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Moore Could Invalidate Decades of Tax Rules

by Steven M. Rosenthal

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In this article, Rosenthal argues that if the Supreme Court in *Moore* revitalizes the realization rule, the decision could upend decades of important tax reforms that were enacted to reflect income more accurately and to stem abuses, all while carefully adhering to the Court's jurisprudence.

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I. Introduction

Former House Speaker Paul Ryan, R-Ohio, recently warned that a "lot of the tax code would be unconstitutional" if the Supreme Court rules for the petitioners in *Moore*.[1] In *Moore*, U.S. shareholders in a "controlled" foreign corporation object to having been taxed on income they had not yet received as a cash distribution. They hope to breathe new life into *Macomber*,[2] a 1920 Supreme Court decision requiring income be "realized" to be taxed, even though that decision has been eroded by later rulings by the Court (as recognized by lower courts and commentators) over the ensuing century.

I share Ryan's concerns, particularly for tax legislation that has been enacted to reflect income more accurately in the absence of a sale or other disposition. Much of that legislation was in response to complex international and financial structuring designed to facilitate tax avoidance. The IRS has administered this tax legislation and taxpayers have followed it for decades, with few difficulties by either.

These laws should survive the Court's review. I know firsthand, as a former congressional staffer, how carefully Congress crafted the reforms both to work in practice and to conform to all relevant precedents, including the Court's jurisprudence. In deciding *Moore*, the Court should correspondingly exercise care and recognize the powers and practices of Congress.

Such judicial recognition of Congress's taxing power is especially important now. The political will to raise taxes is dwindling while the level of services the government is expected to provide is rising. As a result, deficits and our national debt are exploding. Upending our tax code and reopening loopholes would be disastrous to our country's financial health. As a matter of fiscal prudence and good practice, Congress must be able to craft tax laws that keep pace with increasingly sophisticated markets without fear of judicial reproach.

[1] Alexander Rifaat, "*Moore* Could Upend Tax Code, Says Paul Ryan," *Tax Notes Federal*, Oct. 2, 2023, p. 178, discussing *Moore v. United States*, 36 F.4th 930 (9th Cir. 2022), *cert. granted*, 143 S. Ct. 2656 (2023) (Question presented: "Whether the Sixteenth Amendment authorizes Congress to tax unrealized sums without apportionment among the states."). Ryan presided over the House as Republicans passed the massive 2017 Tax Cuts and Jobs Act, which included the tax that the *Moore* petitioners now challenge. *See also* the October 3 letter from the Joint Committee on Taxation to House Ways and Means Committee Chair Richard E. Neal, D-Mass.

[2] *Eisner v. Macomber*, 252 U.S. 189 (1920) (a stock distribution by a U.S. corporation to a U.S. shareholder was not "income" within the meaning of the 16th Amendment).

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This article briefly reviews the Court's decisions on the power of Congress to tax and, specifically, its power to tax unrealized income. It considers how Congress responded to those decisions by adopting rules taxing unrealized income, which it reasonably believed to be constitutional. The focus here is on Congress's critical power to tax unrealized income arising in international and capital market transactions. With this narrative, I hope to add, to the many analyses *Moore* has already generated, a unique perspective grounded in my own experience as a congressional staffer and tax practitioner.

II. Congress's Power to Tax Unrealized Income

For more than a century, the Court has respected Congress's power to tax unrealized income, and the lower courts have followed.

The U.S. Constitution empowers Congress "to lay and collect taxes . . . to provide for the common Defence and general Welfare of the United States."[3] It further authorizes Congress "to make all Laws which shall be necessary and proper for carrying into Execution the foregoing Powers."[4] At nearly the start of the republic, the Court pronounced: "The great object of the Constitution was to give Congress a power to lay taxes, adequate to the exigencies of the government."[5]

Congress currently enjoys wide constitutional latitude to tax income, but that was not always so. Even though, in *Springer*, in 1881, the Court unanimously upheld the Congress's first income tax, imposed during the Civil War, that ruling would not hold.[6] In *Pollock*, in 1895, the Court, in a 5-4 decision in a twice-argued case, struck down the next income tax, modeled on the earlier one, ruling that a tax on income from property was a "direct" tax, which the Constitution requires to be apportioned among the states by population.[7] *Pollock* created a "public furor."[8]

