THE PAST AND FUTURE OF TAXING "INCOMES"

104 N.C. L. REV. __ (forthcoming 2025)

Clint Wallace & Bret Wells*

Abstract

For at least half a century, the text of the Sixteenth Amendment—"Congress shall have the power to lay and collect taxes on incomes, from whatever source derived"—has been treated by courts, lawmakers and scholars as giving Congress plenary 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 income had different meanings in different contexts.*

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 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' income tax power so that a tax on income cannot not morph into a tax on capital.

* For helpful comments and discussion, we thank Reuven Avi-Yonah, 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.

Table of Contents

INTRODUCTION 2

I. SEARCHING FOR LIMITS IN THE SIXTEENTH AMENDMENT 8

II. THE HEADWATERS OF U.S. FEDERAL INCOME TAXATION 14
A. Income Tax Theory in the Pre-Ratification Era *17*
B. The Practical Origins of "Mark to Market" *24*

III. TEMPORAL CHALLENGES, THEN AND NOW 34
A. Constraints of the Annual Accounting Period *36*
B. Alternative Methods of Tax Accounting *38*
C. Debt and Specialized Timing Rules *41*
D. Deferral and "Yield Exemption" *45*

IV. TAX BASIS TO TRACK "INCOMES" OVER TIME 52
A. Harmonizing Timing Rules with Basis Adjustments *53*
B. Understanding Income "in the U.S. Sense" *64*

CONCLUSION 67

INTRODUCTION

Time and time again, justices of the U.S. Supreme Court 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* in 1920, a narrow 5-4 majority of the Court used this fruit analogy to narrow the potential reach of Congress' power under the Sixteenth Amendment.[2] To constitute income for tax

---

[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, 1709 (2024) (Thomas, J., & Gorsuch, J., dissenting).

[2] U.S. CONST. amend. XVI; Eisner v. Macomber, 252 U.S. 189 (1920); *see* Marjorie E. Kornhauser, *The Story of Macomber: The Continuing Legacy of Realization* in TAX STORIES 103 (WEST 2009, Paul Caron ed.).

purposes, the "fruit or crop," the Court intoned, must be "severed from the capital."[3] The opinion referred to this occurrence as a "realization."[4]

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[5]) has repeatedly discovered that its desired shiny apple is just beyond its grasp.[6] A thicket of judicial opinions along with extensive scholarship have shown that the concept of income defies a *simple* formula.[7] 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[8]—distinguishable fact patterns abound, each raising distinctive considerations.[9]

In this Article, we contend that the abiding challenge with articulating a simple working definition of income is grappling with *time*.[10] 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

---

[3] Macomber, 252 U.S. at 206–07.

[4] *Id.*

[5] The story goes that Tantalus was condemned to Hades for an eternity for crossing the Gods, where He was made to stand beneath a fruit tree, with his feet in a shallow pool of water. The tree branches would lift out of his reach when he tried to pick a fruit, and the pool would recede when we tried to drink any water.

[6] *See infra* Part I (discussing disagreements among current members of the Supreme Court) & 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).

[7] *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 185–187 discussing varied Supreme Court attempts to define income.

[8] 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.

[9] *See infra* notes 190–200 and accompanying text.

[10] *See infra* Part II.

are necessary because income, conceptually, has a temporal aspect: income is a change in economic position *over some period of time*.[11]

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 19th and early 20th centuries.[12] 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.[13] The *Macomber* Court observed that capital may be "depicted as a reservoir supplied from streams, [while income is] the outlet stream, to be measured by its flow during a period of time."[14] 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, evaporates up and precipitates back down, involves evaluating volumes by adopting timing and measuring conventions.[15] 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.[16] 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

---

[11] *See infra* Part III.A, 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).

[12] *See infra* Part II. *See* Irving Fisher, *What is Capital?*, THE ECONOMIC JOURNAL 509, 514–517, v.6 no.24 (Dec. 1896); *see also* EDWIN CANAAN, THEORIES OF PRODUCTION AND DISTRIBUTION 14 (London 1894); SIMON NEWCOMB, PRINCIPLES OF POLITICAL ECONOMY 325 (New York, 1886).

[13] *See What is Hydrology?*, U.S. GEOLOGICAL SURVEY (May 23, 2019), https://www.usgs.gov/special-topics/water-science-school/science/what-hydrology#Hydrology.

[14] Eisner v. Macomber, 252 U.S. 189, 206 (1920).

[15] U.S. Geological Survey, *supra* note 13.

[16] *See infra* Part IV.

a 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 19th century, a concept of "economic income" that was attentive to the challenges of temporality, and that included both realized and unrealized gains.[17] Though the *Macomber* court does not cite their work, in 1896 economist Irving Fisher (who was joined by others, both earlier and later) explained this conception of income by way of the hydrological analogy.[18] This is important because this broad theory of income, including an emphasis on temporality,[19] anticipates and sheds light on the time-related practical challenges that have emerged in the most recent Constitutional income tax debates. The intellectual history we uncover in this Article, shows that similar issues were already presenting themselves by the 1890s.[20]

We also uncover a prevalent non-realization conception of income in a practical setting.[21] 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[22]—had long employed an accounting practice that computed income and prepared balance sheets for financial reporting purposes that eschewed the

---

[17] See *infra* Part II.A

[18] Fisher, *supra* note 12, at 525–26; *see infra* notes 84–99 (discussing Fisher's subsequent work, along with the work of other notable economists making similar arguments). Fisher cited Professor 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. NEWCOMB, *supra* note 12, at 396. Newcomb was notable in his time; Fisher is one of the most renowned economists in American history.

[19] As we elaborate in Part 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 12, at 514. He goes on to explain how income is "more in need of explanation," because measurement requires considering the passage of time. *Id.*

[20] *See infra* Part III.D.

[21] *See infra* Part II.B.

[22] 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. Pardy & Julian M. Alston, *The Driver's of U.S. Agricultural Productivity Growth*, FEDERAL RESERVE BANK OF KANSAS CITY, https://www.kansascityfed.org/documents/7107/the-drivers-of-us-agricultural-productivity-growth.pdf.

realization principle. Under this long-held practice, commodity merchants prepared their financial statements by including unrealized gains and losses in income, and revalued their inventory on their balance sheet at market. They did this by "marking-to-market"[23] their physical inventory and associated hedges[24] in order to determine the income derived on 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 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.[25] When early Treasury Department field auditors pushed back against applying this approach for tax purposes under the first income tax laws following the ratification of the Sixteenth Amendment, the industry explained the intricate details of their well-established approach and why their non-realization approach was critically important for measuring income of grain and cotton merchants.[26] The realization principle contradicted their universally-held understanding of income, and it failed to clearly reflect their income appropriately. In a series of decisions that still carry water today, Treasury accepted their arguments.[27]

This early economic theory of income and the early financial accounting practice we uncover repudiates the notion that the realization principle was a commonly understood limiting factor on the determination of income and has been underappreciated in contemporary academic and judicial attempts to parse the meaning of the Sixteenth Amendment of the pre-ratification era.[28]

---

[23] 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 128–132 and accompanying text (elaborating on mark-to-market accounting).

[24] *See infra* notes 121–127 and accompanying text (explaining hedging generally and late 19th century commodities industry hedging practices in particular).

[25] *See infra* notes 123, 139 and accompanying text.

[26] *See infra* notes 139–143 and accompanying text.

[27] *See infra* notes 144–148 and accompanying text.

[28] 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 promptly struck down as unconstitutional two years after enactment in Pollock v. Farmers' Loan & Tr. Co.,

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' power to tax "incomes" under the Sixteenth Amendment. However, we argue that the temporality of income initially conceived back then—represented by 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 argue that the tax basis rules have worked to harmonize various timing rules so that income is taxed only once across time periods. These measuring and tracking conventions resolve income versus source in a coherent manner and allows for contextual flexibility to appropriately determine incomes from a variety of sources and circumstances. Thus, tax basis has served to limit Congress' income tax power and has ensured that a tax on income cannot morph into a tax on capital which is what the Court in *Macomber* and *Moore* have sought to uphold.

We explore the nation's history and tradition for how the temporality of income determinations is harmonized so that income is only taxed once under the contemporary income tax. Congress long ago established the basic temporal architecture of the Federal income tax—an annual measurement period, conventions such as the cash and accrual methods for determining what is included when. Thereafter, Congress and the Court then fashioned a variety of special timing rules along with tools to track inclusions and deductions within this architecture, across time periods.[29] Various challenges arose—debt is particularly thorny.[30] Perhaps most challenging, taxpayers and scholars identified that timing rules that allowed tax deferral (by keeping gains out of income) can create the equivalent benefit of an income tax *exemption* with respect to the returns on tax-deferred investment.[31] Modern finance theory now makes clear that

157 U.S. 429, affd on reh'g, 158 U.S. 601 (1895), 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.

[29] *See infra* Part III.

