THE PAST AND FUTURE OF TAXING "INCOMES"[*]

CLINT WALLACE[**] & BRET WELLS[***]

For at least half a century, the text of the Sixteenth Amendment—"Congress shall have power to lay and collect taxes on incomes, from whatever source derived"—has been treated by courts, lawmakers, and scholars as giving Congress broad authority to define and tax income, perhaps without any limitation. Recently, however, some members of the Supreme Court started to revive a seedling planted in the 1920s but left for dead: that the "realization rule" should be elevated to the status of a constitutional limit to Congress's power to determine what is income. With this, we seem to be entering a new era in constitutional tax jurisprudence, focused on the meaning of income and limits to Congress's power to tax it.

This Article places realization in broader context, based on a novel investigation of the intellectual and functional roots of U.S. federal income taxation, with a particular focus on the temporality of income. We find commonality between time-conscious income tax theory developed by leading economists in the pre-ratification era (some now largely forgotten), and functional concerns percolating around the same time that we uncover in financial accounting practices and tax administrative guidance. Temporal issues are central: measuring income across time periods is a dynamic and complex undertaking, and theorists and practitioners alike recognized realization as one of many possible, partial resolutions. The history we uncover here dispels the notion, advanced recently by some scholars and Supreme Court Justices, that when the Sixteenth Amendment was ratified there was a common understanding of income that rested solely on realization. It suggests instead that there was not a single meaning of "incomes" as limited to realized gains, but rather that income had different meanings in different contexts.

** Clint Wallace is a Professor of Law at the University of South Carolina Joseph F. Rice School of Law.

*** Bret Wells is the John Mixon Chair and Professor of Law at the University of Houston Law Center. For helpful comments and discussion, we thank Reuven Avi-Yonah, Lad Boyle, Tommy Crocker, Brian Galle, Christine Kim, as well as participants in the Association of Mid-Career Tax Professors 2024 workshop, the UC-Irvine *Moore* Symposium and the National Tax Association 2024 Annual Conference. Thanks to William Raffone and Vanessa McQuinn for research and editing assistance.

The historical account we develop here both anticipates and sheds light on the time-related challenges that have emerged since, including in recent constitutional income tax debates. Realization has proven especially problematic—then and now. In lieu of the realization principle, we argue that tax basis rules have served as a mechanism that effectively limits the scope of the time-bound income tax. We argue that the formulation of the concept of tax basis has worked to harmonize various timing rules so that income is taxed only once across time periods. In that way, tax basis can and does limit Congress's income tax power so that a tax on income cannot morph into a tax on capital.

INTRODUCTION

Time and time again, Justices of the Supreme Court of the United States have returned to a simple analogy to help understand the concept of income and how it might be distinguished from capital.[1] Capital, the Court explains, is like a seed or tree planted in the ground. Income, in contrast, is the fruit that the tree produces. In one of its most important early opinions on what constitutes income, *Eisner v. Macomber*[2] in 1920, a narrow 5–4 majority of the Court used this fruit analogy to trim back the reach of Congress's power under

1. *See, e.g.*, Lynch v. Hornby, 247 U.S. 339, 344 (1918) (describing dividends as the "fruit" of stock, which constitutes income); United States v. Safety Car Heating & Lighting Co., 297 U.S. 88, 99 (1936) (analogizing to capital as the "seed" and income as the "fruit that it will yield"); Moore v. United States, 144 S. Ct. 1680, 1722 (2024) (Thomas, J., dissenting).

2. 252 U.S. 189, 206 (1920).

the Sixteenth Amendment.[3] To constitute income for tax purposes, the Court intoned, "the fruit or the crop" must be "severed from the capital."[4] The opinion referred to this act of severance as a "realization."[5]

This agrarian, fruit-based analogy represents an effort by the Court to develop a straightforward conception of income that can be applied consistently. But despite the judicial appeal of this kind of pronouncement, the Court (like the mythological Tantalus[6]) has repeatedly discovered that its desired shiny apple of a universal timing rule is just beyond its grasp.[7] A thicket of judicial opinions along with extensive scholarship have shown that the concept of income defies a simple formula.[8] In short, context matters. While the image of picking a fruit may be helpful in some instances—for example, thinking about dividends paid to an owner of corporate stock[9]—distinguishable fact patterns abound, each raising distinctive considerations.[10]

In this Article, we contend that the abiding challenge with articulating a simple working definition of income is grappling with *time*.[11] Income taxation requires timing conventions for each taxpayer and every source and type of income, specifying when to include items into income, when to allow deductions from income, and how to keep track of what has been included or deducted in earlier time periods. These kinds of timing rules are necessary because income, conceptually, has a temporal aspect: income is a change in economic position *over some period of time*.[12]

3. U.S. CONST. amend. XVI; *Macomber*, 252 U.S. at 206; *see* Marjorie E. Kornhauser, *The Story of Macomber: The Continuing Legacy of Realization*, *in* TAX STORIES 94, 104, 105 (Paul Caron ed., West 2d ed. 2009) [hereinafter Kornhauser, *The Story of Macomber*].

4. *Macomber*, 252 U.S. at 206–07 (emphasis omitted).

5. *Id.* at 209.

6. The story goes that, as punishment for crossing the gods, Tantalus was condemned to Tartarus for an eternity, where he was made to stand beneath a fruit tree, standing up to his chin in a pool of water. Whenever he tried to pick a fruit, the tree branches would lift out of his reach, and whenever he tried to drink any water, the pool would recede. *Tantalus*, MERRIAM-WEBSTER, https://www.merriam-webster.com/dictionary/Tantalus [https://perma.cc/3KVN-34N2].

7. *See infra* Part I (discussing disagreements among current members of the Supreme Court); *infra* Part III (discussing timing issues that arose after the Court decided *Macomber* and led the Court to back away from the broad holding *Macomber* seemed to represent initially).

8. *See, e.g.*, John R. Brooks, *The Definitions of Income*, 71 TAX L. REV. 253, 253, 294–308 (2018) (identifying and detailing twelve distinct definitions of income used by the federal government in different contexts and describing that "a truly complete and rigorous definition of income is impossible or unworkable"); *see infra* notes 201–04 (discussing varied Supreme Court attempts to define income).

9. The precise issue in *Macomber* was dividends paid in the form of more stock, which the Court determined not to constitute "fruit" of the tree, and thus not to constitute income. *Macomber*, 252 U.S. at 207–10.

10. *See infra* notes 205–21 and accompanying text.

11. *See infra* Part II.

12. *See infra* Sections III.A, III.B (describing the basic temporal architecture of the U.S. federal income tax, including the annual accounting period and the cash and accrual methods of accounting, both of which were adopted by statute and endorsed by the Supreme Court shortly after the Sixteenth Amendment was ratified).

The challenges presented by the temporality of income may be understood through another analogy, one that we show in this Article has its roots in the income tax theory developed by economists in the late nineteenth and early twentieth centuries.[13] It was also, not incidentally (we think), mentioned briefly in the *Macomber* opinion. In the same paragraph in which the Court wrote about the tree and its fruit, the opinion turned to the science of hydrology—studying and measuring the movement of water through an ecosystem.[14] The *Macomber* Court observed that capital may be "depicted as a reservoir supplied from springs, [while income is] the outlet stream, to be measured by its flow during a period of time."[15] This hydrological conception of income is more apt than fruit: the movement of water is dynamic and complex—measuring water accurately as it flows in and out and evaporates up and precipitates back down involves evaluating volumes by adopting timing and measuring conventions.[16] A stream may have twists and turns, pools and eddies, and its size and route may change over time. Similarly, income can take on different forms, and measuring the flow of income requires timing rules and various subsidiary conventions, most importantly, tax basis.[17] As with drops of water, money is indistinguishable and fungible, so determining what you have now as compared to what you started with is not as simple as counting the fruit you have plucked from a tree.

The very early hydrological conception of income has largely been overlooked by commentators and in judicial opinions in the intervening century, and the connection between the reference to it in *Macomber* and the significant, early literature on income tax theory has been lost in contemporary discourse. In this Article, we show that scholars had developed, by the late nineteenth century, a concept of "economic income" that was attentive to the challenges of temporality, and that included both realized and unrealized gains.[18] Though the *Macomber* Court does not cite his work, economist Irving Fisher (who was joined by others, both earlier and later) explained this conception of income in 1896 by way of the hydrological analogy.[19] Their work

13. *See infra* Part II; Irving Fisher, *What Is Capital?*, 6 ECON. J. 509, 514–17 (1896); *see also* EDWIN CANNAN, A HISTORY OF THE THEORIES OF PRODUCTION AND DISTRIBUTION IN ENGLISH POLITICAL ECONOMY FROM 1776 TO 1848, at 14, 273 (London, Rivington, Percival & Co. 1894); SIMON NEWCOMB, PRINCIPLES OF POLITICAL ECONOMY 325 (New York, Harper & Bros. 1886).

14. *Macomber*, 252 U.S. at 206; *see What Is Hydrology?*, U.S. GEOLOGICAL SURV. (May 23, 2019), https://www.usgs.gov/special-topics/water-science-school/science/what-hydrology#Hydrology [https://perma.cc/T49Q-HU4L].

15. 252 U.S. at 206.

16. *What Is Hydrology?*, *supra* note 14.

17. *See infra* Part IV.

18. *See infra* Section II.A.

19. Fisher, *supra* note 13, at 525–26; *see infra* notes 94–105 (discussing Fisher's subsequent work, along with the work of other notable economists making similar arguments). Fisher cited Professor

is important because such an expansive understanding of income, including an emphasis on temporality,[20] anticipates and sheds light on the time-related practical challenges that have emerged over the course of the twentieth century and in the most recent constitutional debates about the income tax.[21]

We also uncover a prevalent nonrealization conception of income in that same time period in a practical setting.[22] At the time the Sixteenth Amendment was ratified, commodity merchants for grain and cotton—i.e., the buyers and sellers of almost all of the agricultural output in the United States[23]—had long computed income and prepared balance sheets for financial reporting purposes by way of accounting conventions that eschewed the realization principle. Under this long-held practice, commodity merchants prepared their financial statements by including unrealized gains and losses in income. They did this by "marking-to-market"[24] their physical inventory and associated hedges[25] in order to determine the income derived from their commodities each year. Referencing market values for these exchange-traded goods was viewed as the only practical means to determine income for financial accounting purposes—i.e., in a way that reflected the income of the business over the specified time period in a meaningful and accurate way—in this time-sensitive and highly volatile sector of the economy. As a result, since around the Civil War, this industry determined annual income by including unrealized gains and losses on physical commodities as well as unrealized losses and gains on their associated hedges.[26] Early Treasury Department field auditors pushed back against applying this approach for tax purposes under the first income tax laws

Simon Newcomb, a mathematician and astronomer who, in Fisher's description, wrote about economics for a "popular audience," including explaining the difference between capital and income by analogy to the difference between a "fund and a flow," as early as 1886. Fisher, *supra* note 13, at 525–26; NEWCOMB, *supra* note 13, at 396. Newcomb was notable in his time; Fisher is one of the most renowned economists in American history.

20. As we elaborate in Section II.B, Fisher explains that "all wealth presents a double aspect in reference to *time*. It forms a *stock* of wealth, and it forms a *flow* of wealth. The former is, I maintain, capital, the latter, income . . . ." Fisher, *supra* note 13, at 514. He goes on to explain how income is "more in need of explanation," because measurement requires considering the passage of time. *Id.*

21. *See infra* Section III.D.

22. *See infra* Section II.B.

23. In 1900, agriculture was the single largest industry in the nation, contributing 15.5% of the gross domestic product and employing nearly 40% of the nation's workforce. Phillip G. Pardey & Julian M. Alston, *The Drivers of U.S. Agricultural Productivity Growth*, FED. RSRV. BANK OF KAN. CITY, https://www.kansascityfed.org/Agriculture/documents/7107/the-drivers-of-us-agricultural-productivity-growth.pdf [https://perma.cc/2JTC-KTW9].

24. The term "mark-to-market" entails referencing public trading values or market values for assets, including, in the commodities industry, actual grain and contracts for the future sale and purchase of grain. *See infra* notes 167–71 and accompanying text (elaborating on mark-to-market accounting).

25. *See infra* notes 140–45 and accompanying text (explaining hedging generally and late nineteenth-century commodities industry hedging practices in particular).

26. *See infra* notes 140, 156 and accompanying text.

following the ratification of the Sixteenth Amendment.[27] But in response, the industry explained the intricate details of why its well-established nonrealization approach was critically important for measuring income of grain and cotton merchants.[28] Imposing a realization requirement for income tax purposes would contradict the industry's operational conception of income and fail to gauge income in any meaningful way given time distortions in the industry. In a series of decisions that still carry water today, the Treasury Department accepted the industry's arguments.[29]

The early economic theory of income and financial accounting practices we uncover repudiates the notion that the realization principle was a commonly understood limiting factor on the determination of income. The extant economic literature and tax reporting practices that predated the ratification of the Sixteenth Amendment have been underappreciated in contemporary academic and judicial attempts to parse the meaning of the Sixteenth Amendment in that era.[30]

To be sure, although these historical insights dispel the notion that the realization principle ever served as an absolute limiting factor on the meaning of income, these insights do not directly resolve the new search for a limit to Congress's power to tax "incomes" under the Sixteenth Amendment. However, we argue that the persistent challenge of the temporality of income—first conceived in the pre-ratification era as the flow of water rather than the picking of fruit—suggests a theoretical and doctrinal answer that has been hidden in plain sight. The temporality of income taxation—in contrast to a property or wealth tax—means that once income is taxed in one period, it cannot be taxed as income again in another period. In practice, the contemporary income tax includes rules that protect against the potential for multiple taxation through the mechanism of *tax basis*.

We show that the tax basis rules have worked to harmonize various timing conventions to generally ensure that income is taxed only once across time periods. Careful measuring and tracking of income inclusions provides a coherent resolution to the challenges of distinguishing income from source, and the tax basis mechanism preserves contextual flexibility for Congress to

27. *See infra* Section II.B.

28. *See infra* notes 157–61 and accompanying text.

29. *See infra* notes 162–66 and accompanying text.

30. Throughout, we refer to the "ratification era," meaning the decades leading up to the ratification of the Sixteenth Amendment, and specifically the years from 1895, when the first non-wartime federal income tax was promptly struck down as unconstitutional two years after enactment through to the time the Sixteenth Amendment was proposed and voted on in Congress in 1909 and its ratification in 1913, which was followed promptly by the enactment of the first income tax statute later that same year. Pollock v. Farmers' Loan & Tr. Co., 157 U.S. 429, 586 (1895), *aff'd on reh'g*, 158 U.S. 601, 637 (1895).

determine incomes appropriately in a variety of different circumstances. Through it all, basis adjustments have been utilized to ensure that a tax on income cannot morph into a tax on capital. Thus, the use of the tax basis mechanism, calibrated with context-specific timing rules, has worked in tandem to limit the scope of Congress's power to tax *only* income without impinging Congress's ability to design timing conventions that are administrable and work in practice. Recently, the Court in *Moore v. United States*[31] has returned to a concern over distinguishing income from its source as suggested by the text of the Sixteenth Amendment.[32] But the Court in *Moore* did not appreciate that the tax basis mechanism already calibrates the imposition of divergent timing rules so that the constitutionally required distinction between income and its source can be maintained over time.

In this Article, we explore how the Tax Code has been harmonized to ensure that income is only taxed once. We find a long history and tradition going back to the earliest income tax statutes that show that Congress has indeed limited its taxation under the Sixteenth Amendment to only income and not its source even though no singular omnibus timing convention was ever adopted to define income. In fact, from the very outset and out of practical necessity, Congress established the basic temporal architecture of the federal income tax—an annual measurement period and the cash and accrual methods for determining what income is included when. Thereafter, Congress and the Court fashioned a variety of special timing rules along with tools to track inclusions and deductions within this architecture, across time periods.[33] Various challenges arose—debt is particularly thorny.[34] Perhaps most challenging, taxpayers and scholars identified that timing rules that allow tax deferral (by excluding unrealized gains from income) can create the equivalent benefit of an income tax *exemption* with respect to the returns on tax-deferred investment.[35] Modern finance theory now makes clear that strict adherence to a realization-based income tax frustrates rather than effectuates Congress's power to tax "incomes, from whatever source derived."

This Article proceeds as follows. Part I provides an overview of the Supreme Court's multiple opinions in the *Moore* case in 2024, which presented divergent ideas about how the Sixteenth Amendment might be interpreted to limit Congress's taxing powers. Part II introduces the tangled intellectual and functional history of income, showing that it was recognized—before and as the Sixteenth Amendment was ratified—to present unique challenges related to time. Even as the meaning of income was inconsistent across different contexts

31. 144 S. Ct. 1680 (2024).
32. *Id.* at 1687, 1689.
33. *See infra* Part I.
34. *See infra* Section III.C.
35. We detail the mechanics of this exemption benefit *infra* Section III.D.

in the pre-ratification era, the historical account we develop here shows that realization was neither an absolute rule nor necessary element of any shared understanding of income. Part III further contextualizes the challenge of time in income taxation, showing how scholars, Congress, and the Court have refined and focused the concerns that early theorists and tax administrators confronted, producing a multitude of different timing rules that are imposed in different contexts.

In Part IV, we argue that there is a unifying conceptual consistency across these rules: because income is a temporal concept, an income tax requires tracking rules—what we know today as tax basis—to ensure that income is only taxed one time. A tax imposed on the same value multiple times is not an income tax in the sense it was understood by anyone in the pre-ratification era or since. Conversely, the hydrological conception of income and its incorporation of temporality that we resurface in this Article work in tandem with a variety of timing rules to appropriately distinguish income from capital over time.

I. SEARCHING FOR LIMITS IN THE SIXTEENTH AMENDMENT

In the two decades that followed the 5–4 opinion in *Macomber*, the Court began to articulate that "realization" was not a constitutional requirement, and thus not a limiting factor to the taxation of income.[36] Rather, the Court gave Congress increasingly broad latitude with regard to timing of inclusions in income, along with other administrative issues like whether or not a particular taxpayer actually received income (rather than passing it off to someone else).[37] By the 1950s, the Court announced explicitly in *Glenshaw Glass Co. v. Commissioner*[38] that the definition of income provided in *Macomber* "was not meant to provide a touchstone to all future gross income questions," even as it might remain "useful" for the purpose of "distinguishing gain from capital."[39] Eventually, commentators and the Court generally agreed that the conceptual limits of income were to be treated as a *statutory* issue, and the phrase "all income from whatever source derived," as enacted in Section 61 of the Tax Code, covers

36. *See, e.g.*, United States v. Kirby Lumber Co., 284 U.S. 1, 3 (1931) (limiting the meaning of "realization" to exclude loan proceeds, discussed further *infra* notes 220–31); Helvering v. Horst, 311 U.S. 112, 115–16 (1940) (grasping onto the agrarian analogy to hold that "fruit" assigned by one taxpayer to another is nonetheless income to the first taxpayer even when he "disposes of his right to collect it").

37. *See Kirby*, 284 U.S. at 3; *infra* notes 220–31; *Horst*, 311 U.S. at 116; *see also* Cottage Savs. Ass'n v. Comm'r, 499 U.S. 554, 559 (1991) ("As this Court has recognized, the concept of realization is 'founded on administrative convenience.'" (quoting *Horst*, 311 U.S. at 116)).

38. 348 U.S. 426 (1955).

39. *Id.* at 431.

"all economic gains not otherwise exempted" by Congress.[40] Constitutional challenges to Congress's power to tax income had, until very recent years, come to be almost universally perceived as a dead end.[41]

With this apparent abandonment of *Macomber* as a constitutional dictate, there did not seem to be much, if any, substantive limitation on Congress's power to tax under the Sixteenth Amendment.[42] Rather, bad income tax policy came to be viewed as a political problem, not a constitutional infirmity.[43] Legislators who enact an ill-advised tax scheme might find themselves regretting it on election day, victims of America's history and tradition of political tax protests.[44]

Then, in the 2024 *Moore v. United States* case, the Supreme Court returned to the issue, and, in so doing, reopened it. The Court took up *Moore* following a Ninth Circuit opinion holding that "the Supreme Court has made clear that realization of income is not a constitutional requirement."[45] The question upon which certiorari was granted in *Moore* was direct: whether the Sixteenth Amendment requires that income must be "realized" before it can be subject to income taxation, such that "unrealized" gains could not be taxed as income.[46]

40. Comm'r v. Banks, 543 U.S. 426, 433 (2005) (unanimous decision) (citing first 26 U.S.C. § 61(a); and then *Glenshaw Glass*, 348 U.S. at 429–30).

