

Current Federal Tax Developments

Week of January 27, 2020

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ACCOUNTING
CONTINUING EDUCATION

CURRENT FEDERAL TAX DEVELOPMENTS
WEEK OF JANUARY 27, 2020
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Published in 2020 by Kaplan Financial Education.

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Kaplan Financial Education

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SECTION: 165

IRS DOES NOT NEED TO CARRY BURDEN ON EACH INDIVIDUAL TRANSACTION IF DISALLOWING KICKBACKS AND ILLEGAL PAYMENTS UNDER §165(C)

Citation: Chief Counsel Advice 202003004, 1/17/2020

In Chief Counsel Advice 202003004¹ the IRS Chief Counsel's office looked at the impact of the burden of proof imposed on the agency when it asserts that payments are to disallowed under IRC §165(c) as illegal kickbacks, bribes, and the like.

IRC §162(c)(1)-(2) read as follow:

(c) Illegal bribes, kickbacks, and other payments

(1) Illegal payments to government officials or employees

No deduction shall be allowed under subsection (a) for any payment made, directly or indirectly, to an official or employee of any government, or of any agency or instrumentality of any government, if the payment constitutes an illegal bribe or kickback or, if the payment is to an official or employee of a foreign government, the payment is unlawful under the Foreign Corrupt Practices Act of 1977. The burden of proof in respect of the issue, for the purposes of this paragraph, as to whether a payment constitutes an illegal bribe or kickback (or is unlawful under the Foreign Corrupt Practices Act of 1977) shall be upon the Secretary to the same extent as he bears the burden of proof under section 7454 (concerning the burden of proof when the issue relates to fraud).

(2) Other illegal payments

No deduction shall be allowed under subsection (a) for any payment (other than a payment described in paragraph (1)) made, directly or indirectly, to any person, if the payment constitutes an illegal bribe, illegal kickback, or other illegal payment under any law of the United States, or under any law of a State (but only if such State law is generally enforced), which subjects the payor to a criminal penalty or the loss of license or privilege to engage in a trade or business. For purposes of this paragraph, a kickback includes a payment in consideration of the referral of a client, patient, or customer. The burden of proof in respect of the issue, for purposes of this paragraph, as to whether a payment constitutes an illegal bribe, illegal kickback, or other illegal payment shall be upon the Secretary to the same extent as

¹ Chief Counsel Advice 202003004, January 17, 2020, <https://www.irs.gov/pub/irs-wd/202003004.pdf> <https://www.irs.gov/pub/irs-wd/202003004.pdf> (retrieved January 17, 2020)

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he bears the burden of proof under section 7454 (concerning the burden of proof when the issue relates to fraud).

IRC §7454(a) provides that “[i]n any proceeding involving the issue whether the petitioner has been guilty of fraud with intent to evade tax, the burden of proof in respect of such issue shall be upon the Secretary.” As the Tax Court held in the recent case of *Purvis, et ux v. Commissioner*, TC Memo 2020-13, that burden is to prove the matter by clear and convincing evidence.

What if the taxpayer in question engaged in a large number of transactions that the IRS suspects are covered by these provisions? May the agency use a sample, presumably statistically significant, in which such bad conduct is shown by clear and convincing evidence to then propose an assessment covering the entire population based on the results of the sample? Or is the IRS required to obtain evidence on each specific transaction in question? This memorandum considers that issue.

The memorandum summarizes the issue as follows:

Taxpayer engaged in the manufacture, promotion, and sale of Product. Taxpayer’s managers allegedly encouraged sales representatives to persuade Individuals to Perform Action for Taxpayer’s Product by taking the Individuals out for repeated dinners and paying the Individuals for speaker engagements. The sales representatives allegedly warned the Individuals that these benefits would not continue if they failed to Perform Action for Taxpayer’s Product. Taxpayer deducted the dinner expenses as meals and entertainment expenses, while payments made to Individuals for speaker engagements were deducted as advertising expenses (collectively, “Expenses”).²

The taxpayer entered a guilty plea on a criminal charge related to the events. The taxpayer also was subject of a related civil suit. The taxpayer settled the suit, but did not admit guilt in the settlement. However, the memorandum notes:

...[I]n the civil settlement, Taxpayer agreed to pay the plaintiffs more than \$C, but made no admission of guilt. Taxpayer did not admit to the entirety of the facts as alleged by the government, but did admit that from Date 2 through Date 3, sales representatives took Individuals out for dinners that included little or no education and that certain speakers were paid fees to provide promotional presentations even though, in certain instances, they did not give a complete presentation or any presentation at all.³

The IRS then took the following actions:

When the Commissioner analyzed Taxpayer’s books and records, it was determined that the amount of Expenses was approximately \$D.