[30] *See infra* Part III.C.

[31] We detail the mechanics of this exemption benefit *infra* Part III.D.

strict adherence to a realization-based income tax frustrates (instead of effectuating) 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' taxing powers. Part II introduces the tangled intellectual and functional history of income, showing that it was recognized—before the Sixteenth Amendment was ratified—to present unique challenges related to time. Even as the meaning of income was inconsistent across different contexts in the pre-ratification era, the historical account we develop here shows that realization was not 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.

As elaborated in Part IV, 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. But, 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. A final Part concludes.

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.[32] Rather, the Court gave Congress increasingly broad latitude with regard to

---

[32] *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 191–200); Helvering v. Horst, 311 U.S. 112, 116 (1940) (grasping onto the agrarian analogy to hold that "fruit" assigned by one taxpayer to another is nonetheless is income to the first taxpayer even when he "disposes of his right to collect it").

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).[33] By the 1950s, the Court announced explicitly 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 capital from income."[34] 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 "all economic gains not otherwise exempted" by Congress.[35] Constitutional challenges to Congress's power to tax income had, until very recent years, come to be almost universally perceived as a dead-end.[36]

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.[37] Rather, bad income tax policy came to be viewed as a political problem, not a constitutional infirmity.[38] Legislators who enact an ill-advised tax scheme

---

[33] *Id.*; *see also* Cottage Sav. v. Comm'r, 499 U.S. 554, 559 (1991) (stating "[a]s this Court has recognized, the concept of realization is 'founded on administrative convenience'" and citing *Horst* for this proposition).

[34] Glenshaw Glass Co. v. Comm'r, 348 U.S. 426, 431 (1955).

[35] Comm'r v. Banks, 543 U.S. 426, 433 (2005) (the quoted language is from a unanimous 9-0 decision, citing *Glenshaw Glass*).

[36] 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* 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' Sixteenth Amendment power to tax was left "to die 'a slow death").

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

[38] *See* Ackerman, *supra* note 36, 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). .

might find themselves regretting it on election day, victims of the history and tradition of political tax protests that is part of the American tradition.[39]

Then, in the recent *Moore v. United States* case, the Supreme Court returned to the issue, and, in so doing, reopened it.[40] 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."[41] 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.[42]

Four justices in the majority, joined by a concurring Justice Jackson who wrote a separate opinion, agreed to resolve the case on narrower grounds while expressly preserving the possibility of some substantive

---

[39] *See* STEVEN R. WEISMAN, THE GREAT TAX WARS: LINCOLN TO WILSON—THE FIERCE BATTLES OVER MONEY AND POWER THAT TRANSFORMED THE NATION 3–4 (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) (explaining the judicial tradition of deference to congressional tax lawmaking, and discussing some procedural and constitutional limits on tax legislation).

[40] Moore v. United States, 144 S. Ct. 1680 (2024).

[41] Moore v. United States, 36 F.4th 930, 936 (2022).

[42] *Moore*, 144 S. Ct. at 1696. 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* Reuven Avi-Yonah, Clint Wallace & Bret Wells, Brief of Amicus Curiae in Support of Respondent in Moore v. United States, No. 22-800 (Oct. 20, 2023), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4607547. If unrealized income 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).

limitation in Congress's Sixteenth Amendment powers.[43] Even so, the justices in the majority agreed 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.[44]

Four other justices staked out the position that realization is a constitutionally-mandated limit on Congress's ability to impose income taxation under the Sixteenth Amendment.[45] The two most vehement dissenters, Justices Thomas and Gorsuch, emphasized "severance" 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.[46]

According to the dissent, realization is required because "the only way to draw such a distinction [between income and its source] is with a realization requirement."[47] They also sought to shadow the Sixteenth Amendment in light of the direct tax clause of the Constitution, which it described as "'one of the bulwarks of private rights and private property.'"[48] From this premise, the dissent then made a conceptual leap

---

[43] *See id.* at 1684 (Kavanaugh, J. joined by Chief Justice Roberts, Justices Kagan, Sotomayor, and Jackson) (sidestepping the question presented). . Justice Jackson explained separately her view that the only limits on Congress powers under the Sixteenth Amendment are political, not legal or substantive. *Id.* at 1697. 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*, 144 S. Ct. 1680 (No. 22-800).

[44] *Moore*, 144 S. Ct. at 1693 & 1696.

[45] *See id.* at 1699 (Barrett, J. & Alito, J. concurring); *id.* at 1709 (Thomas, J., & Gorsuch, J., dissenting).

[46] *Id.* at 1722 ("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 & Alderman of Savannah*, 60 Ga. 93, 100 (1878), as a "well-cited case" that expressed similar reasoning, and that used the tree/fruit analogy. The case has been cited a total of 48 times prior to Thomas's reliance on it in *Moore*, according to a recent Westlaw search.

[47] *Moore*, 144 S. Ct. at 1709 (citing *Macomber*).

[48] *Id.* at 1719 (quoting *Pollock*, which declared the pre-Sixteenth Amendment income tax to be unconstitutional unapportioned direct tax).. Although this

to conclude that Congress is permitted to tax only income that has been *realized*[49] as a matter of constitutional "necessity."[50] This is because "the Sixteenth Amendment requires a way to distinguish between income and source,"[51] which, turning to the fruit analogy, requires a "severance" to which realization is an apt proxy for effectuating this fruit analogy.[52] The *Moore* opinion thus portends a new era in constitutional jurisprudence.[53]

---

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. It was abandoned by the Court over the course of the twentieth century, Ackerman, *supra* note **Error! Bookmark not defined.**, 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, 1714. 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* Eisner v. Macomber, 255 U.S. a 220 (J. Holmes 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."). Nonethless, "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, *supra* note 39, at 837–39 (arguing against resurrecting the "inflated" apportionment requirement introduced in the *Pollock* decision).

[49] *Id.* at 1709.

[50] *Id.* at 1697–98.

[51] *Id.* at 1721.

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

[53] 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' constitutional tax authority as well. *See infra* note 226.

Among the dissenting justices in *Moore*, what exactly constitutes realization remains a point of disagreement.[54] Justice Barrett, joined by Justice Alito, also seems to subscribe to a realization requirement as a limitation over the taxing powers granted under the Sixteenth Amendment.[55] She asserts that "realization may take many forms,"[56] including "a sale or other transaction," and also "exchange of property, payment of the taxpayer's indebtedness, relief from a liability, or other profit realized from the completion of a transaction."[57] If realization covers all of these circumstances, it is far from clear what the term actually means.[58] Justices Thomas and Gorsuch offer 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 or disposal.'"[59] These varied conceptions across just two opinions agreed to by four justices leaves a distinct lack of clarity.[60] Nonetheless, Justices Thomas and Gorsuch assert that "the concept of realization was well understood at the time of ratification."[61]

We agree with the dissent that the Sixteenth Amendment requires distinguishing in some circumstances between income and its source, capital—with the former subject to taxation under Congress' 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 means of determining income is betrayed by the intellectual development of the concept of income that pre-dated the Sixteenth Amendment, and by practical applications of the concept of

---

[54] *Id.* at 1721; *id.* at 1709.

[55] 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.

[56] *Id.* at 1704 (Barrett, J., concurring).

[57] *Id.* at 1701, 1703.

[58] *See infra* notes 190–192 (introducing inclusion of cancellation of debt as an example of the type of contextual timing rule that Congress has and should be empowered to enact in order to tax all incomes).

[59] *Moore*, 144 S. Ct. at 1722 (Thomas, J., dissenting) (quoting *Macomber*).

[60] 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. *Moore*, 144 S. Ct. at 1709; *id.* at 1722. 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.

[61] *Id.* at 1721.

income at that time.[62] The *Moore* opinions fail to grapple with these historical facts and also fails to grapple with the fundamentally temporal considerations that undergird the income tax. What is more, 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.[63]

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*. 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.[64] As Ajay Mehrotra explains in his history of progressive taxation in the U.S., "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.'"[65]

Haig's concise formulation maintains vitality today: "[i]ncome is the money value of the net accretion to one's economic power between two points of time."[66] 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 of the store of property rights between the beginning

[62] *See infra* Part II.

