



## **THE POTENTIAL ECONOMIC CONSEQUENCES OF DISALLOWING THE TAXATION OF UNREALIZED INCOME**

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### **ABSTRACT**

In a pending Supreme Court case, *Moore v. United States*, the plaintiffs are challenging the constitutionality of a provision in the 2017 Tax Cuts and Jobs Act that imposes a transition tax on certain undistributed foreign profits of US taxpayers. The outcome of this case may severely constrain the ability of Congress to tax unrealized income—income that taxpayers have earned but which they have not yet received in the form of a cash distribution. It could place major long-standing provisions of the current federal income tax at risk, lead to substantial revenue losses, and mainly benefit the highest-income taxpayers.

## EXECUTIVE SUMMARY

The outcome of a pending Supreme Court case, *Moore v. United States*, may severely constrain the ability of Congress to tax unrealized income—income that taxpayers have earned but which they have not yet received in the form of a cash distribution. A judicial limitation on the taxation of unrealized income would have substantial fiscal and economic effects.

The plaintiffs in *Moore* are challenging the constitutionality of a provision in the 2017 Tax Cuts and Jobs Act (TCJA) that imposes a one-time transition tax on undistributed profits taxpayers accrued within US controlled foreign corporations (CFCs) between 1986 and 2017. The transition tax was part of a larger reform that enacted a modified territorial system of international taxation that, for the most part, taxes income where it is earned.

The 16th amendment to the US Constitution grants Congress the power to “lay and collect taxes on income, from whatever source derived, without apportionment among the several states and without regard to any census or enumeration.” Although the plaintiffs limit their complaint to the transition tax, many organizations that have submitted amicus briefs in their support to the Supreme Court argue that the 16th amendment does not apply to any unrealized income.

This paper examines six provisions in current law that tax unrealized income: the Section 965 transition tax in TCJA, the taxation of Global Intangible Low Tax Income (GILTI) of US multinational corporations, the taxation of Subpart F income of CFCs of US multinational corporations, the minimum tax on book income of US corporations, the taxation of undistributed income of partnership and S corporations, and the rules for taxing accrued interest on original issue discount bonds.

We find that the steady-state annual revenue from these provisions amounts to about \$87 billion in 2024 and \$125 billion in 2028, with the increase in 2028 reflecting the expiration of the individual tax cuts in the TCJA and the phasing in of the higher GILTI tax rate.

Behavioral responses could make the revenue losses of disallowing taxation of unrealized income many times larger than the estimates reported in this paper. We also find that taxes on the forms of income that might escape tax if the court ruling prohibits taxation of unrealized income are concentrated among those with the highest incomes. Behavioral responses that would increase the revenue loss include increased shifting of reported profits of US multinational corporations to low-tax foreign jurisdictions, increased retained earnings by partnerships and S corporations, increased use of pass-through business structures instead of subchapter C corporations, and increased issuance of original issue discount bonds. Taxpayers and their advisors undoubtedly will also create new forms of financial transactions, not identified in this paper, to convert realized income to unrealized income.

In response to an inability to tax unrealized income, Congress may enact alternative measures to restrain the forms of avoidance that current taxes on unrealized income curtail. But such new measures could have other

negative side effects and will be difficult to enact in part because of ideological opposition to measures that increase net revenues.

The exact form of any decision in *Moore* is uncertain. Some of these provisions may be retained either wholly or in part if the Court rules in favor of the plaintiffs or may become subject to further litigation. In addition, taxpayers may take more aggressive positions on provisions that tax unrealized income in the hopes that future court rulings will sustain their positions.

Any court decision in *Moore* that casts doubt on the constitutionality of taxing unrealized income will create considerable uncertainty for taxpayers and the government, substantial revenue losses, and serious challenges for sustaining a progressive income tax.

## BACKGROUND

Later this year, the US Supreme Court will hear *Moore v. United States*, a case in which the plaintiffs, Charles and Kathleen Moore, are challenging the constitutionality of Section 965 of the Internal Revenue Code. We refer to this provision, which was enacted in the 2017 TCJA, as the transition tax. It imposes a tax on undistributed profits accrued within CFCs between 1986 and the end of 2017.

The TCJA lowered the corporate tax rate from 35 to 21 percent and moved the US to a more “territorial” system that mainly taxes income where it is earned. As part of the transition to that new system, the TCJA imposed a one-time tax on the \$3 trillion in undistributed corporate earnings that had accumulated overseas. This transition tax was imposed at rates of 8 percent on noncash assets and 15.5 percent on cash assets and could be paid in 2018 or on a specified schedule over an eight-year period, if the US shareholder chooses to do so.<sup>1</sup> The tax applied without regard to whether the profits are retained within the CFC or distributed to its US shareholders and accompanied another provision that eliminated taxation of distributions to US shareholders from US CFCs.

Before the 16th amendment was ratified in 1913, the Supreme Court in 1895 had struck down an earlier income tax as a violation of two parts of the US Constitution. Article 1, Section 9, Clause 4 states that “no capitation, or other direct tax, shall be laid unless in proportion to the Census or Enumeration herein before directed to be taken.” A similar provision in Article 1, Section 2, Clause 3, stipulates that “direct taxes shall be apportioned among the several states which may be included in this union, according to their respective numbers.” These provisions require that direct taxes be apportioned to achieve equal per-capita tax liability among the states.

