The Story of Macomber: The Continuing Legacy of Realization

Tax cases rarely make front-page news. On March 9, 1920, however, *Eisner v. Macomber*, decided the previous day by the United States Supreme Court, not only made *The New York Times*’ front page but also dominated the headlines. The case remained in the news for several weeks, but courts (including the Supreme Court), Congress, and commentators discussed it for decades. Although the case briefly plunged the financial market into disarray and inflamed contemporary criticism of judicial review, its primary influence has been in the tax field. From the time of its decision to the present, the case has generated voluminous litigation and shaped major aspects of the income tax, including the taxability of stock dividends (the transaction at issue in the case), corporate taxation generally, exchanges of property, the definition of income. The key to Macomber’s continuing importance lies in its explication of realization, one of the most basic elements of taxation. The context in which the realization issue was raised, and the manner in which the Court resolved it, heightened the case’s impact. The constitutional slant that the Macomber Court gave to the realization requirement inevitably made the case a reference point for years. By the time that requirement was (apparently) downgraded to mere administrative convenience, the case had already left its indelible mark. In terms of both its short and long term effects, *Macomber* undeniably deserves its status as “one of the most celebrated cases in the annals of federal income taxation.”

1 252 U.S. 189 (1920). There were, in fact, several articles on the front page. See infra notes 42–44 & 48–50 and accompanying text.

Background

Realization is one of the most stable, and powerful, elements of an almost constantly changing income tax code. By deferring the tax consequences of gains and losses beyond the time of their economic occurrence, realization causes economic distortion, creates inequity among some taxpayers, generates much of the complexity of the tax law, and provides many opportunities for taxpayers to manipulate their tax status to achieve desirable tax consequences. For example, taxpayers can take tax deductions by realizing losses but defer income by delaying realization on appreciated assets. In this manner, realization bestows a tax advantage on certain types of income, which in turn creates economic distortions and produces much of the tax law’s complexity by requiring, for example, detailed accounting or timing rules and rules about capital gains taxation.\(^3\)

An easy way to understand the concept of realization and the Macomber case is to think about the current stock market. During the past few years, investors in the stock market, especially technology stocks, have seen the value of their holdings rise and fall as much—and as precipitously—as the scariest roller coaster. A share of TotalTech stock, for example, that you bought for $50 two years ago might have gone up in value to $150 last year before plummeting to a current worth today of only $20. Being an optimist (or lazy), you have done nothing with the stock in these two years except keep the stock certificate in the bank vault. Nevertheless, you may have acted very differently when the stock was worth $150 a share than now when it is worth $20, and people may have behaved very differently towards you. For example, when your stock was worth $150 a share, you might have wanted to borrow money to buy an expensive house or take a cruise, and a bank might have been

willing to lend it to you. When your stock is worth only $20 a share, however, you may no longer have wanted to borrow the money, or the bank may no longer have been willing to lend it to you.

Although the value of your stock, your wealth, and possibly even your behavior have fluctuated during the two year period, have you had any income or loss from your stock ownership since all you have done with the stock is continue to own it? When the stock skyrocketed to $150 a share did you have $100 of income? When it decreased in value did you sustain a loss? Economists might give you different answers than the Internal Revenue Code.

What is income from an economic perspective is not necessarily income for tax purposes. Most economists would say in the above instance that you had both income and a loss as the price fluctuated. To understand this, you must understand the difference between wealth and income. Both are measurements. Wealth, however, measures value at a frozen moment in time, while income is a flow, a measurement over a period of time, which could be as short as a month, as long as a lifetime, but most often is a year. More formally, income, under the classic Haig-Simons definition, is “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 and end of the period in question.” From an economic perspective, then, income and loss occur when the value changes between the beginning and end of the period of time. In the example, therefore, the mere accretion of value of the stock from $50 to $150 would have been $100 of income last year, and the decrease in value this year to $20 would be a loss of $130.

The Internal Revenue Code, in contrast, generally holds that you had neither income nor loss because the requirement of “realization” had not been met. Although realization is a basic concept in our income tax laws, its exact parameters are hazy. The core idea, however, is that the mere increase (or decrease) in an asset’s value is not enough to impose income tax consequences. Rather, some transaction, usually a market transaction, must occur which changes the taxpayer’s relationship to the asset. So, for example, although you would have $100 of economic income if your stock increased in value from $50 to $150 while you owned it, you would not have taxable income because there was no change in your relationship to the stock—that is, no realization. If, however, you had sold the stock when it was worth $150, the $100 of increased value would be realized and taxable income would have coincided with economic income.

In most situations, the Code makes realization a necessary, but not sufficient, condition to taxation. Recognition must also occur before tax

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liability results. Recognition is merely the technical term the Code gives to the decision that the transaction is an appropriate time to tax. Generally, recognition occurs at the same time as realization. Section 1001(a), for example, states that gain or loss is realized on the disposition of property, and § 1001(c) provides for recognition, or assignment of tax consequences, unless some other section further defers the gain or loss by providing for non-recognition. Sometimes recognition is delayed for non-tax purposes such as a desire to encourage certain business transactions, but sometimes it is also delayed because Congress was unsure whether realization had occurred. Even the existence of recognition, however, does not ensure taxability because some other code section may exclude the gain or loss permanently, such as § 121, dealing with certain gain from the sale of a residence.

In contrast to the non-recognition or exclusion sections that defer gain or loss beyond realization, there are a few sections that do the opposite: abandon the requirement entirely and require taxation as the gain or loss actually occurs or accrues in the economic sense. This abandonment of realization generally occurs only when an easily valued asset is involved. Section 1256, for example, uses a pure accretion method of taxation and “marks to market” certain easily valued assets, such as regulated futures contracts, at the end of the taxpayer’s taxable year.5 Tax liability is then imposed on the increase or decrease in value in the same manner as if the taxpayer had sold the asset. The original issue discount rules also create taxability as interest accrues rather than when it is actually received. On a broader scale, some basic aspects of the Code ignore realization. Depreciation, for example, can be viewed as the allowance of unrealized losses to the extent that they represent a loss of value due to the passage of time. The structure for taxing partners and certain corporate shareholders also ignores realization at the individual level (but not the entity level) by taxing the owner on gains and losses sustained by the partnership or corporation even though the gain or loss is not distributed to the individual owner.

There are conceptual, historical, and practical reasons why our tax system generally requires realization before tax liability is imposed. Conceptually, especially in the early years of the income tax, there was disagreement as to whether there was income without realization. As long as money is still invested in an asset, it is still at risk and arguably the fact and amount of income are uncertain. For example, if Microsoft stock is currently selling for $72 per share, and you bought it at $60 per share, you indeed have a $12 increase in value. However, the stock may plummet in value next month and the entire $72 disappear while you own the stock. Consequently, any increases in value while you hold the

5 See e.g., §§ 467, 475, 817A, 1296, and the original discount rules.
stock are, allegedly, merely *paper gains* that may disappear. The Supreme Court's early pronouncement in *Macomber* that realization was a constitutional component of income gave added weight to this concept of income and ensured that realization played a large role in the development of the tax laws.

Even if there were no conceptual or historical reasons to require realization, there are practical ones. A system that taxes pure accretions in value rather than waiting until realization occurs has two major administrative problems. First, there is the valuation problem. Although some assets are easily valued because they are frequently traded on an established stock market, other assets have a less discernible value. Some stock is so infrequently traded that it may be impossible to determine its value—and hence any amount of gain—until it has been sold at a definite price to a willing buyer. Second, there is a liquidity problem. Even if the exact amount of increased value can be definitely determined, the taxpayer who holds the appreciated stock may have no money with which to pay a tax unless he sells the asset in question.

The practical and conceptual aspects of realization, broadly construed, point towards a consumption tax. Both valuation and liquidity issues totally disappear when an asset is converted into cash and consumed. More theoretically, if the primary reason for realization is the uncertainty of gain actually materializing until the funds are no longer subject to risk, then realization, taken to its extreme, requires no taxation until money is withdrawn from investment and used to purchase items of consumption. The concept of realization, then, is entwined in the basic question of what should be the tax base—income or consumption. Of course, using a lifetime cycle—and assuming all income is consumed in a lifetime—realization does not change the amount of income or loss, just the *timing*. Assume, for example, that the tax rate is always 10%, and a person's lifetime consists of three taxable cycles in which she earns $10,000 each cycle but consumes only $5,000 in the first two cycles and $20,000 in the third (the $10,000 she earned that cycle plus the $10,000 she had saved from the previous two). Under both an income tax (which taxes the money when earned) and a consumption tax (which taxes only the money spent), the taxpayer has a total of $3,000 of tax over her lifetime. The timing of that tax, however, differs. Under an income tax, she has a tax of $1,000 each year. Under a consumption tax, her tax liability is $500 for each of the first two cycles and $2,000 for the last one.

The timing of taxes, however, can make a tremendous difference. Realizing losses, but not gains, can decrease present tax, and deferring the realization of gains gives the taxpayer the free use of the money that would go to pay taxes. Moreover, delaying the tax until the future is advantageous because a future tax is only a possible tax whereas a
current tax is an actuality. Congress, for example, may abolish or decrease the tax; the taxpayer may figure out how to avoid (or evade) the tax.

As important as the monetary consequences of realization are, they are not the only significant consequences of basing a system on a realization requirement. Realization throws up barriers to achieving four of the classic goals of a tax system: economic efficiency, certainty, simplicity, and equity. For example, realization distorts economic behavior by favoring investment in assets that appreciate without realization (real estate, for example) over assets whose profit is realized annually (bonds). It diminishes certainty of a tax by creating confusion as to when realization will occur. Simplicity is also lost as the law attempts to deal with all these issues. Finally, equity is disturbed since, among other things, two taxpayers with the same amount of economic gain will be taxed differently.

Since realization plays such a central role in both the practical and conceptual aspects of the tax laws, anyone who wants to understand the tax system should study *Macomber*. Although the case did not invent the concept of realization, it was the Supreme Court’s first elaboration of its meaning. Its constitutional aspects guaranteed *Macomber* a prominent role in tax legislation and litigation for years. Since those years were formative years of the income tax, the case helped shape not only the actual law but also administrative practice and the ways people think about tax. As a result, over eighty years after its decision, *Macomber* still exerts a powerful, even if subterranean, influence on the United States tax system, despite the disappearance of its constitutional constraints. Understanding *Macomber*, therefore, is a gateway to understanding much that is basic to the current system.

**Prior Proceedings**

Although realization focuses on the timing of income, the issue was complicated in *Macomber* by the facts of the case as well as contemporary conceptions of income, theories of corporations, and legal precedent. In 1916, Mrs. Myrtle H. Macomber was a stockholder in the Standard Oil Company of California when it declared a dividend to each stockholder in the form of one share of stock for every two shares already owned. As a consequence, she—like the other shareholders—increased the number of her shares but saw no change in her percentage of ownership or the value of the stock.⁶

Standard Oil could have done one of three things with its earnings for the year; at the time of the case, the tax treatment of two of the

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⁶ For financial purposes, the corporation transferred money from earned surplus to capital stock. 252 U.S. 189, 200–01 (1920).
possibilities was clear. If Standard Oil had done nothing but retain all the profits in corporate solution, Mrs. Macomber would not have been taxed. If Standard Oil had paid a cash dividend, Mrs. Macomber would have been taxed because each income tax statute since the passage of the Sixteenth Amendment had included cash dividends in income. Only the treatment of stock dividends was uncertain. The first tax laws under the amendment were silent on the issue, and initially the Internal Revenue Bureau interpreted this silence to mean that stock dividends were not taxable. By the end of 1915, however, it reversed itself. The 1916 Act reflected this new position, and for the first time, the law clearly stated that income included stock dividends paid from post March 1, 1913 profits (the effective date of the original income tax).\textsuperscript{7}

In 1917, pursuant to the new law, Mrs. Macomber included in her 1916 income tax return—and paid tax on—the portion of her stock dividends made out of post February 1913 earnings and profits. On February 14, 1918, she filed an appeal with the Commissioner of Internal Revenue, who disallowed her appeal. She then filed suit in the United States District Court for the Southern District of New York, claiming that the provision of the 1916 Act taxing stock dividends was unconstitutional.\textsuperscript{8}

The case proceeded through the courts with great speed. Six months after the complaint was filed, the district court issued a one line memorandum overruling the government’s demurrer to dismiss the complaint for lack of a cause of action but giving it leave to answer.\textsuperscript{9} Rather than answering, the United States filed an assignment of error on March 7, 1919, and one week later, attorneys for Mrs. Macomber, joined by the government, filed a motion to advance to the Supreme Court, stating that the constitutional issue involved—whether stock dividends were income under the Sixteenth Amendment—“directly affect[] the administration of the revenue, are of grave importance and we conceive it to be in the public interest that this case should be advanced.”\textsuperscript{10} Oral arguments occurred a month later on April 16, 1919, with re-arguments on October 17th and 20th. On March 8, 1920, only 1\textfrac{1}{2} years after Mrs. Macomber originally filed suit, the Supreme Court announced its decision.

