Bar the Exit (Tax)!
Section 877A, the Constitutional Prohibition Against Unapportioned Direct Taxes and the Realization Requirement

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I. Introduction

Tax practitioners wade into the deep waters of constitutional law at our peril. Indeed, a leading constitutional scholar, Professor Bruce Ackerman of Yale, has characterized even the efforts of respected tax *professors* along these lines as "not generally backed by an elaborate analysis of the constitutional issues," suggesting that their "impoverished analysis" is a matter of "benign neglect" that is "par for the course for modern tax lawyers."[1] With this in mind, the prospect of mounting—or even articulating—a constitutional challenge to Congress's recent imposition of an exit tax on deemed asset sales by expatriates and certain long-term green card holders under section 877A[2] on the basis that it is an unapportioned direct tax imposed on something that is not "incomes" within the meaning of the Sixteenth Amendment seems daunting. This is particularly so given Professor Ackerman's eloquent and spirited—albeit zealously partisan[3]—argument that the changes in the legal landscape wrought by the Thirteenth through Sixteenth Amendments and the Supreme Court's later embrace of the New Deal effectively nullified the prior constitutional prohibition against unapportioned taxes on

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[1] Bruce Ackerman, *Taxation and the Constitution*, 99 Colum. L. Rev. 1, 52 (1999) (citing as examples, books by Professors Marvin Chirelstein, Michael Graetz, and Deborah Schenk).

[2] Unless otherwise indicated, all "section" references herein are to the Internal Revenue Code of 1986, as amended, or a predecessor statute. Section 877A was enacted as part of the Heroes Earnings Assistance and Relief Tax Act of 2008, Pub. L. 110-245, §301(a), 122 Stat. 1624, 1638–46.

[3] *See, e.g.*, Ackerman, *supra* note 1, at 6 (stating that Professor Ackerman is "happy to be numbered" among "liberal Democrats," and making it clear that he is deploying his constitutional analysis in this instance in the service of the "rising issue on the liberal agenda" of attacking the "wealth gap that is dividing our society" by imposing "a tax on net wealth that ranges up to three percent a year").

wealth.[4] Nonetheless, a careful review of the relevant provisions of the Constitution and the Supreme Court's decisions interpreting and applying them indicates that there is a compelling argument that the exit tax on deemed sales under section 877A (1) is a "direct tax" within the meaning of Article I, Sections 2 and 9 of the Constitution; (2) is not a tax on "incomes" within the meaning of the Sixteenth Amendment to the Constitution; and (3) therefore, because it is unquestionably not apportioned among the 50 states—that is, the tax is not borne by the citizens of each state in proportion to the states' respective populations—is unconstitutional.[5]

II. First Principles—The Relevant Constitutional Provisions

The Constitution grants to the Congress the "Power To lay and collect Taxes, Duties, Imposts and Excises."[6] While this power is, in a sense, the foundation of all of the other powers delegated to the federal government under the Constitution, it is not an unlimited power. For example,[7] Article I, Section 9 of the Constitution provides that "No Capitation, *or other direct*, *Tax* shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken."[8] Similarly, Article I, Section 2 of the Constitution provides that:

> Representatives and *direct Taxes* shall be apportioned among the several States which may be included within this Union, according to their respective Numbers, which shall be determined by adding to the whole Number

[4] The separate constitutional objections to the exit tax—that it violates the Due Process and Equal Protection Clauses of the Fifth Amendment and that it inappropriately burdens the right of a U.S. citizen to leave the United States—are beyond the scope of this discussion. For a discussion of these issues, see Staff of J. Comm. on Tax'n, 104th Cong., Issues Presented by Proposals to Modify the Tax Treatment of Expatriation, at 82–100 (Comm. Print 1995) [hereinafter 1995 Joint Committee Report]. A discussion of the *wisdom* of Section 877A as a policy matter is also beyond the scope of this article.

[5] It should be noted that this discussion is limited to the constitutionality of the provisions of section 877A that deem there to be a taxable sale of the assets of certain individuals relinquishing their citizenship or green cards. The constitutional infirmity discussed herein may well not apply to, for example, the special rules under section 877A for trust interests and deferred compensation arrangements of such an individual. For a discussion of the constitutional prohibition against unapportioned direct taxes in a different context—namely, the tax–penalty provisions of the 2010 health care legislation—see Steven J. Willis & Nakku Chung, *Constitutional Decapitation and Healthcare*, 128 Tax Notes (TA) 169 (July 12, 2010).

[6] U.S. Const. art. I, § 8, cl. 1.

[7] Other constitutional limitations on the taxing power, such as the requirements that "all Duties, Imposts and Excises shall be uniform throughout the United States" and that "[a]ll Bills for raising Revenue shall originate in the House of Representatives" are beyond the scope of this discussion. U.S. Const. art. I, § 7, cl. 1; U.S. Const. art. I, § 8, cl. 1.

[8] U.S. Const. art. I, § 9, cl. 4 (emphasis added), *amended by* U.S. Const. amend. XVI (excluding taxes on "income" from the apportionment requirement). The Constitution prohibited any amendment of this provision prior to the year 1808. U.S. Const. art. V.

> of free Persons, including those bound to Service for a Term of Years, and excluding Indians not taxed, three fifths of all other Persons.[9]

For purposes of these provisions, apportionment of a tax means setting the rate and other features of the tax such that the amount of revenue raised by the tax collected from each state is in proportion to its population. For example, if the population of New Jersey makes up three percent of the total population of the United States, an apportioned tax would yield three percent of its revenues from collections in New Jersey.[10] In all but the simplest case of a flat-rate per capita tax, apportionment of a tax would require setting different tax rates in different states, which—in addition to being administratively cumbersome—would presumably be politically impossible. For example, an apportioned income tax would require a high tax rate in states having relatively low per-capita income and lower tax rates in states having relatively high per-capita income.[11]

The Sixteenth Amendment, ratified in 1913, provides the following significant exception to the above-noted prohibition on the imposition of unapportioned direct taxes:

> The Congress shall have the power to lay and collect *taxes on incomes, from whatever source derived*, without apportionment among the several States, and without regard to any census or enumeration.[12]

To summarize, at the time of the founding, the Constitution prohibited the imposition of any direct tax unless such tax were apportioned among the states, such that the burden of the tax fell on the states in proportion to their respective populations. Since 1913, when the Sixteenth Amendment was ratified, taxes on incomes have not required apportionment even if and to the extent they are direct taxes. Thus, based on the text of the Constitution, the analysis in determining whether an unapportioned tax is constitutional is as follows:

1. If the tax is not a direct tax, no apportionment is necessary.
2. If the tax is a direct tax, and if it is a tax on incomes, no apportionment is necessary.

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[9] U.S. Const. art. I, § 2, cl. 3 (emphasis added), *amended by* U.S. Const. amend. XIV (deleting the three-fifths provision) and XVI (excluding taxes on "incomes" from the apportionment requirement).

[10] *See, e.g.*, 1 Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates and Gifts ¶ 1.2.2 (3d ed. 1999); Calvin H. Johnson, *Fixing the Constitutional Absurdity of the Apportionment of Direct Tax*, 21 Const. Comment. 295, 296 (2005).

[11] *See, e.g.*, Johnson, *supra* note 10, at 296 ("Apportionment of tax among the states by population turns out to be an absurd requirement, almost always impossible or else so perverse in effect that no democracy, indeed no rational government, could adopt it. Apportionment by population preys upon poor states, requiring tax rates to be highest where the tax base is thinnest.").

[12] U.S. Const. amend. XVI (emphasis added).

3. If the tax is a direct tax and is not a tax on incomes, it is unconstitutional absent apportionment.

The foregoing makes it clear that the key to the constitutional analysis is to define the terms "direct Taxes" as used in Article I, Sections 2 and 9, and "incomes" as used in the Sixteenth Amendment.[13]

III. Defining the Constitutional Terms

A. *Direct vs. Indirect Taxes*

Discussions of the meaning of the constitutional term "direct Taxes" tend to begin somewhat mysteriously, with the following passage from the records of the debates at the Constitutional Convention in 1787: "Mr [Rufus] King [of Massachusetts] asked what was the precise meaning of direct taxation? No one answd."[14] From the text of the Constitution, which explicitly proscribes an unapportioned "Capitation, or other direct, Tax,"[15] two things are clear: capitations—head taxes—are considered direct taxes and therefore are permissible only if apportioned, and there exist "other direct" taxes that are not capitations.[16]

The debates at the Constitutional Convention illuminate the category by distinguishing direct taxes from indirect taxes. When the concept of direct taxation found its way into the Constitution during the debates, as part of the "three-fifths" compromise involving the counting of slaves for purposes of representation in the House of Representatives and taxation, the drafter, Gouverneur Morris of Pennsylvania, noted that the apportionment require-

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[13] *But see* Calvin H. Johnson, *Apportionment of Direct Taxes: The Foul-Up in the Core of the Constitution*, 7 Wm. & Mary Bill Rts. J. 1, 80 (1998) (arguing for a "functional definition of 'direct tax'" as an alternative to having "judges pull their jurisprudence from a dictionary").

[14] The Records of the Federal Convention of 1787, at 350 (Max Farrand ed., rev. ed. 1966) (1787) [hereinafter Debates], *quoted in*, *e.g.*, Ackerman, *supra* note 1, at 11; Erik M. Jensen, *The Apportionment of "Direct Taxes": Are Consumption Taxes Constitutional?*, 97 Colum. L. Rev. 2334, 2377 (1997); Bittker & Lokken, *supra* note 10, ¶ 1.2.2; and Pollock v. Farmers' Loan & Trust Co. (*Pollock II*), 158 U.S. 601, 640 (1895) (Harlan, J., dissenting).

[15] U.S. Const. art. I, § 9, cl. 4.

[16] For an argument that "capitations" may have been intended to include both head taxes imposed in a uniform per-person amount—for which taxes an apportionment requirement would have been superfluous—and head taxes imposed in amounts that vary from taxpayer to taxpayer, see Jensen, *supra* note 14, at 2392–93 (citing Adam Smith, The Wealth of Nations 818–21 (Edward Cannan ed., Random House 1937) (1776)). For a countertextual argument that the direct tax clauses should be construed to apply, if at all, only to capitations, see Ackerman, *supra* note 1, at 51 ("[I]t would be entirely wrong to expand the direct tax provisions beyond this textually enshrined example [capitations] in obedience to a deal with slavery that America has otherwise abrogated."). For an argument, acknowledged by its author to be "ahistorical[]," that the only direct taxes are "head taxes and requisitions from the several states," *see* Johnson, *supra* note 13, at 70. Professor Johnson elsewhere acknowledges, however, that "[l]and taxes . . . would have been considered direct taxes by all speakers at the time of the [framing of the] Constitution." Calvin H. Johnson, *The Constitutional Meaning of "Apportionment of Direct Taxes,"* 80 Tax Notes (TA) 591, 600 (Aug. 3, 1998).

ment would be inapplicable to "indirect taxes, on exports & imports & on consumption."[17] There is evidence that the Founders understood indirect taxes to be those that can be passed on to the consumer as part of the price of articles of consumption, such as customs duties, excise taxes, and what we would now call sales taxes, and that they deemed it unnecessary to limit Congress's power to impose indirect taxes by the apportionment requirement because the market would provide adequate protection against intolerable levels of indirect taxation.[18] Direct taxes, by contrast, were thought to include head taxes and real property taxes, which were imposed directly on an individual and could not be passed on to another. In the absence of a market-based check on abusive impositions of direct taxes, the apportionment requirement provided a constitutional check on intolerable levels of direct taxation by making the imposition of such taxes cumbersome.[19]

As indicated by the silence of the delegates in response to Rufus King's question, however, the precise contours of the category of direct taxes were unclear. Very early on, the Supreme Court had occasion to interpret the direct tax clause in *Hylton v. United States*.[20] *Hylton* involved a federal tax on carriages "kept by or for any person, for his or her own use, or to be let out to hire, or for the conveying of passengers."[21] The four Justices participating in the case unanimously upheld the tax, and in their seriatim opinions, the three Justices who wrote opinions expressed considerable hostility to the apportionment rule and made little attempt to discern the meaning of "direct Taxes" independently of the apportionment requirement.