In response to the furor, Congress passed the 16th Amendment, which when ratified by sufficient states in 1913, gave Congress the authority to tax "incomes from whatever source derived," without apportionment. Congress quickly created another income tax, which treated as gross income "gains or profits and income derived from any source whatever."[9] By the breadth of its definition, Congress intended to use the "full measure of its taxing power."[10]

But the Court dealt one last setback to congressional taxing authority. In 1920 the Court in *Macomber* ruled, again 5 to 4, that a stock dividend was not income within the meaning of the 16th Amendment. The Court defined income strictly as "the gain derived from capital, from labor, or from both combined."[11] And the Court explained that "gain derived from capital" requires "something to be received or drawn by the recipient (the taxpayer) for his separate use." But a stock dividend changed "only the form, not the essence," of a taxpayer's investment. The notion that income requires something, like cash or property, to be received or drawn by the taxpayer is now known as the "realization rule," which, as explained below, is merely a rule of administrative convenience.

The realization rule articulated in *Macomber* now is of dubious significance as a matter of constitutional law. In *Horst*, a 1940 decision, the Court clarified, and repeated decades later, that

[3] U.S. Const. Art. I, section 8.

[4] *Id.*

[5] *See Hylton v. United States*, 3 U.S. 171, 173 (1796).

[6] *Springer v. United States*, 102 U.S. 586, 602 (1881) ("Our conclusions are that direct taxes, within the meaning of the constitution are only capitation taxes, as expressed in that instrument and taxes on real estate.").

[7] *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429 (1895). Apportionment is impractical. It would require, for example, that if 10 percent of the nation's population lives in California, 10 percent of the tax revenue must come from California — regardless of what share of national income Californians receive.

[8] *See* Bruce Ackerman, "Taxation and the Constitution," 99 *Columbia Law. Rev.* 1, 5 (1999). *See also* John R. Brooks and David Gamage, "Taxation and the Constitution, Reconsidered," 76 *Tax Law Rev.* 75 (2022) (describing the evolution of our income tax).

[9] This broad definition included in the 1913 income tax law is now reflected in section 61 ("Gross income means all income from whatever source derived."). From 1913 to 1939, Congress enacted the federal income tax annually. In 1939 Congress enacted the first Internal Revenue Code, which remained in effect until the 1954 code. The 1954 code remained in effect until the 1986 code, which is the code in force today.

[10] *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 429-430 (1955) (punitive damages are taxable income).

[11] The Court in *Glenshaw Glass* also dismissed the *Macomber* strict definition of income ("gain derived from capital, from labor, or from both combined"), asserting that it "was not meant to provide a touchstone to all future gross income questions." *Id.* at 437.

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"the rule that income is not taxable until realized . . . [is] founded on administrative convenience . . . and is only one of postponement of the tax to the final event of the enjoyment of the income, usually the receipt of it by the taxpayer."[12] Put another way, realization is not about what is income, but when income is taken into account for tax purposes. And that timing is a matter of administrative convenience.

Almost immediately after *Horst*, preeminent tax scholars noted the demotion of the realization rule, concluding that the Court had effectively eviscerated realization as a constitutional requirement. In 1941, the leading tax law expert of his time, Stanley S. Surrey, declared that the "formalistic doctrine of realization proclaimed by [*Macomber*] is not a constitutional mandate."[13] Rather, the answer to the question of when to tax income "must be in practical terms and must be shaped by considerations of administrative convenience and taxpayer convenience."[14] Other scholars then, and in later decades, overwhelmingly concurred.[15]

Today *Macomber* remains a lonely outlier as "the only judicial decision where imposition of a federal tax was found to be unconstitutional on the ground that the taxpayer had not yet realized income within the meaning of the Sixteenth Amendment at the time the tax was imposed."[16]

III. Congress's Departures From Realization

History shows that Congress respects the realization rule as administrative, not constitutional. So, as appropriate, Congress departs from the rule to reflect income more accurately and curb tax avoidance.

In the immediate wake of *Macomber*, Congress, in 1921, excluded stock dividends from taxable income.[17] In its 1924 revenue act, Congress required that any taxable gain on the amount realized on an appreciated asset be established by a sale or other disposition of that asset.[18] This "sale or other disposition" formulation is, as the Court later observed, Congress's implicit adoption of the realization rule.[19]

As an administrative matter, a sale or other disposition of property is a simple and sure way to measure gain or loss for tax purposes. And the sale generates cash to pay any tax due, which is helpful to the taxpayer.

