No. 22-800

In The
Supreme Court of the United States

CHARLES G. MOORE AND KATHLEEN F. MOORE,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

BRIEF OF PROFESSOR THEODORE P. SETO AS AMICUS CURIAE IN SUPPORT OF RESPONDENT

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INTERESTS OF THE AMICUS CURIAE[1]

Theodore Seto is the Frederick J. Lower, Jr. Chair and Professor of Law at Loyola Law School, Loyola Marymount University, Los Angeles, California. He practiced individual, corporate, partnership, and international tax law at Drinker Biddle and Reath in Philadelphia from 1983 to 1991, the last five years as a partner in the tax department of that firm. He joined the faculty at Loyola Law School in 1991. In 2000, he co-founded the law school's Graduate Tax Program. In 2019, he co-founded the law school's online Tax LLM Program, which has since become the 3rd-ranked such program in the United States. His research has been published by the Tax Law Review, the Virginia Tax Review, Oxford University Press, the University of Pennsylvania Law Review, the Yale Law Journal, and the Harvard Law Review, among others. He is a Fellow of the American College of Tax Counsel and has been a member of the bar of this Court since 1983.

Professor Seto is interested in this case as a result of his concerns regarding harms that may result to the integrity and administrability of the Federal income tax system if the decision of the Ninth Circuit Court of Appeals is reversed. This brief will lay out some of the

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[1] Counsel of record is the author of this brief. No counsel for a party authored this brief in whole or in part. Counsel of record funded the preparation and submission of this brief out of the activities budget provided by Loyola Law School as part of his employment agreement. No other persons or entities made any monetary contribution towards the preparation or submission of this brief.

possible collateral consequences of this Court's decision for other parts of the Federal income tax system.

SUMMARY OF ARGUMENT

Realization is an event-based accounting convention. Its function is to allow recordkeepers, including individual taxpayers, to record income and losses largely mechanically without having to exercise significant independent judgment. When implemented, realization seriously limits the ability of the Internal Revenue Code ("Code") to measure economic income correctly. First, the realization principle ignores the economic value of deferral. Second, in many situations, realization is elective with the taxpayer. If realization is elective and taxation depends on realization, then taxation becomes elective as well. In order more accurately to measure economic income, the Code deviates from the realization principle in many contexts. For example, its rules for the taxation of securities dealers and financial derivatives do not turn on realization at all.

This brief will use the term "direct realization" to refer to accounting events experienced by taxpayer himself. "Indirect realization," by contrast, involves accounting events that occur to someone other than taxpayer, often a related party. Indirect realization is used extensively in the taxation of international transactions. It also underlies all of partnership taxation. If indirect realization is constitutionally sufficient to

permit the taxation of income, then the tax challenged here is constitutional. If indirect realization is not constitutionally sufficient, large portions of the Code are unconstitutional. A constitutional realization requirement would also require constitutional examination of a multitude of individual tax sections and subsections.

The tax challenged here, 26 U.S.C. 965, enacted as part of the Tax Cuts and Jobs Act of 2017 ("TCJA"), was an integral part of a larger whole. The TCJA effected a fundamental change in the Code's approach to the taxation of foreign subsidiaries. Instead of taxing the earnings of foreign subsidiaries on a deferred basis, when repatriated as dividends, such earnings would thereafter be taxed currently to such subsidiaries' U.S. corporate parents and other major U.S. shareholders. The tax challenged here was a transition tax, designed to ensure that all foreign subsidiary earnings that Congress believed should be taxed would be taxed under either the pre-TCJA regime or the post-TCJA regime. For this reason, if this Court invalidates 26 U.S.C. 965, its severability jurisprudence may require it to invalidate the entirety of Subtitle D, Part I of the TCJA.

Finally, a constitutional realization requirement would substantially undermine the ability of Congress to lay and collect an income tax that accurately measures economic income and would thereby undermine the fiscal capacity of the United States.

ARGUMENT

Introduction

This brief, for the most part, does not argue the law. Its purpose is rather to assist the Court by locating the parties' arguments within the larger Federal tax system and alerting the Court to possible collateral consequences of its decision to other parts of the Internal Revenue Code (the "Code") and the Federal tax system as a whole.

Technically, petitioners challenge only the constitutionality of Section 14103 of the Tax Cuts and Jobs Act, P.L. 115-87, 131 Stat. 2054 (2017) ("TCJA"), which added 26 U.S.C. 965. They do so on the ground that taxing corporate parents and other major shareholders of foreign corporations on income already realized by such foreign corporations but not yet realized by their corporate parents or other major shareholders is a direct tax in violation of the apportionment requirement of Article I, Section 2, clause 3 and Article I, Section 9, clause 4 of the Constitution and is not an income tax within the meaning of the Sixteenth Amendment.

