Moore v. United States: The Mandatory Repatriation Tax Survives Supreme Court Scrutiny (but Barely)

by Robert S. Horwitz

On June 20, 2024, the Supreme Court issued its decision in *Moore v. United States*, 603 U.S. ___, upholding the constitutionality of the Mandatory Repatriation Tax ("MRT"). While it was pending, the case was the subject of more commentary than any tax case in recent memory. Many commentators were in a twitter that a ruling in favor of the Moores would undermine many of the income tax provisions of the Internal Revenue Code ("IRC"). This was because if the Court held that to be taxable, income must be "realized" by the taxpayer, it would superimpose on the IRC the requirement that a taxpayer had to have actually receive the funds. Such a requirement would call into question the constitutionality of Subchapter K (taxation of partnerships), Subchapter S (taxation of S corporations) and a number of other provisions of the IRC. These fears proved unfounded.

What Is the MRT

The MRT was a key provision of the reformation of the Subchapter F provisions of the IRC, implemented by the 2017 Tax Cuts and Jobs Act ("TCJA"). Subchapter F, (IRC §§951-965), requires U.S. shareholders of Controlled Foreign Corporations ("CFC") to include in gross income their pro rata shares of the income of the CFC. A foreign corporation is a CFC if more than 50% of its stock is owned by U.S. shareholders. A "U.S. shareholder" is a U.S. person who owns at least 10% of a CFC's stock.

Prior to the TCJA, Subchapter F did not tax all of a CFC's active business income. This resulted in CFCs accumulating trillions of dollars in untaxed undistributed income. Most of these trillions were in CFCs owned by U.S.-based multinational corporations. To encourage U.S. corporations to repatriate the funds that had accumulated offshore, the TCJA provides a domestic corporation that own 10% or more of a foreign corporation a 100% deduction for the portion of dividends received from the foreign corporation attributable to previously "undistributed foreign earnings." IRC §245A. The MRT was a one-time tax on a U.S. shareholder's pro rata share of previously untaxed earnings of the CFC that accumulated from 1986 to 2017.

The Moores' Investment in a CFC and Their Refund Claim

In 2005, a friend of the Moores started a corporation in India named KisanKraft Machine Tools Private Ltd. The Moores invested $40,000 in KisanKraft in 2006 and received 13% of its stock. Because over 50% of KisanKraft's stock was owned by U.S. persons, it was a CFC. By 2017, their share of KisanKraft's accumulated undistributed income was $508,000.

On their joint income tax return for 2017, the Moores included in gross income their pro rata share of KisanKraft's gross income, including their share of its accumulated income. They paid the tax and then sought a refund. They claimed that the MRT is an unapportioned direct tax and that it is impermissibly retroactive in violation of the Due Process Clause of the Fifth Amendment.

Proceedings in the Lower Courts

The Moores filed a refund suit in the U.S. District Court in Seattle, raising both the argument that the MRT is an unapportioned direct tax and that it violates the Due Process Clause. The district court granted the Government's motion to dismiss. The court held that the MRT is an income tax and, thus, does not have to be apportioned, and that it is not impermissibly retroactive.

The Ninth Circuit affirmed the district court. 36 F. 4th 930 (2022). The Ninth Circuit held that "realization" is not required by the constitution and that Congress can attribute to a shareholder his pro rata share of a corporation's income. It also rejected the Moores' claim that the MRT's retroactive period is "impermissibly long."

The Moores filed a petition for certiorari on the question of whether the MRT was an unapportioned direct tax. They did not raise the issue of whether the MRT's retroactive period violates the Due Process Clause. The Supreme Court granted certiorari.

The Question Before the Court

Article I, Section 2 of the Constitution provides that "direct Taxes shall be apportioned among the several States which may be included within this Union" while Article I, Section 8 provides that "The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, … but all Duties, Imposts and Excises shall be uniform throughout the United States." In *Pollock v. Farmers' Loan & Trust Co*., 158 U.S. 601 (1895), the Supreme Court held that taxes on income derived from property were direct taxes requiring apportionment. In reaction, the 16th Amendment to the Constitution was ratified. It provides:

> The Congress shall have 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.

