

The Honorable Ricardo S. Martinez

UNITED STATES DISTRICT COURT  
WESTERN DISTRICT OF WASHINGTON  
AT SEATTLE

UNITED STATES OF AMERICA,  
  
Petitioner,  
  
v.  
  
MICROSOFT CORPORATION,  
  
Respondent.

No. 2:14-mc-00117-RSM  
  
MOTION FOR A STATUS  
CONFERENCE BEFORE ANY SHOW  
CAUSE ORDER IS ISSUED  
  
NOTE ON MOTION CALENDAR:  
December 26, 2014

INTRODUCTION

Microsoft Corporation ("Microsoft") respectfully asks the Court to schedule a status conference prior to issuing any Show Cause Order, due to the complexity of the issues that bear upon the Court's consideration of the Petition to Enforce Internal Revenue Service Summons (the "Petition"). A status conference will enable the Court to gain a clearer understanding of the factual and procedural background and Microsoft's affirmative defenses, to clarify the potential scope of the enforcement proceeding, to establish a briefing schedule, and to discuss whether an evidentiary hearing would be helpful to the Court.

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Case No. 2:14-mc-00117-RSM

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STATEMENT OF FACTS

The Petition was filed on December 11, 2014, but it has not been served. Microsoft learned of its filing through news reports on December 15, 2014. (Bernard Decl., ¶ 2)<sup>1</sup>

The Petition seeks enforcement of a summons dated October 30, 2014 (the "Summons"). The Summons is not a typical summons under 26 U.S.C. § 7602; it is alleged to be a "designated summons" described in 26 U.S.C. § 6503(j). Although the Petition characterizes the Summons in passing as a designated summons (see, e.g., Petition, ¶7), the Petition and supporting declaration fail to allege all the specific facts necessary for the issuance of a valid designated summons under 26 U.S.C. § 6503(j)(2)(A).<sup>2</sup> In addition, the Petition fails to advise the Court that the IRS has issued 18 additional, allegedly "related summonses" within the meaning of 26 U.S.C. § 6503(j)(1)(A)(ii)— to Microsoft, to KPMG LLP ("KPMG"), to Ernst and Young LLP (E&Y), and to current or former Microsoft, KPMG and E&Y employees. (Bernard Decl., ¶ 3) Under 26 U.S.C. § 6503(j), the United States may ask this Court to enforce these related summonses during this proceeding or in separate proceedings.

The IRS's audit of Microsoft's 2004-2006 taxable years began in January 2007, nearly eight years ago. Microsoft has cooperated throughout the audit, producing approximately 1.2 million pages of documents and making over 50 employees available for interviews, in

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<sup>1</sup> The facts set forth above are supported by the Declaration of Michael J. Bernard, U.S. Tax Counsel for Microsoft Corporation ("Bernard Decl. "). Mr. Bernard has been involved in the Internal Revenue Service ("IRS") audit of Microsoft's taxable years ended December 31, 2004, 2005, and 2006, which are at issue in this case. (Bernard Decl., ¶ 1)

<sup>2</sup> Specifically, the Petition does not address the pre-issuance review requirement under 26 U.S.C. § 6503(j)(2)(a)(i).

1 response to 220 Information Document Requests ("IDRs") issued by the IRS. No summonses  
2 were issued to Microsoft before October 30, 2014. (Bernard Decl., ¶ 4)

3 On May 3, 2011, over 3 ½ years ago, the IRS concluded its field audit and issued a  
4 thirty-day letter, a revenue agent's report, and an external economist's report determining the  
5 IRS's proposed values for the buy-in royalties required to be paid by foreign participants to  
6 Microsoft as arm's length consideration under 26 U.S.C. § 482 for pre-existing intangibles  
7 made available in two cost sharing arrangements. These cost sharing arrangements covered  
8 the production and distribution of software products in certain Asian and Pacific markets and  
9 Western Hemisphere markets (the "APAC Cost Sharing Arrangement" and the "Americas  
10 Cost Sharing Arrangement," respectively). (Bernard Decl., ¶ 5)

11  
12 In response to the thirty-day letter, Microsoft filed a protest brief on June 29, 2011.  
13 Microsoft's protest would normally have resulted in the IRS Examination Division's  
14 forwarding this dispute to the IRS Appeals Division, which has the authority to settle tax  
15 disputes on behalf of the IRS based on the parties' respective litigation hazards. (*See* Bernard  
16 Decl., ¶ 6); 26 C.F.R. § 601.106(f)). But the IRS did not allow the dispute to proceed to the  
17 IRS Appeals Division. Rather, the Director of Transfer Pricing Operations ("TPO") within  
18 the IRS Large Business & International Examination Division asked for six months to  
19 conduct additional field work for the purpose of developing a secondary or alternative buy-in  
20 value and a transfer pricing adjustment with respect to the Americas Cost Sharing  
21 Arrangement.  
22

