

Federal Court Holds Microsoft Documents Not Privileged, Falling Within Tax Shelter Exception

On January 17, 2020, a federal district court in Washington ordered Microsoft Corporation (“Microsoft”) to produce many documents to the Internal Revenue Service (“IRS”) that Microsoft asserted were privileged. Microsoft had argued that most of the documents were protected by the work product doctrine and the federally authorized tax practitioner privilege set forth in 26 U.S.C. § 7525 (“tax practitioner privilege”), and that a small number of documents were protected by the attorney-client privilege. For the majority of the documents, the court held that none of these protections applied. The court held the work product protection did not apply because there was no active litigation at the time and the primary purpose of the communications was business, not legal. The court held the tax practitioner privilege did not apply to Microsoft’s communications with KPMG LLP (“KPMG”) because the communications fell within the tax shelter exception to the tax practitioner privilege (in § 7525(b)). The court concluded that “a significant purpose, if not the sole purpose, of Microsoft’s transactions was to avoid or evade federal income tax.”¹

In concluding that “a significant purpose” of the “transactions was to avoid or evade federal income tax,”² the court focused on the small number of disputed communications, rather than considering the broader scope of Microsoft’s business decision as to whom should own intellectual property. This conclusion is in tension with well-established U.S. Supreme Court precedent allowing taxpayers to make decisions in a tax-efficient manner. In 1934, Learned Hand stated that “any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes.” *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934), *aff’d* 293 U.S. 465 (1935). This bedrock principle was upheld by the Supreme Court in that same case, and has been repeatedly reaffirmed.

Microsoft’s Discovery Dispute with IRS

The January decision was part of a long-running discovery dispute between Microsoft and the IRS, in connection with the IRS’s examination of Microsoft’s cost-sharing transactions with its Puerto Rican subsidiary that had purchased intellectual property from a U.S. affiliate. Microsoft had engaged KPMG to provide “tax consulting services” to explore whether and how to enter into this cost-sharing transaction.³ Cost-sharing transactions must satisfy an arm’s length standard in order to be respected by the IRS.⁴ In this dispute, the IRS has argued that the transactions were “designed and implemented for the purpose of avoiding tax.”⁵

The IRS had issued a summons to Microsoft requesting documents; while Microsoft had produced a large number of documents, there were documents withheld or redacted as privileged. In 2015, the IRS sought to have its summons enforced by the district court. In November 2015, the court ordered the IRS summons be

¹ *United States v. Microsoft Corp.*, No. C15-102RSM, 2020 WL 263577, at *7 (W.D. Wash. Jan. 17, 2020) (order directing producing of documents) [hereinafter, Order].

² Order at *7.

³ Order at *2.

⁴ Order at *1.

⁵ Order at *2 (citing Dkt. #146 at ¶ 20).

enforced. In 2016, Microsoft produced many documents, but withheld some as privileged. In fall 2016, briefs were submitted regarding privileged documents whose production was disputed. In May 2017, the court ordered in camera review of the disputed documents.

More than two and a half years later, on January 21, 2019, the court finally ruled on the 174 documents it had reviewed, ordering Microsoft to produce the majority of those documents.⁶ The party asserting the privilege bears the burden of proving the privilege to the court. In this case, therefore, Microsoft had to convince the judge that the documents were privileged. The court ruled that, for the majority of the documents, no privilege applied. The court employed additional scrutiny to the majority of the documents because the documents served dual business and legal purposes.

Work Product Protection Did Not Apply

Work product protection generally protects documents that are created in anticipation of litigation, by or at the direction of an attorney, unless an exception applies.

The *Microsoft* court held that the work product protection did not apply to any of the documents because their primary purpose was business, not legal, and the documents were not created to defend against an existing legal dispute. (Microsoft had argued that work product protected 170 of 174 documents.) Instead, the court held that the documents were created because Microsoft thought the IRS would challenge the transaction. “Microsoft’s documents were not created in anticipation of litigation. Rather, Microsoft anticipated litigation because of the documents it created.”⁷ The court also noted that, even though Microsoft claimed to anticipate litigation regarding the transaction, Microsoft had not engaged KPMG to represent it in the anticipated litigation.⁸

Attorney-Client Privilege Applied to Small Number of Documents

The attorney-client privilege generally protects confidential communications between attorneys and their clients made for the purpose of requesting or providing legal advice, unless an exception applies.

