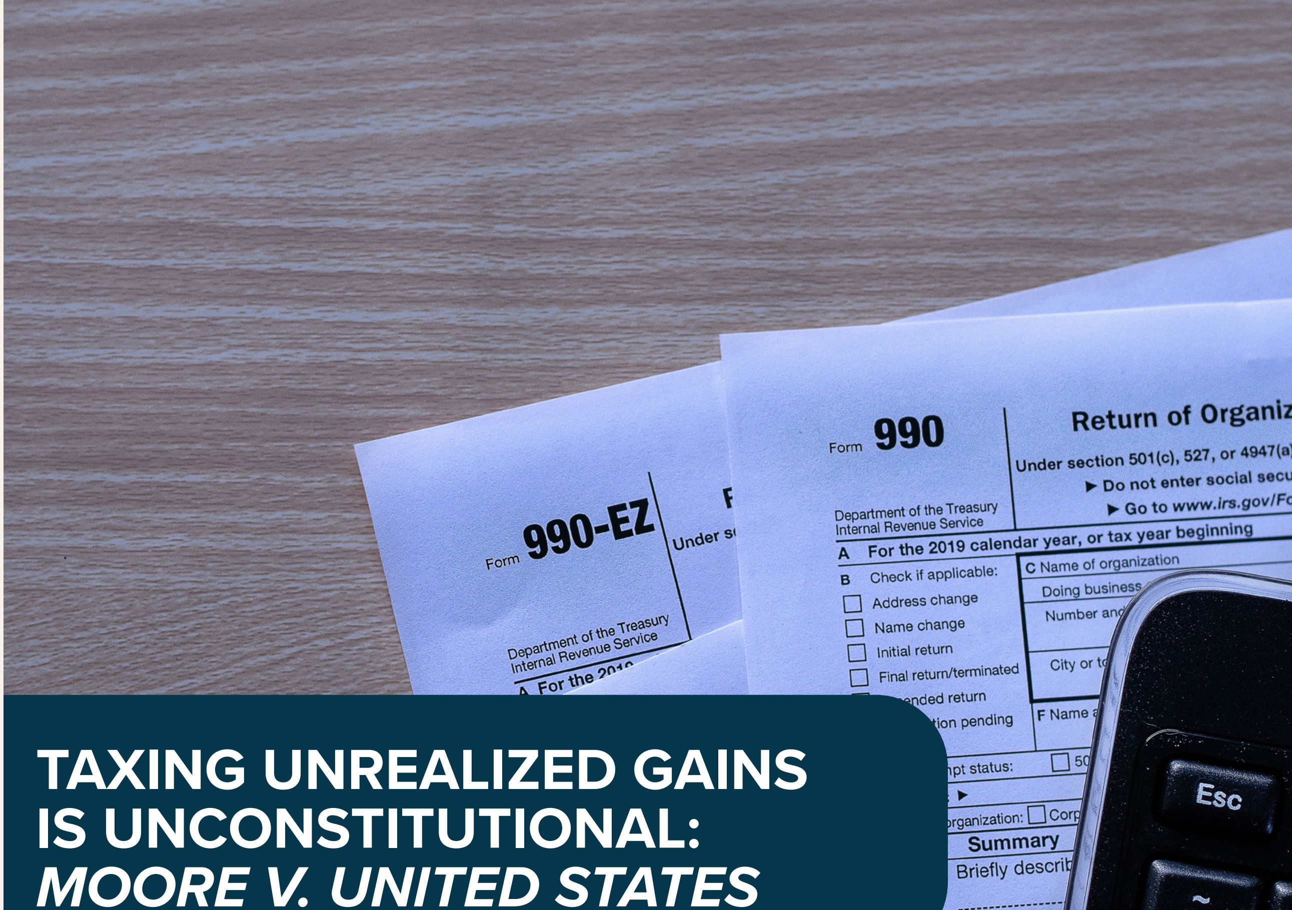
POLICY BRIEF



TAXING UNREALIZED GAINS IS UNCONSTITUTIONAL: *MOORE V. UNITED STATES*

BY JACK SALMON JUNE 2023

In recent years we have seen growing political momentum for wealth taxes, the most common of which is a proposal to tax unrealized capital gains.[1] A tax of this nature could have significant negative impact on philanthropy and charitable organizations. Taxing unrealized gains means investors would have to pay taxes on the gains they have not yet received, reducing the amount of money available for charitable giving.

