

Chapter 2: The Story of *Eisner v. Macomber*: The Continuing Role of “Realization” in
Tax Law and Policy
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Eisner v. Macomber [252 U.S. 189 (1920)], which held that dividends in the form of stock were not taxable income, is one of those “old chestnut” cases familiar to every tax expert, and even most tax students. Unlike most tax cases, however, the decision dominated the New York Times’ front page, created an instantaneous political furor, and even today still exerts a powerful influence on major aspects of the U.S. income tax system. The key to its immediate and continuing importance lies in its constitutionally framed explication of the concept of realization, or the requirement that income taxation cannot occur until there has been some change in the relation of the income to its capital, most commonly separation. Occurring in the formative years of the income tax, the case has indelibly marked it, not just in shaping the concept of realization, but also in other major areas.

This chapter begins with a description of *Macomber* and the immediate reactions to the case, including the political furor about judicial review engendered by the Court’s ruling that the 1916 provision taxing stock dividends was beyond Congress’ constitutional power to tax. It then describes how the existence of the constitutional requirement of realization, the uncertainty of its meaning, and congressional concern about judicial review immediately affected both judicial and legislative actions in several significant tax areas. It proceeds with a description of *Macomber*’s effect on the development of the realization concept. It concludes that since the logic of realization as described in *Eisner v. Macomber* leads to a consumption tax, the case was a strong motivation and support for the many consumption tax provisions within the income tax.

Macomber immediately affected at least four major areas of taxation in ways that continue to this day. First, by stressing the separation of the corporation from the individual shareholders, the *Macomber* decision delayed early explorations of integrating the corporate tax with individual tax due to congressional belief that realization required separate taxation of corporations. This is evidenced by several provisions Congress enacted such as its 1921 revision of the personal holding company provision so as to impose the tax on the corporation rather than the shareholder.

Second, legislative history indicates that the constitutional necessity for realization was instrumental in the enactment in 1921 of provisions that defer taxation on the exchange of property, such as §1031 which defers taxability when one piece of property is exchanged for a like kind piece. Congressional debate involved the same factors that the Court had mentioned in *Macomber*: the existence of only ‘paper gains’ and the liquidity problem if the taxpayer were forced to pay tax on an exchange that had produced no cash. Given *Macomber*’s constitutional requirement that realization occur, Congress’ confusion as to when realization occurred and the dismay caused when *Macomber* overruled it, a natural

and cautious congressional response would be to defer taxability until such a time that realization clearly existed. The like kind provision did exactly that.

Third, *Macomber* helped influence the Supreme Court's decision to uphold the taxability of capital gains the following year. At that time (1921), legal opinion as to the taxability of capital gains was divided and even the Court's own precedents were contradictory. Given the indeterminacy of the law, political and economic ramifications of *Macomber* may have persuaded the Supreme Court to find capital gains taxable for several reasons. Most notably, a decision taxing capital gains would help quiet two criticisms of the Court that arose from the *Macomber* decision and threatened its authority. First, the decision stirred up old concerns about judicial review and the balance between Court and legislature. Many people believed that a decision that capital gains were not income would again put the Court in direct conflict with Congress and fan the anti-Court sentiment engendered by *Macomber*. Second, many believed that a decision not to tax capital gains would further damage the Court's reputation because it would exacerbate the perception, engendered by *Macomber*, that the Court favored the rich by shielding them from tax even though their wealth had increased. In contrast, a decision taxing capital gains not only calmed criticism of the Court but also helped maintain the revenue base that *Macomber* had threatened. If capital gains were not taxed, the revenue deferred by *Macomber's* realization requirement would never be collected. Taxing capital gains ensured that the government would ultimately collect the tax deferred by realization when the asset was sold.

The fourth, and most obvious, area of taxation that *Macomber* immediately influenced was the realization requirement. Although the concept pre-dated the case and arose out of administrative concerns, the constitutional formulation given to it by the Court guaranteed that realization became an essential part of the income tax system. The Court eventually expanded its definition of realization and apparently downgraded the requirement from constitutional mandate to administrative convenience, but realization still remains the general rule. Although Congress has eliminated the requirement in certain limited areas where valuation is easy, such as section 1256, marking certain contracts to market, and the original issue discount rules, proposals to switch to a broader accretion system have not met—and most likely will not meet—with success. *Macomber* plays a large role in this failure. By engraining 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.

This deep-seated commitment to the realization concept helps explain the many consumption tax provisions that exist in the current income tax. The realization concept itself generally supports a consumption tax, as opposed to an income tax, because it 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. The specific language of *Macomber* further encourages this, with its conflicting discussion of whether accretions to capital were income. This is especially true since 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 questions the existence of income and the wisdom of using income as the tax base. 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.

Some commentators believe *Eisner v Macomber* is now only an historical curiosity that should be relegated to the footnotes of a casebook. In support of their position they claim its holding that realization is constitutionally mandated has long since been weakened, if not totally eviscerated. Their statement overlooks, however, the many ways in which the case shaped and continues to shape the income tax laws. Consequently, the reports of *Macomber's* demise are, as Mark Twain once said of reports of his own death, greatly exaggerated.