The Honorable Ricardo S. Martinez

UNITED STATES DISTRICT COURT

WESTERN DISTRICT OF WASHINGTON

UNITED STATES OF AMERICA, Petitioner, v. MICROSOFT CORPORATION, et al., Respondents.	Case No. 2:15-cv-00102 RSM REPLY BRIEF OF RESPONDENT KPMG LLP NOTE ON MOTION CALENDAR: October 27, 2016

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Respondent KPMG LLP ("KPMG") respectfully submits this Reply Brief in response to Petitioner United States' Response to Microsoft's Brief Regarding Privileged Documents Still in Dispute ("Response Brief") (Dkt. #145) for the limited purpose of addressing the United States' argument that certain KPMG documents in dispute are not protected by the federally authorized tax practitioner's privilege under I.R.C. §7525(a) because KPMG allegedly promoted Microsoft Corporation's ("Microsoft") participation in a tax shelter under I.R.C. §7525(b).[1]

I. INTRODUCTION

The United States does not contend that the Americas Cost Sharing Arrangement is an abusive tax shelter or an otherwise illegitimate transaction. Nor does it argue that KPMG marketed the transaction to Microsoft or engaged in any other activity that has been traditionally viewed as "promotion." Rather, the United States aggressively argues for the wholesale dismissal of an established privilege. The United States argues that routine tax advice provided by federally authorized tax practitioners at KPMG to its long-standing client, Microsoft, are excluded from the federally authorized tax practitioner's privilege under I.R.C. §7525(a) because they constitute communications "promoting participation in a transaction with a significant tax avoidance purpose." (Resp. Br. at 1.) This position, if accepted, would create such a broad exception to the scope of the federal tax practitioner's privilege that it would render the protection that the legislature intended to provide to such confidential communications a nullity.

Congress enacted the federally authorized tax practitioner's privilege in recognition of the fact that communications between a taxpayer and its tax advisor should be afforded the same protection as that afforded to communications between a taxpayer and its attorneys. Congress created a limited exception to this privilege by adopting I.R.C. §7525(b), which excludes written communications in connection with the "promotion" of a corporation's participation in a "tax shelter" from the scope of that privilege. The legislative history

[1] KPMG reserves the right to respond to additional allegations or arguments that the Government may raise in any subsequent filing or hearing.

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underlying the adoption of I.R.C. §7525(b) makes clear that this exception was intended to be narrow in scope and not to apply to routine tax advice—communications that were "part of the routine relationship between a tax practitioner and a client." H.R. Rep. No. 105-599 (1998). The legislature thus concluded that this exception would not "adversely affect such routine relationships." *Id.*

The limited number of cases to have addressed Section 7525(b) have nearly all construed this provision in a manner consistent with the legislature's stated intent. For example, in *Countryside Limited Partnership. v. Commissioner*, the court examined the statutory language in light of the legislative history and concluded that the term "promotion" did not include an advisor's provision of routine tax advice: (1) in response to the taxpayer's request; (2) that fell within his area of expertise; (3) to a long-standing client; and (4) where he retained no stake in his advice beyond his employer's right to bill hourly for his time. 132 T.C. 347, 354 (2009). Under this established framework, the tax advice that KPMG provided to Microsoft in this case cannot constitute "promotion" of a tax shelter. Microsoft approached KPMG seeking tax advice regarding Microsoft's own plan to implement a cost sharing arrangement in the Americas. KPMG provided this advice, which fell within its area of expertise, to its long-standing client and retained no direct financial stake in the engagement beyond billing its time at hourly rates.

The United States ignores *Countryside* and the other cases that have interpreted Section 7525(b) consistently with Congress's intent. Instead, the United States argues that routine tax advice such as "solv[ing] problems that presented obstacles to implementation, and ma[king] recommendations," in response to a long-standing client's requests, amounts to the "promotion" of a tax shelter and is therefore not protected by the federally authorized tax practitioner's privilege. (Resp. Br. at 1, 16.) The only authority on which the United States relies for this position is *Valero Energy Corp. v. United States*, 569 F.3d 626 (7th Cir. 2009). As explained below, however, *Valero* does not even address the issue of whether routine tax advice can constitute "promotion" under Section 7525(b), and thus provides no support for the United States' position. Moreover, the United States' interpretation of Section 7525(b) would

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lead to absurd results. Under the United States' view, *any tax advice* that could assist a client in legally reducing Federal taxes would be viewed as the "promotion" of a tax shelter, thereby effectively nullifying the federally authorized tax practitioner's privilege and stripping taxpayers of the ability to have confidential, candid and frank communications with their tax advisors—a result that is contrary to the plain meaning of the statute, the legislature's stated intent, and the case law interpreting this provision.