41. In one of the more serious constitutional challenges—to a portion of the Tax Code addressing taxation of foreign corporations owned by U.S. taxpayers—the Second Circuit observed that the constitutional claim "borders on the frivolous," given precedent and traditions of tax policy in that area. Garlock Inc. v. Comm'r, 489 F.2d 197, 202–03 (1973) (cited in Moore v. United States, 144 S. Ct. 1680, 1693 (2024)); *see also* Bruce Ackerman, *Taxation and the Constitution*, 99 COLUM. L. REV. 1, 47–48 (1999) (synthesizing opinions from the 1930s through the 1980s to explain that *Macomber*'s creation of a limitation on Congress's Sixteenth Amendment power to tax was left "to die 'a slow death'").

42. *See* United States v. Ptasynski, 462 U.S. 74, 79 (1983) ("Congress' power to tax is virtually without limitation.").

43. *See* Ackerman, *supra* note 41, at 20–25, 55–56 (describing politics as central in the early decades following the founding, and again once it became clear that *Macomber* would not be sustained by the Court).

44. *See* STEVEN R. WEISMAN, THE GREAT TAX WARS: LINCOLN TO WILSON: THE FIERCE BATTLES OVER MONEY AND POWER THAT TRANSFORMED THE NATION 1–7 (2002) (introducing his history of six decades of political discourse around the income tax by reference to early political tax that sparked the American revolution and animated the country's founding); Ari Glogower, *The Constitutional Limits of the Taxing Power*, 93 FORDHAM L. REV. 782, 819–22 (2024) [hereinafter Glogower, *Constitutional Limits*] (explaining the judicial tradition of deference to congressional tax lawmaking, and discussing some procedural and constitutional limits on tax legislation); Daniel Hemel, *Formalism, Functionalism, and Nonfunctionalism in the Constitutional Law of Tax*, 2024 SUP. CT. REV. 327 (describing the Origination Clause and Uniformity Clause of the Constitution as having been rendered "essentially meaningless" by the Supreme Court (quoting John R. Brooks & David Gamage, *Taxation and the Constitution, Reconsidered*, 76 TAX. L. REV. 75, 89 (2022))).

45. Moore v. United States, 36 F.4th 930, 936 (9th Cir. 2022).

46. Moore v. United States, 144 S. Ct. 1680, 1696 (2024). The case consisted of a challenge to Section 965 of the Tax Code, which treated certain foreign corporations owned by U.S. shareholders as pass-through entities, thus including previously earned profits in the income of their U.S. owners. *See* Brief for Reuven Avi-Yonah, Clint Wallace & Bret Wells as Amicus Curiae Supporting Respondent at 2–4, Moore v. United States, 144 S. Ct. 1680 (2024) (No. 22–800). If unrealized income

Five Justices in the majority agreed to resolve the case on narrower grounds—setting aside realization and focusing on alternative grounds for upholding the specific provision at issue—while expressly preserving the possibility of some substantive limitation in Congress's Sixteenth Amendment powers.[47] The majority warned that the imposition of a realization requirement could create a potential "fiscal calamity" that would have a "blast radius" that might cripple the federal government's ability to fund its existing governmental programs.[48] Further, the majority opinion flatly stated that, "[b]ecause income taxes are indirect taxes, they are permitted under Article I, § 8 without apportionment."[49] Even so, this important statement in the majority opinion is arguably dicta, because the majority opinion stated elsewhere that it would not reach the certified question of whether or not unrealized gains are assessable without apportionment among the states.[50]

Four other Justices staked out the position that income taxation is a direct tax that Congress is empowered to levy without apportionment only by reason of the Sixteenth Amendment and that realization is a constitutionally mandated limit on Congress's ability to impose income taxation.[51] The two most vehement dissenters, Justices Thomas and Gorsuch, emphasized "sever[ance]" and relied on the fruit analogy to make their case—unharvested fruit cannot be included in income, they argued, pointing to *Macomber* along with some little-known nineteenth-century case law.[52]

were determined to fall outside of the Sixteenth Amendment conception of income, the result would be that unrealized income would need to be "apportioned" as a direct tax, making it practically impossible to tax in practice. *See* John R. Brooks & David Gamage, *Taxation and the Constitution, Reconsidered*, 76 TAX L. REV. 75, 94–97 (2022) (explaining apportionment in detail, and showing historical evidence that apportionment and uniformity were understood by the Founders to be alternatives, such that any practically unapportionable tax should pass constitutional muster if made uniform, and vice versa).

47. *See Moore*, 144 S. Ct. at 1683, 1696. Justice Kavanaugh wrote for the majority and was joined by Justices Robers, Kagan, Sotomayor, and Jackson. *Id.* at 1684. Justice Jackson explained in a separate concurrence her view that the only limits on Congress powers under the Sixteenth Amendment are political, not legal or substantive. *Id.* at 1697–99 (Jackson, J., concurring). Justice Kavanaugh may agree—in oral argument, he posited something similar, responding to a hypothetical by Justice Alito regarding a tax on appreciation in securities or real property by noting that "members of Congress want to get reelected." *See* Transcript of Oral Argument at 126, Moore v. United States, 144 S. Ct. 1680 (2024) (No. 22–800).

48. *Moore*, 144 S. Ct. at 1693, 1696.

49. *Id*. at 1688.

50. *Id.* at 1689–90 (limiting the scope of the case to "whether Congress may attribute an entity's realized and undistributed income to the entity's shareholders or partners, and then tax the shareholders or partners on their portions of that income").

51. *See id.* at 1699 (Barrett, J., concurring); *id.* at 1709 (Thomas, J., dissenting).

52. *Id.* at 1722 (Thomas, J., dissenting) ("That understanding of income as being something '*severed from*' its source predated the Sixteenth Amendment."). For this proposition, Thomas cited a Georgia Supreme Court case, Waring v. Mayor of Savannah, 60 Ga. 93, 100 (1878), as a "well-cited case" that expressed similar reasoning, and that used the tree/fruit analogy. 144 S. Ct. at 1722. The case

According to the dissent written by Justice Thomas, realization is required because "the only way to draw such a distinction [between income and its source] is with a realization requirement."[53] They also sought to shadow the Sixteenth Amendment in light of the direct tax clause of the Constitution, which the dissent described as "one of the bulwarks of private rights and private property."[54] Nowhere in the text of the Sixteenth Amendment is the term "realization" used, but the dissent reasoned that there should be some limiting factor and the realization requirement by default must be it. From this premise that rejects *sub silentio* any alternative means to effectuate a distinction between income and its source (such as the usage of the tax basis mechanism), the dissent then makes a further conceptual leap to conclude that Congress is permitted to tax only income that has been realized as a matter of constitutional necessity.[55] Through this reductive logic, the dissent concluded that "the Sixteenth Amendment requires a way to distinguish between income and source,"[56] which, turning to the fruit analogy, requires a "severance" to which realization is an apt proxy for effectuating this fruit analogy.[57] Both of the *Moore* dissents' efforts to uncover a constitutional limit on the scope of the Sixteenth Amendment thus

was cited to by courts a total of thirty-one times prior to Thomas's reliance on it in *Moore*. WESTLAW: *WARING V. MAYOR OF SAVANNAH*: CITING REFERENCES, 31 results (Nov. 10, 2025) (on file with the North Carolina Law Review) (filtered by "Cases" and "All Dates Before 06/20/2024").

53. *Moore*, 144 S. Ct. at 1709 (Thomas, J., dissenting) (citing Eisner v. Macomber, 252 U.S. 189, 207 (1920)).

54. *Id.* at 1719 (quoting Pollock v. Farmers' Loan & Tr. Co., 157 U.S. 429, 583 (1895)) (stating that *Pollock* declared the pre-Sixteenth Amendment income tax to be unconstitutional, unapportioned, direct tax). Although this federalism argument appeared in *Pollock*, it has been subject to withering criticism, starting with the dissent in *Pollock*, as an ahistorical and "contrived" analysis of the historical context surrounding the direct tax clause of the Constitution. *See* OWEN M. FISS, HISTORY OF THE SUPREME COURT OF THE UNITED STATES, VOLUME VIII: TROUBLED BEGINNINGS OF THE MODERN STATE, 1888-1910 at 91–95 (1993). It was abandoned by the Court over the course of the twentieth century. Ackerman, *supra* note 41, at 44–47. The dissent further asserted that states and the federal government "share" power to impose direct taxes, and this sharing was "an essential component of the constitutional compromise" one that "was a critical aspect of the balance between state and federal power in the original design of the Constitution." *Moore*, 144 S. Ct. at 1712, 1715 (Thomas, J., dissenting). The dissent explains that, to them, policing the line between direct and indirect taxes is thus a part of adherence to "federalism principles" that animated the taxing clauses of the Constitution as well as the Sixteenth Amendment. *Id.* at 1720. This extension of *Pollock* has been resisted even at the time of the *Macomber* decision. *See Macomber*, 252 U.S. at 220 (Holmes, J., dissenting) (opining that ratification of the Sixteenth Amendment has vested Congress with plenary authority to determine taxation without any practical restraint imposed by "nice questions as to what might be direct taxes"). Nonetheless, "classical liberal" legal scholars have continued to promote the Pollock majority's approach. *See, e.g.*, RICHARD EPSTEIN, THE CLASSICAL LIBERAL CONSTITUTION 196 (2014) (discussing the direct tax clause in similar manner). *But see also* Glogower, *Constitutional Limits*, *supra* note 44, at 785, 837–39 (arguing against resurrecting the "inflate[d]" apportionment requirement introduced in the *Pollock* decision).

55. *See Moore*, 144 S. Ct. at 1709–10 (Thomas, J., dissenting).

56. *Id.* at 1721.

57. *Id.* at 1722 ("That understanding of income as being something '*severed from*' its source predated the Sixteenth Amendment.").

portend a new era in constitutional tax jurisprudence—the dissenters are one vote shy of commencing a paradigm shift in how the courts interpret Congress's power to tax income.[58]

Among the Justices in *Moore* who embraced a realization requirement as part of the Sixteenth Amendment, what exactly constitutes realization remains a point of disagreement.[59] Justice Barrett, joined by Justice Alito,[60] stated that "realization may take many forms,"[61] including "a sale or other transaction," and also an "exchange of property, payment of the taxpayer's indebtedness, relief from a liability, or other profit realized from the completion of a transaction."[62] If realization covers all of these circumstances, it is far from clear what the term actually means.[63] Justices Thomas and Gorsuch offered their own definitions, quoting *Macomber* to opine that realization is satisfied when an amount is "received or drawn by the recipient . . . for his separate use."[64] These varied conceptions across just two opinions agreed to by four Justices leave a distinct lack of clarity.[65] Nonetheless, Justices Thomas and Gorsuch asserted that "the concept of realization was well understood at the time of ratification."[66]

We agree with the dissent that the Sixteenth Amendment requires distinguishing between income and its source, capital—with only the former subject to taxation under Congress's Sixteenth Amendment powers, but not the latter. However, from here the dissent errs. As this Article shows in Part II, the assertion that the realization principle was the only accepted and possible means of determining income is betrayed by the intellectual development of the concept of income that predated the Sixteenth Amendment, and it is also

58. While our focus here is on the Sixteenth Amendment, the dissent's invocation of the direct tax clause along with political debates about the viability of a wealth tax have opened up fresh debates on other aspects of Congress's constitutional tax authority as well. *See infra* note 259.

59. *Moore*, 144 S. Ct. at 1721–22 (Thomas, J., dissenting); *id.* at 1710.

60. The Barrett concurrence agreed with the majority that the particular statutory provision at issue in the *Moore* case was constitutional but expressed that nonetheless realization is a requirement. *Id.* at 1700–01 (Barrett, J., concurring).

61. *Id.* at 1704.

62. *Id.* at 1701, 1703 (quoting Helvering v. Bruun, 309 U.S. 461, 469 (1940)).

63. *See infra* notes 219–22 (contending that inclusion in income of cancellation of debt is an example of the type of contextual timing rule that Congress has and should be empowered to enact in order to tax all incomes).

64. *Moore*, 144 S. Ct. at 1722 (Thomas, J., dissenting) (quoting Eisner v. Macomber, 252 U.S. 189, 207 (1920)).

65. Both opinions also point to ratification-era dictionaries to argue that "realization" meant essentially the same thing as "derivation," providing a textual hook finding that the Sixteenth Amendment requires realization. *Id.* at 1700–01 (Barrett, J., concurring); *id.* at 1722 (Thomas, J., dissenting). They represent that those dictionaries define "'realize' as 'to convert any kind of property into money,'" but, as noted above, Justice Barrett does not seem to believe that realization today should be so limited. *Id.* at 1722.

66. *Id.* at 1721 (Thomas, J., dissenting).

betrayed by the practical applications of the concept of income that at that time had already envisioned that income could include unrealized gains.[67]

The *Moore* dissenters fail to grapple with these historical facts, and their reductive logic that concluded that realization was required out of necessity fails to grapple with the fundamentally temporal considerations that undergird the income tax. Contrary to the dissenters' statements that the realization is a necessity because it is the only means to make a distinction between income and its source, we argue that a distinction can be (and has been) achieved through the tool of the tax basis mechanism, which can be adapted and calibrated to work alongside a variety of timing rules, not just realization.[68] Although the tax basis mechanism was not framed as a constitutional imperative in prior eras as courts considered and refined tax basis doctrine, tax basis has effectively served the function of distinguishing income from capital in exactly the manner that the Sixteenth Amendment suggests.

II. THE HEADWATERS OF U.S. FEDERAL INCOME TAXATION

The history of the *concept* of income has not held much constitutional import until recently—and it deserves further scrutiny. The standard contemporary understanding of the history of income taxation is that in the 1920s and 1930s, as Congress and the Court began to consider the basic architecture of the income tax, economists developed the concept of *economic income*.[69] This innovation is generally sourced to economist Robert Haig at a 1920 conference discussing *Macomber*, while that case was pending before the Supreme Court, and a publication that followed in 1921.[70] As Ajay Mehrotra explains in his history of progressive taxation in the United States, "Haig set out to contrast the differences between economic and legal definitions of income, with the goal of assisting tax experts and lawmakers in their efforts to bring 'the statutory' meaning of income closer to the economist's 'conceptual' definition."[71]

Haig's concise formulation maintains vitality today: "Income is the money value of the net accretion to one's economic power between two points of time."[72] Economist Henry Simons built on it with his 1938 work, explaining more precisely that "income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value

67. *See infra* Part II.

68. *See infra* Parts III, IV.

69. *See infra* notes 72–76 and accompanying text.

70. Robert Murray Haig, *The Concept of Income—Economic and Legal Aspects*, *in* THE FEDERAL INCOME TAX 1 (Robert Murray Haig ed., 1921), *reprinted in* AM. ECON. ASS'N, READINGS IN THE ECONOMICS OF TAXATION 54–76 (Richard A. Musgrave & Carl S. Shoup eds., 1959).

71. AJAY K. MEHROTRA, MAKING THE MODERN AMERICAN FISCAL STATE: LAW, POLITICS, AND THE RISE OF PROGRESSIVE TAXATION, 1877–1929, at 390 (Christopher Tomlins ed., 2013).

72. Haig, *supra* note 70.

of the store of property rights between the beginning and end of the period in question."[73] This latter definition is taught in introductory economics and tax law courses and widely referred to as "Haig-Simons income."[74]

The dissent in *Moore* picks up on this standard story, maintaining that at the time the Sixteenth Amendment was adopted there was a unified and very limited understanding of income—echoing the description of the narrow legal definition of income that Haig and Simons purported to be expanding. The original meaning of income, in the dissent's telling, is amenable to the fruit-and-tree explanation, while a broader concept of income that includes unrealized gains (i.e., unpicked fruit) strains the analogy and came about only later.[75]

But this story does not comport with reality, because Haig and Simons were *not* the actual beginning of the story of economic income. They did not claim to be, either—each explained that their concepts of income built on earlier work by other economists.[76] Moreover, even Haig's and Simons's own citations[77] and references understate the extent to which a broad concept of economic income—one that was not dammed up by realization—was part of the discourse among leading economists in America and elsewhere in the Sixteenth Amendment ratification era.[78]

The intellectual lineage of Haig-Simons income that predates the ratification era has largely been overlooked—or perhaps was downplayed by Haig's and Simons's contemporaries. Haig, in particular, may have found it challenging to give a capacious endorsement to his intellectual forebearers because of the politics of the post-ratification era in which he was working. Haig was a student of R.A. Seligman, a widely recognized and politically engaged professor at Columbia University, who made his name as a proponent of progressive income taxation starting in the 1890s.[79] Seligman was active in post-

73. HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 50 (1938).

74. *See, e.g.*, DANIEL L. SIMMONS, MARTIN J. MCMAHON, BRADLEY T. BORDEN & BRET WELLS, FEDERAL INCOME TAXATION 7 (8th ed. 2020); LAURIE MALMAN, LINDA SUGIN & CLINTON G. WALLACE, THE INDIVIDUAL TAX BASE: CASES, PROBLEMS, AND POLICIES IN FEDERAL TAXATION 53–56 (3d ed. 2019).

75. Moore v. United States, 144 S. Ct. 1680, 1722 (2024) (Thomas, J., dissenting).

76. *See, e.g.*, Haig, *supra* note 70, at 2–3 (citing Irving Fisher, among others); SIMONS, *supra* note 73, at 60–63 (citing Georg Schanz).

77. Haig, *supra* note 70, at 20 (citing Schanz); SIMONS, *supra* note 73, at 60–63 (same).

78. We generally mean the decades leading up to the ratification of the Sixteenth Amendment, specifically the era from about 1894—when the first non-wartime federal income tax was enacted and promptly struck down as unconstitutional in the 1895 *Pollock* decision—through to the time the Amendment was proposed and voted on in Congress in 1909, and its ratification in 1913, followed promptly by the enactment of the first income tax statute later that same year.

79. HERBERT HOVENKAMP, THE OPENING OF AMERICAN LAW: NEO-CLASSICAL LEGAL THOUGHT 1870–1970, at 98–99 (2015) [hereinafter HOVENKAMP, THE OPENING OF AMERICAN

ratification debates about the legal definition of the income tax, and for him the *Macomber* case was just the latest round of his advocacy in support of the income tax as the primary source of revenue for the federal government.[80]

Indeed, Seligman's writing may well be the source of the fruit-and-tree analogy adopted by the Supreme Court in *Macomber*. As the case was making its way toward the Court, he wrote an article describing the stock dividend issue and advocating that realization could serve as a constitutional limitation on Congress's authority under the Sixteenth Amendment.[81] Seligman used the fruit analogy to argue that "separation is the essence of income";[82] the piece was included with the taxpayer briefs submitted to the Supreme Court.[83]

Around the time he wrote this piece, Seligman was continuing to advocate for the primacy of the income tax, making the case that the government should pay for the expense of World War I by primarily relying on the income tax along with borrowed funds.[84] This put him at odds with economists, including Irving Fisher of Yale,[85] who favored adopting a consumption tax alongside the income tax, rather than borrowing money.[86] Seligman seemed to view the possibility of a national sales tax as a threat to the income tax, potentially undermining his life's work.[87] It may have been politically appealing to Seligman to help moderate the income tax by establishing a limit to its reach that protected powerful allies—holders of capital—from income taxation. Regardless of motivation, Seligman's arguments glossed over important contributions to the concept of economic income that already included

LAW]; MEHROTRA, *supra* note 71, at 151–67. *See generally* EDWIN R.A. SELIGMAN, THE INCOME TAX: A STUDY OF THE HISTORY, THEORY, AND PRACTICE OF INCOME TAXATION AT HOME AND ABROAD (1st ed. 1911) [hereinafter SELIGMAN, THE INCOME TAX] (outlining Seligman's support for graduated income taxation). Seligman's political advocacy seems to have backed him into some intellectually inconsistent corners. For example, although he made his name as a champion of the progressive income tax, during the ratification process he published a study of income taxes that offered, in the introduction no less, that his preferred method of administration made graduated rates unfeasible. *Id.* at 36–38, 671–72.

80. MEHROTRA, *supra* note 71, at 325–26.

81. *See* Edwin R.A. Seligman, *Are Stock Dividends Income?*, 9 AM. ECON. REV. 517, 536 (1919) [hereinafter Seligman, *Stock Dividends*] (answering the Court's question for them: no, stock dividends are not income, because of the conceptual imperative of "separation" of capital from income, which requires "realization"). His analysis throughout the *Macomber* saga showed intellectual flexibility—after advocating for the Court to create a realization requirement, once it did, he published an essay berating the Court's decision. Kornhauser, *The Story of Macomber*, *supra* note 3, at 111 (quoting Seligman as lamenting the majority's "regrettable tying of the hands of the legislator and undue curtailment of legislative discretion").