This would lead to a decrease in donations to charitable organizations, hindering their ability to carry out their missions and support those in need. Philanthropists may be discouraged from making charitable donations if they are subject to taxes on unrealized gains, which could have a long-term effect on charitable giving. What's more, if such taxes are deemed constitutional, this could open the door to additional federal taxes on property, wealth, and possibly even the assets of charitable foundations.

Before the passage of the Tax Cuts and Jobs Act (TCJA) in 2017, shareholders were never taxed on income a corporation reinvested into its business. The TCJA included a Mandatory Repatriation Tax (MRT) which imposes a tax on all post-1986 accumulated foreign earnings, even if they haven't been distributed. By taxing unrealized gains, the MRT violates the equal apportionment clauses of the Constitution and possibly the due process clause of the 14th Amendment. Over a century of case law has found that a tax on unrealized gains is by no measure or definition a tax on "income."

1 Salmon, Jack. "The Return of the Wealth Tax Debate." *Philanthropy Roundtable* (blog). March 1, 2023. https://www.philanthropyroundtable.org/the-return-of-the-wealth-tax-debate/

LITIGATION CHALLENGING MRT

In 2005, Charles and Kathleen Moore invested $40,000 for a 13% stake in an Indian company, KisanKraft. The company, founded by a friend of Charles, supplies power tools to small-scale individual farmers aimed at making their operations more productive. The Moores never received any income from their shares in the company as the company reinvested its profits back into the business to continue supporting small-scale farmers. Although the Moores never reaped any financial gains from their investment, they were happy knowing their initial investment was helping a growing number of small-scale farmers by giving them access to affordable power tools, improving the livelihoods of many rural farmers.

Even though the Moores never received a penny from the company in realized gains, they had to declare an additional $132,512 as taxable income to comply with the MRT after the passage of the TCJA. The Moores filed a complaint for a refund in 2019, but last year the Ninth Circuit Court of Appeals became the first court in the country to say an "income tax" doesn't require that a "taxpayer has realized income."[2] The Ninth Circuit held that "Realization of income is not a constitutional requirement." The Moores have since petitioned the U.S. Supreme Court to review the lower court's decision upholding the unconstitutional tax.[3]

THE MRT VIOLATES THE EQUAL APPORTIONMENT CLAUSE

When drafting the Constitution, the founders sought to avoid vesting too much taxing power in a central government that might prefer one region of the federation to another. They therefore qualified in Article 1 that "No capitation, or other direct tax shall be laid, unless in proportion to the census."[4] As an unapportioned direct tax on personal property (namely shares in certain foreign corporations), the MRT violates the Direct Tax and Equal Apportionment Clauses and must therefore be applied equally to all 50 states, according to population size. The only possibility that might excuse the MRT from equal apportionment requirements is if the MRT is determined to be a tax on "incomes" within the meaning of the 16th Amendment. As the Buckeye Institute noted in its amicus brief supporting the petitioners in *Moore v. United States:*

"If the power to lay income taxes is untethered from the realization of income, the safeguards against direct taxation found in Article 1 will be severely weakened if not effectively nullified. Congress could deem appreciations in property to be 'income'—and could then tax them as such—without apportionment. The principle applies whether the subject is minority ownership of a corporation, the assessment of one's home, or the value of a family's farmland."[5]

2 *Moore v. United States*. United States Court of Appeals for the Ninth Circuit, 2022. https://cei.org/wp-content/uploads/2019/09/Moore-USSC-Petition-for-Writ-of-Certiroari-2.pdf