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[17] Debates, *supra* note 14, at 591–92.

[18] *See* Jensen, *supra* note 14, at 2393–96 (citing The Federalist No. 36, at 219 (Alexander Hamilton) (Clinton Rossiter ed., 1961); The Federalist No. 21, at 142 (Alexander Hamilton) (Clinton Rossiter ed., 1961); The Federalist No. 12, at 93 (Alexander Hamilton) (Clinton Rossiter ed., 1961)); *see also* Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429, 558 (1895); Joseph Story, Commentaries on the Constitution of the United States 472–73 (1833). The Constitution imposes a uniformity requirement, rather than an apportionment requirement, on indirect taxes. U.S. Const. art. I, § 8, cl. 1.

[19] *See* Jensen, *supra* note 14, at 2389–402 (citing The Federalist No. 36, at 219, 223 (Alexander Hamilton) (Clinton Rossiter ed., 1961)); Story, *supra* note 18, at 472–73; Debates, *supra* note 14, at 592. *But see* Johnson, *supra* note 13, at 69 (citing statements by Madison and Hamilton indicating that certain taxes the incidence of which could be shifted to consumers were considered direct taxes).

[20] Hylton v. United States, 3 U.S. 171, 172 (1796).

[21] Act of June 5, 1794, ch. 45 § 1, 1 Stat. 373, 374 (repealed 1802), *quoted in* Jensen, *supra* note 14, at 2351. Professor Jensen argues that the Supreme Court had no jurisdiction to hear the *Hylton* case, since the plaintiff claimed to have more carriages than existed at that time in all of Virginia in order to appear to meet the then-applicable threshold jurisdictional amount. Jensen, *supra* note 14, at 2351–52 (citing William R. Casto, The Supreme Court in the Early Republic: The Chief Justiceships of John Jay and Oliver Ellsworth 102 (1995); Edward B. Whitney, *The Income Tax and the Constitution*, 20 Harv. L. Rev. 280, 283 n.1 (1907)); *see also* Ackerman, *supra* note 1, at 20 (describing *Hylton* as a case with respect to which Thomas Jefferson and James Madison supported "a Republican effort to rig up a lawsuit that might allow the Court to strike down Hamilton's sinister financial scheme").

Justice William Paterson was explicit about this: "The rule of apportionment . . . is radically wrong; it cannot be supported by any solid reasoning. Why would slaves, who are a species of property, be represented more than any other property? The rule, therefore, ought not to be extended by construction."[22] Justices Samuel Chase and James Iredell each took the view that a tax should not be considered a direct tax and, therefore, should not be subject to apportionment, unless apportionment can "reasonably apply" to such tax.[23] Justice Chase went on to posit a case where two states have equal populations but in one state there are 100 carriages and in the other there are 1,000.[24] He concluded that if a national carriage tax were treated as a direct tax and required to be apportioned, the two states with equal populations would bear the same amount of tax only if the rate of tax in the state with 100 carriages were ten times the tax rate in the state having 1,000 carriages.[25] Apparently, this result was considered so outrageous as to require the circular conclusion that the carriage tax could not be considered a direct tax because it could not be reasonably apportioned.[26] Since, however, it is the very nature of apportionment to require different rates of tax in states having unequal populations or incidents of taxation—for example, carriages or aggregate income, as the case may be[27]—the effect of Justice Chase's analysis is to nullify the constitutional apportionment requirement in all but the simplest case of a head tax imposed at a flat, per-person rate—in effect limiting the application

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[22] *Hylton*, 3 U.S. at 178 (opinion of Paterson, J.).

[23] *Id.* at 174 (opinion of Chase, J.); *id.* at 181 (opinion of Iredell, J.).

[24] *Id.* at 174 (opinion of Chase, J.).

[25] *Id.*

[26] *See also* Johnson, *supra* note 10, at 297 (arguing that to the Founders, the term "direct taxes" was a synonym for "apportioned tax," such that the "best understanding" of the direct tax provisions in the Constitution is that should Congress choose to apportion a tax, slaves must be included in the apportionment calculation and counted at three-fifths). As discussed below, it is extremely difficult to square this view with the explicit prohibition in the Constitution against unapportioned direct taxes. While Professor Johnson might prefer an "obliterating construction" of the direct tax clauses that creates a null set—that is, causes there to be no taxes to which the apportionment requirement applies apart, perhaps, from a flat-rate head tax which is by definition always apportioned, *see* Johnson, *supra* note 13, at 71, 80, 82—it is axiomatic that interpretations of the Constitution that give no meaning to entire provisions are, to say the least, disfavored.

[27] Indeed, "Congress did impose a number of direct taxes on real estate (lands, improvements, dwelling houses, and slaves) in the country's early years," and took pains to ensure that such taxes met the constitutional apportionment requirement. *See* Jensen, *supra* note 14, at 2355, 2355 nn.110–11.

of the apportionment rule to situations in which it is not much of a limitation.[28]

In dicta, Justice Chase went on to suggest, without citing any evidence that the Framers shared this view, that the "only two" direct taxes "contemplated by the Constitution, are . . . a capitation, or poll tax, simply, without regard to property, profession, or any other circumstance; and a tax on land."[29] Justice Iredell stated that "there may possibly be considerable doubt" regarding this proposition, and Justice Paterson acknowledged that these two taxes are the principal taxes "that the framers of the Constitution contemplated as falling within the rule of apportionment," but would not go so far as to say that they are the only direct taxes.[30] For nearly 100 years following *Hylton*, the Court continued down this path, finding that, at least as a matter of Congressional practice, the only direct taxes were capitations and taxes on real property.[31]

All of this changed in 1895 with the Supreme Court's two decisions in *Pollock v. Farmers' Loan & Trust Co*.[32] At issue in *Pollock* was whether an unapportioned income tax that had been enacted in 1894 was an unconstitutional direct tax. The tax was imposed on individuals having total income—including income from rents, interest, dividends, and wages—in excess of $4,000, and thus the tax applied to an extremely small percentage of the population.[33] In *Pollock I*, the Court examined the debates at the Constitutional Convention as well as congressional debates thereafter, and concluded, in an opinion by Chief Justice Melville Fuller, as follows regarding the distinction between direct and indirect taxes:

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[28] *See id*. at 2356; *see also* Murphy v. Internal Revenue Service, 493 F.3d 170, 184 (D.C. Cir. 2007) (rejecting the government's "position that direct taxes are only those capable of satisfying the constraint of apportionment" on the ground that "such a constraint is no constraint at all," and rejecting the position that direct taxes are only those "capable of apportionment in a manner that does not unfairly tax some individuals more than others" on the grounds that even a land tax would fail such a test), *cert. denied*, 553 U.S. 1004 (2008); *cf.* Johnson, *supra* note 13, at 70–71 (arguing that applying the apportionment requirement even to a land tax would be absurd and contrary to the intent of the Framers).

[29] *Hylton*, 3 U.S. at 175 (opinion of Chase, J.). Presumably, by "simply," Justice Chase meant to limit the first category to flat per-person head taxes, as distinguished from head taxes that vary in amount depending on landholdings or income. Justice Chase made it explicit that this language was dicta by stating that he was not giving a judicial opinion on this point.

[30] *Id*. at 183 (opinion of Iredell, J.); *id*. at 177 (opinion of Paterson, J.).

[31] *See, e.g.*, Springer v. United States, 102 U.S. 586, 602 (1881) (upholding an unapportioned tax on earned income); Veazie Bank v. Fenno, 75 U.S. 533, 549 (1869) (upholding an unapportioned tax on state bank notes). *But cf.* Scholey v. Rew, 90 U.S. 331, 347 (1875) (the question of whether there are any direct taxes other than capitations and land taxes is "not absolutely decided"). Direct taxes on slaves were considered as falling into the category of direct taxes, as slaves were generally thought of as real property for tax purposes. *See* Jensen, *supra* note 14, at 2364, 2364 n.159.

[32] Pollock v. Farmers' Loan & Trust Co. (*Pollock I*), 157 U.S. 429 (1895); *Pollock II*, 158 U.S. 601 (1895).

[33] *See* Jensen, *supra* note 14, at 2342–43, 2366–67 (citing sources indicating that the tax might have affected one or two percent of the population).

> Ordinarily all taxes paid primarily by persons who can shift the burden upon some one else, or who are under no legal compulsion to pay them, are considered indirect taxes; but a tax upon property holders in respect of their estates, whether real or personal, or of the income yielded by such estates, and the payment of which cannot be avoided, are direct taxes.[34]

By a 6–2 vote, the Court held that the tax as applied to income from real estate was an unconstitutional direct tax, but the Court was divided 4–4 regarding whether the tax was unconstitutional either as applied to income from personal property or in its entirety.

The Court reheard the case later the same year to resolve the remaining constitutional issues. In *Pollock II*, the Court, in a 5–4 decision, ruled that a tax on income from personal property was also a direct tax, and the Court struck down the tax, including the provisions that taxed earned income.[35] In the words of the Court: "[W]e are unable to conclude that the enforced subtraction from the yield of all the owner's real or personal property . . . is so different from a tax upon the property itself, that it is not a direct, but an indirect tax, in the meaning of the Constitution."[36] The dissenting Justices variously described the majority opinion in *Pollock II* as a "disaster to the country,"[37] a "disastrous blow . . . at the constitutional power of Congress,"[38] and "a surrender of the taxing power to the moneyed class."[39] Be that as it may, and however misguided—and short-lived—the Court's determination that a tax on income from property is the constitutional equivalent of a tax on the property itself, the *Pollock* cases continue to stand for the more general proposition that the constitutional restriction on unapportioned direct taxes, which the Court had previously rendered all but a dead letter, has continuing vitality.

After *Pollock*, the Court had occasion to clarify further the meaning of "direct tax." In *Knowlton v. Moore*, the Court determined that an unapportioned inheritance tax imposed in 1898 was a tax on transfers of property at death rather than on the property itself and, therefore, was a valid indirect tax.[40] In so holding, the Court stated no fewer than three times that a tax

[34] *Pollock I*, 157 U.S. at 558.
[35] *Pollock II*, 158 U.S. at 618.
[36] *Id.*
[37] *Id.* at 684 (Harlan, J., dissenting).
[38] *Id.* at 706 (Jackson, J., dissenting).
[39] *Id.* at 695 (Brown, J., dissenting).
[40] 178 U.S. 41, 81–83 (1900).

"imposed upon property solely by reason of its ownership" is a direct tax.[41]

Likewise, in *Bromley v. McCaughn*,[42] the Court found an unapportioned gift tax to be an indirect tax. Significant to this discussion, the Court articulated the distinction between direct and indirect taxes as follows:

> Whatever may be the precise line which sets off direct taxes from others, we need not now determine. While *taxes levied upon or collected from persons because of their general ownership of property may be taken to be direct*, this Court has consistently held, almost from the foundation of the government, that a tax imposed upon a particular use of property or the exercise of a single power over property incidental to ownership, is an excise which need not be apportioned, and it is enough for present purposes that this tax is of the latter class.
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> It is a tax laid only upon the exercise of a single one of those powers incident to ownership, the power to give the property owned to another. Under this statute all the other rights and powers which collectively constitute property or ownership may be fully enjoyed free of the tax. So far as the constitutional power to tax is concerned, it would be difficult to state any intelligible distinction, founded either in reason or upon practical considerations of weight, between a tax upon the exercise of the power to give property *inter vivos* and [the following taxes that the Court had previously found to be indirect taxes: a tax upon] disposition of [property] by legacy,[43] . . . the succession tax[44] . . . , the tax upon the manufacture and sale of colored oleomargarine[45] . . . , the tax upon sales of grain upon an exchange[46] . . . , the tax upon sales of shares of stock[47] . . . , the tax upon the use of foreign built yachts[48] . . . , [and] the tax upon the use of carriages[49] . . . .
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> It is true that in each of these cases the tax was imposed upon the exercise of one of the numerous rights of property, *but each is clearly distinguishable from a tax which falls upon the owner merely because he is owner, regardless of the use or disposition made of his property*. The persistence of this distinction and the justification for it rest upon the historic fact that taxes of this type were not understood to be direct taxes when the Constitution was adopted

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[41] *Id*. The Court in *Knowlton* also noted that the *Pollock* decisions clarified that a tax is a direct tax if it is imposed solely by reason of ownership of personal property as well as real property. *Id*. at 82; *see also* Eisner v. Macomber, 252 U.S. 189, 217 (1920) ("[T]hat . . . taxation of property because of ownership . . . would require apportionment under the provisions of the Constitution, is settled beyond peradventure by previous decisions of this court."); Brushaber v. Union Pac. R.R., 240 U.S. 1, 19 (1916) (the Sixteenth Amendment "at least impliedly" imports into the Constitution the holding in *Pollock* that taxes levied on personal property "because of its ownership" are direct taxes).