The JCT staff identified the policy considerations underlying the realization rule as: "(1) administration — i.e., the administrative burden of constant accretion tax reporting; (2) valuation — i.e., the difficulty of repeatedly determining valuation absent sale of property; and (3) liquidity — the potential hardship to taxpayers of obtaining funds to pay tax on accrued gains."[20]

Yet, sometimes, Congress can depart from realization but also address administrative concerns. Those departures from the realization rule may be necessary to reflect income more accurately or stem tax avoidance. And they are critical to create a tax system that reflects real-world economics and taxpayer behavior.

In these instances, Congress may deem income to have been realized, or a sale or

[12] *Helvering v. Horst*, 311 U.S. 112, 116 (1940). *See also Cottage Savings v. Commissioner*, 499 U.S. 554 (1991) (repeating that the realization rule is "founded on administrative convenience"). *Cf. Helvering v. Bruun*, 309 U.S. 461, 468-469 (1940) (the "expressions" from *Macomber* that income must be received were "used to clarify the distinction between an ordinary dividend and a stock dividend," and "not controlling" elsewhere); *Helvering v. Griffths*, 318 U.S. 371, 393-394 (1943) (explaining that *Horst* undermined "the original theoretical bases" of a constitutional realization requirement).

[13] Surrey, "The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions," 35 *Ill. L. Rev. NW. U.* 779, 791 (1941).

[14] *Id.* at 792.

[15] *See*, *e.g.*, Boris I. Bittker and Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts*, para. 5-19 (1999) ("Though badly eroded, if not wholly undermined, as a constitutional principle, realization remains largely intact as a rule of administrative convenience (or legislative generosity))"; Marvin Chirelstein, *Federal Income Taxation*, para. 5.01 (2009) ("Realization is strictly an administrative rule and not a constitutional, much less an economic, requirement of 'income.'"). *But see* Henry Ordower, "Revisiting Realization: Accretion Taxation, the Constitution, *Macomber* and Mark to Market," 13 *Va. Tax Rev.* 1 (1993) ("realization remains a constitutional prerequisite for the taxation of gains from property").

[16] JCT, "Issues Presented by Proposals to Modify the Tax Treatment of Expatriation," JCS-17-95 (June 1, 1995). The JCT's statement remains true to this day.

[17] Section 201(d) of the Revenue Act of 1921 ("A stock dividend shall not be subject to tax.").

[18] Section 202(a) of the Revenue Act of 1924.

[19] *Cottage Savings*, 499 U.S. at 559.

[20] JCS-17-95, *supra* note 16, at 75.

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disposition to have occurred, without the receipt of cash or a formal "sale or other disposition." Two other professions with an interest in timing and measuring income — accounting and economics — take similar approaches.[21]

Congress's earliest departures from realization, discussed below, required U.S. shareholders to report as income undistributed earnings of foreign corporations.[22]

In 1937 a congressional investigation uncovered widespread tax abuses by U.S. investors, requiring extensive loophole closures.[23] Among the findings were that in the 1920s, in the aftermath of *Macomber*, U.S. taxpayers created hundreds of "incorporated pocketbooks" in the Bahamas, Panama, Newfoundland, and Prince Edward Island. This tax-dodging maneuver siphoned income out of the United States into foreign countries with low or no taxes on income.

In response, Congress assigned the income of these "foreign personal holding companies" to their U.S. shareholders and held them personally responsible for any taxes due, disregarding the separate entity of their corporations.[24] Taxpayers challenged the tax regime on constitutional grounds but lost. The Second Circuit found that Congress had a legitimate interest in defending the efficacy of the tax code by dealing harshly with the foreign "incorporated pocketbook" loophole and that the method of taxation was "a reasonable means to achieve the desired ends."[25]

In 1961 the Kennedy administration recommended that Congress extend the taxation of undistributed foreign earnings to foreign operating corporations that were controlled by U.S. shareholders.[26] The administration sought to make it harder for companies to shift profits to tax havens abroad to avoid U.S. taxation. Narrowing Kennedy's proposal somewhat, Congress in 1962 added the subpart F rules to the code (sections 951 through 965), which tax U.S. shareholders of controlled foreign corporations on undistributed earnings from interest, dividends, royalties, and other forms of income that can be easily offshored and are thereby most prone to tax-haven abuse.