² Chief Counsel Advice 202003004, p. 3

³ Chief Counsel Advice 202003004, p. 3

Based on a sample of E line-items of Expenses, the Commissioner found that only F% of the meals and entertainment expenses paid to Individuals were acceptable as legitimate expenses, and none of the advertising expenses paid to Individuals were acceptable as legitimate expenses. The Commissioner issued notices of proposed adjustments, proposing to disallow the Expenses that were not considered legitimate expenses.⁴

The memorandum concludes that the IRS is not required to demonstrate by clear and convincing evidence that the requirements of IRC §§162(c)(1) and/or (c)(2) were met for each individual transaction. The memorandum holds:

Section 162(c)(1) and (2) disallow deductions for certain payments that would otherwise be deductible under § 162(a), and place the burden of proving that a payment is one described in § 162(c)(1) or (2) on the Commissioner to the same extent as he or she bears the burden of proof under § 7454 (concerning the burden of proof when the issue relates to fraud). Section 7454(a) provides that for proceedings involving fraud with the intent to evade tax, the burden of proof with respect to that specific issue is on the Commissioner. This burden is to be carried by clear and convincing evidence. Rule 142(b), Tax Court Rules of Practice. The Commissioner may meet his burden by presenting several badges of fraud throughout the entire record. *Hicks Co. v. Comm'r*, 56 T.C. 982, 1019 (1971).

Although the burden of proving fraud falls upon the Commissioner, the burden of proving entitlement to deductions is with the taxpayer. *Id.* at 1031. Once the Commissioner proves fraud with clear and convincing evidence, the burden shifts to the taxpayer to rebut the Commissioner's deficiency determination on any items falling within the logical ambit of that fraud, and, further, such rebuttal must take the form of something more than bank statements, receipts, and cancelled checks, or cursory, unsubstantiated assertions of business need. See *Neaderland* at 538-541.⁵

The analysis continues:

Thus, in the present case, similar to fraud cases, once the Commissioner proves that some of the Expenses are kickbacks described in § 162(c)(1) or (c)(2), he or she then separately determines the total deficiency in the income tax. This means that while the burden of proof falls to the Commissioner with respect to the issue of whether some of the Expenses are described in § 162(c)(1) or (c)(2), the Commissioner retains the presumption of correctness in regard to the determination of any deficiencies. The burden of proof regarding Taxpayer's deficiency does not shift to the Commissioner unless a separate provision shifts that burden. For example, § 7491(a) shifts the

⁴ Chief Counsel Advice 202003004, p. 3

⁵ Chief Counsel Advice 202003004, p. 4

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burden of proof as to all issues relevant to the amount of the taxpayer's liability if the taxpayer introduces credible evidence, substantiates items, maintains required records, and fully cooperates with the Commissioner's requests.

Here, the Commissioner is required to prove by clear and convincing evidence, by considering the entire record, that Taxpayer made some payments that are kickbacks described in § 162(c)(1) or (c)(2). Once the Commissioner has met this burden of proof, he or she may disallow Taxpayer's deductions for Expenses by making a determination of deficiency. This determination has a presumption of correctness. The Commissioner does not bear the burden of proving by clear and convincing evidence that each individual payment is a kickback described in § 162(c)(1) or (c)(2).⁶

SECTION: 401 FINANCIAL INSTITUTIONS GRANTED RELIEF FOR ISSUING ERRONEOUS NOTICES OF RMDs DUE TO SECURE ACT CHANGES IF CORRECTED NOTICES ISSUED BY APRIL 15, 2020

Citation: Notice 2020-06, 1/24/20

In Notice 2020-06⁷ the IRS has provided some relief to financial institutions due to the late change in the determination of IRA account owners who have required minimum distributions that was part of the SECURE Act. The SECURE Act was included as part of the Further Consolidated Appropriations Act, 2020 signed into law in late December.

The notice explains the requirements institutions have for reporting required minimum distributions due from IRA accounts they maintain:

If an IRA owner has an RMD due for 2020, the financial institution that is the trustee, custodian, or issuer maintaining the IRA must file a 2019 Form 5498 (IRA Contribution Information) by June 1, 2020, and indicate by a check in Box 11 that an RMD is required for 2020. The financial institution may also choose to provide further information in Box 12a (RMD Date) and Box 12b (RMD Amount). Additionally, under Notice 2002-27, 2002-1 C.B. 814, if an IRA owner has an RMD due for 2020, the financial institution must furnish an RMD statement to the IRA owner by January 31, 2020, that informs the IRA owner of the date by which the RMD must be distributed, and either provides

⁶ Chief Counsel Advice 202003004, p. 5

⁷ Notice 2020-06, January 24, 2020, <https://www.irs.gov/pub/irs-drop/n-20-06.pdf> (retrieved January 24, 2020)

the amount of the RMD or offers to calculate that amount upon request.

The RMD statement required under Notice 2002–27 should not be sent to IRA owners who will attain age 70½ in 2020.⁸

Of course, financial institutions are used to this deadline, and most likely have systems in place to automatically generate those notices based on the prior law. However, those systems are set to issue initial RMD notices to those who will attain age 70½ during 2020, along with notices for all of those who had received notices in earlier years.

The SECURE Act, especially in its phase-in period, has complicated this matter.