In 2006, the Moores acquired almost 13 percent of shares in a CFC incorporated in India that retained profits earned prior to 2017. Following the enactment of the TCJA, they were assessed and paid tax under the

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<sup>1</sup> A special rule for S corporation shareholders allows them a virtual indefinite deferral in paying the transition tax. The Moores did not take advantage of this provision.

transition tax. The Moores claim that their share of accumulated income in the CFC is not income within the meaning of the 16th amendment because they did not receive a distribution from the CFC. Numerous organizations have submitted amicus briefs in support of the Moores, arguing more generally that their share of accumulated income of the CFC is not realized income and therefore not covered by the 16th amendment.

Lower courts rejected the Moores' argument, but the Supreme Court agreed to hear the case. The broad issue at stake is whether taxes on unrealized gains are subject to the apportionment requirement, which would effectively make them impracticable. (A wide variation in tax rates across states would be needed to equalize per-capita tax liability.)

While the plaintiffs are only contesting Section 965, a ruling in their favor may place at risk other provisions that tax unrealized gains, including some longstanding and fundamental parts of the income tax that apply to accrued income.<sup>2</sup> The impact on the provisions would depend on the wording of the court's ruling in *Moore*, how lower courts interpret its ruling, and how taxpayers respond to the ruling—especially if other provisions are struck down. The Supreme Court is likely to decide the case in the spring of 2024.

This paper explores the potential fiscal and economic implications of a court decision that would limit the ability of the federal government to tax unrealized income. Based on early scholarly work by Robert Haig and Henry Simons, economists have generally defined income to include all increases in the value of a taxpayer's assets over a given time period, without regard to whether or not the taxpayer converts the gain to cash by selling the asset (JCT, 2012).

Under the current federal income tax, capital gains are usually taxable only when realized by sale or other disposition. This policy is followed for reasons of administrative convenience, political feasibility, and practicality, in the case of gains on assets not traded in organized markets (Toder and Viard 2016). There are, however, important exceptions to this general rule when necessary to prevent avoidance of tax in cases where realized and accrued gains are close substitutes and in cases where tax may be avoided by inserting intermediary organizations between taxpayers and income earned on their behalf. As a result, many provisions of business taxation are based on an accrual concept of income.

This paper takes no position on the constitutional issues raised by *Moore*. But understanding the economic definition of "income" is important. Departures from a comprehensive definition of income in the tax base can have adverse consequences for both economic efficiency and the fairness of tax law, in terms of its relative treatment of taxpayers with similar abilities to pay tax. Although current tax law exempts or defers tax on significant amounts of unrealized income, there are circumstances in which limiting taxation of selected forms of unrealized income can have serious adverse effects on efficiency and fairness and lead to a significant erosion of the income tax base.

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<sup>2</sup> Taxpayers have accrued income whenever an asset they own increases in value, without regard to whether they receive any cash proceeds from the gain.

# ECONOMICS OF TAXING ACCRUED INCOME

## **Income as a Measure of Ability to Pay**

As noted above, economists define income in any year as the sum of consumption and the change in net worth. This measure captures taxpayers' ability to pay by their ability to consume goods and services without decreasing their wealth.

*Income is an accrual concept.* A taxpayer's amount of income does not depend on their level of saving or whether they convert any wealth increase into cash. If person A and person B both earn \$100,000, their income is the same, even if person A chooses to spend \$80,000 and save \$20,000 and person B consumes the entire \$100,000. Similarly, if person A and person B have the same earnings and both receive a \$10,000 increase in the value of their shares of a business, they have the same income, even if person A sells their stock and realizes a capital gain, while person B holds onto the stock. Both had the same increase in wealth.

Longstanding accounting rules for reporting income of public companies also rely on accrual concepts.<sup>3</sup> Companies count additions to accounts receivable as income and to accounts payable as reductions in income. Costs of purchasing inventories are deducted from income only when offset by sales from that inventory. Purchases of capital assets are generally treated as expenses over time, as the assets depreciate based on schedules designed to reflect wear and tear and obsolescence. Rules for measuring taxable business income are also often based on accrual concepts, though policymakers depart from them for different reasons, such as offering incentives for investment and allowing for simplified tax calculations for small businesses.

## **Sources of Unrealized Income**

Unrealized income arises from two main sources. The first is unrealized capital gains of a business. The value of a business will increase if prospective investors believe its future income will be more than previously expected. This increase in value could come from many sources, including the development of new products and production processes, changes in global markets, and other factors that increase the value of the resources that the business holds or the goods and services it produces. Taxpayers may receive these gains either as an appreciation in the value of publicly traded corporate shares or as an increase in the value of a closely held business, although the latter gains are difficult to measure in the absence of a sale of the business.

Investors may also receive unrealized income by investing in entities that generate income on their behalf. For example, owners of publicly traded corporations can receive unrealized income if the companies they own retain and reinvest a portion of their profits instead of distributing them to shareholders. Current and accumulated realized income of the company becomes unrealized income to its shareholders. For the the

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<sup>3</sup> Since 2007, all public companies must use "fair value" accounting. Fair value accounting effectively marks to market assets on balance sheets (AICPA 2023).