82. Seligman, *Stock Dividends, supra* note 81, at 519–22.

83. Kornhauser, *The Story of Macomber*, *supra* note 3, at 100 n.11.

84. MEHROTRA, *supra* note 71, at 325–26, 326 n.73.

85. *See infra* Section I.A.

86. MEHROTRA, *supra* note 71, at 325.

87. *See id.* at 388. *See generally* SELIGMAN, THE INCOME TAX, *supra* note 79 (discussing Seligman's dedication to income taxation scholarship).

inclusions of unrealized gains and losses within their scope.[88] Haig, Seligman's prodigy, did not contradict his mentor, and the combination of their work has obscured the historical record to those who might desire an originalist understanding of "incomes" in the ratification era.[89]

Section I.A that follows expands on the intellectual history of the concept of income that preceded ratification. Section I.B turns to the use of income as an accounting concept in that same period, showing that even in the pre-ratification era there was a prominent on-the-ground practice of including unrealized gains in income in certain contexts, which anticipates contemporary rules that include income without realization.

A. *Income Tax Theory in the Pre-Ratification Era*

The intellectual headwaters of the concept of economic income began more than a decade before the Sixteenth Amendment was proposed, and from geographically disparate places—Germany, England, and the United States. The key progenitor in the United States was economist Irving Fisher (Seligman's antagonist in the consumption tax debate[90]), who published extensively on income tax theory starting in the late 1890s, on his way to becoming widely recognized as one of the great American economists.[91] Fisher received the first economics PhD granted by Yale and studied in Berlin before returning to Yale where he taught economics for decades.[92] In 1896, he published an essay titled *What Is Capital?*, in which he distinguished capital from income in temporal terms, and explained the difference by reference to the flow of water.[93] He wrote that "all wealth presents a double aspect in reference to *time*. It forms a *stock* of wealth, and it forms a *flow* of wealth. The former is, I . . . maintain, capital, the latter, income."[94]

In his essay, Fisher built upon work by a professor at Johns Hopkins University, which was designed to be a United States version of a German research university.[95] Professor Simon Newcomb was not an economist by training and he did not study in Germany himself, but he typified Johns

88. *See supra* notes 84–87 and accompanying text.

89. *See supra* notes 73–76 and accompanying text.

90. *See infra* notes 129–31 and accompanying text.

91. *See* JOHN KENNETH GALBRAITH, A HISTORY OF ECONOMICS: THE PAST AS THE PRESENT 151–52 (1987) (describing Fisher as "one of the two most interesting and original of American economists," in particular for his work on the money supply); JOSEPH A. SCHUMPETER, TEN GREAT ECONOMISTS: FROM MARX TO KEYNES 222–38 (Taylor & Francis 2003).

92. HAROLD M. GROVES, TAX PHILOSOPHERS: TWO HUNDRED YEARS OF THOUGHT IN GREAT BRITAIN AND THE UNITED STATES 108 (Donald J. Curran ed., 1974).

93. Fisher, *supra* note 13, at 514.

94. *Id.*

95. *See* EMILY J. LEVINE, ALLIES AND RIVALS: GERMAN-AMERICAN EXCHANGE AND THE RISE OF THE MODERN RESEARCH UNIVERSITY 39, 43–44 (2021).

Hopkins University's early success in recreating the German research university atmosphere (and, like many of his professor colleagues, he spoke fluent German).[96] In 1886, Newcomb wrote an extended explanation of income as a product of "monetary flow[s]."[97] He emphasized that income must be measured on a net basis—accounting for inflows and outflows (expenditures).[98] Income for "the community comprises all the values produced by its labor *plus* all the increase in the value of fixed property brought forth without labor *minus* all the decay in value which has occurred."[99] For each individual, income is "the measure of what he adds to total production," including "all increase of value produced by any circumstance whatever."[100] Newcomb explained that inflows included in income should reflect increased value of capital even if that capital was not converted into cash, as long as the measurement of the increased value of capital was not "the result of a general increase in the scale of prices, arising from a diminution in the absolute value of the dollar"—that is, increases in value net of inflation.[101] He continued, explaining that if "the rise of prices is confined to the particular stock of goods he deals in, and grows out of some scarcity in the supply, the greater value would represent an actual increase of his capital, and might be counted as profit, and therefore as an addition to his income."[102]

Fisher's work, building on Newcomb's, was noticed and widely embraced by his economist colleagues. In England, Edwin Cannan at the London School of Economics reacted to Fisher's first essay, noting that Fisher was "the first to announce the true relation of capital and income . . . and in such a way as to command attention."[103] Cannan emphasized the temporal element of Fisher's distinction: "[A]n individual's capital exists at a point of time, and . . . his income exists in a length of time."[104] He concludes that "income is divided into

96. *Id.* at 48; J.J. O'Connor & E.F. Robertson, *Simon Newcomb: Biography*, MACTUTOR (Oct. 2003), https://mathshistory.st-andrews.ac.uk/Biographies/Newcomb/ [https://perma.cc/9BA8-3QGH].

97. NEWCOMB, *supra* note 13, at 359.

98. *Id.*

99. *Id.* at 364–65.

100. *Id.* Newcomb elaborated as follows, hypothesizing an individual who

> has purchased a stock supposed to be worthless and, having held it a year or two, it has without any effort on his part become of great value . . . . In order, therefore, that the law may be correctly applied we must include in production all increase of value . . . and must credit this increase to the owner of the object whose usefulness was enhanced. This remark applies to all cases of the ownership of land, real estate, machinery, ores, etc., the value of which may change without the application of labor, merely through the movement of population and the action of supply and demand.

Id. at 364.

101. *Id.* at 361.

102. *Id.*

103. Edwin Cannan, *What Is Capital?*, 7 ECON. J. 278, 278 (1897).

104. *Id.* at 281.

two parts, (1) the increase of the capital, and, (2) the things enjoyed."[105] Cannan was explicit about the irrelevance of realization to his concept of income in his treatise, writing that property may "rise in value as time goes on, and the increment of value is part of their owners' income, although it may not be 'realised' as stockbrokers say, that is, sold for money, every year."[106] He provided an example of a person who owns a "plantation of trees" who might harvest and use the "annual increment" which is part of income; the alternative is to "engage[] in a form of saving" by using the income to "add[] to [the] property."[107]

Fisher's and Cannan's work promptly received notice from perhaps the leading economist in the world at that time, Alfred Marshall of the University of Cambridge. In the 1898 edition of his renowned treatise, *Principles of Economics*, Marshall explained that "with the growth of a money economy, there has been a strong tendency to confine the notion of income to those comings in which are in the form of money," but he emphasized that "of course income is now to be treated more broadly and not strictly to that which takes the form of money."[108] Marshall expressly points to and celebrates Fisher's and Cannan's work as "full of suggestion" on the subject of distinguishing income from capital.[109] Cannan would make and elaborate on a similar point in his own treatise a few years later: "We are so accustomed to estimate and compare incomes by estimating their total values in the medium of exchange, that we have fallen into the habit of talking as if incomes consisted of amounts of the medium of exchange."[110]

Fisher, for his part, continued thinking in the same vein with another publication in 1904, and in his well-regarded treatise, *The Nature of Capital and Income*, published in 1906.[111] His ideas were spreading. Economist Frank Fetter—whose career had taken him to the University of Indiana, then

105. *Id.* at 284. Cannan seems to take this insight as a given; the focus of his essay is to debate with Fisher the extent to which a distinction between gross income and net income is material to understanding a single concept of income. *See id.*

106. EDWIN CANNAN, ELEMENTARY POLITICAL ECONOMY 58–59 (3d ed. 1903) [hereinafter CANNAN, ELEMENTARY POLITICAL ECONOMY]. The quote above comes from the third edition published in 1903, but based on the preface to that edition it appears very likely that this same passage appeared in the second edition, published in 1897, and perhaps as well in the 1888 first edition; we suspect that Cannan's view of income dated to the 1890s if not earlier.

107. *Id.* at 59.

108. ALFRED MARSHALL, PRINCIPLES OF ECONOMICS 143, 145 (1898) (contemplating income inclusions not received in cash, including material benefits derived from the ownership of property like shelter provided by an owner-occupied house, which today is described as "imputed income").

109. *Id.* at 154.

110. CANNAN, ELEMENTARY POLITICAL ECONOMY, *supra* note 106, at 80.

111. Irving Fisher, *Precedents for Defining Capital*, 18 Q.J. ECON. 386 (1904); IRVING FISHER, THE NATURE OF CAPITAL AND INCOME (1906).

Stanford, then Cornell, and would eventually land him at Princeton, and who is recognized as one of the most important American economists of the era[112]—agreed with Fisher.[113] In 1904, Fetter described Fisher's 1896 essay as "indispensable to an understanding of the development of this important phase of a new economic theory."[114]

The leading American and British economists were not the only ones who were focused on the temporality of income and the optionality of realization when income was understood as a flow. Even in the standard history,[115] the most widely credited wellspring of this concept of income is German economist George Schanz in his 1896 publication *Der Einkommensbegriff und die Einkommensteuergesetze*, which roughly translates to *The Concept of Income and Income Tax Laws*.[116] Schanz favored the hydrology analogy to distinguish income from capital, and he was direct about the issue of separation: "It is immaterial whether . . . income is actually realized," he wrote.[117] Schanz's work was written in German and published in Germany, not in the United States, and still today it is not well-translated into English and not well-appreciated outside of Europe. But Schanz was certainly familiar to American economists in the pre-ratification era—specifically because many of the leading American economists, including Seligman and Fisher, studied in Germany and made conscious efforts to import German economic thinking to the United States.[118]

The degree of cross-pollination and likely familiarity with this prior literature is illustrated in Professor Seligman's introduction to his treatise on the income tax, which he completed and published in 1911 as the Sixteenth Amendment was being ratified by the states.[119] In an opening section titled *The Meaning of Income*, Seligman explains: "Strictly speaking, income as contrasted with capital denotes that amount of wealth which flows in during a definite period and which is at the disposal of the owner for purposes of consumption, so that in consuming it, his capital remains unimpaired."[120] He then explains

112. *See* Herbert Hovenkamp, *The First Great Law & Economics Movement*, 42 STAN. L. REV. 993, 1000 n.41 (1990) (including Fetter with Fisher, John Bates Clark, and Simon Patten).

113. *See* FRANK A. FETTER, THE PRINCIPLES OF ECONOMICS WITH APPLICATIONS TO PRACTICAL PROBLEMS 39–45, 109–17 (1904).

114. *Id.* at 575.

115. *See supra* notes 70–71; *see also infra* text accompanying note 127.

116. Georg Schanz, *Der Einkommensbegriff und die Einkommensteuergesetze* [*The Concept of Income and Income Tax Laws*], 13 FINANZARCHIV 1, 23 (1896) (Ger.).

117. Paul H. Wueller, *Concepts of Taxable Income I*, 53 POL. SCI. Q. 83, 98–103 (1938) (quoting Schanz in English).

118. *See* MEHROTRA, *supra* note 71, at 86, 98, 103 (reporting that Seligman and other leading proponents of the income tax—Richard T. Ely, Henry Carter Adams—trained in Germany, and that they, and "especially" Seligman, "helped initiate the transatlantic transfer of ideas and pedagogy"); GROVES, *supra* note 92, at 108.

119. SELIGMAN, THE INCOME TAX, *supra* note 79, at 3–38.

120. *Id.* at 19.

that "defining income with such precision as completely to avoid any net impairment of capital" raises significant practical challenges.[121] In a footnote, Seligman cites Fisher's *The Nature of Capital and Income*, explaining that Fisher "attempts to give precise analysis of income; but . . . concedes that for purposes of taxation [Fisher's] scheme, while ideal in theory, would be difficult to carry out in practice."[122]

Seligman then attempts to elaborate on how to draw the line in a way that allows for an administrable tax. He explains that clearly "money income" that is received with "regularity" must be subject to tax.[123] The more complicated question, he describes, is how to address "the so-called enjoyable or psychic income, that is, the pleasurable sensation or usufruct that flows in to the individual in the shape not of money, but of money's worth."[124] He then works through an example, familiar to introductory income tax students, of imputed income derived by way of enjoying property that one owns.[125] He concludes "that income, at least for purposes of taxation, signifies in general money income, with an occasional inclusion of such psychic income as is notorious and easily calculable."[126] These, of course, are practical concerns, not conceptual insights.

Haig and Simons both credited Schanz's work, and Schanz has occasionally garnered mention by more contemporary tax theorists. For example, writing in the *Harvard Law Review* in 1967, Richard Musgrave noted that what is known as Haig-Simons income was first proposed by Schanz, citing the German publication, and stating that it was "introduced into the American discussion" by Haig in 1921 and "developed systematically" by Simons in 1938.[127] Like so many tax thinkers since, Musgrave was not seeking to uncover the exact genesis of the economic concept of income, nor to explore the intellectual history. By crediting Haig in 1921 with originating the concept of economic income, the standard history recounted by Musgrave and others

121. *Id.*

122. *Id.* at 19 n.1. Seligman begins his treatise by positioning it in relation to Fisher's work and the gap in creating an administrable income, so much so that this is Seligman's first substantive citation in the entire treatise.

123. *Id.* at 20. The "regularity" point relates to another element of the conceptual debate over income—whether one-off receipts constituted income—that also related to how to treat income from capital.

124. *Id.* (explaining the valuation issues that arise in attempting to assess nonmoney income).

125. *Id.*

126. *Id.* at 20–21. Although Seligman cites only to Fisher, this passage very much echoes Marshall's and Cannan's analysis of the same issue, as well as Schanz's. *See supra* notes 108–10 and accompanying text.

127. *See, e.g.*, R.A. Musgrave, *In Defense of an Income Concept*, 81 HARV. L. REV. 44, 48 n.7 (1967) (citing SIMONS, *supra* note 73; Schanz, *supra* note 116). For a discussion of this early evolution, see Christopher H. Hanna, *Tax Theories and Tax Reform*, 59 S.M.U. L. REV. 435, 436–39 (2006).

overlooks the fact that the broad conception of income as encompassing unrealized gains not only predated the Sixteenth Amendment but was prominent in American economic literature.

By the time Seligman published his treatise, as the Sixteenth Amendment was moving toward ratification, Professor Fisher had turned his sights to his seminal and groundbreaking work on the money supply, which would eclipse his early contributions to income tax theory.[128] Fisher did, however, continue to refine his views, and his concerns about the temporal issues in income taxation led him to become an advocate for a consumption tax: taxing consumption eliminated the temporal challenges and inequities that income taxation seemed to invite.[129] Further, he saw no real controversy in his own explanation of how to distinguish capital from income. As he wrote in his 1896 essay,

> Many economists now content themselves with the mere qualitative statement that wages are paid 'out of' capital. This is true, but the same is true of all income, *e.g.*, profits, rent, etc. *All* material wealth must exist, that is, be capital, between its production and consumption, but the truth is no more profound than that the waters which a river empties into the sea come 'out of' the water in the river bed.[130]

The economists described above were the leading economic thinkers and leading income theorists of the pre-ratification era. Each of them embraced notions of economic income that included unrealized income within their understanding, and none of them ruled out the definition of income based on the existence or nonexistence of realization events, either conceptually or as a practical necessity. Notwithstanding Seligman's successful advocacy in favor of the fruit-and-tree analogy for the *Macomber* Court, that analogy and the theory of realization and separation it represented were *not* widely adopted by early (pre-ratification) economists like Fisher. Rather, the academics of that era were particularly concerned with trying to incorporate capital gains into a cohesive theory of income.

As the *Macomber* majority noted, "The fundamental relation of 'capital' to 'income' has been much discussed by economists . . . ."[131] The *Macomber* majority's opinion did not elaborate on this. But, as we have shown in this Section, there was, in fact, a significant body of work in the pre-ratification era

128. *See* GALBRAITH, *supra* note 91, at 152–53.

129. GROVES, *supra* note 92, at 108–10 (citing Irving Fisher, *The Income Concept in the Light of Experience*, *in* 3 WIESER FESTSCHRIFT DIE: WIRTSCHAFTS THEORIE DER GEGENWART (1927) (Aust.)). Fisher would remain attentive to the income tax, however. *See* HOVENKAMP, THE OPENING OF AMERICAN LAW, *supra* note 79, at 81 (citing Irving Fisher, *A Statistical Method for Measuring "Marginal Utility" and Testing the Justice of a Progressive Income Tax*, *in* ECONOMIC ESSAYS CONTRIBUTED IN HONOR OF JOHN BATES CLARK 157–93 (J.H. Hollander ed., 1927)).

130. Fisher, *supra* note 13, at 524.

131. Eisner v. Macomber, 252 U.S. 189, 206 (1920).

that was focused on *temporality* and the challenges of treating income as a *flow* rather than as an object. The *Macomber* majority, aided by Seligman, was able to disregard the gestalt of this work, and, at least in part *because* of the *Macomber* decision, Haig's and Simons's concept of economic income was treated as a post-ratification, post-*Macomber* economic innovation. This narrative is unsupported by the economic literature of the period that had already conceptualized income as a flow that might include changes in wealth and not be limited to realization events.

Additionally, the *Macomber* majority disregards the use of the plural "incomes" in the text of the Sixteenth Amendment.[132] The use of plural suggests at different types of income and lends support to the idea that there was not a common, singular understanding of income at the time of ratification. Seligman elaborated on this point in his 1911 treatise: because, in practice, income taxation consists of "a series of assessments on different kinds of income, it has sometimes been called a tax on incomes rather than a tax on income."[133] The effort to circumscribe the meaning of income to a singular definition based solely on the realization principle fails to consider the plurality of the word "incomes" used in the Sixteenth Amendment.

Shortly after issuing its *Macomber* opinion, the Supreme Court more explicitly recognized that its narrow definition of income failed to consider the full breadth of the economic literature: "In determining the definition of 'income' thus arrived at, this Court *has consistently refused to enter into the refinements of lexicographers or economists* . . . ."[134] The Court's explicit rejection of the pre-ratification economic literature undercuts the argument that the Court in *Macomber* provided an originalist understanding of the Sixteenth Amendment. Far from it, the Court in *Macomber* set forth a constricted formulation of income, which is inherently an economic concept, that conscientiously disregarded the economic literature of that era. It would be revisionist history to reposition the Court's opinion in *Macomber* as "an originalist opinion" because in *Macomber* the Court did not articulate a decision that was based on common understanding, dictionaries, or prevailing economic theory.[135] What is more, as the next Part will show, the Court's formulation of income in *Macomber* failed to consider how certain taxpayers had actually determined their income for accounting purposes for decades before the Sixteenth Amendment was ratified.

132. U.S. CONST. amend. XVI.
133. SELIGMAN, THE INCOME TAX, *supra* note 79, at 37.
134. *See* Merchs.' Loan & Tr. Co. v. Smietanka, 255 U.S. 509, 519 (1921) (emphasis added).
135. *Macomber*, 252 U.S. at 189.

B. *The Practical Origins of "Mark to Market"*

Income became a legal concept for tax purposes with the ratification of the Sixteenth Amendment and enactment of the first income tax laws in 1913. But income was already, by that time, a well-established concept used by businesses for financial reporting purposes. This Section uncovers how one conception of income that did not entail realization was entrenched in some financial accounting practices in the half-century preceding ratification. This discussion thus reveals a widely shared misconception about unrealized income: in contemporary policy discussions, it is generally thought—incorrectly, we show here—that including unrealized gains as part of taxable income is a recent innovation advanced by an active or perhaps overzealous government. The history described here, however, depicts quite a different story. Based on correspondence between taxpayers and early Department of the Treasury tax administrators working in the newly formed Bureau of Internal Revenue (herein the "Bureau," the predecessor to the Internal Revenue Service) that was disclosed as part of later official guidance on the subject, we find that including unrealized gains and losses into income (based on market values) originated in industry business practices.[136] Contrary to recent assumptions, the first arguments in favor of accounting for unrealized gains and losses in taxable income were initiated not by the government but rather by taxpayers—seeking to conform tax accounting with financial accounting practices that were well-established even before the ratification era.[137]

Our focus here is on the purchase and sale of agricultural commodities, the largest industry in America at the time of ratification.[138] Among commodity dealers, timing was and is critically important, because future events (changing expectations of high or low crop yields) drive changes in inventory value and are highly unpredictable.[139] To protect against price volatility, commodities

136. A.R.M. 100, 3 C.B. 66 (1920) [hereinafter B.I.R., 1920 Ruling]; A.R.M. 135, 5 C.B. 67 (1921) [hereinafter B.I.R., 1921 Ruling].

