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Will the Supreme Court Invalidate One or More Sections of the Tax Cuts and Jobs Act?

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A tax case pending in the United States Supreme Court, *Moore v. United States*,[1] may cause a cataclysmic change in the federal income tax. The 16th Amendment to the United States Constitution empowers Congress to impose "taxes on incomes from whatever source derived without apportionment among the several states, and without regard to any census or enumeration."[2] The Court will decide if the 16th Amendment taxes income only if the taxpayer "realizes" it. The specific question on which the petition for certiorari was granted is whether the 16th Amendment authorizes Congress to tax unrealized sums without apportionment among the states. In the context of the case before the Court, the question is whether a sum not in the hands of the taxpayer but instead in the hands of the taxpayer's corporation is not realized by the taxpayer and therefore not taxable to the taxpayer.

Action Items: Every tax professional probably has an opinion about the merits and outcome of the *Moore* case. Nonetheless, all taxpayers should consider whether they paid federal income taxes on mark-to-market increases in property values (under circumstances described below) and whether a protective refund claim should be filed if the Court broadly applies the concept of realization to the 16th Amendment. Additionally, if federal protective claims are to be filed, protective state income tax claims may also be in order. While some may believe that the question before the Court is meritless, the granting of a petition for certiorari requires a favorable vote of at least four Supreme Court justices. Although no prediction about the outcome of the case can be based on the granting of the petition, it is obvious that at least four justices think that the question deserves full analysis.

Constitutional Provisions: The United States Constitution authorizes Congress to lay and collect taxes[3] but no capitation or other *direct* tax may be laid unless it is apportioned among the states according to the census.[4] But, as stated above, the 16th Amendment excludes income taxes from the state-apportionment requirement.

The Tax Cuts and Jobs Act: In 2017, Congress passed, and President Donald Trump signed, the Tax Cut and Jobs Act,[5] which substantially amended the Internal Revenue Code. One provision required a United States shareholder of a controlled foreign corporation to include in 2017 federal taxable income tax the undistributed income that the controlled foreign corporation accumulated after 1986.[6] The Moore case addresses this provision and is part of a new integrated system of taxation.

The Moore Case: Mr. and Ms. Moore owned 11% of a controlled foreign corporation and were required by the Tax Cuts and Jobs Act to include their share of the accumulated income of the corporation in their 2017 federal income tax return. The federal income tax on that income was $15,000. They filed a refund claim with Internal Revenue Service for the $15,000, and when the claim was not allowed, they filed an action in federal district court to recover the tax, arguing that the tax was an unconstitutional unapportioned direct tax because they personally did not *realize*—they never received—the income. The district court granted the motion of the United States to dismiss the action.[7] The Ninth Circuit affirmed the dismissal.[8] The Moores then petitioned the Supreme Court, which accepted the case.

History of the Sixteenth Amendment: In 1894, Congress enacted an income tax on the income from real and personal property.[9] The tax was challenged as an unconstitutional unapportioned direct tax on the property, itself. In *Pollock v. Farmer's Loan and Trust Company*,[10] the Supreme Court ruled that a tax on income from the property was equally direct and unconstitutional. Further, the Court invalidated all sections imposing the tax because they constituted one entire scheme of taxation.[11]

Following the decision in *Pollock*, Western Republicans and Democrats lobbied for a new income tax.[12] Conservative Republicans opposed the tax but reached a compromise with the Western Republicans and Democrats, which called for submission for ratification of what would become the 16th Amendment.[13] The amendment was ratified on February 13, 1913.

<u>The Moores' Argument</u>: The term "realization" does not appear in the 16th Amendment, but the Moores argue that beginning in 1920, the Supreme Court ruled in *Eisner v. Macomber* that "income," as used in the 16th Amendment, required income to be realized in order not to be classified as a direct tax.[14] They find "realization" in the 16th Amendment phrase, "from any source derived." In their view, absent distribution, the income is not derived, meaning realized.[15] They express the concern that without a realization requirement, Congress could impose an income tax on a mere increase in the wealth of a taxpayer.

<u>The United States' Response</u>: The United States responded that the U.S. Constitution itself explains that a direct tax is a capitation tax[16] and a property tax, neither of which is a tax on the accumulated income of the controlled foreign corporation in which the Moores invested. The United States dismissed the Moores' reliance on *Macomber* and other Supreme Court cases as not mandating a universal definition of income for purposes of the 16th Amendment. Moreover, Congress has successfully taxed for many years other activities with respect to which the taxpayer did not receive cash or property.[17] The United States emphasized that the controlled foreign corporation itself, in which the Moores invested, "realized" the accumulated profits, and that nothing in the 16th Amendment prohibits Congress from taxing the shareholders of that corporation on their share of the corporation's realized earnings.

Finally, as to the concern expressed by the Moores that absent a realization requirement in the 16th Amendment, Congress could impose a tax on the worth of wealthy individuals, the United States reminded the Court that it did not exercise legal oversight of the legislative and executive branches or issue advisory opinions on matters not before it.

The case will be argued in the term of the Supreme Court beginning in October 2023. The date for the argument has not yet been set. [18]

Please contact the authors of this alert or your Miller Canfield attorney to discuss further.

[1] No. 22-800 (Feb. 21, 2023).

[2] A federal tax is apportioned among the states and based on the population of each state if the revenue from the tax generated by each state is proportional to the population of each state based on census data. A federal income tax is not proportional to the population of each state because a state's percentage of the total United States population does not equal that state's percentage of the income tax generated in the state of the total income tax generated in the United States.

[3] U.S. Const. Art. I, sec. 8, cl. 1.

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[4] U.S. Const. Art. I, sec. 2, cl. 3, Art. I, sec. 9, cl. 4.

[5] P.L. 115-97 (December 22, 2017).

[6] IRC §965(a).

[7] Moore v. U.S., 2020 WL 6799022 (W.D. Wash. Nov. 19, 2020).

[8] Moore v. U.S., 36 F.4th 930 (9th Cir. 2022).

[9] Act Aug. 27, 1894, 28 Stat. 509, c. 349.

[10] 158 U.S. 601 (1895).

[11] If IRC §965 is invalidated by the Court, what other sections of the Tax Cuts and Jobs Act will the Court invalidate because they constitute one entire scheme of taxation of which IRC §965 is a part?

[12] D. Kahn, P. Gann, "Corporate Taxation and Taxation of Partnerships and Partners" (1979). p. 2.

[13] *Id.*

[14] 252 U.S. 189 (1920) (stock dividend not income because shareholder's claim on net worth did not increase).

[15] Petition for Certiorari, pp. 17-18 (Feb. 21, 2003).

[16] An example of a capitation tax is a tax on every individual at a fixed amount.

[17] Examples cited by the United States are undistributed income of controlled corporations, IRC §§951-964 (Subpart F); partnership income not distributed to partners, IRC §§701-761 (Subchapter K); S corporations, IRC §§1361-1379 (Subchapter S); U.S. citizens who relinquish their citizenship, IRC §877A; regulated futures contracts, IRC 1256(a), -(b); securities dealers' securities, IRC§475(a); and assets held by insurance companies, IRC §817A(b). Brief of United States, pp. 10-11 (May 16, 2023).

[18] Amicus briefs in support of the Moore's have been filed by the Cato Institute, the Landmark Legal Foundation, the Chamber of Commerce of the United States, The Manhattan Institute for Policy Research, the Southeastern Legal Foundation, the Buckeye Institute, the Pacific Research Institute, and Americans for Tax Reform. None have yet been filed in support of the United States.