\textsuperscript{7} In February 1915, the Commissioner had announced stock dividends were not taxable, and then reversed the decision in December of the same year. T.D. 2163, 17 Treas. Dec. Int. Rev 114, rev’d, T.D. 2274, 17 Treas. Dec. Int. Rev. 279 (1915).

\textsuperscript{8} Complaint at 12 [in the microfiche version it is on page 7].


\textsuperscript{10} Defendant-in-Error’s Motion to Advance, No. 914318, filed March 15, 1919 at 6–7.
The Supreme Court Decision

The rapid progress of the case was only one sign of its importance. The voluminous debates by tax and financial experts, including the noted tax expert Professor Edwin R. A. Seligman of Columbia, was another.\(^{11}\) Mrs. Macomber’s legal team was a powerhouse. The once and future Supreme Court Justice Charles Hughes\(^{12}\) represented her, and George Wickersham, the former United States Attorney General under President Taft, filed an *amicus* brief on her behalf. Certainly, the constitutional question concerning the scope of the Sixteenth Amendment was an important, perhaps even dominant, reason for the amount of attention the case received. The financial aspects played a role as well. The issue “vital” affected the interests of wealthy taxpayers and corporations.\(^{13}\) Moreover, since uncertainty about the taxability of stock dividends affected the willingness of corporations to issue them, the pending case also affected the financial markets for at least six months prior to the decision.\(^{14}\) The government, for its part, worried about the loss of revenue if stock dividends were held non-taxable and about possible tax evasion.\(^{15}\) The unsettled state of the law made planning difficult for both the government and taxpayers. Consequently, a decision, whether for or against Mrs. Macomber, was desirable to make certain the tax consequences of stock dividends. This last factor may have influenced the date of the Court’s decision, which was announced just one week before the 1919 tax returns were due.

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\(^{11}\) Seligman, the noted economist and tax expert, claimed that stock dividends were not income in an article submitted with the Defendant-in-Error’s Brief, *Are Stock Dividends Income?*, 9 Am. Econ. Rev. 1 (1919).

Opinion as to both what the court should and would do was divided. Interestingly, the *New York Times* had conflicting statements in its March 9 edition. A front-page article believed that “a preponderance of opinion lately that the decision would be unfavorable [meaning taxable].” *New Stock Issue May Follow Ruling*, N.Y. Times, March 9, 1920, at 1. The editorial for that day, however, said that the Court’s decision was expected. Editorial, *The Stock Dividend Decision*, N.Y. Times, March 9, 1920, at 10.

\(^{12}\) Hughes, a former governor of New York, had been appointed by President Taft. Confirmed in late 1910, he resigned in 1916 in order to accept the Republican nomination for president. In 1930, President Hoover appointed him Chief Justice, a position he filled until July 1, 1941 when he resigned. 2 *Who Was Who in America* 391 (1950).

\(^{13}\) George Wickersham and Charles Smith, *Amici* at 2.

\(^{14}\) *New Stock Issues May Follow Ruling*, N.Y. Times. March 9, 1920, at 1 (case was one of “first importance”).

\(^{15}\) *Government Loses $100,000,000 Taxes*, N.Y. Times, March 9, 1920, at 1. The exact amount of tax loss was debated. See, e.g., *Sees Billion Tax Loss*, N.Y. Times, March 10, 1920, at 21. See *infra* notes 50–52 and accompanying text.
The basic issue in the case was not whether the stock dividend made Mrs. Macomber richer. The government, despite some language to the contrary in both the briefs and the opinion, basically conceded that the declaration and payment of a dividend, whether in cash or stock, does not make a shareholder any richer than she was the moment before the dividend. What was relevant, it said, was whether the taxpayer was richer than she had been at the beginning of the taxable period. If Standard Oil earned $10,000 of profit while Mrs. Macomber owned 10% of the stock, she was $1,000 richer than before. The government agreed with the taxpayer that this increased wealth would not change regardless of whether the corporation paid her (and other shareholders) that $1,000 in the form of a cash dividend, a stock of another company, or its own stock. Both sides also agreed that if the corporation paid the profit to the shareholder in the form of cash that it would be taxable income to the shareholder.

The parties disagreed, however, about the situation before the Court in which the profit was paid in the form of a stock dividend. Two years previously, in Towne v. Eisner, the Court had held that such a dividend was not taxable. The situation in that case, however, differed in two respects from that in Macomber. First, in Towne the dividend was paid out of profits earned before 1913 (i.e. pre-Sixteenth Amendment), whereas some of the dividends in Macomber were paid out of post–1913 earnings. Second, the 1913 statute at issue in Towne did not specifically include stock dividends in income, whereas the 1916 statute in Macomber did. As a consequence of these two differences, the two sides differed on the application of Towne to the present case. Both argued the case in constitutional terms.

Attorneys for Mrs. Macomber claimed—and the district court agreed—that Towne controlled. As in Towne, Mrs. Macomber’s receipt of a stock dividend was not income, her attorneys claimed, because she was no richer after the dividend than she had been before. More broadly, they argued, a stock dividend cannot be income under the Sixteenth Amendment because it is capital. Since a corporation is a separate legal entity from the shareholder, its undivided, undistributed profits may enrich the shareholder but cannot be income to the shareholder until they are distributed. Consequently, a tax on a stock dividend is a direct

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16 252 U.S. at 192; Brief for the United States at 16–17.

17 245 U.S. 418 (1918).

18 Defendant’s Supplemental Brief at 27–29. The Brief countered the government’s argument that Collector v. Hubbard, 12 Wall. 1 (1870), was authority for taxing undistributed profits as income by stating that Hubbard did not have to decide whether a
tax upon property that must be apportioned under the constitution.\textsuperscript{19}

The government, on the other hand, argued that \textit{Towne} did not control for three reasons. First, the case applied only to stock dividends paid out of earnings accrued before March 1, 1913. Second, the opinion was one of statutory construction only. At most, then, it held only that the ordinary meaning of the word “dividend” does not include a stock dividend and consequently the 1913 Act, which did not speak specifically of stock dividends, did not include them as income. Third, since the 1916 Act specifically taxed stock dividends accrued after March 1, 1913, the government claimed that congressional intent was clear. The “only question,” therefore, was “whether the levying of such a tax is within the power of Congress.”\textsuperscript{20}

The government’s answer was a resounding yes. Mrs. Macomber was richer in 1916 when she received the stock dividend than she was in 1913, and the stock dividend was “concrete evidence” of that gain.\textsuperscript{21} The government further contended that a distribution—whether in cash or stock—was not even necessary for taxability because “the tax is levied on income \textit{derived from corporate earnings}; that such income may be taxed either as the earnings accrue to the corporation or when they are \textit{received} by the stockholder.”\textsuperscript{22} In other words, the government claimed that Congress had the power to tax undistributed corporate profits, and in fact, Congress had done so under the 1864 income tax act.\textsuperscript{23} Congress had simply chosen not to do so in 1916. Instead, the 1916 act taxed shareholders only when the gain was “realized” or segregated from the corporation’s undivided profit in some form such as the receipt of a stock dividend.\textsuperscript{24}

Thus, the government argued broadly that separation from the corporation of some of its assets was not essential to the existence of income. It claimed Congress had the power to tax the income as it accrued, but if a realization or segregation of any kind were necessary, that realization occurs when the shareholder receives a stock dividend.\textsuperscript{25}

\textsuperscript{19} Brief for Defendant-in-Error (Mrs. Macomber) at 6, 36–41.
\textsuperscript{20} Brief for the United States at 4.
\textsuperscript{21} Brief for the United States at 16.
\textsuperscript{22} Government’s Supplemental Brief at 5, 10.
\textsuperscript{23} See Brief for the United States at 8–10. See \textit{also} Government’s Supplemental Brief at 21–34.
\textsuperscript{24} Government’s Supplemental Brief at 5 and 35–38.
\textsuperscript{25} Government’s Supplemental Brief at 35–38. When a dividend is declared—whether in cash or stock—the shareholder’s share of undistributed profits are “converted into a
The Opinion

On March 8, 1920, one week before 1919 income tax returns were due, the Supreme Court announced the decision that had been speculated about for weeks. Justice Pitney, speaking for a narrowly divided (5–4) Court, vividly characterized the Government’s position as follows: “The Government claims the right to tax gains when wearing a new dress only when they were taxable in their old dress. The [taxpayer’s] contention cannot succeed unless the new dress destroys the power to tax which existed before it was put on.”26 Speaking in the same constitutional terms as the parties, the Court held that Congress had no power to tax the gains in their old dress. Gains were taxable as income only when realized. In reaching this decision, the Court staked out a position (albeit sometimes a muddled one) on several important issues of the day, including the scope of the Sixteenth Amendment, the nature of a corporation, the definition of income, and the relationship between court and legislature.

Formally, the Court rested its decision on Towne, despite the differences between the two cases, which it stated was based on the fact that “the essential nature of a stock dividend necessarily prevents its being regarded as income in any true sense.”27 Since a stock dividend was not income, the Court continued, any tax upon one is a direct tax that must be apportioned under Article I, section 2, clause 3 and Article I, section 9, clause 4 of the Constitution. The 1916 Revenue Act’s treatment of a stock dividend as income did not change the result.

According to the Court, the purpose of the Sixteenth Amendment was not to extend Congress’ taxing power but instead to remove the apportionment requirement with respect to income so that Congress could impose a tax on income “from whatever source derived.” That limited purpose cannot be expanded by “loose construction,” and Congress “cannot by any definition it may adopt conclude the matter since it cannot by legislation alter the Constitution, from which alone it derives its power to legislate and within whose limitations alone that power can be lawfully exercised.”28 Congress cannot turn capital into income merely by calling it so. The essence of income, the Court said, is that it must be

26 252 U.S. at 192.
27 252 U.S. at 205.
28 Id. at 206.
realized or derived from capital which entails separating the income from the capital.\textsuperscript{29}

Although the Court created the \textit{requirement} that realization must occur, it did not create the \textit{concept} of realization. Some other contemporary competing theories of income incorporated such a concept, and there were indications that the tax laws implicitly accepted the realization concept, even though there was no explicit mention of it. The Revenue Act of 1918, for example, spoke of sustaining a gain or loss on the disposition of property. Similarly, the 1918 regulations for the 1916 statute actually used the term “gain realized.”\textsuperscript{30} The \textit{Macomber} decision not only removed any ambiguity about the existence of the requirement but also elaborated on it by clearly announcing that the principle was a component of income and a constitutional one at that. In holding that it was a component of income, however, the Court did not clearly adopt any of the available theories of income.

The Court had two basic theories to choose from, each having its supporters. The traditional theory, originating in a stable, land-based society, emphasized the recurrent nature of income. Under this theory, income was the periodic product of capital, and capital was the asset itself regardless of whether its size or value changed. Capital was like a fruit tree that might grow from a tiny seed, increasing in size and value, but at all times the entire tree—whether large or small—was capital. Only the regular, periodic fruit of that tree was income. Consequently, under this \textit{res} theory, if a person bought Greenacre for $100,000 and sold it some time later for $150,000, he had no income; like any prudent person he would reinvest all $150,000 as capital and never consume any of it. Only the rents from the capital were income, and only they were available for consumption. Even windfalls or occasional receipts, such as gifts, were not income under this theory. Since they were not a periodic flow or fruit, a rational person would treat them as capital.

