COMMENTARY & ANALYSIS
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Future Perfect Taxation: After a Reversal in *Moore*

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In this article, Rosenbloom and Child consider the potential consequences of the U.S. Supreme Court's eventual decision in *Moore v. United States*.

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On December 5 the U.S. Supreme Court will review *Moore*,[1] a case presenting the question whether the Constitution prohibits taxation of U.S. shareholders in a foreign corporation on the undistributed earnings of that corporation accumulated over a period of years. The statute under consideration is section 965 of the Internal Revenue Code, sometimes referred to as the "transition tax." The constitutional provisions invoked are the 16th Amendment, which authorizes taxes on income, and the "direct tax" clauses of Article I. The taxpayers argue that a tax on unrealized income is not a constitutional income tax and that the transition tax is a direct tax on property. The Court rarely grants certiorari in a matter that does not involve a conflict among federal circuits unless it intends to reverse the lower court's decision. The lower court decision in this case, by the Ninth Circuit, rejected the constitutional challenge.[2]

There is a large volume of history and judicial precedent bearing on the issue presented, and the Court's grant of certiorari has unleashed a torrent of commentary, analysis, historical references, and proclamations regarding "apportionment" of direct taxes, "uniform" tax rates, and of course, the constitutional requirement (or not) that an income tax must fall on "realized" income. We are in for another history lesson from the Court. In all probability, we are also in for a holding that section 965, and perhaps other code sections, are constitutionally defective.

The realization issue presented to the Court arises, of course, in a specific factual context. The taxpayers are individuals, not entities. The earnings imputed to the taxpayers by section 965 are earnings of a controlled foreign corporation. Those earnings were accumulated over many years and are subject to taxation under section 965 at reduced rates. Charles and Kathleen Moore hold a minority interest in the foreign corporation, less than 15 percent of shares outstanding but more than the 10 percent required for U.S. shareholder status under section 958 and the other rules of subpart F.

[1] *Moore v. United States*, No. 22-800.

[2] *Moore*, 36 F.4th 930 (9th Cir. 2022), *aff'g* No. 2:19-cv-01539 (W.D. Wash. 2020).

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Section 965 does not create a new tax; its novelty is that it places existing earnings within subpart F. The taxation of shareholders of a CFC on certain income realized by the corporation, regardless of whether that income is distributed, has been a hallmark of subpart F since 1962 (and of the foreign personal holding company rules before that). Such taxation is also found in the global intangible low-taxed income regime of section 951A. Notwithstanding the host of potentially limiting factual circumstances in the case, there is a possibility that a Supreme Court decision in favor of the Moores will implicate more than the application of section 965 to individual minority shareholders' interests in accumulated earnings of a CFC.

The Court received numerous amicus briefs taking a variety of positions, and there has been a great volume of discussion among scholars, and palpable angst in the tax community. A decision is expected in the spring, and it could contain surprises. Indeed, the real surprise would be if there were no surprises. The smart bet is on a holding that the transition tax is not an income tax within the meaning of the 16th Amendment on the facts of *Moore*, and that, at least in these circumstances, the transition tax is a direct tax that cannot survive constitutional scrutiny without apportionment, which is impossible. How far beyond that result the Court might choose to venture is anyone's guess.

Even if realization is a constitutional requirement of some kind, it is odd to think the requirement could extend to this case. There is no doubt that the corporation in which the Moores hold shares realized the income on which they were subjected to tax. That, however, is not relevant to the argument the Moores are making, which is that they received no distributions from the corporation, and they are therefore being taxed on income they did not realize. In other words, the existence of the corporation is imbued with constitutional significance, even though a corporation is nothing but a piece of paper conferring beneficial legal effects upon owner-shareholders. It is what Sidney Roberts, a pioneer of U.S. international taxation, famously referred to as a "talisman."[3] A decision for the Moores would give the talisman, a legal fiction, constitutional significance. Moreover, unlike the corporation in *Eisner v. Macomber*,[4] the precedent on which the taxpayers rely, the corporation in this case is foreign, so the question presented implies acceptance of the corporate status that India has accorded to the entity.[5]

These oddities, however, are not the main point of this article, which proceeds on the assumption that there will be a finding of unconstitutionality and focuses on the consequences. Without hazarding a guess on how much of the code will fall, the bedrock assumption is that something will fall, for some category of persons. What then?

There appear to be three sorts of "what" to consider. First, there are the immediate collateral consequences of a holding that section 965 is invalid. Second, there are the conceivable policy responses by a Congress wishing to reprise the tax policies it pursued in the rules for taxing outbound investment. And finally, there are the higher-level consequences to the U.S. tax system, for which some commentators have foreseen decline and fall.

We focus upon only the first two of these categories of consequences, in part because the third category is nearly impossible to discuss in detail, much less analyze, until there is a decision. Moreover, developments in the first two categories could moot the third one to a large extent.

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[3] Sidney Roberts, "From the Thoughtful Tax Man," 40 *Taxes* 355 (1962).

[4] *Eisner v. Macomber*, 252 U.S. 189 (1920).

