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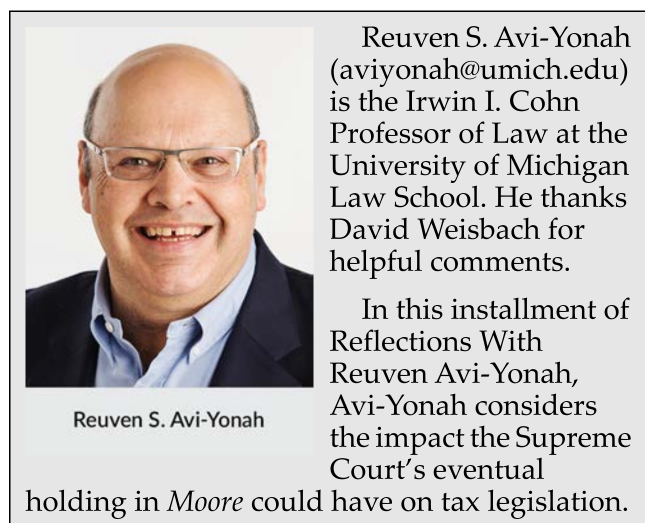
What Matters in *Moore*

by Reuven S. Avi-Yonah



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In this installment of Reflections With Reuven Avi-Yonah, Avi-Yonah considers the impact the Supreme Court's eventual holding in *Moore* could have on tax legislation.

Why does the pending *Moore*[1] case in the Supreme Court matter?

The obvious answer is that if the Court decides that realization is a constitutional requirement for an income tax, the holding will have significant implications for the existing income tax regime. Depending on how broad the decision is, it could enable constitutional challenges to subpart F, the global intangible low-taxed income regime, partnership and subchapter S taxation, and sections 275, 877A, 1256, and 1259, to name just a few. And even if most or all of these challenges are ultimately decided against the taxpayers (for example, because realization does not apply to corporate taxpayers, because partnership taxation is just about aggregation, because subchapter S is generally elective, and because the other sections mentioned above are excise, not income, taxes), this will take time. Meanwhile, taxpayers would rely on *Moore* as substantial authority and not pay tax on a lot of income.[2]

But this column will focus not on *Moore*'s collateral damage but on the impact the holding could have on future legislative change. Specifically, the reason the Court took the case is because a holding that realization is constitutionally required would prevent Congress from enacting a mark-to-market tax on billionaires, as proposed by the Biden administration and by Senate Finance Committee Chair Ron Wyden, D-Ore.[3]

Even if the Court avoids the realization issue by holding that the Moores could be taxed on income realized by KisanKraft, the Indian controlled foreign corporation, the decision could still raise significant doubts as to the constitutionality of this proposed legislation, further reducing its chances of being enacted. At least some of the justices could suggest in dicta that mark-to-market taxes are unconstitutional,

[1] *Moore v. United States*, No. 22-800.

[2] *See* Reuven S. Avi-Yonah, "If *Moore* Is Reversed," *Tax Notes Int'l*, June 26, 2023, p. 1725; Brief of Amici Curiae Reuven Avi-Yonah, Clinton G. Wallace, and Bret Wells in Support of Respondent, *Moore*, No. 22-800 (U.S. Oct. 19, 2023).

[3] See the Billionaires Income Tax Act (S. 3367), introduced by Wyden and 15 other Democratic senators just before the oral argument in *Moore*. *See* U.S. Senate Committee on Finance, "Wyden Leads Democratic Colleagues in Introducing Billionaires Income Tax" (Nov. 30, 2023). Under the proposal, traded assets would be marked-to-market and non-traded assets would be subject to an interest charge upon realization. Contrary to some commentary, *Moore* is not about a wealth tax because it is widely conceded (even by Solicitor General Elizabeth Prelogar in the oral argument) that an unapportioned wealth tax would be unconstitutional regardless of whether realization is required in an income tax. But see Ari Glogower, "A Constitutional Wealth Tax," 118 *Mich. L. Rev.* 717 (2020), for a proposal to avoid this issue. For an argument that mark-to-market taxes are constitutional even if realization is a necessary element of income because the income tax should be judged as a whole, see Amandeep S. Grewal, "Billionaire Taxes and the Constitution," 58(1) *Ga. L. Rev.* 249 (2023). For an explanation why a wealth tax is fundamentally different from a mark-to-market income tax, see Avi-Yonah, "What Is the Best Candidate for a Post-*Moore* Constitutional Challenge?" *Tax Notes Int'l*, Jan. 1, 2024, p. 17.

