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In this installment of U.S. Tax Review, the authors review recent court cases on IRS summons, cryptocurrency, and the deductibility of patent defense costs, as well as a new IRS crackdown on inflated COGS.

Summons Cases

The IRS won two summons cases, one in the U.S. Court of Appeals for the Ninth Circuit and the other in the U.S. District Court for the Northern District of California, but the summons approved by the district court was narrower than the IRS wanted.

In *Agrama*,[1] the Ninth Circuit affirmed a district court denial of a request for an evidentiary hearing and enforced an IRS summons against Frank Agrama for certain records, including records related to his prosecution for tax crimes in Italy.

Agrama argued that the summons was issued in bad faith and that, at a minimum, the district court erred by ordering enforcement of the summons without an evidentiary hearing.

In an unpublished opinion, the Ninth Circuit held that the district court did not clearly err by enforcing the summons, nor did it abuse its discretion by denying Agrama an evidentiary hearing. To enforce an IRS summons, the government must make a prima facie showing that the summons was issued in good faith by showing that:

- the summons is for a legitimate purpose;
- the information sought may be relevant to that purpose;
- the information sought is not already within the IRS's possession; and
- the administrative steps required by the IRC have been followed (the *Powell* factors).[2]

If the government meets its burden, the taxpayer challenging the summons then has the heavy burden of proving either a lack of institutional good faith or an abuse of process.[3] A taxpayer challenging a summons is entitled to an evidentiary hearing only when there are specific facts or circumstances plausibly raising an inference of bad faith.

[1] *United States v. Jehan Agrama*, No. 22-55447.

[2] *United States v. Powell*, 379 U.S. 48, 57-58 (1964).

[3] *United States v. LaSalle National Bank*, 437 U.S. 298, 316 (1978).

The court stated that Agrama offered no evidence to prove — or even to raise a plausible inference — that the IRS summons was motivated by anything other than a desire to ensure that the IRS had accurate and complete copies of anything it obtained from other sources.

In the U.S. District Court for the Northern District of California case, on July 30 the court granted the government's February petition to enforce an IRS summons against Kraken.[4] The summons at issue is similar to the summons enforced by the same district court in 2017 against Coinbase. Kraken is a centralized cryptocurrency exchange founded in 2011 that offers its exchange and related services to users in more than 190 countries, including the United States.

The summons sought information about activities of various users of the Kraken platform, including the user's identity (name, date of birth, taxpayer identification number, physical address, telephone number, and email address), use and access of the platform (including, among other things, payment cards, IP addresses, and other similar information), and information about the transactions in which they engaged (including the full transaction history and cryptographic records and ledgers relating to the transactions).

Kraken alleged the summons was overbroad and would impose too heavy a compliance burden. Kraken argued that the summons was significantly broader than the summons that the IRS issued to Coinbase, which was limited by a judge.[5] The government argued that the limitations on the Coinbase summons were excessive.

Applying the *Powell* factors (specifically, whether the Kraken summons served a legitimate purpose and sought relevant information), the district court limited the summons to identifying information and certain transaction history. The court found that certain information requested by the government, including an individual user's employment, net worth, and source of wealth, as well as anti-money-laundering logs and records, was outside the proper scope of a summons at this stage in the IRS investigation. As the district court stated:

> While this information might shed light on a tax violation by an account holder, at this stage of the Government's investigation, it is only speculating on that point. To move beyond speculation, it must first address whether there is anything in the user's transaction history — whether considered on its own or in combination with other information the IRS has collected on that user after it has identified the account holder — that makes it reasonable to conclude that the information it seeks in these requests will actually yield information relevant to that user's tax compliance. At that point, the Government can issue another Doe summons or follow the preferable path of issuing a summons to the account holder.[6]

The Coinbase and Kraken cases show that district courts continue to apply a significant, substantive review of the broad John Doe summonses that are, and have been, issued to centralized cryptocurrency exchanges. Here, the district court required the government to demonstrate that it is legitimately seeking relevant information before enforcement, and the court narrowed the summons. Importantly, however, the court allowed transaction hashes and blockchain addresses to be included within the summons based on the government's evidence showing it needed this information to analyze transactions for tax compliance purposes.

Constitutionality of Section 958(b)(4) Repeal

On August 2 the Justice Department filed an answer in *Altria* regarding the constitutionality of the repeal of the limitation on downward attribution in section 958(b)(4).