3 Greenberg, Dan. "Washington Couple Challenging Federal Shareholder Tax Petition Supreme Court to Take Up Their Case." Competitive Enterprise Institute. Last modified February 21, 2023. https://cei.org/news_releases/washington-couple-challenging-federal-shareholder-tax-petition-supreme-court-to-take-up-their-case/

4 The United States Constitution. Article 1, § 9, cl. 4; id. § 2, cl. 3 1787.

5 *Moore v. United States*. Brief amicus curiae of Buckeye Institute in Support of Petitioners. Supreme Court of the United States. March 27, 2023. https://www.buckeyeinstitute.org/library/docLib/2023-03-27-The-Buckeye-Institute-Amicus-Brief-in-Moore-v-United-States-amicus-brief.pdf

OVER A CENTURY OF COURT PRECEDENT SUGGESTS MRT IS NOT A TAX ON INCOME

The 16th Amendment allows direct taxation to avoid equal apportionment if the tax is levied on income. In the simplest of terms, the meaning of income includes a realization requirement—for it to be considered income money must "come in" (hence "in-come"). Luckily, we have over a century of case law that clearly defines the public meaning of "income."

Even before the ratification of the 16th Amendment and creation of the federal income tax in 1913, over six decades of case law had already defined the public meaning of income. For example, the South Carolina Court of Appeals noted in 1849 that for something to be considered income it must be "realized and ascertained."[6] Similarly, in 1869 the Supreme Court of Missouri assessed a state proposal to levy additional taxes. The court in this instance noted: "Whatever was so received or realized by him is for that reason assessed as income."[7]

With the passage of the 16th Amendment, the 1913 Revenue Act defined income to include gains, profits, salaries, wages, or compensation for personal services, in addition to income from interest, rent, dividends, securities or transaction of any lawful business carried on for gain or profit, or gains or profits, and income derived from any source. Notice here how the word "income" is preceded by the words "gains" and "profits."[8] Decades of case law that followed corroborate these distinct definitions that emphasize the realization requirement:

Eisner v. Macomber (1920): "The gain derived from capital, from labor or from both combined" and "Mere growth or increment of value in a capital investment is not income; income is essentially a gain or profit, in itself, of exchangeable value, proceeding from capital, severed from it, and derived or received by the taxpayer."

Helvering v. Horst (1940): "Income is not taxable until realized."[9]

Helvering v. Bruun (1940): "Realization of gain" and "other profit realized from the completion of a transaction."[10]

6 South Carolina Court of Appeals. *State ex rel. Tait v. Elfe.* January 1849. Case Law Access Project, https://cite.case.law/scl/34/395/

7 Supreme Court of Missouri. *Glasgow v. Rowse.* March 1869. Case Law Access Project, https://cite.case.law/mo/43/479/

8 The Revenue Act of 1913. (ch. 16, 38 Stat. 114): Sixty-Third Congress, 1913. Federal Reserve Bank of St. Louis, https://fraser.stlouisfed.org/files/docs/historical/congressional/underwood-tariff-1913.pdf

9 Supreme Court of the United States. *Halvering v. Horst.* October 1940. Justia, https://supreme.justia.com/cases/federal/us/311/112/

10 Supreme Court of the United States. *Halvering v. Bruun.* February 1940. Justia, https://supreme.justia.com/cases/federal/us/309/461/

Commissioner v. Glenshaw Glass Co. (1955): "Undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."[11] This was reiterated in 1996 (*Quijano v. United States*).[12]

Decades of court rulings that define the public meaning of income have two common features: First, the realization requirement (if it isn't realized, it isn't income). Second, once taxpayers receive payment, they have complete dominion over the received funds. The Mandatory Repatriation Tax fails to meet either of these requirements and is therefore by no measure or definition an income tax. Charles and Kathleen Moore have never realized any income from their investment and don't have any dominion over the unrealized gains for which they were taxed. The Ninth Circuit claim that "Realization of income is not a constitutional requirement" is clearly at odds with over a century of legal precedent.