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thereby encouraging challenges to some of the other provisions listed above.[4]

Why would that matter?

As is widely recognized, billionaires do not pay a lot of federal income taxes, and their effective tax rate is frequently lower than that of wage earners (as Warren Buffett famously said, his tax rate is lower than his secretary's).[5] The reason is the realization requirement: As Elon Musk showed when he borrowed against his unrealized gains in Tesla to buy Twitter, the ultrarich can pursue a buy-borrow-die strategy of acquiring assets, borrowing against unrealized appreciation to fund their lifestyle or imperial ambitions, and then leave the assets to their heirs who can sell them at a stepped-up basis. This strategy does not trigger an income tax liability, and although the ultrarich are subject to the estate tax, that tax is notoriously porous and can be avoided legally.

Moreover, even if the ultrarich do realize investment income in the form of dividends or capital gains, they are subject to a rate that is about two-thirds the rate on ordinary income (23.8 percent versus 37 percent). And this lower rate also applies to sales of shares in corporations by their founders and to the profits of hedge fund managers, both of which are income from labor, not from capital. The reason for this rate disparity (which has been a feature of the code since 1921, with a brief exception in 1986-1991) is the realization requirement, because absent realization, none of the traditional arguments in favor of the lower capital gains rate (the effects of inflation, "bunching" of income in one year under progressive rates, or lock-in) applies. This is why professor William D. Andrews called realization the Achilles heel of the income tax.[6]

The impact of the lower capital gains rate can be seen historically. Professor W. Elliot Brownlee calculated the ETR of the top 1 percent of earners before 1986 and showed that the ETR on their realized income was always much lower than the top statutory rate on ordinary income.[7] The reason is the capital gains rate. That is why it is inaccurate to claim that the high statutory tax rates of the 1935-1980 period were the reason that inequality was lower then. The reduced level of inequality had more to do with benefits achieved by the middle class (such as unionization, the GI bill, Social Security, Medicare, and Medicaid) than with taxing the rich.

Nor did the reduction of the statutory rate on ordinary income in the post-Reagan period, from 70 percent in 1980 to a maximum of 39.6 percent in 1993, have much to do with increased inequality, which was more the result of globalization, increased returns to the financial sector, the decline of unions, and Reagan economic policy that backtracked New Deal and Great Society gains. Taxation could do little to reverse this trend given the lower capital gains rate, which was cut from 28 percent in 1986 to as low as 15 percent and has never exceeded 23.8 percent since.

Thus, the real issue in *Moore* is whether it will ever be possible to eliminate the realization requirement. Without a mark-to-market regime, taxing billionaires becomes close to impossible.

However, the stakes are actually much lower than that because the reality is that a mark-to-market federal income tax is very unlikely to be enacted, even if it is restricted to billionaires. The reason is that there is widespread public opposition to taxes on "phantom income," and as Justice Brett M. Kavanaugh pointed out in the *Moore* oral argument when Justice Samuel A. Alito Jr. raised the specter of a federal mark-to-market tax, members of Congress want to be reelected.[8]

The more important question is, does that matter? Of course, it matters to the ultrarich individuals who would face billions in taxes on

[4] *See* Avi-Yonah, *supra* note 3.

[5] That is not true for the top 1 percent of the income distribution because it includes a lot of taxpayers with income from services subject to the ordinary income tax rates. *See* Gerald Auten and David Splinter, "Income Inequality in the United States: Using Tax Data to Measure Long-Term Trends" (Sept. 29, 2023).

[6] Andrews, "The Achilles Heel of Income Taxation" in *New Directions in Federal Tax Policy for the 1980s* (1983).

