SCOTUS Rejects Constitutional Challenge to Mandatory Repatriation Tax, Holding It Applies to Realized but Undistributed Income of Foreign Corporations

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In *Moore v. United States*, the U.S. Supreme Court rejected a constitutional challenge to the Mandatory Repatriation Tax (MRT), holding that the MRT does tax income — the realized earnings of foreign corporations — and thus is a constitutionally permissible income tax authorized by the Sixteenth Amendment. The MRT is a "one-time, backward-looking" tax in the 2017 Tax Cuts and Jobs Act imposed on some U.S. shareholders of foreign corporations controlled by U.S. shareholders, when the corporation accumulated earnings abroad.

The taxpayers had argued that the MRT is unconstitutional because it is not an income tax, and thus must be directly apportioned among the states under Article I of the Constitution — a standard the MRT cannot satisfy. In the Moores' view, income occurs only when it is realized — that is, when the gains come into the taxpayers' hands — and the MRT taxes a corporation's shareholders before the shareholders receive any income.

The Court explained that, in light of its "longstanding precedents, reflected in and reinforced by Congress's longstanding practice," "Congress may attribute an entity's realized and undistributed income to the entity's shareholders or partners, and then tax the shareholders or partners on their portions of that income."

The Court emphasized that its holding is "narrow." It did not address whether Congress can "tax both the entity and the shareholders or partners on the entity's undistributed income," or whether a gain must be realized to be "income" under the Constitution. Nor did it address taxes on holdings, wealth, net worth, or appreciation.

Background

Congress typically taxes the income of U.S. businesses, like partnerships and corporations, differently. For example, some entities (like partnerships) are taxed on a "pass-through" basis. That means the entity itself does not pay income tax; instead, the entity's income is "passed through," or attributed, to individual partners. The partners then pay income tax even if the entity has not actually distributed money to them.

In contrast, some entities (like corporations) are taxed directly on their income, and shareholders are not taxed until the corporation issues them a dividend or the shareholders sell their stock and have capital gains.

Congress has special rules when it comes to foreign entities. Congress typically does not directly tax the income a U.S.-controlled foreign corporation earns abroad. Instead, Congress attributes some of the income of such corporations to U.S. shareholders and taxes them on the attributed income. For example, subpart F of the Internal Revenue Code attributes certain categories of income earned by U.S.-controlled foreign corporations to U.S. shareholders, and then taxes the U.S. shareholders on that income.

The 2017 Tax Cuts and Jobs Act (TCJA) changed the United States' approach to international taxation and sought to encourage U.S. corporations to repatriate foreign earnings to the United States. Among other things, the TCJA implemented the MRT — a "one-time, backward looking" tax on accumulated earnings of U.S.-controlled foreign corporations. The MRT was designed to collect taxes on undistributed and untaxed income that had accumulated abroad by attributing that income to the U.S.-controlled foreign corporation's U.S. shareholders and taxing the shareholders on their pro rata shares.

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History and facts of *Moore*

In the early 2000s, Charles and Kathleen Moore invested in a U.S.-controlled foreign corporation and received a 13% ownership stake in exchange. The company generated income, but by 2017 had not distributed it to the Moores or other U.S. shareholders. The United States thus had not taxed the foreign company or the Moores on that income.

It was undisputed that the MRT applied to the Moores, and that by the end of 2017, they owed income tax as a result. The Moores paid their income tax and sued for a refund, claiming the MRT was unconstitutional.

As relevant here, the Moores argued that the MRT violated the Direct Tax Clause of the U.S. Constitution, which requires that direct taxes — *i.e.*, taxes on persons or property — be apportioned among the states according to each state's population. *See* U.S. Const. art. I, § 9, cl. 4; *id.* § 2, cl. 3.

Congress has not enacted an apportioned tax since the Civil War, and so the Internal Revenue Code contains no direct taxes. The reason is that apportionment leads to "complicated and politically unpalatable result[s]," with citizens in different states carrying unequal burdens based on the state's population.

Indirect taxes, in contrast, "are the familiar federal taxes imposed on activities or transactions" — like "duties, imposts, and excise taxes, as well as income taxes." The Constitution requires that indirect taxes "be uniform throughout the United States" rather than apportioned to the states based on population, art. I, § 8, cl. 1; and the Sixteenth Amendment authorizes a federal income tax.

In the Moores' view, the MRT is a direct tax on their shares in the foreign corporation's stock rather than an indirect income tax. They argued that income requires realization, which "occurs when gains come into the taxpayer's coffers." But because they had not yet "realized" any income from the foreign corporation, the Moores argued, there was no income to tax, and the MRT must be sustained, if at all, only as a direct tax subject to the apportionment requirement. The Moores thus contended that the MRT was unconstitutional because it is not apportioned among the states.

The district court dismissed the suit and the U.S. Court of Appeals for the Ninth Circuit affirmed. The Ninth Circuit concluded, among other things, that the MRT is a tax on income within the meaning of the Constitution rather than a direct tax that must be apportioned.

Majority opinion

In an opinion authored by Justice Brett Kavanaugh, the Supreme Court affirmed the Ninth Circuit's decision, concluding that the MRT is an indirect tax on income that need not be apportioned among the states.

The Court reasoned that its precedent, "reflected in and reinforced by Congress's longstanding practice," establishes that "Congress may attribute an entity's realized and undistributed income to the entity's shareholders or partners, and then tax the shareholders or partners on their portion of that income." Whether Congress taxes a business entity on its earned income or attributes that income to the partners or shareholders and taxes them instead, the "Court has held that the tax remains a tax on income — and thus an indirect tax that need not be apportioned."