Prior to the TCJA, foreign subsidiaries of U.S. multinationals were, in practice, largely exempt from U.S. taxation on their current income.[2] Instead, their

[2] In theory, foreign corporations were subject to U.S. taxation on income effectively connected with the conduct of a U.S. trade or business, 26 U.S.C. 881, and U.S.-source "fixed or determinable annual or periodical gains, profits, and income," 26 U.S.C. 882. In practice, however, taxpayers generally structured their affairs so as to ensure that their foreign subsidiaries did not recognize any such income. *See* Theodore P. Seto, *Modeling*

earnings were taxed to their U.S. corporate parents and other U.S. shareholders later, when they were distributed as dividends. This deferral had two inimical effects. First, it created an incentive for multinationals to move operations, plant, and jobs out of the United States, where they would be subject to current U.S. taxation, to other countries, where they would not. Second, it created an incentive to leave foreign earnings offshore and not repatriate them back into the United States.

The TCJA effected a fundamental change in the Code's approach to the taxation of foreign subsidiaries. Instead of taxing the earnings of foreign subsidiaries on a deferred basis, when repatriated as dividends, such earnings would thereafter be taxed currently to such subsidiaries' U.S. corporate parents and other major U.S. shareholders. This change was effected by Subtitle D, Part I of the TCJA, TCJA Sections 14101 through 14304. TCJA Section 14101, which added 26 U.S.C. 245A, effectively repealed the tax on dividends paid by foreign subsidiaries to U.S. corporate parents. TCJA Section 14201, which added 26 U.S.C. 951A,

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Changes in U.S. International Tax Rules, TAX NOTES, April 15, 2019, *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3417936. In addition, limited categories of foreign subsidiary income were currently taxable to their U.S. parents – but not to the subsidiaries themselves – under the so-called "Subpart F" rules. 26 U.S.C. 951-960. The Subpart F rules, however, were limited to types of income easily shifted to tax haven jurisdictions and did not generally apply to income with substantive links to the foreign jurisdictions in which the foreign corporations were incorporated.

imposed a new tax on "global intangible low-taxed income" ("GILTI") of foreign subsidiaries, which tax was to be payable currently by such subsidiaries' corporate parents and other major U.S. shareholders. The remaining sections of TCJA Subtitle D, Part I conformed other aspects of U.S. international tax law to reflect this regime change.

The tax challenged in this case, imposed by new 26 U.S.C. 965, was a transition tax, designed to ensure that all foreign subsidiary earnings that Congress believed should be taxed by the United States would be taxed under either the pre-TCJA regime or the post-TCJA regime. It was not imposed on wealth or on the fair market value of the foreign subsidiaries' stock. Rather, it was imposed on the previously untaxed and undistributed earnings of foreign subsidiaries that would ultimately have been taxed upon repatriation under the old regime but would never be taxed to corporate parents under the new regime.[3] In other words, it was imposed to ensure that all foreign subsidiary earnings that Congress believed should be taxed would be taxed once and only once at the corporate level, notwithstanding the change in regimes.

The amounts involved were substantial. The revenue estimates prepared by the staff of the Joint

[3] The TCJA did not repeal the tax on dividends received by noncorporate taxpayers. In this regard, it treated foreign corporations similarly to domestic corporations. Income earned by domestic corporations is taxed twice – first when earned by the corporation, then when distributed to individual shareholders as dividends.

Committee on Taxation, on which Congress relied in enacting both the regime change described above and the TCJA as a whole, projected that 26 U.S.C. 965, by itself, would raise a total of $338.8 billion over the 10-year period Congress uses for revenue estimation purposes. *See* JCX-67-17, *Estimated Budget Effects of the Conference Agreement for H.R. 1*, *the "Tax Cuts and Jobs Act."* The TCJA as a whole was projected to lose $1,456 billion over that same period. *Id.*

Petitioners contend that realization is a prerequisite to the taxation of income under the Sixteenth Amendment. Part I of the argument will outline some of the possible consequences to the Code's tax accounting rules and provisions that rely on book accounting if petitioners' argument is accepted. Part II will explore the difference between direct and indirect realization. If indirect realization is not sufficient to permit the taxation of income under the Sixteenth Amendment, large portions of the current Federal income tax system are unconstitutional, including the new international tax regime imposed by TCJA Subtitle D, Part I, and the Code's treatment of entities taxed as partnerships. Part III will identify some of the possible collateral consequences to a sample of detailed partnership tax rules if petitioners' argument is accepted. Part IV will frame the severability issues presented by petitioners' challenge. Part V will outline possible collateral consequences of petitioners' argument to the Federal income tax system as a whole.

I. Realization is an event-based accounting convention which, when implemented, limits the ability of the Internal Revenue Code to measure economic income correctly.

Realization is an event-based accounting convention. Its function is to allow recordkeepers, including individual taxpayers, to record income and losses largely mechanically without having to exercise significant independent judgment. For this reason, it underlies large portions of both the Code and generally accepted accounting principles ("GAAP" or "book" accounting) promulgated by the Financial Accounting Standards Board ("FASB") and used by businesses to report their operating results to shareholders, partners, lenders, the Securities and Exchange Commission, and others.

