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 FOR TAX ECONOMISTS AS AMICI CURIAE IN SUPPORT OF RESPONDENT

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Table of Contents

Interest of Amici Curiae 1

Summary of Argument 2

Argument 4

A. The MRT is not a direct tax requiring apportionment but for the Sixteenth Amendment 4

   1. An external tax is not a direct tax 5

   2. An exaction on petitioners' use of a deferred foreign corporation is not a direct tax 10

B. Reversal would disrupt key elements of the tax system and the economy 15

Conclusion 22

TABLE OF AUTHORITIES

Page(s)

CASES

Charles C. Steward Mach. Co. v. Davis,
301 U.S. 548 (1937) 13

Eisner v. Macomber,
252 U.S. 189 (1920) 10, 13, 14

Flint v. Stone Tracy Co.,
220 U.S. 107 (1911) 10, 11, 12, 13, 15

Graves v. New York ex rel. O'Keefe,
306 U.S. 466 (1939) 14

Knowlton v. Moore,
178 U.S. 41 (1900) 10

Nat'l Fed'n Indep. Bus. (NFIB) v. Sebelius,
567 U.S. 519 (2012) 10

New York ex rel. Cohen v. Graves,
300 U.S. 308 (1937) 14

Pac. Ins. Co. v. Soule,
74 U.S. 433 (1868) 11

Pollock v. Farmers' Loan & Trust Co.,
158 U.S. 601 (1895) 2, 3, 10, 11, 13, 14

South Carolina v. Baker,
485 U.S. 505 (1988) 14

Spreckels Sugar Refin. Co. v. McClain,
192 U.S. 397 (1904) 11, 14

Taft v. Bowers,
278 U.S. 470 (1929) 12

The Collector v. Hubbard,
79 U.S. 1 (1870) 11, 13, 14

United States v. Phellis,
257 U.S. 156 (1921) 12

CONSTITUTION, STATUTES, AND REGULATION

U.S. Const. art. I, § 2, cl. 3 4

U.S. Const. art. I, § 8, cl. 3 10

U.S. Const. art. I, § 9, cl. 4 4

U.S. Const. art. I, § 9, cl. 5 6

26 C.F.R. § 301.7701-3(a) 17

26 U.S.C. §§ 1(h)(1)(D), 1411(a)(1) 17

26 U.S.C. § 11(b) 17

26 U.S.C. §§ 541, 851 20

26 U.S.C. §§ 951–59, 1291–98 20

26 U.S.C. § 959 13

26 U.S.C. § 961 13

26 U.S.C. §§ 1271–1275 21

26 U.S.C. § 1361(b)(1)(B) 18

Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131
Stat. 2054 (2017) 8

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505 (2022) 9

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Robert G. Natelson, *What the Constitution Means by "Duties, Imposts and Excises"— and "Taxes" (Direct or Otherwise)*, 66 Case W. Rsrv. L. Rev. 297 (2015) 3, 5

Henry Ordower, *Abandoning Realization and the Transition Tax: Toward a Comprehensive Tax Base*, 67 Buff. L. Rev. 1371 (2019) 9

Rev. Uniform Limited Liability Co. Act § 108(a) (Uniform Law Comm'n 2006) (last amended 2013) 17

Rev. Uniform Limited Partnership Act §§ 303(a), 503(b) (Uniform Law Comm'n 2001) (last amended 2013) 18

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INTEREST OF AMICI CURIAE[1]

Amici are economists who share a common belief in free enterprise, American strength and global leadership, and a pluralistic entrepreneurial culture. Collectively they have drafted, negotiated, and advised on scores of tax bills and items of tax guidance. While amici are skeptical regarding the constitutionality of an unapportioned general tax on wealth, they believe that the tax at issue in this case is nothing like such a tax. Amici have no personal stakes in the outcome of this case. They wish to ensure that the Court fully considers a threshold legal issue not meaningfully addressed by petitioners as well as the adverse effects that might arise from a decision to reopen fundamental legal questions the tax policy community has long considered settled, and on which businesses and individuals have relied in arranging their tax affairs. They are filing this brief solely as individuals and not on behalf of the institutions with which they are affiliated.

Alex M. Brill is a Senior Fellow at the American Enterprise Institute. He previously served as senior advisor and chief economist to the House Committee on Ways and Means and as staff economist at the President's Council of Economic Advisers.

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[1] Pursuant to this Court's Rule 37.6, counsel for amici curiae states that no counsel for any party authored this brief in whole or in part, and no party or counsel for a party, or any other person other than amici curiae and their counsel, made a monetary contribution to fund the preparation or submission of this brief.

