Protective Refund Claims Amidst "Transition Tax" Challenge

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As the world of taxation undergoes constant transformation, an upcoming case in the U.S. Supreme Court may write a new chapter in U.S. tax law. The spotlight now falls on the constitutionality of the so-called **"Transition Tax,"** under Internal Revenue Code Section 965, a repatriation tax regime introduced under the Tax Cuts and Jobs Act (TCJA) of 2017, with the ongoing legal battle presented in the Supreme Court case of *Moore v. United States*.

Prior to the enactment of the Transition Tax, U.S. shareholders were predominantly taxed on the earnings and profits of controlled foreign corporations when those earnings qualified as Subpart F income or when distributed as dividends. Subpart F income is specific types of highly mobile income that taxpayers can easily shift to low tax jurisdictions and avoid paying U.S. taxes indefinitely absent these rules (e.g. dividends, interest, royalties, and other types of operating income). **However, the TCJA introduced the concept of the Transition Tax as a mechanism to tax previously untaxed foreign earnings as the U.S. moved to a hybrid territorial system of taxing profits.** This tax imposed an unexpected burden on untaxed earnings of foreign subsidiaries of U.S. companies by deeming those earnings to be repatriated regardless of an actual cash distribution. Taxpayers were faced with a mandatory tax rate of 15.5% on post-1986 accumulated foreign earnings held in cash or cash equivalents, and an 8% mandatory tax on post-1986 accumulated foreign earnings held in illiquid assets. Furthermore, taxpayers had the option to pay the Transition Tax in installments over an 8-year period, which provided some relief to taxpayers.

However, a looming constitutional question emerged. **Is it constitutional to tax unrealized income, as the Transition Tax effectively does?** The heart of the issue centers on whether the Transition Tax complies with the 16th Amendment of the U.S. Constitution, which does not allow Congress to tax unrealized sums without apportionment among the states, which has led to the *Moore v. United States* case. The petitioners in *Moore* are individual shareholders of an Indian company who had not received distributions from the company during the period of their investment but were required to pay the Transition Tax on their proportionate share of the foreign company's reinvested earnings. The petitioners argued that this tax was unconstitutional and sued for a refund. Although the U.S. Court of Appeals for the Ninth Circuit initially ruled against the taxpayers, the Supreme Court has agreed to hear their case.

Given the uncertainty surrounding the outcome of *Moore v. United States*, it is important to consider a protective claim for a refund. Such a claim could safeguard your ability to recover a portion of the Transition Tax should it be declared unconstitutional. However, the viability of a protective refund claim hinges on various factors, including whether a taxpayer has chosen to pay the Transition Tax in installments. Despite this, and the uncertainty of the ongoing litigation, one may nevertheless consider filing a protective claim as a means to protect a taxpayer's ability to reclaim taxes before the expiration of the statute of limitations.

In the coming months, as we await the Supreme Court's decision in *Moore v. United States*, we will remain vigilant and prepared to provide our clients with up-to-date guidance, and we hope to have clearer guidance before April 15, 2024. **To learn more about the Transition Tax and how it may affect you, please contact Gwayne Lai, Partner of Anchin's International Tax Group, or your Anchin Relationship Partner.**

Watch a video *where we discuss three recent international tax controversy cases – Bittner, Farhy, and Moore – and what they mean in terms of ongoing compliance* *requirements, potential reporting changes, and refund opportunities.*