The quantum theory, on the other hand, viewed capital as only a specific pecuniary amount. Under this theory, any increase in value beyond that amount was income. Consequently, the taxpayer who purchased Greenacre for $100,000 would have $50,000 of income when he sold it for $150,000. A quantum theory was more in tune with an American economy that accumulated much of its wealth through speculating on rapidly appreciating assets, including easily available land. Although a quantum theory of income considered changes of value when computing income, the theory did not specify when this consideration should occur. Many economists advocated accounting for these changes.

\textsuperscript{29} \textit{Id.} at 20.

in value as they occurred. Under this point of view, a person who bought Greenacre for $100,000 this year would have income of $50,000 when it rose in value to $150,000 by the end of the year, even if he did not dispose of the land.

A few other economists, however, argued that taxation should occur only as income was consumed. This theory of income is akin to the res theory in that both focus on investment and consumption, but there are differences. For example, the res theory would never include in income the $50,000 representing the increased value of Greenacre because it was still capital, even if it was (unwisely) consumed. Under a consumption theory of tax, however, it would be taxed when it was consumed. Similarly, a res theory would always include the money received from rentals of Greenacre, whereas taxability under a consumption theory would not occur if the rents were invested.

The Macomber Court’s definition of income fell somewhere between the res and quantum theories, adopting elements of each. Its statement that income never included “enrichment through increase in value of capital investment” was pure res theory. Its holding that realization or separation from capital was a necessary component of income, however, was more ambiguous. This criterion of income complemented the aspect of a res theory that focused on the fruit being separate from the tree. At the same time, however, it also was compatible with a quantum theory of income, albeit not a pure accretion model, since it indicated that the increased value of capital was taxable only when it was separated from the capital.

Macomber’s emphasis on realization also involved the Court in another major tax issue: the proper taxation of a corporation and its shareholders. The lack of clarity regarding tax treatment reflected the uncertainty regarding the legal nature of a corporation generally. The Macomber Court reasoned that if a corporation were a separate entity, then a shareholder had no right to any particular asset until a dividend was declared and therefore couldn’t be taxed on corporate income. If, on the other hand, the shareholder and the corporation were viewed as one, the corporation could be taxed as the income was incurred, but the shareholder could never be taxed “separately and additionally” to the corporation. Even if the shareholder received a cash dividend, it wouldn’t be taxable because it would be just as if “one’s money were to be removed from one pocket to another.”

Finding that the corporation was a separate entity distinct from its shareholders, the Court stated that until there was a realization or separation of the gain from the original investment, the taxpayer had only a profit on paper, and the corporation’s gains could not be taxed to the shareholder. Until separation, the

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32 252 U.S. at 214.
individual might never receive anything since his entire amount was still invested in the separate corporate entity and still at risk.\textsuperscript{33}

The majority opinion also touched on a more practical side of the realization issue that was unsettled. Specifically, a tax system encounters two large administrative problems if it imposes a tax on unrealized appreciation. The first problem is determining the amount of the increased value. The second problem concerns a question of payment since the taxpayer may lack liquidity—owing a tax but having no cash with which to pay it. Both problems disappear if taxation does not occur until the taxpayer receives cash. Such a solution, of course, is untenable because it is an open invitation to tax avoidance. Taxpayers would arrange their affairs so that even when they disposed of property, they would receive non-cash property in return. In the prior several years, statutes, administrative rulings, and courts had all tried different approaches to the problem by altering the point at which property exchanges would be taxable and varying the definition of cash equivalent.

The *Macomber* Court’s definition of income minimized both valuation and liquidity problems. Requiring a separation of income from capital decreased the chance of valuation issues since at separation the taxpayer was likely to receive cash. Therefore, separation also decreased the likelihood of liquidity problems for the taxpayer. In fact, the Court cited the lack of liquidity as an important factor in holding that realization was a necessary component of income. Receipt of a stock dividend could not be income, the Court said, since the shareholder might have to sell the stock in order to pay the tax. This fact “clearly” showed that a stock dividend could not be income.\textsuperscript{34}

Four justices dissented in two separate opinions. On the largest issue, the scope of the constitutional power to tax, all read the Sixteenth Amendment more broadly than the majority. This broad reading left the Court with only a minimal role in the income tax area. Justice Holmes, who had written the opinion in *Towne* declaring stock dividends non-taxable, believed that they were taxable in *Macomber*. *Towne* did not control, he stated, because it was decided solely on statutory grounds, whereas in *Macomber* taxability was a constitutional question. From a constitutional standpoint, the definition of income was broad because the scope of the Sixteenth Amendment was broad. The amendment, he opined, ought to be interpreted:

in a sense most obvious to the common understanding at the time of its adoption. . . . The known purpose of this Amendment was to get rid of nice questions as to what might be direct taxes, and I cannot

\textsuperscript{33} *Id.* at 211.

\textsuperscript{34} *Id.* at 213.
doubt that most people not lawyers would suppose when they voted for it they put a question like the present to rest.\textsuperscript{35}

Justice Brandeis also based his longer dissent, joined by Justice Clarke, on a broad interpretation of the Sixteenth Amendment, coupled with a presumption of interpretation that what Congress enacts should be constitutional.\textsuperscript{36} A “grant of power so comprehensive as that authorizing the levy of an income tax,” he argued, allowed the income tax laws to ignore the legal fiction of the corporate personality and tax increases in value without a segregation of assets (i.e., without realization).\textsuperscript{37} The constitutionality of such a taxing scheme, he stated, was clear since it had existed under the Civil War income tax laws and was still used under present laws to tax partners on partnership profits regardless of whether they received any cash or other property.\textsuperscript{38}

Justice Brandeis objected to realization on theoretical grounds as well as constitutional ones. The majority required realization, or separation of income from capital, in order to determine the existence of profits. The realization requirement failed to achieve this goal, Justice Brandeis stated, because even separation did not determine the existence of profits. Such determination could occur only when the business is finally liquidated, or at the least, only when the taxpayer withdrew an amount of cash that exceeded the original investment.\textsuperscript{39} In other words, Justice Brandeis exposed the consumption theory of taxation that underlies a realization requirement.

Finally, Justice Brandeis stated that even if realization were a prerequisite for income taxation, it had occurred. Using a substance-over-form argument, he explained that a pro rata stock dividend, such as the one before the Court, was the economic equivalent of a cash dividend coupled with an option to purchase stock at a price low enough to ensure that all shareholders did so.\textsuperscript{40}

\section*{The Immediate Impact of \textit{Macomber}}

Contemporary response to \textit{Macomber} was both instantaneous and intense. Newspapers and journals gave the decision heavy coverage, and academic journals discussed the decision for years, as did both the Court

\begin{itemize}
\item \textsuperscript{35} 252 U.S. at 220 (Holmes, J., dissenting). Justice Day joined his short opinion.
\item \textsuperscript{36} 252 U.S. at 226, 231, 238 (Brandeis, J., dissenting).
\item \textsuperscript{37} 252 U.S. at 231.
\item \textsuperscript{38} \textit{Id.} at 230–32.
\item \textsuperscript{39} \textit{Id.} at 230.
\item \textsuperscript{40} \textit{Id.} at 221.
\end{itemize}
and Congress. Its impact extended beyond taxes into financial and political realms as well.

The financial market’s immediate reaction to the Macomber decision was extreme and chaotic. At first, it declined steeply, only to recover shortly afterwards. This chaotic response stemmed from the procedure by which Supreme Court decisions were announced. In 1920, the initial announcement of a decision was oral. The entire opinion was read aloud with no printed copies available until completion of the oral announcement. After only a few paragraphs of the decision had been read, news correspondents rushed to report the news. Unfortunately, they misunderstood (or misheard) and incorrectly reported that stock dividends were taxable, which led to heavy selling of stocks. Only toward the end of the decision did the news services recognize their mistakes and send out corrections. Less than an hour elapsed between the erroneous and correct announcements, but it was enough time for the market to plummet. Although it ultimately recovered, the investment companies with private wires in Washington made big profits in the market in the minutes before the general public was aware of the correct decision.

William Hurst, the Treasurer of the New York News Bureau, stated, somewhat defensively, that it was surprising that more mistakes were not made. The decisions are generally read, he said, “in a low or mumbling tone. It is necessary to strain your ears to catch the words, and under the circumstances mistakes in interpreting the meaning are not surprising.” He welcomed the various calls for an investigation that were being made, but no investigation ever occurred, in part because of a belief that the mistake was an “honest” one and in part because “news agencies bow to no authority but their own.”

The error also did not immediately change the procedure by which the Court announced its decision but probably influenced the change.

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42 Stock Prices Down Under False News, Up on Tax Exemption of Stock Dividends; Government Loses $100,000,000 Taxes, N.Y. Times, March 9, 1920, at 1.

43 Id.

44 Explanations Offered for the Error; News Bureau Man Want an Investigation, N.Y. Times, March 9, 1920, at 1.

that ultimately occurred after yet another serious mistake in reporting a lengthy opinion. In 1935, after the Associated Press misreported the opinion in the *Gold Clause Cases*, the bureau chief suggested to the Chief Justice of the Supreme Court that a written copy of the opinion be provided simultaneously with the oral reading of the opinion in order to avoid similar mistakes. The Chief Justice was Charles Evans Hughes who, as the plaintiff’s attorney in *Macomber*, knew well the damage that could occur when the press reported an opinion erroneously. Not surprisingly, he reacted favorably to the suggestion and the new practice was instituted.

Although the financial markets recovered quickly from the initial, incorrect *Macomber* decision, their response to the (correct) decision was more long-term. Immediately after the decision, companies that had refrained from issuing stock dividends while the decision was pending proceeded to declare them. There was also speculation that the decision would increase merger activity, which had also been hindered by fear of taxation.

The government, for its part, was faced with an immediate—and large—loss of revenue due to the necessity of refunding taxes paid in 1917 and 1918 on stock dividends, as well as the possible need for another source of revenue to replace millions lost from taxing future stock dividends. By the day after the decision, the Commissioner of

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47 David L. Grey, *The Supreme Court and the News Media* 37–38 (1968). (Motivated by the Associated Press’s mis-reporting of the opinion in the 1935 *Gold Clause Cases*, the AP bureau chief suggested to a receptive Hughes that once the reading of the opinion started, reporters receive a complete written copy). In 1920, the Justices gave the Clerk’s office two proof copies of each opinion consisting of a master proof, which was sent to the printer, and a copy for the Clerk’s office use. Newsmen and other interested people, such as the parties’ counsel, could inspect this latter copy. Later, some Justices gave the Clerk more proofs, which in turn were given to newsmen or counsel on request. Gradually, more proofs were provided so that by November 1935 (9 months after the *Gold Clause Cases*), there were 21 authorized proofs that were available immediately following the announcement of the opinion. Clerk of Court, Memorandum for the Chief Justice, *Distribution of Proof Copies of Opinions of the Court* (November 22, 1935) found in Papers of Clerk Cropley, Collection of the Supreme Court. My thanks to Matt Hofstedt at the Office of the Curator, Supreme Court of the United States, for discovering this information.

48 See *New Stock Issues May Follow Ruling*, N.Y. Times, March 9, 1920, at 1; infra note 72 and accompanying text (statement of Oldfield).