- Those who attained age 70½ before the end of 2019 will receive notices based on the same rules as applied in prior years and thus will need to receive RMD notices for 2020 even though they may not attain age 72 before the end of 2020; and
- Those who attain age 70½ after 2019 will be subject to RMD notices under the new rules, triggered in the year in which they attain age 72. None of these IRA owners should receive a notice indicating that an RMD is required for 2020, as none of them will attain age 72 in 2020.

Reprogramming software to take into account these distinctions will not be a simple process, and it will take time to program the systems and test them. Financial institutions have protested that these systems will not be revised and properly tested by the time the notices of RMD amounts are due to IRA owners on January 31, 2020.

The IRS therefore has decided to turn a blind eye to the fact that financial institutions may end up sending out erroneous RMD notices to taxpayers attaining age 70½ in 2020. The Notice provides:

...[I]n recognition of the short amount of time after the enactment of the SECURE Act that financial institutions have had to change their systems for furnishing the RMD statement, relief is being provided. Under this relief, if a financial institution provides an RMD statement to an IRA owner who will attain age 70½ in 2020 (including by providing a Form 5498), then the Internal Revenue Service (IRS) will not consider such a statement to have been provided incorrectly, but only if the IRA owner is notified by the financial institution no later than April 15, 2020, that no RMD is required for 2020.⁹

While the notice appears to allow for an initially wrong account holder copy of Form 5498 to go to the account holder showing a 2020 required minimum distribution, the notice implies that the agency expects the Forms 5498 eventually filed with the IRS will not have that error on the form, as the notice states:

⁸ Notice 2020-06, p. 2

⁹ Notice 2020-06, p. 2

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For IRA owners who will attain age 70½ in 2020, the 2019 Form 5498 should not include a check in Box 11 or entries in Box 12a or 12b.¹⁰

The IRS uses this notice to ask a favor of financial institutions to remind those who turned 70 ½ in 2019 that they still must take distributions, stating:

The SECURE Act did not change the required beginning date for IRA owners who attained age 70½ prior to January 1, 2020. In order to reduce misunderstanding among IRA owners, the IRS encourages all financial institutions, in communicating these RMD changes, to remind IRA owners who attained age 70½ in 2019, and have not yet taken their 2019 RMDs, that they are still required to take those distributions by April 1, 2020.¹¹

Since financial institution and plan software may still show RMDs for those that will attain age 70 ½ in 2020, some may start making distributions that are meant to be RMDs for that category of taxpayers—and tell them that, as RMDs, they are not eligible to be rolled over. The IRS recognizes this issue, but has not yet decided how to deal with the issue:

The Department of the Treasury and the IRS are considering what additional guidance should be provided with respect to the SECURE Act, including guidance for plan administrators, payors, and distributees if a distribution to a plan participant or IRA owner who will attain age 70½ in 2020 was treated as an RMD.¹²

What this all means is that certain clients of advisers will have received documents around January 31, 2020 erroneously telling the client that he/she has a required minimum distribution that must be taken for 2020 since he/she will attain age 70 ½ before the end of 2020. Some of those clients may end up taking some or all of what they believe are required minimum distributions before discovering, either when the adviser tells the client or when the client receives the corrected statement from the financial institution, that they have no required distributions for 2020.

Preferably, the client will be told the truth prior to taking any distributions from the plan or IRA. But, if not, the adviser will need to watch for the IRS guidance on whether any relief will be available and, if so, what steps the taxpayer will need to take.

¹⁰ Notice 2020-06, p. 3

¹¹ Notice 2020-06, p. 3

¹² Notice 2020-06, p. 3

SECTION: 642

PROPOSED REGULATIONS TO RESOLVE EXCESS DEDUCTIONS ON TERMINATION ISSUE DUE "REAL SOON NOW"

Citation: Jonathon Curry, "Coming Regs on Estate Fees to Settle Excess Deductions Question," *Tax Notes Today Federal*, 1/24/20

The late Dr. Jerry Pournelle wrote a column in *Byte* magazine beginning in the early years of the "microcomputer" era (the term before IBM came out with their Personal Computer when the common reference became PCs) on using the devices.

Dr. Pournelle often used the term "real soon now" in his column to deal with some new feature a vendor promised was almost ready to be released, but which quite often would either take years to arrive or never actually see the light of day. The term came to mind when I saw a story posted on *Tax Notes Today Federal* regarding the issue of IRS guidance on excess deductions on termination and comments made by Catherine Hughes, attorney-adviser, Treasury Office of Tax Legislative Counsel in response to questions at a District of Columbia Bar Conference on January 23.¹³

The questions arose regarding the impact of the changes made to IRC §67(g), which bars a deduction for miscellaneous itemized deductions, on the excess deductions passed out to beneficiaries under §642(h)(2) on termination of a trust or estate.

Reg. §1.642(h)-2(a) indicates that this amount is "is allowed only in computing taxable income and must be taken into account in computing the items of tax preference of the beneficiary; it is not allowed in computing adjusted gross income." As it is not listed in §67(b) as a deduction not allowed in computing adjusted gross income that is excluded from the miscellaneous classification, it appears to be barred as a deduction by IRC §67(g).

