repatriation of the foreign taxpayer's effectively connected earnings and profits even though there is no realization event in that particular year and even though the foreign taxpayer has no current-year earnings. The branch profits tax, which is designed without regard to the necessity for an underlying realization event, has been a longstanding feature of the inbound international

taxation regime since 1986. Notably, the United States has renegotiated many of its tax treaties with foreign countries to allow for the imposition of the branch profits tax. *See, e.g.,* Convention Between the United States of America and Canada With Respect To Taxes On Income And On Capital, art. 10(6), Nov. 12, 1980, T.I.A.S. No. 11087.

B. Taxes on Income Not Currently Realized by the Taxpayer Subject to Tax

Additional Nonrealization Rules work to tax income that is not realized by the particular taxpayer subject to tax or is taxed at a time other than when the realization event occurs. These, too, are important elements of facilitating the consistent taxation of all incomes.

1. The Subpart F Regime

Early in the history of the modern income tax, a problem emerged: a closely-held corporation could be used to shield investment income if its earnings are not distributed to its shareholders. First, individuals used domestic corporations for this maneuver, and Congress responded by imposing additional tax on earnings at the corporate level.[3] 26 U.S.C. §§ 531 (accumulated earnings tax), 541 (personal holding company surtax).

Taxpayers also used foreign corporations to shelter investment income in foreign jurisdictions that had lower tax rates and that were not subject to U.S.

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[3] These rules date back to 1934. *See* H.R. Rep. No. 558, at 13 (1934); S. Rep. No. 704, at 11 (1934).

jurisdiction.[4] Congress conceived a straightforward solution in 1937, enacting a shareholder-level tax on the undistributed corporate earnings held by a foreign personal holding company. *See* Internal Revenue Act of 1937, Pub. L. No. 75-377, § 201, 50 Stat. 813, 818-26. Constitutional considerations were not lost on the drafters. *See* H.R. Rep. No. 1546, at 14 (1937) ("[O]n account of lack of direct jurisdiction over such [foreign] companies, . . . your committee is of the opinion that it is justifiable on all grounds, including constitutional grounds, to provide for a method of taxation which will reach the shareholders who own stock in such [foreign] companies and over whom the United States has jurisdiction."); S. Rep. No. 1242, at 16 (1937) (same). In short, if income accruing in foreign corporations was to be taxed at all, Congress needed to tax the U.S. shareholders without regard to whether and when those shareholders realized the income themselves.

The foreign personal holding company regime has been in place in some form for nearly ninety years. Today, it is incorporated into subpart F, 26 U.S.C. §§ 951-965, which was enacted in 1962 to address the original foreign personal holding company problem, as well as a variety of similar tax evasion maneuvers involving domestic corporations shifting income to foreign subsidiary corporations. Professor Stanley Surrey identified this genre of tax evasion as the "tax haven subsidiary" problem. *See* Stanley S. Surrey,

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[4] Today, the U.S. is able to tax foreign corporations only on income that is "effectively connected" to the conduct of a U.S. trade or business or, absent that U.S. trade or business, on its U.S.-sourced "fixed or determinable" income. 26 U.S.C. §§ 881, 882.

Current Issues in the Taxation of Corporate Foreign Investment, 56 COLUM. L. REV. 815, 829-30 (1956); *see also* JOSEPH ISENBERGH & BRET WELLS, INTERNATIONAL TAXATION: U.S. TAXATION OF FOREIGN PERSONS AND FOREIGN INCOME, chrs. 68 & 70 (6th ed. rev. 2023).

Subpart F applies to U.S. shareholders of "controlled foreign corporations" ("CFC"), which are more than 50 percent owned by 10 percent or greater U.S. shareholders. 26 U.S.C. § 957(a). If a foreign corporation is a CFC, then the CFC's pro rata share of subpart F income must be included in the income of the U.S. shareholders as a deemed dividend even if the CFC does not distribute any earnings. 26 U.S.C. § 951. The Transition Tax is in subpart F and uses the same mechanism (i.e., increasing the amount of subpart F income based on accumulated deferred foreign income of the foreign corporation that U.S. shareholders must include in income).[5]

2. Partnership Taxation

Since 1954, subchapter K, 26 U.S.C. §§ 701-761, has provided for taxation of partners on the income of a partnership, regardless of distributions. *See* 26 U.S.C. § 702(a). For example, if two individuals form a partnership and the partnership earns $100 of income, the individual partners would be taxed immediately on their allocable share of the $100

[5] Global Intangible Low-Taxed Income ("GILTI") enacted in 2017 and assessed against U.S. shareholders of controlled foreign corporations on an ongoing basis is another component of the subpart F regime. 26 U.S.C. § 951A. None of subpart F, the Transition Tax nor GILTI applies to income currently realized by U.S. shareholders.

despite the absence of any realization event for the partners. No distribution of cash or property is required for the partners to be taxed on income earned at the partnership level.