[5] In a critical passage in *Macomber*, the Court said that it had "no doubt of the power or duty of a court to look through the form of the corporation and determine the question of the stockholder's right, in order to ascertain whether he has received income." *Id.* at 213-214. However, the Court respected the separateness of the corporation on the facts of *Macomber* because (1) a shareholder had no equitable right to partition corporate assets; (2) logically, the shareholder could be regarded as receiving a "dividend" only if the corporation was a separate taxpayer; and (3) the corporation was in fact separately taxable on its income. Of these, the only circumstance common to the facts in *Moore* appears to be the shareholder's lack of an equitable partition right. This seems insufficient to carry *Macomber*'s result on its own, particularly in light of later Court holdings that effectively look through the corporation when stock dividends alter the stockholders' relative indirect interests in its assets or retained earnings.

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The Immediate Aftermath

What, then, would be the immediate consequences of the demise of section 965? It seems reasonable to begin with the assumption that taxpayers generally believed section 965 was a valid provision and acted on that belief. Many taxpayers repatriated funds, thinking those funds were previously taxed by reason of section 965 and could not be taxed again. Some doubtless sold shares thinking their basis had increased as a result of the section 965 inclusion. Some may have liquidated corporations from which section 965 inclusions came.

If section 965 did not validly impose tax, it would seem the transactions in question should be evaluated through a pre-section-965 lens. In other words, the transactions produced the tax effects that would have applied if section 965 had not existed. This seems much clearer in the case of individuals, for whom the pre-section-965 rules continue to apply, than for corporations, for which the Tax Cuts and Jobs Act created a "participation exemption" in section 245A (structured as a dividend deduction). It is conceivable that a Supreme Court holding for the Moores could include an essay on international taxation that would extend to these associated questions, but that seems unlikely.

In the case of individuals, the distribution of earnings would have been taxable under normal rules, and if it were qualified under section 1(h)(11), the income tax rate would be no higher than 20 percent.[6] If the distribution was a dividend but not qualified, the tax might rise to the highest tax rate for individuals. In either event, the tax would be higher than the tax produced by section 965.

If the logic of a reversal in *Moore* extended to the corporate income tax,[7] then for 10 percent corporate shareholders, everything would depend on whether the section 245A deduction for dividends survives a decision that section 965 is unconstitutional. Presumably it should not, because one of the principal rationales for the transition tax was that, in light of the creation of the partial participation exemption system of section 245A, a rule was needed to prevent past earnings from escaping U.S. taxation permanently. In other words, the transition tax was a clear quid pro quo for the participation exemption. If section 245A is not discarded along with section 965, earnings that were subject to the transition tax would bear no U.S. tax upon repatriation to a 10 percent corporate shareholder — a windfall many times larger than the paltry amount of tax refund sought by the Moores. Yet it is hard to see how the Supreme Court would reach this question in *Moore*, regardless of the breadth of its holding. That would require comment on a collateral corporate issue in a case not involving a corporate shareholder.

The fallout from these questions would be further complicated by the statute of limitations, and the rules governing set offs against claims for refund. There would also be complex questions governing relief regarding state income taxes.

'Electivizing' Outbound Taxation

For policymakers, the most obvious place to turn if section 965 is declared invalid is the provisions of the code regarding passive foreign investment companies. Those rules, starting with section 1291, were developed in 1986 to deal with foreign corporations whose assets or income were mostly passive. They were designed to apply when the CFC rules did not, including when U.S. shareholders had limited ability to gather information about the foreign corporation's earnings or were mere portfolio owners unable to compel payment of a dividend. The PFIC rules have no test for U.S. control and no ownership test for taxpayers, so a U.S. person with even a minimal amount of stock in an entity overwhelmingly controlled by foreign persons may be covered. Taxation is triggered by either a disposition of shares or an excess distribution, defined as a distribution in excess of 125 percent of the average amount distributed over the prior three years. To the tax imposed on the disposition or excess distribution is added a "deferred tax amount," reflecting an irrebuttable presumption

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[6] The net investment income tax adds 3.8 percent.

[7] Section 965 seems less likely to be invalidated as applied to corporate U.S. shareholders as a result of *Moore*. For one thing, the Moores are individuals rather than corporations. For another, Supreme Court precedents before the enactment of the 16th Amendment, such as *Flint v. Stone Tracy Co.*, 220 U.S. 107 (1911), characterized income taxes on corporations as an "excise" on the privilege of doing business as a corporation rather than as a "direct tax," for constitutional purposes. But the hypothesis here is in keeping with the spirit of this article, which assumes a reversal in *Moore* of unknown breadth.

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that the income or gain realized is attributable ratably to each day of the taxpayer's ownership of the PFIC shares, and the amount of tax that would have been due and payable for each year during the period of ownership must be computed and interest added at compound rates from the date when a return for the year was due through the date of the triggering event. The earnings or income of the entity are not relevant. A PFIC charge can apply when PFIC assets consist of a Van Gogh whose value appreciated after it was contributed to the PFIC. An excess distribution need not be a dividend.