Accordingly, the Court should reject the United States' position and find that KPMG's tax advice to Microsoft regarding the Americas Cost Sharing Arrangement did not constitute the "promotion" of a tax shelter under Section 7525(b).

II. FACTS

The relevant facts that relate to Section 7525(b) and the Americas Cost Sharing Arrangement are simple and essentially unchallenged.[2]

Cost sharing arrangements, such as the Americas Cost Sharing Arrangement, are not novel or recent innovations. As far back as 1968, the Treasury Department published regulations allowing taxpayers to enter into "cost sharing arrangements" through which offshore affiliates who agreed to fund a portion of research and development would be, for tax purposes, deemed to own the intellectual property that was developed. (Declaration of Michael P. Boyle, dated September 12, 2016 ("Boyle Decl.") (Dkt. #143) ¶ 18.)

Microsoft has employed such cost sharing arrangements for many years. In 1999, Microsoft implemented a cost sharing arrangement relating to the Europe, Middle East and Africa ("EMEA") retail market. Microsoft subsequently implemented cost sharing

[2] In multiple sections of its brief, the United States quotes limited excerpts from KPMG documents out of context to tell a story of its liking. As just one example, the United States makes frequent citations to notes from an internal KPMG planning meeting that includes the phrase, "[w]hat can we do to make this thing real?" Resp. Br. at 7 ("[S]omeone on the KPMG team asked the question that would seem to encapsulate the entirety of KPMG's work on the project: 'What can we do to make this thing real?'") (quoting Ex. 22 at 15151-52). The United States pretends that this quote supports the conclusion that the final Americas Cost Sharing Arrangement was illusory. But the quote supports the opposite conclusion. The notes do not ask what can be done to make the Americas Cost Share Arrangement *appear* real or *seem* real. Rather, they reflect KPMG's efforts to provide advice that would ensure the arrangement *was* real—that it had real economic substance. In the interests of not overburdening the Court with responses to factual assertions that are not directly related to the legal issues at hand, KPMG does not address each of the Government's inaccurate factual assertions in this filing.

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arrangements relating to the EMEA original equipment manufacturer market and for the Asia-Pacific region ("APAC"). (Boyle Decl. ¶¶ 21-22.)

In 2004, Microsoft approached and engaged KPMG to provide tax advice and economic services in connection with Microsoft's plan to enter into the Americas Cost Sharing Arrangement, which involved Microsoft's business in the Americas and a wholly owned subsidiary operating in Puerto Rico. (Declaration of Brett A. Weaver, dated September 12, 2016 ("Weaver Decl.") (Dkt. #144) ¶ 10.)[3] Microsoft conceptualized the proposed transactions that comprised the Americas Cost Sharing Arrangement and retained KPMG to provide tax advice on those Microsoft concepts. (Boyle Decl. ¶ 29.) All of the work that KPMG performed on the Americas Cost Sharing Arrangement that the United States describes in its Response Brief, therefore, was performed in response to Microsoft's request for tax advice. (Resp. Br. at 4-10.)

Brett Weaver was the project partner at KPMG for this engagement. (Weaver Decl. ¶ 11.) KPMG, both through Mr. Weaver and through others at KPMG, had a long-standing relationship with Microsoft, and Microsoft regularly sought tax advice from Mr. Weaver on a variety of tax issues. (*Id.* ¶¶ 8-9.) The work that Mr. Weaver and his team performed for Microsoft on this engagement was billed at hourly rates and KPMG had no direct financial stake in the outcome of the Americas Cost Sharing Arrangement. (*Id.* ¶ 17.)