137. *Cf.* John R. Brooks & David Gamage, *The Original Meaning of the Sixteenth Amendment*, 102 WASH. U. L. REV. 1, 44–45 (2024) (discussing Treasury guidance under the Corporate Excise Tax of 1909, a corporate income tax that was enacted prior to the ratification of the Sixteenth Amendment, that shows Treasury following "mark-to-market" accounting treatment of unrealized gains in certain corporate assets).

138. *See* Pardey & Alston, *supra* note 23. By way of disclosure, one of the co-authors of this Article was trained in-house with the largest privately held grain merchant in the United States and in that period became aware of that company's use of mark-to-market accounting for its commodity inventory and hedges since the late-1800s. *See* WAYNE G. BROEHL, JR., CARGILL: TRADING THE WORLD'S GRAIN 10 (1992). This history is further documented in exhibits to the administrative guidance B.I.R., 1921 Ruling, *supra* note 136, at 71–78.

139. The example that follows is highly simplified, though it is similar to a set of transactions detailed in the Federal Trade Commission's Report on the Grain Industry, which provides a detailed history of how the grain industry functioned, based on a comprehensive examination conducted in the years 1912 to 1918. The hedging transaction described in that report was carried out by a grain elevator rather than a merchant (a facility that actually stores grain, whereas a merchant might employ an

merchants began, by the mid-nineteenth century, to enter into hedging transactions in exchange traded futures contracts to protect against the risk of adverse changes in future market prices on their physical commodity inventory positions.[140] For example, consider a merchant who, in April, agrees to purchase from numerous farmers some amount of wheat to be delivered in October. The merchant's contracts with the farmers are *forward purchase contracts*. The merchant will plan to, in turn, sell wheat to one or more food processors to be delivered in October and later. Until offsetting forward sales contracts are entered into, the merchant is exposed to the risk of future price fluctuations with respect to its forward purchases entered into in April because the merchant has a *long position*—meaning, the value of the purchase contract has already been locked into a fixed purchase price. If the season produces a bumper crop, with more wheat produced overall than was expected when the April forward purchase contract was consummated, the market price of wheat will be depressed come October.[141]

To protect against this futures price risk, the merchant will want to, immediately upon consummating the purchase contacts, enter into *short* October futures contracts on a commodities exchange. The short futures contract locks in a future sales price for the referenced volumes of wheat to protect against the situation where the price of wheat decreases.[142] With both the forward purchase contracts and the futures (selling) contracts in hand, the merchant has now hedged its futures risk, and as a result has locked in a profit on its inventory equal to the difference between the purchase price and its

elevator to store physical inventory), and it was placed in the year 1913, which was coincidental via-a-vis the income tax—there was no discussion of tax issues in the report. *See* FEDERAL TRADE COMMISSION, REPORT OF THE FEDERAL TRADE COMMISSION ON THE GRAIN INDUSTRY VOL. I: COUNTRY GRAIN MARKETING 20, 207–12 (1920) [hereinafter FTC, GRAIN INDUSTRY MARKETING]; *see also* FEDERAL TRADE COMMISSION, REPORT OF THE FEDERAL TRADE COMMISSION ON THE GRAIN TRADE VOL. V: FUTURE TRADING OPERATIONS IN GRAIN (1920) [hereinafter FTC, GRAIN INDUSTRY FUTURE TRADING].

140. *See* FTC, GRAIN INDUSTRY FUTURE TRADING, *supra* note 139, at 27 (describing the early history of futures contracts in the grain industry commencing during the Civil War).

141. If the opposite occurs and prices rise relative to the merchants purchase price, then the merchant will have a windfall profit. But this sort of speculative gain is not the goal for grain merchants—the futures risk of an unhedged position that could result in a windfall represents an existential threat that must be avoided, because of the downside risk. *See id.* at 18, 156, 272–77 (explaining the nonspeculative focus of futures trading, and cases of speculative trading that constituted illegal gambling).

142. Forward contracts are customized contracts between a buyer and seller. Futures contracts are standardized contracts, which makes them more fungible and allows for them to be traded on exchanges. In practice, commodities merchants use a mix of forward contracts that entail actual delivery of specified commodities and futures contracts that may be cash-settled, meaning that instead of terminating the contract on delivery of specified inventory, the contract can be concluded by one party paying the other party based on the market price fluctuation of the contract.

futures sales price, regardless of market fluctuations.[143] These practices, though perhaps inscrutable to the general public, were no secret among industry participants, accountants, lawyers, and regulators.[144]

At any given time, a good commodities merchant needs to know its unhedged exposure to price fluctuations on its net inventory position comprised of its forward purchase contracts with farmers and forward sales contracts with food processor customers and unsold inventory held on hand. Trading on a commodities exchange—most notably, the Chicago Board of Trade, which was established around 1880—merchants could determine these values and hedge their futures exposure on commodity inventory on a daily basis.[145] This was accomplished by each merchant revaluing its physical inventory and its existing hedges based on current market prices, which allows it to identify its unhedged exposure and any gaps in its hedges. And, by this same method—referencing current market prices of commodities and futures to revalue its positions to market—a merchant can determine its net income, including gains and losses on its physical inventory and hedges, by revaluing all these positions to market values. Indeed, that is what merchants did for financial accounting purposes starting in the nineteenth century.[146]

Against the backdrop of this widespread practice, in what was at the time the largest industry in the country,[147] the first income tax statute was enacted under the Sixteenth Amendment to impose a tax on the "net income" including "gains, profits and income" arising from "businesses, trade, commerce, or sales,

143. As the merchant enters into forward sales contracts with food processors for October and later delivery, the commodity merchant will go back into the commodities exchange market to offset the earlier futures (sell) contract that hedged the forward purchase contracts.

144. For example, the Supreme Court dealt with and explained various nontax legal issues related to futures and hedges in the early 1900s. *See* Bd. of Trade v. Christie Grain & Stock Co., 198 U.S. 236, 249 (1905) (discussing how hedging futures risk is an integral business practice); Clews v. Jamieson, 182 U.S. 461, 484, 488 (1901) (detailing that exchange traded futures contracts are brought to market and settled at the close of each day as fully and effectually as if those futures contracts were sold or bought that day with regard to realization events).

145. *See* FTC, GRAIN INDUSTRY FUTURE TRADING, *supra* note 139, at 28–29. By the time of the 1912-1918 investigation by the Federal Trade Commission, Chicago was by far the largest location for trading futures contracts. *See* FTC, GRAIN INDUSTRY MARKETING, *supra* note 139, at 231–32.

146. FTC, GRAIN INDUSTRY FUTURE TRADING, *supra* note 139, at 28–29. There are many examples that can give rise to unhedged exposure, including time periods when the forward contracts deliver inventory that the merchant does not have futures contracts to sell or if the merchant sells grain it acquired earlier than expected, then it must enter into additional offsetting futures contracts immediately in order to cancel out the futures contract that originally was put into place for a longer physical inventory holding period.

147. *See supra* note 23. One of the industry submissions explains that "[t]he volume of this [grain] business is so huge that it constitutes the largest single industry in the United States." B.I.R., 1921 Ruling, Exhibit A, *supra* note 136, at 71; *see also Christie Grain & Stock Co.*, 198 U.S. at 245–49 (describing the history of trading futures contracts for wheat and other commodities dating back to 1859, and explaining that the Chicago Board of Trade transacts "a large part of the grain and provision business of the world").

or dealings in property, whether real or personal."[148] This language leaves room for the commodity industry's financial accounting approach to including unrealized gains and losses to determine income from forward contracts and hedges, based on their fair market value as of the end of the year.

But soon enough, Bureau field agents audited cotton merchants—a much smaller industry than grain, but one that used the same accounting practices and concept of income described above. The audited taxpayers argued that their inventory of cotton included both their physical inventory and their hedging positions, and that the value of that inventory should be determined by market prices for income tax purposes.[149] This would have been at least partially consistent with early treatment of physical inventory of manufacturing businesses, in that the Bureau had already permitted taxpayers to value inventories at the lower of cost or market.[150] But the field agents disagreed with allowing market valuation of physical inventory above cost and objected to revaluing hedges. Eventually, the Bureau issued an Appeals Review and Memorandum[151] holding that neither inventory nor hedges could be adjusted above cost, and hedges could not be considered in income until the occurrence of a realization event.[152]

This set off a frantic back-and-forth that culminated in a hearing in front of the Bureau's Committee on Appeals and Review in 1921.[153] This, in turn, led to the issuance of a new memorandum in which the Bureau adopted the industry's financial accounting definition of income "for the purpose of determining taxable income."[154] The memorandum adopting this position, along with others as the issue unfolded, was published in the earliest Cumulative Bulletins, which is the still-running collection of published administrative tax guidance.[155]

148. Underwood Tariff Act of 1913, ch. 16, 1913 Stat. 114, 167 (repealed).

149. B.I.R., 1920 Ruling, *supra* note 136, at 68.

150. The first ruling to sanction the lower of cost or market methodology was T.D. 2609, 19 Treas. Dec. Int. Rev. 401 (Dec. 19, 1917). This methodology is not strictly based on realization as for write-downs on inventory before a realization event when inventory value is below cost. The lower of cost or market methodology remains to this day. *See* Treas. Reg. § 1.471-4 (1960).

151. *See* Rev. Proc. 67-6, 1967-1 C.B. 576 (explaining that starting in 1919, the Treasury published tax law guidance under various different titles). The Appeals Review and Memorandum was an early precursor to the modern Revenue Ruling, which is a form of subregulatory guidance.

152. B.I.R., 1920 Ruling, *supra* note 136, at 67–68.

153. *See* B.I.R., 1921 Ruling, *supra* note 136, at 78.

154. *Id.* at 79.

155. I.T. 1166, 1 C.B. 56 (1922) (citing A.R.M. 185, 5 C.B. 67 (1921)) (holding that commodity merchants could treat open futures contracts as hedges against spot inventory for balance-sheet purposes but could not include unrealized gains in taxable income until realization, and that inventory values could not be written up above cost).

The final 1921 memorandum is remarkable because the Review Committee explains that it "knows of no better way of presenting the arguments of taxpayers engaged in these lines of industry so as to give them full force and effect than by reproducing in this memorandum the briefs, as submitted by counsel, substantially in full."[156] The historical explanation these industry participants share provides a window into their understanding of income as well as the inner workings of the industry. To begin, the cotton industry representatives explained the business (in particular, forward contracts and hedges), and then shared some history:

> In the keeping of books in the cotton business, it has been the custom, existing over a period of approximately 50 years, for the cotton merchant to take into consideration at market his forward sales, purchases, and hedges, and if they show a profit, that is added to the season's business. If, on the other hand, they show a loss, it is deducted from the season's business. His real profit, or loss, is thereby determined for the year.[157]

The practices the cotton merchants described were not limited to the cotton industry—the nation's largest commodity merchants (those in the grain industry) joined in as well:

> The method of accounting universally employed in keeping the books of grain dealers has been to take into account their futures contracts at the value thereof at the close of the fiscal year, as determined in the manner already described. These figures on one side, as against the inventory value of actual grain on hand on the other, exhibit the true condition of the business and permit an accurate computation of the gain or loss for the year and of the taxable net income for the same period.[158]

The grain merchants emphasized that their market-price-based concept of income was not simply a matter of preference—rather, it was a necessity that allowed these industries to function and allowed their auditors to produce financial statements that creditors could rely on:

> All financial institutions which extend credit to the dealers insist upon the use of this method; public accountants will not certify any statement of the taxpayer as correct which does not show such entries, and the experience of half a century has failed to disclose any error in its results or to discover another mode of bookkeeping that will produce a true exhibit of the business.[159]

156. *Id.* at 68.
157. *Id.* at 69.
158. *Id.* at 73.
159. *Id.*

Further, the grain merchants explained that the realization principle failed to appreciate the temporality of income and failed to clearly reflect income if only realized income were included in any given tax year:

> In this case we are dealing not only with the method regularly employed by a particular taxpayer, but with a method universally employed and recognized in the trade and considered as the only method which does, in fact, for any particular twelve months' period, truly reflect income for that period. The Bureau has before it, in cases now in process of audit, numerous instances in which the forcible separations of the primary trade from its balancing hedge has resulted in obviously distorting income and losses; for example, such forcible separation frequently results in apparent large loss in one year and apparent large gains in another, when, in fact, by reason of the continued balancing, as outlined above, and the continual readjustment of accounts, the business at no time deviated very far from its normal course of a small profit or loss per bushel of grain. The method of hedging employed absolutely guaranteed the dealer against gains or losses on a large scale due to fluctuation in the market. The only correct method of reflecting the annual income of the business is one which reflects the fact that substantial losses from fluctuation have been eliminated. No method is correct, obviously, which indicates large losses or large gains due to market fluctuation in the case of a business that has effectively avoided any such gains or losses.[160]

Finally, the grain merchants vehemently railed against the realization principle as a disastrous methodology for determining income, warning with apocalyptic overtones that such an approach threatened the very existence of the grain industry:

> Considering the tremendous volume and importance of the grain trade, the vital part that it plays in the subsistence of the people, the enormous bank credits without which the business cannot be maintained, and the disastrous consequences that will result to dealers, as well as consumers and producers, from any course of action that will seriously disturb the proper and efficient functioning of the business, it is obvious that extreme care must be taken not to embarrass the steady operation of the rather complicated and extended system by which grain is moved from farm to terminals, mills, and ocean vessels, not to jeopard[ize] the food supply of millions of people, not to imperil the credit which makes the continuance of the business possible, and not to ruin by unjust, inequitable, and erroneous methods of taxation (or of determining the taxable income) the thousands of business men whose genius and enterprise have built up the largest single industry in the United States.

160. *Id.* at 77–78.

> It is, accordingly, respectfully suggested that the clearly established accounting practice followed in this peculiar business should be recognized and approved by the Bureau, and that all contracts for the purchase or sale of grain in the future, outstanding at date of inventory, should be required to be included as assets or liabilities of a taxpayer at the market at close of business on that day, in computing taxable income for the fiscal year then ended.[161]

In the end, the Bureau agreed that a taxpayer's unrealized gains and losses could be included within computation of income under the newly enacted income tax laws.[162] The Bureau's decision avoided a fiscal disaster for the agricultural industry. It formally acknowledged the longstanding practices in the cotton and grain industries of calculating income by valuing positions at market values (referred to as "mark-to-market" accounting).[163] This approach allowed companies to report both realized and unrealized gains and losses, rather than limiting calculations to realized gains alone.[164]

The correspondence and record of administrative decisions uncovered above is little known—and have been entirely absent thus far in the discussion of the pre-ratification era understanding of the concept of income.[165] The few references in academic literature to this guidance exist because the approach the

161. *Id.* at 75.

162. *Id.* at 79 ("Therefore, the Committee holds: That dealers in cotton and grain and in such other commodities as are dealt in in a similar manner may, for the purpose of determining taxable income, incorporate in their balance sheets at the close of any taxable year, such open 'future' contracts to which they are parties as are 'hedges' against actual 'spot' or cash transactions."). The Bureau affirmed and expanded this holding in the years that followed. *See* S.R. 5084, IV-2 C.B. 120 (1925); S.M. 5693, 1926-1 C.B. 20.

163. *See supra* note 24 and accompanying text.

164. B.I.R., 1921 Ruling, *supra* note 136, at 79; *see also* Clews v. Jamieson, 182 U.S. 461, 476–77 (1901) (describing the practice of settling open futures contracts on a daily basis by reference to market prices).

165. The 1921 ruling has been cited in law reviews just three times ever according to a recent Westlaw search, and the 1920 ruling was cited in the same articles plus one additional, all in the context of assessing contemporary mark-to-market rules. *See* Linda M. Beale, *Book-Tax Conformity and the Corporate Tax Shelter Debate: Assessing the Proposed Section 475 Mark-to-Market Safe Harbor*, 24 VA. TAX. REV. 301, 309–59 (2004) (recounting the history); Alex Raskolnikov, *Contextual Analysis of Tax Ownership*, 85 B.U. L. REV. 431, 447 (2005); Robert H. Scarborough, *How Derivatives Use Affects Double Taxation of Corporate Income*, 55 TAX L. REV. 465, 499 (2002); Steven A. Bank, *Mergers, Taxes, and Historical Realism*, 75 TUL. L. REV. 1, 83 (2000) (citing only the 1920 ruling). Additionally, the guidance was cited, and the history described and quoted at length in a piece published in the now-defunct publication *Taxes: The Tax Magazine* in 1997, reflecting in part a project that one of the authors of this Article (Bret Wells) assisted with as a law student research assistant. *See* Edward D. Kleinbard & Thomas L. Evans, *The Role of Mark-to-Market Accounting in a Realization-Based Tax System*, 1997 TAXES 788, 789–90; *see also* Thomas L. Evans, *The Evolution of Federal Tax Accounting—A Growing Trend Towards Mark-to-Market?*, 1989 TAXES 824, 824–25.

Bureau blessed in 1921 has continued essentially unchanged to this day for commodity dealers.[166]

Congress has statutorily required mark-to-market treatment in discrete areas. For example, Section 1256 of the Tax Code requires that a taxpayer's annual gain or loss be determined based on market price, just as the commodities merchants of the 1800s did.[167] Because publicly traded commodities have known fair market values, these values can be used to impose taxation in any given year on the increase in value of certain regulated futures contracts without regard to realization.[168] Thus, this tax treatment follows the model established by commodities futures exchanges by accounting for the gain or loss on each contract on a daily basis.[169]

More recently, Congress adopted other mark-to-market rules when it concluded that deferral by way of realization is similarly distortive. For example, responding to tax shelters used by securities traders on profits that were reported in their financial statements but not realized, Congress in 1993 enacted Section 475, which requires dealers and traders in securities as well as commodities to determine gain or loss annually based on market values of the securities they are holding in inventory.[170] Congress has enacted similar regimes in other contexts when it believed realization provided too much ground for manipulation.[171] These rules reveal that the concept of income in practice has never been wholly limited by a realization rule. Realization is one timing rule, to be sure, but it has never been the only timing rule as prior mark-to-market accounting practices discussed in this Part demonstrates.

III. TEMPORAL CHALLENGES, THEN AND NOW

The intellectual and practical backdrop to the ratification of the Sixteenth Amendment introduced some—but by no means all—of the timing issues that would come to the fore as the income tax matured. This Part demonstrates that

166. Subsequent rulings simply updated—but did not change in substance—this longstanding historic treatment. *See* Rev. Rul. 74-227, 1974-1 C.B. 120; Rev. Rul. 74-226, 1974-1 C.B. 119; Rev. Rul. 74-223, 1974-1 C.B. 23; I.R.S. Gen. Couns. Mem. 35,043 (Sep. 20, 1972); I.R.S. Priv. Ltr. Rul. 6001225460A (Jan. 22, 1960). With the enactment of Section 475(e) in 1993, this longstanding practice was explicitly adopted by Congress. The net positions in all of a merchant's forward and futures purchase and sales contracts are generally aggregated on a daily basis, an approach which has now been explicitly endorsed in tax regulations if appropriately identified. *See* Treas. Reg. § 1.1221-2 (2002).

167. I.R.C. § 1256(a)(1); *see* S. REP. NO. 97-144, at 155–57 (1981), *as reprinted in* 1981 U.S.C.C.A.N. 105, 254–56.

168. *See* Robert A. Rudnick, Linda E. Carlisle & Thomas F. Dailey, *Federal Income Tax Treatment of Commodity Transactions*, 24 B.C. L. REV. 301, 330 (1983).

169. *See supra* notes 140–44 and accompanying text.

170. Omnibus Budget Reconciliation Act of 1933, Pub. L. No. 103-66, § 475, 107 Stat. 312, 481–85 (codified as amended at I.R.C. § 475).

171. *See infra* text accompanying note 252 (describing more of these rules).

a variety of subsidiary timing issues followed as soon as Congress and the Treasury set about implementing the income tax in 1913. These design features, however, serve to demonstrate that Congress has crafted the nation's income tax laws from the outset so that these income tax provisions appropriately distinguish income from source under a variety of differing timing rules that were crafted for specific contexts.

To begin with, a temporal tax requires a period of measurement, but neither the concept of income nor the text of the Sixteenth Amendment requires a particular period. As discussed in Section III.A, Congress somewhat controversially set the period as one year. Periodicity demands additional general rules, which Congress enacted and the Court approved in the form of standard accounting methods—cash or accrual basis—discussed further in Section III.B. Other contexts require more specialized timing rules. For example, loans that extend across time periods create immediate liquidity for a taxpayer but also a future obligation to repay—and the possibility that the debt will not be satisfied. As Section III.C explains, the Sixteenth Amendment does not prescribe any particular timing rule for when proceeds from a loan should be included in income. Through it all, Congress and the courts have had to prescribe appropriate timing rules, and each follows from the basic conceptual and practical issues that emerged in the pre-ratification era.