Moores, the accumulated realized income of the CFC in India in which they owned shares became unrealized income to them when the CFC retained its profits instead of distributing them.

### **Deferral and Exemption of Unrealized Capital Gains**

Individuals typically do not pay tax on capital gains until they are realized through a sale or other disposition.<sup>4</sup> Gains held until death are exempt from the tax because of the step up in basis for assets transferred by the deceased. There is also an exemption for gains on appreciated assets that are donated to charities (combined with the deduction of the full market value of the gift).

Taxes on capital gains are deferred until realization for several reasons. For some assets, such as assets in privately held businesses, it is difficult to measure the change in value in any year. Taxpayers may lack the cash to pay tax on unrealized gains from illiquid assets. Finally, much of the public does not consider unrealized gains to be income, although sophisticated investors understand that all gains are income when making portfolio decisions.

Taxing gains only on realization creates its own problems. It puts taxpayers who realize gains at a disadvantage compared with similar investors who hold on to their appreciated assets. It also creates a lock-in effect by deterring investors from selling appreciated assets. For many investors, selling an asset for cash or to reinvest in other assets is a close substitute to holding onto it for future income production.<sup>5</sup> Moreover, some investors borrow against their appreciated assets to avoid a taxable realization, while receiving cash benefits from the capital gain. Many studies show that taxpayers reduce realizations substantially in response to higher capital gains tax rates (Dowd et al. 2015; for an alternative view, see Sarin et al. 2021).

Taxing realized gains at preferential rates helps reduce this lock-in effect but gives an advantage to individuals with income from capital gains versus those who earn more of their income from fully taxable sources, such as wages (Gale and Vignaux 2023). It also creates incentives for taxpayers to structure transactions in ways that convert ordinary income to capital gains, thereby eroding the income tax base.

There is no perfect solution to the lock-in problem. Lowering the tax rate on realized gains reduces lock-in but widens the disparity between tax rates on capital gains and ordinary income. This encourages transactions that convert ordinary income to capital gains, such as the practice of compensating active partners in private equity companies with “carried interest” instead of wages or performance bonuses (TPC 2020). Taxing gains as accrued reduces lock-in (because there is no benefit to holding on to asset with gains) and enables equalizing tax rates on gains and ordinary income. But it too is an imperfect solution because the ability to measure accrued gains (and tax them fairly) differs among asset classes.

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<sup>4</sup> Some sales or other dispositions do not trigger a taxable realization. For example, so-called “like-kind” exchanges are not treated as realizations (IRS 2023a).

<sup>5</sup> Lock-in reduces economic efficiency if it causes taxpayers to hold onto assets with lower returns than alternative assets to avoid paying tax on realized gains.

## ***Current Taxes on Unrealized Income***

The current US income tax includes many exceptions to the general rule of deferring tax on unrealized gains:<sup>6</sup>

- The implied annual interest income yield on original issue discount bonds is taxable annually, even though the bondholder receives no payment of this implied interest until the bond has matured. This prevents bondholders from deferring tax on interest income that would otherwise be taxable.
- Some transactions, such as commodity straddles, are taxable on a mark-to-market basis. This prevents taxpayers from taking economically offsetting positions—with no possibility of either a net gain or loss—and then deferring realization of the gain while realizing the loss. By this technique, taxpayers could otherwise generate permanent tax losses without assuming any financial loss or risk.
- Individuals who expatriate are taxed on a mark-to-market basis as of the day prior to their expatriation.<sup>7</sup>
- Securities dealers are taxed on a mark-to-market basis on their gains and losses. This tax treatment follows their accounting treatment.

Other provisions prevent taxpayers from using intermediary entities to defer income tax. For example, income from partnerships and S corporations, which pay no entity-level tax, is taxable to partners and S corporation shareholders, whether their profits are paid out or are instead retained and reinvested.

Finally, several important provisions prevent US taxpayers from accruing certain forms of undistributed income tax-free within foreign corporations:

- Under a provision commonly referred to as Subpart F, US taxpayers are subject to annual taxation at the US corporate rate (with a credit for foreign income taxes) on certain income they accrue within CFCs. CFCs are foreign companies in which five or fewer US shareholders own at least 50 percent of the shares. (US shareholders must own 10 percent of the stock). Subpart F was enacted in 1962 to curb the ability of US taxpayers to “defer tax on certain kinds of movable income … by earning such income through foreign corporations” (IRS 2023b). It applies to passive income, such as interest and dividends, which Congress believed would otherwise be shifted to foreign affiliates to avoid the US corporate income tax.<sup>8</sup>
- The TCJA imposed a reduced-rate tax on GILTI accrued within CFCs. GILTI is income greater than a 10 percent return on tangible assets. GILTI was enacted in TCJA to prevent the increased shifting of income to low-tax countries that would have occurred because of TCJA’s elimination of taxation of

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<sup>6</sup> For a similar list of provisions that may be affected by a Supreme Court decision in Moore, see Barthold (2023).

<sup>7</sup> An election to defer mark to market treatment is permitted under certain circumstances.

<sup>8</sup> Subpart F also applies to certain related party transactions involving foreign base company sales and services income and to investments in US property (a relatively broad term) that taxes US shareholders on their share of current and accumulated earnings, including earnings from active businesses.

repatriated dividends from CFCs. GILTI is taxed at a rate of 10.5 percent (half the US corporate rate), with a credit for 80 percent of foreign income taxes. The 80 percent foreign tax credit means that a company is subject to a US residual tax on GILTI whenever the foreign income tax rate is 13.125 percent or less.