Any "eligible entity," including state law partnerships and limited liability companies with at least two members, can elect to be taxed under subchapter K. Treas. Reg. §§ 301.7701-2, 301.7701-3. A partnership is defined for tax purposes as a "person," equivalent to an individual or corporation—i.e., it is an entity separate from its partners. 26 U.S.C. § 7701(a)(1); *see* 26 U.S.C. § 707(a)(1) ("If a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this section, be considered as occurring between the partnership and one who is not a partner."). Even so, the Treasury Department retains authority to treat a partnership entity as an aggregate of its partners in whole or in part to ensure that the use of a partnership entity does not subvert the purposes of the nation's income tax laws. *See* Treas. Reg. § 1.701-2(e).

The constitutionality of this regime has been repeatedly attacked by taxpayers who have claimed that a partner should be taxed only if the partner has a realization event or constructive receipt of the underlying partnership income. Nonetheless, and notwithstanding repeated requests for it to do so, this Court has refrained from imposing a partner-level realization requirement as a precondition for imposing partner-level tax on undistributed profits of a partnership.

In *Heiner v. Mellon*, 304 U.S. 271 (1938), this Court refused to impose a realization requirement or constructive receipt requirement even though the partnership assets and income were unreachable by the partners. That is, even in situations in which profits are blocked or restricted and therefore cannot be distributed to the partners, those partners still must report and pay tax on their share of partnership income. *Id.* at 281. In *Basye v. United States*, 410 U.S. 441 (1973), *rev'g* 450 F.2d 109 (9th Cir. 1971), *aff'g* 295 F. Supp. 1289 (N.D. Cal. 1968), this Court reversed the lower courts to hold that it is within Congress's authority to impose taxation on the partners on their distributive share of partnership income regardless of whether they had control over the undistributed partnership income. Citing Treasury regulations and numerous lower courts, the Court observed that "[f]ew principles of partnership taxation are more firmly established than that no matter the reason for nondistribution each partner must pay taxes on his distributive share." *Id.* at 454.

All these partnership provisions reflect careful judgments by Congress. For example, the law provides that some items of income or loss retain their character (as ordinary or capital) when they flow through a partnership while other items do not. 26 U.S.C. § 702. Similarly, distributive shares of partnership income and loss can be allocated in ways that do not follow the partners' interest in the partnership. 26 U.S.C. § 704. These flexible rules allow for consistent and predictable tax treatment while allowing partnerships to account for complex business and economic arrangements.

3. The Grantor Trust Rules

What is now subpart E of subchapter J was first enacted in the Internal Revenue Code of 1954 to codify a confusing body of case law taxing the grantor of a trust on the trust's income based on the grantor's close connection to the trust. For almost seventy years under these rules, the grantor of certain trusts has been taxed on income earned by the trust, regardless of whether the income is retained in the trust, distributed to the grantor, or distributed to a different beneficiary.

As with the partnership tax regime, the grantor trust rules reflect a careful calibration by Congress of which party is to be subject to tax based not on the *receipt* of income by that party but rather on that party's *relationship* to that income, which could be fairly attenuated. For example, in the case of an irrevocable, discretionary trust, even if neither the grantor nor the grantor's spouse is a beneficiary, the grantor could be taxed on the trust's income merely because the trustee is a relative such as the grantor's sister. 26 U.S.C. §§ 672(c), 674(c). Further, if the trustee—the grantor's sister—becomes a non-U.S. person or if the trust adds a non-U.S. person trustee, then the grantor must include gain in income as if the trust had sold all of its assets for their fair market value. 26 U.S.C. §§ 684, 7701(a)(30), (31). Under these circumstances, the grantor must include the income on her return, even though the grantor does not realize any income and has no right to the income of the trust. 26 U.S.C. § 671. These rules are necessary to ensure U.S. income taxation of certain foreign trusts and also to effectuate Congressional intent regarding the proper party to be subject to tax.