The Second and Tenth circuits, the only circuit courts to consider the issue, rejected constitutional challenges to the subpart F rules.[27]

Over the years, Congress has continued to tax income that arose from mere ownership of property (that is, without any distributions). In 1969 Congress targeted the use of original issue discount bonds for tax arbitrage with special rules (now sections 1272 through 1275). Most bonds pay interest at regular intervals, which is taxable in the year received. But some bonds, such as zero-coupon bonds, are issued for a price less than the face amount of the bond — the interest being included in the face amount that is paid when the bond matures. Traditionally, the bondholder was not taxed on the interest until the bond was redeemed at maturity (unless the bond was earlier sold or otherwise disposed in a taxable transaction). The issuing corporation, on the other hand, deducted the amount of OID each year over the life of the bond. Congress ended the discrepancy in tax treatment of this bond interest by enacting the OID rules, which taxed the

[21] Since 2007, accountants require all public companies to use mark-to-market for their financial assets. American Institute of CPAs, "AICPA Media Center — FAQs About Fair Value Accounting" (undated). Economists look to the increase in the value of a taxpayer's assets over a given period, whether realized or not. Haig, ed., *The Federal Income Tax* 7 (1921) (income is "the money value of net accretion to one's economic power between two points of time."). *See generally* JCT, "Overview of the Definition of Income Used by the Staff of the Joint Committee on Taxation in Distributional Analyses," JCX-15-12, at 3 (Feb. 8, 2012) ("Economists generally agree that the Haig-Simons measure of income is the best measure of economic well-being.").

[22] The U.S. corporate income tax applies only to the earnings of domestic corporations, not the foreign earnings of foreign corporations. The absence of a U.S. entity-level tax on foreign undistributed corporate earnings is the motivation for taxing those earnings at the shareholder level (*i.e.*, to stem tax avoidance schemes).

[23] *See* Randolph E. Paul, "The Background of the Revenue Act of 1937," 5 *U. Chi. L. Rev.* 41 (1937).

[24] *See* section 201 of the Revenue Act of 1937. In 2004 Congress shifted the foreign personal holding company rules to subpart F. American Jobs Creation Act of 2004, section 412.

[25] *Eder v. Commissioner*, 138 F.2d 27 (2d Cir. 1943) (The result was particularly harsh for some taxpayers because Columbian law prevented the foreign corporation from paying a dividend to U.S. shareholders.).

[26] "Hearings on the President's 1961 Tax Recommendations Before the House Committee on Ways and Means," 87th Cong., 1st Sess. Vol. 1 (1961).

[27] *Garlock Inc. v. Commissioner*, 489 F.2d 197 (2d Cir. 1973), *cert. denied*, 417 U.S. 911 (1974) (ruling that the constitutional argument "borders on the frivolous in the light of this court's decision in *Eder v. Commissioner*"). *See also Whitlock v. Commissioner*, 494 F.2d 1297 (10th Cir. 1974), *cert. denied*, 417 U.S. 911 (1974) (holding that subpart F is constitutional).

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imputed interest earned each year, even though, in a default, the interest might never be collected.[28]

In the 1970s a new abuse emerged in the financial marketplace: straddles constructed with exchange-traded commodities contracts (called "regulated futures contracts"). This technique allowed a taxpayer to defer income and to convert a short-term capital gain into a lower-taxed long-term capital gain.[29] And while some investment professionals had used these techniques for years, straddles had developed into retail tax shelters that individuals and corporations used to slash their tax bills.[30]

In 1981 Congress added several rules to stem this abuse — most importantly, a rule that forces taxpayers to mark-to-market regulated futures contracts (section 1256). Mark-to-market is a method of accounting that treats property as sold at market value at the end of the year and treats gain or loss as realized.

The Ninth Circuit rejected the only constitutional challenge to the mark-to-market rules, holding that "Congress acted well within its authority when it decided to treat [commodities futures] differently from other capital assets."[31] The court did not reach the broader issue of whether Congress could tax the gains inherent in other capital assets before their realization because Congress had stopped well short of that. (Congress did not view the section 1256 rules as the first step toward more broadly taxing unrealized gains; it based the tax rules on the peculiar operations of futures trading: Traders are allowed to receive profits as a matter of right, for instance, and are required to pay losses in cash daily.)

