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TAX LITIGATION ISSUES

# Supreme Court Round-Up on Tax Issues

**By Jeremy H. Temkin**

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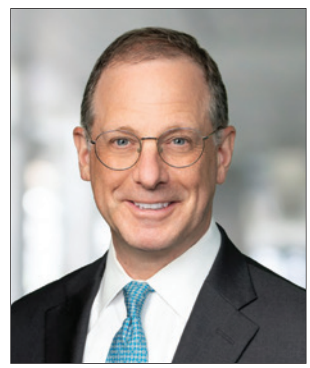
On July 1, 2024, the Supreme Court concluded its October 2023 Term. While the term will probably be best known for the presidential immunity decision in *Trump v. United States*, the court decided two cases (*Moore v. United States* and *Connelly v. United States*) addressing tax issues, and one non-tax case that will reduce the deference courts give the Internal Revenue Service's statutory interpretations and therefore will impact tax controversies for years to come.

### 'Moore v. United States', No. 22-800 (June 20, 2024)

As part of the Tax Cuts and Jobs Act of 2017, Congress imposed a one-time mandatory repatriation tax (MRT) on the accumulated profits in foreign corporations controlled by Americans. 26 U.S.C. §965.

In *Moore*, the taxpayers had invested in KisanKraft, an American-controlled foreign corporation based in India. The corporation was successful but did not distribute any income to its shareholders for over a decade. As a result, KisanKraft's undistributed income was subject to the MRT. The Moores paid $14,729 in tax and sued for a refund. After losing in both the district court and the U.S. Court of Appeals for the Ninth Circuit, the Moores petitioned for certiorari, arguing that the MRT was unconstitutional.



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Some brief background is required to understand the Moores' argument. Article I, Section 8 of the Constitution grants Congress the power, "To lay and collect Taxes, Duties, Imposts and Excises," provided those taxes are "uniform throughout the United States." Section 9 of Article I, however, limits Congress's power to impose direct taxes (such as property taxes) by requiring that they be apportioned among the states in proportion to their population. U.S. Const. Article I § 9, cl. 4.

The Constitution does not require apportionment of indirect taxes which, as the

Sixteenth Amendment makes clear, includes income taxes.

The Moores argued that the Sixteenth Amendment's authorization of taxes on "income" includes a realization requirement. That is, for an income tax to be constitutional, it must tax income that has been realized, or is in the possession or control of the taxpayer. The Moores claimed that the Supreme Court had endorsed this position in *Eisner v. Macomber*, 252 U.S. 189 (1920), where it defined income to encompass property that is "*received* or *drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal" (emphasis in original). As the Moores had not received any distributions from their investment in KisanKraft, they claimed the MRT was a tax on property, not income, and thus an unconstitutional, unapportioned direct tax.

Justice Brett Kavanaugh, writing for a majority that included Justices John Roberts, Sonia Sotomayor, Elena Kagan and Ketanji Brown Jackson, avoided the realization question by holding that "the MRT *does* tax realized income—namely, income realized by the corporation" and then attributed the income to the corporation's shareholders. *Moore*, Slip Op. at 8. The majority noted that "the precise and narrow question that the Court addresses today is whether 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."

Answering the question in the affirmative, the court relied on longstanding congressional practice and cases decided shortly after the Sixteenth Amendment was ratified in 1913, in which it first held that Congress could constitutionally attribute partnership income to individual partners even in the absence of realization by the partners, and later permitted attribution of income generated by corporations to their shareholders.

The majority rejected the taxpayers' reading of *Eisner v. Macomber*, concluding that the case had not addressed Congress's power to tax under the Sixteenth Amendment, but rather held only that a dividend paid in shares did not increase the economic value of existing shareholders' holdings, and therefore did not result in a taxable gain.

The majority also noted that the MRT was indistinguishable from pass-through taxation of partnerships, S-corporations, and controlled foreign corporations pursuant to Subpart F of the Internal Revenue Code, all of which attribute income to partners and shareholders pro rata without realization. Significantly, the Moores had conceded that these taxes were constitutional under their reading of the Sixteenth Amendment.

Notably, four justices seemed ready to find a realization requirement in the Sixteenth Amendment. In a concurring opinion, Justice Amy Coney Barrett, joined by Justice Samuel Alito, noted that the term "income" requires realization, but concluded that the MRT was indistinguishable from Subpart F, which the Moores conceded was constitutional.

Justices Clarence Thomas and Neil Gorsuch dissented, agreeing with the Moores that taxes on income required realization to be constitutional, and arguing that the majority's attribution doctrine was a new invention. Thus, while *Moore* upheld the MRT, the court avoided deciding whether the Sixteenth Amendment includes a realization requirement and did nothing to open the door for Congress to implement a wealth tax.

### ‘Connelly v. United States’, No. 23-146 (June 6, 2024)

The other tax case decided by the court this term addressed the valuation of shares in a closely-held corporation for estate tax purposes.

Michael and Thomas Connelly were the only shareholders in a building supply company. Michael held 77.18% of the company, while his brother Thomas held the remainder. To keep the company in the family, Michael and Thomas entered into an agreement that required the company to redeem the shares owned by the first brother to pass away. To ensure that it would be able to do so, the company took out life insurance policies on each brother.