Thus, the Court explained, "the MRT *does* tax realized income — namely, income realized by the [foreign] corporation." The MRT just attributes the foreign corporation's income to the shareholders, "and then taxes the shareholders (including the Moores) on their share of that undistributed corporate income." That is "the same basic way" that "Congress's longstanding taxation of partnerships, S corporations, and subpart F income" operates.

In addition, the Court expressed concern that, if the Moores' theory were correct, it "could render vast swaths of the Internal Revenue Code unconstitutional," depriving the federal government of "trillions in lost tax revenue." The Court gave "taxes on partnerships, on S corporations, and on subpart F income" as examples of taxes "the Moores cannot meaningfully distinguish from the MRT." The Court reasoned that "[t]he Constitution does not require that fiscal calamity."

At the same time, the Court underscored that its holding is "narrow." The Court explained that its ruling is "limited to: (i) taxation of the shareholders of an entity, (ii) on the undistributed income realized by the entity, (iii) which has been attributed to the shareholders, (iv) when the entity itself has not been taxed on that income." The Court thus left open the question of whether Congress can "tax both the entity and the shareholders or partners on the entity's undistributed income," and explicitly declined to "address the Government's argument that a gain need not be realized to constitute income under the Constitution."

The Court also did not weigh in on any potential issues raised by hypothetical unapportioned taxes on holdings, wealth, net worth, or appreciation. Additionally, although the government

acknowledged "that there are due process limits on attribution to ensure that the attribution is not arbitrary," the Moores had not raised before the Court — and the Court thus did not address — any due process concerns with the MRT's attribution scheme.

Justice Jackson's concurring opinion

Justice Ketanji Brown Jackson concurred, praising the Court's "restrained approach" in light of Congress' "'plenary power' over taxation." She wrote separately to underscore that, before finding a lawfully enacted tax to be unconstitutional, "the Court would need to be persuaded" of two points "that [the Court] wisely [did] not reach": (i) "that Congress can tax income only if it is actually received or 'realized'"; and (ii) that the tax at issue is, in fact, a direct tax. She emphasized that the "alleged [realization] requirement appears nowhere in the text of the Sixteenth Amendment."

Justice Barrett concurs in the judgment

Justice Amy Coney Barrett, joined by Justice Samuel Alito, concurred in the judgment to state that she would hold that the Constitution requires gains to be realized to be taxed as income.

In Justice Barrett's view, the Constitution does not allow Congress to tax unrealized funds without apportionment among the states. In other words, income must be realized — which means "one must receive something new and valuable beyond the property she already owns" — before it can be taxed without apportionment.

Justice Barrett concluded that the Moores hadn't realized income from their shares of the foreign company, but the corporation itself *had* realized income. She wrote to explain her view that "[j]ust because Congress can attribute income of a closely held foreign corporation … to its shareholders does not mean it has equal power to attribute the income of a publicly traded domestic corporation" to any of its shareholders regardless of ownership stake.

Justice Thomas' dissent

Justice Clarence Thomas, joined by Justice Neil Gorsuch, dissented. Justice Thomas agreed with the Moores "that a tax on unrealized investment gains is not a tax on 'incomes'" under the Sixteenth Amendment, and so cannot be imposed "without apportionment among the several States."

"Incomes" under the Sixteenth Amendment "include only income realized by the taxpayer," Justice Thomas explained. And because the Moores' investment gains did not actually end up in their coffers, the gains were unrealized and were not taxable "income" under the Sixteenth Amendment.

Implications

Commentators have viewed *Moore* as a potential opportunity for the Supreme Court to preempt a tax on wealth rather than income. Although the Court expressly said it wasn't addressing the constitutionality of a wealth tax, the decision suggests that there may be five votes to strike down such a tax if Congress enacts one.

A wealth tax wouldn't be based on realization of income, but rather on already accumulated property, and four Justices — Justice Barrett, joined by Justice Alito concurring in the judgment; plus Justice Thomas, joined by Justice Gorsch in dissent — would have held that the Constitution requires realization of gains for Congress to impose an income tax.

What's more, the majority observed that "the Government indicated" "[i]n its brief and at oral argument … that a hypothetical unapportioned tax on an individual's holdings or property (for example, on one's wealth or net worth) might be considered a tax on property, not income." Given the basic principles at play, that concession seems like one that a fifth Justice may well endorse.

And just as importantly, striking down a wealth tax would not threaten broader damage to the Internal Revenue Code precisely because an unapportioned wealth tax would be novel and unlike the income tax structures Congress has previously imposed. For that reason, the Court may be unlikely to have concerns about "fiscal calamity" to the Treasury that formed a key component of the majority's reasoning.

Separately, the Justices left open the possibility of due process challenges while noting that the Moores had not raised due process arguments before the Court. For example, the Court observed that the government "acknowledges that there are due process limits on attribution to ensure that the attribution is not arbitrary — for example, limits based on the taxpayer's relationship to the underlying income." The Court similarly noted that the Moores had failed to raise "a due process retroactivity argument — that the MRT taxes income that was earned too far in the past."

Concurring in the judgment, Justice Barrett and Justice Alito opined that "an arbitrariness limit on income surely exists" while noting that "its contours are uncertain." In light of this discussion, courts are likely to confront arguments that attribution of income to certain taxpayers violates the due process guarantee.

Conclusion

If you have questions, please reach out to any of the attorneys listed on the next page.

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