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SUMMARY OF ARGUMENT

This Court should not use this case to reopen the constitutional meaning of "income" under the Sixteenth Amendment. The Sixteenth Amendment was enacted as an exception to this Court's holding in *Pollock v. Farmers' Loan & Trust Co.*, 158 U.S. 601, 637 (1895), that a general tax on income from personal property is a direct tax requiring apportionment. But the tax at issue here is not a direct tax contrary to petitioners' contention, so the Court need not and should not reach the Sixteenth Amendment question.

The one-time transition tax imposed by section 965 of the Internal Revenue Code (the "mandatory repatriation tax" or "MRT") was enacted as part of a comprehensive statutory scheme to deal with taxpayer use of controlled *foreign* corporations to defer taxes imposed on off-shore business activity and to facilitate the repatriation of off-

shore earnings to the United States. There is no historical support for petitioners' position that a tax specifically falling on foreign commerce is a direct tax that requires apportionment but for the Sixteenth Amendment. Nor does any precedent of this Court support that argument. The historical sources make clear that "*all* direct taxes were *internal*." Robert G. Natelson, *What the Constitution Means by "Duties, Imposts and Excises"—and "Taxes" (Direct or Otherwise)*, 66 Case W. Rsrv. L. Rev. 297, 329 (2015) (emphases added). There is nothing "internal" about an exaction on the repatriatable earnings of foreign corporations. The MRT is therefore not a direct tax.

The MRT is not a direct tax for the additional reason that it falls on a particular use and on a particular circumstance: namely, the use of a controlled foreign corporation to shield offshore earnings from U.S. taxation. Even *Pollock* distinguished such taxes from direct taxes requiring apportionment. This Court permitted taxes on corporate income and undivided earnings prior to the enactment of the Sixteenth Amendment. Such authorities retain their vitality to this day, and the Court accordingly does not need to determine whether the Sixteenth Amendment's exception to apportionment applies here.

The facts of this case are far afield from a general tax on wealth that some amici incorrectly claim to be at issue in this case. And the facts certainly provide no basis for imposing a constitutional realization requirement for taxation of income, as urged by petitioners. A reordering of the U.S. tax-system to a realization-based regime could result in, among other things, more than $50 billion in *annual* new tax liability for private equity firms organized as limited liability companies or limited partnerships, and would delay more than $20 billion in annual losses now claimed by real estate companies using those business

forms. These tax consequences would likely have a significant impact on the ability of these firms to raise and retain capital at a time when commercial real estate is particularly vulnerable.

A realization regime would also threaten important business tools for incentivizing investors, such as accelerated depreciation or expensing, both of which permit businesses to claim deductions for the cost of a property before it is sold. The power to tax undistributed business earnings is essential to any modern tax system.

The settled expectation that the Constitution permits taxation of unrealized sums should not be upended on the facts of this case. This Court should instead affirm the court of appeals on the grounds that the MRT is not a direct tax. Such a path affords the Court the opportunity to reaffirm that traditional wealth and property taxes are direct and must be apportioned. Alternatively, it should dismiss the writ of certiorari as improvidently granted.

Argument

A. The MRT is not a direct tax requiring apportionment but for the Sixteenth Amendment.

This Court granted the petition for a writ of certiorari to answer the question whether the Sixteenth Amendment authorizes Congress to tax unrealized sums without apportionment among the States. That question was premised on petitioners' assertion that the MRT is a direct tax that must be apportioned under the Constitution's Enumeration Clause, U.S. Constitution, Article I, Section 2, clause 3, and its Direct Tax Clause, U.S. Constitution, Article I, Section 9, clause 4, unless the Sixteenth Amendment's exception to apportionment applies. But that assertion is incorrect. The MRT is *not* a direct tax for either of two reasons, and therefore—separate and apart from the Sixteenth Amendment—it does not

require apportionment. The MRT is not a direct tax because it falls on foreign commerce and such taxes have never been understood to be direct. It is also not a direct tax because it falls on petitioners' use of a particular corporate vehicle—a controlled foreign corporation—to defer U.S. taxation that otherwise would have been owed. This Court thus need not, and should not, reach the question presented for either of these two sufficient reasons.

1. An external tax is not a direct tax.

The very scholarship that petitioners and their supporting amici rely upon confirms that a tax falling on foreign commerce like the MRT is not a direct tax. As one such scholar explained, "[b]efore the Revolution there had been much discussion of the difference between 'internal' taxes (levies imposed within jurisdictional boundaries) and 'external taxes' (levies on foreign trade)." Robert G. Natelson, *What the Constitution Means by "Duties, Imposts, and Excises,"—and "Taxes" (Direct or Otherwise)*, *supra*, at 329. Similarly, whatever else may have been meant by the term "direct tax" at the time of the founding, this much was clear: "all direct taxes were internal." *Ibid.*; *see also* James R. Campbell, *Dispelling the Fog About Direct Taxation*, 1 Brit. J. Am. Leg. Studs. 109, 115 (2012) ("the power of direct taxation covered a broad array of well-known '*internal'* taxes") (emphasis added).