[63] *See infra* Parts III and IV.

[64] Robert M. Haig et al., *The Concept of Income—Economic and Legal Aspects*, *in* THE FEDERAL INCOME TAX 7 (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).

[65] AJAY MEHROTRA, MAKING THE MODERN AMERICAN FISCAL STATE: LAW, POLITICS, AND THE RISE OF PROGRESSIVE TAXATION, 1877–1929 at 390 (2013).

[66] Haig, *supra* note 64.

and end of the period in question."[67] This latter definition is taught in introductory economics and tax law courses, and widely referred to as "Haig-Simons income."[68]

The dissent in Moore picks up on this standard story, claiming that at the time of the adoption there was a unified and very limited understanding of income—an approximation of the narrow legal definition 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.[69]

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.[70] The next section shows that even their own citations and references understate the extent to which a broad concept of economic income—one that was not in the least hemmed in by realization—was part of the discourse among leading economists in America and elsewhere in the Sixteenth Amendment ratification era.[71] Correctly viewed, the intellectual lineage of Haig-Simons income predates the ratification era and has largely been overlooked—or perhaps was downplayed by Haig's and Simons' contemporaries. Haig, in particular, may have found it challenging to give any fulsome 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

---

[67] HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 49–50 (1938).

[68] *See, e.g.*, DANIEL L. SIMMONS, MARTIN J. MCMAHON, BRADLEY T. BORDEN & BRET WELLS, FEDERAL INCOME TAXATION at 7 (FOUNDATION PRESS, 8th ed. 2020); LAURIE MALMAN, LINDA SUGIN & CLINTON G. WALLACE, THE INDIVIDUAL TAX BASE: CASES, PROBLEMS, AND POLICIES IN FEDERAL TAXATION 53-56 (WEST AMERICAN CASEBOOK SERIES, 3d ed. 2019).

[69] *Moore*, 144 S. Ct. at 1722.

[70] *See, e.g.*, Haig, *supra* note 64, at 2-3 (citing Irving Fisher); SIMONS, *supra* note 67, at 60-63 (citing Georg Shanz).

[71] 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, then promptly struck down as unconstitutional in the *Pollock* decision in 1895, 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.

recognized and politically engaged professor at Columbia University, who made his name as a proponent of progressive income taxation starting in the 1890s.[72] Seligman was active in post-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.[73] Seligman advocated publicly in favor of a realization concept as a constitutional limitation on Congress authority under the Sixteenth Amendment.[74]

He was successful in this endeavor—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.[75] Seligman used the fruit analogy to argue that "separation is the essence of income,"[76] and the piece was included with the taxpayer briefs submitted to the Supreme Court.[77] 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

---

[72] HERBERT HOVENKAMP, THE OPENING OF AMERICAN LAW: NEO-CLASSICAL LEGAL THOUGHT 1870-1970 at 98–99 (2015); MEHROTRA, *supra* note 65, at 151–167; 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). 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, 672.

[73] MEHROTRA, *supra* note 65, at 325–26.

[74] *See* Seligman, *Are Stock Dividends Income?*, AMERICAN ECONOMIC REVIEW, vol. 9, num. 3, at 517 (Sept. 1919) (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 during the *Macomber* saga showed similar flexibility—after advocating for the court to create a realization requirement, once it did he published an essay berating the Court's decision. Kornhauser, *supra* note 2, at 111 (quoting Seligman as lamenting the majority's "regrettable tying of the hands of the legislator and undue curtailment of legislative discretion").

[75] Seligman, *supra* note 74, at 517.

[76] *Id.* at 522.

[77] Kornhauser, *supra* note 2, at 100 n.11.

income tax along with borrowed funds.[78] This put him at odds with economists, including Irving Fisher of Yale (discussed below), who favored adopting a consumption tax alongside the income tax, rather than borrowing money.[79] Seligman seemed to view the possibility of a national sales tax as a threat to the income tax, potentially undermining his life's work.[80] It may have been politically appealing to Seligman to help moderate the income tax by establishing an inherent limitation in its conceptual 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 within their scope inclusions of unrealized gains and losses. Haig, Seligman's prodigy, did not forcefully call out his mentor, and his failure to do so has obscured the historical record to those who might desire an originalist understanding "incomes" in the ratification era.

The Section that follows expands on the intellectual history that preceded ratification, and the section after that turns to the concept of income in practice in that same period, showing that even in the pre-ratification era there was on-the-ground experience including unrealized gains in income in certain contexts that anticipate 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 U.S. The key progenitor in the U.S. was economist Irving Fisher (Seligman's antagonist in the consumption tax debate[81]), 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.[82] Fisher received the first economics PhD granted by Yale and studied in Berlin

---

[78] MEHROTRA, *supra* note 65, at 325, 326 n.74.

[79] *Id.* at 325.

[80] *See id.* at 368; *see generally* SELIGMAN, *supra* note 72.

[81] *See infra* notes 115-116 and accompanying text.

[82] *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(1952, reprinted 1997, 2003).

before returning to Yale where he taught economics for decades.[83] 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. 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 ..." (emphasis in original).[84]

In his essay, Fisher cited Johns Hopkins University professor Simon Newcomb. Although Newcomb was not an economist by training, he had, in 1886, written an extended explanation of income as a product of "monetary flow[s]."[85] He emphasized that income must be measured on a net basis—accounting for inflows and outflows (expenditures).[86] Income for "the community comprises all the values produced by its labor *plus* all the increase in value of fixed property brought forth without labor *minus* all the decay in value which has occurred."[87] For each individual, income is "the measure of what he adds to total production," including "all increase of value produced by any circumstance whatever[.]"[88] Newcomb explained that in-flows to be 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 increase 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."[89] 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

---

[83] GROVES, *supra* note 106, at 108.

[84] Fisher, *supra* note 12, at 514.

[85] NEWCOMB, *supra* note 12, at 359.

[86] *Id.*

[87] *Id.* at 364–65.

[88] *Id.* at 365. 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 applied correctly, 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.

[89] *Id.* at 361.

actual increase of his capital, and might be counted as profit, and therefore as an addition to his income."[90]

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."[91] Cannan emphasized the temporal element of Fisher's distinction: "an individual's capital exists at a point of time, and ... his income exists in a length of time."[92] He concludes that "income is divided into two parts, (1) the increase of the capital, and, (2) the things enjoyed."[93] 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."[94] 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."[95]

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

---

[90] *Id.*

[91] Edwin Cannan, *What is Capital?*, THE ECONOMIC JOURNAL v.7 no. 26, at 278 (Jun. 1897).

[92] *Id.* at 281.

[93] *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.*

[94] EDWIN CANNAN, ELEMENTARY POLITICAL ECONOMY 58–59 (3d ed. 1903). [Quoting from the third edition, 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.]

[95] *Id.* at 59.

not strictly to that which takes the form of money."[96] Marshall expressly points to and celebrates Fisher and Cannan's work as "full of suggestion" on the subject of distinguishing income from capital.[97] 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."[98]

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.[99] His ideas were spreading. Economist George Fetter—whose career had taken him to the University of Indiana, then 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[100] —agreed with Fisher.[101] 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."[102]

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,[103] the most widely credited well-spring of this concept of income is German economist George Shanz in his 1896 publication *Der Einkommensbegriff und die Einkommen-steuergesetze*, which roughly

[96] 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").

[97] *Id.* at 154.

[98] CANNAN, *supra* note 94, at 80.

[99] Irving Fisher, *Precedents for Defining Capital*, QUARTERLY J. OF ECON. (May 1904); IRVING FISHER, THE NATURE OF CAPITAL AND INCOME (1906).

[100] *See* Herbert Hovenkamp, *The First Great Law and Economics Movement*, 42 STANFORD L. REV. 993, 1000 n.42 (1990) (including Fetter with Fisher, John Bates Clark, and Simon Patten).

[101] GEORGE A. FETTER, THE PRINCIPLES OF ECONOMICS WITH APPLICATION TO PRACTICAL PROBLEMS, Chs. 6 & 14 (1904).

[102] *Id.* at 575.