[42] 280 U.S. 124, 136–38 (1929).

[43] *Id.* (citing Knowlton v. Moore, 178 U.S. 41 (1900)).

[44] *Id.* (citing Scholey v Rew, 90 U.S. 331 (1875)).

[45] *Id.* (citing McCray v. United States, 195 U.S. 27 (1904)).

[46] *Id.* (citing Nicol v. Ames, 173 U.S. 509 (1899)).

[47] *Id.* (citing Thomas v. United States, 192 U.S. 363 (1904)).

[48] *Id.* (citing Billings v. United States, 232 U.S. 261 (1914)).

[49] *Id.* (citing Hylton v. United States, 3 U.S. 171 (1796)).

> and, as well, upon the reluctance of this Court to enlarge by construction, limitations upon the sovereign power of taxation by Article I, § 8, so vital to the maintenance of the National Government.
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> It is said that since property is the sum of all the rights and powers incident to ownership, if an unapportioned tax on the exercise of any of them is upheld, the distinction between direct and other classes of taxes may be wiped out, since the property itself may likewise be taxed by resort to the expedient of levying numerous taxes upon its uses; that *one of the uses of property is to keep it, and that a tax upon the possession or keeping of property is no different from a tax on the property itself. Even if we assume that a tax levied upon all the uses to which property may be put, or upon the exercise of a single power indispensable to the enjoyment of all others over it, would be in effect a tax upon property, and hence a direct tax requiring apportionment, that is not the case before us.*
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> The power to give cannot be said to be a more important incident of property than the power to use, . . . and even though differences in degree may be carried to a point where they produce distinctions in kind, *the present levy falls so far short of taxing generally the uses of property that it cannot be likened to the taxes on property itself which have been recognized as direct*. It falls, rather, into that category of imposts or excises which, since they apply only to a limited exercise of property rights, have been deemed to be indirect and so valid although not apportioned.[50]

The holding in the *Pollock* cases that income taxes are invalid unless apportioned was, of course, overruled by constitutional amendment in 1913.[51] Significantly, however, the Sixteenth Amendment—which is discussed in some detail below—while eliminating the apportionment requirement in the case of "taxes on incomes, from whatever source derived," did not repeal the apportionment requirement for direct taxes generally.[52] Indeed, Congress rejected explicit attempts during the ratification process to do so.[53] Soon after the ratification of the Sixteenth Amendment, the Supreme Court cast serious doubt on the conclusion in *Pollock* that taxes on income from property are direct taxes,[54] absent which the Sixteenth Amendment would have been largely unnecessary. Nonetheless, the Court has left standing the prohibition

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[50] *Id*. at 136–38 (emphasis added) (citations omitted).

[51] U.S. Const. amend. XVI.

[52] *See* Ackerman, *supra* note 1, at 38 ("To be sure, the [Sixteenth] [A]mendment still did not go all the way to the complete repeal of the 'direct tax' clauses . . . .").

[53] For a detailed account of the ratification process in Congress, including the failed attempts by the Progressive faction in Congress to pass a constitutional amendment that would have repealed the direct tax clauses outright, see *id.* at 33–38.

[54] *See* Brushaber v. Union Pac. R.R., 240 U.S. 1 (1916); Stanton v. Baltic Mining Co., 240 U.S. 103 (1916).

against unapportioned direct taxes.[55]

Professor Calvin H. Johnson of the University of Texas, echoing the views expressed by Justice Chase in *Hylton*, has argued in several articles[56] that the constitutional prohibition against unapportioned direct taxes should be construed so as never to apply to a tax the apportionment of which would—at least in Professor Johnson's view—be unreasonable or inconvenient or lead to absurd or perverse results. Since, in Professor Johnson's view, apportionment is always unreasonable, inconvenient, absurd, and perverse, his construction of the prohibition, which he styles an "obliterating construction," would in effect repeal it.[57] Like Professor Ackerman, Professor Johnson employs this analysis in the context of an argument in favor of a federal wealth tax.[58] Professor Johnson reaches this conclusion on a number of bases, the most significant of which are the absurdity and unworkability of an apportionment requirement as a policy and political matter, skepticism that the Framers understood the mechanics of apportionment and could have intended to require it, passages in the constitutional debates suggesting that some of the participants used the term "direct tax" to mean only a tax that is in fact apportioned, and the absence of evidence in the debates that the Framers viewed the apportionment requirement as actually preventing the imposition of any federal tax.[59]

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[55] Eisner v. Macomber, 252 U.S. 189, 206 (1920) (confirming that the Sixteenth Amendment did not repeal the direct tax clauses except as to income taxes); Ackerman, *supra* note 1, at 56–58 (conceding that *Pollock* as well as *Macomber* would have to be overruled in order for an unapportioned federal wealth tax to pass constitutional muster); Johnson, *supra* note 10, at 351 ("*Pollock* was not technically overruled by the Sixteenth Amendment, which merely authorized an income tax."); *see also* Bittker & Lokken, *supra* note 10, ¶ 1.2.3 ("[A]ny direct tax that is not imposed on 'income' remains subject to the rule of apportionment."); *cf.* South Carolina v. Baker, 485 U.S. 505 (1988) (overruling *Pollock I*, but only insofar as it held that a tax on state bond interest is unconstitutional).

Resisting a literal reading of the Constitution, Professor Ackerman argues that the direct tax clauses should be limited to capitation taxes. *See supra* note 16. He bases this argument on an "intergenerational synthesis" of the Fourteenth Amendment's repeal of the three-fifths compromise in 1868 with the direct tax provisions of 1787, which he maintains is similar to the "incorporation" of provisions of the Bill of Rights against the states via the Fourteenth Amendment, and treatment of the Sixteenth Amendment as a "'transformative amendment' requiring a reshaping of vast areas of our constitutional law in light of grand new principles." Ackerman, *supra* note 1, at 31–32, 39, 51–56. Regarding Professor Johnson's somewhat similar resistance to a literal reading of the Constitution, see *infra* text accompanying notes 56–61.

[56] *See* Johnson, *supra* note 10; Calvin H. Johnson, *Purging Out* Pollack*: The Constitutionality of Federal Wealth or Sales Taxes*, 97 Tax Notes (TA) 1723 (Dec. 30, 2002); Johnson, *supra* notes 13, 16.

[57] Johnson, *supra* note 13, at 82 (arguing that "the apportionment requirement should be construed so tightly as to amount almost to repeal").

[58] *See* sources cited *supra* note 56.

[59] *See, e.g.*, Johnson, *supra* note 10, at 309–17, 322–30; Johnson, *supra* note 13, at 5–24, 46–71.

A full discussion of Professor Johnson's numerous arguments and the many passages he cites from the constitutional debates is beyond the scope of this discussion. Nonetheless, it is worth noting that notwithstanding the politically untenable results that apportionment would reach in many cases and the statements that Professor Johnson culls from the constitutional debates to support his arguments, the fact remains that the Constitution explicitly provides that "[n]o . . . direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken."[60] To be sure, as Professor Johnson points out, the motivating force behind the Constitution was the inadequacy of the prior Articles of Confederation in terms of permitting the government to raise revenues, and giving Congress the power to impose direct taxes as well as import duties was one of the main achievements of the constitutional delegates.[61] But that is not to say that "[a] serious restraint on tax in that context would have been unthinkable" to the Framers,[62] and in any event these observations do not justify our ignoring the explicit and crystal clear language by which the Constitution flatly prohibits unapportioned direct taxes. Indeed, even if the constitutional debates and ratification battles in the states were replete with statements by delegates, Federalists, and Anti-Federalists to the effect that apportionment was not meant to be a restriction on the federal taxing power, the express language to the contrary in the Constitution as ratified should be considered a strong indication that those arguments were ultimately rejected.[63]

B. *"Taxes on Incomes"—The Constitutional Realization Principle*

As noted, while the Sixteenth Amendment did not repeal the prohibition on unapportioned direct taxes generally, it does permit unapportioned "taxes on incomes, from whatever source derived." Thus, for an unapportioned direct tax to pass constitutional muster, it must be imposed on "incomes." Not long after the Sixteenth Amendment was ratified, the Supreme Court had occasion to determine the meaning of "incomes" as such term is used in the Sixteenth Amendment, in *Eisner v. Macomber*.[64] In that case, the Court addressed the constitutionality of a tax on the value of a stock dividend. A taxpayer who received a pro-rata, common-on-common stock dividend challenged the constitutionality of the tax, claiming that the pro-rata dividend was not income within the meaning of the Sixteenth Amendment.

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[60] U.S. Const. art. I, § 9, cl. 4.

[61] Johnson, *supra* note 13, at 21–23.

[62] Johnson, *supra* note 10, at 298. Indeed, as noted, the Framers included several serious restraints on tax in the Constitution. *See supra* note 7.

[63] As to Professor Johnson's argument that the Framers could not have intended to impose a restriction on governmental power that necessarily leads to politically untenable results in many cases, it should be noted that the same could be said of many of the restrictions on governmental power found in the Bill of Rights, which were of course *designed* to lead to politically untenable results by prohibiting Congress from taking certain politically popular actions.

[64] 252 U.S. 189 (1920).

Squarely addressing the constitutional issue of the meaning of income as such term is used in the Sixteenth Amendment, the Court held as follows:

> For the present purpose we require only a clear definition of the term "income," as used in common speech, in order to determine its meaning in the [Sixteenth] Amendment; and, having formed also a correct judgment as to the nature of a stock dividend, we shall find it easy to decide the matter at issue.
>
> After examining dictionaries in common use, we find little to add to the succinct definition adopted in two cases arising under the Corporation Tax Act of 1909. "Income may be defined as the gain derived from capital, from labor, or from both combined," provided it be understood to include profit gained through a sale or conversion of capital assets . . . .
>
> Brief as it is, it indicates the characteristic and distinguishing attribute of income essential for a correct solution to the present controversy. The Government, although basing its argument upon the definition as quoted, placed chief emphasis upon the word "gain," which was extended to include a variety of meanings; while the significance of the next three words was either overlooked or misconceived. *"Derived—from—capital"; "the gain—derived—from—capital,"* etc. Here we have the essential matter: *not* a gain *accruing to* capital, not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital however invested or employed, and *coming in,* being "*derived*," that is, *received* or *drawn* by the recipient (the taxpayer) for his *separate* use, benefit and disposal;—*that* is income derived from property. Nothing else answers the description.
>
> The same fundamental conception is clearly set forth in the Sixteenth Amendment—"incomes, *from* whatever *source derived*"—the essential thought being expressed with a conciseness and lucidity in harmony with the form and style of the Constitution.[65]

Having thus held that there can be income derived from property within the meaning of the Sixteenth Amendment only if there is a severance from the capital rather than a mere growth or increment of value, the Court went on to hold that a pro-rata, common-on-common stock dividend is not sufficient, in language that made even clearer what has come to be known as the realization principle:

> We are clear that not only does a stock dividend really take nothing from the property of the corporation and add nothing to that of the shareholder, but that the antecedent accumulation of profits evidenced thereby, while indicating that the shareholder is the richer because of an increase of his capital, at the same time shows *he has not realized or received a* [*sic*] *income in the transaction.*

[65] *Id*. at 206–08 (emphasis in original) (citations omitted).