Compound interest is a powerful force — what Albert Einstein supposedly referred to as the eighth wonder of the world. Any well-advised taxpayer with exposure to PFICs would be prudent to consider an alternative offered by the statute — the qualified electing fund of section 1293. A QEF entails flow-through treatment for the corporation's income and capital gain, effectively converting the PFIC into something resembling a partnership. Current corporate income of the entity is recognized by shareholders regardless of whether it is distributed. Income taxed on a flow-through basis is treated as previously taxed when it is distributed and is not taxed again. Basis in shares is adjusted to reflect taxed but undistributed corporate income. A foreign tax credit is potentially available. There is an exception to flow-through treatment for income that has been highly taxed by a foreign country or that is subject to U.S. tax as effectively connected with a U.S. trade or business. In short, QEF treatment is similar to the treatment of shareholders under the subpart F regime.

It would appear there is nothing so objectionable about unrealized income that a taxpayer may not elect to be taxed on it. Thus, a decision for the taxpayers in *Moore* might not preclude taxation under a QEF election. The PFIC regime does not appear vulnerable because its default rules defer taxation to a realization event and income flows through only with the taxpayer's affirmative consent.

PFIC technology could be adapted to make subpart F an elective proposition similar to the QEF regime. In addition to applying to foreign corporations that have mostly passive income or assets, the PFIC rules might also apply to a U.S. shareholder of a CFC. However, a U.S. shareholder of a CFC would be afforded a QEF-type election to opt out of the default PFIC rules and to include income of the CFC on a current basis under the rules for GILTI and subpart F income.

One could view the GILTI and subpart F rules as depending upon the fact that U.S. shareholders of a CFC are presumed to have access to sufficient information to make current inclusions of the types of income that raise deferral concerns. CFC status, of course, implies substantial U.S. ownership. Like nearly all PFIC shareholders, U.S. shareholders in CFCs would not want to be subject to section 1291 fund treatment when sufficient information is available (or if the U.S. shareholders join together, can be made available) to allow for current inclusions under the QEF rules. So permitting U.S. shareholders to elect into the GILTI and subpart F regimes would be an error-prone charade. The only motivation for this change would be to cure a constitutional concern.

A Future Perfect Solution

This brings us to the relationship between the fallout from a reversal in *Moore* and potential responses by policymakers in the context of section 965. The Supreme Court pointedly did not grant certiorari on the issue of whether section 965 was invalid as a retroactive tax. Congress has the power to impose even explicitly retroactive taxes in some cases,[8] and although it does not often exercise that power, many tax enactments have implicit retroactive effect in the sense that they affect the value of existing, long-term investments.[9] Why not take inspiration from the

[8] *See, e.g.*, *United States v. Carlton*, 512 U.S. 26 (1994) (holding that retroactive application of a tax statute does not violate due process provided that it is "supported by a legitimate legislative purpose furthered by rational means").

[9] *See, e.g.*, Louis Kaplow, "An Economic Analysis of Legal Transitions," 99(3) *Harv. L. Rev.* 509 (1986). There is a vast literature on legal transitions as applied to tax law.

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PFIC rules to adopt a prospective tax incorporating retrospective elements?[10]

In principle, it would seem possible for Congress to cure a reversal in *Moore* and reestablish the status quo by providing a default rule that (for example) dividends and section 1248 gain attributable to the deferred tax amount realized on and after the date of the Supreme Court's opinion in *Moore* will be subject to a retroactive interest charge computed as if the U.S. shareholder had included the amount in 2017 or 2018.[11] If taxpayers so choose, they might elect to be taxed under the section 965 regime. The Moores, like other U.S. shareholders, could make their own decision.

If there is any question about the constitutionality of such a tax, it merely highlights yet another major consequence that would flow from a decision for the Moores — a consequence for the Supreme Court itself. The implications of pretty much any decision in *Moore* that insists realization is an indispensable attribute of an income tax are vast, and hardly limited to the rules of outbound taxation, or international taxation generally. Any such decision seems likely to be only the first of many related decisions, sought and probably issued with regularity, for years to come. In practice, the Court likely would be compelled to resolve many questions: Imagine a years-long circuit split on whether the holding in *Moore* also invalidates subpart F. The justices will become the ultimate arbiters of the Internal Revenue Code, for better or worse. An institution that has not recently manifested particular interest in federal taxation would be likely to begin an interesting and prolonged journey, as would the rest of us. ■

[10] For comparison, consider Congress's response to *Macomber* in section 306. Once *Macomber* allowed shareholders to receive a pro rata preferred stock dividend without current tax, they could then dispose of that stock and monetize corporate earnings at capital gain rates, rather than the (historically higher) ordinary income rates for dividends. Section 306 "taints" preferred stock so received and taxes the amount realized on its later sale as a dividend, but only up to the stock's ratable share of the amount that would have been a dividend at the time of the original distribution. These rules impose a prospective tax with retrospective elements — with the possible result that shareholders might just accept the consequences of a dividend in the first place.

[11] It would be only sporting to compute the interest charge on a lower base, such as by reference to the reduced rates applicable to inclusions of the deferred tax amount under section 965.

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