Finally, scholars and taxpayers figured out that certain timing rules that allow for deferral of income—most prominently, realization—in certain circumstances can result in some income from capital being *exempted* from income taxation. As we explain in Section III.D, "yield exemption" (i.e., exempting from income taxation the returns on certain investments) can be obtained by careful tax planning around the timing of realization events, even where Congress has not enacted a substantive tax exemption. We show that this effect is a derivative of the concerns that Fisher and others raised during the pre-ratification period, and it has led Congress to enact various pre-realization timing rules to prevent abusive yield exemption transactions.

Each of the time-related challenges detailed in this part is elemental to the history and long tradition of time-conscious income taxation, developed before and since ratification. In each case, the policy responses that Congress and the Court have embraced—dating back to before the *Macomber* decision—would be constitutionally suspect if realization were adopted as a constitutional requirement. The challenges we detail here show that now—as was the case back then—the concept of income is best understood to have different and inconsistent meanings in different contexts. But, as we will show in Part IV, the goal of limiting income taxation to only income can be preserved through an appropriately calibrated understanding of the concept of tax basis.[172]

A. *Constraints of the Annual Accounting Period*

The concept of incomes requires a temporal starting point and ending point for measurement. Although today it may seem basic—or even inevitable—that a taxpayer must compute income and pay tax each year, this feature was not fully articulated early on in the administration of the income tax. Following the ratification of the Sixteenth Amendment, Congress quickly decided to impose the federal income tax on an annual basis.[173] A taxpayer promptly challenged the annual accounting period construct in *Burnet v. Sanford & Brooks Co.*[174] The Court rejected this challenge and explored some of the subsidiary temporal challenges posed by a periodic tax system that the Sixteenth Amendment had left unspecified.[175]

The taxpayer, the Sanford & Brooks Company, entered into a contract to dredge a channel in exchange for payment based on the amount of material removed from the channel.[176] The dredging process began in 1913 and took several years, and it did not go as smoothly as planned.[177] In the first few years, the taxpayer lost money under the contract, collecting less in payments than was spent on the work; after 1916, it abandoned the contract and sued for damages to recover excess expenses.[178] In 1920, Sanford & Brooks Co. prevailed in that contract litigation, and received a payment of around $200,000 based on previously uncompensated work and expenses.[179] The IRS assessed additional tax for 1920 based on the $200,000 payment received.[180]

The taxpayer argued that it had lost money on the contract overall and considering all years, and that because the income tax was supposed to apply to *net* income, no tax should arise from the final payment.[181] The government responded, and the Court agreed, that given the annual accounting convention

172. *See infra* Part IV (explaining that tax basis is a mechanism to prevent multiple taxation of income, specifically, in more than one time period).

173. Revenue Act of 1913, Pub. L. No. 63-16, § 2(A)(1), 38 Stat. 114, 166 ("[T]here shall be levied, assessed, collected and paid annually upon the entire net income arising or accruing from all sources in the preceding calendar year to every citizen of the United States . . . .").

174. 282 U.S. 359 (1931).

175. *Id.* at 363–67.

176. *Id.* at 361.

177. *Id.* (citing United States v. Atl. Dredging Co., 253 U.S. 1 (1920) (detailing the contract dispute that arose between the federal government and the dredging company)).

178. *Id.* at 361–62 (the taxpayer lost money in 1913, had positive net income in 1914, then had losses again in 1915 and 1916).

179. *Id.* at 362.

180. *Id.*

181. *Id.* at 362–63.

that Congress had adopted, the only issue to consider was the amount of income the taxpayer received in the year at issue.[182] The Court held that the taxpayer must include income in the year the contractual payments were received, notwithstanding the fact that the taxpayer's damage recovery was less than the prior year losses incurred under its contracts.[183] An alternative approach (under the lower court's opinion, which the Supreme Court overruled) would have had the taxpayer file amended returns to carry back amounts received in 1920 and reduce the prior year losses for contractual amounts ultimately recovered.[184]

Based on the lack of explicit attention to timing in the Sixteenth Amendment, the Court might have adopted a transactional approach—to be sure, there is something problematic about imposing tax on a contract that did not actually earn the taxpayer net income. The Court, however, approached the matter of time as inextricably linked with the concept of income.[185] Because income requires reference to *some* time period—in the Court's explanation, "on the basis of annual or other fixed taxable periods"—there is always a possibility that a taxpayer might be "required to pay a tax on income in one period exceeded by net losses in another."[186]

Even though time is fundamental to income, the Sixteenth Amendment says nothing explicit about it.[187] Still, the Court made clear that "Congress is not required by the amendment" to rectify the "inequalities" that result from a fixed period.[188] In this respect, the periodic timing convention was understood from early in the modern income tax to trump a more flexible approach that might be taxpayer favorable in some instances.[189] The Court explained that "an annual accounting system is a practical necessity if the federal income tax is to produce revenue ascertainable and payable at regular intervals."[190]

But Congress was not constitutionally restricted from addressing the perceived inequities either. To blunt the harshness that an annual accounting convention might create, Congress in 1918 provided prospective statutory relief to taxpayers like Sanford & Brooks Co. through its enactment of the net

182. *Id.* at 364–66.

183. *Id.*

184. Sanford & Brooks Co. v. Comm'r, 35 F.2d 312, 315 (4th Cir. 1929), *rev'd*, 282 U.S. 359 (1931).

185. *Burnet*, 282 U.S. at 365–66.

186. *Id.*

187. *See* U.S. CONST. amend. XVI.

188. *Burnet*, 282 U.S. at 365.

189. Subsequent experience has shown that it can also be taxpayer unfavorable: in 1986 Congress imposed transactional accounting for long-term contracts under Section 460, a rule that generally accelerates income inclusions. I.R.C. § 460. Congress exempted certain smaller taxpayers (for example, construction contractors with gross receipts less than $25 million) from this rule. *Id.* §§ 460(e)(1)(B), 448(c)(1). Deferred accounting for long term contracts had been allowed under regulations prior to 1986. *See* Treas. Reg. § 1.451-3 (2021).

190. *See* Hillsboro Nat'l Bank v. Comm'r, 460 U.S. 370, 377–81, 380 n.12 (1983).

operating loss carryover provisions that remain to this day in Section 172.[191] In 1938, Congress enacted further mitigation provisions to prevent erroneous income inclusions (for example, incorrectly including income in an earlier year that was not actually received until later) from creating a *double* taxation of income.[192] Thus, even though *Burnet v. Sanford & Brooks Co.* is a leading precedent for the proposition that Congress can determine income under the Sixteenth Amendment based on the discrete events of a particular year, Congress has subsequently fashioned rules that balance the need for annual reporting with the goal of ensuring that income taxed once is not subsequently included *again* and subject to a second round of purported income taxation.[193]

B. *Alternative Methods of Tax Accounting*

Congress has provided two alternative general timing conventions for determining what is to be included into income in any given tax year. The "cash and disbursements" method generally requires that a taxpayer include income when it is received and deduct expenses when those expenses are paid.[194] The accrual method, on the other hand, provides that a taxpayer must include items in income when the taxpayer is *entitled* to the items, even if the taxpayer does not actually receive or pay the amounts until later.[195] As the Supreme Court has explained, "Income taxes must be paid on income received (or accrued) during an annual accounting period."[196] The Tax Code requires that each taxpayer use the method of accounting that that taxpayer otherwise uses for financial accounting purposes.[197] For individuals, this generally means the cash method; businesses may use either cash or accrual, although larger businesses are

191. *See* Revenue Act of 1918, Pub. L. No. 65-254, § 204, 40 Stat. 1057, 1060–61. The current iteration of Section 172 provides that a net operating loss can be carried forward indefinitely. *See* I.R.C. § 172(b)(1)(A)(ii)(I).

192. *See* Revenue Act of 1938, Pub. L. No. 75-554, § 820, 52 Stat. 447, 581; S. REP. NO. 75-1567, 75TH CONG. 3D SESS. at 49 (Apr. 5, 1938) (stating recoupment and other judicial principles are not effective for this purpose and that disputes as to which year income would be reported "should never have the tax burden of income . . . result in a double tax"); John MacArthur Maguire & Philip Zimet, *Hobson's Choice and Similar Practices in Federal Taxation*, 48 HARV. L. REV. 1281, 1321–22 (1935) (describing how the pre-codification judicial doctrines had only partially mitigated the possibility of multiple taxation of income).

193. *See infra* Part IV (discussing the method for ensuring that income is only taxed once is tax basis).

194. I.R.C. §§ 446(c)(1), 451(a); Treas. Reg. § 1.446-1(c)(1)(i) (2024).

195. I.R.C. §§ 446(c)(2), 451(c)(1)–(2).

196. United States v. Lewis, 340 U.S. 590, 592 (1951).

197. I.R.C. § 446(a).

required to use the accrual method.[198] Either approach results in an inclusion in income in a particular single period, in which an item is received or accrued.[199]

None of this is preordained by the Sixteenth Amendment, but *a* method of accounting is necessary for any income tax regime to work. Inevitably, the two methods that Congress has made available have given rise to various subsidiary issues. With the accrual method, what is the standard to determine what period a taxpayer is entitled to accrue income or claim a deduction? The eponymous *all events test* provides that an item accrues when "all events" have occurred to establish the right to receive that income and the amount of income.[200]

With the cash method, the doctrines of "constructive receipt,"[201] "cash equivalency,"[202] and "economic benefit"[203] each address the question of what exactly is sufficient to result in an inclusion in income. These doctrines each respond to different circumstances in which actual receipt does not occur, but nonetheless income taxation seems appropriate—each is oriented toward establishing a time marker for inclusion of income when the usual factual predicate for inclusion is muddied. The cases have used a fact-intensive approach to flesh out the contours of the cash method of accounting.[204]

Other specific contexts have given rise to further context-specific timing rules, sometimes established by the Court and sometimes enacted by Congress. In *Helvering v. Bruun*,[205] for example, a lessee entered into a ninety-nine-year lease in 1929 and then erected leasehold improvements with a useful life of fifty years or less—not as long as the lease.[206] In 1933, the lessee forfeited the lease in the midst of the Great Depression.[207] It is clear that the lessee's annual rent payments represented income to the lessor, but the questions before the Court

198. *Id.* § 448(a), (c) (imposing a gross receipts test that requires the accrual method for any corporation or partnership that has had average gross receipts in excess of $25 million over the three prior taxable years).

199. *Id.* § 451(a) ("The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for in a different period.").

200. Treas. Reg. § 1.446-1(c)(ii)(A). Deductions are further limited by the economic performance rules of Section 461(h).

201. *See* Loose v. United States, 74 F.2d 147, 150 (8th Cir. 1934).

202. *See* Cowden v. Comm'r, 289 F.2d 20, 25 (5th Cir. 1961).

203. *See* Sproull v. Comm'r, 16 T.C. 244 (1951), *aff'd* 194 F.2d 541, 541 (6th Cir. 1952).

204. *Cowden*, 289 F.2d at 24 (stating that a note of a solvent obligor received by a cash method taxpayer is a cash equivalent if it was "unconditional and assignable, not subject to set-offs, and of a kind that is frequently transferred to lenders or investors at a discount no substantially greater than the generally prevailing premium for the use of money").

205. 309 U.S. 461 (1940).

206. *Id.* at 461.

207. *Id.* at 468–69 (where the Supreme Court described the *Macomber* holding as merely clarifying the distinction between ordinary dividends and stock dividends and holding that a severance from capital is not necessary for income to be subject to taxation).

were whether the leasehold improvements were income to the lessor and if so, when they should be included in income.[208]

The Court held that the value of the leasehold improvements represented income to the cash method lessor in the year of the leasehold's forfeiture, with the income inclusion amount determined to be equal to the enhancement in value of the improvements made to the leasehold estate in the year of the forfeiture.[209] The taxpayer had argued against such a timing rule based upon the apparent severance requirement from *Macomber*.[210] The Court in *Bruun* announced that its decision in *Macomber* was "not controlling here."[211] Importantly, even though the leasehold improvements in *Bruun* were not severed from the lessor's land and the lessor continued to own the land, the Court still held that the leasehold improvements represented income because the enhancement represented a new addition to the lessor's preexisting capital interest in the land.[212] The holding is a non sequitur with the tree-fruit analogy, but it fits nicely with a hydrological alternative that reflects the broader theory of income developed in the pre-ratification era: the leasehold increased the reservoir volume, and the Court's rule set a time at which to count (value) that increase (and include it as income).

C. *Debt and Specialized Timing Rules*

The cancellation of debt raises distinct timing issues that show the difficulty of employing the severance requirement that was envisioned by the *Macomber* Court. Although Congress has never enacted a rule to address the issue directly, the receipt of loan proceeds generally is *not* included as income in the year of the borrowing—notwithstanding the receipt of cash or other valuable benefits that might flow from a loan agreement.[213] This noninclusion treatment is conceptually justified because the gain to the taxpayer of the amount received is exactly offset by an obligation to repay the borrowed amount

208. The Treasury Department, through regulations, had determined that leasehold improvements gave rise to income in the year the improvements were made, but this timing rule was invalidated in subsequent case law to the extent that the leasehold improvements did not have a useful life to the lessor that would extend beyond expiration of the lease. *See* Hewitt Realty Co. v. Comm'r, 76 F.2d 880, 882–84 (2d Cir. 1935). The Supreme Court in an earlier dubious case had also held that leasehold improvements did not represent income even if they had value at the expiration of the lease because their value was uncertain. M.E. Blatt Co. v. United States, 305 U.S. 267, 278–80 (1938).

209. *Bruun*, 309 U.S. at 634–35.

210. *Id.* at 468.

211. *See id.* at 469.

212. *Id.* at 468–69.

213. *See* William D. Popkin, *The Taxation of Borrowing*, 56 IND. L.J. 43, 43 n.1 (1980) ("Borrowed funds, as we all know, are not income.").

in full in some future year.[214] But initial noninclusion in income of the receipt of loan proceeds creates challenges later on if a borrower is relieved of some or all of the obligation to repay the debt. A taxpayer in this position has an accession to wealth viewed on an overall basis in the amount of loan received but not repaid.[215]

But what is to be done about the compartmentalizing of the loan proceeds received in one accounting year and the extinguishment of the repayment obligation into a different accounting year? This fact pattern creates a conundrum in terms of how to construct a reasonable timing rule. In the later year of the debt discharge, there is nothing that would typically be described as a realization event—the taxpayer does not receive anything and there is no severance of the value forgiven from whatever might secure the loan or whatever the taxpayer used the loan proceeds to buy or do. And yet, there is an accession to wealth sometime over the life of the loan—the taxpayer's net worth is enhanced. The realization rule and the fruit-and-tree analogy are inapt for this fact pattern. In contrast, the hydrology analogy better accords with this context as the later year debt cancellation is fundamentally inconsistent with the original premise for why the receipt of loan proceeds was excluded from income. A net accession of reservoir volumes has occurred for the taxpayer that represents income.

Since at least 1918, the Treasury Department had taken the position that a taxpayer's settlement of its debt at a discount results in cancellation of indebtedness ("COD") income in the year of cancellation—*not* the year in which the loan proceeds were received.[216] The Supreme Court agreed with this approach in *United States v. Kirby Lumber Co.*,[217] upholding the government's assertion of COD income in the year of the debt cancellation.[218] The Court's then-recent holding in *Macomber* presented an obstacle to this approach because the mere improvement of the debtor's financial status—by not having to repay—seemed analogous to an increase in a taxpayer's existing but unsevered capital.[219]

214. *See* Comm'r v. Tufts, 461 U.S. 300, 307 (1983) (this is the most recent, definitive Supreme Court opinion on tax treatment of debt, in particular distinguishing recourse and nonrecourse debt); United States v. Rochelle, 384 F.2d 748, 751 (5th Cir. 1967); Gatlin v. Comm'r, 34 B.T.A. 50 (1936).

215. I.R.C. § 61(a)(11) (providing that cancellation of indebtedness is included in income).

216. *See* Reg. 45, art. 544 (1921) (applying the principle to bonds purchased at a discount); Reg. 45, art. 51 (1921) (applying the concept to a taxpayer liability that was forgiven).

217. 284 U.S. 1 (1931).

218. *See id.* at 3 ("The defendant in error has realized within the year an accession to income, if we take words in their plain popular meaning, as they should be taken here."); *see also* Comm'r v. Jacobson, 336 U.S. 28 (1949).

219. The Court wrestled with this shortly after *Macomber* in its decision in *Bowers v. Kerbaugh-Empire Company*. 271 U.S. 170, 174–75 (1926) (citing Eisner v. Macomber, 252 U.S. 189, 206 (1920)) (refusing to find cancellation of indebtedness income in the context of a foreign borrowing); *see also* Meyer Jewelry Co. v. Comm'r, 3 B.T.A. 1319, 1322–23 (1926) ("[E]nrichment through increase in

The Court did not cite *Macomber* for its holding in *Kirby Lumber*, perhaps appreciating that the apparent realization imperative announced in *Macomber* simply does not fit in the debt cancellation context. The Court also did not entertain the alternative that loan income should be realized in the year received, which would necessitate a deduction in the year repaid. Nor did it contemplate chipping away at the annual accounting period, which could yield a more accurate approach. That alternative treatment would require the taxpayer to file an amended return to treat the loan proceeds as income in the year received, based on the after-the-fact discharge of its repayment obligation. According to the Court in *Kirby Lumber*, the important aspect of debt cancellation is that the change in economic position must be included as income at some point, and only once.[220] It is clear that no standard understanding of "realization" fits with taxing debt proceeds in *any* period.

In the resolution of the issues set forth in *Kirby Lumber*, Justice Holmes swept away any need to discuss the realization principle as an overarching definitional constraint on the meaning of "incomes" by simply stating that "[w]e see nothing to be gained by the discussion of judicial definitions."[221] This disavowal of any need to mention the realization principle harkens back to Justice Holmes's dissent in *Macomber*. In that dissent, he asserted that the need for such definitional niceties was inconsistent with the original intent of the Sixteenth Amendment because the intent of that amendment's enactment "was to get rid of nice questions as to what might be [a] direct [tax]."[222] With the majority of the Court joining Justice Holmes's opinion in *Kirby Lumber*, commentators understood that the Court's decision repudiated its earlier restrictive definition of income in *Macomber* and instead signaled that going forward it would determine the meaning of income based on a broader contextual approach.[223]

value of capital investment is not income in any proper meaning of the term." (quoting *Macomber*, 252 U.S. at 214–15)). For a discussion of the early prohibition to finding of cancellation of indebtedness income based on *Macomber* prior to the Supreme Court decision in *Kirby Lumber*, see Boris I. Bittker & Barton H. Thompson, Jr., *Income from the Discharge of Indebtedness: The Progeny of* United States v. Kirby Lumber Co., 66 CALIF. L. REV. 1159, 1159–61 (1978), and Fred T. Witt, Jr. & William H. Lyons, *An Examination of the Tax Consequences of Discharge of Indebtedness*, 10 VA. TAX REV. 1 (1990).

220. *See Kirby Lumber*, 284 U.S. at 3 (citing Burnet v. Sanford & Brooks Co., 282 U.S. 359, 364 (1931)).

221. *Id.*

222. *Macomber*, 252 U.S. at 219–20 (Holmes, J., dissenting).

223. *See* ROSEWELL MAGILL, TAXABLE INCOME iii (Ronald Press Co. 1945) ("The spell of the *Eisner v. Macomber* definition of income having been broken by Mr. Justice Holmes in *U.S. v. Kirby Lumber Company*, it would be a hardy judge who would attempt to restore that definition, or indeed any definition, to judicial favor.").

The breadth of the Supreme Court's decision in *Kirby Lumber* sent taxpayers clamoring to Congress for statutory cutbacks.[224] In 1938, Congress enacted a bankruptcy exception to the cancellation of indebtedness income,[225] and in 1939, Congress enacted an insolvency exclusion.[226] These provisions and other exclusions live on in current Section 108 of the Tax Code.[227] In 1954, at the same time Congress enacted Section 108, it codified the inclusion of cancellation of indebtedness income in the predecessor of current Section 61(a)(11), but left its meaning to be determined by the case law.[228]

Although the contours for the recognition of COD income and its exclusions have been reformulated over time,[229] the interrelationship of those rules and the basis consequences of excluded cancellation of indebtedness income have remained consistent in terms of their conceptual symmetry. If a taxpayer has cancellation of indebtedness income, then the taxpayer preserves existing basis. If a taxpayer excludes cancellation of indebtedness income from income, then a basis reduction (or reduction of some other tax attribute, such as net operating loss carryovers) is required to avoid a double benefit.[230] This

224. *See generally* Stanley S. Surrey, *The Revenue Act of 1939 and the Income Tax Treatment of Cancellation of Indebtedness*, 49 YALE L.J. 1153 (1940) (discussing the effort to enact the predecessor to Section 108).