49 *Id.*

50 *Government Loses $100,000,000 Taxes*, N.Y. Times, March 9, 1920, at 1. The exact amount of tax loss was debated. *See, e.g.*, *Sees Billion Tax Loss*, N.Y. Times, March 10, 1920, at 21. The decision, announced one week before 1919 returns were due, meant that no refunds for 1919 were involved. The *Wall Street Journal* claimed that the $100,000,000
Internal Revenue had already telegraphed tax collectors instructions explaining how taxpayers could claim what was expected to be more than $100 million in refunds.\textsuperscript{54} Subsequently, Secretary of the Treasury David F. Houston, admitting that it was difficult to estimate the amount of revenue loss, stated that the $100 million figure was probably the maximum amount, and a more likely estimate of the loss was less than $25 million.\textsuperscript{52}

The decision, with its emphasis on the separate nature of a corporation, also created concern about future revenue losses arising out of increased tax evasion. Representative Hull, the “author” of the income tax, stated that the decision opened the way to widespread tax evasion since anyone could now form an “artificial” entity and avoid his “fair” share of taxes by keeping the money in the entity while at the same time “avail himself to a large extent of [the stock’s] benefits by mortgaging it, and even get a deduction of his interest paid, and therefore live upon its value without selling it, and of course, without ever paying [the sur-]tax.”\textsuperscript{53} This fear meshed with the belief, held by some, that the decision would result in a greater concentration of wealth.\textsuperscript{54}

Some commentators saw the true importance of Macomber as resting not on the tax consequences of the decision but on its conception of the respective roles of court and legislature. In 1803, Marbury v. Madison had established the Supreme Court’s power of judicial review, but the Court rarely used its powers to invalidate Congressional laws.\textsuperscript{55} When it did, attacks upon the validity or wisdom of the Court’s power of judicial review usually ensued. This was the case following Macomber’s invalidation of the 1916 stock dividend provision. Even tax experts such as Thomas Reed Powell and Professor Charles E. Clark of Yale, who

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  \item amount was vastly overstated, and that the “average estimate” of the refund was only $500,000. The Literary Digest 160, April 17, 1920 (quoting the Wall St. Journal). The Treasury estimated the cost of the decision at $105 million: $35 million for refunds for 1918 and a $70 million decrease in revenue in 1919. The Treasury expected a net loss of less than $25 million, however, because of the assumption that tax would ultimately be collected when the stock dividends were sold. Secretary of the Treasury, Annual Report 36 (1920).
  \item \textsuperscript{51} Must Give Details to Recover Taxes, N.Y. Times, March 10, 1920, at 20.
  \item \textsuperscript{52} 59 Cong. Rec. 4466, 66th Cong., 2nd Sess. (March 17, 1920) (March 1920 letter from Secretary of the Treasury, David F. Houston, to Rep. Joseph W. Fordney, Chairman of the House Committee on Ways and Means).
  \item \textsuperscript{53} Government Loses $100,000,000 Taxes, N.Y. Times, March 9, 1920, at 3.
  \item \textsuperscript{54} See, e.g., T. David Zuckerman, Are Stock Dividends Income? 28 J. Pol. Econ. 591, 599 (1920).
  \item \textsuperscript{55} Marbury v. Madison, 1 Cranch 137 (1803). Charles E. Hughes, the attorney for Mrs. Macomber, wrote in his 1928 history of the Supreme Court that between the adoption of the Constitution and the Civil War only 2 acts were held unconstitutional (those in Marbury and in the Dred Scott case) and only 53 since the Civil War. Charles E. Hughes, The Supreme Court of the United States 88 (1928).
\end{itemize}
believed that the decision was correct from an economic standpoint, felt that the decision was incorrect from a political standpoint. In a *Yale Law Journal* article, Clark stated that the Court’s bias in interpreting a constitutional provision should be in favor of upholding the statute and the judgment of Congress.\(^56\) Other criticism of the Court’s “abuse” of its power was sharper. An anonymous editorial in the *New Republic*, allegedly written by Felix Frankfurter, said “the deeper implications” of *Macomber* “challenge the wisdom of leaving the ultimate law-making power of the nation to nine men. At least they call for a consideration of the safeguards to be imposed upon the extraordinary judicial power of the Supreme Court.”\(^57\) Within weeks, Senator Nelson of Minnesota proposed amending the Sixteenth Amendment to specifically include stock dividends as income.\(^58\) More than a year later, Senator Watson was still complaining that the decision was “a perfectly rotten decision,” and that the Supreme Court had no right to annul a Congressional act.\(^59\)

Some commentators, such as the eminent income tax expert E. R. A. Seligman, believed that the *Macomber* Court’s narrow interpretation of the Sixteenth Amendment and the definition of income would result in a “regrettable tying of the hands of the legislator and an undue curtailment of legislative discretion, with the result of raising many new problems in the place of the single problem which the courts [had] endeavor[ed] to settle.”\(^60\) Seligman was correct. The constitutional aspect of the decision necessitated an activist Court in the tax field that took years to wane. It also created confusion for years in many aspects of income tax law and immediately influenced actions by both Court and Congress in at least several major areas—the taxation of capital gains, the treatment of exchanges of property, and reorganizations. Some of these issues were ultimately resolved (more or less) by the Court and Congress, as with the Court’s broad definition of income under *Glenshaw Glass*\(^61\) and the current, complicated § 305 concerning the taxability of dividends.

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\(^56\) Clark, supra note 41, at 737. See also Thomas Reed Powell, *The Judicial Debate on the Taxability of Stock Dividends as Income*, 5 Bull. of the Nat’l Tax Ass’n, 247, 256 (1920) (“There is much to be said in favor of the political wisdom of Mr. Justice Holmes . . . even though we are quite certain that the . . . economic argument of Mr. Justice Pitney is more meritorious . . .”).


\(^61\) See Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955), and Chapter 1 of *Tax Stories*. 
ty of stock dividends. In the process, the Court retreated from its activist role and seemingly abandoned the constitutional element of realization, but not before it left its indelible mark on the shape and theory of income tax. Even after the Court’s retreat from the constitutional aspect of *Macomber*, its articulation of realization continues to influence not just the actual tax laws but how we think about tax policy.

This section further examines the immediate reactions to the case in 1920 and the following year. It focuses on the constitutional and political influence of *Macomber* before the Court whittled away the constitutional aspect. First, it sets the case in the context of the *Lochner* era and an activist Court. Second, it briefly explains how these constitutional and political concerns shaped both Court and Congressional action in several important areas of the tax law: corporate taxation, capital gains, and exchanges of property.

1. Macomber and the Lochner Court.

*Macomber* is best understood as part of the struggle during the *Lochner* era to define the nature and scope of government. The income tax played a critical function in this struggle because its broad base enables a government to expand its functions and, in theory if not practice, redistribute wealth. In fact, in 1895 *Pollock v. Farmers’ Loan & Trust Co*, commonly called the “Income Tax Case,” was the most criticized of the three cases that inaugurated the *Lochner* era. The *Pollock* Court held the Income Tax Act of 1894, the first peacetime income tax, unconstitutional on the ground that it was a direct tax which had to be apportioned under the Constitution (Article I, section 2, clause 3 and section 9, clause 4). This decision reversed the Court’s expansive view of congressional taxing power—a view that had previously upheld an income tax during the Civil War. It was, however, in keeping with the traditional scholarly view of the Court of this period as one actively protecting economic property rights against both an expanding regulatory state and the populist and progressive principle of wealth redistribution.

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63 *Lochner* v. New York, 198 U.S. 45 (1905), which invalidated a New York law limiting the number of hours bakers could work as a violation of the freedom to contract, typifies this attitude and gave its name to a whole era. The *Lochner* era, however, stretches from the 1890s into at least the mid 1920s. See, e.g., Friedman, supra note 62, at 1391. Today,
The two major criticisms of *Pollock* were typical of the *Lochner* era. The first criticism claimed that the Court’s overruling of a Congressional act was an abuse of judicial discretion, especially since it was a 5–4 decision determined only after a rehearing. The second criticism denounced the decision’s pro-business bias. Commentators and the parties themselves saw the case in *Lochnerian* terms of wealth and property rights, frequently speaking of socialism. Even the Justices viewed the case in this same light. Justice Brown, for example, said in his dissent that “the decision involves nothing less than the surrender of the taxing power to the money class” and might “prove the first step toward the submergence of the liberties of the people in a sordid despotism of wealth.”

After the passage of two decades and a constitutional amendment, Congress enacted another income tax in 1913. In 1916, the Court upheld its constitutionality, but it did so in a manner that left room for an active judicial role in income taxation. Although the Court acknowledged that Congress had “a complete and all-embracing taxing power,” it cautioned that this power was limited by the constitutional requirements of apportionment of direct taxes and uniformity of all other taxes. The Sixteenth Amendment, it clearly stated, gave no new powers to Congress but merely eliminated the requirement to apportion income taxes that were direct; all other direct taxes must still be apportioned. By emphasizing the importance of defining income, the Court thus paved the way for *Macomber*.

The 1920s were generally a time of renewed criticism of an activist, pro-business Court, and *Macomber* gave the critics plenty of opportunity to complain. Once again the Court interpreted the Sixteenth Amendment as granting no new powers to Congress. As a consequence, taxability hinged on whether stock dividends fell within the definition of income. By making that definition a constitutional issue, the Court—in the eyes of many, including the dissent—destroyed the purpose of the Sixteenth Amendment, which was to avoid making these fine decisions. More importantly, the decision put the Court on a collision course with some scholarly re-evaluations of the *Lochner* era argue that the Court was not merely protecting corporate interests but was legitimately following its legal precedents. For a discussion of the *Lochner* era and description of traditional and revisionist views of it, see, for example, Seligman, *supra* note 61, at 1344–46; Friedman, *supra* note 62. Professor Barry Friedman argues, however, that judicial legitimacy is not sufficient to support the legitimacy of the Court and judicial review. There must also be social legitimacy, that is acceptance by the general public. Friedman, *supra* note 62, at 1387.

158 U.S. 601, 695 (1895) (Brown, J., dissenting).
66 *Id.* at 13.
67 *See* Friedman, *supra* note 62, at 1445–47.
Congress. By making the definition of income a constitutional issue, the Court actively inserted itself in the income tax process. Indeed, three months later the Court in *Evans v. Gore* once again interpreted the Sixteenth Amendment narrowly and overruled Congress by holding that Congress had no power to tax the income of federal judges.\(^{68}\) The fact that *Macomber*, like *Pollock*, was yet again a 5–4 decision merely served to heighten the perception that the Court once again abused its power of judicial review. Add in the charges of pro-wealth bias, such as those by Senator Nelson of Minnesota,\(^ {69}\) and it is no wonder that many people thought that *Macomber* was the "*Lochner* of federal income taxation."\(^^{70}\)

Congress, well aware of the decision, expressed its concern—and sometimes outrage—several times during debates of the 1921 Revenue Act. Senator Watson, for example, stated that Congress had the power to annul the *Macomber* decision, but that the Supreme Court had no authority to invalidate a properly enacted act of Congress.\(^{71}\) Representative Oldfield proposed re-enacting the provision taxing stock dividends because *Macomber* allowed great amounts of wealth to avoid taxation. Re-enacting the provision might be worthwhile, he claimed, since *Macomber* had been decided only by a 5–4 majority, and "the court might change."\(^{72}\) In the end, however, Congress did not challenge the Court. The 1921 Revenue Act exempted stock dividends from income because, according to both the House and Senate Committee Reports, the *Macomber* decision required it.\(^{73}\) The controversy, however, did not end. In 1923, for example, Representative Frear asserted that the *Macomber* Court wrongly contradicted the will of the people, as expressed by the passage of the Sixteenth Amendment, and the will of Congress, as expressed in its revenue act. He was particularly outraged because the decision hurt the common man and was made by a 5–4 majority. In order to prevent another judicial overturning of the people’s will, he proposed

\(^{68}\) 253 U.S. 245 (1920). Justices Holmes and Brandeis once again dissented, stating that even if the original Constitution did not permit taxing judges' salaries, such a tax was constitutional under the Sixteenth Amendment since its purpose was to allow the taxation of income from whatever source derived. *Id.* at 267.

\(^{69}\) 61 Cong. Rec. 6473 (1921) (Sen. Nelson). Others pointed out that the wealth could be taxed by means of an undistributed profits tax. *Id.* at 6474 (Sen. Jones of New Mexico).


