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What Did *Macomber* Decide?

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In this article, Susswein and Camacho assume that *Macomber* is binding constitutional precedent and examine the implications of its seldom-discussed second holding — that Congress could not constitutionally tax the shareholders of Standard Oil on the corporation's income as if they were partners in a partnership. They explore whether that holding would apply today to the mandatory repatriation tax or subpart F income of the foreign corporation in *Moore*.

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In *Moore*,[1] the core dispute is whether the Constitution limits the ability of Congress to tax the shareholders of a corporation as if they were partners in a partnership. That is exactly what the Supreme Court decided in *Eisner v. Macomber*. The Court held that the shareholders of Standard Oil could not be taxed under the individual income tax as if they were partners in a partnership: "We cannot . . . ignore the substantial difference between corporation and stockholder, treat the entire organization as unreal, look upon stockholders as partners when they are not such."[2] That was the second, and lesser known of the Court's two constitutional holdings. The first was the well-known holding that a pro rata stock dividend (equivalent to a stock split) did not actually distribute anything of substance to the shareholders.

If the Supreme Court considers both of its 1920 holdings to be binding precedent, that second holding might be dispositive of *Moore*. At the time, of course, Standard Oil was the equivalent of a domestic C corporation. The question today is whether that holding would apply with equal force to the foreign-source income of a foreign corporation. Why has there been so little focus on this second holding in *Macomber*? Although headnotes are not authority, this second holding does have its own headnote in our online edition of RIA Checkpoint. Note the reference to taxing the shareholders on the corporation's accumulated profits "rather than" on the dividend itself:

> *14. Internal Revenue — Tax on Interest of Stockholder in Undivided Profits Must be Apportioned.* Revenue Act Sept. 8, 1916, section 2 (Comp. St. section 6336b), providing that stock dividends shall be considered income, if construed as imposing the tax on the stockholder's interest in the accumulated and undivided

[1] *Moore v. United States*, No. 2:19-cv-01539 (W.D. Wash. 2020), *aff'd*, 36 F.4th 930 (9th Cir. 2022), *reh'g denied*, 53 F.4th 507 (9th Cir. 2022), *cert. granted*, No. 22-800 (June 26, 2023).

[2] *Eisner v. Macomber*, 252 U.S. 189, 214 (1920).

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> profits, rather than on the dividend, is invalid, as taxing property because of ownership, without apportionment according to population.

When reading *Macomber*, most of us focus on the Court's first holding that a pro rata stock dividend (equivalent to a stock split) does not distribute anything of substance to the shareholders. After reaching that decision, however, the Court went on to consider what appeared to be the government's fallback argument. That is, even if the stock dividend itself was not income, Congress was validly taxing the shareholders on their share of the corporation's previously realized operating income. The Court explained what it called the government's "alternative" argument:

> The government, recognizing the force of the decision in *Towne v. Eisner*, *supra*, and *virtually abandoning* the contention that a stock dividend increases the interest of the stockholder or otherwise enriches him, *insisted as an alternative* that, by the true construction of the Act of 1916, the tax is imposed *not upon the stock dividend, but rather upon the stockholder's share of the undivided profits* previously accumulated by the corporation, the tax being levied as a matter of convenience at the time such profits become manifest through the stock dividend.[3] [Emphasis added.]

In yet another excerpt, focus on the phrase, "or the accumulated profits behind it." That also is a reference to the government's alternative argument that even if it could not treat the stock dividend as a distribution, the stock dividend was evidence of the corporation's actual earnings, or an announcement of those earnings, and the government could simply impute those actual corporate earnings to the shareholders as if they were partners in a partnership. That, the Court held, it could not do:

> Thus, from every point of view, we are brought irresistibly to the conclusion that neither under the Sixteenth Amendment nor otherwise has Congress power to tax without apportionment a true stock dividend made lawfully and in good faith, *or the accumulated profits behind it*, as income of the stockholder. The Revenue Act of 1916, in so far as it imposes a tax upon the stockholder because of such dividend, contravenes the provisions of Article 1, Section 2, cl. 3, and Article 1, Section 9, cl. 4, of the Constitution, and to this extent is invalid notwithstanding the Sixteenth Amendment.[4] [Emphasis added.]