[28] JCT, "General Explanation of the Tax Reform Act of 1969," JCS-16-70, at 129 (1970).

[29] In a simple commodity straddle, a taxpayer would take long and short positions in the same commodity with different delivery dates. The taxpayer expected the two positions, called "legs," to move in opposite directions in roughly the same magnitude. But in a tax dodging maneuver, the taxpayer would close (or realize) the loss leg, while holding open the gain leg into another year. *See generally* JCT, "General Explanation of the Economic Recovery Tax Act of 1981," JCS-71-81, at 294-296 (1981).

[30] *Id.* at 282.

[31] *Murphy v. United States*, 992 F.2d 929, 931 (9th Cir. 1993).

IV. My Experience With Congress's Departures

In the early to mid-1990s, I worked as a legislation counsel at the Joint Committee on Taxation.[32] The JCT's duties include developing and analyzing legislative proposals for members of Congress, preparing official revenue estimates of all proposed tax legislation, drafting legislative histories for tax-related bills, and investigating various aspects of the federal tax system. In my experience, the JCT staff incorporated administrative considerations in all those functions.

At the time, we understood the decline of realization as a constitutional requirement.

Indeed, in 1991, shortly after I started at the JCT, the Supreme Court reaffirmed that realization is "founded on administrative convenience."[33] In 1993 the Ninth Circuit expressly upheld the mark-to-market method of tax accounting for regulated futures contracts and, three months later, Congress extended that method to securities dealers.[34]

In 1995 the JCT staff reported the following to Congress on *Macomber* and the realization rule: "The vast majority of commentors view *Macomber* as effectively overruled or the validity of the holding so restricted to its facts, such that the concept of realization no longer has constitutional significance." Rather, realization is "a matter of fairness and administrative convenience and, thus, a question of tax policy for the legislature and not the courts."[35]

The JCT staff occasionally also helped develop important tax reforms that departed from the realization rule.

Two examples are described below: the mark-to-market rules for securities dealers and constructive sales. Both reforms tax property as if it has been sold for its full market value, even though the property has not been sold or otherwise disposed of. These departures satisfied Congress's administrative concerns. And

[32] The JCT, established originally under the Revenue Act of 1926, is a nonpartisan, bicameral committee of the U.S. Congress. It is tasked with analyzing and developing tax legislation. JCT, "Overview" (undated).

[33] *Cottage Savings*, 499 U.S. at 559.

[34] *Murphy*, 992 F.2d 929.

[35] JCS-17-95, *supra* note 16, at n.18.

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importantly, they measured income more accurately and stemmed tax avoidance.

A. Mark-to-Market for Securities Dealers

The reform to which I devoted the most attention while at the JCT was the mark-to-market method of tax accounting for a securities dealer's inventory (and securities similar, or related, to inventory), enacted in 1993.[36] These dealers maintain inventories of corporate shares, bonds, and other financial instruments as a stock of securities available for sale much like a grocer stocks cans of soup, rather than as straightforward investments.

Dealers now are required to increase (or decrease) their income annually on any gain (or loss) in the value of their inventory. Before the reform, securities dealers could use a tax accounting method known as "lower of cost or market" to determine any gain. Since cost was usually lower than market, they would routinely assign their original cost to their inventory at the end of the tax year — unless the value had gone down, in which case they would mark to market to generate a tax-saving loss.

By contrast, for financial accounting purposes, securities dealers had, from the early 1970s, been required to value their inventory at market at the end of the year, rather than at original cost or any other method. (While other taxpayers might struggle to value their securities if they are not actively traded, dealers can use both publicly available data and sophisticated financial models to determine the value of their inventory.)

Republican President George H.W. Bush first challenged the discrepancy between tax and financial accounting. He proposed in 1992 that Congress conform the tax rules to the financial rules by requiring securities dealers to value all their inventory at market price at year-end.[37]

Congress assigned the JCT staff to work on Bush's proposal. Over the next two years, JCT staffers met over a dozen times with Treasury and IRS officials to draft the statute. JCT staff also met with industry lobbyists, made presentations to industry and professional conferences, and consulted outside tax and accounting professionals.

