

PROCEDURAL AND FACTUAL BACKGROUND

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2 These summons enforcement proceedings arise out of an investigation by the Internal
3 Revenue Service (“IRS”) into Microsoft’s 2004 to 2006 taxable years. Case No. 15-1002,
4 Dkt. # 37 (“Bernard Decl.”), ¶ 2. The IRS audit, allegedly ongoing since 2007, focuses on two
5 cost-sharing arrangements that Microsoft entered into with its affiliates in Puerto Rico (the
6 “Americas cost sharing arrangement”) and in Asia (the “APAC cost sharing arrangement”)
7 during the subject time period. *Id.* at ¶¶ 3-4; Dkt. # 40 (“2d Hoory Decl.”), ¶ 5. Through
8 October 2014, the IRS examination team conducted fact gathering by issuing over 200
9 information documents requests (“IDRs”) to Microsoft and conducting informal interviews
10 with its employees. *Id.* at ¶¶ 26, 27, 71.

12 In furtherance of its investigation, the IRS issued a designated summons to Microsoft
13 on October 30, 2014, pursuant to 26 U.S.C. §§ 7602 and 6503(j). Bernard Decl. at ¶ 24; Dkt.
14 # 1 (“Petition”), ¶ 7. Beginning December 11, 2014, the IRS filed a series of petitions with
15 this Court to enforce this and related designated summonses, which this Court consolidated
16 into the two above-captioned cases. *See, e.g.*, Case No. 2:14-mc-117; Case No. 15-cv-102,
17 Dkt. # 16. The Court determined that the IRS had made the requisite initial showing to obtain
18 the Court’s enforcement of the summonses and issued an Order to Show Cause why they
19 should not be enforced. Dkt. # 34. In accordance with the parties’ stipulated briefing schedule,
20 Microsoft filed the instant Motions seeking to obtain an evidentiary hearing in order to
21 demonstrate that discovery into the IRS’s alleged abuse of process is warranted prior to the
22 Court’s final enforcement determination.

24 Microsoft’s allegations of impropriety concern the IRS’s engagement of the private
25 law firm, Quinn Emanuel Urquhart & Sullivan, LLP (“Quinn Emanuel”), as a private
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1 contractor to assist in the IRS's examination of Microsoft's 2004 to 2006 tax years. The IRS
2 awarded Quinn Emanuel a contract for "Professional Expert Witness" services, agreeing to
3 pay the firm \$2,185,500 for its work investigating the Americas cost sharing arrangement.
4 Bernard Decl., ¶ 20; 2d Hoory Decl, ¶ 78; Dkt. # 37 ("O'Brien Decl."), Ex. D. (contract), §§
5 B.2, C. Microsoft asserts that this contract represented the first time that the IRS had engaged
6 private civil litigators in a U.S. income tax audit. *Id.* at ¶ 6.

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8 Although the contract covers Quinn Emanuel's performance throughout four non-
9 severable phases, only the first phase is actually detailed therein. *See id.*, Ex. D at pp. 7-8, 22.
10 Among services to be performed in the first phase, Quinn Emanuel is to "support continued
11 development, analysis, and preparation of the issues under examination" by "identifying
12 additional information deemed necessary to develop clearly defensible positions, including
13 any necessary data, documents, or interviews; assisting with further factual development
14 through document review, identifying and preparing new document requests, preparing for or
15 participating in interviews[; etc.]" *Id.* at p. 8.

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17 On June 9, 2014, the Treasury Department and the IRS issued, without notice and
18 comment, a "temporary regulation" providing for third-party contractors like Quinn Emanuel
19 to participate in the summons process. *See* 26 C.F.R. § 301.7602-IT(b)(3); O'Brien Decl., ¶ 7.
20 The regulation "make[s] clear" that third-party contractors "may receive books, papers,
21 records, or other data summoned by the IRS and take testimony of a person who the IRS has
22 summoned as a witness to provide testimony under oath." 79 Fed. Reg. 34,625 (June 18,
23 2014); 26 C.F.R. § 301.7602-IT(b)(3).