\(^{71}\) 61 Cong. Rec. 6474 (1921) (Sen. Watson).

\(^{72}\) See also 61 Cong. Rec. 5177 (1921) (Rep. Oldfield listing the companies that had declared stock dividends since the decision).

amending the 1923 revenue bill so that no portion of the act could be held invalid if at least two justices dissented.\textsuperscript{74}

The Court eventually withdrew from the active role in the tax area that \textit{Macomber} necessitated by (apparently) whittling the constitutional aspect of realization down to an administrative concern. In this manner, it ceded to Congress broader discretion to determine what was taxable income. Before this occurred, however, \textit{Macomber} and its constitutional constraint left its indelible imprint on the income tax system. As might be expected, the effect of the constitutional aspects of \textit{Macomber} was felt most strongly by both the Court and the legislature in the first few years following the decision, but the decision consciously affected their actions in tax matters well into the 1930s and beyond. The effect of the decision was magnified because, as discussed later, the constitutional requirement has never been decisively revoked. Just as importantly, early decisions made in the strong light of \textit{Macomber}'s constitutional requirement set the tax laws in directions still felt today.

2. \textit{The Corporate Tax}

One area heavily affected by \textit{Macomber} was corporate taxation. The most immediate consequence of the decision, naturally, was the amendment of the stock dividend provision in 1921 to comply with the decision. The decision had broader implications for the taxation of corporations and shareholders, however, because it involved the question of whether a shareholder could ever be taxed directly on his share of corporate gain. The answer depended on whether the separate nature of the corporate entity must always be respected, which in turn was part of a more basic question about the nature of a corporation. This issue was still a matter of contemporary legal debate, and the \textit{Macomber} decision reflected it. Although corporations had long been separately taxed, it was not entirely clear, from a theoretical standpoint, whether this was because they were considered separate entities or because they were a convenient method of reaching the shareholders’ wealth. The majority opinion in \textit{Macomber} seemed to stress the separate nature of a corporation, stating that the shareholder was not taxable until the corporate profits were separated from the corporation, whose separate identity must be respected. Justice Brandeis’ dissent, in contrast, emphasized that Congress had the power to directly tax the shareholders even on undistributed corporate gain as it had done under the Civil War income tax statute, which the Court had previously upheld.\textsuperscript{75} A closer reading of the majority

\textsuperscript{74} 64 Cong. Rec. 1257 (1923) (Rep. Frear). One year later in the course of a long debate on whether Congress should re-enact the provision taxing stock dividends, he made the same proposal again. 65 Cong. Rec. 2797 (1924) (Rep. Frear).

\textsuperscript{75} Hubbard, 12 Wall. at 1.
opinion, however, shows that even it did not always demand separate taxation. Justice Pitney’s opinion, for example, recognized that the corporate veil could be pierced in certain abusive situations. Moreover, it was arguable that the decision did not prevent taxing shareholders on undistributed corporate profits since the case held that what was being taxed in *Macomber* was not income.

Commentators disagreed about the degree to which the decision required separate corporate taxation, although most agreed that ignoring the corporate entity would be permissible in order to prevent tax evasion.\(^{76}\) Congress, however, either did not agree with this view or was unwilling to risk another direct confrontation with the Court. In its treatment of corporate taxation over the next few decades, it interpreted *Macomber* as requiring separate taxation of corporations. For example, in 1921, it revised the personal holding company provision because of doubts about the constitutionality of the then current law in the light of *Macomber*.\(^{77}\) The prior law had imposed a tax on shareholders when their corporation retained what was deemed an improper amount of profits. The new law, still retained to this day in §§ 531 and 541, levied the tax on the corporation instead of the shareholder because of *Macomber*’s emphasis on the separate existence of the corporation preventing corporate profits from being taxed to the shareholders when still retained in corporate form. Similarly, Congress viewed its ability to tax corporate undistributed profits in the 1930s, a great concern at the time, as greatly constrained by the case.\(^{78}\) If *Macomber* made Congress unwilling to ignore the separate existence of the corporation even when tax evasion was involved, it surely was unwilling to consider more radical schemes to generally disregard the corporate structure so as to tax shareholders on undistributed profits in the same manner that partnerships did. In this manner, *Macomber* helped reinforce the idea of a separate tax on

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\(^{78}\) On Congressional concern about *Macomber*’s affect on the constitutionality of undistributed profits tax in 1936 as well as on provisions to stop tax evasion through the use of corporations, see Griffiths, 318 U.S. at 377, 387 (quoting from the Congressional Record as well as both House and Senate Hearings on the Revenue Act of 1936 such as the House Ways and Means Committee, 74th Cong. 2nd Sess. See 79 Cong. Rec. 193, 734 (the personal holding company tax)); Charles Stuart Lyon, *Old Statutes and New Constitution*, 44 Colum. L. Rev. 599, 609 (1944). Senator Hugo Black, for instance, stated that *Macomber* prevented the taxation of a shareholder on a corporation’s undistributed profits. 80 Cong. Rec. 8813.
corporations and may have hindered the early exploration of integrating the corporate and individual taxes that otherwise might have occurred.\textsuperscript{79}

The remainder of this Part concentrates on just two actions in 1921, one by Congress and one by the Court, that were influenced by \textit{Macomber}. Each decision still profoundly affects the tax law, although the connection between \textit{Macomber} and the tax law may not be obvious today. The first is a judicial action, the Court’s decision upholding the taxation of capital gains. The second is a legislative action, the enactment of provisions deferring the taxation of certain exchanges of property.

3. \textit{Capital Gains Taxation}

In one sense, the \textit{Macomber} decision narrowed the definition of income by requiring realization, but in another, it opened the door for broadening it. In 1920, there was some uncertainty as to whether capital gains were taxable income. \textit{Macomber}, of course, had clearly stated that the mere increase in value of the stock while a taxpayer held it did not create taxable income, nor did the distribution of a stock dividend that left a shareholder’s proportionate interest in the corporation unchanged. But what happened if a shareholder sold the stock for its fair market value of $150 when he had bought it for only $50? Today most people would agree that there would be $100 of income. In 1920, however, others argued, using an older concept of income, that there still would be no income. Under this \textit{res} theory of capital, the entire $150 was still capital because capital consisted of the thing itself (the stock in this instance) whether its value was $10, $50, or $150.

At the time of the \textit{Macomber} decision, whether such gains were constitutionally taxable as income was far from clear. All revenue acts since 1913 stated that income included gains and profits from the sale or dealings with property, and since 1914 the Internal Revenue Bureau had interpreted this provision as applying to gains from the sale of capital assets. In 1919, the Treasury finally issued a regulation to this effect.\textsuperscript{80} In 1920, however, four taxpayers challenged the Internal Revenue Bureau’s taxation of their capital gains. Three of the suits were filed months after the \textit{Macomber} decision, possibly emboldened by the Court’s narrow interpretation of the Sixteenth Amendment and its concomitant narrow definition of income. In the lead case, \textit{Merchants’ Loan & Trust...
Co. v. Smietanka, the Court defined income to include capital gains, ostensibly using the same test of the “common understanding” of the term that it had used in Macomber. In reality, however, both the common and the expert opinions were divided on the issue of whether capital gains were income. The New York Times, for example, proclaimed that increases in the value of capital assets, in accordance with the res theory of capital, were not income but capital, and therefore, “if the Sixteenth Amendment means anything at all it confirms the principle that direct taxes must be apportioned to populations.” This view of the amendment fit comfortably with the Court’s narrow interpretation of the amendment in both Macomber and Evans v. Gore. Others believed, however, that capital gains were income, some even citing Justice Pitney’s statement in Macomber that if and when a shareholder sold the stock dividend, he would be taxable on any (post-Sixteenth Amendment) profits that arose while he held the stock.

The Supreme Court’s position on whether capital gains were legally income, however, was more complicated than Pitney’s statement. In prior cases involving other statutes, the Court had issued contradictory statements. Even in Macomber itself, Justice Pitney both approved a definition including profits from the sale of property in income (as just described) and denied that income included the “enrichment through increase in value of capital investment.” In short, despite the Merchants’ Loan Court’s assurances to the contrary, neither common, economic, nor legal opinion as to the nature of capital gains clearly indicated that they were income. Why, then, with opinion undecided and legal precedent to support such taxation mixed at best, did the Court hold that capital gains were income? Although the answer can never be known definitively, several aspects of the Macomber decision the previous year pointed towards taxability.

First, the concern about judicial activism and the balance of power between court and legislature had not yet abated. Since the statutory and regulatory wording gave the appearance that Congress intended to

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81 255 U.S. 509 (1921).
82 Editorial, Taxation of Capital Gains, N.Y. Times, Feb. 15, 1921, at 8.
83 252 U.S. at 212. See, e.g., Warren, supra note 42, at 899 (lead article in the May 1920 issue stating that capital gains were income). If capital gains were income, then the estimates of revenue loss from the Macomber decision were overstated because eventually the gain would be taxed when realized. See, e.g., Clark, supra note 41, at 738 (“And if, as hereinafter discussed, realized capital gains are taxable, the fears of Justice Brandeis and of Congressmen as to the great loss of revenue to the government are largely groundless.”).
tax capital gains, a Court decision to the contrary would again put the Court and Congress in direct conflict, inflaming opinion even more. Finding taxability would avoid that conflict. As the *Harvard Law Review* warned, shortly after the district court in *Brewster v. Wash* found capital gains taxation unconstitutional, “[t]he attitude of the majority of the court in *Eisner v. Macomber* in riding rough-shod over Congress’ interpretation of the Sixteenth Amendment raised a storm of criticism; a declaration that capital increment cannot be taxed might well be followed by a constitutional amendment recalling the decision.”

Finding taxability would avoid this situation, which had the potential to damage the Court’s reputation and power.

Second, a decision that capital gains were taxable could also signal that the Court was more willing to withdraw from an active role in determining what was income. This would encourage more certainty in the tax law, always a desirable trait since uncertainty tends to drive up the costs of transactions and otherwise generally hinder economic activity. With a less active Court, taxpayers could plan their activities with the assurance that what Congress said was income was indeed income. Moreover, a decision that capital gains were income promoted more certainty than a decision to the contrary. If gains from the sale of capital assets were not income, but those from the sale of business assets were, then there would always be a question of whether the asset were a capital one or not. The British experience of not taxing capital gains had shown how extensive this problem could be.

Third, the *Macomber* decision may have influenced the Court to tax capital gains because of a common view that *Macomber* favored the rich by shielding them from tax even though their wealth had increased. If the gain were taxed on the sale of the stock, then the wealthy would only be allowed to defer their tax liability rather than permanently avoid it. If capital gains were held non-taxable, however, then the wealthy would perpetually avoid taxation. Charges of tax evasion by the wealthy might re-emerge with even greater strength. Additionally, a permanent exclusion of the gain from income would significantly decrease revenues as opposed to merely deferring them. This was particularly problematic in 1921 because the country was in a recession. Consequently, any decision that narrowed the tax base was of great concern, especially in light of both *Macomber*, which had at a minimum delayed revenues, and *Evans v. Gore*, which had further decreased potential revenues by eliminating judicial salaries from the tax base.

The *Macomber* decision thus provided the Court with several reasons to tax capital gains. Since legal precedent for the capital gains decision was indeterminate (or at least conflicting), all the repercussions

of *Macomber* added weight to a decision favoring taxability and deferral to the legislature in defining income. The battleground in the future would not be Congressional power to tax but administrative (Treasury) power to interpret.

4. **Realization, Recognition, and Deferral: Section 1031**

The *Macomber* decision influenced Congressional as well as Court action in 1921. The case was specifically mentioned several times during Congressional debates of the 1921 revenue act, for example, when discussing tax exempt bonds or undistributed profits. Although *Macomber* was not mentioned by name during discussions of an area directly affected by the case, the realization of income on the disposition of property, the decision nonetheless influenced Congressional actions in this area. Congress had been struggling with this topic for several years prior to *Macomber*, but it was not until 1921 that Congress enacted or broadened several provisions that deferred the taxation of gain in numerous exchanges of property. These sections, still in existence today, include current § 1031 (like kind exchanges), § 1033 (involuntary conversions), § 351 (incorporations), and § 368 (corporate reorganizations).