The *Microsoft* court held that the attorney-client privilege protected only three of the eight documents to which Microsoft had argued the protection applied. For documents that had a dual legal and business purpose, the court held that the documents “primarily serve[d] a business purpose,” so they were not protected.⁹

Federally Authorized Tax Practitioner Privilege Did Not Apply

The tax practitioner privilege generally protects communications between a taxpayer and a federally authorized tax practitioner made for the purpose of providing tax advice, unless an exception applies, including the statutory exception for communications made in connection with the promotion of or participation in a tax

⁶ Order.

⁷ Order at *3.

⁸ Order at *4.

⁹ Order at *5.

shelter. 26 U.S.C. § 7525(b). Notably, there is no analogous tax shelter exception to the attorney-client privilege, which protects client communications with attorneys, or work product protection.

Perhaps the most significant part of the *Microsoft* decision was the court’s holding that the tax practitioner privilege did not protect any of the documents because KPMG’s activities fell within the statutory tax shelter exception. 26 U.S.C. § 7525(b). The court found that tax evasion or avoidance was a “significant” or “primary” purpose of the transaction.¹⁰ The court distinguished a tax shelter from a permissible tax structure, which “achieve[s] a legitimate business purpose.”¹¹ The court noted that the “transactions did not appear necessary to satisfy Microsoft’s operational needs.”¹² The court concluded that KPMG was a promoter of a tax shelter, and that it “originated and drove the structuring of the transactions.”¹³

The court did so without taking into account the economic decision, by Microsoft as a whole, to own and maintain the subject intellectual property. That decision is, without a doubt, business motivated. Once a business decision has been made, a company typically may then structure a transaction or ownership in a manner most efficient. And yet, but focusing on only a small aspect of Microsoft’s intellectual property management (the question of which affiliate should own and assume the responsibility to maintain the property), the court evaluated “tax motivation” on an artificially narrow basis. By doing so, it ignored historically-relevant factors, like whether the Puerto Rican subsidiary was assuming real risks of ownership and whether it could expect actual non-tax benefits from the property over time. Where the IRS’s own focus in the examination—whether the Puerto Rican subsidiary paid enough for the valuable property—there can be no plausible argument that the decision to own and maintain the property in the first place could lack economic reality.

Conclusion and Next Steps

This decision is yet another example of the increased scrutiny by taxing authorities faced by corporations both in the U.S. and abroad. When justifying its decision as being in the public interest, the *Microsoft* court noted the “likely endemic” “under-reporting of corporate taxes.”¹⁴ Courts will continue to carefully examine documents that parties are withholding as privileged, to be sure that a privilege applies. Documents that have both a legal and a business purpose will receive additional scrutiny.

While it is not yet clear whether other courts will adopt this outlier approach to the tax practitioner privilege, entities who engage tax practitioners or attorneys to provide tax or legal advice should be cognizant of the bounds of the respective privileges in order to preserve them. Companies should consider several proactive steps in this regard:

- Discussions with attorneys and tax practitioners regarding tax benefits associated with a particular decision should incorporate the broader business context of the decision.

¹⁰ Order at *7.

¹¹ Order at *8.

¹² Order at *9.

¹³ Order at *8.

¹⁴ Order at *9.

- Written advice should consistently refer back to that broader business context.
- Additionally, when appropriate, entities should strongly consider engaging attorneys to provide tax-related legal advice given the broader scope of the attorney-client privilege.
- Taxpayers should also be mindful that communications with attorneys that involve tax practitioners may not be privileged in certain circumstances, unless the accountants have been engaged to assist the attorneys in providing legal advice.

If you have any further questions, please contact your regular Ropes & Gray advisor or any of the attorneys listed below.

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