When implemented, realization limits the ability of the Code to measure economic income correctly in at least two ways. First, the realization principle ignores the economic value of deferral – known in tax policy analysis as the "time value of money." If realization is required, taxation of economic income accrued over the period taxpayer holds an asset is deferred until the asset is sold. The ability to defer payment of taxes is economically valuable. Deferral reduces effective rates of tax. See Theodore P. Seto, Federal Income Taxation 267-275 (West Academic Publishing 2d ed., 2015). When combined with the Code's depreciation rules, the result can be an effective tax rate of zero or less; it can even be negative. *See id*. This is one of the reasons

taxpayers in the real estate, hotel, and related industries commonly pay little Federal income tax.

Second, in many situations, realization is elective with the taxpayer. For example, a parent corporation may cause its wholly-owned foreign subsidiary not to pay dividends currently. If realization is elective and taxation depends on realization, then taxation becomes elective as well.

One widely publicized tax strategy that takes advantage of the electivity of realization is known as "buy, borrow, and die." See, *e.g.*, Rebecca Lake, *Buy, Borrow, Die: This is How the Rich Avoid Taxes*, Yahoo! Finance (Sept. 1, 2023), *available at* https://finance.yahoo.com/news/buy-borrow-die-rich-avoid-140004536.html. Taxpayer buys or creates an asset that is anticipated to appreciate – for example, real estate or corporate stock. As the asset appreciates, taxpayer borrows against that appreciation, using the loan proceeds to fund his living expenses. Because borrowing does not constitute "realization," taxpayer pays no income taxes, regardless of how extravagant his lifestyle may be, notwithstanding the fact that he is effectively cashing out his appreciation. He then dies, never having paid taxes on the economic income that funded a lifetime of living expenses. ProPublica has reported that Jeffrey Bezos, founder of Amazon and one of the wealthiest men in the world, paid no taxes from 2016 through 2018 using this strategy. *See* Robert Farrington, *How Ordinary Americans Can Also Buy, Borrow, And Die Without Paying Taxes*, Forbes, *available at* https://www.forbes.com/sites/robertfarrington/2021/09/

13/how-ordinary-americans-can-also-buy-borrow-and-die-without-paying-taxes/?sh=177200e7124e. One of the collateral consequences of reversing the Ninth Circuit in this case would likely be to render this strategy constitutionally immune from correction by Congress, thereby making income taxation permanently elective for those in a position to use the strategy.

Such a result would almost certainly have surprised and frustrated the framers of the Sixteenth Amendment. Those framers would reasonably have expected that the term "income," as used in the Sixteenth Amendment, was broad enough to include economic income.

An early response to the electivity of realization was the doctrine of constructive receipt. Under this doctrine, where receipt of income is within taxpayer's control, that income is deemed received for tax purposes even if not actually received. One of the earliest constructive receipt cases explained the doctrine in the following terms:

> The receipt is entirely within his own control and disposition. . . . Brander and Curry were the sole owners of the business and all its assets. Brander, as president, could at any moment have elected to take the $2,904.49 . . . , and no one else could have prevented him. The corporation had sufficient assets to pay him and there was no one to dispute his right to it. . . . It was not that the corporation would not pay, but rather that he would not receive. This election to give the corporation the

> temporary use of the amount is an exercise by him of its enjoyment, and this is one of the primary attributes of income.

Appeal of Brander, 3 B.T.A. 231, 235-236 (1932). Note that under the constructive receipt doctrine, taxpayer is taxed on a deemed, not actual, realization of income. See *id.* at 235.

The transition tax challenged here is limited to corporate parents and major shareholders – taxpayers who might plausibly have had the power to cause the foreign subsidiary to pay dividends. Although the constructive receipt doctrine, as currently applied, would not deem corporate parents and major shareholders to be in automatic receipt of such dividends, the transition tax challenged here represents an application of constructive receipt principles to situations in which taxpayers plausibly have the power to cause their foreign subsidiaries to pay taxable dividends but elect not to do so – one of the principal problems that Subtitle D, Part I of the TCJA was enacted to solve. One of the collateral consequences of reversing the Ninth Circuit in this case would likely be to require this Court to define the validity and scope of constructive receipt principles, both generally and as implemented in 26 U.S.C. 965.

The paradigmatic alternative to an event-based accounting system is mark-to-market accounting. In a mark-to-market system, the market value of each asset is measured at periodic intervals and tax is imposed on changes in that value. No realization is

required. When a securities dealer holds a large inventory of stocks, some with built-in gains and some with built-in losses, under a realization system it can limit its taxes by selling its loss positions and keeping its gain positions. Taxation, in effect, becomes elective. Similarly, financial derivatives can be structured to break the value of any security into multiple positions, some of which are likely to appreciate and others to decline in value. The holder can then sell the loss positions and retain the gain positions, again using the electivity of realization to eliminate current taxation. To more accurately measure the income of securities dealers and holders of financial derivatives, GAAP therefore now requires mark-to-market accounting in both situations. FASB Statement No. 115 (stocks held for resale), see FASB, Summary of Statement No. 115, *available at* https://www.fasb.org/page/PageContent?pageId=/reference-library/superseded-standards/summary-of-statement-no-115.html&bcpath=tff; FASB Statement No. 133 (derivatives), see FASB, Summary of Statement No. 133, *available at* https://fasb.org/page/PageContent?pageId=/reference-library/superseded-standards/summary-of-statement-no-133.html&bcpath=tff.