Altria's complaint, filed in May in the U.S. District Court for the Eastern District of Virginia,[7] seeks a refund of $105 million in taxes for its 2017 tax year. Altria owned slightly more than 10 percent by vote and value of Anheuser-Busch

[4] *United States v. Payward Ventures Inc.*, No. 23-mc-80029-JCS (N.D. Cal. July 30, 2023).

[5] *United States v. Coinbase Inc.*, No. 17-cv-01431-JSC, at *6-7 (N.D. Cal. Nov. 28, 2017).

[6] *Coinbase*, No. 17-cv-01431-JSC, at *77.

[7] *Altria Group Inc. v. United States*, No. 3:23-cv-00293.

InBev SA/NV (ABI), a Belgian publicly traded multinational brewing and beverage company, and, thus, was a U.S. shareholder under section 951.

ABI was not a controlled foreign corporation under section 957 (that is, 50 percent or less of both the vote and the value of the foreign corporation's stock was owned by U.S. persons that each owned at least 10 percent by vote or value of the foreign corporation's stock) before repeal of section 958(b)(4). ABI owned foreign subsidiaries and wholly and directly owned a domestic subsidiary. Therefore, after the Tax Cuts and Jobs Act's repeal of section 958(b)(4), downward attribution resulted in ABI foreign subsidiaries being treated as CFCs and Altria being required to include subpart F income of those foreign subsidiaries.

Altria asserts that it is unconstitutional to tax a U.S. shareholder on a CFC's subpart F income unless U.S. shareholders have control over the applicable CFC. Altria argues that a tax on U.S. shareholders that are in control of a foreign corporation is constitutional because the U.S. shareholders effectively realize the foreign corporation's income. Realization occurs because the U.S. shareholders have the power to determine whether to receive that income through distributions. Altria argues that when subpart F was enacted, Congress explained that it did not violate the constitutional realization requirement because U.S. shareholders are deemed to have constructively received a distribution from a CFC they control.

Altria argues that it lacked the requisite control to cause ABI's foreign subsidiaries to pay dividends and that, consequently, the taxation of ABI's foreign subsidiaries' subpart F income is unconstitutional. In furtherance of this argument, Altria argues that to receive income from a corporation, a shareholder must receive a distribution of earnings under the principles of *Eisner v. Macomber*.[8] Altria thus concludes that absent a distribution (or a constructive distribution), there is no income, the 16th Amendment is inapplicable, and any tax imposed on undistributed earnings must be unconstitutional.

Altria argues that Congress added the stock ownership "attribution rules" in section 958(b) to prevent taxpayers from dispersing formal ownership, and therefore control, of a foreign corporation among related entities in an attempt to avoid the application of subpart F. Altria further argues that Congress intended the repeal of foreign attribution in section 958(b)(4) to target "de-controlling" transaction structures, in which a foreign-owned U.S. corporation "de-controls" its own foreign subsidiary by transferring 50 percent or more of the ownership of the foreign subsidiary to a related foreign corporation, thus eliminating the foreign subsidiary's CFC status under the pre-TCJA rules.

Altria argues that the Senate Committee on Budget expressly provided that the repeal of section 958(b)(4) was not intended to affect unrelated parties, and particularly not intended to affect situations such as Altria's investment in ABI. Further, a Senate amendment to the TCJA was introduced to confirm that the intended effect of the repeal of section 958(b)(4) was limited in scope and that such repeal was not intended to create new CFCs (for example, the ABI wholly foreign-owned subs) with respect to unrelated U.S. shareholders (for example, Altria). The government's answer points out that this language was not adopted.

The Justice Department's answer denies and further disputes Altria's arguments.

Sixth Circuit Issues Decision in *Jarrett*

On August 18 the U.S. Court of Appeals for the Sixth Circuit issued its decision in *Jarrett*,[9] affirming the district court's grant of the government's motion to dismiss. Joshua Jarrett created Tezos tokens through staking and reported the value of the tokens at the time of creation as income. After paying tax, he sued for a refund, arguing that the created tokens were not income at the time of creation but only when there was a realization event (the tokens were sold or exchanged). After answering the complaint, the government proffered a refund to Jarrett and

[8] *Eisner v. Macomber*, 252 U.S. 189 (1920).