RETROACTIVE NATURE OF MRT VIOLATES CONSTITUTION

Another feature of the Mandatory Repatriation Tax that brings its constitutionality into question is its retroactive nature. Passed under the TCJA in 2017, the tax applies to all foreign earnings (including unrealized) after 1986. In other words, under the retroactive rules of the MRT a taxpayer could be subject to taxes on profits or unrealized gains that were made 20 or 30 years ago. As Stanford University tax expert Sean P. McElroy notes, "In the tax case law that developed under the Fifth Amendment, two distinct bodies of law are relevant to the Mandatory Repatriation Tax: (1) the doctrine concerning the constitutionality of retroactive taxation, and (2) the doctrine concerning lack of notice."[13]

In 1994 the Supreme Court examined a due process objection to a tax law enacted in 1987 that was applied retroactively. The 1987 tax reform included a provision of the federal estate tax statute that limited the availability of a recently added deduction for certain employee stock-ownership plans. Taxation is a deprivation of property, so the due process clause requires adequate notice before such tax burdens apply. Congress made this retroactive change to the tax code, becoming effective approximately one year before its enactment. The court concluded that the 1987 amendment's retroactive application met "the requirements of due process."[14] Concerning the retroactive nature of the tax in relation to the Fifth Amendment, the court concluded that "Congress acted promptly and established only a modest period of retroactivity."

Specifically, the period of retroactivity in the 1994 case was slightly longer than one year. Every case in which the court has upheld a retroactive tax against a due process challenge, the law applied retroactively for only a short period of time (typically one

11 Supreme Court of the United States. *Commissioner v. Glenshaw Glass Co.* February 1955. Cornell Law School, https://www.law.cornell.edu/supremecourt/text/348/426

12 First Circuit Court of Appeals. *Quijano v. United States.* February 1996. Uniset, http://www.uniset.ca/other/cs5/1996WL33658418.html

13 McElroy, Sean P. "The Mandatory Repatriation Tax Is Unconstitutional." Yale Journal on Regulation, November 2019. https://www.yalejreg.com/bulletin/the-mandatory-repatriation-tax-is-unconstitutional-2/

14 United States Court of Appeals for the Ninth Circuit. *United States v. Carlton.* February 1994. Justia, https://supreme.justia.com/cases/federal/us/512/26/

year or less). For example, *United States v. Hemme* (one month);[15] *United States v. Darusmont* (ten months);[16] *United States v. Hudson* (one month).[17] Notably, Justice O'Connor made a comment in the 1994 case that is highly relevant to the *Moore* case today. O'Connor noted that "A period of retroactivity longer than the year preceding the legislative session in which the law was enacted would raise, in my view, serious constitutional questions." With a look-back of 30 years, the MRT raises serious due process concerns.

RULING OPENS THE DOOR TO FEDERAL WEALTH TAXES

Constitutional questions aside, the Ninth Circuit ruling creates an environment of uncertainty that could negatively impact the economy. The court has previously said "Tax administration requires predictability."[18] The economic and business uncertainty created by the Ninth Circuit ruling means businesses will have to hire more accountants and lawyers to navigate this uncertainty. What's more, if unrealized gains are going to be taxed, fairness would require that taxpayers deduct unrealized losses, creating an administrative headache. In this scenario, government budgets could end up fluctuating in tandem with the gains and losses of the market.

Increased tax complexity and economic uncertainty would also have the negative effect of chilling charitable giving. Charitable giving can be impacted by tax incentives, and if the rules around tax deductions and exemptions become more complex, it could discourage donors from giving as much as they would otherwise. In turn, this could negatively impact the ability of charities to raise funds and carry out their mission. Additionally, when businesses face uncertainty, they may become more cautious and conservative in their spending, which could lead to a decrease in corporate giving to charities.