This distinction between, on the one hand, external taxation on foreign trade and, on the other hand, direct taxation is reflected in the shared understanding of the Constitution's text at the time of enactment. Pennsylvania delegate Gouverneur Morris introduced the apportionment rule for direct taxes in connection with the constitutional debates over representation. Erik M. Jensen, *The Apportionment of "Direct Taxes": Are Consumption Taxes Constitutional?* 97 Colum. L. Rev. 2334, 2386–87

(1997). Morris initially moved to add a "provision that taxation shall be in proportion to Representation." 1 Max Farrand, The Records of the Federal Convention of 1787, at 591–92 (1911). After a discussion of objections to the proposal, he proposed that the word "direct" be inserted before the word "taxation." Reflecting the distinction between external and direct taxes, Morris said that he "supposed [the objections] would be removed by restraining the rule to direct taxation. With regard to *indirect* taxes on *exports & imports* & on consumption, the rule would be inapplicable." *Id.* at 592. The motion received support. Charles Cotesworth Pinckney of South Carolina reportedly "liked the idea." *Ibid.* Reflecting an understanding that Morris's insertion of the word "direct" before "taxation" would permit Congress to levy unapportioned taxes on all foreign commerce, Pinkney hoped a clause retraining Congress from taxing exports would be added to the Constitution, as it eventually would be in Article I, Section 9, clause 5. *Ibid.*

The State ratification debates confirm that an understanding that direct taxes were internal, not external, was widely shared. During the Massachusetts convention's discussion of the Enumeration Clause, Thomas Dawes remarked that "the paragraph in debate related *only* to the rule of apportioning *internal* taxes …" 2 Debates in the Several State Conventions on the Adoption of the Federal Constitution 41 (J. Elliot ed 1836) ("Debates") (emphases added). In discussing a proposal that collection of direct taxes first be left to the States, R. R. Livingston in the New York convention observed that direct taxes will likely be required because "the necessities of government will call for more than *external* and indirect taxation can produce." *Id.* at 342 (emphasis added). In South Carolina's debates, Pinckney observed that "[w]ith regard to the general government imposing *internal* taxes upon us … it

was absolutely necessary they should have such a power" but that the government could not abuse this power "as each state was to be taxed only in proportion to its representation." 4 Debates at 305–06 (emphasis added).

Alexander Hamilton also understood external and direct taxation to be distinct. Petitioners point to Hamilton's wariness over the partiality or oppression against disfavored persons or places that might arise from unapportioned direct taxation. Pet. Br. 3, 7. But petitioners omit that Hamilton's discussion of the dangers of direct taxation and his comments supporting apportionment explicitly fall under his discussion of *internal* taxes, not *external* ones. The Federalist No. 36, at 227 (Alexander Hamilton) (Clinton Rossiter ed., 1961) ("The taxes intended to be comprised under the general denomination of *internal taxes* may be subdivided into those of the DIRECT and those of the INDIRECT kind.") (emphasis added). Other sources cited by petitioners regarding historical concerns over direct taxation similarly focus on internal taxation. Petitioners refer to the work of Professor James W. Ely, Jr. He notes in the cited article that absent "restrictions on the authority of Congress to impose direct taxes" the Constitution might not have been ratified because permitting the "power of *internal* taxation" to be exercised without limitation "was simply out of the question." James W. Ely, *"One of the Safeguards of the Constitution:" The Direct Tax Clauses Revisited*, 12 Brigham-Kanner Prop. Rts. J. 6, 9 (Vanderbilt L. Rsch. Working Paper, No. 23-02, Feb. 2, 2023) (emphasis added) (citations and quotations omitted).

Like Hamilton, the Anti-Federalist who wrote under the Federal Farmer pseudonym grouped "direct taxes" under the category of "internal taxes." *The Federal Farmer XVII* (Jan. 23, 1788) ("it is not my object to

propose to exclude congress from raising monies by *internal* taxes, as by duties, excises, and *direct* taxes") (emphases in original). Hamilton's treatment of Anti-Federalist arguments again confirms a shared understanding of the distinction. The Federalist No. 30, at 190 (Alexander Hamilton) (Clinton Rossiter ed., 1961) ("The more intelligent adversaries of the new Constitution admit the force of this reasoning; but they qualify their admission by a distinction between what they call INTERNAL and EXTERNAL taxation. The former they would reserve to the State governments; the latter, which they explain into commercial imposts, or rather duties on imported articles, they declare themselves willing to concede to the federal head."). This distinction echoed pre-Revolutionary War debates over taxation. When Benjamin Franklin was examined by Parliament in 1766 regarding the Stamp Act, he observed that "[t]he authority of parliament was allowed to be valid in all laws, except such as should lay internal taxes. It was never disputed in laying duties to regulate commerce." *Examination before the Committee of the Whole of the House of Commons, 13 February 1766*, FOUNDERS ONLINE, https://founders.archives.gov/documents/Franklin/01-13-02-0035.