The Moores claimed that the MRT was a direct tax that was not apportioned and thus violated the constitutional prohibition on unapportioned direct taxes. The Moores and the United States framed the question before the Court differently. The Moores framed the question as:

> Whether the Sixteenth Amendment authorizes Congress to tax unrealized sums without apportionment among the states.

According to the Moores, income cannot be taxed unless it is realized, which requires the taxpayer to have actually received cash or other items of value. Since KisanKraft never distributed the amounts that the Moores were taxed on, the MRT was not an income tax under the 16th Amendment. It was, therefore, a direct tax that was unconstitutional because it was not apportioned.

The United States framed the question as:

> Whether the MRT is a "tax[] on incomes, from whatever source derived," U.S. Const. Amend. XVI, within the meaning of the Sixteenth Amendment.

The United States argued that (a) the MRT is a tax on income, (b) realization is not a constitutional requirement for an income tax, and (c) even if it is, the income that was taxed was realized by KisanKraft. It also argued if the Moores were correct that the MRT was not an income tax, it was constitutional as an excise tax, which did not have to be apportioned.

In the opening paragraphs of the majority opinion, the Court stated the question before it as "whether that 2017 tax (known as the Mandatory Repatriation Tax or MRT) is constitutional under Article I, §§8 and 9 and the Sixteenth Amendment." The Court answered this question "yes."

The Court's Opinion

The Court's majority opinion was written by Justice Kavanaugh and joined by Chief Justice Roberts and Associate Justices Kagan and Sotomayor. Justice Jackson wrote a concurring opinion joining the majority. Justice Barrett wrote an opinion (joined by Justice Alito) concurring in the result because of the way the Moores argued their case. Justice Thomas, joined by Justice Gorsuch, dissented.

The majority opinion began by noting that Congress had long treated partnerships and some corporations as pass-throughs, taxing the partners or shareholders, but not the entity, on their pro rata shares of the entity's income. Since 1962, Congress has treated CFCs as pass-through entities with respect to certain types of income and taxed their U.S. shareholders on their pro rata shares of such income. The Moores conceded that these pass-through taxes are constitutional.

After discussing the MRT, the facts in the case and the decisions in the courts below, the Court turned to the history of taxation in the U.S. Under the Articles of Confederation, the national government had to rely on contributions from the states for its revenues. Because this was a major hinderance to the operations of a federal government, the Founders granted Congress "an expansive taxing power" that included the ability to lay both direct and indirect taxes. Direct taxes, which are imposed on persons and property, were rarely enacted since these must be proportioned among the states based on population. No direct tax has been enacted since the Civil War.

Indirect taxes, on the other hand, are those imposed on activities and transactions. The constitutional requirement is that indirect taxes be uniform throughout the United States. During the Civil War, Congress enacted an income tax that was held to be a constitutional indirect tax. The *Pollock v Farmers' Loan & Trust Co.* case held that a tax on income derived from property was a direct tax that needed to be apportioned. The Sixteenth Amendment confirmed the pre-*Pollock* understanding that a tax on income was an indirect tax.

The Court then turned to the Moores' contention that the MRT is a tax on property that is unconstitutional because it is not apportioned. The Moores argued that realization only occurs when "gains come into the taxpayer's coffers" and that they were being taxed on income they did not realize. In fact, KisanKraft realized the income, which the MRT attributed to the Moores. The Court then rephrased the question before it:

> So the precise and narrow question that the Court addresses today is whether Congress may attribute an entity's realized and undistributed income to the entity's shareholders or partners, and then tax the shareholders or partners on their portions of that income. This Court's longstanding precedents, reflected in and reinforced by Congress's longstanding practice, establish that the answer is yes.

As the Court emphasized it was not addressing the constitutionality of (a) a tax on both an entity and its shareholders or partners on the entity's undistributed income; (ii) taxes on holdings, wealth, or net worth; or (iii) taxes on appreciation.