23  
24 The six-month extended audit has now gone on for three years. During that time the  
25 IRS engaged over a half dozen additional external experts in economics, finance, software  
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1 technology, marketing, and the software industry. They created an economic valuation model  
 2 drafted expert reports, and provided oral advice to the IRS in support of an alternative buy-in  
 3 valuation and transfer pricing adjustment with respect to the Americas Cost Sharing  
 4 Arrangement. The IRS presented its alternative buy-in/pricing model, two supporting expert  
 5 reports and a summary of the experts' oral advice to Microsoft in a meeting on January 14,  
 6 2014. (Bernard Decl., ¶ 7)

8 Throughout the extended audit Microsoft repeatedly asked that, once the IRS  
 9 completed its secondary valuation, the case move to the IRS Appeals Division for settlement  
 10 negotiations. At the January 2014 presentation, the TPO asked Microsoft to enter into direct  
 11 settlement negotiations before the case would be sent to the IRS Appeals Division. After  
 12 some preliminary discussions, Microsoft declined to negotiate with the TPO, because the TPO  
 13 wanted to limit such discussions to agreeing upon modifications to its secondary valuation  
 14 model without any discussion of the parties' respective litigation hazards under 26 U.S.C. §  
 15 482, the regulations thereunder, and the decided case law.<sup>3</sup> (Bernard Decl., ¶ 8)

17 On May 19, 2014, unbeknownst to Microsoft at that time, the IRS engaged the law  
 18 firm of Quinn Emanuel Urquhart & Sullivan, LLP as "an expert in commercial litigation (the  
 19 'Contractor') to assist with the evaluation, analysis, presentation and defense of claims or  
 20 adjustments related to the issues under examination." (Bernard Decl., ¶ 9) On June 14, 2014,  
 21

22 <sup>3</sup> In Veritas Software Corp. v. Commissioner, 133 T.C. 297 (2009), the Tax Court held that  
 23 the IRS's method for valuing the buy-ins in that case was arbitrary, capricious, or  
 24 unreasonable under 26 U.S.C. § 482. Although the IRS issued A.O.D. 2010-005, 2010-49  
 25 I.R.B. 1, characterizing the Tax Court's factual and legal analysis as erroneous, it chose not to  
 26 appeal the Tax Court's decision. The IRS currently is relitigating the Veritas ruling in  
Amazon.com, Inc. v. Commissioner, T.C. No. 31197-12 (trial being conducted in Seattle  
 during November and December 2014).

1 less than one month later, the Treasury Department issued in proposed and temporary form an  
2 amended regulation, 26 C.F.R. § 301.7602-1T(b)(1). (Bernard Decl., ¶ 10) Prior to this  
3 amendment, 26 C.F.R. § 301.7602-1(b) granted authority to "officers and employees" of the  
4 IRS to take sworn testimony of witnesses in accordance with 26 U.S.C. § 7602. As amended,  
5 the temporary regulation would allow external contractors retained by the IRS to "participate  
6 fully in the interview of the witness summoned by the IRS to provide testimony under oath,"  
7 including specifically "questioning the person providing testimony under oath; and asking a  
8 summoned person's representative to clarify an objective or assertion of privilege."  
9

10 During the summer of 2014, the TPO advised Microsoft, for the first time, that the IRS  
11 was considering whether to "designate for litigation" the Microsoft case pursuant to Internal  
12 Revenue Manual Part 33.3.6. Designating a case for litigation bars the IRS Appeals Division  
13 from settling the case other than by the taxpayer's 100% concession of the designated issue.  
14 IRM Part 33.3.6.1(2). The TPO advised Microsoft that it would decide whether to seek  
15 designation after taking 32 depositions in September and October 2014. (Bernard Decl., ¶ 11)  
16 But following these depositions, the IRS did not advise Microsoft whether it would designate  
17 the case for litigation. Instead, on October 30, 2014, it issued the Summons, consisting of 48  
18 separate document requests. Many of these requests are new and seek documents not  
19 previously requested in IDRs. The IRS set a response date of November 20, 2014, and  
20 refused Microsoft's request for a reasonable extension. Microsoft did respond to the  
21 Summons on November 20, 2014, and it is conducting the due diligence necessary to  
22 ascertain whether there are additional documents responsive to these requests. (Bernard  
23 Decl., ¶ 12)  
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1 Microsoft granted eight statute of limitations extensions (IRS Forms 872) during the  
2 audit. The statute of limitations under 26 U.S.C. § 6501 is set to expire on December 31,  
3 2014. Microsoft understands that the IRS was prepared to issue a statutory notice of  
4 deficiency on or about December 15, 2014, reflecting its primary and/or secondary valuations  
5 with respect to the APAC and Americas Cost Sharing Arrangements. (Bernard Decl., ¶ 13)  
6 But instead of issuing the statutory notice of deficiency, the United States filed the Petition  
7 invoking this Court's jurisdiction.  
8