As surely as a tax falling on commercial articles to be imported into the United States is an external tax, so too is the MRT's taxation of repatriatable earnings. The MRT was enacted as part of a comprehensive scheme in the Tax Cuts and Jobs Act ("TCJA"), Pub. L. No. 115–97, 131 Stat. 2054 (2017), to deal with the repatriation of accumulated earnings held by foreign corporations owned by U.S. shareholders. Prior to the MRT's enactment, the United States generally taxed income on a worldwide basis wherever earned. *See* Bret Wells, *"Territorial" Tax Reform: Homeless Income Is the Achilles Heel*, 12 Hous. Bus. & Tax L. J. 1, 11 (2012). Because other countries taxed

income on a territorial basis, U.S. tax policy put U.S. corporations at a competitive disadvantage. *See id.* at 13. As mitigation, Congress permitted U.S. shareholders (whether corporate or individual) of controlled foreign corporations to defer taxes that otherwise would be owed on their earnings until earnings were repatriated to the United States through payment of a dividend or otherwise. *See id.* at 11–14. The U.S. tax on foreign profits was equal to the U.S. tax of 35 percent minus a credit for foreign taxes already paid on those profits. *See* Christopher H. Hanna & Cody A. Wilson, *U.S. International Tax Policy & Corporate America*, 48 J. Corp. L. 261, 262–63 (2023).

Because the U.S. tax rate on repatriated earnings was often higher than was paid to the applicable foreign taxing authority, this structure incentivized controlled foreign corporations to accumulate earnings instead of repatriating them to the United States. *Id.* at 262–63, 279. Over time, trillions of dollars in earnings accumulated in such foreign entities. Reuven Avi-Yonah & Young Ran (Christine) Kim, *Tax Harmony: The Promise and Pitfalls of the Global Minimum Tax*, 43 Mich. J. Int'l L. 505, 527 (2022). To transition to a new system, Congress decided to impose the one-time MRT on such accumulated earnings, effectively deeming them to be repatriated whether or not an actual dividend was paid. *Id.* at 527–28. After paying such tax, the foreign-controlled corporations were then free to repatriate those accumulated earnings to the United States without any further domestic tax. Henry Ordower, *Abandoning Realization and the Transition Tax: Toward a Comprehensive Tax Base*, 67 Buff. L. Rev. 1371, 1380–81 (2019).

There is no authority from this Court holding that an assessment falling specifically on foreign commerce is a

direct tax requiring apportionment. Such a limitation would be flatly inconsistent with Congress's plenary power to "regulate Commerce with foreign Nations." U.S. Const. art. I § 8 cl. 3. As an exaction on earnings repatriatable to the United States by a specific type of corporation used in foreign commerce, the MRT differs fundamentally from the tax on stock dividends at issue in *Eisner v. Macomber*, 252 U.S. 189 (1920), the tax on worldwide income from property at issue in *Pollock*, 158 U.S. at 637, or any generally applicable tax on wealth or ownership. While all such taxes may incidentally fall on foreign commerce, such commerce is not their object.

The Court should not break with the historical understanding of the Constitution's text by imposing an apportionment requirement on an external tax.

2. An exaction on petitioners' use of a deferred foreign corporation is not a direct tax.

The MRT is not a direct tax for the further reason that it falls on petitioners' use of a specific corporate vehicle—a deferred foreign corporation—to shelter investment assets from U.S. taxation. A tax on such a use is nothing like a direct tax.

A direct tax is one that is imposed on taxpayers "simply for existing," *Nat'l Fed'n Indep. Bus. (NFIB) v. Sebelius*, 567 U.S. 519, 572 (2012) (discussing capitation taxes), or "solely" or "simply" because of taxpayer's ownership of certain property. *Flint v. Stone Tracy Co.*, 220 U.S. 107, 150 (1911); *Knowlton v. Moore*, 178 U.S. 41, 81–82 (1900); *see Pollock*, 158 U.S. at 627 (noting that the tax at issue was imposed "merely because of ownership"). A capitation tax "triggered by specific circumstances," *NFIB*, 567 U.S. at 571, or a duty or excise occurring upon "a particular occasion," *Knowlton*, at 178 U.S. at 81, is not direct. A tax "upon the privileges involved in the use of

such property" is also not direct and should be distinguished from a tax on the property as such. *Stone Tracy*, 220 U.S. at 163.

