

Mandatory Repatriation Tax

Cross References

- *Moore*, U.S. Supreme Court, June 20, 2024

Congress generally taxes the income of American business entities in one of two ways. Some entities, such as S corporations and partnerships, are taxed on a pass-through basis, where the entity itself does not pay taxes. Instead, the entity's income is attributed to the shareholders or partners, who then pay taxes on that income even if the entity has not distributed any money or property to them.

Other business entities do pay taxes directly on their income. Those entities' shareholders ordinarily are not taxed on that income but are taxed when the entity distributes a dividend or when the shareholder sells shares.

Congress treats American-controlled foreign corporations as pass-through entities. Subpart F of the Internal Revenue Code attributes income of those business entities to American shareholders and taxes those shareholders on that income. Subpart F, however, applies only to a small portion of the foreign corporation's income, mostly passive income.

In 2017, Congress passed the Tax Cuts and Jobs Act. As relevant to this case, Congress imposed a one-time, backward-looking, pass-through tax on some American shareholders of American-controlled foreign corporations to address the trillions of dollars of undistributed income that had been accumulated by those foreign corporations over the years. Known as the mandatory repatriation tax (MRT), the tax imposed a rate from 8 to 15.5 percent on the pro rata shares of American shareholders. [IRC §965(a)(1), (c), (d)]

In this case, the taxpayers invested in the American-controlled foreign corporation KisanKraft. From 2006 to 2017, KisanKraft generated a great deal of income but did not distribute that income to its American shareholders. At the end of the 2017 tax year, application of the new MRT resulted in a tax bill of \$14,729 on the taxpayers' pro rata share of KisanKraft's accumulated income from 2006 to 2017. The taxpayers paid the tax and then sued for a refund, claiming, among other things, that the MRT violated the Direct Tax Clause of the Constitution because, in their view, the MRT was an unapportioned direct tax on their shares of KisanKraft stock.

The District Court dismissed the suit, and the Ninth Circuit Court of Appeals affirmed.

The U.S. Supreme Court has now ruled that the MRT, which attributes the realized and undistributed income of an American-controlled foreign corporation to the entity's American shareholders, and then taxes the American shareholders on their portions of that income, does not exceed Congress's constitutional authority.

The court explained that Article I of the Constitution affords Congress broad power to lay and collect taxes. That power includes direct taxes, those imposed on persons or property,

and indirect taxes, those imposed on activities or transactions. Direct taxes must be apportioned among the states according to each state's population, while indirect taxes are permitted without apportionment but must "be uniform throughout the United States."

Taxes on income are indirect taxes, and the Sixteenth Amendment confirms that taxes on income need not be apportioned.

The government argued that the MRT is a tax on income and therefore need not be apportioned. The taxpayers argued that the MRT is a tax on property and that the tax is therefore unconstitutional because it is not apportioned. According to the taxpayers, income requires realization, and the MRT does not tax any income that they have realized.

The court stated the MRT does tax realized income, namely, the income realized by KisanKraft, which the MRT attributes to the shareholders. The U.S. Supreme Court's longstanding precedents, reflected in and reinforced by Congress's longstanding practice, confirms that Congress may attribute an entity's realized and undistributed income to the entity's shareholders or partners and then tax the shareholders or partners on their portions of that income.

The Court's longstanding precedents plainly establish that, when dealing with an entity's undistributed income, Congress may either tax the entity or tax its shareholders or partners. Whichever method Congress chooses, the U.S. Supreme Court has held that the tax remains a tax on income.

Congress's longstanding practice of taxing the shareholders or partners of a business entity on the entity's undistributed income reflects and reinforces the Court's precedents. For example, Congress passed an 1864 income-tax law that taxed shareholders or partners on "the gains and profits of all companies." In 1913, Congress enacted a new income tax that, among other things, taxed partners on their "share of the profits of a partnership."

As new business entities arose, Congress employed a similar approach to S corporations, American shareholders of foreign business entities, and American shareholders of American-controlled foreign corporations.

The taxpayers in this case attempted to distinguish the MRT from those taxes long imposed by Congress and long upheld by the U.S. Supreme Court and argued that only the MRT is unconstitutional. Their ad hoc distinctions do not undermine the clear rule established by the court's precedents.

First, the taxpayers argued that taxes on partnerships are distinguishable from the MRT and not controlled by precedent because partnerships are not separate entities from their partners. But that assertion is incorrect. When the Sixteenth Amendment was ratified, the courts, Congress, and state legislatures treated partnerships as separate entities in many contexts, and numerous states imposed taxes directly on partnerships for partnership income. The federal and state treatment of partnerships as separate legal entities for tax purposes contravenes the taxpayers' theory.

Second, the taxpayers argued that taxes on S corporations are distinguishable from the MRT because shareholders of S corporations choose to be taxed directly on corporation income. But consent cannot explain Congress's authority to tax the shareholders of

S corporations directly on corporate income. Rather, S corporations are another example of Congress's authority to either tax the corporation itself on corporate income or attribute the undistributed income to the shareholders and tax the shareholders.

Third, the taxpayers tried to distinguish Congress's long history of taxing shareholders of closely held foreign corporations, including through subpart F, on the ground that those laws apply "the doctrine of constructive realization." That term seems to be a one-off label created by the taxpayers to allow them to sidestep any existing tax that does not comport with their proposed constitutional rule. In any event, the taxpayers' constructive-realization theory does not distinguish the MRT from subpart F and other pass-through taxes.

For example, the taxpayers claim that constructive realization turns on a sufficient degree of control over the entity. But the level of shareholder control with the MRT (at least 10 percent) is the same as under the longstanding subpart F tax. And if, as the taxpayers concede, subpart F is not unconstitutional under the "constructive realization" theory, then the MRT is likewise not unconstitutional on that theory.

The Court's holding is narrow and limited to entities treated as pass-throughs. Nothing in this opinion should be read to authorize any hypothetical congressional effort to tax both an entity and its shareholders or partners on the same undistributed income realized by the entity. Nor does this decision attempt to resolve the parties' disagreement over whether realization is a constitutional requirement for an income tax.

Author's Comment

Two dissenting judges agreed with the taxpayer and said that income must be realized in order for it to be taxed without apportioning it among the states, as the Sixteenth Amendment requires. The U.S. Supreme Court has ruled, for example, that unrealized gains on capital assets is not taxable, because the taxpayer has not yet realized an economic gain. The majority disagreed with the dissenting judges stating that unrealized gains on capital assets are not the same as the realized income of pass-through entities.