> It is said that a stockholder may sell the new shares acquired in the stock dividend; and so he may, if he can find a buyer. It is equally true that *if he does sell*, and in doing so *realizes a profit*, such profit, like any other, is income, and so far as it may have arisen since the Sixteenth Amendment if [*sic*] taxable by Congress without apportionment.[66]

Thus, the Court in *Macomber* held in clear terms that in the context of "gain derived from capital," "incomes" within the meaning of the Sixteenth Amendment requires an event of realization or severance from the capital, and unrealized appreciation in value is not sufficient. In the years since that case was decided, it has become the conventional wisdom that the realization principle has been "badly eroded, if not wholly undermined, as a constitutional principle."[67] Several cases are generally cited in support of this conventional wisdom, but a close examination of these cases suggests that they do not support the principle for which they are cited.

[66] *Id.* at 212 (emphasis added). For a more recent—and rare—example of a judicial determination that an amount received by a taxpayer does not constitute "incomes" within the meaning of the Sixteenth Amendment, see *Murphy v. Internal Revenue Service*, 460 F.3d 79 (D.C. Cir. 2006) (tax on compensatory damages for emotional distress and loss of reputation), *vacated*, 2006 U.S. App. LEXIS 32293 (D.C. Cir. 2006). In *Murphy*, the government in its petition for rehearing en banc argued for the first time that the tax in question was not a direct tax, which would render moot the question of whether it was a tax on "incomes" within the meaning of the Sixteenth Amendment. The Court of Appeals for the District of Columbia Circuit vacated its earlier decision, reheard the case and held that the tax in question was not a direct tax and therefore was constitutionally imposed. Murphy v. Internal Revenue Service, 493 F.3d 170 (D.C. Cir. 2007), *cert. denied*, 553 U.S. 1004 (2008); *see also* 1995 Joint Committee Report, *supra* note 4, at 71 (As of 1995, "[t]he *Macomber* case is 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.").

[67] Bittker & Lokken, *supra* note 10, ¶ 5.2; *see also, e.g.*, 1995 Joint Committee Report, *supra* note 4, at 71 ("Although the *Macomber* decision has never been expressly overruled, most commentators, and many lower courts, have questioned the continuing validity of a constitutional realization requirement found by the majority in *Macomber* to be implicit in the Sixteenth Amendment."); Noel B. Cunningham & Deborah H. Schenk, *Taxation Without Realization: A "Revolutionary" Approach to Ownership*, 47 Tax L. Rev. 725, 741, 741 n.69 (1992) (citing "[t]he scholarly consensus"); Stanley S. Surrey, *The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions*, 35 Ill. L. Rev. 779 (1941).

1. Helvering v. Bruun[68]

The *Bruun* case, which is often cited as a retreat by the Supreme Court from the realization requirement expressed in *Eisner v. Macomber*,[69] involved a 99-year lease of land and a building under which the lessee was permitted to tear down any building on the land and construct a new building at any time during the first 95-1/2 years of the lease. Upon termination of the lease, the lessee was to surrender the land and all improvements to the lessor. In year 14 of the lease, the lessee demolished the existing building and built a new one. Four years later, the lessee defaulted under the lease and the lessor took possession of the land and building, at a time when the fair market value of the building exceeded the unamortized cost of the old building by $51,434.25. The Service, pursuant to the regulations then in effect, determined that the lessor realized a taxable gain in the amount of $51,434.25 in the year the lessee defaulted.[70]

The lessor argued that the increase in value of the real property upon the lessee's default "is not gain derived from capital or realized within the meaning of the Sixteenth Amendment and may not, therefore, be taxed without apportionment."[71] The Court upheld the tax, holding that in light of the parties' apparent agreement that there was an enhancement in value of the real property upon termination of the lease by $51,434.25, "we think that gain in the amount named was *realized* by the [lessor] in the year of repossession."[72] Regarding the taxpayer's argument that under *Macomber*, there is no income within the meaning of the Sixteenth Amendment unless "the gain [is] separate from the capital and separately disposable,"[73] the Court stated that these expressions of the Court in *Macomber* were not controlling in *Bruun*, having been uttered in the context of a stock dividend.[74] This is presumably the part of *Bruun* that has moved commentators to suggest that the case stands for the proposition that realization is not constitutionally required.[75]

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[68] 309 U.S. 461 (1940).

[69] *See, e.g.*, 1995 Joint Committee Report, *supra* note 4, at 71 ("The Supreme Court itself long ago rejected the specific definition of 'income' postulated by the *Macomber* majority that 'income' did not exist until gain was severed from the original capital."); Bittker & Lokken, *supra* note 10, ¶ 5.2 (citing *Bruun* as an example of a situation in which "gain can be taxed even though it has only been realized in a loose sense"); Ackerman, *supra* note 1, at 48 n.193. *But see* Edward T. Roehner & Sheila M. Roehner, *Realization: Administrative Convenience or Constitutional Requirement?*, 8 Tax L. Rev. 173, 176–79 (1953) (arguing that the result in *Bruun* "is not an impairment of the [constitutional] doctrine of realization, but an affirmance of the doctrine"); Henry Ordower, *Revisiting Realization: Accretion Taxation, the Constitution,* Macomber, *and Mark to Market*, 13 Va. Tax Rev. 1, 40 (1993) (arguing that the Court in *Bruun* "in no way relegated realization to the realm of administrative convenience").

[70] *Bruun*, 309 U.S. at 465.

[71] *Id.* at 467.

[72] *Id.* at 468 (emphasis added).

[73] *Id.*

[74] *Id.* at 468–69.

[75] *See supra* note 69.

However, the balance of the Court's opinion in *Bruun* demonstrates that this reading is incorrect:

> While it is true that economic gain is not always taxable as income, it is settled that the *realization* of gain need not be in cash derived from the sale of an asset. Gain may occur as a result of exchange of property, payment of the taxpayer's indebtedness, relief from a liability, or other profit *realized* from the completion of a transaction. The fact that the gain is a portion of the value of property *received* by the taxpayer in the transaction does not negative its *realization*.
>
> Here, as a result of a business transaction, the [lessor] received back his land with a new building on it, which added an ascertainable amount to its value. It is not necessary to the *recognition* of taxable gain that he should be able to sever the improvements begetting the gain from his original capital. If that were necessary, no income could arise from the exchange of property; whereas such gain has always been recognized as *realized* taxable gain.[76]

Thus, the Court in *Bruun*, while retreating from the *severance* requirement that had been articulated in *Macomber*, affirmed the more relevant—for present purposes—teaching of *Macomber* that *realization* of gain is required under the Sixteenth Amendment. The Court upheld the tax in question in *Bruun* on the unsurprising basis that repossession of one's property from a tenant on which there are valuable improvements that were not there upon commencement of the lease is a realization event—just as an exchange of property is a realization event—rather than on the basis that realization is not constitutionally required.[77] Indeed, given the number of times the Court used words such as "realization" and "realized" in its opinion in *Bruun* to describe the types of items that are constitutionally taxable, the argument that the Court had abandoned the realization requirement does not stand up to scrutiny.[78]

2. Helvering v. Horst[79]

Another case often cited in support of the proposition that the realization principle is a dead letter,[80] *Horst* involved a donor who detached from negotiable bonds negotiable interest coupons that had not yet matured and made a gift of the coupons to his son. The issue before the Court was whether the interest income when paid was taxable to the donor or to his son. Invoking the now-familiar assignment-of-income principle, the Court held that the

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[76] *Id*. at 469 (emphasis added) (citations omitted).

[77] *Bruun*, 309 U.S. at 468–69.

[78] *See* Roehner & Roehner, *supra* note 69, at 176–79; Ordower, *supra* note 69, at 40–42.

[79] 311 U.S. 112 (1940).

[80] *See, e.g.*, Bittker & Lokken, *supra* note 10, ¶ 5.2 ("[T]he Court came close to approving a tax on increases in a taxpayer's net worth."); Edward Zelinsky, *For Realization: Income Taxation, Sectoral Accretionism, and the Virtue of Attainable Virtues*, 19 Cardozo L. Rev. 861, 871 (1997) ("[T]he observation of the Horst Court signaled the demotion of realization from constitutional imperative to practical expedient.").

interest income was taxable to the donor.[81]

As with *Bruun*, *Horst* is often cited as an indication that the constitutional realization principle has been severely eroded, mainly because of some language in the Court's opinion which, taken in isolation, might appear to support that view. In *Horst*, the Court described "the rule that income is not taxable until realized" as "founded on administrative convenience,"[82] which according to a leading commentator, is a "slighting reference" that is "quite a demotion from the constitutional status it enjoyed under *Eisner v. Macomber*."[83] However, a reading of the entire opinion in *Horst* makes it clear that the Court did not abandon the realization principle in *Horst*, but rather held that the donor in *Horst* had in fact realized the interest income at issue, albeit not in the form of cash.[84]

The Court began its analysis by acknowledging that while "[f]rom the beginning the revenue laws have been interpreted as defining 'realization' of income as the taxable event, rather than the acquisition of the right to receive it,"[85]

> the decisions and regulations have consistently recognized that receipt in cash or property is *not the only characteristic of realization of income to a taxpayer on the cash receipts basis*. Where the taxpayer does not receive payment of income in money or property *realization may occur* when the last step is taken by which he obtains the fruition of the economic gain which has already accrued to him.[86]

Significantly, the "founded on administrative convenience" language came in the following context:

> But the rule that income is not taxable until realized has never been taken to mean that the taxpayer, *even on the cash receipts basis*, who has fully enjoyed the benefit of the economic gain represented by his right to receive income, can escape taxation because he has not himself received payment of it from his obligor. The rule, founded on administrative convenience, is only one of postponement of the tax to the final event of enjoyment of the income, usually the receipt of it by the taxpayer, *and not one of exemption from taxation where the enjoyment is consummated by some event other than the taxpayer's personal receipt of money or property*.[87]

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[81] *Horst*, 311 U.S. at 120.

[82] *Id.* at 116.

[83] Bittker & Lokken, *supra* note 10, ¶ 5.2.

[84] *See* Ordower, *supra* note 69, at 49 ("[*Horst*] is not a realization decision but the classical income shifting case."); Roehner & Roehner, *supra* note 69, at 181 ("[*Horst*] was designed solely to frustrate attempts at tax avoidance by the diversion of income.").

[85] *Horst*, 311 U.S. at 115.

[86] *Id*. (emphasis added).

[87] *Id*. at 116 (emphasis added).

Thus, rather than eroding or demoting the realization requirement, the Court in *Horst* was merely clarifying that even for a cash-method taxpayer, realization can occur in ways other than the receipt of cash.[88] As if to eliminate any doubt on this score, the Court in *Horst* proceeded to couch the balance of its opinion in terms of a holding that realization had occurred in *Horst*:

> Underlying the reasoning of [the cases holding that a taxpayer's direction of payment of income to another does not change the incidence of taxation] is the thought that *income is "realized" by the assignor* because he, who owns or controls the source of the income, also controls the disposition of that which he could have received himself. . . . The enjoyment of the economic benefit accruing to him by virtue of his acquisition of the coupons *is realized as completely as it would have been if he had collected the interest in dollars and expended them for any of the purposes named*. . . . The power to dispose of income is the equivalent of ownership of it. The exercise of that power to procure the payment of income to another is the enjoyment, *and hence the realization*, of the income by him who exercises it.[89]

In addition to demonstrating that the Court was not eroding the constitutional realization principle—which, tellingly, neither party so much as questioned in *Horst*[90]—this language also makes it clear that *Horst* is not about *when* income is realized and therefore constitutionally subject to tax, but rather *to whom* income that had admittedly been realized is taxable.[91] Indeed, as with assignment-of-income cases generally, the Court in *Horst* found the interest income to be taxable to the donor not at the time the gift was made but rather as and when the donee received the interest income.[92] Thus, *Horst* does not stand for the proposition that the constitutional realization principle articulated in *Macomber* has been eroded or demoted to an administrative rule.

