HONORABLE RICARDO S. MARTINEZ

IN THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF WASHINGTON
AT SEATTLE

UNITED STATES OF AMERICA, Petitioner, v. MICROSOFT CORPORATION, et al., Respondents.	NO. 2:15-cv-00102 RSM MICROSOFT'S BRIEF REGARDING PRIVILEGED DOCUMENTS STILL IN DISPUTE ORAL ARGUMENT REQUESTED **NOTED FOR:** **Thursday, October 27, 2016**

MICROSOFT'S BRIEF REGARDING PRIVILEGED DOCUMENTS STILL IN DISPUTE

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Table of Contents

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Table of Authorities

Other Authorities

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Regulations

Rules

Regulations

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Introduction

The parties are before the Court in connection with the IRS's summons enforcement action. Microsoft and its tax advisers have produced over 1.6 million pages of documents in connection with the IRS's audit. The dispute at this point is limited to the 174 documents that Microsoft has withheld from the IRS. The parties have met and conferred and the 174 documents in dispute are the few that could not be agreed upon. Of the 174 disputed documents, Microsoft has withheld 164 documents under the federally authorized tax practitioner privilege set forth in 26 U.S.C. § 7525, 170 documents as work product, and 12 documents as attorney-client privileged. The 174 disputed documents are listed on the four privilege logs attached as Exhibits A through D to the Declaration of Daniel A. Rosen.

The disputed documents relate to cost sharing arrangements Microsoft entered into in the early 2000s covering the Americas and Asia-Pacific regions, as provided for in regulations that have existed since the 1960s. In deciding whether to enter into those arrangements, and how to comply with complex tax laws, where litigation was anticipated, Microsoft took the usual step of obtaining legal advice from its lawyers. Microsoft also engaged KPMG LLP ("KPMG") and Ernst & Young, LLP ("EY"), as is typical in transactions like these, to help the lawyers provide legal advice, and to give KPMG's and EY's own tax advice.

Microsoft also entered into these cost sharing arrangements with an expectation, based on the experiences of numerous other multinational companies and Microsoft's own history of disputes with the IRS, that the IRS would challenge these cost sharing arrangements. Microsoft's expectation has been borne out by a nine-plus year examination that has led to the proceedings before this Court.

The advice and underlying analyses Microsoft's lawyers and federally authorized tax practitioners provided to evaluate these transactions under the tax laws and to ensure their

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defensibility in litigation are privileged, and protected from disclosure to the government in this summons proceeding. The summonses should not be enforced as to these 174 documents.

Statement of Facts

I. Transfer Pricing and U.S. Taxation of International Operations

Multinational corporations like Microsoft operate globally. Throughout this global network, Microsoft transfers products, intellectual property rights, and services among its various subsidiaries and affiliates, leading to controversy regarding what portions of Microsoft's income are taxable by the different countries in which Microsoft operates. Decl. of Michael P. Boyle, Sept. 12, 2016, ¶ 8.

Each country generally seeks to tax as much of Microsoft's profits as it can. *Id.* With the U.S. taking the lead, countries around the world have agreed that the price at which related parties transfer goods, services, and intellectual property across national boundaries should be based on the arm's length standard. *Id.* The arm's length standard provides that these items should trade among related affiliates upon the comparable terms and prices as those items would trade among unrelated parties. *Id.* The U.S. imposes the arm's length standard upon taxpayers under the transfer pricing rules of 26 U.S.C. § 482 and the hundreds of pages of regulations thereunder. *Id.*

The arm's length price to be charged/paid by related parties for goods, intellectual property, and services is but one of a myriad of issues that arise under the international tax provisions of the Internal Revenue Code. *Id.* ¶¶ 12-14, 19, and 28. For example, U.S. taxpayers that operate abroad may need to analyze complex rules that turn on whether a foreign subsidiary is the "manufacturer" of the products giving rise to the income in question. *Id.* ¶¶ 13, 28. The answer to this question requires a detailed understanding of the manufacturing process and of the content of any contracts that govern the relationships between related and unrelated parties. *Id.* ¶ 28. Application of the tax law in the corporate international tax context depends as much upon the facts as upon the law. *Id.*

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II. Other Multinationals' and Microsoft's History of Controversy with the IRS

As explained in the Declaration of Michael P. Boyle, Microsoft's former Corporate Vice President of Finance and Tax Counsel, other multinational corporations' high-profile litigations with the IRS over transfer pricing, and Microsoft's experience with the IRS, before 2004, both show why Microsoft had good reason to anticipate litigation over the cost sharing arrangements that are the subject of Microsoft's privileged documents. *Id.* ¶¶ 9-14.