24 The IRS attests that, owing to time spent completing procedural and administrative
25 prerequisites, Quinn Emanuel did not begin its performance under the contract until July 15,
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1 2014, over one month after the issuance of the temporary regulation. 2d Hoory Decl., ¶ 80.
2 Nonetheless, the IRS did not disclose to Microsoft its retention of counsel from Quinn
3 Emanuel, until informing Microsoft on August 28, 2014 that “outside counsel from Quinn
4 Emanuel retained to assist” in the examination may be included in scheduled consensual
5 interviews. Bernard Decl., ¶ 16 & Ex. B. Quinn Emanuel representatives subsequently
6 attended Microsoft employee interviews held by the IRS during the weeks of September 22
7 and October 6, 2014, with their direct participation limited to asking follow-up questions. *Id.*
8 at ¶ 84.
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10 The IRS concedes that Quinn Emanuel reviewed documents and transcripts of the
11 interviews and completed an independent assessment of the positions taken by the IRS and
12 Microsoft with respect to the Americas cost sharing arrangement. *Id.* at ¶ 85. While the IRS
13 attests that Quinn Emanuel did not prepare initial drafts of any of the summonses at issue
14 here, it further concedes that Quinn Emanuel was given an advanced copy of a designated
15 summons and that its comments were sought. *Id.* at ¶ 86.
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17 In addition to seeking discovery into the IRS’s retention of Quinn Emanuel through
18 this proceeding, Microsoft has sought related documents from the IRS by way of several
19 Freedom of Information Act (“FOIA”) requests. A first FOIA action filed in the U.S. District
20 Court for the District of Columbia was dismissed on stipulation of the parties on November
21 24, 2014, after the IRS agreed to produce of copy of the Quinn Emanuel contract and related
22 documents. *See Microsoft Corp. v. IRS*, Case No. 14-cv-01982-RBW (D.D.C. Nov. 24, 2014).
23 A second FOIA complaint is currently before this Court. *See Microsoft Corp. v. IRS*, No.
24 2:15-cv-00369-RSM (W.D. Wash.). This latter lawsuit seeks documents related to the IRS’s
25 promulgation of the temporary regulation. Microsoft has also filed two additional FOIA
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1 requests with the IRS seeking documents relating to Quinn Emanuel’s retention and role. *See*
2 O’Brien Decl. at ¶ 17 & Ex. H. Other than those sought in the D.D.C. action, none of the
3 requested documents have thus far been produced. *Id.* at ¶¶ 12, 15, 17.¹

4 LEGAL STANDARDS

5 If a taxpayer neglects or refuses to obey a designated summons, the IRS may bring an
6 enforcement action in United States district court. 26 U.S.C. § 7604(b); *see United States v.*
7 *Clarke*, 134 S.Ct. 2361, 2365 (2014). In order to obtain the court’s enforcement, the IRS must
8 make an initial showing of its “good faith” by establishing its compliance with the *Powell*
9 factors: “that the investigation will be conducted pursuant to a legitimate purpose, that the
10 inquiry may be relevant to the purpose, that the information sought is not already within the
11 [IRS’s] possession, and that the administrative steps required by the [Internal Revenue] Code
12 have been followed.” *United States v. Powell*, 379 U.S. 48, 57-58 (1964). The Court found
13 that the IRS made this *prima facie* showing in this case. *See* Dkt. # 23.

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15 Once the IRS makes this initial showing, the burden shifts to the taxpayer to
16 demonstrate that enforcement of summons would result in an abuse of the court’s process.
17 *Powell*, 379 U.S. at 58; *see also United States v. Gilleran*, 992 F.2d 232, 233 (9th Cir. 1993).
18 This adversarial enforcement proceeding exists to protect against abuse of the power vested in
19 tax collectors. *See Clarke*, 134 S.Ct. at 2367. At the same time, enforcement proceedings are
20 to be “summary in nature,” and the court must eschew any broader role than determining
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23 ¹ Microsoft additionally asks the Court to take notice of the contents of a May 13, 2015 letter written by Senate
24 Finance Committee Chairman Orrin Hatch to IRS Commissioner John Koskinen after the parties’ briefing was filed.
25 Dkt. # 46. As the United States points out, such notices serve to bring new *authority* to the Court’s attention, not new
26 evidence. *See* LCR 7(n); *see also Trans-Sterling, Inc. v. Bible*, 805 F.2d 525, 528 (9th Cir. 1986) (explaining that the
parallel Federal Rule of Appellate Procedure 28(j) “is not designed to bring new evidence through the back door”).
The Court accordingly declines to take notice of these new facts for purposes of this Order, though they may properly
be raised by Microsoft at the evidentiary hearing.

1 whether the IRS issued the contested summons in good faith and without an improper
2 purpose. *Clarke*, 134 S.Ct. at 2367 (quoting *United States v. Stuart*, 489 U.S. 353, 369
3 (1989)).

4 In striking this balance, the Supreme Court has held that a taxpayer is entitled to a pre-
5 enforcement evidentiary hearing upon making a sufficient threshold showing of a defense to
6 enforcement. *See Clarke*, 134 S.Ct. at 2367. This showing requires the taxpayer to “point to
7 specific facts or circumstances plausibly raising an inference of bad faith” or of another
8 “appropriate ground” to quash the summons. *Id.* “Naked allegations of improper purpose are
9 not enough: The taxpayer must offer some credible evidence supporting his charge.” *Id.* Use
10 of circumstantial evidence is sufficient to make this threshold showing. *Id.* Discovery is then
11 warranted if the taxpayer, through the evidentiary hearing, makes a “substantial preliminary
12 showing of abuse or wrongdoing.” *United States v. Stuckey*, 6446 F.2d 1367, 1374 (9th Cir.
13 1981).