225. Act of June 22, 1938, Pub. L. No. 75-696, Sec. 269, 52 Stat. 840, 904 (allowing for the exclusion of COD income for taxpayers whose debt is cancelled in the midst of bankruptcy proceedings). The IRS appears to have afforded a bankruptcy exception even prior to this statutory exclusion. *See* I.T. 1564, II-1 C.B. 59 (1923). In 1940, Congress retroactively amended the basis reduction requirement to ensure that basis could not be reduced below fair market value of the property. *See* Act of July 1, 1940, Pub. L. No. 76-699, Sec. 1, 54 Stat. 709. Congress subsequently revamped these basis adjustment rules in the context of a bankruptcy in 1980 in the Bankruptcy Tax Act of 1980. *See* Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, 94 Stat. 3389 (codified in scattered sections of 6–7 U.S.C.).

226. *See* Revenue Act of 1939, Pub. L. No. 76-155, Sec. 215(a), 53 Stat. 862, 875 (allowing for the exclusion of COD income for taxpayers whose debts exceed the total value of their assets).

227. *See* I.R.C. § 108(a) (excluding from income certain cancellation of debt). This exclusion may be accompanied by basis adjustments which are critically important to understanding how these exclusions are consistent with other inclusion rules. *See infra* note 272.

228. *See* Act of Aug. 16, 1954, Pub. L. No. 83-591, 68A Stat. 17; S. REP. NO. 83-1622, at 14 (1954) (adopting H.R. REP. NO. 83-2543) (explaining that Congress "will leave the situation as it now exists, with the determination as to whether cancellation results in income to the debtor and to what extent, to be settled according to rules developed by the courts"); H.R. REP. NO. 83-2543, at 23 (1954) (Conf. Rep.).

229. Congress substantially reformulated the scope and exceptions set forth in Section 108 in 1980. *See* Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, 94 Stat. 3389. For a helpful formulation of how the Bankruptcy Tax Act of 1980 revamped the prior law by a person that was directly involved in those policy discussions, see Paul H. Asofsky, *Discharge of Indebtedness Income in Bankruptcy After the Tax Act of 1980*, 27 ST. LOUIS U. L.J. 583 (1983).

230. However, when the amount of debt-discharge income exceeds the amount of attributes available for reduction after applying the ordering rule, the excess income generally goes untaxed and thus is referred to as "black hole" cancellation of indebtedness income. *See* CANDACE A. RIDGWAY & COLLEEN E. LADUZINSKI, TAX ASPECTS OF RESTRUCTURING FINANCIALLY TROUBLED BUSINESSES II.G.1.b (2002). In this situation, Congress has set forth a rule that creates an under-

approach ensures that ultimately a tax on income is applied once and only once over time.[231]

D. *Deferral and "Yield Exemption"*

The text of the Sixteenth Amendment authorizes taxation of "incomes, from whatever source derived."[232] This language invites one to engage in a reductive logic that might compete with the reductive logic employed by the dissent in *Moore*: if the realization principle prevents taxation of *all* incomes from *all* sources, then its incorporation into the Sixteenth Amendment as a limiting factor contravenes the plain meaning of the text. Said differently, the realization principle cannot be a constitutionally required constraint if the realization principle frustrates the taxation of all incomes and works to provide a tax preference for earning income from one source over another source.

The articulation of this premise thus opens an inquiry into the normative and constitutional implications posed by tax deferral—that is, delaying inclusion in taxable income to a later tax year. None of the subtleties and attendant consequences that arise as a result of tax deferral were addressed by the Court in its various opinions in *Moore*. But the temporal nature of income and the appropriate timing of its recognition are essential ingredients of the income tax, as income tax scholars and policymakers figured out slowly over the course of the twentieth century. In 1948, Cary Brown, who was a professor of economics at MIT, published what would become a watershed paper demonstrating that the ability to deduct the cost of an investment can, given certain reasonable assumptions, generate a financial benefit exactly equivalent to an outright exemption of the subsequent profit derived from the investment.[233] That is, *deferral* of tax liability provides a tax benefit that is the economic equivalent of *exempting* from tax each instance of accretion on the past accretion.[234]

The economic equivalency between the deferral benefit and yield exemption has significant policy implications. In short, capital owners who can manipulate timing rules to create tax deferral can obtain for themselves the equivalent benefit of an income tax exemption unavailable to day laborers who earn their income from services. Such disparity creates inequities and frustrates

inclusion of income, but again it is within Congress's authority to determine the net income it chooses to tax.

231. *See infra* Part IV (discussing tax basis more generally).

232. U.S. CONST. amend. XVI.

233. *See* E. Cary Brown, *Business-Income Taxation and Investment Incentives*, *in* INCOME EMPLOYMENT AND PUBLIC POLICY: ESSAYS IN HONOR OF ALVIN H. HANSEN 300–16 (1948), *reprinted in* AM. ECON. ASS'N, *supra* note 70, at 525–37.

234. Examples 1 through 3 below explain how this works.

the Sixteenth Amendment's grant of authority to tax all incomes from whatever source derived.

Scholars and policymakers began to understand and confront the implications of Brown's work in earnest in the 1970s.[235] In perhaps the most influential tax article published in the last sixty years, Professor Bill Andrews utilized the Cary Brown theorem to demonstrate that relying on realization as a timing mechanism allows taxpayers to unilaterally capture tax deferral benefits that afford them yield exemption.[236] He explained that "any failure to tax accumulation as it occurs is thus a pro tanto omission from a true accretion base."[237] He deemed the realization doctrine to be the "Achilles' heel" of the income tax due to the deferral benefit—yield exemption—that it ceded to taxpayers to manipulate and control.[238]

Some numbers help make the potential yield exemption effect of deferral more clear. The following algebraic formula expresses the taxation of economic gain in an initial period and the further taxation with respect to the additional investment returns accruing in later periods, where "t" is the tax rate, "r" is the rate of return, and "n" is the number of periods:

Example 1: Full Taxation of Economic Income from Capital

$$\text{After-Tax Amount} = [\text{Economic Gain} * (1\text{-}t)] * [1+(r*(1\text{-}t))]^{n}$$

To understand the Cary Brown theorem, as it is widely known, compare the full taxation of economic income illustrated above with two alternatives. First, consider what happens if subsequent gains (that is, accretion on past accretion) are exempt from taxation. The capital owner's economic gain is taxed in the first period, but thereafter the returns on the after-tax investment are not subject to further taxation—in Cary Brown theorem terminology, the "yield" on investments after the initial gain is exempt from income tax.[239] Congress has facilitated a version of this with Roth retirement accounts, wherein

235. *See, e.g.*, U.S. Treas. Dep't, Tax Depreciation Policy Options: Measures of Effectiveness and Estimated Revenue Losses, 116 CONG. REC. 25,684 (1970); CARL S. SHOUP, PUBLIC FINANCE 302 (1969); STANLEY S. SURREY, PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES 123 (1973). This work was spurred in part by an earlier paper, Paul A. Samuelson, *Tax Deductibility of Economic Depreciation to Insure Invariant Valuations*, 72 J. POL. ECON. 604 (1964), showing that an income tax that allows depreciation deductions only for economic depreciation—that is, the *economic* value resulting from use in the most recent period—results in asset valuations that are independent of the holder's marginal tax rates, whereas accelerated depreciation increases asset valuation for those in higher tax brackets for whom deferral has provided a great tax benefit.

236. *See* William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1127–28 (1974).

237. *Id.* at 1129.

238. William D. Andrews, *The Achilles' Heel of the Comprehensive Income Tax*, *in* NEW DIRECTIONS IN FEDERAL TAX POLICY FOR THE 1980S 278, 278–80 (Charles E. Walker & Mark A. Bloomfield eds., 1983).

239. *See* Brown, *supra* note 233, at 302–04, 314.

contributions are initially included in income and subsequent gains are exempt from tax.[240]

The algebraic formula that represents this outcome is as follows:

Example 2: Yield Exempt from Tax

After-Tax Amount = [Economic Gain * (1-t)] * $(1+r)^n$

In this formula, the economic gain is taxed in the first period with no tax deferral benefit, but gains after that initial period are exempt from tax. For example, assume that a taxpayer's initial gain of $1,000 is subject to the 20% tax, leaving $800 to invest in the next period. The subsequent 10% return is included by adding the rate to the base each time period. In year two, the return would be $80. If no tax is paid on that return for that time period, the taxpayer will have $880 after tax at the end of year two, a better result (by $16) than if the taxpayer were required to pay tax on the $80 of gain. This $16 is the benefit of yield exemption.

Compare the yield exemption result in Example 2 with the benefit of tax deferral on the initial gain. If a taxpayer is able to defer paying tax on his economic gain initially, then he is able to reinvest that full pretax amount into further investments. Congress has facilitated a version of this with taxpayers who are able to invest in traditional 401(k) accounts, which provide for contributions on a pretax basis with income taxation deferred until the time the taxpayer receives distributions from their account at retirement.[241]

The algebraic equation for expressing this deferral benefit is as follows:

Example 3: Deferral Benefit

After-Tax Amount = [Economic Gain * $(1+r)^n$] * (1-t)

Here, the gain attributable to year one is untaxed in the first period—in our example, the taxpayer does *not* have to pay $200 of tax initially. That means that the taxpayer can reinvest the full pretax economic gain of $1,000, earning a return of 10% for each subsequent period it remains invested, represented as $(1+r)^n$ in the above formula. If or when something causes the deferral period to end, the taxpayer must pay tax on the full amount of gain, which is represented

240. *See* I.R.C. § 408A.
241. *See id.* §§ 402(a), 401(a), (k).

as (1-t). If the taxpayer is able to defer for one year, the untaxed $1,000 earns $100, and at the end of year 2, the taxpayer pays a 20% tax on $1,100 total. Tax liability of $220 leaves the taxpayer with $880 after tax—again, just as in Example 2, the taxpayer is $16 better off than he would be with full taxation of economic income as seen in Example 1.

The tax deferral benefit illustrated in Example 3 provides the exact same financial benefit and outcome as the yield exemption benefit illustrated in Example 2. A side-by-side comparison of Examples 2 and 3 reveals the equivalence of the two algebraic equations:

<u>Example 2</u> – Yield Exemption Formula = [Economic Gain * (1-t)] * $(1+r)^n$

<u>Example 3</u> – Deferral Benefit Formula = [Economic Gain * $(1+r)^n$] * (1-t)

Both the yield exemption benefit and the deferral benefit deviate away from full taxation of economic income in exactly the same amount; the order of operation for the two equations is simply flipped.

The tax benefit—of yield exemption or of tax deferral—increases as the number of time periods increases (and also if the tax rate is higher). The table below demonstrates the equivalence of these financial benefits in a scenario where a taxpayer has pretax economic gain of $1,000, faces a tax rate of forty percent, and the time period for the investment return is ten years.

Table 1: Equivalency of Tax Deferral to Yield Exemption

	Column A		Column B		Column C	
Tax Rate: 40% Pretax Investment Returns: 10%	Hair-Simon Taxation of Economic Gain Upfront and Tax on Interim Reinvestment Returns		Yield Exemption Benefit		Deferral Benefit	
Economic Gain	a	1000	f	1000	j	1000
Tax	b	-400	g	-400	Deferral Benefit	
After-Tax	c = a – b	600	h = f – g	600	k = j	1000

Investment Return for Ten Years	d = f - e	1390.8	i = h*(1.1)^10	1556.25	L = h* (1.1)^10	2593.74
Taxation on Ten-Year Yield	e = {c*10%*40%} * [{1.06^10-1} 1.06]	316.3	Yield Exemption	None	m = L * 40%	-1037.50
After-Tax Cash on Hand	f = c*{1.06}^10	1074.5		1556.25		1556.25

Column A shows the outcome of taxing all economic income as it accrues—this initial gain in year one and the further accretion in later periods; Column B shows the outcome that would arise if the capital owner's economic gain were taxed in year one but all subsequent investment returns from reinvestment of that post-tax economic gain were exempted from any further taxation in the subsequent ten periods (i.e., yield exemption outcome for ten years); Column C depicts the outcome that would arise if the economic gain were not taxed in the initial period on the capital owner's economic gain so that a tax deferral benefit is allowed until all economic accretion is finally taxed in year ten.

Full taxation of economic income leaves the taxpayer with after-tax proceeds of $1,074.50. In contrast, the benefits of both yield exemption and tax deferral result in after-tax proceeds of $1,556.25. Table 1 thus clearly demonstrates that tax deferral provides the same economic benefit to a capital owner as yield exemption and that the tax subsidy advantage of the tax deferral benefit increases as the tax deferral period is longer and the taxpayer is nominally subjected to higher rates of taxation (higher income taxpayers, under the existing progressive federal rate structure). The Cary Brown theorem holds true assuming that tax rates remain constant over the relevant timeframe, the upfront tax deduction provides an immediate tax benefit to the taxpayer, and the tax savings garnered by the taxpayer are reinvested and can provide a comparable internal rate of return.[242] As discussed below, it turns out that these

242. Alvin C. Warren, Jr., *Accelerated Capital Recovery, Debt, and Tax Arbitrage*, 38 TAX LAW. 549, 551–52 (1985). Professor Warren popularized a "modified Cary Brown theorem" by indicating that if the tax savings from the deduction provides a lower return than the deducted investment return, the effect of the expensing is to provide an exemption for a normal profit and allow taxation of only supernormal returns. *See* Alvin C. Warren, Jr., *How Much Capital Income Taxed Under an Income Tax Is Exempt Under a Cash Flow Tax?*, 52 TAX L. REV. 1, 4 (1996); *see also* Noël B. Cunningham, *The Taxation of Capital Income and the Choice of Tax Base*, 52 TAX L. REV. 17, 26 (1996).

can be pretty fair assumptions in the real world, at least for some types of investments.[243]

This prompted a profound shift in the discourse around timing issues in the modern income tax. Following the Andrews article, the question became how to cabin the pernicious problem of yield exemption created by reliance on realization as a timing rule for including gains on capital investments.[244] Andrews proposed to abandon attempts to tax investment returns and instead shift to a progressive consumption tax.[245] Professor Alvin Warren, responding to Andrews, argued that reforms to the nation's income tax could be made to address its undeniable timing failures.[246]

Showing the extent of manipulation that tax deferral facilitates in tandem with other features of the modern income tax, Professor Calvin Johnson demonstrated that debt-financed investing—in which the investment is immediately deducted, an interest deduction is fully allowed, and the debt-financed investment generates unrealized gains—can create the equivalent of a negative tax rate under reasonably expected situations.[247] Professor Johnson thus identified that the failure to properly calibrate timing rules and tax deferral benefits was the genesis of a variety of debt-oriented tax shelters, which proliferated into the 1980s.[248]

The change in mindset on how tax deferral—and thus, realization—impeded the income tax, and how the income tax laws needed to reflect time value of money concepts, led to congressional action. Starting in the late 1960s and then accelerating in the 1980s, Congress enacted a variety of tax reform measures that sought to limit the availability of taxpayer-driven deferral (as opposed to deferral policies, like 401(k) accounts, that were expressly prescribed by Congress).[249] These reforms can be understood as a concerted effort on the

243. Further, different tax rates in different time periods, due to different marginal rates applying or changes in law, can supercharge the tax benefits of deferral or yield exemption, depending on the particulars.

244. *E.g.*, INST. FOR FISCAL STUDIES, THE STRUCTURE AND REFORM OF DIRECT TAXATION: REPORT OF A COMMITTEE CHAIRED BY PROFESSOR J.E. MEADE 37 (1978).

245. Andrews, *supra* note 236, at 1165–77. After his devastating attack on the pernicious tax deferral outcomes made possible by the realization requirement, Professor Andrews challenged the conventional wisdom that a consumption tax is per se regressive and argued that a progressive consumption tax could be designed to avoid the inequities in how capital versus labor income is taxed. *Id.* This argument echoes Fisher's later work on a consumption tax as an alternative to the income tax. IRVING FISHER, THE INCOME CONCEPT IN LIGHT OF EXPERIENCE 16–17 (1927).

246. Alvin C. Warren, Jr., Comment, *Fairness and a Consumption-Type or Cash Flow Personal Income Tax*, 88 HARV. L. REV. 931 (1975).

247. *See* Calvin H. Johnson, *Soft Money Investing Under the Income Tax*, 1989 U. ILL. L. REV. 1019 [hereinafter Johnson, *Soft Money*]; *see also* Calvin H. Johnson, *Silk Purses from a Sow's Ear: Cost Free Liabilities under the Income Tax*, 3 AM. J. TAX POL'Y 231 (1984) [hereinafter Johnson, *Silk Purses*].

248. Johnson, *Soft Money*, *supra* note 247; Johnson, *Silk Purses*, *supra* note 247.

249. *See, e.g.*, I.R.C. § 1272 (eliminating deferral opportunities on "original issue discount" debt instruments, enacted by Congress in 1984); *id.* § 1256 (imposing a "mark to market" timing rule for

part of Congress to move the nation's income tax base to a closer approximation of economic income. On first inspection, these various legislative responses appear to be disparate in their approaches, but Professor Daniel Halperin showed that tax deferral in any form could be viewed as an interest-free loan from the government.[250] In fact, Professor Halperin demonstrates that the Cary Brown theorem sets forth a rationale for harmonizing and synthesizing these various timing rule reforms.[251] Halperin demonstrates how eliminating tax deferral and its vagaries could serve as an organizing theorem, which generally worked through a variety of carefully calibrated timing rules.[252]

Other noted academic articles were in accord.[253] Realization began to be treated as a particular timing rule that was the main antagonist that stood in the way of appropriate taxation of income derived from capital—albeit one that remained necessary in some contexts where taxpayer investments may be illiquid, or valuation is not feasible without a market transaction. This scholarship—and more generally the challenge of timing issues in designing income tax rules—is well-appreciated by policymakers, as reflected in the dozens of context-specific timing rules that Congress has enacted as part of the modern income tax.[254] These efforts are reasonable on the part of Congress to ensure that the nation's tax laws clearly reflect income in the many varied contexts in which the income tax laws must be applied. Context matters, and concerns over administrability matter too, but these are just the sort of balancing of interests that the Sixteenth Amendment has sought to empower Congress to solve. Even so, it would be a mistake to conclude that the lack of a unified timing rule for all contexts means that income is subjected to multiple taxation over time, as the next Part demonstrates.

certain commodities contracts, to prevent trading strategies that could accelerate loss deductions and defer inclusion of gains, enacted by Congress in 1981); *id.* § 475 (similar for securities traders generally, enacted in 1993); *id.* § 817A (similar for life insurance contracts, enacted by Congress in 1996).

250. *See* Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money*,*"* 95 YALE L.J. 506 (1986).

251. *Id*. Professor Martin Ginsburg was quoted remarking that one of Professor Halperin's greatest accomplishments was to demonstrate how a generalization of the Cary Brown theorem applies to almost everything in the tax law dealing with time value of money principles. *See* Hanna, *supra* note 127, at 440 n.35.

252. *See* Halperin, *supra* note 250, at 524.

253. *See generally, e.g.*, Noël B. Cunningham & Deborah H. Schenk, *Taxation Without Realization: A "Revolutionary" Approach to Ownership*, 47 TAX L. REV. 725 (1992); David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111 (1986); Martin D. Ginsburg, *Teaching Tax Law After Tax Reform*, 65 WASH. L. REV. 595 (1990); Deborah A. Geier, *The Myth of the Matching Principle as a Tax Value*, 15 AM. J. TAX POL'Y 17 (1998); Christopher H. Hanna, *The Real Value of Tax Deferral*, 61 FLA. L. REV. 203 (2009); Calvin H. Johnson, *Measure Tax Expenditures by Internal Rate of Return*, 139 TAX NOTES 273 (2013).

254. *See, e.g.*, Johnson, *Soft Money*, *supra* note 247; Johnson, *Silk Purses*, *supra* note 247.