Certainly a variety of factors were involved in the passage of these sections, such as a desire to promote certain economic activity in the face of the 1921 recession and the taxability of capital gains, but realization was a crucial factor as the following short explanation of § 1031 illustrates.

Section 1031 defers taxability of gain or loss when a taxpayer exchanges one piece of property for a property of like kind. Traditional explanations of the section focus on three areas, all of which are central to realization: valuation, liquidity, and continuity of investment. Assume that Ima Investor owns Greenacre and that she transfers it to Trader Vic, who gives her Farmland in exchange. Does Ima have any gain or loss on this exchange since she has withdrawn no money from her investments? If she is to be taxed, how much should she be taxed since valuing the properties (and hence the gain) may be difficult since no cash changed hands? Finally, how will she pay the tax since she received no money? Although Congress had been grappling with these difficult issues for several years prior to *Macomber*, the decision’s constitutional mandate for realization made the resolution of the issue more urgent and set the path for that resolution.

The Court’s discussion of realization in *Macomber* seemed to indicate that in the exchange situation there might be no income to tax because there was no realization. According to *Macomber*, realization

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87 61 Cong. Rec. 6473 (1921) (Sen. Nelson); and 61 Cong. Rec. 5825, 6474, 6487 (1921).
only occurred if the gain were separated from the capital. In analyzing whether separation had occurred in the stock dividend situation, the Court had concluded it had not because Mrs. Macomber had only a “paper gain” since all her investment in the corporation was still in corporate solution and still at risk. Moreover, the Court explicitly stated that the taxpayer, having received no cash in the transaction, would have a liquidity problem if she were required to pay tax. Realization was similarly problematic for a taxpayer who exchanged property. The same factors arguing against realization in *Macomber* were also present when a taxpayer exchanged property for like kind property. Such a taxpayer had a liquidity problem if taxability were imposed because she received no cash.88 Similarly, she also had only a paper gain since her entire investment was still at risk in property that was of “like kind.” Congressional debate on the proposed section showed that, one year after the *Macomber* decision, a great deal of confusion remained as to whether there was a profit—let alone a taxable profit—at this point of exchange.89 Given *Macomber*’s constitutional requirement that realization occur and the confusion over when that happens, a natural, and prudent, Congressional response would be to defer taxability until a time when it is clearer that realization exists. The like kind provision did exactly that.

Although the concept of realization is now more broadly defined than in 1921, § 1031 remains in the Code today in only slightly altered form. Despite its characterization as an exception to the recognition provision of § 1001(c) rather than as a realization issue, its roots lie in realization arguments advanced in *Macomber*. Expansively construed by the Court, the provision acts as a major tax shelter allowing taxpayers to exchange vastly appreciated property without incurring any current taxability. Imagine, for example, a taxpayer who purchased vacant land many years ago for $100,000. It is now worth $600,000, but the taxpayer no longer wants the property. If she sells the land for cash, she will have $500,000 of taxable income. If she exchanges it, however, for an office building worth $600,000, she will have no tax liability. Theoretically, of course, § 1031 preserves the gain for later taxation by giving the new property a basis based on the old exchanged property, so that when the taxpayer sells the new property the gain will be taxed.90 The taxpayer, however, can defer the tax yet again by later exchanging the office building for yet another piece of like kind property. In fact, she can eliminate the tax entirely if she dies holding like kind property so long as

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88 The initial version of § 1031 enacted in 1921 deferred gain even when the taxpayer received some cash in the exchange, but this was corrected in 1924.

89 See, e.g., 64 Cong. Rec. 2854–58 (1923) (Reps. Fordney, Green, and Hawley discussing both current § 1031, not requiring a tax until the “profit” has been obtained by receiving cash, as well as mentioning stock dividends).

90 § 1031(d).
the basis in the property acquires a stepped up basis at death under § 1014. Section 1031, enacted under the spell of Macomber, thus magnifies the benefit of deferral that realization provides—allowing a taxpayer to get richer and richer without paying tax.

The Continuing Importance of Macomber Today

Realization’s benefits stem from its power to defer tax liability until a future date, in other words, the time value of money. Assume that on January 1, 2009, a taxpayer invests $10,000 for 2 years, receives 10% interest, and pays a 30% tax on the investment. If the income is taxed annually, as earned, then the consequences are:

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<tr>
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<th>1/1/09</th>
<th>12/31/09</th>
<th>12/31/10</th>
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<td>$10,000</td>
<td>$10,700</td>
</tr>
<tr>
<td>Profit/year</td>
<td>0</td>
<td>$1,000</td>
<td>$1,070</td>
</tr>
<tr>
<td>Taxable profit</td>
<td>0</td>
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<td>$1,070</td>
</tr>
<tr>
<td>Tax</td>
<td>0</td>
<td>$300</td>
<td>$321</td>
</tr>
<tr>
<td>After-tax return</td>
<td>0</td>
<td>$700</td>
<td>$749</td>
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The bottom line is that the taxpayer has paid a total of $621 in taxes and will have $11,449 in her hands, after taxes, at the end of the 2 years, of which $1,149 is profit.

If, however, the taxpayer will not have to pay any tax until there is realization when the asset is sold on December 31, 2010, then the consequences would be:

<table>
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<tr>
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<th>1/1/09</th>
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<tbody>
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<td>Investment</td>
<td>$10,000</td>
<td>$10,000</td>
<td>$11,000</td>
</tr>
<tr>
<td>Profit/year</td>
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<td>$1,000</td>
<td>$1,100</td>
</tr>
<tr>
<td>Taxable Profit</td>
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<tr>
<td>After-tax return</td>
<td>0</td>
<td>$1,000</td>
<td>$1,470</td>
</tr>
</tbody>
</table>

Under this realization scheme, the taxpayer ends up with $11,470 in her hands after taxes at the end of 2010. Although she pays $9 more in taxes, she still ends up with $21 more profit [$1,470−$1,449] than if she had paid taxes on the income as it accrued. This $21 represents the after tax return on the $300 of tax that she did not have to pay at the end of 2009. Instead, this $300 was available for investment at 10%, which yielded an additional $30 in earnings. These earnings created an additional $9 of tax liability, thus increasing after tax profit by $21.

This deferral of tax liability can be viewed as a one year interest free loan by the government of the $300. In 2009, taxpayer would pay $300
tax, but the government would lend it back to the taxpayer giving her $11,000 to invest in 2010. In 2010, taxpayer would pay $330 tax on the $1,100 of income and also would repay the $300 loan. In sum, the taxpayer would have paid a total tax of $630 and be left, after tax, with $11,470 of which $1,470 was profit.

If, in contrast, the government had loaned the taxpayer the $300 at 10%, she would still have had all $1,000 to invest in 2010 but would also have owed $30 of interest. In sum, the taxpayer would have paid the government $651, consisting of $621 in taxes and $30 in interest payments: 2003 tax of $300 on $1,000 and 2004 tax of $321 on $1,070 income [$1,100–$30 deductible interest] plus $30 interest.

An interest-bearing loan from the government would have left the taxpayer with the same $1,449 of after tax profits ($2,100–$651) as she would have had with a yearly accretion tax. Under the realization system, however, the taxpayer owes the government only $630 tax or $21 less than under the taxable loan analysis. This is equivalent to an interest free loan of 2009 tax since it represents the $30 of foregone interest (minus the $9 of tax on it). The time value of money, in other words, means that the realization requirement favors assets whose gain can be deferred to a later time since the deferral serves to increase the yield on those assets.

As the above example illustrates, the realization requirement makes taxation a two-step process. Under an accretion tax system, in contrast, taxation is a one-step process which depends on the resolution of a single question: Has there been a change in wealth? Taxation in a system that incorporates a realization requirement, however, cannot depend solely on whether a change in wealth has occurred because that increase will have occurred earlier. Realization requires an additional question: Is it time to assign tax consequences to the previous increase or decrease? This second step alleviates some difficulties existing in the one-step, pure accretion model such as liquidity and valuation problems, but it creates new ones.

By deferring tax consequences beyond the point in time when the income (or loss) economically occurs, realization significantly increases complexity, distorts economic behavior, alters wealth distribution, and frequently violates horizontal or vertical equity among taxpayers. Realization affects behavior in several significant ways. It encourages the over-investment in those assets whose gain is deferrable such as land, as opposed to investment in assets such as bonds, where taxability on profits cannot be deferred. The deferral provided by realization is also an incentive for people to hold on to their assets to avoid taxability even if they would otherwise sell them. Since deferral is so desirable, it encourages taxpayers to engage in complicated transactions whose sole or
predominant purpose is to avoid realization. This in turn leads to complexity as Congress and the Service respond to these evasive techniques with new legislation and rulings, which in turn trigger other innovative transactions. Finally, the deferral of realization has equitable consequences. It can create horizontal inequity, for example, when two taxpayers have the same amount of economic gain, but only one has realized gain. It also can lead to a violation of vertical equity and affect wealth distribution since wealthier taxpayers have a greater ability to invest in those assets whose taxable gain can be deferred.

Since taxability depends on realization, identification of those events that qualify as realization events becomes critical to the tax system. This identification is not always easy since the economic gain has occurred earlier, and realization is merely the artificial event that is treated as terminating the economic process. Consider, for example, the XYZ corporation, which was worth $50 in 2007 when you bought 20% of its stock for $10. Assume it earned $5 in 2008 and broke even in 2009. Under an accretion income tax, you would have had $1 of income in 2008 and none in 2009 when you sold the stock for $11. Macomber’s realization requirement, however, results in you having no income in 2008 and $1 of income in 2009 when you sold the stock for $11. Not all realization events are so clear, however. Would realization occur if you transferred your stock in exchange for different stock in the same company? What if you exchanged the stock for stock in another, but similar, corporation? Would it matter if that other stock were easily valued and/or marketable? What if you transferred the stock for a note that merely said that the transferee would pay you $11 in the future? Would your answers differ if you were a cash method taxpayer rather than an accrual taxpayer (that is you only had income when you received cash or the equivalent of cash)? Would you have realization if instead of selling the stock you merely borrowed $11 using the stock as security?

The Court began the process of determining which events constituted realization shortly after deciding the Macomber case in a series of cases involving the distribution of stock as stock dividends and as part of reorganizations. These cases, which inform our treatment of reorganization today, can really be understood only in the context of Macomber.\footnote{ Accord Daniel Q. Posin, \textit{Taxing Corporate Reorganizations: Purging Penelope’s Web}, 133 U. Pa. L. Rev. 1335, 1342 (1985).} In most of the cases, the Court found realization and hence taxability. For example, in 1921 the Court decided \textit{United States v. Phellis},\footnote{257 U.S. 156 (1921). The New Jersey corporation was E. I. du Pont de Nemours Powder Company, and the Delaware corporation was E. I. du Pont de Nemours & Co.} in which a New Jersey corporation reincorporated in Delaware, using some of its assets to redeem the old New Jersey corporation’s bonds and distributing all the new common stock, \textit{pro rata}, to its old common...
stockholders. Justice Pitney, once again writing for the Court, stated that the instant case was unlike the situation in *Macomber* where the taxpayer received nothing she had not had before and therefore had not separated the income from the capital. In *Phellis*, he said, there was clearly a realization or separation of income from the original capital since the two corporations were not substantially identical. Since the taxpayer received “property rights and interests materially different from those incident to ownership of stock in the old company,” the receipt of the stock was a taxable event.\(^93\)

*Phellis* was the first of a very long list of cases in which the Supreme Court loosened the realization concept and more generally expanded the definition of income beyond *Macomber*’s definition of income as “the gain derived from capital or labor, or from both combined.”\(^94\) The broadening of the concept allowed Congress more flexibility in determining the definition of income. More importantly, by apparently abandoning the constitutional aspect of realization, the Court ceded to Congress much of the power in the tax area that it had retained for itself in *Macomber*. Before this abandonment occurred, however, *Macomber* had already helped shape the course of the income tax. Even after the alleged abandonment, the case continued to influence the law by serving as a point of reference, even if it was not mentioned directly. The cases that do specifically mention *Macomber*, however, together make up a large part of any basic income tax casebook. The long list includes *Bowers v. Kerbaugh–Empire*,\(^95\) *Helvering v. Bruun*,\(^96\) *Commissioner v. Glenshaw Glass*,\(^97\) and most recently, *Cottage Savings and Loan Ass’n v Commissioner*,\(^98\) decided in 1991.