- The new global minimum tax agreed to by about 140 countries under the Organisation for Economic Co-operation and Development (OECD)'s Pillar 2 proposal (OECD 2021). Though this has not yet been ratified by the US Congress, it could also be viewed as taxation of unrealized income.

In addition to these international provisions, the Inflation Reduction Act of 2022 (IRA) imposed a new 15 percent alternative minimum tax on the reported financial income of large corporations, with adjustments for certain items of difference between taxable and book income (such as depreciation) and an allowance for certain credits (such as credits for research and experimentation and renewable energy). Corporations in future years can claim a prior year's book minimum taxes as a credit against corporate tax income liability, so current minimum tax liability mostly represents an acceleration of tax that would otherwise have been paid in subsequent years. Because much of the difference between financial accounting and tax rules represents a difference between accrual and cash accounting of certain provisions (such as stock options provided to executives), the corporate minimum tax can be viewed mostly as a tax on unrealized income.

## **POTENTIAL REVENUE AND DISTRIBUTIONAL EFFECTS OF DISALLOWING TAXATION OF UNREALIZED GAINS**

This section first presents rough estimates of the revenue generated from selected provisions of current law that tax unrealized income. Because many briefs supporting the Moores seek a ruling that prohibits all taxation of unrealized income, this analysis assumes a Supreme Court ruling with very broad limitations on the ability of Congress to subject unrealized income to tax. Some other briefs, however, claim that a decision to strike down the transition tax will not affect other long-standing provisions of the tax law dealing with unrealized income.

Because the provisions will primarily affect taxation of business and investment income, we also present tables showing how the distribution of taxes on those income sources compare with the distribution of income generally.

The estimates do not include the behavioral responses of taxpayers to a change in policy; that would make the revenue losses from eliminating these provisions much larger than the direct revenues they generate. We discuss these potential behavioral responses and how they could affect federal receipts and economic efficiency.

## **Taxation of Undistributed Profits**

The transition tax at issue in *Moore* imposes a tax on undistributed realized profits US shareholders had accrued in CFCs. It is a case in which an entity (the CFC) realized income that was not realized at the US shareholder level. Similar examples where this may occur are the Subpart F and GILTI provisions.

**Transition tax.** The Joint Committee on Taxation (JCT) estimated that the Section 965 transition tax would raise \$346 billion between fiscal years 2018 and 2026. Taxpayers can choose to pay the tax on a specified schedule over eight years and most have taken that option. Once the tax has been fully paid, it will raise no additional revenue.

We make two additional assumptions to calculate the revenue at risk from disallowing the transition tax. First, we assume that because of a statute of limitations, taxpayers will not be able to recover taxes paid in 2018 through 2020. Second, we assume taxpayers will receive interest through tax year 2024 on taxes paid in the years 2021 through 2023. Under these assumptions, the estimated revenue at risk from disallowing the transition tax is \$202 billion between 2021 and 2026.<sup>9</sup>

We then calculated the present discounted value in 2018 of annual transition tax receipts at risk, using as a discount rate the 10-year Treasury bond rate, as reported (for past years) and projected (for future years) by the Congressional Budget Office (CBO). We then calculated the steady-state revenue gain in calendar years 2024 and 2028 that would be equivalent in present value to the total amount raised by the transition tax, assuming revenue would increase each year at the growth rate of GDP. Using this method, we estimate the transition tax raised the equivalent of about \$8 billion per year at 2024 levels and \$9 billion per year at 2028 levels. This increase in the annual deficit is permanent, reflecting the one-time transfer from the government to taxpayers, most of them large corporations.

**GILTI.** Unlike the transition tax, the tax on GILTI is a permanent feature of the tax law and the rate is scheduled to increase after 2025. Adjusting the original JCT estimate from TCJA for changes in corporate receipts and GDP growth, converting to calendar years, and assuming no behavioral responses, we estimate that the GILTI tax will raise about \$15 billion in 2024 and about \$27 billion in 2028.

**Subpart F.** We were unable to locate any direct estimates of receipts raised by Subpart F. IRS has data through 2019 on subpart F income that companies report. We compute the average foreign tax rate imposed

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<sup>9</sup> If the transition tax is ruled unconstitutional, the IRS will not collect future transition tax revenues. Moreover, taxpayers will be able to recover refunds (with interest) of some past transition tax payments. Unless the statute of limitations has been extended during an audit, refund claims must generally be filed with three years of the filing of the return for the tax or within two years of the tax payment, whichever is later. Tax returns reflecting the transition tax were generally filed for 2017 and 2018, more than three years ago. However, most taxpayers are paying the tax in installments over eight years, so installments paid within two years of the claim may be recovered. It is likely that very few taxpayers (other than the Moores themselves) filed refund claims contesting the transition tax before the court agreed to hear *Moore*, but some taxpayers have likely heeded recommendations of their tax advisors and filed claims since the court took the case. These taxpayers will be able to recover payments made from the summer of 2021 onward if the transition tax is struck down. For a discussion of how the statute of limitations applies to the ability of taxpayers to collect refunds of the 965 transition tax, see Lane Powell (2023).