IV. TAX BASIS TO TRACK "INCOMES" OVER TIME

In this Part, we introduce the practical tool that unites these varied timing rules into a coherent tax system, one that makes income taxation different from property taxes or wealth taxes. That system is *tax basis*, which ensures that income taxed in one period can be tracked and cannot be taxed again in any other time period. We contend that taxation of income requires timing rules—whatever they may be—to assign income into a particular year. Then, a corresponding basis adjustment must be made so that the taxpayer is protected against multiple taxation of the same income in multiple years, including when an investment is later disposed of in a realization event. In this way, tax basis works to impose a limitation on the application of the income tax so that only income—a change in economic position across time—is subject to taxation, meaning a change is only taxed once over time.

This single-taxation-of-income-over-time principle, we argue, should be the fundamental guiding principle for appropriately ensuring that taxation under the Sixteenth Amendment is constrained to only income and not its source.[255] Although many of the various timing and basis rules that have been adopted have not been understood to have constitutional valence, we make the case that they work to the constitutionally relevant end of achieving taxation of income but not its source. Each context-specific timing rule, introduced to determine income in a particular time period, should be accompanied by appropriate basis adjustments to ensure that income taxed in one period cannot be taxed again in another period. Congress should be afforded deference to design timing rules of its choosing so long as those rules adhere to the single-taxation-of-income-over-time principle.

A. *Harmonizing Timing Rules with Basis Adjustments*

If this is a new constitutional moment, understanding income in terms of time and recognizing the concept of tax basis as a limiting factor for the income tax is essential to properly framing whether the income tax has appropriately distinguished income from its source over time. Tax basis is the main tool for tracking previous inclusions in income across time periods and it constitutes a mechanism for distinguishing income from capital—without binding Congress into a single timing rule that cannot work appropriately across all of the myriad of legally distinguishable fact patterns to which the income tax laws must be applied.[256] By tracking what has already been included in income, tax basis

255. *See generally* Marjorie Kornhauser, *The Origins of Capital Gains Taxation: What's Law Got to Do with It?*, 39 SW. L.J. 869, 888–90 (1985) (describing a concept of tax basis as fundamental to a "quantum" theory and exploring the intellectual and case law foundations of this approach to income following the *Macomber* decision).

256. *See supra* Part III. For example, Congress eventually returned to precisely the issue in *Macomber* (dividends of stock) and enacted a framework under which certain stock dividends—such as

ensures that income taxation is not mixed up with taxation of capital—that is, taxation of a value, rather than a change in economic position. This is the precise issue the Supreme Court has been grappling with since *Macomber* by way of the tree-and-fruit analogy. Understood this way, temporality and the basis mechanism serve to distinguish income taxation from other tax regimes, including property taxes and wealth taxes.[257]

To be sure, tax basis rules are complex. As with drops of water, money is indistinguishable and fungible, so determining what you have now as compared to what you started with is, as we have noted, not as simple as counting the fruit you have plucked from a tree. Current tax basis rules—that work to distinguish income from capital consistently in a variety of contexts and in conjunction with a variety of different timing rules—have been fashioned by Congress,[258] the Treasury Department,[259] and lower courts.[260] And, as we discuss in this part, the calibration of the tax basis rules is something the Court has already grappled with in its own income tax precedents. As constructed in the modern income tax, tax basis accounts for every flow of what has already been included into

when some shareholders receive a dividend of stock while others receive cash, thus causing the recipients of stock to own more of the corporation—are included in income. I.R.C. § 305(b)(1). When stock is paid out in this way (as well as other select ways that cause similar results), Congress provides that the amount received is generally included in income, *id.* § 301(c)(1), and that the basis in the stock received is equal to the fair market value, *id.* § 301(d). As a result, if the shareholder sells the newly received stock immediately after receiving it, the sale does not result in any additional tax liability because there is no excess of amount realized over basis. *Id.* § 1001(a).

257. Under a wealth tax or a property tax, a taxpayer is subject to taxation on some value without regard to whether that value has been taxed previously. Our focus here is on the breadth of the Sixteenth Amendment, which provides that taxes "on incomes, from whatever source derived" do not need to be apportioned by state population. U.S. CONST. amend. XVI. While we believe that a wealth tax is justifiable constitutionally outside of the Sixteenth Amendment because such a tax can be designed so that it is not a direct tax as envisioned by the framers, that is quite apart from the question of what constitutes income. Important scholarship addresses this topic, along with the somewhat erratic history of jurisprudence regarding direct and indirect taxes. *See, e.g.*, Ari Glogower, *Comparing Capital Income and Wealth Taxes*, 48 PEPP. L. REV. 875, 898–901 (2021) (surveying early Supreme Court precedent and more recent scholarship on the question of whether a wealth tax is a direct tax); John R. Brooks & David Gamage, *Taxation and the Constitution, Reconsidered*, 76 TAX L. REV. 75, 95 (2022) (arguing that the historical meaning of the direct and indirect tax clauses militates in favor of a looser understanding of what the apportionment requirement might apply to, an interpretation that would render wealth taxes permissible if uniform); Ari Glogower, *A Constitutional Wealth Tax*, 118 MICH. L. REV. 717, 749–52 (2020) (surveying judicial precedent and scholarship prior to *Moore* and concluding that "[t]he weight of constitutional analysis may suggest that the Court should ultimately uphold a traditional wealth tax").

258. *See, e.g.*, I.R.C. §§ 358, 362, 1012, 1014, 1015, 1016, 1019.

259. *See, e.g.*, Treas. Reg. §§ 1.302-2(c), 1.1012-1(c); Rev. Rul. 68-291, 1968-1 C.B. 351; Rev. Rul. 70-510, 1970-2 C.B. 159; Rev. Rul. 68-55, 1968-1 C.B. 140.

260. *See, e.g.*, Inaja Land Co. v. Comm'r, 9 T.C. 727 (1947) (allowing recovery of basis before income is recognized); Fairfield Plaza, Inc. v. Comm'r, 39 T.C. 706 (1963) (prorationing of basis among subdivided property to determined gain or loss); Gladden v. Comm'r, 262 F.3d 851 (9th Cir. 2001); Beaver Dam Coal Co. v. United States, 370 F.2d 414, 417 (6th Cir. 1966).

income and thus has become part of the reservoir of capital, and what portion has not as yet been subjected to income taxation.

With basis available as a tracking tool, the question of income inclusion becomes *only* a temporal one—not *if*, but rather, *when*. If a taxpayer has an economic gain as calculated in the current period, should the gain be included in income *now*,[261] should it be reevaluated and included *later*,[262] or, perhaps, should it *never* be included and instead be exempt from income taxation?[263] We think that Congress should be afforded plenary authority to reasonably determine which time is the most appropriate and practical to assign income into. However, after assigning income to one time period or another, the careful calibration of tax basis with the context-specific timing rule ensures that income is taxed only once over time.

If a taxpayer is subject to taxation on income related to property, under whatever timing rule, the taxpayer receives a positive basis adjustment in that property's tax basis.[264] The basis mechanism allows taxpayers to include in income only the excess of "amount realized" over tax basis, so that a later disposition of that property by the taxpayer does not result in the taxpayer being subjected to taxation again on previously taxed economic gain.[265]

The basis rules work not only to harmonize income inclusions; *deductions* constitute another feature of the income tax that can work due to the basis mechanism. Very often, deductions—in particular deductions reflecting depreciation and amortization—represent another form of a nonrealization timing rule, reflecting negative changes in economic position without regard to realization events. As the cost of the asset is deducted as depreciation,[266] the unrecovered investment in the property for tax purposes (its remaining "adjusted basis") is reduced.[267] This mechanism mirrors the basis *increase* that is provided for when tax on gain is imposed before a realization event. Depreciation and amortization deductions have been a feature of the income tax

261. For example, receipt of wages in exchange of services provided, or disposition of property in exchange for cash at the time of disposition. *See* I.R.C. §§ 61(a)(1) (compensation for services included in gross income), 61(a)(3), 1001(a) (gains, calculated as the amount of money received in excess of basis, from the sale or other disposition of property included in income).

262. For example, retirement savings that Congress has allowed to be deferred from inclusion in income until retirement age, with many limitations and rules accompanying such deferral. *See id.* § 401(k).

263. For example, under current rules, appreciated property owned when an individual dies receives "stepped up basis" in the hands of the decedent's heirs. *Id.* § 1014.

264. *See id.* §§ 1012, 1016.

265. *Id.* § 1001.

266. *See id.* § 167 (allowing deductions for wear and tear of certain property); *id.* § 168 (providing specific rules for the amount and timing of depreciation deductions under § 167).

267. *Id.* §§ 1011(a), 1016(a).

since its inception, allowing taxpayers to recover their investment in tangible and intangible property before disposing of it.[268]

This possibility of using basis to track after-tax investment necessitates a determination of whether an expenditure should be allowed as an immediate deduction or should instead be capitalized into basis of some particular asset.[269] Together, these basis rules establish a matching principle, so that an expenditure capitalized into a taxpayer's basis can be associated with a future disposition of a particular asset and thus used to determine when a taxpayer's receipt of funds in a later period should be considered as a recovery of the taxpayer's prior expenditure.[270]

When the taxpayer purchases an asset with cash, the purchased property generally is afforded a cost basis under the assumption that the taxpayer's original purchase of the property originated from taxpayer funds that have already been subjected to income taxation in some earlier time period.[271] The allowance of a cost basis for the purchase of property with funds that have already been subjected to income taxation ensures that the taxpayer is not taxed again on the same accretion of income when the purchased asset is later disposed of.[272] In short, the operation of this basis system, with upward and downward adjustments, can ensure that income is subject to income taxation *only once over*

268. *See id.* §§ 167, 197.

269. *See id.* §§ 263, 263A. The application of these capitalization rules has been the subject of considerable court interpretation. *See* Comm'r v. Idaho Power Co., 418 U.S. 1 (1974); Thor Power Tool Co. v. Comm'r, 439 U.S. 522, 532 (1979). Capitalization has been viewed as required under the "clearly reflect income" under the taxpayer's method of accounting as prescribed by I.R.C. § 446.

270. For a discussion of the use of forward-looking matching rules (e.g., capitalization rules), backward looking matching rules (e.g., recapture rules that determine later disposition in light of earlier deductions), and matching rules based on how an item is treated by another taxpayer's tax treatment (e.g., related party disallowance rules or deduction deferral rules until income inclusion of another taxpayer), see Charlotte Crane, *Matching and the Income Tax Base: The Special Case of Tax Exempt Income*, 5 AM. J. TAX POL'Y 191, 201–04, 217–25 (1986).

271. *See* I.R.C. § 1012. The working assumption that affords a cost basis for purchased property arguably is overly generous as not all funds in the taxpayer's hands may have been subjected to income taxation and thus may not represent after-tax funds. *See* Crane, *supra* note 270. Taxpayers are also allowed a cost basis even by expending borrowed funds that were excluded from income at the time of receipt. *See* Crane v. Comm'r, 331 U.S. 1, 15–16 (1947). But in this context, the exclusion of loan proceeds is not a permanent benefit because the loan repayment is nondeductible and the general assumption is that the principal repayment is made with after-tax funds. The Court has taken great pains to ensure that a later nonpayment of the borrowed funds in connection with acquiring property does not allow for some loan proceeds to escape inclusion in income. *See id.*; Comm'r v. Tufts, 461 U.S. 300, 310 (1983).

272. Another context that exhibits nuanced use of basis is cancellation of indebtedness. *See supra* notes 224–28 and accompanying text. If the taxpayer is not subjected to taxation on COD income due to an exception granted under Section 108, the taxpayer may be required to reduce tax basis in assets by the amount of the excluded income to prevent a double benefit. I.R.C. § 108(b)(2)(E); Pub. L. No. 75-696, sec. 270, 52 Stat. 840, 904 (1938).

time. This provides a coherent conceptual framework for evaluating whether a rule imposes tax on income or instead on something else.

The Supreme Court's careful handling of the tax basis concept is illustrated in *Hort v. Commissioner*.[273] In *Hort*, a taxpayer acquired a lot and a ten-story office building after his father had passed away in 1928.[274] The taxpayer then leased the first floor under a long-term lease, but in the midst of the Great Depression the tenant proposed to pay $140,000 to the taxpayer-lessor in cancellation of the lease.[275] The taxpayer did not include this $140,000 in gross income and instead claimed a loss of $21,494.75 under the theory that the lessor-taxpayer had received less than the fair market value of the property.[276] Even though the Court accepted that the relinquishment of a leasehold interest represented the acquisition of a property right by the lessor under state law, it held that this transaction was not entitled to return of capital treatment but instead represented a substitute for ordinary income.[277] To reach this outcome, the Court deftly distinguished that property and capital are not necessarily synonymous terms.[278] The Court treated the lease cancellation payment as income in its entirety and not an exchange of property because "[t]he cancellation of the lease involved nothing more than relinquishment of the right to future rental payments."[279] Thus, the Court drew a line in what represents capital that gives rise to a usage of tax basis, which in turn distinguishes a taxpayer's incomes from its source.

The Court further elaborated on how to make this distinction in establishing the "tax benefit rule." For example, consider Annie, who previously loaned Brian $1,000 (giving her $1,000 of basis in the outstanding loan). Last year, Brian declared bankruptcy and Annie's creditor priority entitled her to no recovery from Brian's remaining assets, making the entire $1,000 of the original debt worthless to Annie and allowing her to take a deduction for the lost $1,000.[280] But, surprisingly, this year Brian's fortunes change and he is able to pay back $200 of the debt. In early judicial challenges, courts struggled with the point that a taxpayer recovering a written off debt had any income inclusion because the taxpayer superficially seems to be merely re-collecting back her own original funds. Lower courts questioned whether a taxpayer's recovery of her

273. 313 U.S. 28, 28 (1941).
274. *Id.* at 29.
275. *Id.*
276. *Id.*
277. *Id.* at 31.
278. *Id.*
279. *Id.* at 32.
280. *See* I.R.C. § 166 (allowing a deduction for debt in the amount of the taxpayer's basis in the debt in the year in which it becomes "worthless").

own capital could represent gain derived from capital under *Macomber*.[281] The tax basis concept clarifies the issue: permitting the taxpayer to take a deduction for the bad debt deduction in the prior year has the effect of offsetting taxable income in that prior year, akin to a recovery of basis.[282]

The tax benefit rule follows the logic of basis, in order to prevent taxpayers from capturing a double benefit—for example, allowing Annie to reduce her income by $1,000 last year and then receive a tax-free $200 this year. Instead, the later recovery of previously deducted amount is treated as income, so that the $200 that was previously deducted is income to Annie in the year received. Today, this approach is known as the "inclusionary" prong of the tax benefit rule.[283] In the early decades of the income tax, courts tried to fit this concept—which requires tracking income inclusions and deductions across time periods—within the strictures of *Macomber*. In effect, the later-recouped recovery of one's previously deducted bad debt stands in the place of the gross income which had not been taxed before and is therefore taxable and loses its status as capital.[284] The Ninth Circuit offered a cogent explanation for how to harmonize the inclusionary prong of the tax benefit rule within the strictures of *Macomber*:

> With regard to the recoveries made by petitioner on the debts previously charged off by the smaller banks, the question as to the taxability thereof is: were they recoveries of capital? The Sixteenth Amendment of the Constitution authorizes Congress to levy taxes on "incomes, from whatever source derived". Such income is said to be "the gain derived from capital, from labor, or from both combined". Money received from the conversion of capital represented by something other than money is not income within the meaning of the amendment, although a gain on the conversion is . . . . [W]hen . . . a loan becomes worthless, the amount thereof is loss of capital, but the income tax laws permit the [taxpayer] to recoup its capital by deducting from the profits or income the amount

281. *See, e.g.*, Liberty Ins. Bank v. Comm'r, 14 B.T.A. 1428, 1434 (1929), *rev'd*, 59 F.2d 320 (6th Cir. 1932) (holding that such a recovery was income per *Burnet v. Sanford & Brooks*); *see also* Boris I. Bittker & Stephen B. Kanner, *The Tax Benefit Rule*, 26 U.C.L.A. L. REV. 265, 266 (1978) (discussing the hindrance that the *Macomber* decision had in the early periods).

282. Almost from the beginning, the Treasury Department has asserted that a taxpayer's later recovery of a previously deducted bad debt represents income to the taxpayer in the year of her recovery. *See* Treas. Reg. 33, art. 125 (1914) (promulgated under the Act of October 3, 1913). This principle was re-adopted without change for the 1921 Tax Act in Treas. Reg. 62, art. 51, T.D. 3295, 24 Treas. Dec. Int. Rev. 230–31 (1922). As originally formulated, the Treasury Department had applied this rule to create an income inclusion upon the recovery of a bad debt, whether or not the taxpayer actually obtained a tax benefit from a deduction in an earlier year. *See* S.R. 2940, IV-1 C.B. 129 (1925).

283. *See* Hillsboro Nat'l Bank v. Comm'r, 460 U.S. 370, 405 (1983); *see also* Putman Nat'l Bank v. Comm'r, 50 F.2d 158, 158 (5th Cir. 1931) (noting necessity of an inclusionary tax benefit rule).

284. *E.g.*, Nat'l Bank of Com. of Seattle v. Comm'r, 115 F.2d 875, 876–77 (9th Cir. 1940); *see also In re* Collins, 46 B.T.A. 765, 769 (1942), *rev'd sub nom.*, Harwick v. Comm'r, 133 F.2d 732, 734–35 (8th Cir. 1943), *aff'd in part and rev'd in part*, Dobson v. Comm'r, 320 U.S. 489, 503–04 (1943).

> of the loss. Thus the [taxpayer] does not pay a tax on all its income, but on the amount of income less the loss on the worthless debt. The debt itself then loses its nature as capital, but represents that portion of the income which was not taxed, and the capital is the money taken from the profits or income. If the loan, after being deducted from income, is paid, then the lender is receiving profit or income—otherwise the lender would double its capital on one transaction. In other words, the profits or income used to pay back the capital when the debt is charged off is represented by the worthless loan, so that when such loan is paid the profits are replaced. Such is the theory of the income tax laws . . . .[285]

The Supreme Court would agree with this approach, observing that "by allowing a deduction that it could not have known to be improper at the time, to avoid the possible distortions of income, the courts have long required the taxpayer to recognize the repayment in the second year as income."[286] The inclusionary prong of the tax benefit rule refines the manner in which the tax basis mechanism operates and works to establish a coherent regime that does not over-tax or under-tax events that unfold over multiple years. But this outworking of the inclusionary prong of the tax benefit rule is not accounted for by a strict application of the realization principle. Instead, the inclusionary prong of the tax benefit rule is rightly understood as an effort to appropriately calibrate the scope of the tax basis concept to ensure that income and not its source is taxed only once over time. The Supreme Court rationalized the inclusionary prong of the tax benefit rule as reconcilable with the annual accounting methodology in the following manner:

> The [lower court] has not attempted to revise liability for earlier years closed by the statute of limitation, nor used any expense, liability, or deficit of a prior year to reduce the income of a subsequent year. It went to prior years only to determine the nature of the recovery, whether return of capital or income. Nor has the [court] reopened any closed transaction.[287]

The flip side to the inclusionary prong of the tax benefit rule addresses the problem of basis recovery. Prior to 1942, courts had concluded that the recovery of a bad debt in a later year represented income in the later year, *regardless* of whether or not any prior tax benefit had been garnered from the earlier bad

285. Nat'l Bank of Com. of Seattle v. Comm'r, 115 F.2d 875, 876–77 (9th Cir. 1940) (citations omitted). For another case that justifies the inclusionary prong of the tax benefit rule based on the theory that the recouped recovery of a previously deducted bad debt stands in the place of the gross income which had not been taxed before and is therefore taxable, see *Dobson*, 320 U.S. at 503–04.

286. *Hillsboro Nat'l Bank*, 460 U.S. at 377–79.

287. *Dobson*, 320 U.S. at 493.

debt deduction.[288] Continuing the example above, the pre-1942 rules would tax Annie on the $200 received in the later year, even if she received no deduction for the $1,000 loss initially, perhaps because she had no other taxable income against which to take a deduction. This approach was consistent with a strict realization requirement, and it fits squarely in the fruit-and-tree analogy from *Macomber*: a recovery of debt—i.e., a receipt of cash—is fruit harvested in the year of receipt. But in this situation, it results in over-taxation because a taxpayer could be subject to income taxation on a return of her own capital—the amount Annie previously loaned out—even when no prior year tax benefit had been obtained.[289]

Congress responded by enacting the predecessor to current Section 111, to exclude from income the taxpayer's recovery to the extent that the taxpayer had not obtained a prior year tax benefit.[290] This ameliorative doctrine is often referred to as the "exclusionary prong" of the tax benefit rule.[291] Instead of framing the income inclusion in terms of realization, the exclusionary prong of the tax benefit rule introduces a kind of "quasi basis" concept.[292] A taxpayer no longer has basis in stock she has disposed of, but the taxpayer is given quasi basis credit for any proceeds she later receives with respect to the sold stock to the extent the taxpayer's prior stock basis did not provide a tax benefit in the prior year.[293] In *Dobson v. Commissioner*, the Supreme Court rationalized this conception of quasi basis with the exclusionary prong of the tax benefit rule as

288. *See* Helvering v. State-Planters Bank & Tr. Co., 130 F.2d 44, 46–47 (4th Cir. 1942), *rev'g*, 45 B.T.A. 630, 631 (1941); Comm'r v. U.S. & Int'l Sec. Corp., 130 F.2d 894, 897 (3d Cir. 1942), *modified*, 138 F.2d 416 (1943).