Advising clients with respect to the tax consequences of international transactions, such as the Americas Cost Sharing Arrangement, was a routine part of Mr. Weaver's practice, and he has provided such tax advice to clients, including Microsoft, during his entire career. (*Id.* ¶ 16.) At the time that KPMG provided tax advice to Microsoft in connection with the Americas Cost Sharing Arrangement, disputes over transfer pricing between taxpayers and the IRS were common, particularly disputes over cost sharing arrangements. (*Id.* ¶ 19.) The work performed by KPMG (as well as work performed by accounting firms Ernst & Young LLP and

[3] The Government makes the completely unsupported assertion that, "the general averments of [Brett] Weaver [a KPMG partner] … conflict with documentary evidence already provided to the IRS." (Resp. Br. at 1-2.) Nowhere in the Government's brief does it provide any support for this assertion or identify any statement in Mr. Weaver's declaration that allegedly conflicts with any documentary evidence provided to the IRS.

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PricewaterhouseCoopers LLC for Microsoft on other cost sharing arrangements) was routine international tax analysis and advice that was regularly performed by the major "Big Four" accounting firms. (Boyle Decl. ¶ 29.)

These undisputed facts establish that KPMG provided routine tax advice to its long-standing client, Microsoft, in response to Microsoft's request for advice relating to a plan that Microsoft itself conceptualized—actions that do not, under any standard, qualify as the "promotion" of a tax shelter.

III. ARGUMENT

The United States contends that providing routine tax advice, such as "solv[ing] problems," and "mak[ing] recommendations" in response to a long-standing client's request for such advice amounts to the "promotion" of a tax shelter and is therefore excluded from the scope of the federally authorized tax practitioner's privilege set forth in Section 7525(a). (Resp. Br. at 16.) This position is directly contrary to the legislature's intent and, if adopted, would effectively render the federally authorized tax practitioner's privilege moot.

Section 7525(a)(1) sets forth the federally authorized tax practitioner's privilege and states, in relevant part, "the same common law protections of confidentiality which apply to a communication between a taxpayer and an attorney shall also apply to a communication between a taxpayer and any federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney."

In enacting this provision, Congress intended to extend the protections of the attorney-client privilege to taxpayers and their tax advisors. S. Rep. No. 105-174 at 70 (1999) ("The Committee believes that a right to privileged communications between a taxpayer and his or her advisor should be available in noncriminal proceedings before the IRS and in noncriminal proceedings in Federal courts …"). The well-settled body of law regarding the attorney-client privilege outlines the manifold public policy justifications for such a privilege—policy considerations that are equally applicable to tax practitioners. *See, e.g., Upjohn Co. v. United States*, 449 U.S. 383, 389 (1981) (finding purpose of attorney-client privilege "is to encourage

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full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and administration of justice. The privilege recognizes that sound legal advice or advocacy serves public ends and that such advice or advocacy depends upon the lawyer's being fully informed by the client.").

Section 7525(b) sets forth an exception to this privilege and states that the privilege "shall not apply to any written communication between a federally authorized tax practitioner and a director, shareholder, officer, or employee, agent, or representative of a corporation in connection with the promotion of the direct or indirect participation of such corporation in any tax shelter (as defined in section 6662(d)(2)(C)(ii))."[4] The United States bears the burden of proving preliminary facts necessary to establish this exception to the privilege. *Countryside*, 132 T.C. at 349 (citing *United States v. BDO Seidman, L.L.P.*, 492 F.3d 806, 821 (7th Cir. 2007)).

In response to concerns voiced by Senators as to the scope of Section 7525(b), the Conference Report accompanying H.R. 2676, 105th Cong., 2d Sess. (1998), made clear that the legislature did not intend Section 7525(b) to apply to routine tax advice, stating "[t]he Conferees do not understand the promotion of tax shelters to be part of the routine relationship between a tax practitioner and a client. Accordingly, the Conferees do not anticipate that the tax shelter limitation will adversely affect such routine relationships." H. R. Rep. 105-599, at 269 (1998). Thus, the legislature clearly expressed its intent that the provision of routine tax advice does not constitute the "promotion" of a tax shelter.

Not surprisingly, courts that have interpreted the scope of Section 7525(b) have construed the term "promotion" narrowly in a manner consistent with Congress's intent in enacting the statute. *See, e.g., United States v. Textron Inc.*, 507 F. Supp. 2d 138, 148 (D.R.I. 2007) (rejecting Government's broad interpretation of the term "promotion" and relying on legislative history to hold that "[s]ection 7525(b) is aimed at communications by outside tax

[4] I.R.C. § 6662(d)(2)(C)(ii) defines "tax shelter" to include: "(I) a partnership or other entity, (II) any investment plan or arrangement, or (III) any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax."