The Court then outlined the history of post-Sixteenth Amendment taxes on the income of an entity and Supreme Court holdings that Congress can choose to tax either the entity or its partners/shareholders on the entity's undistributed income. According to the Court, its

> precedents had established a clear rule that directly contradicts the Moores' argument in this case. That line of precedent remains good law to this day. Indeed, since then, it has gone without serious question in both Congress and the federal courts that Congress can attribute the undistributed income of an entity to the entity's shareholders or partners, and tax the shareholders or partners on their pro rata share of the entity's undistributed income.

It noted that, based on this precedent, the courts of appeal had rejected constitutional challenges to Subpart F as bordering on the frivolous.

The lynchpin of the Moores' argument was that *Eisner v. Macomber*, 252 U.S. 189 (1920), held that to be income under the Sixteenth Amendment, there must be realization. For those of you who slept through your individual income tax class in law school, the issue before the Court in that case was whether the Sixteenth Amendment empowers Congress to tax as income a stock dividend issued to shareholders in proportion to their stock. The Court ruled in the negative and held that for Sixteenth Amendment purposes, income is limited to income realized and that declaring a stock dividend "is no more than a book adjustment."

The majority found Moores' reliance on *Macomber* misplaced. The stock dividend in that case did not represent any economic gain, either realized or unrealized. The Court stated that since the MRT taxes income that was realized by the corporation, it did not need to address the United States' claim that the Sixteenth Amendment does not require realization. The Moores' claim that *Macomber* means that a tax attributing a corporation's income to its shareholders is not an income tax was "implausible; attribution was not an issue in *Macomber* and subsequent Supreme Court decisions made clear that Congress has the power to tax a shareholder or a partner on the undistributed income of the entity. *Macomber* "does not proscribe attribution and thus has no bearing on the attribution issues in this case."

To sum up this part of its decision, the Court stated that "Congress may tax either (i) the entity or (ii) its shareholders or partners" on the income of the entity.

Having discussed why its precedent supports the determination that the MRT is not a direct tax that needs to be apportioned, the Court next traced the history of "long-standing Congressional practices" to tax shareholders and partners of business entities on the entities' undistributed income. The Court found that these "long-standing" Congressional practices reinforced Supreme Court precedent.

The Court then turned to the Moores' attempts to distinguish the MRT from partnership, S corporation and Subpart F taxes, all of which the Moores conceded were constitutional. The Court found their attempts to distinguish unconvincing. First, the Moores claim that at the time the Sixteenth Amendment was ratified, partnerships were not viewed as distinct from their partners was "false." At the time of ratification many states taxed partnerships directly on their income and partnerships were often viewed as entities separate from their partners, including in bankruptcy.

Second, the Moores claimed that S corporation taxation was constitutional because the shareholders had to consent to be taxed at the shareholder level. This ignores the fact that if subsequently minority shareholders no longer want the corporation to be taxed as an S corporation, they cannot change that treatment. It also ignores the fact that consent would not eliminate the constitutional apportionment requirement if the Moores were correct.

Third, the Moores attempted to distinguish Subpart F taxes by claiming that it applied a "doctrine of constructive realization." The majority pointed out that no case ever used that term and, if the Moores' concept was accepted, it would mean that the MRT is a tax on constructively realized income and, thus, constitutional.

The Court then raised an *in terrorem* assertion that if the Moores' argument concerning realization was carried to its logical conclusion, large swaths of the IRC would be unconstitutional, which would deprive the Government and the American people of trillions in lost revenue. The Court does not explain how it arrived at the multi-trillion-dollar figure. If realization was required, Congress could tax all corporations and partnerships at the entity level; shareholders and partners could not reduce their income by flow-through losses. If the income of entities was taxed at the same maximum rate for individuals, the loss of tax attributable to income from S corporations and partnerships might be minimal, especially when you factor in that the shareholders and partners would be taxable on any distribution of present or accumulated earnings and profits What the economic effect of accepting the Moores' argument would be has not to my knowledge been quantified and, in any event, the potential economic effect of a ruling should theoretically not be important in determining whether a tax is constitutional. But the Supreme Court does not live in a Cloud Cuckoo Land[1] rather always is usually aware of reality.