[103] *See supra* notes 64–65, *infra* note 114 and accompanying text.

translates to *The Concept of Income and Income Tax Laws*.[104] Shanz 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.[105] Shanz's work was written in German and published in Germany, not in the U.S., and still today it is not well translated into English and not well appreciated outside of Europe. But Shanz 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 then made conscious efforts to import German economic thinking to the U.S.[106]

The degree of cross pollination and likely familiarity is perhaps most clearly made 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.[107] In the 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."[108] He then explains that, "defining income with such precision as completely to avoid any net impairment of capital" raises a significant practical challenges. Then, he cites to Fisher—in a footnote, after identifying the practical challenge for taxing income so precisely, Seligman explains, "Professor Irving Fisher, in *The Nature of Capital and Income* [citation omitted] attempts to give precise analysis of income; but he concedes that, for purposes of taxation his scheme, while ideal in theory, would be difficult to carry out in practice."[109]

---

[104] Georg Von Schanz, *Der Einkommensbegriff und die Einkommensteuergesetze*, *in* FINANZ-ARCHIV 1, 23 (1896) [title as translated by Google (Jan. 13, 2025].

[105] Paul H. Weuller, *Concepts of Taxable Income I*, 53 POL. SCI. QUARTERLY 83, 103 (1938) (quoting Shanz in English).

[106] MEHROTRA, *supra* note 65, at 86, 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, "trafficked in a new wave of transatlantic ideas"); HAROLD M. GROVES, TAX PHILOSOPHERS: TWO HUNDRED YEARS OF THOUGHT IN GREAT BRITAIN AND THE UNITED STATES 108 (Donald J. Curran, ed. 1974).

[107] SELIGMAN, *supra* note 72.

[108] *Id.* at 19.

[109] *Id.* at 19 n.1. This is Seligman's first substantive citation in the entire treatise.

Seligman then attempts to elaborate himself 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.[110] 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."[111] He then works through an example, familiar to introductory income tax students, of imputed income derived by way of enjoying property that one owns.[112] 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."[113] These, of course, are practical concerns, not conceptual insights.

Haig and Simons both credited Shanz's work, and Shanz 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 Shanz, 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.[114] Like so many tax thinkers since, Musgrave's focus was not to explore the intellectual history. Nonetheless, by fixing the origination of the concept of economic income to Haig in 1921, the standard history that Musgrave and so many others have perpetuated misses that the broad notion of income as including unrealized gains not only existed in the American economic literature before the Sixteenth Amendment, but was prominent in that literature.

---

[110] *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.

[111] *Id.* (explaining the valuation issues that arise in attempting to assess non-money income).

[112] *Id.*

[113] *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 Cannan's. *See supra* notes 96–98 and accompanying text.

[114] *See, e.g.*, Richard A. Musgrave, *In Defense of an Income Concept*, 81 HARV. L. REV. 44, 48 n.7 (1967) *citing* SIMONS, *supra* note 11, at 60; Shanz, *supra* note 104. For a discussion of this early evolution, see Christopher H. Hanna, *Tax Theories and Tax Reform*, 59 SMU L. REV. 435, 436–39 (2006).

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.[115] 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.[116] Further, he saw no real controversy in his own explanation of how to distinguish capital from income. As he wrote in his 1897 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.[117]

The economists described above were the leading economic thinkers and leading income theorists of the pre-ratification era. Each of them accepted 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 was *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

---

[115] *See* GALBRAITH, *supra* note 82, at 152.

[116] GROVES, *supra* note 106, at 108–10 (citing an essay written by Fisher and published around 1927 (exact date uncertain), titled *The Income Concept in the Light of Experience*). Fisher would remain attentive to the income tax, however. *See* HOVENKAMP, *supra* note 72, 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 (1927)).

[117] Fisher, *supra* note 12, at 524 (emphasis in original).

of income. As the *Macomber* majority noted, "[t]he fundamental relation of 'capital' to 'income' has been much discussed by economists . . ."[118] The *Macomber's* majority 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 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' 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 limited to realization events.

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: "[i]n determining the definition of 'income' thus arrived at, this Court *has consistently refused to enter into the refinements of lexicographers or economists*."[119] 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. 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.

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 financial accounting in the half-century preceding ratification. This discussion thus reveals a widely shared misconception

---

[118] *Macomber*, 252 U.S. at 206.

[119] See Merchants' Loan & Trust Co. v. Smietanka, 255 U.S. 509, 519 (1921) (emphasis added).

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 we uncover here, however, depicts quite a different story. Based on correspondence between taxpayers and early Department of Treasury tax administrators working in the newly formed Bureau of Internal Revenue (the predecessor to the Internal Revenue Service) 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.[120] 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 pre-ratification era.

Our focus here is on the purchase and sale of agricultural commodities, the largest industry in America at the time of ratification.[121] In the commodity dealer industry, 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.[122] To protect

---

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

[121] *See supra* note 22. 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, CARGILL: TRADING THE WORLD'S GRAIN 10 (1992). This history is further documented in exhibits to the administrative guidance *supra* note 120.

[122] 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—i.e., a facility that actually stores grain, whereas a merchant might employ an 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 VOLUME I: COUNTRY GRAIN MARKETING at 20, 207–11 (1920) [hereinafter FTC, GRAIN

against price volatility, commodities 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.[123] 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.[124]

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.[125] With

---

INDUSTRY MARKETING]; *see also* FEDERAL TRADE COMMISSION, REPORT OF THE FEDERAL TRADE COMMISSION ON THE GRAIN INDUSTRY VOLUME V: FUTURE TRADING OPERATIONS IN GRAIN (1920) [hereinafter FTC, GRAIN INDUSTRY FUTURE TRADING].

[123] *See* FTC, GRAIN INDUSTRY FUTURE TRADING, *supra* note 122, at 27 (describing the early history of futures contracts in the grain industry, commencing during the Civil War).

[124] 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* FTC, GRAIN INDUSTRY FUTURE TRADING, *supra* note 122, at 18, 156, 272–77 (explaining the non-speculative focus of futures trading, and explaining cases of speculative trading that constituted illegal gambling).

[125] 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

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 futures sales price, regardless of market fluctuations.[126] These practices, though perhaps inscrutable to the general public, were no secret in contexts outside of tax law.[127]

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 its futures exposure on commodity inventory on a daily basis.[128] 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—a merchant can and, indeed, did for financial accounting purposes starting in the nineteenth century determine

---

merchants use a mix of forward contracts the 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.

[126] 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.

[127] For example, the Supreme Court dealt with and explained various non-tax legal issues related to futures and hedges in the early 1900s. *See* Bd. of Trade of Chi. v. Christie Grain & Stock Co., 198 U.S. 236, 249 (1905) (discussing how hedging futures risk integral business practice); Clews v. Jamieson, 182 U. S. 461, 463, 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).

[128] *See* FTC, GRAIN INDUSTRY FUTURE TRADING, *supra* note 121, 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 121, at 231–33.

its net income, including gains and losses on its physical inventory and hedges by revaluing all these positions to market values.[129]

Against the backdrop of this widespread practice, in what was at the time the largest industry in the country,[130] 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, or dealings in property, whether real or personal . . ."[131] 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 valued at market prices for income tax purposes.[132] 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.[133] But the field agents disagreed with allowing

---

[129] 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 into in order to cancel out the futures contract originally was put into place for a longer physical inventory holding period.

[130] *See supra* note 22. 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 120, at 71. *See also* Bd. of Trade of Chi., 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").

[131] Underwood Tariff Act of 1913, Section II, Part B, 63d Cong., Sess. I, Ch. 16, at 167.

[132] B.I.R., 1920 Ruling, *supra* note 120, at 68.

[133] The first ruling to sanction the lower of cost or market methodology was T.D. 2609, 19 Treas. Dec. Int. Rev. 401 (Dec. 9, 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.

market valuation of physical inventory above cost and objected to revaluing hedges. Eventually, the Bureau issued an Appeals Review and Memorandum (an early precursor to the modern Revenue Ruling, which is a form of subregulatory guidance[134]) 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.[135]

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.[136] 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."[137] The Memorandum adopting this position, along with others as the issue unfolded, were published in the earliest Cumulative Bulletins, which is the still-running collection of published administrative tax guidance. The final 1921 memorandum is remarkable because the review Committee explains that it "knows 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."[138] The submissions from representatives of the grain and cotton merchants have thus been preserved as submitted to the Bureau in 1921, and the historical explanation they provide is remarkable. To begin, the cotton industry representatives explained how their business works (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.[139]

---

[134] See Rev. Proc. 67-6, 1967-1 C.B. 576 (explain that the starting in 1919, the Treasury published tax law guidance under various different titles).

[135] B.I.R., 1920 Ruling, supra note 120, at 67.

[136] *See* B.I.R., 1921 Ruling, *supra* note 120, at 78.