However, the introduction of §67(g) by the Tax Cuts and Jobs Act caused many advisers to take a second look at the question of whether Reg. §1.642(h)-2 came to the proper conclusion and suggest that such deductions should be allowed to the beneficiaries in the same way they would have been allowed to the trust or estate if there had been sufficient income at the trust or estate level to absorb it. After all, since a trust or estate would not be allowed a deduction that was found to not be a miscellaneous itemized deduction, as it is subject to §67(g) itself, this seems to result in

¹³ Jonathon Curry, "Coming Regs on Estate Fees to Settle Excess Deductions Question," *Tax Notes Today Federal*, January 24, 2020, 2020 TNTF 16-6, <https://www.taxnotes.com/tax-notes-today-federal/estate-gift-and-inheritance-taxes/coming-regs-estate-fees-settle-excess-deductions-question/2020/01/24/2c3cx> (retrieved January 24, 2020, subscription required)

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non-miscellaneous deductions being reclassified into the barred category at the termination of the trust or estate.

It appeared we might get some early resolution of this matter from the IRS, as in Notice 2018-61, issued on July 13, 2018, the IRS stated:

The Treasury Department and the IRS are studying whether section 67(e) deductions, as well as other deductions that would not be subject to the limitations imposed by sections 67(a) and (g) in the hands of the trust or estate, should continue to be treated as miscellaneous itemized deductions when they are included as a section 642(h)(2) excess deduction. Taxpayers should note that section 67(e) provides that appropriate adjustments shall be made in the application of part I of subchapter J of chapter 1 of the Code to take into account the provisions of section 67.

The Treasury Department and the IRS intend to issue regulations in this area and request comments regarding the effect of section 67(g) on the ability of the beneficiary to deduct amounts comprising the section 642(h)(2) excess deduction upon the termination of a trust or estate in light of sections 642(h) and 1.642(h)-2(a). In particular, the Treasury Department and the IRS request comments concerning whether the separate amounts comprising the section 642(h)(2) excess deduction, such as any amounts that are section 67(e) deductions, should be separately analyzed when applying section 67.¹⁴

These proposed regulations, presumably to come “real soon now,” would resolve this matter, hopefully in favor of the individual getting to claim the deduction with taxpayers allowed to rely on the proposed regulation pending their issuance in final form.

True to their “real soon now” status, though, these proposed regulations did not appear in the next few months to allow advisers to use them for tax planning. Similarly, the April 17, 2019 original due date for the individuals affected by this also passed without these regulations appearing, so they couldn’t be relied upon when timely filing a return or even applying for an extension to await this promised guidance. Ultimately the extension for the individual return would also not give enough time to see these regulations, as October 15 passed with no word.

Ms. Hughes was quoted in the *Tax Notes Today Federal Story* regarding the status of those regulations from comments she gave at a District of Columbia Bar conference.

She described the basic issues as follows:

“In the existing regs that have been there since God created the world, it says that excess deductions on termination are a one-line entry for a miscellaneous itemized deduction,” Hughes said. In comments from the public, however, “we universally got the answer that we should say that they’re not miscellaneous itemized deductions and should be

¹⁴ Notice 2018-11, Section 4, July 13, 2018

allowable to the beneficiary to the extent they were allowable in the hands of the trust or estate,” she said.¹⁵

Ms. Hughes goes on to state that the IRS had hoped to get these proposed regulations out by the due date of the fiduciary income tax returns for 2018.¹⁶ Whether she meant the original or extended due date, it’s clear that did not happen.

Ms. Hughes did indicate that final regulations are just around the corner (a close relative of “real soon now”) that will formally adopt the guidance on non-2% deductions at the trust and estate level provided for in Notice 2018-11. But, more significant for most practitioners, these regulations will also give the IRS’s position on how to deal with those excess deductions on termination under §642(h)(2) on the beneficiaries’ returns.¹⁷

The article notes she stated that, due to this delay in issuing guidance, “some taxpayers might need to file amended returns.”¹⁸

Note that Ms. Hughes does not say that the IRS *will* go along with all the comments the agency received on this issue. Presumably, though, prudence would have suggested she might have wanted to have avoided noting the unanimity of comments on the matter if the agency was going to decide they were not going to change Reg. §1.642-2(a) to change the classification of these expenses. Nevertheless, until “real soon now” comes we will face some level of uncertainty on this issue as no clear authority under Reg. §1.6662-4(d) appears to exist to justify claiming the deduction, aside from trying to argue that the IRC demands this result—or, effectively, that the regulation has been in error since it was first issued.