In yet another excerpt, focus on the words "not only" to see that the Court was making two distinct points:

> 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 any income in the transaction.[5] [Emphasis added.]

The briefs filed, so far, disagree on the historical meaning of the words "income" and "realization" and the potential implications of *Macomber* for other fact patterns, like the billionaire income tax. But on the narrow constitutional issue presented in *Moore* the Supreme Court's holding in *Macomber* seems to be quite clear. *Macomber* held that Congress could not simultaneously treat Standard Oil as a corporation (to impose a two-level tax on corporate income) and tax its shareholders on the same corporate income as if Standard Oil were a partnership.

Today, for example, Congress presumably could not tax major American corporations at the corporate level (on their corporate income) and also tax the shareholders (without any actual distribution) on the same corporate income. That would be taxing different taxpayers, the

[3] *Id.* at 217.

[4] *Id.* at 219.

[5] *Id.* at 212.

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corporation and its shareholder (or shareholders), on the same income. Congress clearly could tax the shareholders on an actual distribution of the corporation's after-corporate-tax income. It might also, in some cases, find that a corporation had made a disguised dividend payment (say, by allowing a dominant shareholder to use corporate property for personal use), but that is also an actual distribution of something of value, albeit a disguised one.

To illustrate this point, some years ago Ralph Nader and others publicly criticized Microsoft Inc.'s failure to pay dividends. There was a suggestion that the accumulated earnings tax might properly apply at the corporate level to Microsoft. That tax is a corporate tax imposed on corporations that do not declare sufficient dividends. There was no suggestion that Bill Gates (or any other shareholders) could be taxed directly on Microsoft's income without a distribution, as if they were partners in a partnership.

At least as regards a domestic C corporation, *Macomber* seems to hold, quite directly, that the Constitution does not allow Congress to impute a corporation's income to the corporation's shareholders any more than it could impute the income of one employee of Standard Oil of California to another employee of Standard Oil of California, or to an employee of the Pennsylvania Railroad.

Thus, at least in the case of Standard Oil, there does seem to be a constitutional limitation under the 16th Amendment, not just a statutory or administrative rule, on imputing the corporation's income to its shareholders as if they were partners. The Court went on to explain why its ruling, based on the statutory structure of the corporate and individual income tax, was a constitutional holding. By statute, corporations are subject to a two-level tax. (In 1920 there were no S corporations, and the Court was not dealing with a foreign corporation.) Corporate tax is imposed first on the corporation's realized income. A separate and additional tax is imposed, under the individual income tax, on distributions from the corporation to its individual shareholders. In that system, the Court explained, it could not disregard or look through the corporation (for purposes of the individual income tax) and treat the shareholders as if they were partners in a partnership. The corporation and the shareholders had to be respected as separate persons and taxpayers. Otherwise, the shareholders could not be "additionally taxed" (to use the Court's word for the second level of tax) when previously realized and previously taxed corporate income was distributed to them. The Court explained:

> It is only by recognizing such separateness that any dividend — even one paid in money or property — can be regarded as income of the stockholder. Did we regard corporation and stockholders as altogether identical, there would be no income except as the corporation acquired it; and while this would be taxable against the corporation as income under appropriate provisions of law, the individual stockholders could not be separately and *additionally taxed* with respect to their several shares even when divided, since if there were entire identity between them and *the company they could not be regarded as receiving anything from it, any more than if one's money were to be removed from one pocket to another.*[6] [Emphasis added.]