The JCT staff focused especially on the potential challenges of valuation and liquidity of a mark-to-market method of tax accounting for securities dealers. The staff concluded that such challenges were minimal for inventories already valued at market for financial reporting. Congress, however, eased the immediate tax burden for securities dealers for the increase in valuation of their inventory, which they may have valued at original cost for years or even decades. Congress allowed the dealers to spread the income from the adjustment for a change of method of accounting required by section 481 over five years.[38]

The JCT staff estimated that extending the mark-to-market method of tax accounting to securities dealers would raise $3.8 billion over the next five years.[39]

Finally, after two years of this deliberative process, Congress passed the rules change as IRC section 475, and in August 1993 President Bill Clinton, a Democrat, signed into law a reform proposed by his Republican predecessor.

Significantly, never in that two-year process in which I was involved did I ever hear anyone — whether staff, legislators, or other stakeholders — question whether the new law's taxation of unrealized gains was unconstitutional. Nor have I heard of any constitutional challenges to these mark-to-market rules in the 30 years since.

B. Constructive Sales

One Saturday in July 1994 during my time at JCT, I was engaged in my weekend ritual of perusing the business magazine *Barron's* when I came across a full-page advertisement placed by

[36] Section 475(a)(1) and (2). Some of the securities of a dealer are not technically inventory. And some securities, like a dealer's hedges, are related to inventory.

[37] Treasury, "General Explanations of the President's Budget Proposals Affecting Receipts" (Jan. 1992).

[38] Omnibus Budget Reconciliation Act of 1993, section 13223(c)(2). The transition rule for market to mark-to-market was like the transition by a cash-basis taxpayer to accrual, which led to the enactment of section 481 in 1954. Sales that were not yet reflected at the time of the change might be omitted from gross income permanently if the items had accrued when the taxpayer used the cash method (and would be collected when the taxpayer used the accrual method). *See Commissioner v. Dwyer*, 203 F.2d 522 (2d Cir. 1953), which explicitly overruled *Hardy v. Commissioner*, 82 F.2d 249 (2d Cir. 1936). Note that the Second Circuit's deliberation was over statutory, not constitutional, limitations.

[39] JCT, "Estimated Budget Effects of H.R. 2264," JCX-11-93 (1993).

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the investment firm Bankers Trust. "Get rid of the risk, not the stock," the headline advised, the ad going on to explain that the firm could accommodate clients who wanted to extract the increased value from their investments without actually selling them and paying capital gains taxes.

I ripped out the page and took it with me to an industry conference later that week, where I held it up high so all could see how brazen the wizards of Wall Street had become in devising schemes to allow wealthy investors to dodge taxes on their hefty gains.

The scheme that the investment firm marketed was "equity swaps," which, at the time, were described, as "the first genuinely new financial product of the last 50 years."[40] An equity swap is a contract between two parties for the exchange of future cash flows based on the performance of a stock. Here, the investment firm would pay the investor any decrease in the stock's value for a specified period (plus interest for the period), and the investor would pay the investment firm any increase in the stock's value, plus any dividends for the period. In effect, the investment firm swapped positions with the investor: the investment firm, economically, owned the stock for the period, and the investor owned an interest-bearing asset.[41]

But investors with appreciated stock could use equity swaps to lock in their gains, without tripping a tax. And, after locking in their gains, investors typically borrowed against their stock (that is monetized their positions). And if the investor held the stock or other security until death, the stepped-up basis rule eliminated the taxability of the gain for the inheritor.[42]

"Constructive sales" share key attributes of actual sales. Constructive sales reference market prices, eliminate the economic exposure of holding the stock, and yield cash, which could be used to pay tax. Constructive sales, appropriately, depart from the realization rule.

The JCT and Treasury staffs started developing "constructive sale" rules to close this loophole. Enshrined in law since 1997 as section 1259, these rules treat the entering of an equity swap, a short sale, or other offsetting transaction as a sale even though, in form, it is not. In the constructive sale of section 1259, gains, but not losses, are treated as realized.