SECTION: 7525

FATP WAS PROMOTING A TAX SHELTER, ADVICE NOT SUBJECT TO §7525 PRIVILEGE

Citation: United States v. Microsoft Corp. et al., US DC WD Washington, Case No. 2:15-cv-00102, 1/17/20

Issues related to privilege for documents prepared related to a tax strategy were the issue decided in the case of *United States v. Microsoft Corp. et al.*, US DC WD Washington,

¹⁵ Jonathon Curry, “Coming Regs on Estate Fees to Settle Excess Deductions Question,” *Tax Notes Today Federal*, January 24, 2020

¹⁶ Jonathon Curry, “Coming Regs on Estate Fees to Settle Excess Deductions Question,” *Tax Notes Today Federal*, January 24, 2020

¹⁷ Jonathon Curry, “Coming Regs on Estate Fees to Settle Excess Deductions Question,” *Tax Notes Today Federal*, January 24, 2020

¹⁸ Jonathon Curry, “Coming Regs on Estate Fees to Settle Excess Deductions Question,” *Tax Notes Today Federal*, January 24, 2020

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Case No. 2:15-cv-00102.¹⁹ The case involved Microsoft's tax liabilities for 2004-2006 and a program that was being considered and then implemented to offset an expected increase in taxes.

The situation was summarized by the Court as follows:

Aware of the impending loss of favorable tax treatment, KPMG LLP ("KPMG"), an accounting firm, recommended that "Microsoft should explore US deferral opportunities taking advantage of the existing manufacturing operations in Puerto Rico." Dkt. #146-8 at 3. Representing that continuing operations in Puerto Rico would require "[f]ew operational changes" and would provide Microsoft with "expertise in deferral strategies for the US market," KPMG presented Microsoft with several options for restructuring its Puerto Rico operations to maintain some tax benefit. *Id.* KPMG also represented that it was the right firm to guide Microsoft through the process as it had "significant experience . . . in the migration of [expiring tax credit benefits] to new deferral structures" and had "successfully negotiated significant tax holidays for U.S. companies with the Puerto Rican government." *Id.* at 18.

Central to Microsoft's options was the use of a cost sharing arrangement. The cost sharing arrangement would allow Microsoft's Puerto Rican affiliate to co-fund the development of intellectual property and thereby acquire an ownership interest in that intellectual property. Dkt. #143 at ¶ 18. The affiliate could then manufacture software CDs to sell back to Microsoft's distributors in the Americas. Because some of the intellectual property had already been developed, the Puerto Rican affiliate would need to make a "buy-in payment" to retroactively fund a portion of the development. *Id.* The transactions would be subject to the arm's length standard, presenting a balancing act between entering an arrangement that a third party would enter and significantly disrupting or complicating Microsoft's operations.

Microsoft was interested and retained KPMG to provide "tax consulting services" for a "feasibility phase" which included "modeling the anticipated benefits of the [Intangible Holding Company ("IHCo")] over a ten-year period." Dkt. #146-13 at 1-2. The feasibility phase was "to allow [Microsoft] to develop the information necessary to decide whether moving forward with an IHCo structure at this time is an advisable business decision." *Id.* at 2.²⁰

¹⁹ *United States v. Microsoft Corp. et al.*, US DC WD Washington, Case No. 2:15-cv-00102, January 17, 2020 <https://ecf.wawd.uscourts.gov/doc1/19718938558> (Pacer registration required, retrieved January 22, 2020)

²⁰ *United States v. Microsoft Corp. et al.*, pp. 2-3

The IRS became interested in this transaction, believing that it failed the “arm’s length standard” required for such arrangements.²¹ Thus, the IRS requested numerous documents from Microsoft in the examination.

Microsoft objected that certain of these documents were subject to one or more privileges that would bar the IRS from receiving them.²² The privileges asserted included a work product privilege, attorney-client privilege and the tax-practitioner-client privilege found at IRC §7525. Of particular interest to CPAs are the work product and tax practitioner privilege, as work performed by a CPA may, under the proper circumstances, be covered by those privileges.

Work Product Privilege

The work product privilege is summarized in the Court opinion as follows:

The work product doctrine protects documents and tangible things from discovery if they are prepared in anticipation of litigation by a party, or a party’s representative. FED. R. CIV. P. 26(b)(3). Work product protection prevents “exploitation of a party’s efforts in preparing for litigation.” *Holmgren v. State Farm Mut. Auto. Ins. Co.*, 976 F.2d 573, 576 (9th Cir. 1992) (quoting *Admiral Ins. Co. v. United States District Court*, 881 F.2d 1486, 1494 (9th Cir. 1989)). The court first considers whether the documents were created or obtained “in anticipation of litigation or for trial.” See *United States v. Richey*, 632 F.3d 559, 567 (9th Cir. 2011) (quoting *In re Grand Jury Subpoena, Mark Torf/Torf Emtl. Mgmt. (Torf)*, 357 F.3d 900, 907 (9th Cir. 2004)). Secondly, the court considers whether the documents were created or obtained “by or for another party or by or for that other party’s representative.” *Id.*²³

The opinion notes that some documents may serve multiple purposes and, in that case, the Court looks to whether the documents were created *because of* litigation.²⁴

In this case the Court found that the papers in question were not created because of litigation, but the very transactions being proposed in the documents is what would lead to the litigation:

Here, Microsoft anticipated litigation because it was electing to take an aggressive tax strategy that it knew was likely to be challenged by the government. From the Court’s perspective, there is a significant difference between planning to act in a legally defensible manner and in defending against an existing legal dispute. The record provides no indication that Microsoft would have faced its anticipated legal