[7] Brownlee, "Historical Perspectives on U.S. Tax Policy Toward the Rich" in *Does Atlas Shrug? The Economic Consequences of Taxing the Rich* 61, Table 2.6 (2000); Auten and Splinter, *supra* note 5 (explaining that before 1980, when the top statutory rate was 70 percent or higher, the top 1 percent paid an average rate below 50 percent).

[8] *See* Transcript of Oral Argument, *Moore*, No. 22-800 (U.S. argued Dec. 5, 2023). On the popular opposition to mark-to-market taxes on billionaires, see Zachary Liscow and Edward Fox, "The Psychology of Taxing Capital Income: Evidence From a Survey Experiment on the Realization Rule," 213 *J. Public Econ.* (2022).

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unrealized appreciation in publicly traded assets. But overall, even if we primarily care about reducing inequality, the answer is: not too much. Taxing the ultrarich is more a matter of politics than of tax policy.

An excellent recent paper by Thomas Coleman and David A. Weisbach[9] shows that contrary to some claims, the U.S. tax and transfer system has actually become more progressive in recent years:

> Examining studies of the progressivity and extent of redistribution in the tax and transfer system we find two striking facts. First, the major studies find consistent results on the changes to the tax and transfer system over the last half century. While there are some differences in their estimates of the effects at the top of the distribution, there is broad agreement that there have been large increases in net transfers to the bottom, and the size of those increases swamp any changes at the top. This is robust across different methodologies and datasets. Second and consistent with this finding, the tax and transfer system has become more progressive and more redistributive over the last half century, with much of that increase occurring in the last several decades. The public view that progressivity has declined is incorrect.[10]

The basic point is that for progressivity, what is important is not the tax level on the top 1 percent of earners, but rather the effect of the tax and transfer system as a whole, and for that it is more important to focus on the lower 50 percent of the income distribution range that receives the bulk of federal transfer payments.

But there is also another question, which Coleman and Weisbach do not emphasize. If the focus is not on progressivity but on inequality, then the reality is that despite the increase in progressivity of the tax and transfer system, the United States has become more unequal over recent decades. As I showed in a different article, the after-tax and transfer Gini coefficient in the United States increased from 0.342 in 1966 to 0.384 in 2019.[11] Pretax and transfer Ginis went up more, but the gap between pretax and after-tax Ginis grew, which means that the tax system is doing more, but not enough, to entirely offset the increase in the pretax Gini.[12]

Based on these data, increasing the progressivity of the income tax by eliminating the realization requirement may have some impact on reducing inequality. But given that even the Wyden proposal only focuses on billionaires, it is unlikely to have too much of an effect. There are fewer than 800 billionaires in the United States, and even taxing their unrealized income at 100 percent would not significantly affect the overall Gini coefficient.

Between 1979 and 2018, the U.S. Gini increased steadily both before and after taxes.[13] This pattern is surprising because (1) the United States relies heavily on individual income taxes, and those taxes are very progressive; and (2) the top marginal tax rate and the tax rates on capital gains and dividends changed numerous times during the relevant period. The top rate went from 50 percent in 1983 down to 28 percent in 1987, then gradually up to 39.6 percent in 1993, then down to 35 percent in 2003, then back to 39.6 percent in 2013, then down to 37 percent in 2018. The maximum capital gains rate went up from 20 percent in 1983 to 28 percent in 1987, then down to 20 percent in 1997, then down again to 15 percent in 2003, and up to 23.8 percent in 2013. None of those changes seems to have made an impact on the after-tax Gini. If progressive income taxation reduces inequality, one would expect the before-and-after-tax Ginis to diverge rather than march in parallel.

A more detailed examination of the data, however, suggests the answer to this puzzle. The

[9] Coleman and Weisbach, "How Progressive Is the U.S. Tax System?" University of Chicago Coase-Sandor Institute for Law and Economics Research Paper No. 991 (Nov. 20, 2023).

[10] *Id.* at 33.

[11] The Gini coefficient is zero when all income is distributed equally and 1 when a single person has all the income. The U.S. Gini is higher than that of most other OECD members, and it is also higher than that of many developing countries (for example, China and India). *See* Avi-Yonah, "The Parallel March of the Ginis: How Does Taxation Relate to Inequality, and What Can Be Done About It?" 2 *Am. J. Law & Equality* 238 (2022).