Congress has amended the Code to follow FASB's lead – in the case of the securities industry, by enacting 26 U.S.C. 475, and in the computation of income from financial derivatives, by enacting 26 U.S.C. 1256. Neither section relies on realization in any form. One of the collateral consequences of reversing the Ninth Circuit in this case would likely be to require this Court

to consider the validity of the Code's mark-to-market treatment of securities dealers and financial derivatives.

It is beyond the scope of this brief to identify all respects in which book accounting rules record income prior to realization as defined for tax purposes. It is sufficient to note that – as evidenced by the use of mark-to-market in significant contexts – book accounting rules may do so. There are several reasons that this fact may be relevant here.

First, 26 U.S.C. 446(a) provides that "Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." In other words, the default rule is that tax follows book.

Second, 26 U.S.C. 451(b), enacted by TCJA section 13221(b), requires that accrual method taxpayers be treated as having realized income no later than when such income is taken into account as revenue in "an applicable financial statement of the taxpayer," defined in 26 U.S.C. 451(b)(3) as "a financial statement which is certified as being prepared in accordance with generally accepted accounting principles. . . ." Where GAAP requires that income be taken into account before it is realized for tax purposes, 26 U.S.C. 451(b) requires that it be reportable for tax purposes prior to realization as well. One of the collateral consequences of reversing the Ninth Circuit in this case would likely be to require this Court to consider the validity of 26 U.S.C. 451(b).

Third, Section 10101 of the Inflation Reduction Act of 2022, P.L. 117-169 ("IRA"), added 26 U.S.C. 55(b)(2) to the Code. That subsection imposes a new 15% corporate alternative minimum tax on the "adjusted financial statement income" of large multinational corporations. "Adjusted financial statement income" is defined as "the net income or loss of the taxpayer set forth on the taxpayer's applicable financial statement for such taxable year," subject to certain adjustments. 26 U.S.C. 56A(a). The term "applicable financial statement" has the meaning given in 26 U.S.C. 56A(b). For purposes of the new corporate alternative minimum tax, financial statement income is computed on a consolidated basis, including the current income of foreign subsidiaries. In other words, under the new tax, U.S. parents of foreign subsidiaries are subject to current taxation on their foreign subsidiaries' adjusted book income, notwithstanding the fact that the U.S. parents have not experienced any realization event with respect to that income and notwithstanding the fact that GAAP may require that that income be taken into account before it is realized by the foreign subsidiary for tax purposes. One of the collateral consequences of reversing the Ninth Circuit in this case would likely be to require this Court to consider the validity of the new corporate alternative minimum tax. The revenue estimates prepared by the Congressional Budget Office, on which Congress relied in enacting both the new corporate alternative minimum tax and the Inflation Reduction Act as a whole, projected that, by itself, that new tax would raise a total of $313.1 billion over the 10-year period Congress uses for revenue

estimation purposes. *See* Congressional Budget Office, *Estimated Budgetary Effects of H.R. 5376, the Inflation Reduction Act of 2022* (revised Aug. 5, 2022), *available at* https://www.cbo.gov/publication/58366.

Fourth, on October 8, 2021, the Organisation for Economic Co-operation and Development announced a global tax harmonization agreement known as the Inclusive Framework. See OECD/G20 Base Erosion and Profit Shifting Project, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* (Oct. 8, 2021), *available at* https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf. As of June 9, 2023, 139 nations, including the United States, had agreed to the Inclusive Framework. *Id.* So-called "Pillar Two" of the Inclusive Framework provides for a minimum tax on major corporations at a rate of 15% of consolidated book income. The purpose is to ensure that all international business income will be taxed once and only once at the corporate level, thereby preventing major corporations from avoiding taxation by parking income in tax haven jurisdictions. Book income was chosen as the base for this required minimum tax because book income is computed using substantially the same rules across the world; taxable income, by contrast, varies widely from country to country.

Under the Inclusive Framework, U.S. parents of foreign subsidiaries would be subject to current taxation on their foreign subsidiaries' book income,

notwithstanding the fact that the U.S. parents have not experienced any realization event with respect to such income and notwithstanding the fact that book accounting may require that that income be taken into account before it is realized by the foreign subsidiary for tax purposes. Pillar Two thus suffers from the same possible constitutional infirmities as the new U.S. corporate alternative minimum tax. One of the collateral consequences of reversing the Ninth Circuit in this case would likely be to require this Court to consider whether Congress is permanently disabled from complying with Pillar Two as a matter of U.S. constitutional law. It may be noted that the Inclusive Framework authorizes other signatory countries to impose so-called "top-up" taxes to punish countries that fail to comply with Pillar Two.