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practitioners attempting to sell tax shelters to a corporate client"), *vacated on other grounds*, 577 F.3d 21 (1st Cir. 2009); *Salem Fin., Inc. v. United States*, 102 Fed. Cl. 793, 798 (2012) (rejecting government's broad interpretation of Section 7525(b) as, *inter alia*, inconsistent with Congress's intent, finding that "the Government seeks to broaden the scope of the exception to the tax practitioner privilege beyond its plain meaning. Congress chose to exempt from protection communications in connection with the 'promotion' of participation in a tax shelter; it did not choose to exempt communications in connection with the promotion *and implementation* of a tax shelter, as the Government seeks to do.") (emphasis in original).

For example, in *Countryside*, the United States argued that the tax advisor in question "played a 'substantial role in structuring [the transactions at issue]' and 'was involved in organizing, structuring and assisting with respect to [those transactions],'" and that his activities therefore amounted to the "promotion" of a tax shelter. 132 T.C. at 351. In interpreting the term "promotion" in Section 7525(b), the United States Tax Court reviewed various dictionary definitions of "promotion" and concluded that there was sufficient ambiguity to resort to the legislative history for clarification of this term. Citing to the Conference Report, the court found that the legislature clearly intended that the "promotion" of a tax shelter was not part of "the routine relationship between a tax practitioner and a client." *Id.* at 353-54 (citing H. R. Rep. 105-599, at 269). The court rejected the United States' position and concluded that routine tax advice could not be deemed "promotion" where the advisor rendered tax advice: (1) in response to the taxpayer's request; (2) that fell within his area of expertise; (3) to a long-standing client; and (4) where he retained no stake in his advice beyond his employer's right to bill hourly for his time. *Id.* at 354.

Here, it is undisputed that Microsoft, having implemented similar cost sharing arrangements in EMEA and APAC, originated the concept of the Americas Cost Sharing Arrangement and approached KPMG seeking tax advice regarding Microsoft's plan to enter into a cost sharing arrangement with its wholly owned subsidiary operating in Puerto Rico. (Boyle Decl. ¶¶21-23, 29.) KPMG, therefore, could not possibly have "promoted" Microsoft's own plans to Microsoft. Rather, KPMG's tax advice was provided in direct response to

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Microsoft's request for that advice. KPMG, and Mr. Weaver in particular, had a long-standing relationship with Microsoft, and the type of tax advice KPMG rendered to Microsoft in connection with the tax consequences of international transactions, such as the Americas Cost Sharing Arrangement, has been a routine part of Mr. Weaver's practice throughout his career. (Weaver Decl. ¶¶ 15, 16.) Moreover, KPMG was compensated for its work at hourly rates and had no direct financial stake in the outcome of the Americas Cost Sharing Arrangement. (*Id.* ¶ 17.) Accordingly, consistent with the standards set forth in *Countryside*, the Court should find that the tax advice KPMG provided to Microsoft in connection with the Americas Cost Sharing Arrangement does not constitute the "promotion" of a tax shelter under Section 7525(b).

The United States implicitly rejects the *Countryside*, *Textron*, and *Salem* opinions, as well as the legislature's clear intent in enacting Section 7525(b). Instead, relying solely on one opinion, *Valero*, the United States argues that the "promotion" of a tax shelter is so broad that it includes providing routine tax advice on the structure and timing of a client's plans, "solv[ing] problems," and "mak[ing] recommendations." (Resp. Br. at 16.) *Valero* does not support this position.

In *Valero*, the taxpayer argued that Section 7525(b) should be limited to the promotion of pre-packaged corporate tax-shelters. 569 F.3d at 632. The court rejected this argument based on its interpretation of the term "tax shelter." The court reasoned that "tax shelter" was a broadly defined statutory term that was not limited to pre-packaged corporate tax shelters, and that reading such a limitation into the term would be at odds with the statutory text. *Id.* On that basis, the court held that Section 7525(b) was not limited to the promotion of pre-packaged corporate tax shelters.