4. Intangible Assets Transferred to Foreign Corporations

Before 1986, U.S. pharmaceutical corporations would routinely develop a new drug in the United States and then transfer the patent to a subsidiary in Puerto Rico where the royalties could accumulate tax free. *See Eli Lilly & Co. v. Comm'r,* 856 F.2d 855 (7th Cir. 1988); *Merck & Co. v. United States*, 24 Cl. Ct. 73 (1991). The transfer could be done on a tax-free basis under existing corporate tax provisions that are intended to facilitate business formation and mergers. *See* 26 U.S.C. §§ 351, 361. Section 367(d) seeks to prevent businesses from shifting income from U.S.-developed intangible assets by transferring those intangibles to a foreign corporation. It does this by assigning income earned from the intangible asset back to the U.S. taxpayer that developed the intangible property, essentially creating a stream of deemed royalty payments that are "commensurate with the income attributable to the intangible" even though there is no realization event with respect to the U.S. taxpayer. 26 U.S.C. § 367(d)(2).

Seen in its historical context, section 367(d) is best understood as an expansion of the judicially-created assignment of income doctrine without regard to any realization event so that transfers of intangible property will not work to assign income out of the U.S. tax base. *See* ISENBERGH & WELLS, INTERNATIONAL TAXATION: U.S. TAXATION OF FOREIGN PERSONS AND FOREIGN INCOME, *supra*, chr. 94.

II. THERE IS A WELL-SETTLED CONSENSUS THAT REALIZATION IS A POLICY CHOICE

The Nonrealization Rules detailed above were enacted by Congress over the course of nearly the full century since *Macomber*—from the foreign personal holding company rules in 1937 to Subchapter K in 1954 to Subpart F in 1962, the OID rules in the early 1980s, and the expatriation tax and GILTI in the last fifteen years. These rules show that Congress did not regard realization as constitutionally required under *Macomber*. Neither did the executive branch, as Treasury personnel have promulgated regulations embracing and extending nonrealization into nooks and crannies that Congress did not entirely address. *See, e.g.*, Treas. Reg. § 1.901-2 (discussed below).

Courts, including this Court, have also regarded realization as a policy choice, not a constitutional requirement. Indeed, this Court summarized well the understanding shared across government and among policymakers, academics, and commentators, that basing taxation on a realization event is simply a matter of "administrative convenience." *Cottage Savings Ass'n v. Comm'r*, 499 U.S. 554, 565 (1991). As this Court explained, no definitive realization event "is necessary in order to satisfy the administrative purposes underlying the realization requirement in § 1001(a)." *Id.* This language echoed decisions from decades earlier, for example when this Court made clear that taxation of the undistributed accumulated earnings in a business could be taxed either at the corporate level or the shareholder level according to whatever Congress ultimately chose to do. *See Helvering v. Nat'l Grocery Co.*, 304 U.S. 282, 288 (1938) ("Kohl, the sole owner of the business, could not by conducting it as a corporation, prevent Congress, if

it chose to do so, from laying on him individually the tax on the year's profits."). This Court already said, in *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955), that the *Macomber* definition "was not meant to provide a touchstone to all future gross income questions." This Court should not say otherwise now.

Moreover, not long after the Sixteenth Amendment was ratified, this Court decided *Lucas v. Earl*, 281 U.S. 111 (1930), and *Helvering v. Eubank*, 311 U.S. 122 (1940), in which taxpayers had attempted to assign income to family members in lower tax brackets, and held that such amounts were properly taxable to the assignor even if the amounts were never actually received or realized by them. The Court recognized that "[t]here is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised." *Lucas v. Earl*, 281 U.S. at 114-15.

In short, the Court has been resolute that taxpayers cannot define for themselves when their income is outside the potential reach of the nation's income tax laws. *See Helvering v. Bruun*, 309 U.S. 461, 468-69 (1940). The assignment of income doctrine is just one of many tools that has been used time and again to prevent this most basic tax evasion maneuver, but it would become constitutionally suspect if realization is a constitutional dictate.

Following the guidance of this Court, the lower courts in several cases have rejected constitutional challenges to the laws described above. In *Eder v. Commissioner*, 138 F.2d 27 (2d Cir. 1943), the Second Circuit considered the constitutionality of Congress's

effort to impose shareholder-level taxation on undistributed income of a foreign personal holding company. The taxpayers argued that the imposition of shareholder-level taxation on the undistributed earnings of a foreign personal holding company was unconstitutional when the shareholder did not themselves realize those undistributed foreign corporate earnings. The provision was upheld by the Second Circuit in an opinion by Judge Frank in which Judge Learned Hand joined, citing this Court's decision in *Bruun* and *National Grocery*. *Id.* at 28-29.