14 **DISCUSSION**

15 Here, Microsoft argues that an evidentiary hearing is warranted on two grounds. First,
16 Microsoft contends that, by allowing third-party contractors to participate in taxpayer
17 interviews, the IRS is attempting to outsource an inherently governmental function and is
18 abusing the Court’s process in service of this improper end. Second, Microsoft asserts that the
19 facts and circumstances of the IRS’s contracting with Quinn Emmanuel raise a plausible
20 inference that the IRS has improperly delegated other key aspects of the tax audit to the firm.
21 On response, the United States contends that Microsoft’s first challenge raises a legal issue
22 that does not require discovery and further that Quinn Emmanuel’s participation in the
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1 summons process is fully supported by the law. It also contests that the circumstances raise
2 any inference of impropriety.

3 The Court agrees with Microsoft that it has carried its fairly slight burden to trigger an
4 evidentiary hearing. First, Microsoft has pointed to specific circumstances from which the
5 Court could plausibly infer that the temporary regulation is invalid. The Internal Revenue
6 Code (“IRC”) authorizes the “Secretary” alone to “examine any books, papers, record, or
7 other data,” to issue summons, and to take testimony under oath in order to inquire into tax
8 liability. 26 U.S.C. § 7602(a)(1)-(3). The statute in turn defines the “Secretary” as the
9 “Secretary of the Treasury or his delegate,” the latter of which is limited to any duly
10 authorized “officer, employee or agency of the Treasury Department.” 26 U.S.C. §
11 7701(a)(11)(B), (a)(12)(A)(i).
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13 The IRS is correct that it is a question of law whether the temporary regulation, by
14 arguably authorizing third-party contractors to perform these roles, is contrary to the plain
15 language of the IRC. Nonetheless, Microsoft’s additional challenges to the issuance of the
16 regulation raise questions of fact that may warrant discovery. For instance, factual questions
17 exist as to whether the IRS satisfied one of the enumerated exceptions set forth in 5 U.S.C. §
18 553(b)(3) to issue the regulation without notice-and-comment procedures. They also exist as
19 to whether the temporary regulation is arbitrary and capricious in accordance with Microsoft’s
20 charge that it was issued without reasoned analysis or explanation as to how it could be
21 reconciled with 26 U.S.C. § 7602 and other Treasury Department regulations. Among other
22 circumstances to which Microsoft points, the issuance of the regulation shortly after the IRS’s
23 contracting with Quinn Emanuel plausibly raises an inference of improper motive.
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1 Second, the Court finds that Microsoft has carried its burden to point to facts and
2 circumstances plausibly raising an inference of impropriety in Quinn Emanuel’s role in the
3 summons process. While the United States contests that it has delegated any inherently
4 governmental functions to the firm, the language of the contract itself suggests that the firm
5 may be participating in components of the audit examination for which delegation is
6 statutorily proscribed, such as inspecting books and taking testimony. *See* O’Brien Decl., Ex.
7 D at p. 7 (contemplating Quinn Emmanuel’s assistance in “factual development through
8 document review” and participation in interviews). So too, the timing of Quinn Emanuel’s
9 retention prior to the passage of the temporary regulation plausibly raises an inference that the
10 firm played an unauthorized role in the issuance of several IDRs and that taxpayer
11 information may have been disclosed to it in contravention of the IRC. *See* 26 U.S.C. § 6103.
12 Furthermore, while the contract bars the firm from performing inherently governmental
13 functions, such as “portraying the Contractor as a representative of the government,” Quinn
14 Emanuel counsel appears to have done just that on at least one occasion. *See* Dkt. # 44 (Rosen
15 Decl.), Ex. B at 6:16-17 (“John Gordon, Quinn Emanuel, for the IRS”).

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18 Whether Microsoft has made the more stringent “substantial preliminary showing of
19 abuse or wrongdoing” required to obtain limited discovery, *Stuckey*, 646 F.2d at 1374, is a
20 question that the Court shall address following the evidentiary hearing. Further, the
21 substantive legal issues underlying Microsoft’s allegations of abuse of process shall be
22 addressed through the show cause hearing upon full briefing by the parties. At this stage, all
23 that is required of Microsoft is that it present circumstantial evidence from which it could
24 plausibly be inferred that enforcement of the summons would result in an abuse of the Court’s
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1 process. The Court is persuaded that Microsoft has made a showing sufficient to warrant an
2 evidentiary hearing into the matter.

3 **CONCLUSION**

4 For the reasons stated herein, the Court hereby ORDERS that Microsoft's Motions for
5 Evidentiary Hearing (Case No. 15-102, Dkt. # 34; Case No. 15-103, Dkt. # 35) are
6 GRANTED. The Clerk is directed to schedule an evidentiary hearing upon consultation with
7 the parties.
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9 DATED this day 17 of June 2015.

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11 RICARDO S. MARTINEZ
12 UNITED STATES DISTRICT JUDGE
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