on CFCs of US multinational corporations using IRS Statistics of Income data for 2012, 2014, 2016, and 2018, the latest available years. To estimate subpart F revenue for 2024 and 2028, we first assume that subpart F income after 2019 will grow at the same rate as US GDP. We then assume the foreign tax rate on subpart F income is the same as the overall foreign tax rate on US CFC income, remains fixed, and that US corporations can claim all foreign taxes as credits against their Subpart F liability. Under these assumptions, Subpart F liability is equal to the product of Subpart F income and the net US tax rate (21 percent less the estimated foreign tax rate) on Subpart F income. By this method, we estimate Subpart F will raise about \$8 billion in 2024 and about \$9 billion in 2028. The revenue loss from eliminating Subpart F would be significantly larger than those amounts if US taxpayers take advantage of the ability to earn tax-free income through passive assets their foreign affiliates hold in low-tax jurisdictions.

***Income from partnerships and S corporations.*** Under current law, profits from partnerships and S corporations (pass-through businesses) are allocated to their partners and shareholders, who include them on their individual income tax returns. All such income is taxable, whether distributed as cash payments to owners or reinvested by the pass-through businesses.

We make the conservative assumption that roughly 10 percent of profits of pass-through businesses are currently retained.<sup>10</sup> If unrealized income of pass-through businesses cannot be taxed, based on projections from the Tax Policy Center (TPC) individual income tax model, we estimate that about \$129 billion of flow-through income would escape tax in 2024 and about \$159 billion in 2028. TPC estimates weighted average marginal tax rates on different forms of pass-through income (passive and active, partnership and S corporation) of 28.8 percent in 2024 of 35.8 percent in 2028.<sup>11</sup> At these rates, current revenue from owners of pass-through businesses is about \$37 billion lower in 2024 and about \$57 billion lower in 2028 if retained earnings are not taxed.

Some of that lost revenue will be recaptured by future capital gains taxes, to the extent there are realizations of previously deferred income that are not permanently exempt from tax because of the basis step up at death. Based on assumptions about the average holding period of passive and active partnership and S corporation assets, rates of return on business equity investments, and the share of gains passed on tax-free at death and applying average capital gains tax rates estimated from the TPC model, we estimate that future capital gains will generate revenue of about \$14 billion from deferred profits in 2024 and about \$18 billion from

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<sup>10</sup> The assumption is based on SOI data for S corporations, from which we calculate the ratio of one minus net distributions (distributions less new investments) to net profits. Partnerships are more complex and may retain more of their profits than S corporations, but we were unable to calculate an analogous figure that appeared conceptually correct from reported SOI data on partnership returns.

<sup>11</sup> The increase in the average marginal rate between 2024 and 2028 is because of the expiration of the marginal individual tax cuts and the 20 percent deduction for qualified business income after 2025.

deferred profits earned in 2028. This leaves net revenue from pass-through businesses about \$23 billion lower in 2024 and about \$39 billion lower in 2028.<sup>12</sup>

### **Alternative Minimum Tax on Corporate Financial Income (CAMT)**

JCT estimates that the alternative minimum tax on corporate financial income (CAMT) enacted in the IRA would raise \$159 billion through 2028. The revenue gain is highest in the earliest years, reflecting that much of the revenue raised in the early years is offset by credits of past CAMT payments against future taxable income for companies only temporarily subject to the CAMT.

Because much of the CAMT reflects differences in timing between book income and cash income (other than for depreciation, which was removed from the CAMT base), the CAMT could be at risk from a decision that prevents taxation of unrealized income.

To estimate the steady-state value of CAMT revenues in 2024 and 2028, we calculated the present value of JCT's estimated CAMT revenues from 2023 through 2028, discounted at the estimated Treasury bill rate used by CBO. We then assumed that revenues would grow at the rate of growth of GDP between 2023 and 2028 and set 2023 revenues so that the present value of 2023-28 revenues would equal the present value of revenues from JCT's annual estimates. By this method, we estimated that the new corporate CAMT generates steady-state revenues of about \$24 billion at 2024 levels and \$29 billion at 2028 levels.

### **Original Issue Discount Bonds**

Under current law, owners of original issue discount (OID) bonds pay tax annually on the implied interest income from the expected annual increase in the value of the bond between the bond's issue date and maturity. Capital gains and losses from changes in the value of the bond (relative to its expected value) because of changes in market interest rates are taxable only when realized. This puts OID bonds on an equal footing with bonds that are purchased at their redemption value and periodically pay cash interest (or coupon). Without the OID rules, taxes on the accruing interest would be deferred until redemption.

We assume that, absent the OID rules, 50 percent of currently reported interest income would come from OID bonds. We assume an average bond maturity of 10 years and a bond yield equal to 4.8 percent in 2024 and 4.5 percent (reflecting the CBO projection of yields on 10-year Treasury bonds plus a 77 basis point premium for high-grade corporate bonds over Treasury bonds)<sup>13</sup>. From the TPC individual income tax model, the average marginal tax rate on taxable interest income is 25.7 percent in 2024 and 27.6 percent in 2028. Applying these rates to project total taxable interest income, we estimate taxing accrued income on OID bonds raises about \$26 billion in 2024 and \$39 billion in 2028.