In *Whitlock v. Commissioner*, 59 T.C. 490 (1972), *aff'd in part and rev'd in part*, 494 F.2d 1297 (10th Cir. 1974), the deemed dividend treatment of the subpart F regime was challenged as unconstitutional. The Tax Court noted that the very first income tax after passage of the Sixteenth Amendment had imposed tax on shareholders for undistributed excessive accumulated profits held by corporations that were availed of for the purpose of preventing imposition of shareholder taxation. The Tax Court then observed that, even though this Court had decided *Macomber* in 1920, the Tax Court "cannot read *Macomber* as denying to Congress the power to attribute a corporation's undistributed current income to the corporation's controlling stockholders." *Id.* at 508. The Tenth Circuit affirmed, explaining that when Article I of the Constitution, the Sixteenth Amendment, as well as this Court's opinions in *Glenshaw Glass*, *Macomber*, and *Pollock v. Farmers' Loan & Trust Co.,* 157 U.S. 429, modified on reh'g, 158 U.S. 601 (1895), "are considered together, we find no merit to the contention that the increased earnings provision is contrary to the Constitution." *Whitlock*, 494 F.2d at 1301, *cert. denied*, 419 U.S. 839, *reh'g denied*, 419 U.S.

1041 (1974). This holding was uncontroversial, and accordingly this Court refused to hear an appeal. *See also Garlock v. Comm'r*, 489 F.2d 197, 202 (2d Cir. 1973) (stating that constitutional challenges to the subpart F anti-deferral regime "borders on the frivolous"), *cert. denied,* 417 U.S. 911 (1974); *Murphy v. United States*, 992 F.2d 929 (9th Cir. 1993) (upholding mark-to-market treatment for commodities futures under section 1256 against a challenge based on *Macomber*).

The shared understanding of realization as a policy decision, not a constitutional dictate, was on full display in this Court's opinion just ten years ago in *PPL v. Commissioner*, 569 U.S. 329 (2013). In that case, the United Kingdom imposed a windfall profits tax on prior year profits based on a one-time, twenty-three percent formulary assessment tax on all privatized utility companies. This tax applied to the difference between a company's "profit-making value" and the price at which the company was taken private. There was no realization event, nor any sort of transaction, in the year of assessment. The question before this Court was whether that one-time tax assessment on prior year accumulated profits above a threshold constituted an income tax in the U.S. sense and therefore whether U.S. taxpayers who paid it qualified for a foreign tax credit.

The Court was asked specifically whether the absence of a transaction or event caused the tax to fail the "realization" requirement. In a unanimous opinion, the Court held that "such a rigid construction is unwarranted" and "cannot be squared with the black-letter principle that 'tax law deals in economic realities, not legal abstractions.'" *Id.* at 340 (quoting *Comm'r v. Southwest Exploration Co.*, 350 U.S. 308,

315 (1956)). The Court cited its holding in *Biddle v. Commissioner*, 302 U.S. 573 (1938), for the proposition that U.S. foreign tax credit relief would only be allowed if the U.K. accumulated earnings tax represented an "income tax in the U.S. sense," and that the tax at issue represented an income tax even though it was applied to accumulated earnings that had been previously realized in earlier years. *PPL* at 335-36 (citing Treas. Reg. § 1.901-2(a), (b)).

Redefining the U.S. income tax to require realization would undermine this well-settled law and existing regulations, and severely restrict the eligibility for U.S. foreign tax credit relief as all U.S. foreign tax credits ultimately depend on whether the foreign tax represents an income tax "in the U.S. sense," *Id.* at 334 (quoting Treas. Reg. § 1.901-2(a)(1)), and many nations impose their income taxes on a broader understanding of income than just realized income. In the course of its opinion, the Court stated that Treas. Reg. § 1.901-2 "codifies longstanding doctrine . . . and provides the relevant legal standard." *Id.* The Court also noted that the regulations provided their own definition of "realization" in Treas. Reg. § 1.901-2(b)(2) that was controlling. *Id.* at 336. Those regulations that this Court endorsed set forth a definition of realization that included "pre-realization events." Treas. Reg. § 1.901-2(b)(2)(i)(B), (C).