[12] Auten and Splinter, *supra* note 5.

[13] The following is based on part on Avi-Yonah, *supra* note 11.

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Congressional Budget Office has estimates of the contribution of taxes and transfers to the reduction in the Gini coefficient.[14] According to the CBO's 2011 study, (1) there was some decline in the degree to which taxes and transfers reduced the Gini from 1979 to 2007, but the system as a whole is still quite progressive, reducing the Gini by about 17 percent;[15] (2) both taxes and transfers contributed to the reduction, but transfers contributed more than taxes; and (3) after 1986, despite numerous changes in the tax rates, the contribution of taxes to decreasing inequality was essentially flat, while all the fluctuation was a result of changes in transfers.

These data suggest that the answer to solving the problem of increasing inequality is not more progressive income taxation. High rates of income taxation raise familiar problems, such as individuals engaging in tax avoidance, choosing leisure over labor, and potentially emigrating to low-tax jurisdictions.[16] Although the U.S. top individual tax rate is lower than that in some OECD countries, those countries typically have lower rates on capital income, which is highly concentrated at the top of the income distribution range. The comparison suggests that in a globalized world, the United States does not have a lot of capacity to raise the tax rate on the rich; certainly the 70 percent top marginal rate of 1980 or the 94 percent tax rate of the 1950s appear unlikely to return when the rich can easily move to other countries, give up their U.S. citizenship, and enjoy much lower rates.[17] Taxing unrealized income would not change those realities.

Overall, the U.S. tax and transfer system has a very significant impact on inequality: As the CBO data shows, it reduces the U.S. Gini by over 10 points, which is more than the difference between the pretax Gini of the United States and Sweden.

So if it is not the progressive tax system that does the work, what does? The answer must be the much-maligned "entitlements": Social Security, Medicare, and Medicaid. These programs are very progressive because even though only Medicaid is means-tested, their benefits are more important to lower-income individuals and their funding comes from progressive taxation of labor income (although in the case of Social Security, the funding could be made more progressive by eliminating the income cap).

Thus, one key to reducing inequality in the United States is to bolster the social safety net. In particular, Social Security should be strengthened because most baby boomers do not have nearly enough money saved for retirement (and many saw their savings decline after 2008). The Patient Protection and Affordable Care Act strengthened healthcare, but it will probably require more funding to support insurance for lower-income individuals if too few young, healthy people sign up for the exchanges.

Moreover, strengthening the social safety net is important for sustaining growth. Open economies tend to have stronger safety nets because the gains from having an open economy tend to impose risk on the people who lose from globalization. A strong safety net is a precondition to obtaining widespread political support for openness, which in turn produces growth.[18] Thus, if we want to avoid the pattern that led to the end of the first era of globalization a hundred years ago, we need to maintain a strong safety net lest the U.S. public votes for protectionism, decreased immigration, and less tolerance for the so-called creative destruction of technologically driven growth. Fundamentally, there is an inherent tension among democracy, globalization, and tax competition: If voters desire a robust safety net, they may vote for limits on globalization because that leads to tax competition and the need to cut tax rates, which in turn affects the social safety net. The only solution is to limit tax competition through increased cooperation, which underlies the current OECD

[14] CBO, "Trends in the Distribution of Household Income Between 1979 and 2007," Pub. No. 4031, at 20 (Oct. 2011).

[15] This decrease in the progressivity of the tax and transfer system was reversed more recently because of increases in transfers (*e.g.*, the Patient Protection and Affordable Care Act). *See* Coleman and Weisbach, *supra* note 9.

[16] *See* Avi-Yonah, "And Yet It Moves: Taxation and Labor Mobility in the Twenty-First Century," 67 *Tax L. Rev.* 169 (2014).

[17] The exit tax of section 877A does not change this outcome because the present value of the avoided income and estate tax is higher than the exit tax. *See* Avi-Yonah, "Reforming the Exit Tax," 49(4) *Int'l Tax J.* 37, 41 (2023).

[18] *See* Avi-Yonah, "Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State," 113(7) *Harv. L. Rev.* 1573 (2000).