²¹ *United States v. Microsoft Corp. et al.*, p. 1

²² *United States v. Microsoft Corp. et al.*, p. 4

²³ *United States v. Microsoft Corp. et al.*, p. 5

²⁴ *United States v. Microsoft Corp. et al.*, p. 5

challenges if Microsoft had not made the decision to pursue the transactions. *Fidelity Intern. Currency Advisor A Fund, L.L.C. v. United States*, 2008 WL 4809032 at *13 (D. Mass. April 18, 2008) (“The mere fact that the taxpayer is taking an aggressive position, and that the IRS might therefore litigate the issue, is not enough” to establish work product.”). Even presuming an operational need for the transactions, Microsoft has not provided any reason it could not have planned the transactions in such an unfavorable manner that it was effectively insulated from a tax challenge. Microsoft’s documents were not created in anticipation of litigation. Rather, Microsoft anticipated litigation because of the documents it created.²⁵

The Court also found that the documents for which the taxpayer was trying to claim work product privilege did not appear linked to the anticipated litigation. As the opinion continues:

Microsoft’s arguments to the contrary are further undercut by the relationship between the parties and the actions of the parties. Microsoft indicates that it “hired the best available legal and tax advisors.” Dkt. #143 at ¶ 20. This included Baker & McKenzie, “a well known international law firm that had successfully tried many of the leading transfer pricing cases,” for “tax planning and litigation of [] tax cases and transfer pricing disputes.” *Id.* Microsoft also engaged KPMG “to assist with tax advice.” *Id.*; Dkt. #144 at ¶ 20 (noting that Mr. “Boyle, a lawyer, made plain that he was hiring KPMG to also help Microsoft prepare its defense to the IRS’s challenge”). But Microsoft gives no indication that KPMG would represent it in the anticipated litigation or that its apparent litigation counsel — Baker & McKenzie — directed KPMG to create any documents necessary to an eventual litigation defense or for use at trial. *Torf*, 357 F.3d at 907 (focusing on fact consultant was hired by attorney representing the party).²⁶

Finally, the Court noted that Microsoft did not appear to treat these documents as ones that would be crucial to its defense in litigation, now claiming to be unable to find certain documents in the class for which it wanted to claim privilege:

Rather, Microsoft represents that it was Mr. Boyle who directed KPMG to prepare materials “in anticipation of an administrative dispute or litigation with the IRS over the Puerto Rican cost sharing arrangement, the pricing of the software sales to Microsoft, and other issues expected to be in dispute relating to those transactions.” Dkt. #143 at ¶ 23. That being the case, the Court finds it odd that Microsoft did not protect many of the records it ostensibly created for this very litigation. Dkt. #145 at 23 (noting that “the United States has discovered through this proceeding that the records of several custodians, including [Mr.] Boyle himself, cannot be located”); Dkt.

²⁵ *United States v. Microsoft Corp. et al.*, p. 6

²⁶ *United States v. Microsoft Corp. et al.*, pp. 6-7

#146 at ¶ 25. Microsoft, wholly anticipating this dispute would have acted prudently in carefully maintaining the documents it created in anticipation of the dispute.²⁷

Tax Practitioner-Client Privilege

IRC §7525(a) provides a limited privilege for tax advice found in a communication with a tax professional of the class authorized to practice before the IRS under Circular 230. Such practitioners are CPAs, enrolled agents and attorneys and are referred to as “federally authorized tax practitioners” (FATP).

The general privilege is outlined as follows in the law:

(a) Uniform application to taxpayer communications with federally authorized practitioners

(1) General rule

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.

(2) Limitations Paragraph (1) may only be asserted in—

(A) any noncriminal tax matter before the Internal Revenue Service; and

(B) any noncriminal tax proceeding in Federal court brought by or against the United States.

However, this privilege does not apply to advice related to the promotion of tax shelters, as defined by IRC §6662(d)(2)(C)(ii).²⁸

IRC §6662(d)(2)(C)(ii) defines a tax shelter as follows:

(ii) Tax shelter For purposes of clause (i), the term “tax shelter” means—

(I) a partnership or other entity,

(II) any investment plan or arrangement, or

²⁷ *United States v. Microsoft Corp. et al.*, p. 7

²⁸ IRC §7525(b)

(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.