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[88] *See* Roehner & Roehner, *supra* note 69, at 183 (arguing that the Court in *Horst* was saying that the cash basis of accounting, rather than the realization principle applicable to both cash- and accrual-basis taxpayers, is "founded on administrative convenience"); *cf.* Cottage Sav. Ass'n v. Commissioner, 499 U.S. 554, 559 (1991) (quoting *Horst* for the proposition that the *statutory* concept of realization is founded on administrative convenience).

[89] *Horst*, 311 U.S. at 116–18 (emphasis added).

[90] *See* Roehner & Roehner, *supra* note 69, at 184.

[91] *See* Ordower, *supra* note 69, at 50 ("*Macomber* seeks to define when, not to whom, income is realized, and *Horst* concerns itself only with the latter issue."); Roehner & Roehner, *supra* note 69, at 183 ("There was admittedly realization of income in the constitutional sense [in *Horst*] (no one disputed that the interest was income); the sole question was to whom the income was to be taxed.").

[92] While in *Horst* both events occurred in the same taxable year, this timing point became clear in cases decided simultaneously with or soon after *Horst*, in which the two events occurred in different taxable years. *See, e.g.*, Harrison v. Schaffner, 312 U.S. 579 (1941); Helvering v. Eubank, 311 U.S. 122 (1940).

3. Helvering v. Griffiths[93]

Griffiths involved a tax imposed on stock dividends under a statutory provision that stated that a stock dividend "shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution."[94] Although the Court's review of the legislative history of this statute indicated that Congress did not intend to override *Macomber* legislatively, the government urged the Court to construe the statute as intended to tax the dividends and to overrule *Macomber* and allow the tax to be imposed.

The Court in *Griffiths* noted that *Bruun* and *Horst* "undermined further the original theoretical bases of the decision in *Eisner v. Macomber*"[95] but declined to reconsider *Macomber*. In the Court's view, the relevant statute by its terms did not impose the tax in question, having excluded from the tax stock dividends not constituting income within the meaning of the Sixteenth Amendment.[96] As a result, under the "judicial tradition" that "we do not decide whether a tax may constitutionally be laid until we find that Congress has laid it,"[97] the Court held for the taxpayer.[98] *Griffiths* is surely not authority for the proposition that the constitutional realization principle is dead.

4. Commissioner v. Glenshaw Glass Co.[99]

Notwithstanding that the Court began its analysis in *Glenshaw Glass* by stating that the taxpayers "conceded . . . that there is no constitutional barrier to the imposition of tax on punitive damages" and that the question before the Court was "one of statutory construction," *Glenshaw Glass* is cited as evidence of erosion of the constitutional realization principle, once again on the basis of a passage from the opinion that is taken out of context.[100] In this case, the quoted language states that *Macomber* "was not meant to provide a touchstone to all future gross income questions."[101] However, the full context

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[93] 318 U.S. 371 (1943).

[94] I.R.C. § 115(f)(1) (1939), *cited in Griffiths*, 318 U.S. at 372.

[95] 318 U.S. at 394. This statement has been cited as further support for the proposition that the constitutional realization principle has been undermined. *See* 1995 Joint Committee Report, *supra* note 4, at 72, 72 n.132 (citing this statement in *Griffiths*, and mischaracterizing a general statement in *Griffiths* that Congress should not feel embarrassed "to enact laws which may require the Court to reexamine its previous judgments or doctrine" as suggesting that the Court in *Griffiths* more specifically stated that "Congress should not feel 'embarrassed' to pass legislation that conflicts with the *Macomber* decision").

[96] *Griffiths*, 318 U.S. at 402–04.

[97] *Id.* at 394.

[98] Three Justices dissented, arguing that *Macomber* "should be overruled." *Id.* at 404–10 (Douglas, J., dissenting). While beyond the scope of this discussion, the Court's opinion in *Griffiths* is also significant for its interesting discussion of the validity of retroactive regulations. *Id*. at 395–97.

[99] 348 U.S. 426 (1955).

[100] *See, e.g.*, 1995 Joint Committee Report, *supra* note 4, at 71–72, 72 n.131.

[101] *Glenshaw Glass*, 348 U.S. at 431.

of this statement makes it clear that the Court was not undermining the constitutional realization principle:

> Nor can we accept [the taxpayers'] contention that a narrower reading of [the statute] is required by the Court's characterization of income in *Eisner* v. *Macomber* as "the gain derived from capital, from labor, or from both combined." The Court was there endeavoring to determine whether the distribution of a corporate stock dividend constituted a realized gain to the shareholder, or changed "only the form, not the essence," of his capital investment. It was held that the taxpayer had "received nothing out of the company's assets for his separate use and benefit." The distribution, therefore, was held not a taxable event. *In that context—distinguishing gain from capital—the definition served a useful purpose.* But it was not meant to provide a touchstone to all future gross income questions.
>
> Here we have instances of undeniable accessions to wealth, *clearly realized*, and over which the taxpayers have complete dominion.[102]

The Court in *Glenshaw Glass*, rather than diminishing the importance or continuing vitality of *Macomber*'s realization requirement, was drawing an important distinction between two categories of income—"gain derived from capital,"[103] to which the constitutional realization requirement enunciated in *Macomber* related and continues to apply, and "accessions to wealth" such as the punitive damages at issue in *Glenshaw Glass*, with respect to which *Macomber* does not "provide a touchstone" for the simple reason that *Macomber*'s distinction between capital and gain "*severed from* the capital"[104] is irrelevant to this particular category of income. Indeed, if gain were not a category of Sixteenth Amendment income conceptually distinct from accessions to wealth, a sale of an asset for an amount exactly equal to its fair market value would not constitute income within the meaning of the Sixteenth Amendment, since the seller's wealth in that case is exactly the same before and after the sale. Of course, any gain on such a sale—that is, the excess of the seller's amount realized on the sale over the seller's cost basis—is unquestionably income of the "severed from the capital" variety discussed in *Macomber*, even though it does not result in an accession to wealth as described in *Glenshaw Glass*.[105] Similarly, *Glenshaw Glass* stands for the proposition that accessions to wealth constitute Sixteenth Amendment income even if they do not involve a severance from capital. Thus, just as *Macomber* does not "provide a touchstone" for deciding "accession to wealth" cases, the accession-to-wealth analysis does not "provide a touchstone" for deciding cases involving gain severed from the capital. Once again, *Glenshaw Glass* is incorrectly cited as evidence of an erosion of the constitutional realization principle.

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[102] *Id.* at 430–31 (emphasis added) (internal citations omitted).

[103] *See* Eisner v. Macomber, 252 U.S. 189, 207 (1920).

[104] *Id.*

[105] *Cf.* Helvering v. Bruun, 309 U.S. 461, 469 (1940) (noting that if severance were always necessary, no income could arise from an exchange of property).

5. Cottage Savings Association v. Commissioner[106]

Occasionally, *Cottage Savings* is cited for the proposition that the realization principle is a matter of administrative convenience rather than constitutional imperative.[107] *Cottage Savings*, however, addressed realization as defined under the Code rather than as a Sixteenth Amendment principle. Moreover, read in context, the Court's reference in *Cottage Savings* to realization as founded on administrative convenience is clearly a reference to the adoption by Congress of the realization principle rather than such principle's embodiment in the Sixteenth Amendment:

> Rather than assessing tax liability on the basis of annual fluctuations in the value of a taxpayer's property, *the Internal Revenue Code* defers the tax consequences of a gain or loss in property value until the taxpayer "realizes" the gain or loss. *The realization requirement is implicit in §1001(a) of the Code* . . . . As this Court has recognized, the concept of realization is 'founded on administrative convenience.' *Helvering v. Horst*, 311 U.S. 112, 116 (1940).[108]

As if to remove any doubt on this score, the Court went on to cite *Horst* again when referring to "the administrative purposes underlying the realization requirement in §1001(a)."[109] *Cottage Savings* does not support the conventional wisdom that realization is not required by the Constitution.

6. *Code Provisions Held Constitutional*

Those who suggest that realization is no longer a constitutional imperative also point to certain provisions of the Code that they say would be unconstitutional if realization were required, yet have been upheld by the lower courts.[110] These provisions include the foreign personal holding company rules of former sections 551–558—upheld by the Second Circuit in *Eder v. Commissioner*[111]—the controlled foreign corporation rules of sections 951–964—upheld by the Second Circuit in *Garlock, Inc. v. Commissioner*[112]—and the mark-to-market rule for futures contracts under section 1256—upheld by the Ninth Circuit in *Murphy v. United States*.[113]

a. Eder v. Commissioner. In *Eder*, the foreign personal holding company provisions were applied in a case where foreign exchange restrictions in Colombia prevented the corporation from making actual distributions. The

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[106] 499 U.S. 554 (1991).

[107] *See* 1995 Joint Committee Report, *supra* note 4, at 71–72.

[108] *Cottage Savings*, 499 U.S. at 559 (emphasis added) (citations omitted).

[109] *Id.* at 565.

[110] *See, e.g.*, 1995 Joint Committee Report, *supra* note 4, at 72, 75–77; *cf.* Ackerman, *supra* note 1, at 52, 52 n.211 (asserting that none of these provisions "has been seriously questioned on constitutional grounds").

[111] 138 F.2d 27, 28–29 (2d Cir. 1943).

[112] 489 F.2d 197, 198 (2d Cir. 1973), *cert. denied*, 417 U.S. 911 (1974).

[113] 992 F.2d 929, 931 (9th Cir. 1993).

Board of Tax Appeals, stating that the "sole issue" in the case was the statutory issue—that is, the taxpayer was not raising a constitutional objection—held that the amounts in question were subject to tax under the foreign personal holding company provisions, without even addressing the constitutionality of the statute.[114] On appeal, the Second Circuit remanded the case to the Board of Tax Appeals on a valuation issue but affirmed the conclusion of the Board that the tax applied to the blocked income, adding at the end of its opinion that "[i]nterpreting the statute to bring about such a consequence does not render the statute unconstitutional."[115] Notwithstanding this meager treatment of the constitutional issue in *Eder*, the case has been cited as authority for the proposition that taxes imposed on owners of a corporation on the corporation's undistributed profits are constitutional.[116]

b. Prescott v. Commissioner.[117] One of the cases citing *Eder*, *Prescott* involved a former provision of the Code pursuant to which an unincorporated business could elect to be treated as a corporation for tax purposes and thus subject to a second layer of tax. When this apparently—and not surprisingly—little-used provision was repealed in 1966, the Treasury Department issued regulations pursuant to which, subject to certain exceptions, entities that had elected to be treated as corporations were deemed to be completely liquidated on January 1, 1969 in liquidations taxable under section 331. The taxpayer argued that any tax imposed on such a deemed liquidation was an unconstitutional unapportioned direct tax. Rejecting this argument, the Eighth Circuit held that (1) the constitutional requirement in *Macomber* that gain must be severed from capital to be taxable had been "abandoned" in *Bruun* and *Glenshaw Glass*;[118] (2) the Supreme Court in *United States v. Davis*[119] had replaced the concept of severance with a determination of whether there has been a "taxable event" which marks an appropriate time to tax the increase in value of the assets;[120] and (3) Congress's repeal of the treatment of electing unincorporated businesses as corporations was a sufficient taxable event to meet the new test.[121]

Were the Eighth Circuit's ruling in *Prescott* that a tax on deemed liquidations is constitutional a correct one, this case would lend support to the constitutionality of the exit tax on deemed sales under section 877A. However, the Eighth Circuit's analysis in *Prescott* does not survive even a modicum of scrutiny. First, the Eight Circuit's conclusion that *Bruun* and *Glenshaw Glass*

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114 Eder v. Commissioner, 47 B.T.A. 235, 240 (1942), *remanded*, 138 F.2d 27 (2d Cir. 1943).

115 *Eder*, 138 F.2d at 28–29.

116 *See, e.g.*, Prescott v. Commissioner, 561 F.2d 1287, 1293, 1294 n.8 (8th Cir. 1977); *Garlock*, 489 F.2d at 202–03.

117 561 F.2d 1287 (8th Cir. 1977).

118 *Prescott*, 561 F.2d at 1293.

119 370 U.S. 65 (1962).

120 *Prescott*, 561 F.2d at 1293.