Employing these distinctions, this Court has upheld taxes falling upon income and undistributed sums of certain companies as indirect taxes without recourse to the Sixteenth Amendment. It first did so when it upheld a Civil War-era tax falling on income derived from certain types of business. *Pac. Ins. Co. v. Soule*, 74 U.S. 433, 434, 445 (1868). In another case, the Court held that taxing an investor based on the profitability of an equity investment is an indirect tax, regardless of whether that tax is imposed before profits are divided, *i.e.*, before any dividends are paid. *The Collector v. Hubbard*, 79 U.S. 1, 18 (1870). After the Court decided in 1895 that a general tax on income derived from personal property is a direct tax, *Pollock*, 158 U.S. at 629, it continued to hold that taxes falling on a particular business use are indirect even when measured by receipts or income. It upheld a tax on the gross receipts of persons or corporations engaged in the business of refining sugar. *Spreckels Sugar Refin. Co. v. McClain*, 192 U.S. 397, 412–13 (1904). And it upheld a tax on the use of the corporate entity, with a tax base measured by such entity's net income. *Stone Tracy*, 220 U.S. at 151–52. The tax on the sugar business and the tax on corporations were unapportioned and yet were viewed as constitutional indirect taxes without reference to the Sixteenth Amendment, which had not yet been enacted.

The MRT is an indirect tax under these authorities. Its one-time tax on repatriatable earnings falls on a particular business use and a particular circumstance, namely, on petitioners' use of KisanKraft Machine Tools Private Limited ("KisanKraft"), a controlled foreign corporation, to defer taxation on offshore earnings rather

than repatriating them to the United States. Petitioners were not passive investors. By their own testimony, they were actively involved in the decision to use the structure in question. *See* Pet. App. 71 ("We discussed the short-term, mid-term, and long-term goals of KisanKraft and agreed that the best way for the business to succeed in its social and business missions would be for it to reinvest any earnings, expand geographically, and, perhaps one day, experience a public offering or sale."). They cannot now complain about an exaction falling on their use of a tool employed to shelter earnings from taxation.

The situation therefore is no different from that presented in *Stone Tracy* where this Court held that the challenged tax "may be described as an excise upon the particular privilege of doing business in a corporate capacity, *i.e.*, with the advantages which arise from corporate or quasi-corporate organization … there is nothing in the Constitution requiring such taxes to be apportioned according to population." 220 U.S. at 151–52. Because the MRT is a tax on the doing of business in a particular corporate capacity, petitioners' attempt to distinguish *Stone Tracy*, Pet. Br. 53 n.12, is unavailing.

Petitioners suggest that the MRT can in some circumstances operate as a direct tax to the extent that it taxes corporate profits earned before the taxpayer purchased an interest in the foreign company. As initial investors in KisanKraft, petitioners have no standing to make that argument. But the argument lacks merit because "[t]here is nothing in the Constitution which lends support to the theory that gain actually resulting from the increased value of capital can be treated as taxable income in the hands of the recipient only so far as the increase occurred while he owned the property." *Taft v. Bowers*, 278 U.S. 470, 484 (1929). *See also United States v. Phellis*, 257 U.S.

156, 172, 174–175 (1921) (upholding tax on receipt of dividends from corporation that earned the distributed profits before recipients acquired their stock). Further, petitioners will face no net new taxes as a result of the MRT. Subpart F increases the taxpayer's basis by the amount of any subpart F income, 26 U.S.C. § 961, and credits any subpart F payment against tax on subsequent dividends, 26 U.S.C. § 959.

Petitioners also cite *Macomber* and its statement that a tax on shareholders' property interests in the stock of corporations "valued in view of the condition of the company, including its accumulated and undivided profits," is "taxation of property because of ownership" requiring apportionment. 252 U.S. at 217. There is no suggestion, however, that this statement was intended to overturn this Court's prior, long-standing distinction between a direct tax on ownership and an indirect tax on a particular business use or occasion. To the contrary, *Macomber* states that it is merely relying on the "previous decisions of this court" and provides no analysis other than to refer to *Pollock*. *Id.* The *Pollock* Court *preserved* the traditional distinction between a tax on ownership and a tax on the use of a business. 158 U.S. at 635 (declining to comment, with respect to the tax then before it, "on so much of it as bears on gains or profits from business"). *Stone Tracy* was then endorsed seventeen years *after Macomber*, confirming that *Macomber* did not overrule that key decision. *Charles C. Steward Mach. Co. v. Davis*, 301 U.S. 548, 582 (1937) (citing *Stone Tracy* as support for Congressional power to lay an excise tax on "the enjoyment of a corporate franchise").