II. If indirect realization is not constitutionally sufficient to permit the taxation of income, large portions of the Code are unconstitutional.

This brief will use the term "direct realization" to refer to accounting events experienced by taxpayer himself. For example, when taxpayer sells an asset, gain from that sale is realized directly by taxpayer. "Indirect realization," by contrast, involves accounting events that occur to someone other than taxpayer, often a related party. For example, when a limited liability company taxed as a partnership sells an asset, gain from that sale is realized by the LCC, not by its members, but an allocable portion of that gain is includible

in each member's income nonetheless. 26 U.S.C. 704. Both direct and indirect realization are event-based and allow recordkeepers to record income and losses largely mechanically without having to exercise significant independent judgment.

Indirect realization is now used extensively in the taxation of international transactions. As a practical matter, the Internal Revenue Service and U.S. courts lack the power to enforce U.S. tax rules against foreign corporations that lack a presence in the United States. To tax the foreign earnings of foreign subsidiaries, Congress must therefore either wait until such earnings are distributed as dividends to their U.S. shareholders or tax those U.S. shareholders currently on the income of their foreign subsidiaries. As has been noted, waiting until such earnings are distributed as dividends creates incentives for multinationals to move operations, plant, and jobs out of the United States and to leave foreign earnings offshore.

Indirect realization thus underlies 26 U.S.C. 951A, enacted as part of the TCJA, which imposes a tax on the GILTI of foreign subsidiaries, which tax is payable currently by such subsidiaries' corporate parents and other major U.S. shareholders. It also underlies 26 U.S.C. 55(b)(2), enacted as part of the IRA, which imposes a 15% corporate alternative minimum tax on the "adjusted financial statement income" of large multinational groups. Indirect realization is used extensively in other parts of the U.S. international tax system as well. See, *e.g.*, 26 U.S.C. 951-960 (the "Subpart F" rules), 26 U.S.C. 541-547 (the "personal holding

company" rules), and 26 U.S.C. 1291-1297 (the "passive foreign investment company" rules).

If indirect realization is constitutionally sufficient to permit taxation of income under the Sixteenth Amendment, then 26 U.S.C. 965, the provision challenged in this case, is constitutional. That section taxes U.S. corporate parents and major U.S. shareholders on the previously untaxed earnings of their foreign subsidiaries, which earnings have already been realized by those subsidiaries. Note that that section does not impose a tax on the value of the foreign subsidiary's stock or any other tax on wealth; the tax is imposed only on previously realized but untaxed income. As has been noted, the purpose of 26 U.S.C. 965 is to ensure that all foreign subsidiary earnings that Congress believed should be taxed would be taxed under either the pre-TCJA regime or the post-TCJA regime.

It may be noted that under 26 U.S.C. 965 taxation of a foreign subsidiary's earnings to its U.S. corporate parents and major U.S. shareholders is deferred until the effective date of the change from the pre-TCJA regime to the post-TCJA regime. It may then be argued that deferred taxation of income from indirect realization events should not be constitutional even if current taxation of income from indirect realization events is. As has been noted, however, deferral is taxpayer-favorable. Because of the time value of money, deferred taxation of income reduces the effective rate of taxation on such income. It would be odd to hold that current taxation of income from indirect realization events is constitutional but that the more taxpayer-favorable

deferred taxation of income from such events is not. The Code routinely allows deferred recognition in appropriate circumstances. See, *e.g.*, 26 U.S.C. 453 (installment sales). This has never been thought to raise constitutional concerns. In any event, petitioners have not conceded that Congress has the power to tax them even on income their corporation realized during the year immediately preceding the change in tax regimes.

The Code's partnership tax rules also rely on indirect realization. For tax year 2020, over 4 million partnership tax returns were filed, primarily by small businesses and entities engaged in real estate and related businesses. See IRS, *SOI Tax Stats – Partnership Statistics by Entity Type*, Table 8, *available at* https://www.irs.gov/statistics/soi-tax-stats-partnership-statistics-by-entity-type.

Although Subchapter K of Subtitle A, Chapter 1 of the Code ("Subchapter K") speaks in terms of "partnerships" and "partners," most entities taxed under that subchapter are structured for non-tax purposes as limited liability companies, which afford their members the benefit of limited liability. See *id.*, Table 9. LLCs are legal persons separate from their members. 26 U.S.C. 7701(a)(1) ("The term 'person' shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation."). Consistent with the terminology used in Subchapter K, this brief will refer to LLCs taxed as partnerships as "partnerships" and to their members as "partners."

Under Subchapter K, taxable income is computed at the partnership level, applying realization principles at the partnership level. The partnership's income is then allocated among its partners in accordance with the rules of 26 U.S.C. 704 and reported to those partners on Form K-1. Each partner then reports his, her, or its share of the partnership's income on his, her, or its own income tax return.