9 ARGUMENT

10 As the brief history recounted above illustrates, Petitioner is not asking the Court to  
11 enforce a summons against an uncooperative taxpayer in connection with an ordinary audit.  
12 Microsoft has advised the IRS of its intent to comply with the IRS's document requests,  
13 making the Petition's filing at best premature. By filing the Petition in this Court now, the  
14 United States is attempting to rely on 26 U.S.C. § 6503(j) to suspend the statute of limitations  
15 until the designated and related summons disputes are resolved.  
16

17 Microsoft intends to allege one or more affirmative defenses, including that (1)  
18 Petitioner has acted in bad faith and with improper purpose and (2) enforcement of the  
19 Summons would be an abuse of the Court's process.

- 20 • Petitioner already has developed its audit adjustments: the primary APAC and  
21 Americas buy-in adjustments were set forth in the May 3, 2011 thirty-day letter  
22 and supporting reports, and the secondary Americas buy-in and transfer pricing  
23 adjustments were set forth in the January 14, 2014 valuation model and  
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1 supporting reports. Petitioner was prepared to issue the statutory notice of  
2 deficiency on December 15, 2014.

- 3
- 4 • Petitioner's purpose in issuing an eleventh-hour barrage of summonses after  
5 repeatedly assuring Microsoft that the extended audit would be completed after  
6 the October depositions is suspect. Is Petitioner attempting to force Microsoft  
7 to the negotiating table with the TPO, even though the IRS Examination  
8 function has no authority to settle cases based on litigation hazards? Is  
9 Petitioner attempting to foreclose IRS Appeals' consideration of this case  
10 without formally designating the case for litigation? Is Petitioner no longer  
11 conducting a bona fide audit, but instead attempting to conduct pretrial  
12 discovery without regard to the U.S. Tax Court's discovery rules or even this  
13 Court's electronically stored information discovery rules?  
14
  - 15 • Until mid-summer 2014, senior IRS executives assured Microsoft that the case  
16 would proceed to the IRS Appeals Division for settlement negotiations. But  
17 after Microsoft refused to conduct direct settlement negotiations with the TPO  
18 in the spring of 2014, Petitioner engaged a commercial litigation firm to assist  
19 in developing the case for litigation. The Court may be required to consider  
20 whether the IRS is impermissibly delegating inherently governmental  
21 functions, such as taking sworn, compulsory testimony and possibly  
22 representing the IRS in Tax Court litigation. The Court may be required to  
23 decide the validity of 26 C.F.R. § 301.7602-1T(b)(1).  
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1 Microsoft respectfully requests that the Court schedule a status conference with the  
2 parties before any Show Cause Order is issued in this case. Such a conference would be  
3 useful for clarifying whether Petitioner (1) failed to provide the appropriate specific factual  
4 support required by 26 U.S.C. § 6503(j)(2)(A); and (2) intends to place at issue before the  
5 Court one or more of the related summonses. A conference also could be useful for  
6 addressing an appropriate briefing schedule and determining whether an evidentiary hearing  
7 may be appropriate. Given that Microsoft is currently attempting to respond to the 48  
8 document requests, the Court may wish to limit any immediate Show Cause hearing to  
9 Microsoft's affirmative defenses, allowing more time for the parties to attempt to narrow the  
10 specific document requests at issue.  
11

12 Given counsel's locations, one or both parties may request the ability to participate  
13 telephonically as necessary.  
14

15 WHEREFORE, Microsoft respectfully requests that this Motion be granted, and that  
16 the Court issue an order scheduling a status conference before any Show Cause Order is  
17 issued.

18 Respectfully submitted this 18th day of December, 2014.

19  
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**CERTIFICATE OF SERVICE**

I hereby certify under penalty of perjury that on December 18, 2014, I electronically filed the foregoing with the Clerk of the Court using the CM/ECF system, which will send notification of such filing to all parties.

s/ Robert B. Mitchell  
Robert B. Mitchell  
K&L GATES LLP

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