For the last three decades, the IRS has consistently challenged multinational-corporation transfer pricing. *Id.* ¶¶ 9-10. Leading up to Microsoft's consideration of the cost sharing arrangements at issue, there had been numerous high-profile litigations involving the IRS and transfer pricing. *See, e.g., Eli Lilly & Co. v. Comm'r*, 84 T.C. 996 (1985), *aff'd in part, rev'd in part*, 856 F.2d 855 (7th Cir. 1988); *Sundstrand Corp. v. Comm'r*, 96 T.C. 226 (1991); *Sundstrand Corp. v. Comm'r*, 63 T.C.M. (CCH) 2043 (T.C. 1992); *Perkin-Elmer Corp. v. Comm'r*, 66 T.C.M. (CCH) 634 (T.C. 1993); *Seagate Tech., Inc. v. Comm'r*, 102 T.C. 149 (1994); *Nat'l Semiconductor Corp. v. Comm'r*, 67 T.C.M. (CCH) 2849 (T.C. 1994); *Compaq Computer Corp. v. Comm'r*, 78 T.C.M. (CCH) 20 (T.C. 1999). Short of litigation, multinational corporations (particularly in the high-tech sector) have found themselves frequently defending against the IRS's audit positions on global transfer pricing and related issues. Boyle Decl. ¶ 10. The IRS has also endeavored to change the law and regulations, and to pour more resources into audits and into litigating transfer pricing cases. *Id.* ¶ 9. By 2004, Mr. Boyle was aware through participation in professional and industry associations that transfer pricing disputes were prevalent. *Id.* ¶ 10. Tax publication services provided detailed reporting on transfer pricing developments and disputes, including publications dedicated solely to transfer pricing issues. *Id.*

Microsoft's experience has been similar to that of other multinationals. *Id.* ¶¶ 11-12. Microsoft, like most large, profitable, multinational U.S. corporations, is under continual audit by the IRS. *Id.* ¶ 6. Microsoft has had multiple and ongoing disputes with the IRS, many about global

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transfer pricing. *Id.* ¶¶ 11-14. The taxes in dispute have been significant, ranging from millions to billions of dollars over the last decade. *Id.*

Some of Microsoft's disputes have led to litigation. *Id.* ¶¶ 12-14. With respect to two issues involving the same tax years, Microsoft had to litigate in the United States Tax Court to defend against the IRS's claims of tax underpayment. *Id.* Although Microsoft ultimately prevailed on both issues, the litigation did not end until shortly before the years at issue in this summons enforcement action. *Id.* ¶¶ 12-15.

The first issue involved the IRS's assertion that Microsoft's manufacturing subsidiary in Puerto Rico did not "manufacture" software within the meaning of the Internal Revenue Code. *Id.* ¶ 13. The manufacturing issue was an issue of national importance to the IRS and gave rise to potentially billions of dollars of exposure for Microsoft over time. *Id.* The IRS even "designated the case for litigation." *Id.* Designating the case for litigation was a rare step, and meant that the IRS offered only two alternatives to Microsoft—trial or concession. *Id.* Microsoft stood by its position and refused to concede. *Id.* After several years of audit and litigation, the IRS ultimately "de-designated" the case and then conceded the Puerto Rican manufacturing issue. *Id.* The IRS also directly challenged Microsoft's transfer pricing determination involving Microsoft and its Puerto Rican affiliate. *Id.* The IRS's transfer pricing challenge was subsequently held invalid by the Tax Court based on the expiration of the statute of limitations. *Microsoft Corp. v. Comm'r*, 75 T.C.M. (CCH) 1747, 1998 WL 51853, at *7 (T.C. 1998); Boyle Decl. ¶ 13.

The second issue involved the IRS's claim that Microsoft had wrongfully overstated the tax benefits received from its Foreign Sales Corporation. Boyle Decl. ¶ 14. Again, the tax amounts at issue were significant, involving millions of dollars for the years before the Tax Court and even more for future years. *Id.* After a lengthy Tax Court trial, the Tax Court, in 2000, ruled in favor of the IRS. In 2002, however, Microsoft ultimately prevailed when the Ninth Circuit reversed the Tax

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Court ruling. *Microsoft Corp. v. Comm'r*, 311 F.3d 1178, 1189 (9th Cir. 2002), *rev'g* 115 T.C. 228 (2000); Boyle Decl. ¶ 14.

Microsoft also has had many transfer pricing disputes with the IRS. Boyle Decl. ¶ 11. Specifically, the IRS has challenged Microsoft's transfer pricing for royalties, seeking very large adjustments, in virtually every year since 1986, when Microsoft established its international manufacturing operations. *Id.*

III. The Genesis of Microsoft's Asia-Pacific and Americas Cost Sharing Arrangements

According to Michael Boyle, it was clear that the IRS would continue to challenge Microsoft's global transfer pricing. *Id.* ¶¶ 9-11, 15. The Company nonetheless needed to conduct its business around the globe, moving goods, services, and intellectual property among its affiliates. *Id.* ¶ 15. By the end of the 1990s, Microsoft began to evaluate cost sharing arrangements, an approach it believed was consistent with Microsoft's business interests as well as the tax regulations, and that would, in the long term, decrease disputes with the IRS. *Id.* ¶¶ 15, 17-18.

Cost sharing arrangements were enshrined in the transfer pricing regulations in 1968, when the IRS published regulations that allowed offshore affiliates of U.S. companies to agree to share research and development costs and thereby also share ownership of the intellectual property created through this joint investment. *Id.* ¶ 18. Under the IRS regulations, if one party came to the cost sharing arrangement with intellectual property already developed, the other cost sharing entities would make that entity whole by paying for the market value of that intellectual property. *Id.* This payment for pre-existing intellectual property came to be known under the regulations as a "buy-in payment." *Id.*

The IRS established cost sharing arrangements, in part, to decrease disputes about transfer pricing for intellectual property. *Id.* Setting up a cost sharing arrangement avoids having to calculate a license royalty at which the jointly created intellectual property would otherwise have to be transferred, since that property belongs to both entities for tax purposes. *See generally* 26

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C.F.R. § 1.482-7. While the buy-in, if any, still must be established, that is typically a one-time question rather than one that must be determined anew in each tax year. Boyle Decl. ¶ 19.