The Court then critiqued the concurring and dissenting opinion and emphasized how narrow its holding was:

> For their part, the dissent and the opinion concurring in the judgment focus primarily on the realization issue— namely, whether realization is required for an income tax. We do not decide that question today. When they reach the attribution question that we do decide, the separate opinions disagree with our reading of some of the Court's precedents. We respect their views. But as we thoroughly explained above, we read the Court's precedents differently. That said, 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.

The majority opinion emphasized that it did not need to resolve the issue of whether realization was a constitutional requirement to decide the case. It affirmed the judgment of the Ninth Circuit.

Justice Jackson wrote a concurring opinion joining in the judgment, but expressing her view that there was no constitutional requirement that income had to be realized to be constitutionally taxed under the Sixteenth Amendment. Even if the Moores were correct about realization, the Court would have to address the United States' argument that the MRT is an excise tax that is not subject to apportionment.

Justice Barrett's concurring opinion stated there is a constitutional requirement that income be realized for it to be subject to tax. The Sixteenth Amendment allows a tax without apportionment on income "from whatever source derived." "Derived" and "realized" are synonymous and Supreme Court decisions use these terms interchangeably. The Constitution does not give Congress power to attribute carte blanche a corporation's income to its shareholders and the concurrence agrees with the Court that Congress cannot "arbitrarily" attribute corporate income to shareholders. The question of whether Congress can attribute the income of a closely held corporation is a difficult one that was "barely addressed" by the parties. Given the Moores' concession that Subpart F is constitutional and since the MRT is not meaningfully different, they failed to meet their burden of proving that they are entitled to a refund. On that ground, Justices Barrett and Alito concurred in affirming the judgment of the Ninth Circuit.[2]

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[1] See Aristophones' *The Birds*.

[2] If the Moores had not conceded that Subchapters K and S and Subpart F were constitutional, Justice Barret and Alito would probably not have concurred and the opinion would have been 5-4.

The dissent argued that the Sixteen Amendment has a realization requirement and that this required that income be "derived," which means it must be received. Since the Moores did not receive any of KisanKraft's undistributed income, that income is not taxable to them. The dissent would thus reverse the Ninth Circuit.

The Impact of *Moore v United States*

Given how narrowly drawn the Supreme Court's decision was in *Moore*, it was undoubtedly a compromise decision. If the Court held that realization was a constitutional requirement, Justice Jackson would not have joined. If it held that it was not a requirement, Justices Barrett and Alito would not have concurred and one of the justices who joined the majority may have dissented, in which case the MRT tax would have been unconstitutional and, with it, potentially the taxes imposed by Subchapter K (partnerships), Subchapter S (S corporations) and subpart F (CFCs) would probably be ruled unconstitutional, as would such things as mark-to-market and original issue discount provisions of the IRC.

What do we know for certain: although the Court said it was not ruling on the issue of taxing both an entity and its shareholders/partners on undistributed income of the corporation, a majority of justices would probably find such a tax unconstitutional. Similarly, a majority would probably find a wealth tax unconstitutional.

Whether and in what circumstances a tax on the appreciation in value of a taxpayer's assets would be unconstitutional is not clear. The Court listed as provisions that would be unconstitutional if it bought into the Moores' realization argument (a) the mark-to-market provisions of IRC §1256(a) that tax increases in value of certain options and futures contracts and (b) the original issue discount provisions of IRC §1252, *et seq*. that taxes persons holding debt instruments ratably on the excess of the stated redemption price of a debt instrument over its issue price.

What we can say is that the current provisions for taxing pass-through entities (partnerships, S corporations and CFCs) are safe for the foreseeable future. Whether the Court will recognize a realization requirement as constitutionally mandated for a tax on income will need to wait for another day, possibly in a case involving the mark-to-market or original issue discount provisions of the IRC. But we are undoubtedly in for an uncertain future regarding many provisions of the IRC.

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