Further support for imposing tax on income without realization lies in Congress's plenary power "To lay and collect Taxes" conferred by Article 1, Section 8, Clause 1—an observation made by Judge Tannenwald in *Dougherty v. Commissioner*, 60 T.C. 917 (1973). In that case, the taxpayer was subject to taxation on accumulated earnings that were deemed included in the current year by reason of an

investment in U.S. property that triggered the application of section 956. The Tax Court held that taxation of accumulated earnings to U.S. shareholders in an amount equal to their pro rata share of investment in U.S. property was not forestalled by *Macomber* and that Congress must have an authority to impose taxation apart from realization as an incidental part of its plenary power to lay and collect an income tax that clearly reflects the income of the ultimate U.S. person. *Id.* at 928-30.

III. BASIS ADJUSTMENT RULES ENSURE THAT INCOME IS TAXED ONLY ONCE

The operation of the Transition Tax as well as the regulations this Court considered in *PPL* highlight an important feature of the Nonrealization Rules that tax income without realization: these rules are fully integrated into the income tax by way of basis adjustments. In each situation in which items are included in income without realization, Congress has provided mechanisms to integrate these inclusions with realization-based taxation. Specifically, adjustments are made in the taxpayer's basis in property, shares or interests so that the taxpayer is not subject to duplicate taxation upon a later realization event, for example when the taxpayer receives a distribution or disposes of the property.[6]

The foreign tax credit regulations at issue in *PPL* require that a "pre-realization" tax cannot be an

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[6] This is one of the ways in which the taxation of income without realization at issue in this case is distinguishable from a wealth tax, which is a tax on property and therefore has no regard for the double taxation of income. There is no basis adjustment mechanism in a wealth tax.

income tax in the U.S. sense if, "upon the occurrence of a later event," a tax can be imposed a second time. Treas. Reg. § 1.901-2(b)(2)(i)(C). On the other hand, under those Treasury regulations, a tax levied on a "pre-realization event" satisfies the income tax requirement if it is applied on deemed distributions, as long as appropriate basis adjustments are made thereafter so that the taxpayer is not taxed a second time on the same accretion to wealth. Treas. Reg. § 1.901-2(b)(2)(i)(C)(3).

As the regulations explain, a tax on property that does not afford basis increases would be a property tax, but a tax on a deemed distribution from property where basis adjustments are afforded so that the gain is not taxed a second time moves that property tax into the realm of an income tax applied on the property's gain. *Compare* Treas. Reg. § 1.901-2(b)(2)(iii) ex. 1, *with id.* ex. 2.

The Transition Tax at issue in this litigation has a similar feature that ensures that unrealized income will not be taxed a second time. The Moores and any other U.S. shareholders subject to the Transition Tax are given a basis increase in their stock for the undistributed earnings they included in income. If the controlled foreign corporation subsequently distributes the previously taxed earnings, the U.S. shareholders do not include such amounts again in gross income, although each shareholder's basis in the shares will be reduced to reflect the distribution. 26 U.S.C. § 959. Similarly, if the stock were sold before those earnings were distributed, then the increased basis in the shares will reduce the gain on the sale or create a greater loss. 26 U.S.C. § 961.

Similar basis adjustments are also incorporated in the other Nonrealization Rules discussed above. In each nonrealization taxation scenario, the taxpayer is given basis adjustments in the property so that the taxpayer is not taxed a second time when there is a future realization event. *See* 26 U.S.C. §§ 307(a), 475(a)(2), 877A(a)(2), 959, 1272(c)(2), 1256(a)(2).

This basis adjustment mechanism also applies to another nonrealization feature of the income tax: *deductions* without realization. Depreciation and amortization deductions have been a feature of the income tax since its inception, allowing taxpayers to recover their investment in tangible and intangible property without a cash outlay before realization. 26 U.S.C. §§ 167, 197. These realization-free deductions are accompanied by basis reductions, which results in subsequent taxation if a realization event occurs. 26 U.S.C. § 1016(a). This basis adjustment mechanism mirrors the basis increase that is provided for when tax is imposed without realization.

In sum, nonrealization is not an alternative or diversion from the ordinary operation of the income tax; rather, it is deeply intertwined with the taxation of economic income. These provisions are necessary and proper elements of the nation's tax laws that allow those laws to reach a clear reflection of income that can withstand reactive tax planning utilized by sophisticated taxpayers. If Congress were not able to incorporate nonrealization provisions as necessary and proper elements of the nation's tax laws, then Congress simply would not be able to accomplish its enumerated authority under the Sixteenth Amendment to enact tax laws that reach all incomes.