Other multinational corporations had been using cost sharing arrangements for many years before Microsoft decided to set up several such arrangements in different regions. *Id.* ¶¶ 18, 21-23. Microsoft looked to these IRS-approved cost sharing arrangements as a way to avoid what had become annual fights with the IRS over transfer pricing for Microsoft's intellectual property under the existing licensing royalty structure. *Id.* ¶ 18. The Company anticipated that the IRS would challenge the buy-in payments to be paid by Microsoft's offshore affiliates for pre-existing intellectual property contributed by Microsoft to the cost sharing arrangements, a dispute the Company knew could involve billions of dollars. *Id.* ¶ 19. But Microsoft's hope was that once the buy-in disputes were resolved, disputes going forward over transfer pricing for intellectual property could be minimized. *Id.*

The Company's first two cost sharing arrangements related to operations in Europe, the Middle East, and Africa ("EMEA"). *Id.* ¶ 21. The cost sharing arrangements were completed in May 1999 and January 2003. *Id.* As expected, the IRS challenged both. *Id.* These disputes were ultimately resolved administratively with the IRS. *Id.*

The Company also entered into additional cost sharing arrangements relating to its operations in the Asia-Pacific ("APAC") and Americas regions. *Id.* ¶¶ 22-23. The Company fully expected the IRS to challenge the buy-in payments and other aspects of the cost sharing participants' operations. *Id.* Recognizing the inevitability of an IRS challenge, Microsoft was determined to be adequately prepared to defend these cost sharing arrangements as appropriate under the regulations. *Id.* To that end, Microsoft hired Baker & McKenzie, a firm known to have successfully tried many of the leading transfer pricing cases. *Id.* ¶ 20. Baker & McKenzie was not unknown to Microsoft. *Id.* The Company had used Baker & McKenzie for many years in both tax planning and litigation of the tax cases and transfer pricing disputes mentioned above. *Id.* The

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Company also engaged the accounting firms of Arthur Andersen, KPMG, PricewaterhouseCoopers LLP ("PwC"), and EY to provide tax advice. *Id.* ¶¶ 20-24. The Company's goal was to prepare the soundest position in order to respond to the IRS, administratively and in court, to defend the cost sharing arrangements as proper under the law. *Id.* ¶¶ 7, 20-24.

Microsoft hired EY to assist in planning and building the defense of Microsoft's cost sharing arrangement with its APAC affiliates. *Id.* ¶ 22. The Company knew that the IRS would challenge the arm's length value determined for the pre-existing intellectual property made available to the cost sharing arrangement for research and development purposes. *Id.* Microsoft hired EY to assist in preparing for that challenge. *Id.*

KPMG assisted Microsoft in planning the cost sharing arrangement with the Company's Puerto Rican operations. *Id.* ¶ 23; Decl. of Brett A. Weaver, Sept. 12, 2016, ¶ 10. Microsoft understood that the IRS would likely challenge the buy-in amount that the Company determined for the arm's length value of the pre-existing intellectual property made available to the cost sharing arrangement. Boyle Decl. ¶ 23. Microsoft also recognized that the IRS would challenge the sales prices of software its Puerto Rico affiliate sold back to Microsoft in the United States, as the IRS had done for years by that point. *Id.* ¶¶ 13, 23. Microsoft asked KPMG to assist in the planning and building of the defense of the cost sharing arrangement, the pricing of the software sales to Microsoft in the United States, and a myriad of other issues expected to be in dispute related to the ongoing operations undertaken by the foreign cost sharing participant. *Id.* ¶ 23; Weaver Decl. ¶ 10. Accordingly, Microsoft wanted to ensure that its best position and defense was prepared on all of these issues. Boyle Decl. ¶ 23.

To advise on all of these complex tax issues, EY and KPMG had to understand many detailed facts about Microsoft's operations in these regions – many U.S. corporate tax questions are intensely fact-driven. *Id.* ¶ 28. Similarly, as discussed above, the IRS had previously challenged Microsoft's software manufacturing activities in Puerto Rico, arguing that those

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activities did not constitute manufacturing within the meaning of the Internal Revenue Code. *Id.* As part of its arguments against Microsoft, the IRS had argued about various nuances of the manufacturing process in Puerto Rico, including what was done and by whom, as well as about the content of various contracts among related and unrelated entities. *Id.* These issues require the application of tax law, but that application is based on facts. In order to provide their tax advice about Microsoft's cost sharing arrangements, EY and KPMG likewise had to understand the nuances of all aspects of the proposed operations and to advise as to which activities or contractual arrangements would be acceptable under the law, as well as to which arrangements would not satisfy tax law requirements. *Id.*

Microsoft entered into the cost sharing arrangement for the APAC region effective April 3, 2004, and into the cost sharing arrangement for the Americas region effective July 1, 2005.

IV. The Privilege Dispute Relating to the 2004-2006 Audit

The IRS audit of the APAC and Americas cost sharing arrangements now exceeds nine years. The parties are before the Court in connection with the IRS's summons enforcement action. At this point the disputes between the parties relate to a defined universe of documents that Microsoft has withheld from production on privilege and work product grounds.