Michael died in 2013. On his death, the company had assets of approximately $3.86 million, plus the life insurance proceeds. Thomas, as executor of Michael’s estate, argued that the company’s obligation to redeem Michael’s shares offset the proceeds from the life insurance policy, and thus valued Michael’s shares at a little under $3 million (*i.e.*, 77.18% of $3.86 million). The IRS disagreed and included the life insurance proceeds in its valuation of the shares, notwithstanding the redemption obligation. The estate paid the asserted deficiency and sued for a refund. The district court and the U.S. Court of Appeals for the Eighth Circuit both agreed with the IRS’s position.

The Supreme Court affirmed in a short, unanimous opinion by Thomas. The court held that the redemption obligation does not offset the value of the shares because it does not affect any shareholder’s economic interest. Using a simple example of a company with $10,000,000 in assets and two shareholders, A who holds 80% and B who holds 20%, Thomas pointed out that if the company redeemed B’s shares, it would have to pay him $2 million, leaving A the sole shareholder of a company worth $8,000,000. The fair market value of A’s shares is not affected by the redemption of B’s shares: A just owns more of a less valuable company. Applying this reasoning to Michael’s case, at the time of his death, the company was worth its operating value, $3.86 million, plus the $3 million in life insurance proceeds earmarked for the redemptions.

While Michael’s estate persuasively argued that no arm’s length buyer would consider the proceeds of the insurance policy to be part of the value it would receive for the shares, as that money would go to satisfy the redemption obligation, the court found that the statutory need to value the shares at the time of Michael’s death meant the value of the company would necessarily include the insurance proceeds, without consideration of the redemption obligation. At the time Michael died, his 77.18% interest in the company included a right to share in both the operating assets of the company and the life insurance proceeds, and the redemption obligation funded by the insurance proceeds did not diminish the value of Michael’s shares.

### ‘Loper Bright Enterprises et al. v. Raimondo’, No. 22-451 (June 28, 2024)

In *Loper Bright*, the court overruled the 40-year-old precedent established in *Chevron U.S.A. v. Natural Resources Defense Council*, 467 U.S. 837 (1984). Although not a tax case, *Loper Bright* is a landmark administrative law decision that will have wide ranging effects on administrative agencies, including the IRS.

Under *Chevron*, reviewing courts were required to defer to a reasonable interpretation of an ambiguous statutory provision made by the agency that administers the statute even if they would interpret the statute differently.

In *Loper Bright*, Roberts, writing for a majority including Thomas, Alito, Gorsuch, Kavanaugh and Barrett, ruled that *Chevron* could not be squared with Section 706 the Administrative Procedure Act (APA), which provides that "the reviewing court *shall decide all relevant questions of law*, interpret constitutional and statutory provisions, and determine the meaning or applicability of the terms of an agency action." 5 U. S. C. §706 (emphasis added). Because *Chevron* deference required courts to abandon the role the APA assigned to them in favor of agency interpretations, the doctrine was contrary to the statute, and could not be preserved.

The court also found that the *Chevron* doctrine had become unworkable and moribund, as it had not used the doctrine to resolve any case since 2016, and that principles of *stare decisis* did not warrant preserving *Chevron*. Thomas and Gorsuch filed concurring opinions, while Kagan dissented, joined by Sotomayor and Jackson.

In *Mayo Foundation for Medical Education & Research v. United States*, 562 U.S. 44, 58 (2011), the Supreme Court expressly accorded *Chevron* deference to the IRS's interpretations of the Internal Revenue Code, and *Chevron*'s demise will likely open new avenues for tax practitioners to advocate on behalf of their clients.

While the rejection of *Chevron* has the potential to change the result in some cases, *Loper Bright* did not per se overrule all cases that had relied on *Chevron* deference. The *Loper Bright* majority expressly stated that, despite overruling *Chevron*, it was not "call[ing] into question prior cases that relied on the *Chevron* framework.

The holdings of those cases that specific agency actions are lawful—including the Clean Air Act holding of *Chevron* itself—are still subject to statutory *stare decisis* despite our change in interpretive methodology." *Loper Bright*, Slip Op. at 34. As a result, taxpayers seeking to challenge a prior decision that relied on *Chevron* deference to the IRS's interpretation of the Code will have to find some "special justification" beyond *Chevron*'s overruling to avoid application of *stare decisis*.

It remains to be seen how willing courts will be to overrule prior precedents that relied on *Chevron* deference to the IRS. As an initial matter, only cases that relied on agency interpretations that deviate from the views of the reviewing judge are vulnerable; *Loper Bright* will not create hurdles in cases where the reviewing judge shares the agency's reading of the statute. *Loper Bright* will be most impactful in cases involving ambiguous statutes where the IRS's interpretation has not previously been reviewed. In such cases, the IRS will no longer be able to point to *Chevron* to argue that its regulations are valid. Instead, the IRS will have to persuade courts that its interpretations were correct, not merely reasonable. The extent to which taxpayers will benefit from this new "interpretive methodology" remains to be seen, but *Loper Bright* presents important new avenues for tax practitioners challenging the IRS.

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