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effort to establish minimum corporate taxes and combat individual tax evasion.[19]

How can the U.S. safety net be financially sustained in the long run? The answer cannot be more deficit financing, because this just means passing the buck to our children, which seems both unfair and risky. As the population ages, the ratio of the number of working-age adults to seniors (the dependency ratio) will decline in the United States as it already has elsewhere,[20] unless we are willing to accept much more immigration, which carries its own issues.[21]

Nor is raising the income tax rate the answer. There are not enough rich people to support the safety net, and as stated above, the rich can adjust to higher rates by avoiding taxes, working less, or moving.[22]

Another reason why the social safety net cannot be financed by increased taxes on labor (either through income or payroll taxes) is intergenerational equity. The benefits of Social Security and Medicare flow to the old, while income and payroll taxes are borne by the young. In addition to dependency ratio concerns, it seems unfair (and will certainly appear so to many young voters) to transfer so much wealth from the young to the old.

The solution is to enact a broad federal consumption tax: a VAT. This proposal has been developed in detail elsewhere.[23] For present purposes, a VAT has an important advantage: Unlike income and payroll taxes, consumption taxes do not discourage work, and because the old as well as the young consume, they are borne by everyone, including the principal beneficiaries of the social safety net.[24] VATs are used in over 150 countries and have a demonstrated capacity to raise revenue even in countries with far weaker tax administrations than the IRS.

But the VAT is regressive, and although there are ways to mitigate its regressivity, such as exempting basic living necessities, those exemptions subsidize well-off consumers and make the tax needlessly complicated. However, if VAT revenues are used to fund Social Security, Medicare, and Medicaid, the inherent progressivity of those programs mitigates the regressivity of the underlying tax.

Moreover, in addition to bolstering the safety net, a VAT can be used to fund opportunity programs for the next generation, like free universal pre-K, which will contribute directly to improving social mobility. The biggest obstacle to enhancing social mobility in the United States is that by the time children start formal schooling, many of them lag so far behind their peers that even good public schools cannot enable them to get into college, which is the essential gateway to the middle class in a technology-dominated economy.[25]

Ultimately, the challenge in enacting a VAT is political. Al Ullman, House Ways and Means Committee chair in the 1970s, supposedly lost his reelection campaign in 1980 after proposing one. But this story is a myth; Ullman lost his seat because of the Reagan landslide, not the VAT proposal. Effective politicians like John Howard, former prime minister of Australia, have managed to build a broad legislative coalition to enact a VAT even after promising not to do so, and to win reelection decisively.[26] A VAT serves the political right's need for fiscal balance and the left's need to expand social outlays, so it represents the ultimate grand bargain in American politics. It is a fair and sensible way to address the inequality that threatens our future. ■

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[19] *See* Avi-Yonah, "Globalization, Tax Competition and the Fiscal Crisis of the Welfare State: A Twentieth Anniversary Retrospective" in *Thinker, Teacher, Traveler: Reimagining International Tax, Essays in Honor of H. David Rosenbloom* 39 (2021).

[20] *See, e.g.*, Luke Rogers and Kristie Wilder, "Shift in Working-Age Population Relative to Older and Younger Americans," U.S. Census Bureau (June 25, 2020).

[21] *See, e.g.*, Paul Collier, *Exodus: How Migration Is Changing the World* (2013). The main issues are pressure on wages and resistance to rapidly changing demographics.

[22] *See, e.g.*, Elizabeth Warren and Amelia Warren Tyagi, *The Two-Income Trap: Why Middle-Class Parents Are Going Broke* (2016).

[23] Avi-Yonah, "Designing a Federal VAT: Summary and Recommendations," 63 *Tax L. Rev.* 285 (2010).

[24] Economists view the VAT as a tax on labor income because it excludes savings, but most taxpayers would not reduce their work effort because they believe it is a tax on consumption, not labor.

[25] *See* Shera S. Avi-Yonah and Avi-Yonah, "Leveling the Playing Field: The Case for an Education VAT," *Tax Notes*, Sept. 28, 2015, p. 1529.

[26] *See* Kathryn James, "We of the 'Never Ever': The History of the Introduction of a Goods and Services Tax in Australia," 2007(3) *Brit. Tax Rev.* 320 (2007).

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