The Ninth Circuit decision also opens the door to additional federal taxes on property and wealth. The MRT is only the tip of the legislative iceberg. In 2021, Senator Elizabeth Warren (D-MA) introduced the Ultra-Millionaire Tax Act (S. 510) in the Senate which proposed implementing a 5-8% tax on net value of assets above $1 billion.[19] Most strikingly, this 2021 proposal included plans to tax the wealth of private foundations and endowment funds, which would have a serious adverse impact on the communities those funds serve. One year later, a Billionaire Minimum Income Tax Act was introduced in the House by Representative Steve Cohen (D-TN) aimed

15 Supreme Court of the United States. *United States v. Hemme.* March 1986. Justia, https://supreme.justia.com/cases/federal/us/476/558/

16 Supreme Court of the United States. *United States v. Darusmont*. January 1981. Justia, https://supreme.justia.com/cases/federal/us/449/292/

17 Supreme Court of the United States. *United States v. Hudson.* January 1937. Justia, https://supreme.justia.com/cases/federal/us/299/498/

18 United States Court of Appeals for the Tenth Circuit. Okla. *Tax Comm'n v. Chickasaw Nation.* June 1995. Justia, https://supreme.justia.com/cases/federal/us/515/450/#:~:text=Regarding%20Oklahoma's%20income%20tax%2C%20the,in%20Oklahoma%20outside%20Indian%20country

19 U.S. Senator Elizabeth Warren of Massachusetts, "Warren, Jayapal, Boyle Introduce Ultra-Millionaire Tax on Fortunes Over $50 Million." Last modified March 1, 2021. https://www.warren.senate.gov/newsroom/press-releases/warren-jayapal-boyle-introduce-ultra-millionaire-tax-on-fortunes-over-50-million

at taxing unrealized gains by 20% for those with net worth over $100 million.[20] Most recently, President Biden's 2024 budget proposal included a 25% tax on wealth for those with net assets above $100 million.[21]

Unless overturned, the ruling of the Ninth Circuit has the potential to initiate a new era of federal taxes being levied on properties, stocks, farmland and other assets that appreciate in value. Opening the door to the possibility of imposing federal taxes on wealth could have profound implications for the charitable sector. Proponents of wealth taxes have previously suggested taxing the assets of charitable foundations.[22] Considering that charitable foundations in the U.S. contributed $91 billion to nonprofit organizations in the previous year, any change in their assets would be consequential. If the foundations of affluent individuals experience a decrease in their assets, it could have a substantial adverse effect on the communities currently benefiting from those donations.

CONCLUSION

The case of Charles and Kathleen Moore's investment in KisanKraft highlights the direct impact of tax laws on investors and the potential impact on the charitable sector. Despite not receiving any financial gains from their investment, the Moores were content knowing their money was being put to good use, helping small-scale farmers improve their livelihoods. The Ninth Circuit's ruling that "income tax" does not require realized income could pave the way for the imposition of federal taxes on wealth, including the assets of charitable foundations. This could have a profound effect on the charitable sector, particularly for individuals who contribute significant amounts to charitable foundations. It remains to be seen how the Supreme Court will rule on this issue, and what the long-term implications will be for charitable funds, wealth creators, and the charitable organizations they support.

20 "H.R.8558 - Billionaire Minimum Income Tax Act." Congress.Gov. Accessed April 6, 2023. https://www.congress.gov/bill/117th-congress/house-bill/8558

21 Budget of the U.S. Government Fiscal Year 2024. Office and Management and Budget, 2023. https://www.whitehouse.gov/wp-content/uploads/2023/03/budget_fy2024.pdf

22 Saez, Emmanuel, and Zucman, Gabriel. "Progressive Wealth Taxation." Brookings Papers on Economic Activity 2019, no. 2 (2019), 437-533.

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Philanthropy Roundtable is a nonprofit organization dedicated to building and sustaining a vibrant American philanthropic movement that strengthens our free society. To achieve this vision, the Roundtable pursues a mission to foster excellence in philanthropy, protect philanthropic freedom and help donors to advance liberty, opportunity and personal responsibility.

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