While *Macomber* said that one of the cases in this pre-Sixteenth Amendment tradition—*Hubbard*—should be regarded as overruled by *Pollock*, *see Macomber*, 252

U.S. at 218, the doctrinal grounding for that assertion has itself since been repudiated. The relevant part of the decision in *Pollock* hinged upon a supposed equivalence between taxing income and taxing mere ownership that in turn depended upon the then-settled doctrine that a tax on income from state bonds was equivalent to taxing the state sovereign directly. 158 U.S. at 630 ("it follows that if the revenue derived from municipal bonds cannot be taxed, because the source cannot be, the same rule applies to revenue from any other source not subject to the tax"); *see New York ex rel. Cohen v. Graves*, 300 U.S. 308, 315 (1937) (noting a "parity of reasoning" that immunity of an income-producing instrument was extended to income). This Court has since rejected that underlying proposition about municipal bonds, calling into doubt the foundational premise that led first to *Pollock* and then to *Macomber's* treatment of *Hubbard*. *See Graves v. New York ex rel. O'Keefe*, 306 U.S. 466, 480 (1939) ("The theory … that a tax on income is legally or economically a tax on its source, is no longer tenable."); *South Carolina v. Baker*, 485 U.S. 505, 516–24 (1988). That is, *Macomber* relied on *Pollock* to sidestep *Hubbard*, but this Court has rejected the premises *Pollock* depended on. *See* Alan O. Dixler, *Direct Taxes Under the Constitution: A Review of the Precedents*, 113 Tax Notes 1177, 1188 (Dec. 25, 2006) ("*Graves* … made the holdings in *Pollock* concerning the income tax absolutely untenable").

Because *Hubbard* may be viewed as good law in the wake of these post-*Macomber* decisions, it is not relevant that the MRT falls on an individual shareholder rather than on the corporation. That same conclusion follows in any event under other cases that were left in place by *Macomber*, including the decision in *Spreckels* taxing persons as well as corporations for the privilege of conducting a certain type of business. 192 U.S. at 411. It also follows

under the logic of *Stone Tracy* that the use of a corporate form may be taxed based on its net income, particularly given petitioners' admission that they were instrumental in the decision process to structure the business in a particular way. *See* 220 U.S. at 151–52.

In sum, as an exaction upon the particular privilege of doing business in a corporate capacity, the MRT is not a direct tax and requires no apportionment. For that reason, the Court need not and should not decide whether the MRT lays a tax on income within the meaning of the Sixteenth Amendment. To the extent that this Court believes it should revisit the meaning of the word "income" in the Sixteenth Amendment, it should wait for a direct tax on income, not an indirect tax on the use of a foreign corporation.

B. Reversal would disrupt key elements of the tax system and the economy.

Petitioners seek a decision from this Court establishing a constitutional requirement that any unapportioned income tax must apply only to realized income. This is a dangerous ask. The U.S. income tax system, like all modern tax systems, depends on the ability to tax unrealized earnings. Departures from realization are pervasive in the current tax system. Letter from Thomas Barthold, Joint Committee on Taxation, U.S. Cong., to Richard E. Neal, U.S. House of Representatives (Oct. 3, 2023), Tax Notes, https://www.taxnotes.com/research/federal/legislative-documents/congressional-tax-correspondence/jct-provides-background-on-16th-amendment-issues-in-moore/7hdym. Accepting petitioners' theory that realization is a constitutional requirement would therefore disrupt significant portions of the U.S. economy. Eric Toder, The Potential Economic Consequences of Disallowing the Taxation of Recent Income 8–13 (Tax Pol'y Ctr. Oct. 11,

2023), https://www.taxpolicycenter.org/publications/potential-economic-consequences-disallowing-taxation-unrealized-income/full. A victory for petitioners would also likely bring into question important tax rules that currently limit wasteful tax planning, as the non-partisan Joint Committee on Taxation and the Government have explained. *See* Letter from Thomas Barthold, *supra*; Resp. Br. 29–31

The economic effects of petitioners' proposed rule would be profound.

First, petitioners' theory would risk major disruption of pass-through businesses, particularly in the real estate and private equity sectors. Such businesses are generally taxed under Subchapter K of Chapter 1 of the Internal Revenue Code, which operates in a manner similar to the MRT. Under Subchapter K, equity investors are taxed on a "pass-through" basis, with annual gains and losses of the business divided among the investors and reported on the investors' individual returns, even if no profits have been paid out. Robert J. Peroni & Steven A. Bank, Taxation of Business Enterprises 780–84 (4th ed. 2012). In 2019, residential real estate generated more than $20 billion in immediate tax deductions for such investors. Internal Revenue Service, Statistics of Income Division, Partnerships Tbl. 8 (Apr. 2022) ("IRS SOI"). Under a realization regime, these losses would not be reportable by investors until the investor had cashed out their equity interest in the business.