Although the Court (in 1920) did not anticipate S corporations, limited liability companies, publicly traded partnerships, subchapter K of the 1954 code, or a check-the-box entity classification system, the constitutional principle seems clear enough. In effect, Congress has a binary choice to make by statute. One statutory choice is to treat an entity as an alter ego (for tax purposes) of the shareholders like a partnership, in which case the partners or owners can be taxed immediately (and presumably later, if some deferral is allowed by statute) on the entity's operating income, whether or not it is distributed. The other statutory choice is to treat the entity as a taxable or taxpaying entity distinct from the shareholders. In that case, Congress can impose a tax on the corporation (or other state law entity treated as a corporation for tax purposes)

[6] *Macomber*, 252 U.S. 189, at 214.

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when its income is realized at the entity level, and then impose a second tax when the corporation makes a distribution to its shareholders.

If Congress decides, by statute, to treat the corporation or other entity as a distinct entity, subject to a corporate-level or entity-level tax on its income, it cannot treat that income as the income of the shareholders or owners, who are entirely separate and distinct persons. They are distinct persons not only as a matter of local law (or form) but also for tax purposes, by virtue of the two-tier tax structure. Once treated as distinct, the Constitution does not allow the income of one taxpayer to be treated as if it were the income of another taxpayer.

To draw an analogy, John and Mary may be engaged to be married and living in a community property state. It seems, as a constitutional matter, that Congress cannot tax 50 percent of Mary's income to John until they are actually married. Until then, they are separate individuals, separate taxpayers, just as a domestic C corporation and its shareholders are separate taxpayers.

To draw another analogy, perhaps overly dramatic but still instructive on the constitutional point, if a crime has been committed but the jury is not sure whether it was committed by Smith or Jones, they cannot convict Smith just because they know one of the two committed the crime. Smith can only be convicted for the crimes of Smith, and Jones can only be convicted for the crimes of Jones. Similarly, Smith can be taxed on Smith's income and Jones on Jones's income. The 16th Amendment allows Congress to impose an income tax, but it does not allow Smith to be taxed on Jones's income, even if it is clearly "income" of someone. And it does not allow both Smith and Jones to be taxed on Jones's income.

Does that mean that the MRT and subpart F are unconstitutional? Not necessarily. The question is whether an Indian public limited company (deemed a per se corporation by the 1996 Treasury regulations) is in the category of "corporation" or "passthrough entity" under the second holding in *Macomber*.

If we are correct that the essential underpinning of the Supreme Court's analysis was the existence of a two-level tax system (in the case of Standard Oil and other domestic corporations), which does not exist in the case of a traditional, 1920-style partnership, then *Macomber*'s holding might still be an important and vital constitutional rule that would apply today to the shareholders of any domestic C corporations. It would not apply, however, to any entity that is taxed as a passthrough entity (partnership, LLC, S corporation, or other business entity electing or defaulting to passthrough treatment). What then is the proper category for a foreign corporation with foreign-source income?

For purposes of *Macomber*'s second, constitutional holding, is a foreign corporation with foreign-source income the equivalent of a domestic C corporation like Standard Oil, or the constitutional equivalent of a passthrough entity? The *Macomber* Court clearly viewed partnership or passthrough taxation as constitutionally appropriate, but not for entities like Standard Oil that were double-taxed corporations. In *Moore*, the taxpayers' business was selling farm equipment in India through an Indian public limited company. That company is not a corporation under Indian law, but it is classified under the 1996 Treasury regulations as a corporation for U.S. tax purposes. However, because it is a foreign corporation, the United States does not impose a two-level tax on its foreign-source income. The only tax the United States imposes on that income is an owner-level or shareholder-level tax.

In some cases, the entity-level realized income of that entity is taxed by the United States (only to the U.S. shareholders) when it is actually distributed. In some cases it is taxed when it is deemed distributed, and in other cases it is taxed to certain U.S. shareholders under an imputation regime like subpart F or the MRT. In all cases, because there is no double-tax regime (and therefore no "additional" tax on a cash distribution if that amount has already been taxed as a deemed distribution or under an imputation regime),[7] there is no double-tax system to protect.