Allocations of income under 26 U.S.C. 704 need not be accompanied by distributions. Indeed, allocations do not necessarily involve any realization event whatever at the partner level. The income allocation rules of Subchapter K depend entirely on indirect realization. One of the collateral consequences of reversing the Ninth Circuit in this case would likely be to require this Court to consider whether Subchapter K is unconstitutional in its entirety.

III. A constitutional realization requirement would also require constitutional examination of a multitude of detailed tax sections and subsections.

A full exploration of the detailed rules that would be called into question by a constitutional realization requirement is impossible within the page limits imposed by this Court's rules. This brief will therefore offer only three examples of detailed partnership tax rules that would likely raise constitutional questions if this Court were to reverse the Ninth Circuit. The examples chosen illustrate the level of technical analysis

in which Article III courts would need to engage to resolve the resulting constitutional questions.

Example 1: The "mixing bowl" rules of 26 U.S.C. 704(c)(1)(B). Partner A contributes property to a partnership. Under 26 U.S.C. 721, that contribution is a nonrecognition event. Assume that at the time of contribution, Partner A has accrued unrealized gain on the property. Thus, for example, the property might have a fair market value of $100,000 and a tax basis of only $20,000. The partnership takes the property with carryover basis of $20,000. 26 U.S.C. 723. Sometime later, the partnership distributes that same property to Partner B. In the absence of further rules, this too is a nonrecognition event under 26 U.S.C. 731, and Partner B takes the property with carryover basis as well. 26 U.S.C. 732(a)(1). Now Partner B holds the property that Partner A contributed with the same built-in gain – property with a fair market value of $100,000 and a basis of $20,000. Finally, Partner B sells the property, recognizing gain of $80,000.

Note that, in the absence of further rules, Subchapter K has been used to shift gain that ought to have been taxed to Partner A to Partner B's return instead. If Partner B is a lower-rate taxpayer – say, a tax-exempt organization or a foreign corporation – the result may be to subject Partner A's built-in gain to a substantially lower U.S. tax burden or to no U.S. tax at all.

To make this game more difficult to play, Congress enacted 26 U.S.C. 704(c)(1)(B), which provides that if

built-in gain property is distributed to any partner other than the contributing partner within 7 years after the contribution, then, at the moment of the distribution, the contributing partner must recognize the amount of the gain built into the property at the time of the contribution to the extent that that gain would have been recognized if the property had been sold for its fair market value at the time of the distribution. In our hypothetical, if the distribution to Partner B occurs within 7 years after Partner A's contribution and the property is still worth $100,000, Partner A is required to recognize $80,000 of gain by reason of the distribution of the property to Partner B.

Partner B has experienced a realization event – a distribution of property reducing his investment in the partnership. Partner A, however, has not. Neither has the partnership. Under 26 U.S.C. 704(c)(1)(B), the realization event triggering income to Partner A is doubly indirect: Partner A is related to the partnership and the partnership is related to Partner B, but Partners A and B need not be related to each other at all. If indirect realization is problematic under the Sixteenth Amendment, realization that is doubly indirect would presumably be problematic as well.

Example 2: The "phantom exchange" rules of 26 U.S.C. 751(b). Subchapter K assumes that if a partnership has built-in gains or losses on ordinary income assets ("hot assets") and capital gain assets ("cold assets"), each partner will end up reporting the same percentage interest of all such gains and losses. A problem arises when some partners prefer capital gains or

losses, and other partners prefer ordinary income or losses or are indifferent as between capital and ordinary items. The latter may, for example, be C corporations, which are taxed at the same rates on both types of income, or tax-exempt entities or foreign taxpayers, which may not be taxed on either. Prior to the enactment of 26 U.S.C. 751(b), partnerships might distribute assets of one category, hot or cold, to one set of partners, thereby increasing their share of the built-in gains or losses on the distributed assets and reducing their share of built-in gains or losses on retained partnership assets of the opposite type.

The phantom exchange rules were enacted to shut down this avoidance technique. If a partner receives a distribution that changes his percentage interests in the partnership's hot and cold assets, 26 U.S.C. 751(b) deems him to have received the distribution that he should have received to keep his percentage interest in each category constant. For example, assume that Partner A receives a distribution of cash, which the statute treats as cold. Assume that the partnership also has hot assets – say, inventory that has appreciated in value. The distribution of cash will increase his share of cold assets and decrease his interest in hot assets. 26 U.S.C. 751(b) requires that we pretend that he instead received some portion of the hot assets in the distribution. It then deems him to have engaged in a taxable exchange with the partnership in which he returns what it has previously deemed him to have received in exchange for what he actually received. This is the "phantom exchange." In our example, we have

pretended that he received some portion of the partnership's hot assets. In the phantom exchange, we then pretend that he exchanges those hot assets (which we pretended that he received) for the cash that he actually received. Since this is a taxable exchange, he thereby recognizes ordinary income or loss on the hot assets we pretended he received and then exchanged back. The result is to force him to recognize his share of the built-in gains or losses on the hot assets.