The opinion notes that this privilege is limited to that which an attorney would have under the more general attorney-client privilege—and there are many situations where that privilege is not applicable:

But section 7525 does not suggest “that nonlawyer practitioners are entitled to privilege when they are doing other than lawyers’ work.” *United States v. McEligot*, No. 14-CV-05383-JST, 2015 WL 1535695, at *5 (N.D. Cal. Apr. 6, 2015) (quoting *United States v. Frederick*, 182 F.3d 496, 502 (7th Cir. 1999)). Equivalently, communications made primarily to assist in implementing a business transaction are not protected by the tax practitioner privilege. See *ChevronTexaco Corp.*, 241 F. Supp. 2d at 1076-78 (treating FATP privilege congruently with the attorney-client privilege). Rather, and as with the attorney-client privilege, the primary purpose of the communication must be the provision of tax/legal advice.²⁹

The opinion notes that making this determination is often not easy, as in the real world it’s often the case that the facts are messy:

The Court’s consideration is inherently messy. See *Valero Energy Corp. v. United States*, 569 F.3d 626, 630 (7th Cir. 2009) (“Admittedly, the line between a lawyer’s work and that of an accountant can be blurry, especially when it involves a large corporation like Valero seeking advice from a broad-based accounting firm like Arthur Anderson.”). The parties’ broad arguments are often of little help in the consideration of individual documents. Likewise, the limited record before the Court makes it difficult to place each individual record — spanning several years — in its proper context. But the Court also remains mindful that “it is nevertheless the burden of the withholding party to demonstrate that the ‘primary purpose’ was the rendering of legal advice on a document-by-document basis.” *Phillips*, 290 F.R.D. 615, 631 (D. Nev. 2013) (citing *In re Vioxx Prod. Liab. Litig.*, 501 F. Supp. 2d 789, 801 (E.D. La. 2007)).³⁰

The IRS had pointed out that many of KPMG’s documents indicated that the firm was not providing legal advice to Microsoft. But the Court found that the IRS had read too much into those statements, noting:

The Court was not greatly influenced by the government’s argument — supported by several contemporaneous documents — that KPMG itself represented that it “was not providing legal advice to Microsoft.” Dkt. #145 at 18 (citing to instances). This is too broad a

²⁹ *United States v. Microsoft Corp. et al.*, p. 12

³⁰ *United States v. Microsoft Corp. et al.*, p. 13

characterization to attribute to the general limitations KPMG placed on its advice. KPMG's consideration of the complex transactions from the tax perspective obviously did not obviate the need for Microsoft to consider the transactions from additional legal perspectives. The Court has not placed undue weight on KPMG's admonition that Microsoft should pursue the advice of additional specialists.³¹

But that doesn't mean that all of KPMG's advice is going to be covered by the FATP privilege, or that the Court is going to accept the taxpayer's claim that only such protected advice was involved:

But the Court also is not persuaded by Microsoft's conclusory argument, supported only by counsel's declaration, that KPMG provided only tax advice, "not business or non-legal advice." Dkt. #140 at 19 (citing Dkt. # 141 at ¶¶ 13-14); *Dolby Labs. Licensing Corp. v. Adobe Inc.*, 402 F. Supp. 3d 855, 866 (N.D. Cal. 2019) ("A vague declaration that states only that the document 'reflects' an attorney's advice is insufficient to demonstrate that the document should be found privileged.") (quoting *Hynix Semiconductor Inc. v. Rambus Inc.*, No. 00-cv-20905-RMW, 2008 WL 350641, at *3 (N.D. Cal. Feb. 2, 2008)). The nature of the advice was no doubt constantly shifting. *ChevronTexaco*, 241 F. Supp. 2d at 1069 (noting that counsel provided legal advice, assisted with implementation, and addressed legal issues that arose during implementation).³²

But the Court also notes that, as explained earlier, the law bars from protection advice promoting a tax shelter. To the extent the Court decides that KPMG's advice was promoting a tax shelter, the privilege does not apply.

The first issue to be determined is whether the transactions in question were a tax shelter, a question the Court answers in the affirmative:

...[T]he Court finds itself unable to escape the conclusion that a significant purpose, if not the sole purpose, of Microsoft's transactions was to avoid or evade federal income tax. The government argues persuasively that the transactions served a primary purpose of shifting taxable revenue out of the United States. Microsoft has not advanced any other business purpose driving the transactions and one does not materialize from the record. The only explanation Microsoft attempts is that it entered the cost sharing arrangements to replace annual disputes over its licensing and royalty scheme. But this is not a reason for why Microsoft needed or wanted this arrangement for business purposes. Instead, Microsoft noted favorably that the transaction "should NOT have much impact on how we serve customers" and that, while operational expenses were expected to increase by "\$50 million over 10 years," it would result in "tax savings of nearly \$5 billion over 10 years." PMSTP0000028. With no real impact on how

³¹ *United States v. Microsoft Corp. et al.*, pp. 13-14

³² *United States v. Microsoft Corp. et al.*, p. 14

customers were served, the tax savings appears to have driven the decision-making process. Valero, 569 F.3d at 629 (expressing skepticism that “rigamarole” of transactions was necessary restructuring rather than attempt to “avoid paying taxes”).³³

The second issue is whether the FATP providing the advice (KPMG in this case) was promoting the tax shelter. If KPMG is not promoting the shelter, then the mere fact the transaction might have been a shelter would not bar the FATP privilege. But the opinion concludes that, in fact, KPMG was involved in the promotion of this shelter, as the term is used in §7525:

The Court is further left to conclude, after reviewing the records in camera, that all the documents created by KPMG “promoted” the transactions. Other than the unadorned testimony of Mr. Weaver and Mr. Boyle, Microsoft and the record provide no indication that the plans for the transactions originated with Microsoft. Even where testimony is sparse on particulars, the Court does not set it aside lightly. But the record before the Court leads to the conclusion that KPMG originated and drove the structuring of the transactions and that but for its promotion, Microsoft may not have pursued the same or similar transactions. Thereafter, and in furtherance of the transactions, KPMG continued to address possible roadblocks and continued to tweak the transactions to maximize — as far as possible — the revenue shifted while minimizing any operational effects of the restructuring. KPMG’s advice did not, as Microsoft argues, “merely inform a company about such schemes, assess such plans in a neutral fashion, or evaluate the soft spots in tax shelters that [Microsoft] has used in the past.” Dkt. #177-1 at 10 (quoting Valero, 569 F.3d at 629) (quotation marks omitted).³⁴

Microsoft argued that such a holding would destroy the FATP privilege, since it is normal for those seeking advice from an FATP to be looking to reduce taxes.

The Court indicates that not all tax reductions are tax shelters—rather, it requires a look into the purpose of a transaction:

But the tax shelter exception turns, at least partly, on the purpose for the transaction. See 26 U.S.C. § 6662(d)(2)(c)(ii). A tax structure may be a permissible method to achieve a legitimate business purpose in one context and an impermissible tax shelter in another. *Valero*, 569 F.3d at 632 (noting that “[o]nly plans and arrangements with a significant — as opposed to an ancillary — goal of avoiding or evading taxes count” as tax shelters). The Court’s reading is true to the statutory language and does not eliminate the privilege.³⁵

³³ *United States v. Microsoft Corp. et al.*, p. 16

³⁴ *United States v. Microsoft Corp. et al.*, pp. 17-18

³⁵ *United States v. Microsoft Corp. et al.*, p. 17

The Court also distinguishes the actions of KPMG in Microsoft's case with that of the tax adviser in the case of *Countryside Ltd. Partnership v. Commissioner*, 132 T.C. 347:

The Court also is not convinced that its common sense reading of “promotion” conflicts with the statutory privilege. Microsoft relies on Tax Court opinions to argue that Congress did not intend to implicate the “routine relationship between a tax practitioner and a client.” Dkt. #177-1 at 9-10 (citing *Countryside Ltd. P'ship v. Comm'r*, 132 T.C. 347, 352 (2009); *106 Ltd. v. Comm'r*, 136 TC 67, 80 (2011)). From this, Microsoft puts great emphasis on the Tax Court's conclusion in *Countryside* that a “FATP was not a promoter, because he ‘rendered advice when asked for it; he counseled within his field of expertise; his tenure as an adviser to the [client] was long; and he retained no stake in his advice beyond his employer's right to bill hourly for his time.’” Dkt. #177-1 at 10-11 (quoting *Countryside*, 132 T.C. at 354-55). But each case will necessarily turn on its own facts. The Court does not read *Countryside* as setting forth a static test, but as listing relevant considerations for that case. The existence of a routine relationship between a FATP and a taxpayer is certainly a relevant consideration but should not extend the privilege into the impermissible promotion of tax shelters.³⁶

And the Court found a different case more useful in making this promotion call:

In this regard, the Court finds the reasoning of the Seventh Circuit Court of Appeals in *United States v. BDO Seidman, LLP* instructive. 492 F.3d 806, 822 (7th Cir. 2007). There the court noted the similarities between the crime-fraud exception to the attorney-client privilege and the tax shelter exception to the tax practitioner privilege. *Id.* In the crime-fraud context, the Supreme Court has indicated that the need for privilege falls away “where the desired advice refers not to prior wrongdoing, but to future wrongdoing.” *Id.* (quoting *United States v. Zolin*, 491 U.S. 554, 563 (1989) (emphasis in original)) (quotation marks and citation omitted). Similarly, the Seventh Circuit viewed the tax shelter exception as vitiating the FATP privilege once the privilege no longer served the goals of assuring full disclosure to counsel and compliance with the law. *Id.*

This reasoning guides the Court's determination that KPMG strayed into promotion of a tax shelter. As noted previously, the transactions did not appear necessary to satisfy Microsoft's operational needs. KPMG did far more than flesh out or tweak Microsoft's preliminary plans where its expertise reasonably permitted it to do so. KPMG worked to make the transaction fit both Microsoft's existing operations and the relevant tax laws — a task that appeared, at times, to create internal strife. But it did so only to promote Microsoft's avoidance of tax liability and the Court concludes that all of KPMG's

³⁶ *United States v. Microsoft Corp. et al.*, pp. 17-18

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written communications were “in connection with promotion” of a tax shelter. 26 U.S.C. § 7525(b).³⁷

The opinion concludes, noting:

While Congress has provided for certain communications to be treated as privileged, the privilege is not absolute. Where, as here, a FATP’s advice strays from compliance and consequences to promotion of tax shelters, the privilege falls away.³⁸

³⁷ *United States v. Microsoft Corp. et al.*, pp. 18-19

³⁸ *United States v. Microsoft Corp. et al.*, p. 19