Petitioners incorrectly argue that a realization requirement would not affect Subchapter K filers because partners are state-law owners of partnership property. Pet. Br. 41. That is not the law. Uniform Partnership Act §§ 201, 203 (Uniform Law Comm'n 1997) (last revised

2013) ("Property acquired by a partnership is property of the partnership and not of the partners individually.").

Moreover, 75 percent of Subchapter K filers are limited liability companies ("LLCs"), not partnerships. *See* IRS SOI Tbl. 8 (stating that in 2019, 2,731,022 LLCs filed partnership tax returns versus 893,123 limited and general partnerships). About half of all individual equity owners in Subchapter K entities are members of an LLC, not partners. *Ibid*. Like petitioners, an LLC member has no ownership of the entity's property and no right to demand payment under default state law. Rev. Uniform Limited Liability Co. Act § 108(a) (Uniform Law Comm'n 2006) (last amended 2013) ("A[n] [LLC] is an entity distinct from its … members."); *id.* § 304 (stating there is no personal liability of members for LLC obligations); *id.* § 404(b) ("A person has a right to a distribution … only if the company decides to make an interim distribution."); *see also* Suren Gomstian, *Contractual Mechanisms of Investor Protection in Non-Listed Limited Liability Companies*, 60 Villanova L. Rev. 955, 974 (2016) (finding that minority members have replaced default provisions with the contractual right to put interests to majority members in 36.9% of a sample of LLCs).

LLCs are currently allowed to elect between taxation as corporations or partnerships. 26 C.F.R. § 301.7701-3(a). It is unclear what options would be available to LLCs if pass-through taxation were held to be unconstitutional. Absent relief from the Treasury, an LLC could be subject to double taxation, first as a corporation at the 21% corporate income tax, 26 U.S.C. § 11(b), and second as an individual at a rate of up to 23.8%, 26 U.S.C. §§ 1(h)(1)(D), 1411(a)(1).[2] These two levels of tax on corporate profits

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[2] Small LLCs with no tax-exempt investors might be eligible for taxation as S Corporations. But it is not clear under petitioners'

would result in additional economic distortions. Financial services firms organized as LLCs (a category that includes private equity organizations) reported over $117 billion in profits in 2020, and limited partnerships reported another $143 billion. IRS SOI Tbl. 8. Even the possibility of an unexpected $50 billion annual tax burden on these entities would likely significantly complicate their efforts to raise and retain capital, with major downstream effects on the businesses they fund.

As with LLC members, limited partners also lack legal ownership and rights to distributions. *See* Rev. Uniform Limited Partnership Act §§ 303(a), 503(b) (Uniform Law Comm'n 2001) (last amended 2013). A realization rule would also potentially upend their current tax treatment.

Second, a holding that realization is a constitutional requirement could upend tax rules regarding accelerated depreciation and expensing. These rules allow purchasers of business or investment property to claim deductions before the property is sold or otherwise disposed of, contrary to a strict realization requirement. *See* George Mundstock, *Taxation of Business Intangible Capital*, 135 U. Pa. L. Rev. 1179, 1226 (1987) (calling depreciation the "most significant exception" to the realization principle); Edward A. Zelinsky, *For Realization: Income Taxation, Sectoral Accretionism, and the Virtue of Attainable Virtues*, 19 Cardozo L. Rev. 861, 957 (1997). Accelerated depreciation is an important tool for stimulating capital investment.

Third, Plaintiff's proposed realization regime is undesirable because it is economically incoherent. Alan D.

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theory why pass-through taxation of S Corporations is constitutional. In any event, few private equity firms would likely qualify for S Corp status, due to the presence of tax-exempt investors. 26 U.S.C. § 1361(b)(1)(B).

Viard, *Moving Away from the Realization Principle*, 145 Tax Notes 847, 848–49 (2014). Tax economists typically favor two coherent tax bases: income or consumption. Under an income tax, individuals are taxed on their increased power to consume; under a consumption tax, individuals are taxed on their actual consumption. A realization-based income tax, however, is consistent with neither type of tax base. It does not comprehensively tax income because it exempts assets that appreciate in value but are not sold for profit. It does not comprehensively tax consumption because it taxes individuals who sell their assets and reinvest (rather than consume) the proceeds, while exempting consumption that is funded through borrowing.