[137] B.I.R., 1921 Ruling, supra note 120, at 79.

[138] B.I.R., 1921 Ruling, supra note 120, at 68.

[139] *Id.,* Cotton Industry Brief, at 69.

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.[140]

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 obtain financial statements that anyone would rely upon, including creditors:

> 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.[141]

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

[140] *Id.*, Exhibit B, at 73.
[141] *Id.*

> 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.[142]

Finally, the grain merchants vehemently railed against the realization principle as a disastrous methodology for determining income, one that threatened in apocalyptic overtones 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 jeopardize the food supply of millions of people, not to imperil the credit which makes the continuance of

[142] B.I.R., 1921 Ruling, Exhibit A, *supra* note 120, at 77–78.

> 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.
>
> 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.[143]

The Bureau agreed.[144] The cotton and grain industries were permitted to continue their longstanding historic practice of calculating income by reference to market values (i.e., "mark-to-market" accounting[145]), without restricting gains and losses to *realized* gains and losses.[146] The correspondence and record of administrative decisions uncovered above is little known—and has been entirely absent thus far in the discussion of the pre-ratification era understanding of the concept of income.[147] The few

---

[143] *Id.* at 75.

[144] B.I.R., 1921 Ruling, *supra* note 120, 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.

[145] *See supra* note 23, and accompanying text.

[146] B.I.R., 1921 Ruling, *supra* note 120, at 79; *see also* Clews v. Jamieson, 182 U. S. 461, 476-78 (1901) (describing the practice of settling open futures contracts on a daily basis by reference to market prices).

[147] The 1921 ruling has been cited in law reviews just three times ever according to a recent WestLaw search, and the 1920 ruling in the same articles plus one additional article, all in the context of assessing contemporary mark-to-market rules. *See* Linda 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 (2004) (recounting the history); Alex Raskolnikov,

references in academic literature to this guidance exist because the approach the Bureau blessed in 1921 has been continued essentially unchanged to this day for commodity dealers.[148]

Today, for example, section 1256 requires that a taxpayer's annual gain or loss can be determined based on market price, just as the commodities merchants of the 1800s did.[149] 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. 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.[150]

More recently, Congress has adopted other mark-to-market rules when it concluded that deferral is inappropriate. 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

---

Contextual Analysis of Tax Ownership, 85 B.U. L. REV. 431 (2005); Robert H. Scarborough, *How Derivatives Use Affects Double Taxation of Corporate Income*, 55 TAX L. REV. 465 (2002); Steven A. Bank, *Mergers, Taxes, and Historical Realism*, 75 TUL. L. REV. 1 (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*, 75 TAXES 788 (Dec. 1997); *see also* Thomas L. Evans, *The Evolution of Federal Tax Accounting—A Growing Trend Towards Mark-to-Market?*, 67 TAXES 824 (Dec. 1989).

[148] Subsequent rulings simply updated—but did not change in substance—this longstanding historic treatment. *See* Rev. Rul. 74-227, 1974-1 C.B. 119; Rev. Rul. 74-226, 1974-1 C.B. 119; Rev. Rul. 74-223, 1974-1 C.B. 23; G.C.M. 35,043 (Sept. 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.

[149] 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.

[150] *See supra* notes 122–126 and accompanying text.

commodities to determine gain or loss annually based on market values of the securities they are holding in inventory.[151] Congress has enacted similar regimes in other contexts when it believed realization provided too much ground for manipulation.[152]

Congress' decision of when and where to impose income taxation on a pre-realization basis represents a judgment that balances administrability concerns with concerns that taxable income should represent a clear reflection of the taxpayer's income in the correct time period. These are practical judgments and always have been. The concept of income, in theory and in practice has never been wholly limited by the realization principle. Realization is one timing rule, but it has never been the only timing rule as prior mark-to-market accounting discussed in this Part aptly demonstrates. What is more, income was widely conceptualized in prominent economic literature of the pre-ratification era as including all changes in value—flows—without regard to realization events.

As a final point on this topic, there is one textual clue about the varied, contextual understandings of income that existed in the pre-ratification era—a clue that has received little exegetical comment in recent debates: the use of the plural "incomes" in the text of the Sixteenth Amendment. This hints at different types of income, and the use of the plurality 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."[153] An effort to impose a singular definition of income based on solely the realization principle fails to consider the plurality of the word "incomes" used in the Sixteenth Amendment. The next Part explains how the kind of theoretical and practical challenges that yielded varied conceptions of income in the pre-ratification era have continued since that time.

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. As this Part demonstrates, a variety of subsidiary timing issues followed as

---

[151] I.R.C. § 475; *see* H.R. REP. NO. 102-631, at 57 (1992).

[152] *See infra* note 220 (describing more of these rules).

[153] SELIGMAN, *supra* note 72, at 32.

soon as Congress and the Treasury set about implementing the income tax in 1913. A temporal tax requires a period of measurement, but neither the concept of income nor the text of the Sixteenth Amendment require a particular period; Congress set the period as one year, but not without some controversy, as discussed in Part III.A. Some of the many timing issues can be resolved through general rules, which Congress enacted and the Court approved in the form of standard methods of accounting—cash basis or accrual basis, which we elaborate in Part 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 Part 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—namely, realization—in certain circumstances can result in some income from capital being *exempted* from income taxation. As we explain in Part 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 that sets forth the history and long tradition of time-conscious income taxation developed before and since ratification, and 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.[154]

---

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

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.[155] A taxpayer promptly challenged the annual accounting period construct in *Burnet v. Sanford & Brooks Co.*[156] 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.[157]

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.[158] The dredging process began in 1913 and took several years, and it did not go as smoothly as planned.[159] In the first few years, the taxpayer lost money under the contract, collecting less in payments than was spent on the work, and after 1916 it abandoned the contract and sued for damages to recover excess expenses.[160] 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.[161] The IRS assessed additional tax for 1920 based on the $200,000 payment received.[162]

The taxpayer argued that the contract, overall and considering all years, had lost them money, and that because the income tax was supposed

[155] Revenue Act of 1913, § 2, pt. A, subdiv. 1, 38 Stat. 114 ("[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.").

[156] 82 U.S. 359 (1931).

[157] *Id.* at 363–66.

[158] *Id.* at 361.

[159] *See* 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).

[160] *Burnet*, 282 U.S. at 361 (the taxpayer lost money in 1913, had positive net income in 1914, then had losses again in 1915 and 1916).

[161] *See Atl. Dredging*, 253 U.S. at 2.

[162] *Burnet*, 282 U.S. at 362.

to apply to *net* income, no tax should arise from this additional payment.[163] The government responded, and the Court agreed, that given the annual accounting convention that Congress had adopted, the only issue to consider was the amount of income the taxpayer received in the year at issue.[164] 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.[165] 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.[166]

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. 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."[167]

Even though time is fundamental, the Sixteenth Amendment says nothing explicit about time. Still, the Court made clear that "Congress is not required by the amendment" to rectify the "inequalities" that results from a fixed period.[168] 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.[169] The Court

---

[163] *Id.* at 362–63.

[164] *Id.* at 364–65.

[165] *Id.*

[166] 35 F.2d 312, 315 (4th Cir. 1929), *rev'd* 282 U.S. 359 (1931).

[167] *Burnet*, 282 U.S. at 365–66.

[168] *Id.* at 365.

[169] 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. I.R.C. §§ 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.

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."[170]

Still, Congress was not constitutionally prevented from addressing the perceived inequities either. To blunt the harshness of this outcome for some taxpayers, Congress in 1918 provided prospective statutory relief to taxpayers like Sanford & Brooks Co. through its enactment of the net operating loss carryover provisions that remain to this day in Section 172.[171] In 1938, Congress enacted 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.[172] 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.[173]

B. Alternative Methods of Tax Accounting

At a very high level of generality, Congress has provided two alternative timing conventions for determining what is to be included into income in any given tax year. As the Supreme Court has explained, "Income taxes must be paid on income received (or accrued) during an

---

[170] *See* Hillsboro Nat'l Bank v. Comm'r, 460 U.S. 370, 380 n.12 (1983).

[171] *See* Pub. L. No. 65-254, Sec. 204, 40 Stat. 1057, 1061 (1919). 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).

[172] *See* Pub. L. No. 75-554; Sec. 820, 52 Stat. 447, 581 (May 26, 1938), currently enacted as I.R.C. §§ 1311 through 1314 (providing an exception to the statute of limitations to amend a previously filed tax return). *See* 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"). *See* 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).