289. *See* Hearings Before the Committee on Ways and Means on the Revenue Revision of 1942, 77th Cong. 2d Sess., at 88 (1942) (statement of Randolph Paul, Tax Advisor to the Secretary of the Treasury).

290. *See* Pub. L. No. 77-753, sec. 116, 56 Stat. 798, 812–13 (1942) (enacting the predecessor to current Section 111). The House Report tersely indicated that the exclusionary prong of the tax benefit rule was "designed to remove existing inequities." *See* H.R. REP. NO. 77-2333, 77TH CONG. 2d SESS., at 44 (1942). Treasury's treatment of the issue went back and forth prior to 1942: initially, it adopted the exclusionary prong of the tax benefit rule such that a recovery of a bad debt would create an income inclusion only if the earlier deduction by the taxpayer had caused a reduction in the taxpayer's taxable income. G.C.M. 20854, 1939-1 C.B. 104 ("To the extent that a deduction does not result in such a benefit to the taxpayer, the deduction cannot be said to have accomplished a return of capital. Until a taxpayer has had the income tax equivalent of a full return of the capital represented by his debt, there is no valid ground for treating as income any amount received in recovery of the debt."); G.C.M. 18525, 1937-1 C.B. 55 (same). It then reversed itself, giving rise to the cases referenced *supra* note 288.

291. *See Hillsboro Nat'l Bank*, 460 U.S. at 380 n.12.

292. Professor Johnson originated this terminology in his classroom teaching, and Professor Daniel Shaviro adopted it in response as well. *See* Daniel N. Shaviro, *Psychic Income Revisited: Response to Professors Johnson and Dodge*, 45 TAX L. REV. 707, 709 (1990).

293. The Senate Report framed the exclusionary prong of the tax benefit rule as a "recovery exclusion" for the amount of the taxpayer's prior basis that did not result in a reduction of the taxpayer's income tax liability for a prior year. *See* S. REP. NO. 77-1631, 77TH CONG. 2D SESS., at 79 (1942).

a "proper adjustment" to give recognition to the portion of the taxpayer's capital that had not afforded a basis benefit.[294] The tree-and-fruit concept of income is useless in this context—the Court had to sidestep it to reach a reasonable result.[295] Instead, the hydrological conception of income is more helpful, allowing a conceptual query as to whether the draw has already been measured and accounted for as previously taxed income (thus capital) or is a current new accession to wealth. A flow that has already been measured and counted once should not be included again.[296]

Thus, the basis concept allows taxpayers and the government to track and distinguish income from capital in a variety of contexts. This nuanced use of the tax basis concept and the companion tax benefit rule doctrine addresses the practical challenges that arise under an annual accounting system. These doctrines can be synthesized as follows: the taxpayer does not have income upon the return of her own capital to the extent that the taxpayer received back her own capital and had not previously obtained a tax benefit from that portion of her returned capital in a prior period.

These context-specific timing rules, along with basis adjustments, ensure that income taxed in one period is not subjected to further taxation in another period. This mechanism prevents the income tax from morphing into an annual wealth tax on pre-existing capital. Tax basis allows that realization is not a necessity: realization can simply be set aside in capital recovery contexts in favor of applying tax basis or quasi basis concepts. In this way, tax basis, not

294. Dobson v. Comm'r, 320 U.S. 489, 502–04 (1943), *superseded by statute*, I.R.C. § 7482(a)(1) (2018), *as recognized in*, Battat v. Comm'r, 148 T.C. 32 (2017). In *Dobson*, the taxpayer's overall tax basis in shares of stock was apportioned to blocks of stock, some of which the taxpayer sold with basis that exceeded the taxpayer's sales price, resulting in a capital loss on that stock disposition. *Id.* at 491. Some of the resulting capital loss provided no tax benefit to the taxpayer, but nonetheless the taxpayer no longer had actual basis as the stock had been sold. *Id.* at 492. This required the Court to decide what portion of the taxpayer's stock basis that had not afforded a tax benefit could represent quasi basis entitled to return of capital treatment at the time of a further recovery on the sold stock. *Id.* at 504.

295. The appellate court in *Dobson* had applied a "realization event" timing rule to determine that the taxpayer had income in the year of the recovery's receipt as it believed that this was a required outcome under the confines of the annual accounting construct of *Burnet v. Sanford & Brooks* and the application of the realization principle. Harwick v. Comm'r, 133 F.2d 732, 737 (8th Cir. 1943), *aff'd in part and rev'd in part*, *Dobson*, 320 U.S. 383, *superseded by statute*, I.R.C. § 7482(a)(1), *as recognized in*, Battat v. Comm'r, 148 T.C. 32 (2017) (*Harwick* was one of several cases consolidated under the heading of *Dobson*). The Supreme Court chided the appellate court for its reliance on a realization-based timing rule because in that context it was inapposite to the real question of whether or not the taxpayer's recovery was simply a return of the taxpayer's original capital. *Dobson*, 320 U.S. at 492–93.

296. *See Hillsboro Nat'l Bank*, 460 U.S. at 383. The Court explained that the tax benefit rule would only be triggered if the later event were "fundamentally inconsistent" with the earlier utilization of basis. *See id.* at 383; *see also* Allstate Ins. Co. v. United States, 20 Cl. Ct. 308, 312 (1990), *rev'd*, 936 F.2d 1271 (Fed. Cir. 1991) ("The tax benefit rule works as a compromise between the ideal of measuring income in transactional parity and the bureaucratic necessity of annual reporting."). Commentators agree. *See, e.g.*, Wm. D. Elliott, *The Tax Benefit Rule: A Common Law of Recapture*, 39 SW. L.J. 845 (1985).

realization, acts as a limiting factor so that income taxation applies only to income—and not capital—over time.

B. *Understanding Income "in the U.S. Sense"*

In a different context, the Supreme Court has relied on the temporal conception of income, enforced by the use of tax basis to track inclusions and deductions across time: to determine whether a foreign levy is an income tax. Specifically, the Court identified basis adjustments as the key distinguishing feature to determine whether a foreign tax levy constitutes an income tax "in the U.S. sense."[297] Under this well-established line of judicial precedent and regulatory guidance, the correct use of basis adjustments to address the temporality of income is the hallmark that the Court and Department of the Treasury have consistently looked for to distinguish income taxes from other types of taxes.

In 1918, Congress introduced a key feature of U.S. taxation of income earned abroad: the foreign tax credit.[298] It consists of a credit against U.S. income taxes for "income, war-profits, and excess-profits taxes paid . . . to any foreign country, upon income derived from sources therein."[299] That is, the foreign income taxes are creditable against U.S. income tax, but foreign taxes that are not income taxes are not creditable.[300] As a result, the concept of income—and how to distinguish income taxes from other types of tax—lies at the heart of this complex statutory system that dates back to almost the very beginning of income taxation under the Sixteenth Amendment. Still, the Tax Code says almost nothing more about creditable foreign income taxes beyond its use of the operative words "income . . . taxes paid." Further, the members of Congress who drafted and enacted the credit initially explained almost nothing that articulated the ultimate purpose of the foreign tax credit.[301] As a result, the Supreme Court has played an active role in determining what constitutes an "income tax" for purposes of the U.S. foreign tax credit regime.[302]

297. PPL Corp. v. Comm'r, 569 U.S. 329, 338 (2013), discussed *infra* notes 313–17 and accompanying text.

298. Revenue Act of 1918, ch. 18, § 222(a), 40 Stat. 1057, 1073.

299. *Id.* (the same language is codified today at I.R.C. § 901(b)(1)).

300. I.R.C. § 901(b)(1) (creditable taxes include "any income . . . taxes paid . . . to any foreign country").

301. *See* H.R. REP. NO. 65-767, at 12(1918); 56 CONG. REC. APP. 667–78 (1918). The record reflects a few practical objections to double taxation (for example, taxation of the same income by two jurisdictions, which is the result if one jurisdiction does not provide a credit for tax paid in the other jurisdiction).

302. Burnet v. Chi. Portrait Co., 285 U.S. 1, 7 (1932) (stating the foreign tax credit is designed "to mitigate the evil of double taxation"); Am. Chicle Co. v. United States, 316 U.S. 450, 451 (1942), *superseded by constitutional amendment*, U.S. CONST. amend. XVI., *as recognized in*, United States v. Goodyear Tire & Rubber, 493 U.S. 132, 141 n.6 (1989) ("The purpose of the [foreign tax credit] . . . is

In deciding what foreign taxes represent income taxes eligible for U.S. foreign tax credit relief, two sentences of dictum in a Supreme Court opinion handed down in 1938, *Biddle v. Commissioner*,[303] have taken center stage. In its discussion of the issue of whether taxes had actually been paid, the Court offered the following thought:

> "[I]ncome taxes paid," as used in our own revenue laws, has for most practical purposes a well-understood meaning to be derived from an examination of the statutes which provide for the laying and collection of income taxes. It is that meaning which must be attributed to it . . . .[304]

In 1983, the Department of the Treasury issued regulations in an effort to impose clarity in terms of the actual formal design features that must exist in foreign law to constitute an income tax for foreign tax credit purposes.[305] These regulations are noncommittal in terms of timing rules that a foreign jurisdiction might utilize. The regulations invoke "realization" but define it expansively to include the standard sort of realization events (e.g., sales or other dispositions), but then also include that an income tax might be imposed on a "pre-realization" or "post-realization" basis.[306] The resulting varied timing rules allow for income taxation upon the recovery or recapture of a previously allowed tax deduction or credit,[307] increases or decreases in the value of property,[308] the "physical

to obviate double taxation."); *Goodyear Tire & Rubber*, 493 U.S. at 140 ("The legislative history of the indirect credit also clearly reflects an intent to equalize the treatment between domestic corporations that operate through foreign subsidiaries and those that operate through unincorporated foreign branches."); Comm'r v. Am. Metal Co., 221 F.2d 134, 137 (2d Cir. 1955) (stating the "primary objective of [the foreign tax credit regime] is to prevent double taxation and a secondary objective is to encourage American foreign trade"). The legislative history is consistent and longstanding. *See* H. REP. NO. 83-1337, at 76 (1954) ("The [foreign tax credit] provision was originally designed to produce uniformity of tax burden among United States taxpayers, irrespective of whether they were engaged in business in the United States or engaged in business abroad."); S. REP. NO. 73-558, at 39 (1934) ("The present [foreign tax] credit . . . does relieve the taxpayer from a double tax upon his foreign income."); H.R. REP. 65-767, at 91 (1918) (in explaining the rationale for a foreign tax credit, the legislative history stated as follows: "With the corresponding high rates imposed by certain foreign countries the taxes levied in such countries in addition to the taxes levied in the United States place a very severe burden upon such citizens.").

303. 302 U.S. 573 (1938).

304. *Id.* at 579.

305. The Treasury Department has attempted to reformulate the definition of the net income requirement in 2022 in new final regulations. However, the Treasury Department has since indicated that taxpayers may continue to rely on the prior 1983 final regulations in terms of those regulations that apply the realization and basis aspects of the prior regulations until further notice. *See* Notice 2023-80, 2023-55 I.R.B. 1583. However, this key feature of basis remains unchanged even in the 2022 final regulations. For a detailed analysis of the foreign tax credit eligibility rules, see JOSEPH ISENBERGH & BRET WELLS, INTERNATIONAL TAXATION: U.S. TAXATION OF FOREIGN PERSONS AND FOREIGN INCOME ¶ 56 (6th ed. 2024).

306. Treas. Reg. § 1.901-2(b)(2)(i)(A)–(C) (2022).

307. *Id.* § 1.901-2(b)(2)(i)(B).

308. *Id.* § 1.901-2(b)(2)(i)(C)(1).

transfer, processing, or export of readily marketable property" at any time,[309] as well as a "deemed" distribution or "deemed" income inclusion.[310] The actual timing rule that the foreign jurisdiction selects is not dispositive—that is, contra to some of the opinions offered recently in *Moore*, foreign taxes can constitute income taxes even if they include unrealized gains in income.

However, in order to specify whether a tax on unrealized gain is an income tax, the Treasury regulations envision that a foreign levy applied on a nonrealization basis is an income tax only if the foreign jurisdiction provides for basis adjustments to prevent a duplicative taxation of the same income "upon the occurrence of a later event."[311] Thus, although the Treasury regulations under Section 901 are agnostic in terms of whether a foreign levy uses a timing rule that imposes taxation on a realization, pre-realization, or post-realization basis, the Treasury regulations are decidedly not agnostic (and in fact explicitly mandate) that a core feature of income taxation is that the relevant foreign law must afford basis adjustments so that "incomes" of the taxpayer are not taxed again in some other time period.[312]

In its unanimous 2013 opinion in *PPL v. Commissioner*,[313] authored by Justice Thomas, the Court favorably cited these Treasury regulations that conditioned foreign tax credit relief on whether or not the foreign law set forth basis adjustments.[314] The question before the Court was whether a one-time U.K. tax assessment on accumulated profits above a threshold (a "windfall profits tax") constituted an income tax that in turn was eligible for U.S. foreign tax credit relief.[315] The Court cited its holding in *Biddle* for the proposition that U.S. foreign tax credit relief would only be allowed if the U.K. accumulated earnings tax represented an "income tax in the U.S. sense."[316]

The lesson that should be drawn from the unanimous decision in *PPL* is critically important for the post-*Moore* era because *PPL* involved the same search for limits on the scope of an income tax "in the U.S. sense" as the Court

309. *Id.* § 1.901-2(b)(2)(i)(C)(2).

310. *Id.* § 1.901-2(b)(2)(i)(C)(3).

311. *Id.* § 1.901-2(b)(2)(i)(C).

312. *Id.* § 1.901-2(b)(2)(i)(C)(3). The regulations provide that tax basis is not necessary if the value would not be subjected to further taxation by some other companion provision, including because that value accretion is exempted from any further taxation in later periods or because a tax credit is provided against any future income taxation in a future period. This nuance was important in the specific context of the *PPL* controversy, as the imposition of the one-time tax on flotation value represented an excess profits tax that would be imposed only once on the excess profits of the subject taxpayers and future income taxation would never be imposed on those values in future periods.

313. 569 U.S. 329 (2013).

314. *Id.* at 335–36 (citing Treas. Reg. § 1.901-2(a), (b)).

315. *Id.* at 331.

316. *Id.* at 338 ("We agree with PPL and conclude that the predominant character of the windfall tax is that of an excess profits tax, a category of income tax in the U.S. sense.").

signaled that it may be in search of following *Moore*.[317] When basis adjustments are made, then the imposition of taxation on income is an income tax in the U.S. sense. The Court in *PPL* explicitly refused the invitation to require that the foreign levy utilize a realization principle as the limiting factor on what could constitute an income tax in the U.S. sense.[318] The Court was right to refuse the invitation to impose realization as a limiting factor in *PPL*, and the Court should reject such an invitation again now.

CONCLUSION

A fruit analogy like the one we began with portends ominously for the future of the income tax: at least four members of the Supreme Court seem to have planted a seed in their *Moore* decisions that could eventually sprout into a constitutionally mandated realization requirement. The narrow holding by the majority might invite future challenges on the scope of income taxation under the Sixteenth Amendment. If this reading of the tea leaves in the *Moore* opinions is correct, the majority was wise to stop the imposition of such a constitutional constraint now. Sowing such harmful tares into the nation's income tax field would have devastating consequences for the efficacy and fairness of the nation's income tax laws.[319] Both the majority and dissent in *Moore* agree that such a decision would severely threaten the ability of the federal government to raise revenue.[320] Further, the imposition of a constitutionally mandated realization requirement would institutionalize the yield exemption benefit for capital owners and would undercut other anti-abuse timing rules. The inequities and inability to tax "all incomes from whatever source" that such a curtailment would entail would substantially undercut the fairness of the nation's income tax laws.

We argue in this Article that history and tradition—intellectual and practical—going back to the pre-ratification era, militate against a

317. *Id.*

318. Ironically, it was the government that argued that the realization requirement must be satisfied to be an income tax, which the Court rejected in the context of that case. *Id.* at 335–36.

319. Consider the practical effect if the Sixteenth Amendment does allow some or all of the specialized, nonrealization timing rules described *supra* notes 216–28 (addressing debt timing rules), 249 (listing mark-to-market rules applicable in different contexts), 256 (discussing current treatment of deemed stock distributions); *see also* I.R.C. § 877A (imposing an exit tax on individuals giving up their U.S. citizenship); *id.* § 884 (imposing a branch profits tax on certain changes in net assets of U.S. operations of foreign corporations); *id.* §§ 701–755; *id.* § 761 (allowing pass-through taxation of partnerships, without regard for whether partners have received distributions from a partnership); *id.* §§ 951–965 (allowing pass-through taxation of certain income of foreign corporations owned by U.S. shareholders).

320. Moore v. United States, 144 S. Ct. 1680, 1693, 1696 (2024) (imposing a realization requirement risks a "fiscal calamity"); *id.* at 1726 (Thomas, J., dissenting) ("Congress invites calamity by building the tax base on constitutional quicksand, [and] '[t]he judicial Power' afforded to this Court does not include the power to fashion an emergency escape.").

constitutionally imposed realization constraint. A robust, but unappreciated, economic literature that included unrealized gains and losses into its understanding of economic income existed by the time the Sixteenth Amendment was proposed and ratified.[321] In addition, a prevalent functional concept of income in the pre-ratification era also rejected the realization principle as a universal timing rule: commodity merchants in grain and cotton had long-held practices of determining their income in a manner that included unrealized gains and losses dating back to the post-Civil War period.[322] Well before ratification, the grain industry "universally employed" a conceptualization of income that included unrealized gains and losses.[323] Thus, in the pre-ratification era, and throughout the early implementation of the nation's first income tax laws under the Sixteenth Amendment, the economic theory and practical understanding of income was broad and varied enough to include unrealized gains and losses. The historical record indicates that the realization principle was never a universally applied metric to determine income in all contexts, even in that formative era.

Because the Sixteenth Amendment is not explicit about any specific timing rule, it leaves open questions about how to identify the appropriate point in time for determining and including income, and it leaves open questions about how to identify changes in economic position between periods of time. From almost the very beginning, Congress and the Courts have worked in tandem to fashion timing rules that work in their specific contexts.[324] The chosen timing rules have varied. Realization is and was one of many possible alternatives. Congress should have plenary authority to develop context-specific timing rules that it determines to be appropriate.

But this is not to say that there are no limits on income taxation under the Sixteenth Amendment—just that Congress's authority should not be bounded by realization. In *Macomber*, the Court held that taxation under the Sixteenth Amendment cannot be imposed on a taxpayer's pre-existing capital. While other aspects of *Macomber* have been dispensed with by the Court in the intervening century, the distinction between capital and income endures, and can be clarified with a temporal understanding of income. An income tax, with that conceptual starting point understood, should only include a change in economic position *once*. This distinguishes income taxation from other tax regimes, such as a property tax or a wealth tax.

As the courts take up constitutional tax jurisprudence anew following *Moore*, the temporal challenges of income should be front and center. But the

321. *See supra* Section II.A.

322. *See supra* Section II.B.

323. B.I.R., 1921 Ruling, Exhibit B, *supra* note 136, at 78.

324. *See supra* Sections III.A, III.B.

tree-and-fruit paradigm set forth in *Macomber* that Justices Thomas and Gorsuch returned to fails to address the temporal challenges that require context-specific timing rules. Further, the Justices did not consider the role that tax basis has played as a way to ensure that only income and not capital is subjected to income taxation.

The hydrology analogy and the tax basis mechanism provide a better paradigm: income is like a flow into and out of a reservoir, and measuring the volume of the flow requires attention to the passage of time along with carefully calibrated measurement and tracking tools.[325] The temporal considerations that we introduce here help to clarify the stakes and illuminate a doctrinal path forward. Failing to account for time will potentially undermine the dictate that the Sixteenth Amendment empowers Congress to tax "incomes, from whatever source derived."[326]

325. *See supra* Part IV.
326. U.S. CONST. amend. XVI.