In effect, the government could argue that the entity is already disregarded or looked through

[7] Amounts previously taxed, either on account of a deemed distribution, or an imputation regime like the MRT or subpart F, are not taxed again, to an individual shareholder, when actually distributed. *See, e.g.*, section 959.

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(by virtue of the statutory decision of Congress not to impose a corporate income tax on the entity's foreign-source income). In effect, shareholders are already treated (for constitutional purposes in applying the U.S. tax law) as if they were partners in a partnership and not shareholders in a (domestic, double-taxed) corporation. That explanation of *Macomber* could explain the lower court decisions upholding the constitutionality of statutes treating certain foreign corporations as if they were partnerships.[8]

Those decisions did not give any serious attention to the ostensible conflict with *Macomber*'s holding as applied to Standard Oil and other domestic corporations. But this certainly would have been a legitimate basis to distinguish *Macomber* as applying only when there is a statutory tax imposed directly on the corporation or other entity, in addition to an "additional" tax when that previously taxed income is distributed.

We are not the first to suggest this analysis of what *Macomber* actually held. The legendary corporate tax treatise of Boris I. Bittker and James S. Eustice notes the Court's distinct holding about the "accumulated [corporate-level] profits." It also suggests, as we do, a distinction between a domestic C corporation and an S corporation that has the form of a corporation but elects passthrough treatment. For the same reason, any domestic or foreign law business entity under check the box that has a choice of tax treatment and elects (or does not elect out of) passthrough treatment can ostensibly be validly taxed as a passthrough entity, just like an S corporation, regardless of its state law form or the legal rights of any of its owners. As Bittker and Eustice explain:

> The government argued in *Eisner v. Macomber*, 252 US 189 (1920), that a shareholder receiving a stock dividend could be taxed under the Sixteenth Amendment on the accretion (because of accumulated profits) in the value of the shareholder's interest in the corporation. The Court rejected the argument "since the Amendment applies to income only, and what is called the stockholder's share in the accumulated profits of the company is capital, not income." Id., at 219. A tax on capital must be apportioned among the states as a direct tax. Whether the Supreme Court would adhere to this view today is problematical, but Congress has not attempted to compel shareholders to report undistributed corporate income, except in the limited instances of foreign personal holding companies and controlled foreign corporations (see paragraphs 15.40, 15.62). *Optional* inclusion of undistributed income, as under subchapter S (see Chapter 6) or the consent dividend procedure (see paragraph 7.09[2][b]) is, of course, another matter altogether.[9] [Emphasis added.]

The Bittker and Lawrence Lokken income tax treatise makes a similar point. Note their reference to the "legislative context" of a two-tier corporate tax system:

> Second, pointing to the fact that corporate profits belong to the corporation until distributed to the shareholders as dividends, the Court said that until then, "what is called the stockholder's share in the accumulated profits of the company is capital, not income." This view of the shareholder's relationship to corporate profits suggests that if Congress desired to tax shareholders on the undistributed profits of their corporations, it would have to apportion the tax among the states in proportion to population. *The Court's remarks arose in a legislative context involving a separate corporate tax and might have been modified if corporate profits were not taxed to the corporation but only to its shareholders.* The language chosen by the Court, however, was so broad that doubts about the constitutionality of taxing shareholders as they were partners in the corporate enterprise, though less weighty

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

[9] Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, para. 1.02 n.11.

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> than they once were, have not yet wholly disappeared.[10] [Emphasis added.]

The first treatise notes the authors' view that *Macomber* may be "problematical," perhaps suggesting the authors' view that the Supreme Court should overrule the entire decision. However, if it does not overrule *Macomber*'s two 1920 constitutional holdings, those holdings do not seem to be "problematical" as applied to a domestic C corporation. Consider a simple example. If a domestic corporation earned $100 million and paid $21 million of corporate tax, reinvesting the remaining $79 million, could Congress simultaneously tax the shareholders on the same $100 million as if they were partners in a partnership? *Macomber* said no. And then, reverting to the corporate model, could a third tax be imposed when the corporation actually distributed the $100 million (previously taxed both to the corporation and to the shareholders as if they were partners)? That would be a triple tax on the same $100 million of income. *Macomber* said no again. That third tax, the Court explained, would be like taxing someone on moving their money, "from one pocket to another."

