Possible New Issue in Unrealized Gains Case

To the Editor:

The Supreme Court recently granted certiorari in *Moore*,[1] a case involving the issue of unrealized income. Regardless of the Court's conclusion on the mandatory repatriation tax (which may not raise any realization issues since the accumulated earnings there were previously realized), it may have taken the case in part to clarify whether the Constitution would permit Congress to tax unrealized capital gains on a taxpayer's home, farm, ranch, business, or other long-term investments. In that regard, there may be an important constitutional issue not previously briefed or reviewed in this area.

Under *Kelo v. City of New London*,[2] the Fifth Amendment's public use clause may protect a property owner's right to be free from government compulsion — either explicit or indirect — to sell his property when he does not wish to sell, even with just compensation, where the government is compelling the sale only to generate or accelerate taxes and not for any public use of the property itself.

If Congress imposes a capital gains tax on the unrealized gains in a taxpayer's appreciated home or business when the taxpayer does not wish to sell the asset, that may be tantamount to directly compelling the sale of the asset, or a portion of it, to pay the tax. Otherwise, it would be seized by the government for unpaid taxes and then sold by the government.

The possibility that the taxpayer could avoid selling that particular property by selling or liquidating other assets, borrowing, or using currency on hand, would not mean that there was no compulsion to sell. Those alternatives would merely be possible methods of mitigating that compulsion. In all cases, the taxpayer's right to buy and hold his property would be violated, but not for any public use of the property itself — which the Fifth Amendment requires even if "just compensation" is provided. That may constitute an economic compulsion to sell your property solely to satisfy the government's desire to collect more taxes, which are normally due only upon a voluntary sale. The Supreme Court has suggested that such a compulsion to sell could violate the Fifth Amendment's takings clause.

In *Kelo*, the Court posed a strikingly similar issue, but deferred it to another day. While the Court upheld the use of eminent domain in that case, it noted the concern that:

> Nothing would stop a city from transferring citizen *A*'s property to citizen *B for the sole reason that citizen B will put the property to a more productive use and thus pay more taxes*. . . . The hypothetical cases posited by petitioners can be confronted if and when they arise. [Emphasis added; internal citations omitted.]

That very hypothetical would indeed need to be confronted if a capital gains tax on unrealized gains was imposed, because it would potentially compel the taxpayer to sell the property in question to pay the tax. Since the government does not intend to put the property to a public use, the *Kelo* majority opinion may suggest that the government's desire to generate or accelerate taxes that would normally be imposed only if the taxpayer sold the property at a gain is not a sufficient reason under the Fifth Amendment for that compulsion.

Normal ad valorem property taxes or income taxes imposed on the income from property are different. They are a normal cost of property ownership and do not raise the same issue. This would be a tax that would normally be imposed only upon the voluntary sale of the property and would be calculated on unrealized gain, typically at a graduated income tax rate particular to the taxpayer, as if the property were actually sold.

We also note that there may be a compulsion to sell because any later loss on the property (a

[1] *Moore v. United States*, No. C19-1539-JCC (unpublished, W.D. Wash. 2020), *aff'd*, 36 F.4th 930 (9th Cir. 2022), *reh'g den.*, 53 F.4th 507 (9th Cir. 2022), *cert. granted*, No. 22-800.

[2] *Kelo v. City of New London*, 545 U.S. 469 (2005).

capital loss) if the same property declines in value and is sold (vitiating or eliminating the previously assumed and taxed economic gain) would typically not generate any refund of the prior tax. Only by selling and moving to cash could that risk of a tax whipsaw be eliminated. This possibility may also implicate the economic gain issue.

Even under *Glenshaw Glass*,[3] an income tax can't be imposed when there is no economic gain at all. Taxing gains measured by the value of a taxpayer's appreciated assets as if they were sold at the prevailing market price without any mechanism — such as an unlimited capital loss carryback — to refund that tax if the identical asset is actually sold at a lower price in a later year isn't taxing economic gain.

For example, assume that property was purchased for $100 on January 1, was publicly quoted as worth $150 on November 25, dropped back to $100 on December 25, and was then sold for $100 on December 31, all in the same year. There would clearly be no economic gain to tax, even if unrealized gains were taxed at the end of every year.

If the price drop and sale did not occur until Valentine's Day of the next year, and an annual mark-to-market tax on unrealized gains was imposed for the prior year, there would still be no economic gain. But there would be a tax imposed on $50 of paper gains in the first year, with no refund, reduction, or offset on account of the $50 capital loss actually realized in the second year. The second year's capital loss could not be carried back to offset or refund the prior year's tax. The mark-to-market tax, in that case, would not be a tax on economic gain. It would merely be a fluke — an artifact of the annual accounting system.[4]

The tax in that case, and many others, would not even qualify as a wealth tax. The tax system would be arbitrarily taxing an amount that bears no rational relationship to income, gain, or wealth.

The views expressed here are solely ours and are not tax advice.

Donald B. Susswein
Kyle Brown
RSM US LLP
Aug. 18, 2023

[3] *Commissioner v. Glenshaw Glass*, 348 U.S. 426 (1955).

[4] *See* Reuven S. Avi-Yonah and David Gamage, "Billionaire Mark-to-Market Reforms: Response to Susswein and Brown," *Tax Notes Federal*, July 25, 2022, p. 555 ("All serious BIT reforms have mechanisms for refunding losses, at least to the extent of prior recognized gains."); Donald B. Susswein and Kyle Brown, "Mark-to-Market Mechanism: MIA? A Response to Avi-Yonah and Gamage," *Tax Notes Federal*, Oct. 3, 2022, p. 79 ("Unfortunately, the mechanism the professors describe, and say is needed to prevent double taxation, does not appear to exist in the leading proposal in this area.").