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<sup>12</sup> We assume an average four-year holding period for passive and ten-year holding period for active assets of partnerships and S corporations and a 10 percent annual rate of return on business equity investments. We also assume that 25 percent of capital gains will pass tax-free to heirs at death.

<sup>13</sup> Based on recent data on the spread between corporate AAA bonds and 10-year Treasury bonds. See FRED (2023).

Much of that revenue replaces, in present value terms, revenue from deferred taxes paid when the bonds are redeemed (assuming redemptions are done before the death of the holder). If we assume the deferred interest is taxed as ordinary income, the net revenue from taxing accrued interest on OID bonds falls to about \$4 billion in 2024 and \$5 billion in 2028. If the income upon redemption would have been taxed as long-term capital gains, the net revenue from taxing accrued interest is about \$9 billion in 2024 and \$14 billion in 2028.

### **Summary of Revenue Provisions**

Without accounting for behavioral responses, the six provisions we examined that currently tax unrealized gains of corporations and individuals generate steady-state calendar year tax receipts of about \$87 billion per year at 2024 levels and about \$125 billion per year at 2028 levels (table 1). The higher revenue in 2028 reflects three scheduled changes in tax provisions at the end of 2025: the reduction in the GILTI deduction from 50 percent to 37.5 percent, the expiration of the 20 percent deduction for qualified business income for pass-throughs, and the expiration of the marginal income tax rate cuts enacted in TCJA.

Behavioral responses could make the revenue losses from eliminating these provisions much larger, which we discuss briefly in the next section.

We have not attempted to quantify the revenue generating by current mark-to-market rules for commodity straddles, expatriation mark-to-market rules, the mark-to-market rules applicable to securities and commodities dealers, and other provisions that apply accrual taxation to gains of specified transactions. The failure to allow the use of accrual taxation for anti-avoidance purposes could lead to substantial revenue losses, but we have no basis for quantifying them.

**TABLE 1**

## Tax Revenue from Unrealized Gains

Select provisions, billions of dollars, 2024 and 2028



Tax provision	2024	2028
Transition Tax	\$8.2	\$8.7
Taxation of Global Intangible Low-Taxed Income	\$14.8	\$26.3
Taxation of Passive Income of Controlled Foreign Corporations (Subpart F)	\$8.3	\$9.1
Corporate AMT on Book Income	\$24.5	\$28.0
Taxation of Retained Profits from Partnership and Subchapter S Corporations	\$22.7	\$38.8
Taxation of Current Interest on Original Issue Discount Bonds (with capital gains treatment of gain from redemption)	\$8.7	\$13.8
<b>All select provisions</b>	<b>\$87.2</b>	<b>\$124.7</b>

**Source:** Urban-Brookings Tax Policy Center Microsimulation Model (version 0323-2).

**Notes:** Table shows preliminary static estimates of the amount reductions in steady-state calendar year tax liabilities by not taxing unrealized gains.

### Distributional Effects

A decision preventing Congress from taxing unrealized income could place at risk the taxation of some income from interest, long-term capital gains, and profits of partnerships and S corporations. Taxes from these income sources are highly concentrated among tax units at the very top of the income distribution. For example, simulations from the TPC individual income tax model for tax year 2024 show that tax units in the top 10 percent of the income distribution, with 39 percent of income, would receive 72 percent of the benefits from eliminating taxation of interest income, 92 percent of the benefits from eliminating taxation of net long-term capital gains, and 95 percent of the benefits from eliminating taxation of income from partnerships and S corporations. Taxpayers in the top 1 percent, who receive about 16 percent of income, would receive 50 percent of the benefits from eliminating taxation of interest income, 77 percent of the benefits from eliminating taxation of long-term capital gains, 78 percent of the benefits from eliminating taxation of partnership income, and 73 percent of the benefits from eliminating taxation of income from S corporations (table 2).

TABLE 2

## Distribution of Federal Income Taxes in 2024

By expanded cash income percentile and select income sources



Expanded cash income percentile	Share of total expanded cash income	Share of total tax liability from...			
		Interest income	Long-term capital gains	Positive partnership income	Positive S-Corporation Income
Lowest quintile *	4.1%	1.0%	0.4%	0.0%	0.0%
Second quintile	8.2%	1.6%	0.1%	0.1%	0.1%
Middle quintile	14.3%	7.2%	0.8%	0.5%	0.3%
Fourth quintile	20.7%	10.9%	2.8%	1.7%	1.6%
80th-90th percentiles	14.1%	7.6%	3.2%	2.3%	2.7%
90th-95th percentiles	9.8%	6.7%	4.2%	2.6%	3.9%
95th-99th percentiles	13.0%	14.7%	11.1%	15.0%	18.8%
Top 1 percent	15.8%	50.3%	77.4%	77.8%	72.6%

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0323-2).

Notes: \* The lowest quintile includes tax units with negative expanded cash income.

In tax year 2028, tax units in the top 10 percent of the income distribution with 38 percent of income, would receive 68 percent of the benefits from eliminating taxation of interest income, 93 percent of the benefits from eliminating taxation of net long-term capital gains, and about 95 percent of the benefits from eliminating taxation of income from partnerships and S corporations. Taxpayers in the top 1 percent who receive about 15 percent of income, would receive 47 percent of the benefits from eliminating taxation of interest income, 75 percent of the benefits from eliminating taxation of long-term capital gains, 76 percent of the benefits from eliminating taxation of partnership income, and 71 percent of the benefits from eliminating taxation income from S corporations (table 3).