It does not seem "problematical" to conclude that the Supreme Court would not uphold that result, for a double-taxed entity. That is, the proper tax would be a $21 million tax on $100 million of entity income at the entity level, and a shareholder-level tax on $79 million at the owner level, but only when that amount was distributed to a taxable shareholder. Congress could not tax the entity and the shareholders on the same $100 million of entity earnings, and then tax the shareholders again on the same $100 million when it was distributed to them.

The second holding may not apply at all, however, to the income of a business entity that is only subject to a single-level tax by the United States. There would be one, and only one, tax on the entity's $100 million of earnings, imposed on the owners, generally at the time they were realized by the entity (unless deferred by statute). The rate of tax would not be today's corporate rate of 21 percent, it would be whatever tax rate applied at the owner level. Single-taxed entities, for this purpose, would obviously include an S corporation, and any domestic or foreign business entity given the choice of corporate or passthrough treatment that elected passthrough treatment (or did not elect corporate treatment).

The critical question is how the second *Macomber* holding would apply to a foreign business entity that is treated as a per se corporation, like the Indian public limited company in *Moore*. In most foreign countries it would not be labeled as a corporation, as such, and the actual legal rights of the owners to demand a liquidating distribution or a distribution of current earnings could vary both under applicable local law and the terms of any operating agreement. Although *Macomber* discussed the legal rights of Standard Oil's shareholders, local law rights have receded in importance in entity classification since 1920, most dramatically with check the box. Local law rights might no longer be relevant. The critical factor for purposes of the second *Macomber* holding may be whether the entity is subject to a two-level tax system.

If the foreign entity, by statute, is not actually subject to any U.S. corporate income tax imposed at the entity level on its foreign-source income, that might be dispositive. In the case of MRT or subpart F income, that income is ostensibly only taxed by the United States at the owner level. Thus, a foreign corporation may belong more with other entities (like domestic or foreign partnerships) whose income can be constitutionally taxed directly to the owners. Under that analysis, the second constitutional holding in *Macomber* is still perfectly valid constitutional law, but it does not apply to the facts in *Moore.*

It is true that since 1962, active income of a foreign corporation has not been currently taxed the way it would be to a domestic partner in a foreign partnership. But that is statutory largesse. It seems that a domestic shareholder of a foreign corporation could have been constitutionally taxed as if it were a passthrough entity on all of its income. (The 1996 Treasury regulations could have classified an Indian public limited company as a passthrough entity or an entity eligible for a passthrough election.) The termination of a

[10] Bittker and Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts*, para. 1.2.

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generous statutory deferral rule does not seem to raise a constitutional question unless the change in policy is dramatic enough to raise Fifth Amendment questions, which the lower courts found was not the case in *Moore.*

Neither of the parties in *Moore* has explicated the actual holdings of *Macomber* (it seems there were two holdings) in this manner. Perhaps that is tactical.

From the government's tactical perspective, it is certainly possible that the Supreme Court, based on *Macomber*'s second holding, could declare the MRT and subpart F unconstitutional because the U.S. tax code and applicable Treasury regulations formally classify an Indian public limited company and similar foreign law entities as per se corporations. They do not even have an election to check the box and be treated as passthrough entities. The taxpayers might argue that the government should be estopped, in a sense, from arguing that a per se corporation is not a "corporation" for purposes of *Macomber*'s second holding. That could explain the government's failure to discuss the second holding in *Macomber.*

The taxpayers might have the opposite, tactical perspective. They might determine that the Court is more likely to conclude (as we believe appropriate) that an Indian public limited company that is not subject to any U.S. corporate income tax on its Indian-source income (which is what the MRT and subpart F regime tax under an imputation regime) is more analogous (for constitutional law purposes) to a foreign partnership. That would mean a loss for the taxpayers. The MRT and subpart F would be constitutional.