V. Congress's Unfinished Agenda (Derivatives)

Congress continues to develop tax legislation to keep pace with evolving capital markets. In particular, the taxation of derivatives, which are financial contracts that derive their value based on an underlying asset, group of assets, or benchmark, needs further revisions. Bipartisan reforms are pending — reforms that the Supreme Court might block forever if it elevates the realization rule as a constitutional requirement, rather than an administrative convenience.

The current taxation of derivatives is complicated and inconsistent. There are different rules for different derivatives, different rules for the same derivative that is used differently, and different rules for the same derivative held by different taxpayers.

As a result, two derivatives that are economically the same may be taxed quite differently. For many years investors have exploited these different tax treatments to manipulate the character, timing, or source of their income to reduce their tax liability.[43] But the IRS struggles to unravel the wide variety of derivatives-related strategies, which are often abstruse.

A uniform mark-to-market of derivatives has long been the "holy grail" of tax policy for financial products. And Congress could enact such a regime, with a little help on the valuation of derivatives. Such help is possible now because

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[40] Diana B. Henriques and Floyd Norris, "The Wealthy Find New Ways to Escape Tax on Profits," *The New York Times*, Dec. 1, 1996.

[41] *See generally* JCT, "General Explanation of Tax Legislation Enacted in 1997," JCS-23-97, at 172-180 (1997).

[42] A similar scheme was called "shorting against the box." In a short sale, an investor sells borrowed shares in the hope that the price of the shares will decline, which would allow the investor to repurchase the shares and return them to the lender at a lower cost, with the borrower pocketing the difference. An investor shorts against the box when he already owns the shares that he is shorting. Again, the investor locks in the gain, without tripping a tax.

[43] *See, e.g.*, hearing by the Senate's Permanent Subcommittee on Investigations, "Abuse of Structured Financial Products: Misusing Basket Options to Avoid Taxes and Leverage Limits" (July 22, 2014). *See also* Gregory Zuckerman and Richard Rubin, "James Simons, Robert Mercer, Others at Renaissance to Pay Up to $7 Billion to Settle Tax Probe," *The Wall Street Journal*, Sept. 2, 2021.

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of the evolution of financial accounting and the enactment of the Dodd-Frank Act.[44]

In 2013 the chair of the House Ways and Means Committee, Dave Camp, R-Mich., released a discussion draft to reform the taxation of derivatives by marking them to market at year-end. A subcommittee held a hearing to explore the chair's proposed reforms, at which I testified.

In 2021 the chair of the taxwriting Senate Finance Committee, Ron Wyden, D-Ore., introduced his own bill to modernize the taxation of derivatives, largely by requiring them to be marked to market. But his reforms, like Camp's, are still pending.

VI. Conclusion

Congress's efforts to reflect income more accurately and prevent abuses are potentially in jeopardy if the Court, in *Moore*, breathes new life into *Macomber* and its realization rule. The Court could well upend a lot of long-accepted tax rules and reopen abuses.[45] At a minimum, it would cast a cloud of uncertainty over them, which could be resolved only by more litigation.

Recasting the realization rule as a constitutional requirement also would upset a healthy balance between the legislative and judicial branches of government when it comes to the federal tax code. Now more than ever, at a time of staggering deficits and debt, Congress must retain — and the Court must recognize — the legislature's expansive authority in that realm. And only Congress, with its resources, expertise, and experience, can balance administrative convenience and fairness to create tax rules for the evolving international and capital markets. ■

[44] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, P.L. 111-203, 124 Stat. 1376. *See generally* Erika W. Nijenhuis, "New Tax Issues Arising From Derivatives Regulatory Reform," *Tax Notes*, June 14, 2010, p. 1235.

[45] The *Moore* petitioners apparently understand how a ruling for them would upend our tax code — and they attempt to *defend* the constitutionality of several of the tax rules described here. In their opening brief, the petitioners invent the doctrine of "constructive *realization*," which appears related to "constructive receipt," a long-established tax doctrine. To the petitioners, constructive realization "treats as taxable income which is unqualifiedly subject to the demand of a taxpayer." It extends to "property that is subject to liquidation and payment at market value at any time," which presumably would include publicly traded stock that is owned by an investor. The petitioner's ad hoc defense is inconsistent, both with petitioner's other arguments and *Macomber*. *See* Lawrence A. Zelenak, "Reading the Taxpayers' Brief in *Moore*," *Tax Notes Federal*, Oct. 2, 2023, p. 101.

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