[173] The method for ensuring that income is only taxed once is tax basis, which we explore *infra* Part IV.

annual accounting period."[174] The "cash and disbursements" method generally requires that a taxpayer include income when it is received and deduct expenses when those expenses are paid.[175] 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.[176] The Tax Code requires that each taxpayer use the method of accounting that that taxpayer otherwise uses for financial accounting purposes.[177] For individuals, this generally means the cash method; businesses may use either cash or accrual, although larger businesses are required to use the accrual method;[178] either approach results in an inclusion in income in a particular single period (in which the property is received or accrued).[179]

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 *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.[180]

With the cash method, the doctrines of "constructive receipt,"[181] "cash equivalency"[182] and "economic benefit"[183] each address the question of what exactly is sufficient to result in an inclusion in income. These each respond to different circumstances in which actual receipt does not occur,

---

[174] United States v. Lewis, 340 U.S. 590, 592 (1951).

[175] I.R.C. §§ 446(c)(1), 451(a); Treas. Reg. § 1.446-1(c)(1)(i).

[176] I.R.C. §§ 446(c)(2), 451(c)(2).

[177] I.R.C. § 446(a)(1).

[178] I.R.C. § 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).

[179] I.R.C. § 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.").

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

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

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

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

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.[184]

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*,[185] for example, a lessee entered into a 99-year lease in 1929 and then erected leasehold improvements with a useful life of 50 years or less—i.e., not as long as the lease. In 1933, the lessee forfeited the lease in the midst of the Great Depression. It is clear that the lessee's annual rentals represented income to the lessor, but the question before the Court was whether the leasehold improvements were income to the lessor and if so, when should they be included in income.[186]

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 that the improvements made to the leasehold estate valued in the year of the forfeiture. The taxpayer had argued against such a timing rule based upon the apparent severance requirement from *Macomber*. Without explicitly citing *Macomber* but referencing it by positing its essential facts, the Court in *Bruun* simply concluded that its

---

[184] *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").

[185] Helvering v. Bruun, 309 U.S. 461 (1940) (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).

[186] 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 (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 (1938).

decision in *Macomber* "was not controlling here."[187] 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 pre-existing capital interest in the land. 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. 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. This non-inclusion 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 in full in some future year.[188] But initial non-inclusion 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.[189]

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

[187] *See Bruun*, 309 U.S. at 469.

[188] *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).

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

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 asserted 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.[190] The Supreme Court agreed with this approach, upholding in *Kirby Lumber* the government's assertion of COD income in the year of the debt cancellation.[191] 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—seems analogous to an increase in a taxpayer's existing but unsevered capital.[192]

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

---

[190] *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).

[191] *See* United States v. Kirby Lumber Co., 284 U.S. 1, 3 (1931) ("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).

[192] The Court has wrestled with this shortly after *Macomber* in its decision in *Bowers v. Kerbaugh-Empire*, 271 U.S. 170, 174–75 (1926), citing *Macomber* as it refused 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 (1926) (quoting *Macomber* for the proposition that "enrichment through increase in value of capital investment is not income in any proper meaning of the term"). 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 (1978); *see also* Fred T. Witt, Jr. & William H. Lyons, *An Examination of the Tax Consequences of Discharge of Indebtedness*, 10 VA. TAX REV. 1 (1990).

repaid. Nor did it contemplate chipping away at the annual accounting period, which could yield a potentially more accurate approach whereby the taxpayer would file an amended return to treat the loan proceeds as income in the year that they were 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.[193] 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 over-arching definitional constraint on the meaning of "incomes" by simply stating that "[w]e see nothing to be gained by the discussion of judicial definitions."[194] This disavowal of any need to mention the realization principle harkens back to Justice Holmes' dissent in *Macomber* where he had asserted back then 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." With the Court's endorsement of Justice Holmes opinion in *Kirby Lumber*, commentators quickly understood that the Court's decision in *Kirby Lumber* had repudiated its earlier *Macomber* restrictive definition of incomes and instead signaled that going forward that it would determine the meaning of incomes based on a broader contextual approach.[195]

The breadth of scope of the Supreme Court's decision in *Kirby Lumber* sent taxpayer's clamoring to Congress for statutory cut-backs.[196] In 1938, Congress enacted a bankruptcy exception to the cancellation of

---

[193] *See* United States v. Kirby Lumber Co., 284 U.S. 1, 2 (1931) (citing Burnet v. Sanford & Brooks, 282 U.S. 359, 364 (1931)).

[194] Id.

[195] See ROSEWELLL MAGILL, TAXABLE INCOME at iii (Ronald Press Co. 1945) ("The spell of the Eisner v. Macomber definition of income having been broken by Mr. Justic 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").

[196] *See* 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).

indebtedness income,[197] and in 1939 Congress enacted an insolvency exclusion.[198] These provisions and other exclusions live on in current Section 108 of the Tax Code.[199] 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.[200] Although the contours for the recognition of cancellation of indebtedness income and its exclusions has been reformulated over time,[201] 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 one has cancellation of indebtedness income, then one preserves basis. If one excludes cancellation of indebtedness income from income, then attribute reduction (including basis reductions) is required to avoid a double benefit and to ensure that ultimately a single level of taxation is applied on income

---

[197] Pub. L. No. 75-696, Sec. 269, 52 Stat. 840, 904 (June 22, 1938) (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* Pub. L. No. 76-699, Sec. 1, 54 Stat. 709 (July 1, 1940). Congress subsequently revamped these basis adjustment rules in the context of a bankruptcy in 1980 in the Bankruptcy Tax Act of 1980. *See* Pub. L. No. 96-589, 94 Stat. 3389 (Dec. 24, 1980).

[198] *See* Pub. L. No. 76-155, Sec. 215(a), 53 Stat. 862, 875 (June 29, 1939) (allowing for the exclusion of COD income for taxpayers whose debts exceed the total value of their assets).

[199] *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 241.

[200] *See* Pub. L. No. 83-591, 68A Stat. 17 (Aug. 16, 1954); H.R. CONF. REP. NO. 83-2543, 83RD CONG. 2D SESS. at 23 (July 26, 1954) (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").

[201] Congress substantially reformulated the scope and exceptions set forth in Section 108 in 1980. *See* Pub. L. No. 96-589, 94 Stat. 3389 (Dec. 24, 1980). 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).

in some period of time.[202] Under current rules, COD income that is excluded under these provisions may be accompanied by adjustments to tax basis that might allow the fisc to recoup the excluded amounts in the future.[203]

D. Deferral and "Yield Exemption"

There are a number of subtleties that arise from tax deferral—that is, delaying inclusion in taxable income to a later tax year—that 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 in certain reasonable assumptions generate a financial benefit exactly equivalent to an outright exemption of the subsequent profit derived from the investment.[204] 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.[205]

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 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

---

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

[203] *See infra* Part IV (discussing tax basis more generally).

[204] *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 64, at 525–37.

[205] Examples 1 through 3 below explain how this works.

earnest in the 1970s.[206] 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.[207] He explained that "any failure to tax accumulation as it occurs is thus a pro tanto omission from a true accretion base."[208] He deemed the realization doctrine to be the "Achilles' heel" of the income tax due to the deferral benefit—i.e., yield exemption—that it ceded to taxpayers to manipulate and control.[209]

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

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

To understand the Cary Brown theorem, as it is widely known, compare the full taxation of economic income illustrated above with two

[206] *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—i.e., 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 provides a great tax benefit. .

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

[208] *Id.* at 1129.

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

alternatives. First, consider what happens if subsequent gains (i.e., 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.[210] Congress has facilitated a version of this with Roth retirement accounts, wherein income is included initially into income and subsequent gains are exempt from tax.[211]

The algebraic formula that represents this outcome is as follows:

Example 2:

Yield Exempt from Tax

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

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 paid on that return for that time periods, the taxpayer will have $880 after tax at the end of year 2, a better result for (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 pre-tax 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 pre-tax basis with income taxation deferred until the time the taxpayer receives distributions from their account at retirement.[212]

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

---

[210] *See* Brown, *supra* note 204, at 303.
[211] *See* I.R.C. § 408A.
[212] See I.R.C. §§ 402(a), 401(a) & (k).

Example 3:

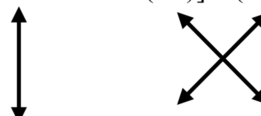
Deferral Benefit

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 re-invest the full pre-tax economic gain of $1,000, earning 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 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:

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



Example 3 – 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 pre-tax economic gain of $1,000, faces a tax rate of 40%, and the time period for the investment return is 10 years.