[9] *Jarrett v. United States*, No. 22-6023 (2023).

argued that the case was moot. Jarrett argued the case was still alive because he was seeking both a judgment and injunctive relief. The district court granted the government's motion to dismiss on mootness, and the Sixth Circuit affirmed.

Patent Infringement Defense Fees Deductible

Fees incurred by a generic drug manufacturer in defending itself against claims of patent infringement are deductible as ordinary and necessary business expenses, the Third Circuit held.

In affirming a Tax Court judgment, the Third Circuit ruled in *Mylan*[10] that because patent infringement claims are tort claims and regulations under section 263 provide that "amounts paid by [a taxpayer] to its outside counsel . . . to resolve . . . tort liability . . . are not required to be capitalized,"[11] Mylan did not have to capitalize its costs of defending against patent infringement claims.

The Third Circuit also noted that it had previously reached a similar result for the legal costs incurred in patent enforcement.

Since 2011 (and in *Mylan*), the IRS has taken the position that patent infringement litigation costs should be treated as the costs of obtaining an Abbreviated New Drug Application (ANDA) under which a generic drug manufacturer could sell its product and, thus, should be capitalized.[12] The ANDA is part of an expedited process for obtaining FDA approval to sell generic drugs. Generic manufacturers typically file an ANDA asserting that any relevant patents are invalid or will not be infringed by the manufacture, use, or sale of the new generic drug for which the ANDA is submitted.

Consolidated Regulations Cleanup

Proposed Treasury regulations (REG-134420-10) issued August 4 would eliminate outdated provisions of current consolidated group regulations, including many provisions that have been obsolete for decades. None of the changes are intended to have any substantive impact.

For example, the proposed regulations would eliminate reg. section 1.1502-11(a)(6), which provides that consolidated taxable income for a consolidated return year is determined by taking into account any "consolidated section 922 deduction." The referenced section 922 deduction was repealed in 1976, effective for tax years beginning after December 31, 1979.

The proposed regulations also would modify the definition of tax in reg. section 1.1502-5(b)(5) to add a reference to section 55(a) (the corporate alternative minimum tax enacted in 2022) and section 59A (the base erosion and antiabuse tax enacted in 2017). Issues regarding the substantive operation of the corporate AMT will be addressed in future guidance.

The proposed regulations also replace gender-specific pronouns with gender-neutral ones.

Consolidated Regulations Correction

Twelve years after a correction to the consolidated return regulations (T.D. 9515) accidentally removed two paragraphs under the matching rule, the IRS issued a correction to restore them (T.D. 9515 (correction)). The restored paragraphs set forth the conditions under which the IRS may determine that treating a selling member's intercompany item as excluded from gross income is consistent with the purposes of reg. section 1.1502-13 and other applicable provisions of the IRC, regulations, and published guidance.

In the case of an intercompany item of income, the IRS may determine that a selling member's intercompany item is excluded from gross income if the corresponding item is permanently disallowed.

If the intercompany item constitutes gain, the IRS may make that determination if the conditions described in reg. section 1.1502-13(c)(6)(ii)(C)(1)(iv) and (v) are satisfied. Those conditions are:

- the effects of the intercompany transaction have not previously been reflected, directly or indirectly, on the group's consolidated return; and
- the consolidated group has not derived, and no taxpayer will derive, any federal income

[10] *Mylan Inc. v. Commissioner*, No. 22-1193 (2023).

[11] Reg. section 1.263(a)-5(*l*), ex. 18.

[12] *See* FAA 20114703F and FAA 20114901F.

tax benefit from the intercompany transaction that gave rise to the intercompany gain or the redetermination of the intercompany gain (including any adjustment to basis in member stock under reg. section 1.1502-32).

Sourcing of Restricted Stock Units Income

Income tax and FICA withholding laws lead to different results when applied to U.S. citizens and permanent residents who receive income from restricted stock units (RSUs) attributable partly to work performed in the United States for a U.S. parent corporation and partly to work performed outside of the United States for a CFC, the IRS advised.