Consistent with the May 25, 2016, Stipulated Motion and Order Pursuant to FRE 502(d) (Case No. 15-102, Dkt. 124), the parties met in an effort to resolve as many privilege claims as possible over twelve separate days during July and August of 2016. The parties engaged in a quick-peek procedure for most of the documents. Microsoft declined to show some documents during the quick peek, but described to the government the nature of the withheld documents to provide the basis and reasoning for Microsoft's privilege claims. As a result of the parties' discussions, the number of privileged documents in dispute is 174.

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Microsoft contends that each of the 174 documents is protected from disclosure by one or more of the Section 7525 federally authorized tax practitioner privilege, the work product doctrine, and the attorney-client privilege.

The 174 disputed documents are listed on the four privilege logs attached as Exhibits A through D to the Declaration of Daniel A. Rosen. Each privilege log provides the following information for each document: (1) the beginning and ending Bates numbers; (2) the date the document was generated, labeled, or transmitted; (3) the sender or author; (4) the recipients; (5) description of subject matter stated with particularity; (6) description of type or nature of the document; and (7) an explanation as to the basis for each assertion of privilege. Decl. of Daniel A. Rosen, Sept. 12, 2016, ¶ 7 & Exs. A-D.

Microsoft's privilege claims are further supported by the Declarations of Michael P. Boyle, William J. Sample, and Brett A. Weaver, filed simultaneously with this brief.

Argument

"[T]he obligation imposed by a tax summons remains subject to the traditional privileges and limitations." *Upjohn Co. v. United States*, 449 U.S. 383, 398 (1981) (citation and internal quotation marks omitted). Federal law governs privilege issues in a summons enforcement proceeding. *See* Fed. R. Evid. 501.

Microsoft makes the *prima facie* showing necessary to establish privilege and work product for the 174 withheld documents.

Virtually all of the documents withheld by Microsoft are protected by multiple privilege claims, as set forth in the privilege logs. Rosen Decl. Exs. A-D.

With respect to the 164 documents for which Microsoft claims the Section 7525 federally authorized tax practitioner privilege, each document reflects a confidential communication between a client (Microsoft) and its tax advisers made for the purpose of seeking tax advice.

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Microsoft also claims work product protection for 170 documents prepared by or for Microsoft in anticipation of litigation with the IRS. As set forth in the Declarations of Messrs. Boyle and Weaver, Microsoft reasonably anticipated litigation with the IRS over the cost sharing arrangements. The public experience of other taxpayers with high profile transfer pricing disputes, Microsoft's own history of litigation and disputes with the IRS (many about transfer pricing), and the enormous potential magnitude of any such dispute, demonstrate that Microsoft reasonably anticipated litigation with the IRS relating to the cost sharing arrangements. Microsoft's anticipation has become reality as the IRS audit enters into its tenth year and the IRS has asserted billions of dollars of adjustments.

Finally, there are 12 documents for which the attorney-client privilege applies. Each document reflects a confidential communication with Microsoft attorneys made for the purpose of providing or seeking legal advice.

I. The Section 7525 Federally Authorized Tax Practitioner Privilege Protects 164 Disputed Documents from Disclosure

The U.S. tax system imposes rigorous requirements on U.S. corporations that conduct business abroad. Multinational corporations, like Microsoft, must painstakingly apply these rigorous standards to assess the tax ramifications of their existing and contemplated operations outside the U.S. Consistent with Microsoft's efforts to evaluate its tax obligations emanating from the cost sharing arrangements, Microsoft sought advice from KPMG and EY on a wide range of issues. This advice is privileged under Section 7525.

A. Section 7525 extends the protections of the attorney-client privilege to communications between a taxpayer and any federally authorized tax practitioner.

Section 7525 extends the protections of the attorney-client privilege to communications "between a taxpayer and any federally authorized tax practitioner." The statute provides:

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> With respect to tax advice, 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.

26 U.S.C. § 7525(a)(1).[1] The Section 7525 tax practitioner privilege is largely co-extensive with the attorney-client privilege. *Schaeffler v. United States*, 806 F.3d 34, 38 n.3 (2d Cir. 2015) (the Section 7525 privilege is "essentially coterminous with the attorney-client privilege both in scope and in waiver"). The Big Four accounting firms regularly provide international tax analysis and advice that is indistinguishable from the legal advice provided by law firms working in the international tax field. Boyle Decl. ¶¶ 25, 29. Section 7525 protects this tax advice.[2] When federally authorized tax practitioners provide such privileged advice, they are doing "lawyers' work." *United States v. BDO Seidman*, 337 F.3d 802, 810 (7th Cir. 2003) (citation and internal quotation marks omitted).

The statute defines "federally authorized tax practitioner" as "any individual who is authorized under Federal law to practice before the Internal Revenue Service if such practice is subject to Federal regulation under section 330 of title 31, United States Code." 26 U.S.C. § 7525(a)(3)(A). 31 U.S.C. § 330 governs practice before the IRS. Pursuant to 31 U.S.C. § 330, the IRS has issued regulations allowing attorneys and CPAs to practice before the IRS. *See* 31 C.F.R. § 10.3.

"Tax advice" is "advice given by an individual with respect to a matter which is within the scope of the individual's authority to practice described in subparagraph (A)." 26 U.S.C.