Table 1:

Table 1	**Column A**		**Column B**		**Column C**	
Tax Rate – 40% **Pre-Tax Investment Return – 10%**	**Haig-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 10 Years	d = f - e	1390.8	i = h*(1.1) ^ 10	1556.25	L = h * (1.1) ^ 10	2593.74
Taxation on 10-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 1 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 is reinvested and can provide a comparable internal rate of

return.[213] As discussed below, it turns out that these can be pretty fair assumptions in the real world, at least for some types of investments.[214]

This prompted a profound shift in the discourse around timing issues in the modern income tax. Following the Andrews article, the question now 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.[215] Andrews proposed to abandon attempts to tax investment returns and instead shift to a progressive consumption tax.[216] Professor Alvin Warren responding to Andrews, argued that reforms to the nation's income tax could be made to address its undeniable timing failures.[217]

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

---

[213] Alvin C. Warren, Jr., *Accelerated Capital Recovery, Debt, and Tax Arbitrage*, 38 TAX LAW. 549, 552 n.12 (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).

[214] 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.

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

[216] Andrews, *supra* note 207, 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.* at 1165–77. 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).

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

situations.[218] 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.[219]

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).[220] These reforms can be understood as a concerted effort on the 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, in an insightful and important article, demonstrated that tax deferral in whatever form could be viewed as an interest-free loan from the government and that the Cary Brown theorem in fact sets forth a rationale for how to harmonize and synthesize these various timing rule reforms.[221] 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.

---

[218] *See* Calvin H. Johnson, *Soft Money Investing Under the Income Tax*, 1989 U. ILL. L. REV. 1019 [hereinafter Johnson, *Soft Money*]; 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*].

[219] Johnson, *Soft Money*, *supra* note 218; Johnson, *Silk Purses*, *supra* note 218.

[220] *See, e.g.*, I.R.C. § 1272 (eliminating deferral opportunities on "original issue discount" debt instruments, enacted by Congress in 1969); § 1256 (imposing a "mark-to-market" timing rule for certain commodities contracts, to prevent trading strategies that could accelerate loss deductions and defer inclusion of gains, enacted by Congress in 1981); § 475 (similar for securities traders generally, enacted in 1993); § 817A (similar for life insurance contracts, enacted by Congress in 1997).

[221] Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money*,*"* 95 YALE L.J. 506 (1986). 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 114, at 440 n.35.

Other noted academic articles were in accord.[222] Realization was now 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.[223] These efforts are reasonable efforts 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. But, 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 so demonstrates.

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 make the case here that taxation of income requires timing rules—whatever they may be—to assign income into a particular year, and then an appropriate 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

---

[222] 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 (Apr. 15, 2013).

[223] *See, e.g.*, *supra* note 220.

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 limitation is inherent in the time-conscious concept of income developed in the pre-ratification era, and thus, we argue, should be incorporated into Sixteenth Amendment jurisprudence.[224]

Although many of the various timing rules 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.

A. Harmonizing Timing Rules with Basis Adjustments

In this 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 frame 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.[225] By tracking what

---

[224] *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).

[225] *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, for example in which 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, I.R.C. § 301(c)(1), and that the basis in the stock received is equal to the fair market value, I.R.C. § 301(d). As a result, if the shareholder sells the newly received stock immediately after receiving it, the sale does not result in any

has already been included in income, tax basis ensures that income taxation is not mixed up with taxation of capital—i.e., 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 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.[226]

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 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

---

additional tax liability because there is no excess of amount realized over basis. I.R.C. § 1001(a).

[226] 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" 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 elsewhere, along with somewhat erratic history of jurisprudence regarding direct and indirect taxes. *See, e.g.*, 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"); 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, *Comparing Capital Income and Wealth Taxes*, 48 PEPPERDINE 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).

fashioned by Congress,[227] the Treasury Department,[228] and lower courts.[229] 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 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*,[230] should it be reevaluated and included *later*,[231] or, perhaps, should it *never* be included and instead be exempt from income taxation.[232] Congress should be afforded plenary authority to reasonably determine which time is the most appropriate and practical in which 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

---

[227] *See, e.g.*, I.R.C. §§ 358; 362; 1012; 1014; 1015; 1016; 1019.

[228] *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.

[229] *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).

[230] 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), (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).

[231] 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* I.R.C. § 401(k).

[232] For example, under current rules, appreciated property owned when an individual dies receives "stepped up basis" in the hands of the decedent's heirs. I.R.C. § 1014.

that property's tax basis.[233] 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.[234]

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 non-realization timing rule, reflecting negative changes in economic position without regard to realization events. As the cost of the asset is deducted as depreciation,[235] the unrecovered investment in the property for tax purposes (i.e., its remaining "adjusted basis") is reduced.[236] This mechanism mirrors the basis *increase* that is provided for when tax on gain before a realization event. Depreciation and amortization deductions have been a feature of the income tax since its inception, allowing taxpayers to recover their investment in tangible and intangible property before disposing of it.[237]

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.[238] 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.[239]

---

[233] *See* I.R.C. §§ 1012, 1016.

[234] I.R.C. § 1001.

[235] *See* I.R.C. §§ 167 (allowing deductions for wear and tear of certain property); 168 (providing specific rules for the amount and timing of depreciation deductions under § 167).

[236] *Id.* §§ 1011(a); 1016(a).

[237] *See id.* §§ 167, 197.

[238] *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.

[239] For a discussion of the use of forward-looking matching rules (e.g., capitalization rules), backward looking matching rules (e.g., recapture rules that

When the taxpayer purchases an asset with cash, the basis of 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.[240] 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.[241] When an asset is received in-kind and fully included into the taxpayer's income, the taxpayer generally is afforded a cost basis so that the taxpayer is not taxed again when the taxpayer later disposes of the property in a later taxable event.[242]

The operation of this basis system, with upward and downward adjustments, can ensure that income is subject to income taxation *only once over time*. This provides a coherent conceptual framework for evaluating whether a rule imposes tax on income or instead on something else: if a timing rule is accompanied by appropriate basis adjustments, it

---

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, etc.), *see* Charlotte Crane, *Matching and the Income Tax Base: The Special Case of Tax Exempt Income*, 5 AM. J. TAX POL'Y 191 (1986).

[240] *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 239. 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 (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 (1983).

[241] Another context that exhibits nuanced use of basis is cancellation of indebtedness. *See supra* notes 196–200. 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 (June 22, 1938).

[242] I.R.C. § 1012; Treas. Reg. § 1.1012-1(a).

ensures that income inclusions attributable to a change in economic position are not included in income and subject to tax again later. This, in turn, allows Congress flexibility to assign income to the discrete time period it believes is most appropriate for taxation.

The Supreme Court's careful handling of the tax basis concept is illustrated in *Hort v. Commissioner*.[243] In *Hort*, a taxpayer acquired a lot and a ten story office building after his father had passed away in 1928.[244] 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.[245] 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.[246] 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. To reach this outcome, the Court deftly distinguished that property and capital are not necessarily synonymous terms. 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."[247] 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.[248] 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

---

[243] 313 U.S. 28 (1941).

[244] *Id.*

[245] *Id.* 29.

[246] *Id.*

[247] *Id.* at 32.

[248] *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").

taxpayer recovering a written off debt had any income inclusion because the taxpayer superficially seems to be merely recollecting back her own original funds. Lower courts questioned whether a taxpayer's recovery of her own capital could represent gain derived from capital under *Macomber*.[249] 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.[250]

The tax benefit rule follows the logic of basis, in order to prevent taxpayers from capturing a double benefit—i.e., 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.[251] 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,* stating in effect that the 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.[252] The Ninth

---

[249] *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).

[250] 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).

[251] *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).

[252] *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 (1942), *rev'd sub nom.* Harwick v. Comm'r, 133 F.2d 732 (8th Cir. 1943), *aff'd in part and rev'd in part*, Dobson v. Comm'r, 320 U.S. 489 (1943).

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". Eisner v. Macomber [. . .] 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 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 . . . .[253]

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

[253] Nat'l Bank of Com. of Seattle v. Comm'r, 115 F.2d 875, 876–77 (9th Cir. 1940). 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 *In re* Collins, 46 B.T.A. 765 (1942), *rev'd sub nom.* Harwick v. Comm'r, 133 F.2d 732 (8th Cir. 1943), *aff'd in part and rev'd in part*, Dobson v. Comm'r, 320 U.S. 489 (1943).

income."[254] 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 Court has rationalized inclusionary prong of the tax benefit rule as reconcilable with the annual accounting methodology:

> The Tax 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 Tax Court reopened any closed transaction.[255]

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 debt deduction.[256] 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

[254] *Hillsboro Nat'l Bank*, 460 U.S. at 378–79.