121 *Id.*

abandoned the constitutional requirement in *Macomber* that gain must be severed from capital to be taxable is, as noted above, based on a misreading of these cases. Second, the Eighth Circuit erroneously imported the "taxable event" concept from *Davis*, a case that not only did not address constitutional issues but also in fact involved an actual realization event—a transfer of property to a spouse pursuant to a divorce.[122] As a result, the Eighth Circuit's conclusion that *Davis* reduced *Macomber*'s holding that there is a constitutional requirement of a severance of gain from capital to a requirement that there be a "taxable event" is erroneous.

Third, and most remarkably, the court in *Prescott* held that acts of the government—the enactment of a statute by Congress and promulgation of regulations by the Treasury Department—qualify as a "taxable event" that justifies imposition of tax. Even if the "taxable event" concept were relevant to the constitutional analysis, the Eighth Circuit's conclusion in *Prescott* that the government itself can create such a taxable event by fiat—simply by declaring that a taxable event, such as a deemed liquidation on January 1, 1966, or, for that matter, a deemed sale of assets by an expatriate, has occurred—cannot be correct. It is self-evident that a constitutional limitation on Congress's taxing power that Congress is able to surmount simply by declaring something to be taxable is no limit at all.

c. Garlock v. Commissioner. In *Garlock*, the controlled foreign corporation provisions in Subpart F were challenged on, among other things, constitutional grounds. The Second Circuit held that the taxpayer's argument that Subpart F is unconstitutional "borders on the frivolous in the light of this court's decision in *Eder*."[123] The only discussion of this issue in *Garlock* appears in a footnote, in which the court rejected the taxpayer's argument that the constitutional issue in *Eder* had been waived, citing the following reference by the *Eder* court to the Supreme Court's opinion in *Heiner v. Mellon*:[124] "Whatever may be the continuing validity of *Eisner v. Macomber*, as applied to the facts in this case it has no validity under *Mellon*."[125] The court's citation of *Mellon* in this context is curious since that case dealt with a tax on the undistributed income of a *partnership* rather than a corporation, which of course raises entirely different issues of realization, and in any event *Mellon* neither addressed the constitutional issue nor even cited *Macomber*.[126]

While at first blush, *Garlock* and *Eder* might appear to reflect a relaxation of the realization requirement articulated in *Macomber*, having—unlike *Glenshaw Glass* and *Cottage Savings*—directly addressed and rejected a con-

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[122] *Compare id.* at 1287, *with Davis*, 370 U.S. at 66.
[123] *Garlock*, 489 F.2d at 202–03.
[124] 304 U.S. 271 (1938).
[125] *Garlock*, 489 F.2d at 203 n.5 (citations omitted).
[126] *See Heiner*, 304 U.S. 271.

stitutional challenge,[127] a close reading of these cases makes it clear that they are distinguishable from *Macomber*. The question in *Macomber* was whether a corporation's *unrealized appreciation* can constitutionally be taxed to a shareholder receiving a pro-rata common-on-common stock dividend.[128] In *Garlock* and *Eder*, by contrast, the question was whether a corporation's *realized income and gains* can constitutionally be taxed to the controlling shareholders of that corporation absent a distribution to them.[129] In light of the shareholders' presumed control over the corporations in these cases and their consequent "command over the corporation's undistributed income," the courts have viewed Subpart F as consistent with the constitutional realization principle articulated in *Macomber* rather than holding that such principle no longer exists.[130] Put differently, these cases—like *Horst*—clearly addressed the question of *who* is taxable on income that has unquestionably been realized, as distinguished from *Macomber*, which addressed the separate question of *whether* and *when*—rather than *to whom*—appreciation in the value of capital may constitutionally be taxed.[131]

d. Murphy v. United States. Unlike the taxpayers in *Eder* and *Garlock*, the taxpayer in *Murphy* actually challenged the constitutionality of a tax on unrealized income—the so-called mark-to-market regime for futures contracts under section 1256. Nonetheless, the court in *Murphy* did not squarely address the constitutional issue. In *Murphy*, the taxpayer was an investor in traded commodities futures contracts. Pursuant to section 1256, the taxpayer marked his contracts to market at the end of 1987, and accordingly paid tax on the increase in their value, and then claimed a refund of the $4,372 of tax he paid on the unrealized gain, arguing that the tax was unconstitutional. The court determined that Congress based the treatment under section 1256 on the particular arrangements applicable to the futures contracts, under which

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[127] *See, e.g.*, 1995 Joint Committee Report, *supra* note 4, at 77 ("In both the *Eder* and *Garlock* decisions, the Second Circuit dismissed the constitutional realization argument without even citing the *Macomber* decision.").

[128] Eisner v. Macomber, 252 U.S. 189, 199 (1920).

[129] *Compare Garlock*, 489 F.2d at 203, *and* Eder v. Commissioner, 47 B.T.A. 235 (1942), *with* Whitlock v. Commissioner, 59 T.C. 490, 508 (1972) ("The reasoning [in *Macomber*] was that such *accumulated* earnings constituted the stockholder's share in capital, and not income. . . . But we cannot read *Macomber* as denying to Congress the power to attribute a corporation's undistributed *current* income to the corporation's *controlling* stockholders." (emphasis added) (citations omitted)), *aff'd on this issue*, 494 F.2d 1297 (10th Cir.), *cert. denied*, 419 U.S. 839 (1974).

[130] *See, e.g., Whitlock*, 59 T.C. at 509 ("Since it is clear in the instant case that petitioners had the actual right and power to manipulate their corporation as if it were the family pocketbook, *Macomber* would be no bar to the application of that legislative determination. . . . [W]e believe the operation of subpart F in the instant case is within the bounds of *Macomber*."); *see also* Dougherty v. Commissioner, 60 T.C. 917 (1973).

[131] *Cf. Dougherty*, 59 T.C. at 928 ("[T]he doctrine of [*Macomber*] does not prevent Congress from bypassing the corporate entity in determining the incidence of Federal income taxation.").

"traders holding futures contracts were entitled to withdraw their gains at the close of every day under the marked-to-market system."[132] From this, the court concluded that "Section 1256 is premised on the doctrine of constructive receipt because the taxpayer who trades futures contracts receives profits as a matter of right daily" and held that "[a]lthough [the taxpayer] did not sell his futures contracts, his gains would be *treated as realized* because he was entitled to withdraw those gains daily."[133]

In conclusion, the court stated the following:

> Because of the unique accounting method governing futures contracts, the gains inherent in them are properly treated as constructively received. Congress acted well within its authority when it decided to treat them differently from other capital assets. . . . *We need not, and do not, decide the broader issue of whether Congress could tax the gains inherent in capital assets prior to realization or constructive receipt.*"[134]

Thus, although *Murphy* is cited for the proposition that the realization principle has been eroded and unrealized gains may be constitutionally taxed,[135] the court in *Murphy* assumed that realization had occurred in that case and therefore explicitly declined to address the issue of whether and to what extent realization is required as a constitutional matter.

IV. The Constitutionality of the Exit Tax Under Section 877A[136]

A. *The Exit Tax Imposed by Section 877A*

Section 877A is a fairly lengthy and complex provision of the Code. Since the constitutional issue discussed herein arises under the basic deemed-sale provisions under section 877A, a description of the many nuances of section 877A—for example, involving trusts and deferred compensation arrangements—is unnecessary for present purposes.[137] Rather, what follows is a summary of the basic deemed-sale provisions of section 877A, referred to herein as the "exit tax" or the "deemed-sale provisions," the constitutionality of which is the subject of this discussion.

Subject to numerous exceptions and special rules, the details of which are not particularly relevant to this discussion, the deemed-sale provisions of sec-

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

[133] *Id.* (emphasis added).

[134] *Id.* at 931–32 (emphasis added).

[135] *See* 1995 Joint Committee Report, *supra* note 4, at 76.

[136] It is beyond question that the tax on deemed sales under section 877A is not apportioned. As a result, the tax is unconstitutional if it is a direct tax that is not imposed on "incomes" within the meaning of the Sixteenth Amendment.

[137] As noted above, this discussion is limited to the constitutionality of the provisions of section 877A that deem an individual relinquishing his or her citizenship or green card to have sold all of his or her assets in a taxable sale, and does not extend to, for example, the special rules under section 877A for trust interests and deferred compensation arrangements of such an individual.

tion 877A(a)(1) provide that "[a]ll property" of (1) a U.S. citizen who relinquishes his or her citizenship or (2) a long-term resident[138] who ceases to be a lawful permanent resident after June 16, 2008, "shall be treated as sold on the day before the expatriation date for its fair market value"[139] and that "notwithstanding any other provision of this title, any gain arising from such sale shall be taken into account for the taxable year of the sale."[140] The first $600,000 of such deemed gain is excluded from the operation of the tax.[141] For purposes of computing the deemed gain that is subject to tax under section 877A, an individual will be considered to have had a basis in any property that he or she held prior to becoming a citizen or resident of the United States equal to its fair market value at that time, unless the individual makes an irrevocable election not to step up—or down—the basis in such property to its fair market value.[142]

B. *Is the Exit Tax a Direct Tax?*

As noted above, the Supreme Court, both in the *Pollock* cases and in cases decided since *Pollock*, has made it clear that the apportionment requirement for direct taxes survived the Civil War amendments to the Constitution. While other aspects of *Pollock* have since been repudiated, some judicially and others by the Sixteenth Amendment, the ongoing applicability of the prohibition against unapportioned direct taxes has not.

In the years since the *Pollock* cases were decided, the Court has also clearly held that for purposes of the constitutional apportionment requirement, direct taxes are those that are "imposed on property solely because of its ownership"[143] and "levied upon or collected from persons because of their general ownership of property [and] which fall[] upon the owner merely because he is owner, regardless of the use or disposition made of his property."[144] A "tax levied upon all the uses to which property may be put, or upon the exercise of a single power indispensable to the enjoyment of all others over

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[138] For this purpose, a long-term resident is an individual noncitizen who is a lawful permanent resident of the United States—a green-card holder—in at least 8 taxable years during the period of 15 taxable years ending with the taxable year of the expatriation date, provided that an individual who is treated as a resident of a foreign country for a taxable year under the provisions of a tax treaty between the United States and such foreign country and who does not waive the benefits of such treaty will not be considered a lawful permanent resident of the United States for such taxable year. I.R.C. § 877A(g)(5); *see also* I.R.C. § 877(e)(2).

[139] I.R.C. §§ 877A(a)(1), (g)(1)(A), (g)(2), (g)(3), (g)(4); *see also* I.R.C. §§ 877(a)(2), 7701(b)(6). For the effective date, see Heroes Earnings Assistance and Relief Tax Act of 2008, Pub. L. 110-245, § 301(g)(1).

[140] I.R.C. § 877A(a)(2)(A). Deemed losses may be netted against deemed gains for this purpose without regard to the wash sale rules of section 1091. I.R.C. § 877A(a)(2)(B).

[141] I.R.C. § 877A(a)(3)(A). The $600,000 exclusion amount is to be adjusted for inflation. I.R.C. § 877A(a)(3)(B).

[142] I.R.C. § 877A(h)(2).

[143] Knowlton v. Moore, 178 U.S. 41, 81–83 (1900).