Importantly, *Valero* did not address the issue presently before the Court: whether the "promotion" of a tax shelter should be interpreted so broadly as to capture the provision of routine tax advice. The *Valero* court recognized that Conference Report statements are "often a good record of Congress's intent," and cited the Conference Report statement that "the promotion of tax shelters [is not a] part of the routine relationship between a tax practitioner

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and a client," and should not "adversely affect such routine relationships." *Id.* at 634.[5] Instead of relying on this clear expression of the legislature's intent to guide its interpretation of the statute, however, the court simply discounted the Committee Report because "[t]he report does nothing to confine the exception to actively marketed tax shelters or prepackaged products." *Id.* While it is certainly true that the Conference Report does not specifically mention prepackaged tax shelters, the *Valero* court did not address what the Conference Report *does* say about the legislature's intent in enacting this provision—that, as the *Countryside* and *Textron* courts have found, "promotion" of a tax shelter under Section 7525(b) does not include the provision of routine tax advice.

Moreover, the *Valero* court acknowledged that even the Government's broad interpretation of "promotion" had limitations. The *Valero* court noted in *dicta* that:

> [p]romotion, even under the broader reading, limits the exception to written communications encouraging participation in a tax shelter, rather than documents that merely inform a company about such schemes, assess such plans in a neutral fashion, or evaluate the soft spots in tax shelters that a company has used in the past.

569 F.3d at 632-33.

Here, KPMG did not "encourage" Microsoft to participate in the Americas Cost Sharing Arrangement. Microsoft originated that plan and at Microsoft's request, KPMG provided objective and independent tax advice regarding Microsoft's plan. Even under *Valero*, therefore, KPMG's actions would not constitute the "promotion" of a tax shelter.

Finally, the United States' position that "solv[ing] problems" and "ma[king] recommendations" constitutes the "promotion" of a tax shelter would lead to absurd results. (Resp. Br. at 16.) If a taxpayer seeks advice and recommendations regarding its plan to reduce its tax burden, and a tax practitioner confirms that the plan complies with the tax code and recommends moving forward, that advice would be deemed "promotion" of the taxpayer's

[5] Where statutory terms are ambiguous or subject to multiple interpretations, courts may look to a statute's legislative history to discern the legislature's intent in enacting the language. *See, e.g., United States v. Pub. Utils. Comm'n. of Cal.*, 345 U.S. 295, 315 (1953) ("Where the [statutory] words are ambiguous, the judiciary may properly use the legislative history to reach a conclusion. And that method of determining congressional purpose is likely applicable when the literal words would bring about an end completely at variance with the purpose of the statute.").

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participation in a tax shelter under the United States' view and would therefore not be privileged. Perversely, if the tax advisor identifies problems with its client's plan and recommends solutions to those problems to ensure compliance with the tax code, such advice would also constitute "promotion" of a tax shelter. Indeed, the only time that tax advice would not be deemed "promotion" under the United States' position is if a tax practitioner advises that its client's plan would *not* comply with the tax code and declines to provide its client with any proposed solutions or recommendations on how the plan could be changed to comply with the tax code.

Any taxpayer considering whether to seek tax advice regarding its plans to reduce its tax burden would have no assurances, therefore, that the advice it ultimately receives will be privileged. This result runs counter to the very public policy justifications for the existence of the federally authorized tax practitioner's privilege because it would dissuade, as opposed to promote, full and frank discussions with tax advisors and dissuade, as opposed to promote, a taxpayer's efforts to seek advice in order to observe and comply with the tax code.

The United States' interpretation of 7525(b) would nullify the protection that Congress intended to afford taxpayers in enacting the federally authorized tax practitioner's privilege. Under the Government's position, even the provision of routine tax advice such as solving tax problems and making tax-related recommendations could qualify as "promotion" of a tax shelter and thereby be excluded from the scope of 7525. Such an interpretation is unsupported by the plain meaning of the statute and its legislative history, would fundamentally alter the relationship between taxpayers and their advisors and would undermine the public policy justification for the creation of this privilege.

IV. CONCLUSION

For the reasons stated above, KPMG respectfully requests that the Court reject the United States' argument that certain KPMG documents in dispute are excluded from the federally authorized tax practitioner's privilege under I.R.C. §7525(a) because they fall within the scope of the exception set forth in I.R.C. §7525(b).

Dated: October 27, 2016

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CERTIFICATE OF SERVICE

I hereby certify that on October 27, 2016, I caused the foregoing document to be electronically filed with the Clerk of the Court using the CM/ECF system which will send notification of the filing to all counsel of record.

DATED: October 27, 2016 ORRICK, HERRINGTON & SUTCLIFFE LLP

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