[255] *Dobson*, 320 U.S. at 493.

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

been obtained.[257] 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.[258] This ameliorative doctrine is often referred to as the "exclusionary prong" of the tax benefit rule.[259] 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.[260] 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.[261] In *Dobson v. Commissioner*, the Supreme Court rationalized this conception of quasi basis with the exclusionary prong of the tax benefit rule as a "proper adjustment" to give recognition to the portion of the taxpayer's capital that

---

[257] *See* Statement of Randolph Paul, Tax Advisor to the Secretary of the Treasury, Hearings before the Committee on Ways and Means on the Revenue Revision of 1942, 77th Cong. 2d Sess. at 88 (Mar. 1942).

[258] *See* Pub. L. No. 77-753, Sec. 116, 56 Stat. 798, 812–13 (Oct. 21, 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 (July 14, 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. 76 (stating that "[t]o 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. 1825, 1937-1 C.B. 55 (same). It then reversed itself, giving rise to the cases referenced *supra* note 256.

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

[260] 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).

[261] 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 (Oct. 2, 1942).

had not afforded a basis benefit.[262] The tree and fruit concept of income is useless in this context—and the Court had to sidestep it to reach a reasonable result.[263] 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.[264]

Thus the basis concept allows taxpayers and the government to track and distinguish income from capital in a variety of context. 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 and can be reformulated in this fashion: 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.

---

[262] Dobson v. Comm'r, 320 U.S. 489, 503–04 (1943). 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.

[263] 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) (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.

[264] *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 384; *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.*, William D. Elliott, *The Tax Benefit Rule: A Common Law of Recapture*, 39 SW. L.J. 845 (1985).

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 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."[265] Under this line of well-established judicial precedent and regulatory guidance the correct use of basis adjustments that address the temporality of income taxation are the hallmark that the Court as well as Department of Treasury have consistently looked for to distinguish income taxes from property or excise or other types of taxes.

In 1918, Congress introduced a key feature of U.S. taxation of income earned abroad: the foreign tax credit.[266] 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."[267] That is, the foreign income taxes are creditable against U.S. income tax, but foreign *non*-income taxes are not.[268] 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 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

[265] PPL Corp. v. Comm'r, 569 U.S. 329, 338 (2013), discussed *infra* notes 281-283 and accompanying text.

[266] Revenue Act of 1918, ch. 18, § 222(a), 40 Stat. 1057.

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

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

explained almost nothing that articulated the ultimate purpose of the foreign tax credit.[269] 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.[270]

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. Commissio*ner,[271] have taken center stage. In its discussion of the issue of whether taxes had actually been paid, the Court offered the following thought: "'Income 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."[272]

---

[269] *See* H.R. REP. NO. 767, 65th CONG., 2d SESS. 11 (1918); 56 CONG. REC. 667–78 (1918). The record reflects a few practical objections to double taxation (i.e., taxation of the same income by two jurisdictions, which is the result if one or the other jurisdiction does not provide a credit for tax paid in the other jurisdiction).

[270] 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, 453 (1942) ("[T]he purpose [of the foreign tax credit] is to obviate double taxation."); United States v. Goodyear Tire & Rubber, 493 U.S. 132, 140 (1989) ("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. 1337, 83RD CONG., 2D SESS. 76–77 (1954) ("The [foreign tax credit] provision originally was 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. 558, 73RD CONG. 2D SESS. at 39 (1934) (noting "the present [foreign tax] credit . . . does relieve the taxpayer from a double tax upon his foreign income"); H.R. REP. 767, 65TH CONG., 2D SESS. (1918), 1939-1 C.B. (Part 2) 86, 93 (in explaining the rationale for a foreign tax credit, the legislative history stated as follows: "[w]ith the corresponding high rates imposed by certain foreign countries that taxes levied in such countries in addition to the taxes levied in the United States upon citizens of the United States place a very sever burden upon such citizens").

[271] 302 U.S. 573, 579 (1938).

[272] *Id.* at 579.

In 1983, the Department of 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.[273] These regulations are non-committal 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 includes that an income tax might be imposed on a "pre-realization" or "post-realization" basis.[274] The resulting varied timing rules allow for income taxation upon the recovery or recapture of a previously allowed tax deduction or credit,[275] increases or decreases in the value of property,[276] the "physical transfer, processing, or export of readily marketable property" at any time,[277] as well as a "deemed" distribution or "deemed" income inclusion.[278] The actual timing rule that the foreign jurisdiction selects is not dispositive—i.e., contra to some of the opinions offered recently in *Moore*, foreign taxes can constitute income taxes even if they include in 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 non-realization 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."[279] 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

[273] 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 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. updated 2024).

[274] Treas. Reg. § 1.901-2(b)(2)(i)(A), (B) and (C).

[275] Treas. Reg. § 1.901-2(b)(2)(i)(B).

[276] Treas. Reg. § 1.901-2(b)(2)(i)(C)(1).

[277] Treas. Reg. § 1.901-2(b)(2)(i)(C)(2)..

[278] Treas. Reg. §1.901-2(b)(2)(i)(C)(3).

[279] Treas. Reg. § 1.901-2(b)(2)(i)(C).

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.[280]

In 2013, in a unanimous opinion in *PPL v. Commissioner* authored by Justice Thomas, the Supreme Court favorably cited these Treasury regulations that conditioned foreign tax credit relief on whether or not the foreign law set forth basis adjustments.[281] 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. 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."[282]

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 signaled that it is in search of following *Moore*.[283] In short, 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.[284] 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: the Supreme Court seems to have planted a seed in its *Moore* decision that could eventually sprout into a constitutionally mandated realization requirement. The narrow holding by the majority can

---

[280] Treas. Reg. § 1.901-2(b)(2)(i)(C)(3).

[281] *PPL Corp.*, 569 U.S. at 335–36 (citing Treas. Reg. § 1.901-2(a), (b)).

[282] *Id.* at 338 (holding "[w]e 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.")

[283] *Id.*

[284] 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.

be read to invite future challenges on the scope of income taxation under the Sixteenth Amendment. If this reading of the tea leaves in the *Moore* opinion is correct, then the Court was wise to stop short of imposing 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.[285] Both the majority and dissent in Moore indicate that such a decision would severely threaten the ability of the federal government raise revenue.[286] 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 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.[287] 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.[288] Well before ratification, the grain industry

[285] Consider the practical effect if the Sixteenth Amendment does allow some or all of the specialized, non-realization timing rules described *supra* notes 190–200 (addressing debt timing rules), 220 (listing mark-to-market rules applicable in different contexts); 225 (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); 884 (imposing a branch profits tax on certain changes in net assets of U.S. operations of foreign corporations); 701–761 (allowing pass-through taxation of partnerships, without regard for whether partners have received distributions from a partnership); 951–965 (allowing pass-through taxation of certain income of foreign corporations owned by U.S. shareholders).

[286] *Moore*, 144 S. Ct. at 1693 & 1696 (majority opinion) (imposition of a realization requirement risks a "fiscal calamity"); *id.* at 1726 (J. Thomas 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.").

[287] *See supra* Part II.A.

[288] *See supra* Part II.B.

"universally employed" a conceptualization of income that included unrealized gains and losses.[289] 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.[290] The chosen timing rules have varied—realization is and was only one of many possible—and, we argue, reasonable and necessary—timing rules.

But this is not to say that there are no limits on income taxation under the Sixteenth Amendment—just that Congress' 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 Court takes up constitutional tax jurisprudence anew, the temporal challenges of income must be front and center. But in *Moore*, the Court failed to fully consider the multifaceted theory and practice for determining income that existed at the time of the Sixteenth Amendment's ratification. The dissent in *Moore* justified a realization requirement as a constitutional necessity because no other limiting factor could be identified. But the 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

---

[289] B.I.R., 1921 Ruling, Exhibit A, *supra* note 120, at 78.

[290] *See supra* Part III.A, B.

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.[291] The temporal considerations that we introduce here help to clarify the stakes and illuminate a doctrinal path forward. Failing to account for time potentially undermines the dictate that the Sixteenth Amendment empowers Congress to tax "incomes, from whatever source derived."[292]

---

[291] *See supra* Part IV.
[292] U.S. CONST. amend. XVI.