Given the importance of the downgrading of realization from constitutional mandate to administrative convenience, it is surprising that there is no clear moment at which realization lost its constitutional status. Indeed, at least one current commentator believes that this status has never been lost.\(^99\) Nevertheless, many commentators, follow-

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\(^93\) Id. at 173. Other cases further broadened the definition of realization as each opinion elaborated yet another set of facts in which the severing of gain from capital occurred. See, *e.g.*, *Marr v. United States*, 268 U.S. 536 (1925); and *Cullinan v. Walker*, 262 U.S. 134 (1923).

\(^94\) 252 U.S. at 207.

\(^95\) 271 U.S. 170 (1926); *Burnet v. Sanford and Brooks Co.*, 282 U.S. 359 (1931).

\(^96\) 309 U.S. 461 (1940).

\(^97\) 348 U.S. 426 (1955).


\(^99\) Ordower, *supra* note 3.
ing the lead of Stanley Surrey, view the 1940 case of Helvering v. Bruun as the critical point.\textsuperscript{100}

In Bruun, the taxpayer leased land to a tenant who demolished an existing building on the land and erected a new one with a useful life less than the term of the lease. In 1933, the tenant defaulted, and Mr. Bruun repossessed the land, thereby gaining possession of the new building. The government and the taxpayer agreed that at the time of repossession the net fair value of the new building (gross value of the new building minus value of the demolished old building) was approximately $50,000. The question was not whether there was any gain but whether Bruun’s repossession of the land caused realization (and hence income taxation) of that gain to occur.

Realization could occur at several points: in 1915, when the lease was signed; in 1929, when the new building was erected, or in 1933, when Mr. Bruun gained possession. According to the Haig–Simons accretion conception of income, under which increases in value are income when they occur, Mr. Bruun would have income in 1915 in the amount of the present value of the lease payments. Under a realization concept requiring separation of income from capital, Mr. Bruun had no income in either 1915, when he signed the lease, or in 1929, when the building was erected. Even under a broader definition of the concept than expressed in Macomber, neither event would trigger realization. Mr. Bruun still owned the building after the signing of the lease and the erection of the building added no value for him. Since its useful life was less than the lease term, Mr. Bruun would have nothing new at the expected time of repossession.

The taxpayer in Bruun argued that there was no realization in 1933 when he gained possession since the improvement could not be separated from the land. The economic gain arising upon repossession is not income under the Sixteenth Amendment, he argued, until he disposed of the asset. The Court disagreed. In a brief opinion stating that gain need not be severed from the capital for there to be income under the Sixteenth Amendment, he argued, until he disposed of the asset. The Court disagreed. In a brief opinion stating that gain need not be severed from the capital for there to be income under the Sixteenth Amendment, the Court stated that Macomber did not control because the language in that opinion regarding separation was not meant to be an all-inclusive definition. It was meant only to “clarify” the stock dividend situation by distinguishing between an ordinary dividend and a stock dividend. Although the Court confirmed “that economic gain is not always taxable as income,” the Court stated that realization could occur without severing the improvement from the original capital as in the exchange of property.\textsuperscript{101} Consequently, the Court held that the owner

\textsuperscript{100} Stanley Surrey, The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions, 35 Ill. L. Rev. 779, 783 (1941) (taxing the improvement without severing it from the original property is “a complete denial” of the Macomber doctrine).

\textsuperscript{101} 309 U.S. at 469. Notice that the Court states that the exchange of property is a realization, but back in 1921, when § 1031 was enacted that was not so clear.
was taxable on the building’s value (minus amortization costs) in 1933 when he came into possession of the land despite the fact that the landlord sold neither the building nor the land. Two years after the *Bruun* decision, Congress overruled it by enacting §§ 109 and 1019 so that the lessor had income only upon the disposition of the property. Just because Congress had the power to tax, it did not have to exercise it to its full extent.

*Bruun* greatly broadened the meaning of realization but technically did not change its constitutional status, even though such experts as Stanley Surrey believed it did. Ten days later, however, in *Helvering v. Horst*, the Court appeared to demote the concept to one of mere administrative convenience. *Horst* involved a taxpayer who gave his son the coupons on a bond he owned but retained the principal for himself. The primary question in the case was who should be taxed on the bond income, the donor father or the donee son. This is an assignment of income issue rather than a timing issue of when income should be taxed. The Court, however, justified its conclusion that the donor was taxable on the interest in terms of the realization concept. The donor was the proper person to tax, the Court stated, because even though he personally never received the income, realization occurred when he exercised his control over the income by gifting the coupons to his son and thereby separating the income from the capital. Realization, it said without further comment, was a rule “founded on administrative convenience,” meant only to delay taxation until “the final event of enjoyment of the income.”

Although *Horst* clearly stated that realization was merely an administrative concern, it did not elaborate, offering neither precedent nor any

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102 Although *Bruun* changed the immediate tax consequences, the end result in terms of the amount of gain ordinarily will be the same. Assume the building is worth $100,000 when the landlord comes into possession, and he holds it for its entire useful life and rents it out for $12,000 per year. Under *Bruun*, if the landowner is taxed immediately on that amount when he comes into possession, he presumably then has $100,000 of depreciation to offset against the rental income. Under § 109, the owner is not immediately taxed but will have no depreciation to offset the rental income since his basis in the building under § 1019 is zero. The amount of tax liability, however, may differ under the two situations because the *Bruun* rule bunched the income, which potentially moved the taxpayer up into a higher tax bracket. Additionally, the amount of tax would depend on the character of the gain, which might be capital, instead of ordinary, if the taxpayer sold the building rather than retained it and rented it out.

103 311 U.S. 112 (1940).

104 *Id.* at 116. The next question is when does the realization occur—when the gift is given or when the interest coupon comes due? The Court in *Horst* was not clear on this issue, perhaps because the coupon matured the same year as the gift. The timing, however, could be significant if coupons for several years were gifted. The Service and courts, however, have held that the realization does not occur at the time of the gift but rather occurs only when the donee actually receives the money. See, e.g., Rev. Rul. 69–102, 1969–1 C.B. 32; S. M. Friedman v. Commissioner, 41 T.C. 428, 436, aff’d, 346 F.2d 506 (6th Cir.1965).
rationale for this demotion. Many people, however, believed it was more than time to plainly overrule *Macomber*, especially many New Dealers who saw a reversal of the case as an opportunity to also “lay a wreath on the memory of Mr. Justice Brandeis,” who had written a powerful dissent in *Macomber*. Three years after *Horst*, the Court had the ideal opportunity to do so in *Helvering v. Griffiths*, which involved a *pro rata* distribution of common stock to common stock shareholders, the exact situation in *Macomber*. Despite *Horst*’s seemingly clear statements about mere administrative convenience, and the government’s urgings, the Court refused to directly overrule *Macomber*.

The statute involved in *Griffiths*, written originally in 1936 with *Macomber*’s constitutional limitations in mind, stated that a stock dividend “shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution.” The government argued that the provision’s legislative history and the administrative regulations under it provided the Court with the mechanism to overrule the *Macomber* decision because they indicated Congress’ intent to challenge the constitutional validity of the decision. The Court recognized that “the question of the constitutional validity of *Eisner v. Macomber* is plainly one of the first magnitude.” Moreover, it acknowledged that both *Bruun* and *Horst* had “undermined further the original theoretical bases of the decision in *Eisner v. Macomber*.”

The Court nevertheless declined to decide the constitutional issue on the grounds that it was not properly before the Court. After extensively examining the legislative history of the statute as well as that of the undistributed profits tax, the Court found no conclusive evidence of Congressional intent to challenge *Macomber*. Moreover, and probably more importantly to Justice Jackson who wrote the opinion, to retroactively overrule the statute would “unsettle tax administration and subject the Treasury itself to many demands in ways that we cannot anticipate and provide for” as well as

105 Stark, *supra* note 70, at 214 (quoting a March 27, 1943 letter from Roswell Magill to Robert Jackson).

106 318 U.S. 371 (1943). Stock dividends in two companion cases decided shortly thereafter were also held non-taxable. *Helvering v. Sprouse* and *Strassburger v. Commissioner*, 318 U.S. 604 (1943). *Sprouse* involved a *pro rata* distribution of nonvoting common stock to the holders of the outstanding voting and nonvoting common stock whereas *Strassburger* involved a *pro rata* distribution of nonvoting preferred stock on the voting common of its sole shareholder. Stark, *supra* note 70, at 217–19, discusses the cases in the context of *Griffiths*.


108 318 U.S. at 394.

109 *Id.*
create unfairness to taxpayers who had executed transactions based on what appeared to be clear law.\textsuperscript{110}

While the majority decision focused on administrative concerns as a reason not to overrule its prior decision, Justice Douglas’s dissent, joined by Justices Black and Murphy, concentrated on constitutional issues. It was time—past time—to overrule \textit{Macomber}. Quoting Justice Brandeis’ dissent in \textit{Macomber}, Justice Douglas stated that stock dividends were taxable as income under the Sixteenth Amendment, which granted Congress the power to tax as income “everything which by reasonable understanding can fairly be regarded as income,” including stock dividends.\textsuperscript{111} Under this broad interpretation of the Sixteenth Amendment, Congress had the power to determine what was income. It legitimately exercised this power when it imposed a tax on stock dividends.

Ironically, the majority’s refusal to deal directly with the constitutional aspect of \textit{Macomber} created many of the administrative difficulties that the Court sought to avoid by not overruling the case. Its failure to explicitly consider the issue meant that the scope of realization’s constitutional validity remained unresolved. This lack of resolution of the status of realization continued to worry Congress. In 1962, for example, Congress enacted provisions taxing United States shareholders on certain undistributed profits of their controlled foreign corporations, but the members of both the House Ways and Means and the Senate Finance Committees were concerned that the provision violated \textit{Macomber’s} constitutional realization requirement.\textsuperscript{112} The constitutionality of taxing unrealized gains arose again in 1963 when President Kennedy proposed taxing unrealized gain at death. The question was still large enough that Treasury Secretary Dillon felt it necessary to submit a legal opinion on the issue. The opinion concluded that that there was “every probability” that the Supreme Court would uphold the constitutionality of taxing...

\textsuperscript{110} Id. at 403. See Lyon, supra note 78, at 610–11 (stating that the majority placed stability of statutory interpretation above proper tax policy especially since the decision had been so widely relied upon).

\textsuperscript{111} 318 U.S. at 409.

\textsuperscript{112} See, e.g., S. Rep. No. 1881–87, at page 382–87 (1962) reprinted in 1962 USCCAN 3683–84; and H.R. Rep. 1447–87, at B–21 (both in Ordower, supra note 3, at 22). The court in Garlock Inc. v. Commissioner, 489 F.2d 197, 203 n. 5 (2d Cir. 1973), cert. denied, 417 U.S. 911 (1974), stated that “whatever may be the continuing validity of the doctrine of \textit{Eisner} v. \textit{Macomber}, it does not apply to the facts.” See also Estate of Whitlock v. Commissioner, 59 T.C. 490, 506–10 (1972), aff’d in part and rev’d in part, 494 F.2d 1297 (10th Cir.), cert. denied, 419 U.S. 839 (1974). \textit{Whitlock} distinguished \textit{Macomber} on the grounds that the corporate earnings taxed in the controlled foreign corporation situation were current as opposed to accumulated ones in \textit{Macomber} (a point noted by Powell back in 1920), and that in the CFC situation, the shareholder had the power to force distribution, which arguably implied some type of evasion situation (again a situation that both Powell and Ballantine had said \textit{Macomber} would allow, piercing the corporate identity).
unrealized appreciation, but others disagreed. The noted tax expert Roswell Magill, for example, believed that the Supreme Court “might very well conclude that it is unconstitutional.” Although there were other reasons for defeating the proposal, uncertainty about its constitutionality certainly increased the odds that it would be defeated.