In the foregoing example, the partner receiving the distribution has in fact experienced a realization event – he has received a distribution of cash. But he has not experienced any realization event whatever with respect to the hot assets. Nevertheless, under the phantom exchange rules he is required to recognize gain or loss with respect to his change in share of the hot assets at the time of the cash distribution. One of the collateral consequences of reversing the Ninth Circuit in this case would likely be to require this Court to consider whether basing income on deemed (that is, fictional) exchanges is constitutional.

Example 3: Treatment of partnership debt under 26 U.S.C. 752. Subchapter K deals with debt incurred by a partnership by pretending that it is incurred instead by the partners, with the loan proceeds then being deemed contributed by the partners to the partnership. 26 U.S.C. 752(a). The various partners' shares of partnership debt are determined under a complex set of rules, the details of which are not material here. See 26 CFR 1.752-1–1.752-3 (the "debt allocation regulations"). When a partner's share of partnership debt

decreases under those rules, Subchapter K pretends that cash in the amount of the decrease is distributed to that partner. 26 U.S.C. 752(b). Distributions of cash reduce a partner's basis in his partnership interest. 26 U.S.C. 733. If cash is distributed to a partner in excess of his basis in his partnership interest, the excess is treated as gain on a deemed disposition of the partnership interest. 26 U.S.C. 731(a)(1).

Consider the following example. A partnership has incurred nonrecourse debt secured by some of the partnership's assets. Assume that under the debt allocation regulations, the debt is allocated among the partners in accordance with their percentage interests. Next, assume that Partner A guarantees the nonrecourse debt. Under the debt allocation regulations, all of the nonrecourse debt must now be allocated to Partner A. Partner B's share of that debt declines as a result. Under 26 U.S.C. 752(b), he is deemed to have received a distribution in cash. If that deemed distribution exceeds his basis in his partnership interest, he recognizes gain on a deemed disposition of his partnership interest.

Note that no one has experienced any realization event at all in the ordinary sense. Guaranteeing a loan is not normally thought to constitute realization. Nevertheless, under the foregoing rules, Partner B, who has in fact received nothing, may recognize gain on a deemed disposition of his partnership interest. One of the collateral consequences of reversing the Ninth Circuit in this case would likely be to require this Court to consider whether Subchapter K's treatment of partnership debt is constitutional.

The foregoing examples and the rules they implicate are illustrative of the myriad detailed technical problems that would likely be raised by a constitutional realization requirement.

IV. If this Court invalidates 26 U.S.C. 965, its severability jurisprudence may require it to invalidate the entirety of Subtitle D, Part I of the TCJA.

This case presents questions different from those presented in the Court's more recent severability decisions. As has been noted, the TCJA effected a fundamental change in the Code's approach to the taxation of foreign subsidiaries, moving from a system in which the earnings of foreign subsidiaries were taxed on a deferred basis, when repatriated as dividends, to a system in which such earnings would be taxed to such subsidiaries' U.S. corporate parents and other major U.S. shareholders on a current basis. The section challenged here, 26 U.S.C. 965, was a transition provision, designed to ensure that all previously untaxed and undistributed foreign subsidiary earnings that Congress believed should be taxed would be taxed under either the pre-TCJA regime or the post-TCJA regime.

26 U.S.C. 7852(a), the Code's severability rule, provides that: "If any provision of this title, or the application thereof to any person or circumstances, is held invalid, the remainder of the title, and the application of such provision to other persons or circumstances, shall not be affected thereby." One question presented

in this case is whether the term "provision of this title" refers to 26 U.S.C. 965 alone or to the entirety of Subtitle D, Part I of the TCJA, which effected the change in tax regimes.

Until recently, this Court's severability jurisprudence seemed relatively settled. In *National Federation of Independent Business* v. *Sebelius*, 567 U.S. 519 (2012), Justice Scalia summarized that jurisprudence in the following terms:

> "The Court has applied a two-part guide as the framework for severability analysis. . . . First, if the Court holds a statutory provision unconstitutional, it then determines whether the now truncated statute will operate in the manner Congress intended. If not, the remaining provisions must be invalidated. Even if the remaining provisions will operate in some coherent way, that alone does not save the statute. The question is whether the provisions will work as Congress intended. Second, even if the remaining provisions can operate as Congress designed them to operate, the Court must determine if Congress would have enacted them standing alone and without the unconstitutional portion. If Congress would not, those provisions, too, must be invalidated."

National Federation of Independent Business (NFIB) v. *Sebelius*, 567 U.S. 519 (2012) (Scalia, J., dissenting).

If the "two-part guide" summarized by Justice Scalia fairly restates the law, it is hard to conclude the

remaining provisions of Subtitle D, Part I of the TCJA would "operate in the manner Congress intended" in the absence of 26 U.S.C. 965. In the absence of that section, very large sums of untaxed foreign subsidiary retained earnings would go permanently untaxed – untaxed under either the pre-TCJA regime or the post-TCJA regime. It also seems unlikely that Congress would have enacted the change in regimes without some sort of transition rule.

