

Microsoft, IRS spar over long-running probe of taxes

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Microsoft and the Internal Revenue Service sparred in court Friday over the agency's power to investigate taxpayers.

The Seattle-area company, seeking a court order to overturn a portion of an IRS probe into its books, says the tax agency's reliance on outside lawyers in the investigation sets a dangerous precedent for taxpayer confidentiality, and could embolden the agency to use powers Congress never intended to it have.

The government's lawyers counter that a ruling in favor of Microsoft may curtail the IRS's ability to bring in outside experts to help make sense of complex tax matters, sabotaging the system the government relies on to make sure companies pay the appropriate amount of tax.

The case began when the IRS sued Microsoft and a group of current and former executives last year, seeking testimony and documents as part of a long-running audit of the software giant. The IRS has been investigating Microsoft's 2004 to 2006 tax years since 2007, a probe that has grown into one of the largest in the agency's history.

Investigators have focused on a pair of deals struck during those years that sent the rights to sell Microsoft's software to subsidiaries in Puerto Rico, Singapore and Bermuda. Under tax law, companies are required to charge a fair market price in such intracompany arrangements.

James Weaver, a Justice Department lawyer representing the IRS, said in

a hearing in August that an early IRS estimate of the appropriate value of those deals would have raised Microsoft's taxable income by billions of dollars. The deals are "an arcane tax-avoidance strategy," Weaver said. "There is a reason the IRS is trying to bring resources to this case."

Microsoft challenged the IRS's latest information requests, leading to a year of court wrangling about the power the federal government has to probe taxpayers' books.

Microsoft's arguments have focused on the IRS's hiring of Los Angeles business litigation firm Quinn Emanuel Urquhart & Sullivan to aid in the audit. The company contends that the use of Quinn Emanuel, particularly in taking testimony from Microsoft employees, is an improper delegation of a government function.

"The IRS has unilaterally decided to hand off the immense power that Congress gave it," Patricia Eakes, a lawyer representing Microsoft, said at Friday's hearing.

She argued that the IRS's latest information requests and the use of Quinn Emanuel represented an effort to gain an advantage in the event the case wound up in tax court, not a good-faith attempt to wrap up the audit.

Weaver disagreed, and said the tax agency acted within its rights in bringing on outside help for the complex investigation.

There's no law that restricts the IRS from farming out certain aspects of its audit interview process, Weaver said. And the audit, he said, is not complete. "It is a highly complex analysis, and it is in process."

Judge Ricardo Martinez probed lawyers on both sides about what limitations exist on the IRS use of contractors and the agency's process,

but he didn't rule Friday on the issue of whether the IRS summonses would be enforced.

Eakes, Microsoft's lawyer, conceded that outside lawyers could review audit documents, be present at interviews, and suggest questions, but said they couldn't ask questions on their own.

"It's not a silly distinction," Eakes said. "It's the difference between helping and doing."

Weaver, the government's lawyer, disagreed with her characterization of Quinn Emanuel's participation. "There was (IRS) control over what Quinn Emanuel was doing," he said.

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