The Supreme Court’s most recent pronouncement on realization reiterates that realization is only an administrative requirement but once again does not expressly overrule *Macomber*. In the 1991 case of *Cottage Savings Ass’n v. Commissioner*, the taxpayer, like most other savings and loan associations in the 1970s, held many long-term mortgages from which it received relatively low rates of income. Since current interest rates had increased, the value of these mortgages had decreased. Moreover, Cottage Savings was in the economically untenable position of having to pay interest to its current depositors and certificate holders at rates higher than it was earning on its mortgage loans. Disposing of the loans would ameliorate its financial situation because the taxable loss on disposition (due to the mortgages' decreased value) would enable it to take a tax deduction (and receive an income tax refund). It was reluctant to dispose of the mortgages, however, because Federal Home Loan Bank Board (“FHLBB”) regulations required it to report any taxable losses. The reported losses would lower its net worth, which in turn would place it at risk of foreclosure. In response to this situation (and to avoid the political consequences of throwing so many S & Ls into bankruptcy), the FHLBB altered its regulations so that lenders could exchange loans without reporting them for regulatory purposes so long as the loans were “substantially identical”. In 1980, Cottage Savings exchanged its loans for similar ones from another S & L. It did not report the loss for regulatory purposes but claimed a loss for tax purposes under § 165. The Service claimed the loss could not be recognized for tax purposes because the similarity of the exchanged loans meant that there was no realization.

Although the Court raised the issue of the constitutional status of the realization requirement, it did not discuss it. Rather, it simply stated that it “recognized” that realization was an administrative concept designed to avoid the administratively difficult task of valuing assets annually. As authority, it simply cited Horst’s brief reference to realization being “founded on administrative convenience.” Once again, the Court failed to explicitly overrule the constitutional necessity of realization established in *Macomber*. Instead, it accepted the concept as a valid
administrative requirement and focused its attention on defining the scope of the regulatory rule.

The Court recognized that realization was not specifically defined in the statute but was contained in § 1001(a), which states that gain or loss is realized on the disposition of property. However, Treas. Reg. § 1.1001–1 elaborates by providing that realization occurs when, among other things, property is exchanged for other property “differing materially either in kind or in extent.” The Court accepted the regulation as a reasonable interpretation of the statute since it was first adopted in 1934 and had remained substantially unchanged through several reenactments of the statute. The Court admitted, however, that determining what constituted a “material difference” was “a more complicated question.”

In answering the question, the Court looked to the early cases, including Macomber itself, and focused on a string of early reorganization cases beginning with Phellis that turned on this issue (although the regulation then used the phrase “essentially different”). These cases indicated that not all exchanges were realization events, although they did not unambiguously define the factors that prevented realization.

The Court indicated that the last of these reorganization cases, Marr v. United States, seemed to articulate the key issue in determining whether realization occurred: did the reorganization cause the taxpayer to acquire any legal rights in the new corporation that were different from those in the old corporation? In Marr, General Motors of New Jersey reincorporated in Delaware, transferring all its assets to the new corporation. The Court held that the taxpayer realized gain when he exchanged all his shares in the old General Motors for shares in the new General Motors because the new corporation had different rights and powers under Delaware law than the old corporation had under New Jersey law. Consequently, the new stock was “essentially different” from the old stock even though the corporations had identical assets, and the shareholder had proportionate interest in both corporations.

115 499 U.S. at 561. This is the re-enactment rule. The 1934 regulation, Treas. Reg. No. 86, Art. 111–1 (1934), is a variation of the 1919 regulation holding that realization occurred when the property received was “essentially different” from the one disposed of. Treas. Reg. No. 45, Art. 1563, 21 Treas. Dec. Int. Rev. 170, 392 (1919) (under § 202(b)).

116 499 U.S. at 562.

117 268 U.S. 536 (1925).

118 Id. at 541. In Weiss v. Stearn, 265 U.S. 242 (1924), decided one year previously, the Court held there was no realization in the only case involving two corporations organized in the same state. Justice McReynolds, the author of that opinion, noted in his separate Marr opinion, however, that the decision was based on receiving a different interest, not on the “relatively unimportant circumstance that the new and old corporations were organized under the laws of the same State.” Loren D. Prescott, Jr., Cottage Savings
In *Cottage Savings*, the government offered an alternative to the *Marr* test, which focused on legal entitlements. Its economic substance test considered all economically relevant facts including "the attitudes of the parties, the evaluation of the interests by the secondary mortgage market, and the views of the FHLBB." The government argued that under this test there was no realization.

The Court, however, adopted the legal entitlement test articulated decades ago in the shadow of *Macomber*. It held that there was realization under a legal entitlement test because the exchanged loans had different debtors and different homes securing them. In so ruling, the majority ignored the similarity of the swapped loans’ interest rates and their similar maturity lengths as well as the fact that the FHLBB considered the loans substantially identical for accounting purposes. Justice Blackmun, dissenting, commented that such an interpretation of a material difference contradicted "common sense."  

The Court’s holding that realization occurred when formal legal entitlements changed allowed the taxpayer to deduct its loss. In the short run, the Service estimated that this loss, together with 96 similar pending cases, involved $419 million of taxes. More importantly, by emphasizing legal rights as critical to realization rather than economic substance, the Court helped preserve tax shelters by allowing taxpayers to manipulate situations so that they could realize losses but not gains without changing their economic position. In 1929, Professor Rottschaefer had stated "the crucial question" was to determine "what differences justify the conclusion that interests are essentially different [the phrase then used instead of materially different]." More than 60 years later, *Cottage Savings* showed that the question is still with us and is still crucial.

**Conclusion**

Realization has been called the “Achilles heel” of the income tax system because it creates so much uncertainty and complexity in the tax

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119 499 U.S. at 562.

120 499 U.S. at 570.


122 Henry Rottschaefer, *The Concept of Income in Federal Taxation*, 13 Minn. L. Rev. 637, 651 (1920) (analyzing the stock dividend and reorganization cases in the 1920s and the significance of realization).
Although it does have the advantage of decreasing both liquidity and valuation problems that arise under a pure accretion model of taxation, these advantages may be overstated and its disadvantages are numerous. Its benefits are exaggerated, according to some commentators, because many assets, in fact, are easily valued and liquidity problems, to the extent they exist, can be ameliorated by such techniques as deferred payments with interest. The disadvantages of realization, on the other hand, are monumental. Deferring the taxation of income beyond the point in time that the income (or loss) economically occurs significantly increases complexity, distorts economic behavior, alters wealth distribution, and frequently violates horizontal or vertical equity among taxpayers.

Despite these substantial negative aspects of realization, the concept is a central part of the United States’ income tax system. Macomber did not create the concept; it existed prior to the case and for practical administrative reasons would probably have continued to develop. What Macomber did do, however, was significantly influence the development of the concept and related areas of the law, including embedding it more deeply in the system than might otherwise have occurred. This influence has been profound not just because of the content of the decision but also because of its timing.

Major decisions made when any new enterprise is established set a tone and structure that influence future decisions. This is as true for a new legal structure as it is for a new business. Fluidity that exists at the start becomes hardened into routines that are hard to break. As time goes by, people automatically think a certain way about conceptual problems, and a whole body of procedure (administrative and judicial in the case of law) develops that encourages continuing in such well-known patterns. Inertia sets in politically as well. Even if people are indifferent between option A and option B before one of the two options is selected, they may be unwilling to switch to option A after option B has been chosen and in force for some time. They may have altered their thoughts and actions to accommodate option B and now have a vested interest in maintaining that option for financial, psychological, or other reasons. And they are willing to spend time and money to maintain that option. The delivery of health insurance via one’s employer is one example of how a decision made in the infancy of group health insurance has so

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124 Professor David Shakow, for example, states that data indicates that liquidity is not as big a problem as believed. David Shakow, supra note 3, at 1167–76. Professor James Repetti, in contrast, argues that valuations for an annual acretions tax would present difficult valuation and liquidity issues as well as erode the tax base because taxpayers would have strong economic motives to minimize those values. James R. Repetti, Commentary, It’s All About Valuation, 53 Tax L. Rev. 607 (2000) (discussing an annual wealth tax).
shaped institutions, thinking, and practice, that change becomes nearly impossible (as the Clinton debacle on health care illustrated).

In the income tax area, *Eisner v. Macomber* is one of those early choices that shaped future development of the tax law. The content of the decision as well as the context in which it occurred heightened its immediate impact. The holding that realization was a constitutional aspect of income was the most dominant aspect of the opinion, especially given the contemporary concerns about judicial review and the respective roles of the Court and Congress generally. Within that perspective, the Court’s mixed view on the theory of income and the nature of a corporation took on extra meaning and affected legislative and judicial actions in the formative years of the development of the tax system. The uncertainty about both the necessity of the constitutional constraint and about the determination of when realization occurs continued for years, and to some degree still continues. In this way, *Macomber* has left its imprint on at least five important areas of taxation.

First, the case is a major reason for the continued general reliance on realization despite realization’s many disadvantages. Although Congress has eliminated the requirement in certain limited areas where valuation is easy such as §§ 1256, 467, 475, 817A, 1296, and the original discount rules, broader proposals to switch to an accretion system have not met—and most likely will not meet—with success. *Macomber* plays a large role in this failure. By ingraining the principle of realization so early and so deeply into the fabric of the tax system, it reinforced political, popular, and institutional inertia against its elimination. Moreover, the Court’s failure to decisively overrule the constitutional aspect of realization makes such a change even more unlikely because it creates uncertainty, however small, as to whether Congress has the power to make such a radical change.

Second, the initial constitutional necessity for realization and uncertainty about when it occurs helped establish important deferral sections that still exist today, including the large real tax shelter created by § 1031. Third, the Court’s decision to uphold the taxation of capital gains was influenced by the virulent reaction to the *Macomber* case the previous year. Fourth, by stressing the separation of corporation and individual taxpayer, *Macomber* may have delayed early explorations of integrating the corporate tax with individual tax. Finally, the realization concept in general encourages, at a minimum, a hybrid income/consumption tax because it provides a rationale for the many consumption aspects of the income tax. The language of *Macomber* further encouraged this thinking for years with its conflicting discussion of whether accretions to capital were income. Although there may be policy reasons for consumption treatment such as to encourage savings, a system that is
neither fish nor fowl can exacerbate complexity, theoretical inconsistencies, and practical inequities.

A serious reevaluation of the realization concept ultimately leads to the question of the proper tax base. The need for realization means that all increases in wealth will not be immediately taxed. Depending on the definition of realization, the moment of taxation can be manipulated—either pulled closer to immediate taxation or pushed farther and farther back. Logically, once the idea that some change in the relationship with the asset is required, there is nothing to stop pushing back the point of taxation until the ultimate change in that relation: the consumption of the asset. Thus the logic of realization exerts pressure to change the basis of taxation from income to consumption. This is especially true when one of the foundational bases for the requirement enunciated in Macomber and still given today is that gains remaining in the investment are merely “paper gains.” Whereas the other two major rationales for realization—problems of liquidity and valuation—are based on administrative convenience, this more theoretical justification at heart questions the existence of income. If there is no income so long as money is still at risk, then the proper basis of taxation would be consumption since it is only at that time that the money is no longer at risk.

Macomber is an old case. Its definition of income with its constitutional aspect has long since been weakened if not totally eviscerated. For this reason, some commentators claim it is now only an historical curiosity that should be relegated to the footnotes of a casebook. Mark Twain once said that reports of his death had been greatly exaggerated. As this chapter has shown, the same may be said of Macomber. Even if the case is truly dead, however, its restless ghost still walks.