Again, the fact that the U.S. owners of a foreign corporation have been allowed (by statute from 1962 to 2017) to defer including certain amounts of the entity's realized operating income until it is actually distributed is statutory largesse. Since they could have arguably been taxed currently, constitutionally, on those amounts, withdrawing a statutory deferral benefit does not seem to raise a constitutional issue, or at least the lower courts so held.[11]

Instead of discussing the actual holdings in *Macomber*, the briefs filed to date seem to include much discussion of the historical meaning of the words "income" and "realization" and a discussion of the potential implications of *Macomber* for other situations (such as whether Congress could tax unrealized capital gains). That is a very important issue, but it was not before the Court in 1920 and it does not appear to be before the Court today.

The good news for both sides may be this: The Court's opinion in *Moore* could (and, in our view, should) confirm that there is indeed an important constitutional rule under the 16th Amendment that precludes taxing the shareholders of domestic C corporations on their allocable share of the corporation's corporate income (absent a distribution). Although that follows from the statutory structure of the tax system, the constitutional point is that one taxpayer's income, the entity's income, cannot be taxed to a different person. It is income, for purposes of the 16th Amendment, but not that other person's income for purposes of the 16th Amendment. In addition, of course, the first *Macomber* holding also stands. That is, imaginary income (like a stock dividend that does not actually distribute anything) cannot constitutionally give rise to income. We do not have to debate whether these rulings fall under the rubric of a "realization" requirement. They are clear, constitutional holdings, whatever label one gives to them.

At the same time, the Court could distinguish the MRT and subpart F to the extent that they only impose a tax on entity-level, realized income that will never (under the existing tax structure) be subject to any entity-level corporate tax. That is, the U.S. tax system does not, in substance, treat the foreign entity and the domestic shareholder as distinct taxpaying persons. Thus, the fundamental rationale for the treatment of Standard Oil in the 1920 case does not apply to the Indian-source income of an Indian public limited

[11] *Moore* did not present any other special facts, such as the possibility that foreign law currency restrictions might preclude any actual distributions to U.S. shareholders or the possibility that the prior year earnings had been destroyed or expropriated

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company merely because it is classified as a corporation by the 1996 entity classification regulations.

Would that interpretation of *Macomber* also mean that Congress cannot tax unrealized capital gains? Is taxing an imaginary or deemed sale as bad as taxing an imaginary or deemed dividend? In 1920 the Court suggested it might be, when it noted that the corporation's "antecedent accumulation of profits evidenced [by the stock dividend] while indicating that the shareholder is the richer because of an increase in his capital, at the same time shows he has not realized or received any income in the transaction."[12] That issue was not before the Court in 1920, and it is not before the Court today in *Moore*. If Congress decided, by statute, to tax the petitioners on the appreciation of their shares (which may well exceed the amount of the entity's accumulated profits, because capital gains often represent a prediction of future, yet-unrealized entity-level income, in addition to any previously realized income that has not yet been distributed), that would be a different issue.

Incidentally, for anyone concerned about the implications for other parts of the tax law, the *Macomber* Court expressly held out partnership taxation as a perfectly valid constitutional model — for entities treated as partnerships for tax purposes by statute. It only held that Congress could not pretend that Standard Oil was simultaneously a corporation and a partnership for tax purposes. It was either one or the other.

In short, both sides may prevail, at least philosophically, in *Moore*. The government can keep the structure (and revenue) of the MRT and subpart F for foreign corporations. The taxpayers and their allies will be vindicated on the principle that the 16th Amendment does, in fact, contain an important and still binding constitutional rule (albeit of still uncertain scope — to be resolved perhaps in other cases). Whether this result or a different result is ultimately reached, we hope that the Supreme Court will decide the case with a complete understanding of what the 1920 case actually decided. ■

[12] *Macomber*, 252 U.S. 189, at 212.

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