[144] Bromley v. McCaughn, 280 U.S. 124, 136–38 (1929).

it" has also been assumed to be a direct tax.[145] By contrast, indirect taxes are taxes imposed "upon a particular use or enjoyment of property or the shifting from one to another or any power or privilege incidental to the ownership or enjoyment of property."[146]

The deemed-sale provisions of section 877A, by treating certain expatriates and former long-term residents as having sold all their assets immediately before their expatriation, impose a tax "on the increase in value of assets that continue to be held by an expatriate or former long-term resident of the United States."[147] The tax is imposed irrespective of whether there is an actual transfer of assets by the individual or any other "particular use or enjoyment" of assets on which an indirect tax could fairly be said to be levied.[148] Indeed, since the deemed-sale provisions of section 877A result in tax being imposed on the unrealized appreciation implicit in all of the individual's assets, including, for example, his or her real property located outside the United States, the tax cannot be characterized as an indirect tax on the transfer of one's property to a place outside the United States but rather is a direct tax imposed on the general ownership of the property. Of course, an argument that the tax is an indirect tax because it is imposed on a sale that Congress has *deemed to occur* must fail; otherwise, nothing would remain of the constitutional distinction between direct and indirect taxes, since any direct tax could be transmuted into an indirect tax simply by legislatively deeming a transaction to occur and imposing the tax on that deemed transaction.[149]

The 1995 Joint Committee Report suggests another possibility—treating the section 877A tax as an "indirect, excise tax imposed on the act of expatriation."[150] In this connection, the 1995 Joint Committee Report points to *Flint v. Stone Tracy Co.*,[151] in which the Supreme Court held that a pre-Sixteenth Amendment unapportioned corporate income tax was an indirect excise tax—measured by income—on the privilege of doing business in corporate form. This approach, however, not only raises grave conceptual difficulties—under the same reasoning, a basic real property tax, which is

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[145] *Id.* at 137; *see also* Murphy v. Internal Revenue Service, 493 F.3d 170, 184–86 (D.C. Cir. 2007) (quoting *Bromley*, and stating that a tax "upon one's ownership of property" is a direct tax), *cert. denied*, 553 U.S. 1004 (2008).

[146] Fernandez v. Weiner, 326 U.S. 340, 352 (1945).

[147] 1995 Joint Committee Report, *supra* note 4, at 69.

[148] I.R.C. § 877A; *see also Fernandez*, 326 U.S. at 352.

[149] This would be similar to—and equally erroneous as—the Eighth Circuit's determination in *Prescott v. Commissioner* that a Treasury Department regulation deeming a corporate liquidation to occur for tax purposes is a sufficient "taxable event" to render an unapportioned tax on that deemed liquidation constitutional. 561 F.2d 1287 (8th Cir. 1977); *see also* Lewis Carroll, *Through the Looking Glass* (1871) ("'When *I* use a word,' Humpty Dumpty said in a rather scornful tone, 'it means just what I choose it to mean—neither more nor less.' 'The question is,' said Alice, 'whether you can make words mean so many different things.' 'The question is,' said Humpty Dumpty, 'which is to be master—that's all.'").

[150] 1995 Joint Committee Report, *supra* note 4, at 77 n.147.

[151] 220 U.S. 107 (1911).

unquestionably a direct tax, could be transmuted into an indirect tax simply by calling it an excise tax on the privilege of owning property—but it would also firmly place the section 877A tax in the category of "'exit taxes' imposed on the act of expatriation rather than as a 'settling up' on potential tax liabilities at the time of expatriation," which "would more squarely present problems under international law."[152] While these international law issues are beyond the scope of this discussion, the combination of the serious conceptual difficulties with characterizing the tax arising from the deemed-sale provisions of section 877A as an indirect tax and the international law problems that even the Joint Committee acknowledges would result from doing so suggest that the better view is to characterize the tax as a direct tax.

To be sure, under Professor Ackerman's elaborate historical analysis and "intergenerational synthesis," since an unapportioned wealth tax imposed on all taxpayers, whether or not they expatriate, would pass constitutional muster,[153] the tax under the deemed-sale provisions of section 877A would *a fortiori* be constitutional—apart, perhaps, from equal protection problems. However, for the reasons discussed in detail above, this approach gives far too little weight to the continuing inclusion in the Constitution of the direct tax clauses after the ratification of the Thirteenth through Sixteenth Amendments, the ongoing applicability and significance of which has been repeatedly confirmed and never repudiated by the Supreme Court in the *Pollock* cases and their progeny. Moreover, as Professor Ackerman himself acknowledges, his approach would require the Court to overrule two of its longstanding precedents—the aspects of *Pollock* that remain good law as well as *Macomber*.[154]

C. *Is the Exit Tax a Tax on "Incomes"?*

Somewhat more conceptually difficult is the question of whether the tax imposed as a result of the deemed-sale provisions of section 877A—assuming it is a direct tax—is a tax on "incomes" within the meaning of the Sixteenth Amendment, in which case the apportionment requirement would not apply. Since this tax is unquestionably imposed on the increase in value of the assets retained by an expatriate by deeming him or her to have sold those assets at their fair market value,[155] it squarely raises the question, discussed above, of whether the realization principle articulated by the Supreme Court in *Macomber* is and continues to be a constitutional requirement. For the reasons discussed in some detail above, and contrary to the conventional wisdom

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[152] 1995 Joint Committee Report, *supra* note 4, at 77–78 n.147 (characterizing the argument that the Section 877A tax is an indirect tax as "a conceptual device to side-step the constitutional realization issue"); *cf.* Johnson, *supra* note 10, at 347–48 (arguing that courts "have a duty" to "avoid apportionment no matter what tax is under consideration" by "manipulative expansion of such terms as 'excise' and 'income'").

[153] *See* Ackerman, *supra* note 1, at 31–32, 39, 51–56.

[154] *Id.* at 56–58.

[155] *See* 1995 Joint Committee Report, *supra* note 4, at 69.

in this regard, the core *Macomber* principle that gain must be realized in order to be considered income within the meaning of the Sixteenth Amendment has never been repudiated and remains the law. To be sure, the principle has been refined over the years, and categories of Sixteenth Amendment income other than gain to which the realization principle has less relevance—such as accessions to wealth—have been recognized, but the core teaching of *Macomber* that unrealized gain is not income within the meaning of the Sixteenth Amendment has never been repudiated or overruled.

But what of the many provisions of the Code that are said to "dispense with a realization requirement"[156] and tax unrealized income? Surely, it is argued, the judicially determined—or generally presumed—constitutionality of these provisions means that direct taxes on unrealized gain must be constitutional taxes on income.[157] The problem with this argument is that most of the provisions cited do not raise the issue because they are not taxes on unrealized gains, and in any event would likely be considered indirect taxes and, therefore, do not run afoul of the constitutional prohibition against unapportioned direct taxes.

Certain of these provisions, such as the former foreign personal holding company rules and the controlled foreign corporation rules,[158] discussed above, have indeed been upheld by the courts.[159] However, these provisions do not actually tax unrealized gains, instead imputing a corporation's *realized* income and gains to certain controlling—or at least presumed by the courts to be controlling—shareholders of the corporation.

Also cited in this regard are the percentage-of-completion method of accounting under section 460[160] and the original issue discount provisions of sections 1271–1275,[161] neither of which is the subject of a reported case in which a taxpayer argued that an unapportioned direct tax was being imposed by reason of these provisions. The percentage-of-completion method is a method of accounting that determines the years in which amounts that are earned over the course of a long-term contract are to be included in income.[162] There is nothing about this method of accounting that taxes unrealized gains or is otherwise inconsistent with the constitutional realization requirement. Rather, the percentage-of-completion method, like the accrual method of accounting and the installment sale rules, starts with realized income and

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[156] *Id.* at 75–76.

[157] *See, e.g.*, *id.* at 72, 75–77; *cf.* Ackerman, *supra* note 1, at 52 n.211.

[158] Cited as an example of Code provisions that have "dispensed with the formal realization notion of *Macomber*" in 1995 Joint Committee Report, *supra* note 4, at 76–77; *see also* Ackerman, *supra* note 1, at 52 n.211.

[159] *See, e.g.*, Garlock, Inc. v. Commissioner, 489 F.2d 197 (2d Cir. 1973), *cert. denied*, 417 U.S. 911 (1974); Eder v. Commissioner, 138 F.2d 27 (2d Cir. 1943).

[160] *See* 1995 Joint Committee Report, *supra* note 4, at 76 (cited as an example of a rule that "can be viewed as contrary to the *Macomber* concept of realization").

[161] *See id.* (cited as a rule that is "considered by many a form of unrealized income"); *see also* Ackerman, *supra* note 1, at 52 n.211.

[162] *See* Reg. § 1.460-4(b).

assigns it to particular taxable years. Moreover, any tax imposed by reason of the percentage-of-completion method is unlikely to be considered a direct tax, since by definition such tax is imposed in respect of a particular transaction. The original issue discount provisions impute interest income to a lender in certain circumstances, and in other circumstances these provisions treat a portion of what otherwise would be treated as gain on a sale as interest income. These rules of character and timing do not tax unrealized gains. Rather, the rules constitute a method of accounting that, in the case of a lender, recharacterizes certain principal payments as interest and accrues that interest ratably over the period of the loan and, in the case of sales transactions, recharacterizes certain *realized* gains as interest.[163] Nothing about the original issue discount rules is inconsistent with the constitutional realization principle.

More to the point, the mark-to-market regime under section 1256 and the Ninth Circuit's rejection of a taxpayer's challenge to that provision in *Murphy* are also mentioned in this regard.[164] However, as noted above, the court in *Murphy*—and Congress—avoided addressing the constitutionality of taxes on unrealized gains by determining that taxpayers entering into regulated futures contracts constructively receive—and thus realize—the income in question.[165] It is by no means clear that if a court were to address squarely whether a different mark-to-market regime—such as that under section 475 for certain securities dealers—taxes "incomes" within the meaning of the Sixteenth Amendment, where neither Congress nor the court has found that the taxpayer had constructively received or otherwise realized the income in question, the court would find the mark-to-market regime constitutional. The 1995 Joint Committee Report suggests that section 475 "did not cause an extended debate regarding the constitutionality of that regime" when it was enacted in 1993.[166] Even assuming this to be true, the absence of a debate at that time does not mean that the provision does not run afoul of the prohibition on unapportioned direct taxes, and the fact remains that no taxpayer has yet challenged the constitutionality of that provision in a reported case.

There are other examples under current law of taxes on unrealized gains that are of dubious constitutionality. Suppose, for example, a U.S. person forms a trust having a single trustee who is a U.S. person, but some years later the trustee becomes a non-U.S. person. At that time, the trust, which was initially considered a domestic trust, is considered to become a foreign trust,[167] and gain is recognized under section 684(a) on a deemed transfer of the trust

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[163] *See* I.R.C. §§ 1271–75.

[164] *See* 1995 Joint Committee Report, *supra* note 4, at 76; Ackerman, *supra* note 1, at 52 n.211.

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

[166] *See* 1995 Joint Committee Report, *supra* note 4, at 76; Ackerman, *supra* note 1, at 52 n.211.

[167] *See* I.R.C. § 7701(a)(30)(E).

assets to a foreign trust.[168] Another example involves sections 1291–1298, the passive foreign investment company (PFIC) provisions. Under regulations that were proposed in 1992 but to date have not been promulgated as final regulations, if a U.S. citizen or resident shareholder in a PFIC becomes a nonresident alien, "the shareholder will be treated as having disposed of the shareholder's stock in the [PFIC] for purposes of section 1291 on the last day that the shareholder is a U.S. person."[169] In each of these cases, since there is no actual transfer or other use or enjoyment of assets, any tax imposed in respect of the deemed sale or other transfer would appear to be a direct tax imposed in a manner that is inconsistent with the constitutional realization requirement.

The 1995 Joint Committee Report goes on to suggest that even if there remains a constitutional realization requirement, the section 877A tax on deemed sales might nonetheless satisfy the requirement:

> [A]ssuming that the realization notion is of constitutional dimension, the question follows whether the expatriation tax proposals could be characterized as imposing tax at the moment of a taxable event that satisfies constitutional standards. In other words, even if an across-the-board tax on accretions in wealth (i.e., a deemed sale rule generally governing all capital assets whenever there are changes in value but not necessarily any other events) were assumed to violate the Constitution, the question must be addressed whether the act of expatriation results in a sufficient change in the attributes of certain property owned by the expatriate such that a "disposition" of such property may be deemed to have occurred.[170]

While, according to the 1995 Joint Committee Report, "[t]here is no definitive answer to this question," the Report goes on to suggest that the concept of realization is sufficiently flexible and vague "to lead to a debate whether a 'realization' always requires the transfer of the ownership of property from one entity to another."[171] After a few less-than-convincing attempts to justify an affirmative answer to this question on the basis of the constructive-receipt rationale of *Murphy* in the context of section 1256 and the then-proposed regulations under section 1001 treating significant modifications of debt instruments as exchanges,[172] the Report settles on a possible "exception to any

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[168] *See* I.R.C. § 684(c); Reg. § 1.684-4.