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended and in effect for the years in issue.

[2] In addition to the common-law elements of, and restrictions on, the attorney-client privilege set forth above, there is a statutory exception to the Section 7525 privilege. That exception is for communications in connection with the promotion of the participation of a person in a tax shelter. *See* 26 U.S.C. § 7525(b). The initial burden lies on the party asserting the exception. The exception does not apply in this case.

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§ 7525(a)(3)(B) (referring to the definition of "federally authorized tax practitioner" in 26 U.S.C. § 7525(a)(3)(A)).

B. The Section 7525 privilege applies to the documents Microsoft has withheld.

"The party asserting the attorney-client privilege has the burden of proving that the privilege applies to a given set of documents or communications." *In re Grand Jury Investigation*, 974 F.2d 1068, 1070 (9th Cir. 1992). "To meet this burden, a party must demonstrate that its documents adhere to the essential elements of the attorney-client privilege adopted by this court." *Id.* at 1070-71.

The Ninth Circuit has "recognized a number of means of sufficiently establishing the privilege, one of which is the privilege log approach." *Id.* at 1071. The court found that a log with supporting affidavits satisfied the *prima facie* showing of privilege when they identified:

> (a) the attorney and client involved, (b) the nature of the document, (c) all persons or entities shown on the document to have received or sent the document, (d) all persons or entities known to have been furnished the document or informed of its substance, and (e) the date the document was generated, prepared, or dated.

Id. (citing *Dole v. Milonas*, 889 F.2d 885, 888 n.3, 890 (9th Cir.1989), and noting that "information on the subject matter of each document" actually went beyond the standards set forth in *Dole*).

The privilege logs and the declarations filed with this brief demonstrate that Microsoft has sufficiently proved the facts necessary to establish the elements of the Section 7525 privilege as to the disputed documents. The logs and declarations show that the disputed documents reflect communications made between federally authorized tax practitioners and Microsoft, or their agents, in confidence, for the purpose of seeking or obtaining tax advice, and the privilege was not waived. The logs set forth document dates, authors / senders / recipients, and the nature of the

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documents. The logs thus make the *prima facie* showing described in *In re Grand Jury Investigation*, 974 F.2d at 1070-71.

The declarations filed with this brief provide further support for the elements of the privilege. The advice was kept confidential and the privilege was not waived. *See* Boyle Decl. ¶ 27; Weaver Decl. ¶ 21; Decl. of William J. Sample, Sept. 10, 2016, ¶ 3. And as discussed below, the privileged documents reflect tax advice.

C. The privileged documents reflect tax advice, not business advice.

Based on the meet and confer sessions, Microsoft anticipates that the government will take the position that the Section 7525 privilege does not apply because the advice contained in the disputed documents was business advice.

The documents reflect tax advice, and not business or non-legal advice. Rosen Decl. ¶ 13-14. The fact that the tax advice was given in contemplation of a business transaction did not make it any less tax advice. Taxation is governed by complex law, including statutes, regulations, and case law. Interpreting, applying, and providing opinions about the tax law, to enable a client to understand the tax law consequences of a proposed transaction and plan the transaction to best comport with the tax law, is legal advice. As *United States v. ChevronTexaco Corp.*, 241 F. Supp. 2d 1065 (N.D. Cal. 2002), explained:

> Determining the tax consequences of a particular transaction is rooted virtually entirely in the law. The advisor must analyze the tax code, IRS rulings, decisions of the Tax Court, etc. Communications offering tax advice or discussing tax planning or the tax consequences of alternate business strategies are "legal" communications. *Accord*, *In re Grand Jury*, 731 F.2d 1032, 1037-1038 (2nd Cir.1984). We realize that corporations often enlist the services of nonlawyers (*e.g.*, accountants, consulting firms) to advise them with respect to tax matters. This does not change the fact that the advi[c]e is rooted in the law and, *when solicited from or given by a client's attorney* it constitutes *legal* advice as contemplated by the attorney-client privilege.

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Id. at 1076 (emphasis in original); *see also, e.g.*, *In re Grand Jury Subpoena Duces Tecum Dated Sept. 15, 1983*, 731 F.2d 1032, 1037-38 (2d Cir. 1984); *United States v. Sanmina Corp. & Subsidiaries*, No. 5:15-CV-00092-PSG, 2015 WL 2412322, at *2-4 (N.D. Cal. May 20, 2015). The fact that tax issues have commercial consequences does not make them any less legal issues. *See Schaeffler*, 806 F.3d at 41 (tax issues were "a legal problem albeit with commercial consequences . . . ."; the fact that large sums of money were at stake "does not render those legal issues 'commercial'").

These tax cases are consistent with cases outside the tax context, which hold that discussions of business or commercial matters for the purposes of legal advice, including counseling and planning advice, are privileged. *Segerstrom v. United States*, No. C 00-0833 SI, 2001 WL 283805, at *2 (N.D. Cal. Feb. 6, 2001) ("[A] client is entitled to hire a lawyer, and have his secrets kept, for legal advice regarding the client's business affairs.") (citation and internal quotation marks omitted); *Note Funding Corp. v. Bobian Inv. Co.*, No. 93 CIV. 7427 (DAB), 1995 WL 662402, at *3 (S.D.N.Y. Nov. 9, 1995) (under state law, documents reflected legal advice when they "include references to, or even fairly extensive discussions of, financial questions and issues of commercial strategy and tactics, but do so in a context that makes it evident that the attorney is presenting the issues and analyzing the choices on the basis of his legal expertise and with an obvious eye to the constraints imposed by applicable law").

