

The Supreme Court Will Review the Constitutionality of Section 965 in *Moore v. United States*; Should Taxpayers Who Paid the Tax Seek a Refund?

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The U.S. Supreme Court recently granted certiorari in *Moore v. United States*,^[1] a case involving a constitutional challenge to section 965 of the Internal Revenue Code. We anticipate that the Court will overturn section 965, at least as it applies to individual taxpayers.

Section 965 imposes tax, for 2017 or 2018, on U.S. shareholders' allocable shares of the 1987-2017 untaxed earnings of certain foreign corporations, even if those earnings had not been distributed. The case raises important issues about whether income must be "realized" in order for a tax on it to be sustained under the Sixteenth Amendment, which allows imposition of an "income tax." There is a great deal of history that bears on the issue now before the Court. In *Flint v. Stone Tracy Co.*, decided prior to the Sixteenth Amendment, the Supreme Court upheld the corporate tax as an excise tax on the exercise of the corporate franchise.^[2] The constitutionality of applying section 965 to corporate taxpayers may thus be less subject to challenge than applying it to individuals. The court's analysis may also be affected by the concerns of the parties and *amici* with the potential implications for future Federal wealth taxes.

Depending on the Supreme Court's approach, its decision could undercut the constitutionality of other Code provisions and proposals allowing for the current taxation of an equity holder's economic share of an entity's income, including among other provisions, subpart F, GILTI, subchapter K (partnerships), and Subchapter S (S corporations). The framing of the Supreme Court's future opinion in *Moore* is difficult to predict but will be critically important to individual and potentially corporate taxpayers.

What is clear is that taxpayers who paid or owe the section 965 tax now have decisions to make. Should they seek refunds or refrain from making section 965 payments? While awaiting the Supreme Court's decision, taxpayers should analyze their section 965 position and strategy, as described below.

Constitutional Authority

The U.S. Constitution authorizes Congress "To lay and collect Taxes."^[3] The Constitution also limits this power, by providing that "direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers,"^[4] and that "No capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken."^[5] On the basis of these provisions the U.S. income tax was declared unconstitutional in 1895^[6] and a Sixteenth Amendment to the Constitution, ratified in 1913, was added to provide that "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

The petitioners in *Moore*, supported by a number of *amici curiae*, sought certiorari on the question of whether the Sixteenth Amendment allows Congress to tax U.S. shareholders of certain types of foreign corporations on the corporations' undistributed earnings. The petitioners are individuals, who held only a minority interest in the foreign corporation in question.

Section 965

Section 965 was enacted as part of the 2017 Tax Cuts and Jobs Act, which partially transitioned the U.S. corporate tax system toward “territorial” taxation (of a U.S. corporation’s U.S.-source earnings) and away from “worldwide” taxation (of a U.S. corporation’s U.S.-source and repatriated foreign earnings). To implement this transition, section 965 provides that U.S. shareholders owning 10% or more – the Moores owned 11% -- of controlled foreign corporations must pay a one-time tax on such corporations’ untaxed foreign earnings accumulated during the period 1987 through 2017, as if those earnings had been repatriated to the United States in 2017 (or 2018 for certain taxpayers). The section 965 transition tax is also known as the mandatory repatriation tax, or MRT.

The amounts taxed by Section 965, by definition, had not yet been paid to the U.S. shareholders subject to the tax. The petitioners in *Moore* asserted that such amounts should not be considered “income,” because those amounts had not been received or otherwise realized by the taxpayer (although the amounts in question had been realized by the foreign corporation). The petitioners further argued that if such amounts are not income, then taxing them is not permitted by the Sixteenth Amendment.

Similarities in how undistributed amounts are treated under section 965 and how they are treated in longstanding Code provisions has raised concerns about the constitutionality of those other provisions. For example, as the government described in its brief opposing certiorari in *Moore*, partners in a partnership and shareholders of S corporations also are taxed on undistributed amounts—namely, their share of the partnership’s or S corporation’s undistributed income. Section 965 itself is part of subpart F of the Code, which since 1962 has required U.S. shareholders owning 10% or more of certain controlled foreign corporations to include in income their pro rata share of current-year undistributed subpart F income. A broad holding by the Supreme Court that only distributed or otherwise realized income is taxable could introduce significant uncertainty for taxpayers and materially reduce federal income tax revenues from a wide variety of sources.

The outcome of *Moore* also may shape future legislation taxing appreciated assets and other accrued wealth. For example, the Supreme Court could conclude that taxing up to thirty-one years of historic earnings is not a tax on “income,” but an improperly apportioned and so unconstitutional tax on “wealth.” Although the petitioners requested certiorari only on the question of income realization, they also contended in the lower courts that section 965 was excessively retroactive and thus violated the due process guarantees of the Fifth Amendment. The Supreme Court may go beyond the petition and base its decision on due process (or other) grounds. We believe it may attempt to frame its decision in a manner that excludes future wealth taxes from the scope of the Sixteenth Amendment.

Taxpayers’ Options, Including Filing for a Refund

We think the Supreme Court likely will reverse the Ninth Circuit’s holding in *Moore*, which treats section 965 as a constitutionally permissible income tax. The Supreme Court granted certiorari despite the absence of a split on this issue between the Ninth Circuit and any other U.S. Court of Appeals and rarely does so absent an intention to overturn the lower court.

In anticipation of the Supreme Court’s future decision in *Moore*, taxpayers should evaluate their section 965 position. If you have paid the section 965 transition tax, either in full or in part under section 965’s 8-year installment provisions, we can help to evaluate whether you should file protectively for a refund. If you are out

of compliance with section 965, we can assist in evaluating the subtleties of your potential section 965 compliance issues, including whether to amend prior returns or make a voluntary disclosure to the IRS of your potential non-compliance. Please contact any of the Caplin & Drysdale attorneys below if you like to discuss your options.

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[1] *Moore v. United States*, No. C19-1539-JCC (unpublished, W.D. Wash. 2020), *affirmed*, 36 F.4th 930 (9th Cir. 2022), *rehearing denied*, 53 F.4th 507 (9th Cir. 2022), *certiorari granted*, No. 22-800 (U.S. 2023).

[2] *Flint v. Stone Tracy Co.*, 220 U.S. 107 (1911).

[3] U.S. Constitution, Article I, § 8, Clause 1.

[4] U.S. Const., Art. I, § 2, Cl. 3.

[5] U.S. Const., Art. I, § 9, Cl. 4.

[6] *Pollock v. Farmer's Loan & Trust Co.*, 158 U.S. 601 (1895).

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