[169] Prop. Reg. § 1.1291-3(b)(2), 57 Fed. Reg. 11024 (1992). In addition to the constitutional issue that this provision would raise if promulgated as a final regulation, the validity of this regulation—the consistency of which with the statute is not at all clear—seems doubtful, even under the standards set forth in the Supreme Court's recent opinion in *Mayo Foundation for Medical Education and Research v. United States*. 131 S. Ct. 704 (2011). *See generally* Mark E. Berg, *Judicial Deference to Tax Regulations: A Reconsideration in Light of* National Cable, Swallows Holding *and Other Developments*, 61 TAX LAW. 481 (2008) (discussing the law before *Mayo Foundation*).

[170] 1995 JOINT COMMITTEE REPORT, *supra* note 4, at 77–78 (footnote omitted).

[171] *Id.* at 78.

[172] *Id.* at 78–79.

constitutional realization requirement in cases involving offshore operations and attempts by Congress to prevent tax evasion" as a possible justification for the constitutionality of the section 877A tax on deemed sales:

> Under this approach, even if there is a general constitutional realization requirement, this requirement—like most constitutional rules—is not absolute. Thus, it could be argued that the expatriation tax proposals are constitutionally valid because a deemed sale is provided for only when the taxpayer's (and Government's) relationship to property is altered due to a change in the jurisdictional attributes of the property for tax purposes and because the deemed sale rule would prevent tax evasion. Because every presumption favors the constitutional validity of a disputed tax statute, there is a reasonable likelihood that the debate over whether a change of jurisdictional attributes of property is a sufficient realization event (and not merely a matter of form with little or no substantive effects as was found with the stock dividend in *Macomber*) would be resolved in favor of upholding the constitutionality of the statute.[173]

The doctrinal confusion in these passages is evident. Was the Joint Committee claiming that laws designed to prevent offshore tax evasion are subject to an "exception to any constitutional realization requirement," or perhaps a limitation on the requirement, or rather that the realization requirement is met when "the taxpayer's (and Government's) relationship to property is altered due to a change in the jurisdictional attributes of the property for tax purposes"?[174] If the former, the question becomes: where is the tax evasion? The U.S. tax system taxes U.S. citizens and green-card holders on their worldwide income, regardless of whether they reside or even set foot in the United States, and taxes nonresident aliens only on certain income that is considered to be either from U.S. sources or effectively connected with a U.S. trade or business. The suggestion that an individual's decision to relinquish his or her U.S. citizenship or green card—thereby becoming subject to the tax regime that is applicable to nonresident aliens—is the type of tax evasion that would justify an exception to or limitation on the constitutional realization requirement seems far-fetched. This is particularly so when one considers that the examples cited for this proposition—the former foreign personal holding company rules and the controlled foreign corporation rules[175]—are not, as discussed above,[176] exceptions to the realization requirement, since they tax shareholders on the *realized* income and gain of the corporation. Moreover, the tax evasion rationale for the section 877A tax on deemed sales is clearly unavailing in the case of U.S. real property owned by the expatriate, the inclusion of which in the deemed sale is inexplicable given that later dispositions of such property by the expatriate would remain subject to U.S.

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[173] *Id.* at 80 (citation omitted).
[174] *Id.*
[175] *Id.* at 79–80, 79 n.153, 80 n.154.
[176] *See supra* Part III.B.6.

tax and withholding under sections 897 and 1445.

Perhaps the rationale is instead that an individual's relocation to another jurisdiction itself constitutes a realization event with respect to that individual's property because of the resulting change in the individual's—and the government's—relationship to the property—that is, that the day before expatriation is the government's last clear chance to impose tax.[177] If so, there are several serious problems with this rationale as well. First of all, the last clear chance rationale is circular, in that it argues that because expatriation may represent the government's last clear chance to impose tax in respect of certain assets, collecting that tax renders it necessary to deem realization to have occurred. Obviously, the constitutional realization requirement would not be much of a restriction on Congress if Congress were able to bypass it simply by deeming realization to have occurred in respect of a deemed sale of assets because otherwise the tax could never be collected.

Moreover, as the 1995 Joint Committee Report itself points out, in the case of assets—such as non-U.S. real property—that are already located outside the United States at the time of expatriation and have never been located in the United States, "it might seem anomalous to employ the legal fiction that gain is 'realized' because the expatriate's assets are effectively being transferred offshore."[178] The Report's answer to this concern—that the Supreme Court has upheld the validity of taxing U.S. citizens on *income* from property located outside the United States and on the *use* of a foreign-built yacht outside the United States[179]—is extremely unsatisfying because the cases cited in the Report dealt with indirect rather than direct taxes. As a result, the realization issue under the Sixteenth Amendment did not arise in those cases.

Likewise, the Joint Committee's attempt to support its conclusion that "[t]he change in the taxpayer's and Government's relationship to such property, which would be viewed as being transferred to a new legal situs,"[180] is a sufficient realization event by analogy to section 367 is also unavailing. To be sure, the Joint Committee is correct that "the net effect of both section 367 and the expatriation tax [provisions] is to prevent tax deferral [that is, deferral of tax until such time as gain is realized] from being converted into permanent tax-free status."[181] However, there is an important difference from the constitutional perspective between the tax imposed by reason of section 367 on certain *actual* transfers of assets to foreign corporations and the tax imposed under section 877A on transfers of assets *deemed* to occur immediately before expatriation—the former is clearly an indirect tax

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[177] The last clear chance rationale might also be employed in defense of the result in *Prescott*, discussed in Part III.B.6.b, as well as the examples set out in Part IV.C involving trustees and PFIC shareholders who become nonresident aliens.

[178] 1995 Joint Committee Report, *supra* note 4, at 81.

[179] *Id.* (citing Cook v. Tait, 265 U.S. 47 (1924) and United States v. Bennett, 232 U.S. 299 (1914)).

[180] 1995 Joint Committee Report, *supra* note 4, at 81.

[181] *Id.*

imposed on the actual transfer of assets and, therefore, such tax is not subject to the apportionment requirement for direct taxes irrespective of whether it is imposed on "incomes" within the meaning of the Sixteenth Amendment, whereas, as demonstrated above, the tax imposed by section 877A on deemed sales is a direct tax, imposed on the owner of property without regard to any transfer or other use of the property by the owner, and as a result is constitutional only if it is imposed on "incomes" within the meaning of the Sixteenth Amendment.

The Joint Committee also cites two early Supreme Court cases involving corporate reorganizations—*United States v. Phellis*[182] and *Marr v. United States*[183]—for the proposition that a "change in . . . legal situs brought about when the corporations changed their State of incorporation" is the type of "significant alteration of legal attributes of assets" that gives rise to realization in the constitutional sense.[184] In both *Phellis* and *Marr*, a New Jersey corporation was reincorporated in Delaware, in what would now be called an F reorganization, with the shareholders receiving shares in a Delaware corporation in exchange for their shares in a New Jersey corporation. The Supreme Court in each case found that because a Delaware corporation "does not have the same rights and powers" as a New Jersey corporation, the shareholders realized gain on the reorganization and had income within the meaning of the Sixteenth Amendment.[185]

While at first blush these cases might seem supportive of the argument that a change of situs can be a realization event, *Phellis* and *Marr* are inapposite because unlike the shareholders in these cases, who exchanged one bundle of rights—shares in a New Jersey corporation—for a different bundle of rights—shares in a Delaware corporation—an individual who relinquishes his or her U.S. citizenship or gives up his or her green card is not exchanging anything and owns precisely the same assets before and after the act of expatriation. An expatriate is more similar to the shareholders in *Weiss v. Stearn*,[186] in which the Supreme Court held that no realization occurs in a reorganization in which the shareholders exchange shares in an Ohio corporation for shares in another Ohio corporation.[187] Put differently, in *Phellis* and *Marr*, it was not the corporations' change of situs alone that was found to be a realization event for the shareholders, but rather the shareholders' actual exchange of property for different property.

Accordingly, the Joint Committee's conclusion that "looking at the aggregate income, estate, and gift tax burden that is escaped when an individual renounces his citizenship may provide a sufficient 'tax evasion' rationale that

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[182] 257 U.S. 156 (1921).
[183] 268 U.S. 536 (1925).
[184] 1995 JOINT COMMITTEE REPORT, *supra* note 4, at 81 n.157.
[185] *Marr*, 268 U.S. at 541; *see also Phellis*, 257 U.S. at 175.
[186] 265 U.S. 242 (1924).
[187] *Id.* at 254.

satisfies any remaining constitutional remnants of *Macomber*"[188] is not tenable, either on the theory that attempts to prevent tax evasion are exempt from the constitutional realization requirement or on the theory that an individual's relocation is itself a sufficient realization event.

V. Conclusion

Given the long history of failed challenges to the constitutionality of income tax provisions, a constitutional attack on the exit tax imposed by section 877A might seem quixotic. Nonetheless, it seems clear that Congress violated the constitutional prohibition on unapportioned direct taxes in enacting this tax. As discussed in detail above, a tax is unconstitutional absent apportionment if it is a "direct tax" within the meaning of Article I, Sections 2 and 9 of the Constitution that is imposed on something other than "incomes" within the meaning of the Sixteenth Amendment. The Supreme Court has long treated as direct taxes those taxes that are imposed on an individual "merely because he is owner [of property], regardless of the use or disposition made of his property,"[189] as contrasted from indirect taxes imposed "upon a particular use or enjoyment of property or the shifting from one to another or any power or privilege incidental to the ownership or enjoyment of property."[190] Under this standard, the exit tax under section 877A, which is imposed on a deemed sale of a taxpayer's property without regard to any transaction or other use of such property, seems clearly to be a direct tax.

As a direct tax that is unquestionably unapportioned, the tax arising from deemed sales under section 877A is constitutional only if it is imposed on "incomes" within the meaning of the Sixteenth Amendment. Contrary to what has become the conventional wisdom on this point, gain in respect of assets constitutes income within the meaning of the Sixteenth Amendment only if and when it is realized. Since the section 877A tax on deemed sales neither satisfies nor is exempt from the constitutional realization requirement, the tax is unconstitutional. It remains to be seen whether the Service will actually collect any tax under the section 877A tax on deemed sales and, if so, whether taxpayers will challenge the imposition of this tax on the constitutional grounds outlined herein.

The constitutional analysis set forth herein has implications well beyond the exit tax on deemed sales imposed by section 877A. As noted above, much of the most ardent recent commentary regarding the direct tax clauses of the Constitution[191] has been written in support of proposals for the enactment of a federal wealth tax.[192] In light of the nation's increasingly dire fiscal situation, these proposals are being made with more frequency and urgency—and

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[188] 1995 Joint Committee Report, *supra* note 4, at 81.
[189] Bromley v. McCaughn, 280 U.S. 124, 137 (1929).
[190] Fernandez v. Weiner, 326 U.S. 340, 352 (1945).
[191] U.S. Const. art. I, § 9, cl. 4; U.S. Const. art. I, § 2, cl. 3.
[192] *See, e.g.*, Ackerman, *supra* note 1; Johnson, *supra* note 56.

by people of all political stripes.[193] A federal wealth tax would be imposed as a percentage of the value of one's assets on a particular date, without regard to whether there is any sale or other use of such assets. It is impossible to imagine that such a tax would be imposed at the different rates in different states that would be necessary for such a tax to meet the apportionment requirement under the direct tax clauses. As a result, the above discussion of the constitutionality of the exit tax under section 877A applies at least equally to a federal wealth tax. Because a wealth tax would be imposed irrespective of whether an individual's assets were sold or otherwise transferred or made use of, a wealth tax would clearly be a direct tax. Moreover, because a wealth tax would be imposed on the value of property irrespective of any realization of gain, a wealth tax would not be considered a tax on incomes permitted under the Sixteenth Amendment. Accordingly, absent apportionment, a federal wealth tax would be an unconstitutional direct tax for the reasons discussed in detail herein.

[193] *See, e.g.*, Ronald McKinnon, *The Conservative Case for a Wealth Tax*, Wall St. J., Jan. 9, 2012, at A13.