The documents in question reflect core tax advice. As explained above, the U.S. tax system imposes rigorous requirements on U.S. corporations that conduct business abroad. Multinational corporations, like Microsoft, must painstakingly apply these rigorous standards to assess the tax ramifications of their existing and contemplated operations abroad. Consistent with its efforts to evaluate the Company's tax obligations emanating from the cost sharing arrangements, Microsoft sought advice from KPMG and EY on a wide range of issues. Boyle Decl. ¶¶ 20, 22-23, 28; Weaver Decl. ¶¶ 12, 14-15. As the accompanying declarations explain, Microsoft retained KPMG

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and EY to evaluate the tax consequences of entering into the CSAs and to advise Microsoft, from a tax law perspective, regarding not only the critical Section 482 questions, but also with respect to a myriad of tax issues arising from the operations to be conducted by the foreign cost sharing participants. Boyle Decl. ¶¶ 20, 22-23, 28; Weaver Decl. ¶¶ 12, 14-15.

* * *

The privilege logs and the declarations filed contemporaneously with this brief show that Microsoft has sufficiently proved the facts necessary to establish the elements of the Section 7525 privilege as to the disputed documents.

II. The Work-Product Doctrine Protects 170 Disputed Documents from Disclosure

Work product protection applies to 170 of the documents that remain in dispute. Microsoft has demonstrated the facts necessary to establish the elements of the work product doctrine as to these documents.

A. Work product protection applies to documents prepared in anticipation of litigation.

The work product doctrine protects "documents and tangible things that are prepared in anticipation of litigation or for trial by or for another party or its representative (including the other party's attorney, consultant, surety, indemnitor, insurer, or agent)." Fed. R. Civ. P. 26(b)(3). "Such documents may only be ordered produced upon an adverse party's demonstration of 'substantial need [for] the materials' and 'undue hardship [in obtaining] the substantial equivalent of the materials by other means.'" *In re Grand Jury Subpoena (Mark Torf/Torf Envtl. Mgmt.)*, 357 F.3d 900, 906 (9th Cir. 2004) (quoting Fed. R. Civ. P. 26(b)(3)); *see also Hickman v. Taylor*, 329 U.S. 495, 510-11 (1947).

"The doctrine is intended to preserve a zone of privacy in which a lawyer can prepare and develop legal theories and strategy with an eye toward litigation, free from unnecessary intrusion by his adversaries." *Schaeffler*, 806 F.3d at 43 (citation and internal quotation marks omitted).

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"[T]he doctrine is an intensely practical one, grounded in the realities of litigation in our adversary system." *Torf*, 357 F.3d at 907 (quoting *United States v. Nobles*, 422 U.S. 225, 238-39 (1975)).

Although originally framed as a protection of a lawyer's work product in *Hickman*, 329 U.S. at 510-11, the protection was broadened in the adoption of Fed. R. Civ. P. 26(b)(3) to apply to materials prepared in anticipation of litigation by or for a party or its representative, not just by or for a lawyer. Work product protection thus covers materials prepared by or for Microsoft, by Microsoft, its lawyers, or its tax advisers, regarding the planning of cost sharing arrangements where tax litigation was reasonably anticipated.

B. The documents were prepared by or for Microsoft.

The work product doctrine protects documents prepared "by or for another party or its representative." Fed. R. Civ. P. 26(b)(3). The privilege logs show that the documents in question were prepared by Microsoft or for Microsoft by its representatives, including KPMG, EY, Arthur Andersen, and PwC, all of whom were retained by Microsoft. Boyle Decl. ¶¶ 20-24; Rosen Decl. ¶ 6 & Exs. A-D.

C. The documents were prepared in anticipation of litigation with the IRS.

The declarations show that these documents were prepared in anticipation of litigation with the IRS. In the tax context, a taxpayer may reasonably anticipate litigation for a variety of reasons, even before entering into the transactions at issue and filing tax returns. Here, Microsoft reasonably anticipated both an administrative dispute and subsequent litigation with the IRS. The documents at issue were prepared because of that anticipation.

Work product may extend to tax planning "documents created prior to the event giving rise to litigation." *United States v. Adlman*, 68 F.3d 1495, 1501 (2d Cir. 1995) (*Adlman I*). "In many instances, the expected litigation is quite concrete, notwithstanding that the events giving rise to it have not yet occurred." *Id.* Nor need the IRS have expressly indicated an intent to pursue litigation. *See United States v. Roxworthy*, 457 F.3d 590, 600 (6th Cir. 2006). "Although not every audit is

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potentially the subject of litigation, . . . a document prepared in anticipation of dealing with the IRS may well have been prepared in anticipation of an administrative dispute and this may constitute 'litigation' within the meaning of Rule 26." *Id.* (citations, internal quotation marks, and alterations omitted). "A document may be considered to have been prepared in anticipation of litigation even if the litigation that caused its preparation was an investigation by a government agency, and not a traditional civil suit." *Abdallah v. Coca-Cola Co.*, No. CIV A1:98CV3679RWS, 2000 WL 33249254, at *5 (N.D. Ga. Jan. 25, 2000).