These problems are exacerbated by the fact that 26 U.S.C. 951A, which now taxes U.S. corporate parents and major U.S. shareholders currently on the GILTI income of their foreign subsidiaries, suffers from some of the same possible constitutional infirmities as the provision challenged in this case. It too relies on indirect realization.

Since *NFIB*, several Justices have raised concerns regarding the foregoing "two-part guide." See, *e.g.*, *Murphy* v. *NCAA*, 138 S. Ct. 1461 (2018) (Thomas, J., concurring); *Seila Law* v. *CFPB*, 140 S. Ct. 2183 (2020) (Thomas, J., dissenting); *Barr* v. *AAPC*, 140 S. Ct. 2335 (2020) (Kavanaugh, J., plurality) (Thomas, J., dissenting); *United States* v. *Arthrex*, 141 S. Ct. 1970 (2021) (Gorsuch, J., dissenting). It is not clear whether any view of how severability issues should be analyzed now commands a majority of the Court.

This brief takes no position as to what rules should govern severability analysis. Its point is rather that one of the collateral consequences of reversing the Ninth Circuit in this case would likely be to require

this Court to consider severability issues – specifically, whether the entirety of Subtitle D, Part I of the TCJA, which effected the change in tax regimes governing the earnings of foreign subsidiaries, should be declared invalid as inseverable from 26 U.S.C. 965. Some language in the "two-part guide" and in various Justices' expressions of concern, cited above, may even raise the question of whether, if 26 U.S.C. 965 is invalid, the whole of the TCJA is invalid as well. It may reasonably be asked whether Congress would have enacted the TCJA at all if it had known that that act would lose an additional $338.8 billion over the $1,456 billion it was already projected to lose.

V. A constitutional realization requirement would substantially undermine the ability of Congress to lay and collect an income tax on economic income and would thereby undermine the fiscal capacity of the United States.

As has been noted, realization limits the ability of the Code to measure economic income correctly. As a result, the Code deviates from realization principles in many contexts. Paul Ryan (R-WI), former Speaker and Chair of the House Ways and Means Committee, has estimated that a constitutional realization requirement could invalidate roughly one-third of the Internal Revenue Code. Alexander Rifaat, *Moore Could Upend Tax Code, Says Paul Ryan*, TAX NOTES Sept. 28, 2023,

available at https://www.taxnotes.com/tax-notes-today-federal/corporate-taxation/moore-could-upend-tax-code-says-paul-ryan/2023/09/28/7hdff?highlight=moore.

Should this happen, several consequences would likely ensue.

First, it is a mathematical truism that the amount of revenue raised by any tax equals its base (that which is taxed) times its rate. Thus, a tax base of $100 taxed at a rate of 20% will generate $20 of revenue. If the tax base is narrowed, the rate required to generate the same amount of revenue must go up. Thus, if the tax base is narrowed to $50, a rate of 40% will be required to raise the same $20 of revenue. A constitutional realization requirement will very significantly narrow the tax base of the Federal income tax. If the Code were to be subject to a constitutional realization requirement, to raise the same overall revenue, Congress would have to set tax rates higher than it otherwise would.

Second, economists theorize that the distortionary effect of any tax varies as the square of its rate. Thus, if rates are doubled, the distortionary effect of a tax will increase by a factor of four. The least distortionary tax is therefore thought to be a tax with the broadest possible base and the lowest possible rates. The Tax Reform Act of 1986, P.L. 99-514, 100 Stat. 2085 (1986), enacted under President Ronald Reagan, broadened the income tax base while lowering rates. It was thought by many to be the most successful tax reform effort of the modern era, reducing the distortionary

effect of Federal taxes and their efficiency costs to the U.S. economy. A constitutional realization requirement would likely reverse the efficiency gains made by that Act, narrowing the base and placing upward pressure on rates, and make future such reforms far more difficult.

Finally, one of the principal reasons that the Founders abandoned the Articles of Confederation and instituted our present Constitution in their stead was to give the Federal government a more robust fiscal capacity. This was also one of the principal reasons the Sixteenth Amendment was proposed and ratified after this Court overturned the Federal income tax in *Pollock* v. *Farmers' Loan & Trust Co*., 157 U.S. 429 (1895).

The need for a robust fiscal capacity is most obvious in times of war or international confrontation. The modern income tax is the tax that won World War II. It is the tax that allowed us to outspend the Soviet Union on military preparedness, which, according to some, led to the collapse of the Soviet state. It is the tax that will allow us to compete effectively with the Peoples Republic of China in coming decades. Drowning the Federal government in a bathtub may be tempting to contemplate in times of peace. But history suggests that a robust fiscal capacity will inevitably become essential once again. Petitioners and their amici in effect seek another *Pollock*. But permanently disabling the Federal government from facing future challenges is

neither wise nor warranted as a matter of constitutional law.

CONCLUSION

The judgment of the Ninth Circuit should be affirmed.

Respectfully submitted,

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