**TABLE 3**

## Distribution of Federal Income Taxes in 2028

By expanded cash income percentile and select income sources



Expanded cash income percentile	Share of total expanded cash income	Share of total tax liability from...			
		Interest income	Long-term capital gains	Positive partnership income	Positive S-Corporation Income
Lowest quintile *	4.2%	1.6%	1.4%	0.0%	0.0%
Second quintile	8.5%	2.5%	0.1%	0.1%	0.1%
Middle quintile	14.5%	8.1%	0.8%	0.6%	0.3%
Fourth quintile	20.8%	11.6%	2.4%	1.8%	1.7%
80th-90th percentiles	14.0%	7.8%	2.9%	2.7%	2.9%
90th-95th percentiles	9.8%	7.2%	4.7%	3.0%	4.4%
95th-99th percentiles	12.9%	14.5%	12.2%	16.1%	19.6%
Top 1 percent	15.3%	46.7%	75.4%	75.6%	71.0%

**Source:** Urban-Brookings Tax Policy Center Microsimulation Model (version 0323-2).

**Notes:** \* The lowest quintile includes tax units with negative expanded cash income.

## BEHAVIORAL RESPONSES

Behavioral responses of companies and individuals could substantially increase the revenue losses from eliminating current law taxation of unrealized income. Congress could take actions to stem these revenue losses, although such actions could create negative consequences that the current provisions avoid. A court ruling limiting taxation of some unrealized income in *Moore* may ultimately leave other provisions unaffected.

### **Responses of Companies and Individuals**

**International taxation provisions.** In the previous section, we estimate the Subpart-F and GILTI provisions together will raise about \$23 billion in 2024 and \$35 billion in 2028. Eliminating these provisions will provide a large incentive for US companies to invest in passive assets and increase their intangible asset holdings in their affiliates in low-tax countries. We cannot quantify how large those shifts in reported income will be, but the resulting revenue loss could be several multiples of the revenue figures we report.

**Taxation of partnerships and S corporations.** We estimate in the previous section that allowing individuals to defer recognition of income retained by partnerships and S corporations could reduce receipts by \$23 billion in 2024 and \$39 billion in 2028. This estimate was based on assuming that 10 percent of profits of partnerships

and S corporations are currently retained and reinvested instead of being paid out. If, however, retained profits of pass-through businesses cannot be taxed until distributed (or realized by sale as capital gain), we should expect a substantial increase in the portion of profits that partnerships and S corporations retain. If retentions increased to 60 percent, receipts would decline by \$136 billion in 2024 and \$233 billion in 2028.<sup>14</sup>

Elimination of this component of unrealized income taxation would provide a substantial incentive for many closely held C corporations to recharacterize themselves as S corporations to avoid any current taxation on retained profits, as they would no longer pay corporate income tax. Again, as with foreign-source income, behavioral responses could make the revenue loss from exempting retained profits of partnerships and S corporations many times larger than our estimate of the tax paid on their current retained profits.

***OID bonds.*** Current law provides equivalent tax rules for bonds that return periodic interest payments and bonds that provide the same yield without interest payments by selling at a face value less than their redemption value. Requiring the receipt of cash to trigger a taxable event would favor OID bonds, leading to an increase in the share of bonds issued at a discount, which could make the revenue loss about double what we estimated.

### **Responses of Legislators**

If the Supreme Court were to prevent taxation of all unrealized income, Congress might take other steps to prevent or minimize the erosion of the income tax base.

***Limiting interest deductions.*** Congress could place additional limits on interest deductions to prevent taxpayers from engaging in “tax arbitrage” transactions by incurring deductible debt to finance the purchase of assets that accrue tax-free income. Current law already includes some limits; taxpayers cannot deduct interest on loans used to secure the holding of tax-exempt bonds. And businesses can deduct only 30 percent of their adjusted taxable income (ATI).<sup>15</sup>

***Taxing businesses as C corporations.*** Congress could require that all businesses above a certain size be taxed as C corporations, eliminating the opportunity for them to claim partnership or S corporation status. This would represent a departure from ideal income measurement rules, which require individual taxpayers to include all their business income in taxable income. Instead, it would subject them to multiple levels of taxation—the corporate tax plus an additional tax (currently at preferential rates) when the corporation’s profits are distributed. Depending on the corporate and dividend tax rates and the share of profits that corporations pay out, this could end up subjecting them to either under-taxation or over-taxation. This would depend on the combined tax rates applied to corporate profits and their dividends compared with their individual marginal income tax bracket.

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<sup>14</sup>This figure comes from an estimate that average corporate dividends are 40 percent of earnings, based on internal calculations using 10K filings from Calcbench.

<sup>15</sup> Beginning in 2022, ATI is earnings before interest and taxes.

*Restoring taxation of distributed foreign profits.* If tax cannot be imposed on income that US multinationals retain in their foreign subsidiaries, then Congress may consider restoring taxation of distributed profits and raising the corporate tax rate to make up for any lost revenues. This would be a step backward, reversing the reforms in TCJA and leading once again to increased retention of profits in foreign affiliates of US companies. Yet such a response may be the only tool available to limit profit shifting to low tax countries by US multinationals.