In the tax setting, a variety of circumstances may lead a taxpayer, even one planning a transaction, to reasonably anticipate heightened IRS scrutiny, an administrative dispute, and litigation. *See Schaeffler*, 806 F.3d at 43-45 (EY's tax memorandum regarding a business transaction "was necessarily geared to an anticipated audit and subsequent litigation, which was on this record highly likely") (citing *United States v. Adlman*, 134 F.3d 1194, 1195 (2d Cir. 1998) (*Adlman II*), for the point that "predicted litigation was virtually inevitable because of size of transaction and losses"); *Roxworthy*, 457 F.3d at 599-601; *ChevronTexaco*, 241 F. Supp. 2d at 1082-83; *Sanmina*, 2015 WL 2412322, at *5.

Circumstances considered in relevant tax cases include:

- The identification of a specific transaction that could result in litigation, *Roxworthy*, 457 F.3d at 600;
- The identification of a specific legal controversy that would be at issue in the litigation, *id.*;
- The size of the company, *id.*;
- The size of the transaction, *Schaeffler*, 806 F.3d at 44; *Roxworthy*, 457 F.3d at 600; *Sanmina*, 2015 WL 2412322, at *5;
- "[T]he complexity and ambiguity of the appropriate tax treatment," *Schaeffler*, 806 F.3d at 44;
- The IRS's examination of all the taxpayer's returns, *ChevronTexaco*, 241 F. Supp. 2d at 1082;

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- The IRS's previous questioning of similar transactions, *id.*; and
- The fact that the taxpayer hired an outside accounting firm, and the accounting firm prepared many of the documents, because the taxpayer and the accounting firm "anticipated a vigorous legal challenge by the IRS," *id.*

These circumstances were present here. Based on both other multinational corporations' high-profile litigations with the IRS over transfer pricing, and Microsoft's experience with the IRS, Microsoft had good reason by 2004 to anticipate litigation over the cost sharing arrangements that are the subject of Microsoft's privileged documents. *See* pp. 3-5 *supra*; Boyle Decl. ¶¶ 9-14.

Boyle experienced firsthand that disputes over transfer pricing issues were prevalent. Boyle Decl. ¶¶ 7, 9-11, 13. The IRS was actively auditing other companies and litigating cost sharing issues, including many high-profile transfer pricing cases in litigation. *Id.* ¶¶ 7, 9-10. Tax publications regularly focused on transfer pricing disputes and issues. *Id.* ¶ 10.

Microsoft itself had been under continuous audit by the IRS since Mr. Boyle joined the Company in 1986 and was under audit at the time these documents were created. *Id.* ¶¶ 6, 11. In fact, Microsoft has continued to be under audit through the present, as shown by this summons enforcement proceeding. Microsoft also had a long history of disputes with the IRS. *Id.* ¶¶ 11-14. Shortly before Microsoft executed the Americas and APAC cost sharing arrangements, two of those disputes had resulted in Tax Court litigation. *Id.* ¶¶ 12-15.

In addition, the Americas and APAC cost sharing arrangements were large transactions involving very substantial tax dollars that the government, in this proceeding, claims warrant income tax adjustments in the multiple billions of dollars. *See* U.S. Resp. to Mot. for Evid. Hr'g, Case No. 15-102, Dkt. 39 at 4 ("Once TPO began reviewing the IRS's existing transfer pricing inventory, it identified Microsoft's transfer pricing issues as among the largest transfer pricing issues the IRS had, potentially involving tens of billions of dollars in U.S. taxable income."). The relevant law and regulations (Section 482, the transfer pricing regulations, and a variety of other areas of tax law and regulations), were and are incredibly complex. The appropriate tax

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treatment was correspondingly complex. Boyle Decl. ¶¶ 8, 18, 28. Given all these factors, Mr. Boyle and Microsoft expected that the Americas and APAC cost sharing arrangements would inevitably draw intense scrutiny by the IRS and result in an adversarial dispute and litigation with the IRS. *Id.* ¶¶ 22-23, 28. Boyle sought and received tax advice from KPMG and EY not only to ensure the CSAs complied with the tax law, but also to prepare for the real threat of litigation with the IRS. *Id.* ¶¶ 7, 22-23.

Microsoft's history of significant tax disputes with the IRS is undisputed. That history included multiple audits accompanied by significant proposed tax adjustments, some of which led to lengthy litigation in Tax Court that ended shortly before the 2004-2006 tax years at issue. In light of that history, Microsoft reasonably anticipated litigation over the APAC and Americas cost sharing arrangements. Microsoft sought legal advice regarding the defensibility of the Company's position on both the Section 482 issues involved with establishing the APAC and Americas cost sharing arrangements, and a myriad of other tax issues related to the contemplated operations of the foreign cost sharing participants. In these circumstances, Microsoft had a reasonable anticipation of heavy scrutiny, and a forceful challenge and litigation, by the IRS. *See Schaeffler*, 806 F.3d at 43-45; *Roxworthy*, 457 F.3d at 599-601; *ChevronTexaco*, 241 F. Supp. 2d at 1082-83; *Sanmina*, 2015 WL 2412322, at *5.