IV. THE DAMAGE WROUGHT BY A REALIZATION REQUIREMENT WOULD BE EXTENSIVE AND DIFFICULT TO CONTAIN

If *Moore* is reversed, the Nonrealization Rules discussed above and other components of the Federal income tax, *see, e.g.,* note 2, *supra*, would be constitutionally suspect. The consequences would be staggering. As we explain below, even the *possibility* of successful constitutional challenges to these rules will immediately make the income tax less integrated with business realities and open to tax avoidance and manipulation of income in ways that Congress previously addressed and, no doubt, will have to address in the future. In any event, the uncertainty will be profound. The partnership rules alone affect more than 4.2 million partnership returns filed each year and more than 28 million partners. Statistics on Income Division, *SOI Tax Stats – Partnership Statistics by Entity Type*, IRS tbls. 9a, 9c (Apr. 2022), https://www.irs.gov/statistics/soi-tax-stats-partnership-statistics-by-entity-type.

Some of the repercussions will be immediate. A decision for the Moores will give advisors grounds to conclude that taxpayers have "substantial authority" to exclude tax without a realization event or are "more likely than not" to prevail in litigation over such a position, notwithstanding laws and regulations on the books that require including such income. 26 U.S.C. § 6694(a)(2); 31 C.F.R. § 10.34(a) (2011). The onus will be on the IRS to defend Nonrealization Rules throughout the Code, and a flood of litigation will follow.

Certain large corporations are required to disclose such positions to the IRS, Treas. Reg. § 1.6012-2(a)(4),

and certain individual taxpayers may be required to provide disclosures when taking a return position contrary to a regulation, Treas. Reg. § 1.6662-4(f)(1). But current rules provide that such taxpayers can be insulated from penalties even if they do not prevail. *See* 26 U.S.C. § 6662(d)(2). Even if the IRS is made aware of, or can detect, taxpayers taking these positions, the administrative burden of defending each Nonrealization Rule taxpayer-by-taxpayer will be insurmountable.

The Moores seek to dismiss the implications of their position by painting the Transition Tax as Congress's only real departure from realization in contrast to other aspects of the income tax that are justified by the so-called "doctrine of constructive realization." Pet. Br. 47. No court, including this one, has recognized such a "doctrine." It is an invention of the Moores that borrows heavily from case law addressing the doctrine of constructive receipt that "treats as taxable income which is unqualifiedly subject to the demand of a taxpayer . . . , whether or not such income has actually been received in cash." Pet. Br. 48 (quoting *Ross v. Comm'r*, 169 F.2d 483, 490 (1st Cir. 1948)). None of the Nonrealization Rules discussed above rely on income being subject to demand. Indeed, if that were the case, then none of the statutes would have been necessary. In their effort to explain away the ways in which Congress has protected the tax base by taxing income without realization, the Moores would have this Court transform the doctrine of constructive receipt into something unrecognizable and undefined and not an antidote to the real policy challenges that constitutionalizing realization would create.

The longer term consequences are bleak as well. Even if this Court attempts to craft a narrow version of constitutionalized realization, reversing *Moore* will upset careful policymaking in numerous areas which has established sturdy equilibria that have stood for many decades. This would *re*introduce a decades-long whack-a-mole game of shutting down tax evasion.

We believe that Congress and Treasury can redesign *some* of the provisions threatened by a constitutionally imposed realization requirement so that, once new laws are enacted, in practice some unrealized income could once again be subject to taxation. But significant portions of income will be permanently shielded from taxation, regardless of how skillfully and quickly Congress redesigns these longstanding rules. In a constitutional-realization world of tax enforcement, Congress and Treasury would have one hand tied behind their backs, unable to deploy nonrealization concepts to catch sheltered income premised on highly structured planning.

Many of the tax evasion opportunities that will ensue if the Moores prevail would accrue to the benefit of a very narrow portion of current U.S. taxpayers. Foreign corporations and non-U.S. people would benefit immensely. U.S. citizens and residents with investment income will have myriad opportunities to structure their holdings to avoid U.S. tax entirely, particularly through indirectly-owned foreign entities. Tax shelters using straddles and short sales against the box and discounted debt instruments will proliferate once again. Tax lawyers and accountants, together with their well-resourced clients, will have a field day. Low tax bills will be the norm for those who can afford to pay their advisors to arrange them.

A victory for the Moores will undermine the fundamental purpose of the Sixteenth Amendment to allow Congress to tax all incomes. A constitutionally imposed realization requirement creates the specter that *only some income* will be subject to tax. Of course, those who derive their income from their own labor will invariably continue to pay.

CONCLUSION

For the foregoing reasons, the judgment of the court below should be affirmed.

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