ILM 202327014 explains that the definition of wages under section 3401(a), which applies to income tax withholding, does not carve out payments to U.S. citizens and permanent residents for services performed abroad for foreign persons. In fact, reg. section 31.3401(a)-1(b)(7) specifies that wages include payments received as an employee of a nonresident alien individual, foreign partnership, or foreign corporation whether that alien individual or foreign entity is engaged in trade or business within the United States. Therefore, the full amount of the RSU income is subject to U.S. income tax withholding, regardless of the extent to which the employee performed services outside the United States between the grant date and the vesting date.

In contrast, section 3121(b) generally defines the term "employment" for FICA purposes as any service, of whatever nature, performed by an employee for the person's employer, irrespective of the citizenship or residence of either, within the United States or performed outside the United States by a U.S. citizen or resident as an employee of an American employer. Section 3121 defines an American employer as the United States or any U.S. instrumentality, an individual who is a resident of the United States, a partnership, if two-thirds or more of the partners are residents of the United States, a trust, if all of the trustees are residents of the United States, or a corporation organized under the laws of the United States or of any state or the District of Columbia.

In order to determine the portion of RSU income that is wages for FICA purposes, the employer must use a reasonable method for allocating the amount of RSU income that is attributable to services performed within the United States. Often, a reasonable method will be to allocate as U.S.-source income a ratio of the total RSU income equal to the number of days the individual performed services as an employee within the United States over the employee's total number of days of performance of services for both the U.S. parent and a CFC.

Different results may apply if there is an income tax treaty or a totalization agreement between the United States and the foreign jurisdiction where the employee provides services to a CFC.

IRS Targets Inflated Costs of Goods Sold

The IRS announced a new enforcement campaign focusing on large businesses and international taxpayers that meet certain indications of inflated COGS to reduce taxable income. The IRS did not elaborate on its reasons for launching the campaign.

As the Tax Court has explained, COGS for any year can be determined by aggregating the costs of the items acquired or produced during the year and combining that total with the aggregate cost of the items on hand at the beginning of the year to produce the total cost of the goods available for sale during the year. This total is then allocated among items on hand at the end of the year (the cost of ending inventory) and items sold during the year (the COGS).[13]

Priority Guidance Recommendations

The National Foreign Trade Council (NFTC) submitted recommendations on the 2023-2024 Priority Guidance Plan as requested by Treasury and the IRS in Notice 2023-36, 2023-21 IRB 855.

NFTC requested three additions. The first is for guidance regarding the creditability of OECD pillar 2 top-up taxes, including qualified domestic minimum top-up taxes, income inclusion rules, and undertaxed profits taxes. The second

[13] *Huffman v. Commissioner*, 126 T.C. 322 (2006), *aff'd*, 518 F.3d 357 (6th Cir. 2008).

recommended addition is for guidance regarding which entity's employer identification number survives in a merger or acquisition. Finally, the NFTC requested guidance on section 174 capitalization and amortization in the context of cost-sharing arrangements.

The NFTC also had a number of recommendations related to the corporate AMT.

The NFTC had a few recommendations regarding the corporate AMT adjusted financial statement income (AFSI). It recommended clarification that unrealized gains and losses be excluded from AFSI for all investments. It also recommended clarification that other comprehensive income is not included within AFSI, and it requested simplification in the calculation of a partner's distributive share of AFSI.

NFTC also requested guidance regarding the application of the corporate AMT to CFCs, including confirmation that CFC dividends are not included in AFSI and that CFC income adjustments and foreign tax credits are aggregated. NFTC also requested confirmation that when the foreign income adjustment is a loss and income in the succeeding tax year is reduced, the succeeding tax year adjustment includes any cumulative unused prior year negative CFC adjustments. Also, the NFTC requested confirmation that the CFC income adjustment occurs on the last day of the CFC's local accounting period.

Other recommendations for corporate AMT guidance include clarification of whether and to what extent purchase accounting or push-down accounting are taken into account for purposes of the corporate AMT. Clarification was also requested that FTCs become available when the later of the two credit tests occur if they occur in different years. In addition, the NFTC requested clarification that income attributable to a U.S. permanent establishment is measured in the same manner as effectively connected income and is based on the application of any tax treaty. NFTC also sought confirmation that a partner in a partnership can receive a corporate AMT FTC for foreign taxes paid by the partnership and clarification of how the amount of that corporate AMT FTC is determined.

For previously taxed earnings and profits, the NFTC recommended clarification on applying section 961(c) to consider lower-tier basis adjustments for purposes of computing tested income. ■