D. The documents were prepared *because of* Microsoft's anticipation of litigation with the IRS.

Not only did Microsoft reasonably anticipate litigation, but also the documents were prepared because of that anticipation. Documents prepared "exclusively in anticipation of litigation" clearly are work product. *Torf*, 357 F.3d at 907 (internal quotation marks omitted). Documents may also have a "dual purpose," both in anticipation of litigation and for another purpose. *Id.* For dual purpose documents, the Ninth Circuit has adopted the "because of" standard,

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following the leading case of *Adlman II* and other authorities. *Torf*, 357 F.3d at 907-08 (discussing *Adlman II*, 134 F.3d 1194).

The "because of" standard protects documents that were prepared in anticipation of litigation, but have "the purpose of assisting in the making of a business decision." *Adlman II*, 134 F.3d at 1198-99. That is because "an attorney's assessment of the likely outcome of litigation" should not become "freely available to his litigation adversary merely because the document was created for a business purpose rather than for litigation assistance." *Id.* at 1200.

Even where a document's litigation preparation purpose is intertwined with other purposes, the document is protected. *Torf*, 357 F.3d at 910 (documents protected where, "taking into account the facts surrounding their creation, their litigation purpose so permeates any non-litigation purpose that the two purposes cannot be discretely separated from the factual nexus as a whole").

The fact that KPMG's advice helped Microsoft set up a business transaction, therefore, does not change the fact that that advice was protected work product. The role KPMG played in that transaction was litigation preparation. The documents were not created in the ordinary course of business. Instead they reveal the very issues Microsoft and its advisers were evaluating and provide a roadmap to the Company's mental impressions, strategies, assessments of strengths and weaknesses, and assessments of positions by Microsoft representatives, whether in-house attorneys, in-house tax practitioners, or outside tax practitioners. Rosen Decl. ¶ 16. Revealing this information to the government would allow the government to operate on "wits borrowed from the adversary," the harm the work product doctrine is meant to prevent. *Adlman II*, 134 F.3d at 1200 (quoting *Hickman*, 329 U.S. at 516 (Jackson, J., concurring)). The expectation of litigation permeated the documents at issue, affecting both the issues discussed and the level of detail of the analysis. Rosen Decl. ¶ 16. The IRS has already gathered substantial information related to the transactions. It should not also be allowed to access Microsoft's and its advisers' assessments and thought processes and use them as a roadmap to litigation.

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III. The Attorney-Client Privilege Protects 12 Disputed Documents from Disclosure

A. The attorney-client privilege protects confidential communications between a client seeking legal advice and an attorney providing such advice.

"The attorney-client privilege is the oldest and arguably most fundamental of the common law privileges recognized under Federal Rule of Evidence 501." *In re Napster, Inc. Copyright Litig.*, 479 F.3d 1078, 1090 (9th Cir. 2007), *abrogated on other grounds by Mohawk Indus., Inc. v. Carpenter*, 558 U.S. 100, 105 n.1 (2009). "The attorney-client privilege protects confidential communications between a client seeking legal advice and an attorney providing such advice." *In re Grand Jury Subpoena 92-1(SJ)*, 31 F.3d 826, 829 (9th Cir. 1994). "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." *Upjohn*, 449 U.S. at 389; *see also Napster*, 479 F.3d at 1090 (by enabling open communication between attorneys and clients, the privilege promotes compliance with the law).

The elements of the attorney-client privilege are:

> (1) Where legal advice of any kind is sought (2) from a professional legal adviser in his capacity as such, (3) the communications relating to that purpose, (4) made in confidence (5) by the client, (6) are at his instance permanently protected (7) from disclosure by himself or by the legal adviser, (8) unless the protection be waived.

United States v. Graf, 610 F.3d 1148, 1156 (9th Cir. 2010) (citation and internal quotation marks omitted).

B. The attorney-client privilege applies to the documents Microsoft has withheld.

The privilege logs and declarations demonstrate that Microsoft has proved the preliminary facts necessary to establish the attorney-client privilege as to the 12 disputed documents. The logs and declarations show that the disputed documents reflect communications made between Microsoft and its attorneys, or their agents, in confidence, for the purpose of seeking or obtaining legal advice, and the privilege was not waived. The logs satisfy the *prima facie* showing by

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providing information about document dates, authors / senders / recipients, and the nature of the documents. *See In re Grand Jury Investigation*, 974 F.2d at 1070-71.

In addition, the declarations filed with this brief establish that for documents for which Microsoft claims attorney-client privilege, the documents reflect confidential legal advice, or were created for the purpose of seeking or providing confidential legal advice, from Microsoft's in-house or outside attorneys. Rosen Decl. ¶¶ 8-10. The documents analyze legal issues that arose while planning the transactions. Rosen Decl. ¶ 10. The documents reflect legal advice, not business discussions or non-legal advice. *See id.* Microsoft kept this advice confidential and the privilege was not waived. *See* Rosen Decl. ¶ 11; Boyle Decl. ¶ 27; Weaver Decl. ¶ 21; Sample Decl. ¶ 3.

Conclusion

Microsoft respectfully requests that the Court find that the disputed documents are not subject to production under the IRS's summonses because the documents are privileged and work product.

DATED this 12th day of September, 2016.

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I hereby certify that on September 12, 2016, I electronically filed the foregoing with the Clerk of the Court using the CM/ECF system which will send notification of such filing to the following:

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