This incoherence creates opportunities for tax avoidance and economic inefficiency. The primary distortion created by realization-based income taxation is "lock-in." Under a realization-based income tax, a tax is applied only to an appreciating asset when it is sold. Although the appreciating asset produces income for the taxpayer each year, a tax is only due when the asset is ultimately sold for profit. This ability to defer taxation on this income reduces the tax burden and the benefit of deferral grows the longer an asset is held. Taxpayers therefore have an incentive to hold on to assets to avoid a tax, even if, in the absence of taxation, it would make sense to sell them.

Under a strict realization regime, investors would be free to use business entities (other than pass-through entities such as partnerships or LLCs) to delay or escape a tax. An investor could attempt to defer taxation by buying shares in mutual funds or other entities that hold investment assets. If the entity pays no dividends, the investor might pay no tax on gains in the underlying assets until the investor sells their shares in the entity. The current tax code blocks this tactic, for domestic mutual funds and

"personal holding companies," by imposing a tax directly on the entity. *See* 26 U.S.C. §§ 541 (PHC), 851 (mutual funds).[3] Similarly, multinational corporations could escape taxation by using controlled foreign corporations as they did prior to the enactment of the TCJA as discussed above. The U.S. cannot readily tax foreign entities; instead, it imposes mark-to-market taxation on U.S. investors who hold their wealth overseas. *See* 26 U.S.C. §§ 951–59, 1291–98. Under a strict realization requirement, investors would be strongly incentivized to remove money from U.S. mutual funds and relocate them offshore.

It is for these reasons that commentators across the political spectrum agree that a tax system built solely on realization is inefficient, complex, and creates arbitrary winners and losers. Marjorie E. Kornhauser, *The Story of* Macomber: *The Continuing Legacy of Realization*, *in* Tax Stories: An In-Depth Look at Ten Leading Federal Income Tax Cases (Paul L. Caron ed. 2005); Scott Eastman, Taylor Lajoie, and Chad Qian, *Evaluating Mark-to-Market Taxation of Capital Gains*, Tax Foundation Fiscal Fact No. 681, at 7–8 (Dec. 2019).

Fourth, a realization regime leads to wasteful spending on tax avoidance that will slow economic growth and increase systemic risk. For example, beginning in the 1970s, investors with appreciated positions monetized gains without paying an immediate tax through use of forward contracts, calls, and similar derivative instruments.

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[3] Mutual funds are often described informally as "pass-through" entities, similar to the regime for partnerships and LLCs. But mutual funds reach that result through a different method. The fund is separately taxable, like a corporation, but is allowed a deduction for distributions to its investors. The net result is that the investors are taxed on their distributions and the fund, if its distributions are large enough, faces no net tax.

Joseph E. Stiglitz, *Some Aspects of the Taxation of Capital Gains*, 21 J. PUB. ECON. 257, 266–67 (1983); Alvin C. Warren, *Financial Contract Innovation and Income Tax Policy*, 107 Harv. L. Rev. 460, 470-73 (1993). Taxpayers spent more than $1 billion annually ($3.5 billion in 2023 dollars) to generate spurious tax losses using commodities futures alone. S. Rep. 97-144, at 146 (1981). Congress responded with a set of anti-abuse rules that rely on departures from realization-based taxation, including mark-to-market rules that went into effect in 1981. Warren, *supra*, at 474, 492. Section 1259, for example, deems taxpayers to have sold appreciated assets on the date they enter into certain forward contracts with respect to those assets. Sections 475 and 1256 involve similar rules. All of these mark-to-market rules would be placed at risk in a realization regime.

Finally, the legal uncertainty that would result from reversal is itself economically damaging. Investors respond to such uncertainty by reallocating money away from productive investments and toward the identification of and hedging against risks related to a foundational change in the current law. The resulting bargaining over how to allocate the risk of possible changes to the taxability of the business arrangements throws a cloud over a broad swath of the economy, adding delay, negotiation costs, and uncertainty premia. That is because buyers and sellers are often adverse with respect to tax treatment. As but one example, in the case of rules dealing with installment sales and similar arrangements, *see* 26 U.S.C. §§ 1271–1275, Treas. Reg. §§ 1.1275-1, -4, sellers generally want subsequent payments treated wholly as part of the sale price, so that the payments can be offset with basis. Buyers, on the other hand, prefer that payments be characterized as interest, which would be deductible

immediately, rather than as non-deductible basis in the financial instrument or stock of the acquired company.

Given the inherent economic deficiencies of a realization-based tax regime, the Court should be wary of any argument enshrining it as a constitutional requirement. Certainly, the facts of this case do not present a proper vehicle to impose such a rule.

CONCLUSION

The judgment of the court of appeals should be affirmed, or the writ of certiorari should be dismissed as improvidently granted.

Respectfully submitted,

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