These responses, and other provisions to offset revenue losses from limits on taxing undistributed profits, would be scored as tax increases. Reductions in revenue because of a Supreme Court ruling would reduce baseline revenue, but they would not be scored as a tax cut. Given the strong political and ideological resistance to legislation that is scored as a net tax increase, it may be very difficult to offset any lost revenue from a decision that unrealized income cannot be taxed without apportionment.

### **A More Limited Effect of a Supreme Court Ruling in Favor of the Plaintiffs**

So far, this paper has explored the potential consequences of a ruling that prevents Congress from taxing unrealized income. But the scope of a Supreme Court ruling in *Moore*, as modified by subsequent judicial rulings, may be narrower in scope and still permit some of the provisions discussed in this paper to remain in effect.

For example, the court may distinguish GILTI and Subpart F, which taxes accrued income of foreign affiliates on a current basis, from the transition tax on income accrued over many prior years that therefore may seem to resemble a wealth tax. The court may decide that any ruling on taxing unrealized income applies only to taxation of individuals, based on a prior holding that the corporate income tax is an excise tax that was never subject to the apportionment clause (Library of Congress 2023). Because the bulk of revenues from the transition tax comes from corporate taxpayers, a ruling that strikes down the tax only for individual taxpayers would have a very small revenue effect by itself.

Similarly, courts may rule that undistributed partnership and S corporation income may still be taxable, on the theory that, unlike C corporations, businesses taxed as pass-throughs are not entities separate from their owners. This would mean that any income of the partnership or S corporation is also income of their owners, whether paid to them in cash or redistributed. Courts may also rule that accrued interest on discount bonds are functionally equivalent to interest payments on bonds sold at par and therefore should be viewed as realized income.

None of these outcomes are guaranteed, however, and the language of the plaintiffs and many of the amicus briefs suggests a very broad attack on the idea that any undistributed income is covered by the 16th amendment. It is also unclear that a bright line between realized and unrealized income can be established, leaving future courts to make distinctions among similar provisions and creating more uncertainty for taxpayers and policymakers.

As noted above, this paper takes no position on the constitutionality of various provisions of the current income tax or of new provisions that may be enacted by proponents of taxing accrued capital gains on a broader base or of taxing wealth. And we make no forecast of how the Supreme Court will rule. Our purpose is to spell out what could happen if courts prevent Congress from taking unrealized income.

## CONCLUSIONS

This paper has examined the potential effects of a Supreme Court decision in *Moore v. United States* that any taxes on unrealized income must be apportioned on a per-capita basis among states, thereby rendering them impracticable. We note that income is an accrual concept and that a tax that is neutral among all forms of income would need to include all accretions of income in the tax base, whether in the form of cash or an increase in the value of a taxpayer's assets. We also note that, for practical and political reasons, many gains are taxed only when realized by sale or exchange. However, tax law contains numerous examples where taxation of unrealized income is used to prevent erosion of the income tax base.

We examine six provisions in current law that tax unrealized income: the Section 965 transition tax in TCJA, the taxation of Global Intangible Low Tax Income (GILTI) of US multinational corporations, the taxation of Subpart F income of Controlled Foreign Corporations of US multinational corporations, the minimum tax on book income of US corporations, the taxation of undistributed income of partnership and S corporations, and the rules for taxing accrued interest on original issue discount bonds. While *Moore* only directly references the transition tax, these other provisions may also be at risk from a broad or opaque limitation on taxing unrealized income.

We find that the steady-state annual revenue from these provisions amounts to about \$87 billion in 2024 and \$125 billion in 2028, with the increase in 2028 reflecting the expiration of the individual tax cuts in the TCJA and the phasing in of the higher GILTI tax rate. Behavioral responses could make the revenue losses of disallowing taxation of unrealized income many times larger than the estimates reported in this paper. We also find that taxes on the sources of income that might escape tax if the court rules out taxation of unrealized income are highly concentrated among those with the highest incomes.

Behavioral responses that would increase the revenue loss include increased shifting of reported profits of US multinational corporations to low-tax foreign jurisdictions, increased retained earnings by partnerships and S corporations, increased use of pass-through business structures instead of subchapter C corporations, and increased issuance of original issue discount bonds. Taxpayers and their advisors undoubtedly will also create new forms of financial transactions, not identified in this paper, to convert realized to unrealized income.

In response to an inability to tax unrealized income, Congress may enact alternative measures to restrain the forms of avoidance that current taxes on unrealized income curtail. But such new measures could have other

negative side effects and will be difficult to enact in part because of ideological opposition to measures that increase net revenues.

Although the exact form of any decision in *Moore* is uncertain at this time, other tax provisions may also be at risk. Some of these provisions may be retained either wholly or in part if the court rules in favor of the plaintiffs on the specific application of the transition tax to noncorporate entities. But other provisions may become subject to further litigation. In addition, taxpayers may take more aggressive positions on provisions that tax unrealized income in the hopes that future court decisions will sustain their positions.

Any Supreme Court decision in *Moore* that casts doubt on the constitutionality of taxing unrealized income will create considerable uncertainty for taxpayers and the government, substantial revenue losses, and serious challenges for sustaining a progressive income tax.

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