Department of the Treasury	Internal Revenue Service	**Office of Chief Counsel**	**N o t i c e**

CC-2006-003

October 25, 2005

Subject:	Disclosure of Third Party Tax Information in Tax Shelter Matters	**Cancel Date**:	Upon incorporation into CCDM

I. Purpose

This Notice provides guidance regarding the disclosure under the item and transaction tests of section 6103 of third party returns and return information gathered in examinations or other investigations of tax shelter promoters or investors by Service and Chief Counsel employees. The Notice also provides guidance regarding disclosure of third party tax information in judicial or administrative tax proceedings.

II. In General

The Service conducts numerous investigations of tax shelter promoters and investors. Often, during the course of an investigation of a promoter for civil promoter penalties, injunctions, or criminal conduct, the Service secures information and documents pertaining to investors. This information may include investors' names, information on shelters established for the investors, and promotional material, such as prospectuses and sales contracts. Similarly, during the course of an examination of a tax shelter investor, the Service often secures information and documents pertaining to the promoter. This may include information provided to multiple investors, including promotional material, statements or promises made by the promoter to the investor, or information regarding payments of fees to the promoter, and the promoter's activities in setting up the entities, plans or arrangements to facilitate the shelter. This type of information may provide evidence of a pattern or practice, referred to as "pattern evidence," relevant to issues arising in judicial or administrative tax proceedings involving tax shelters. For example, information obtained from an investor may be pattern evidence that demonstrates a consistent lack of a bona fide business purpose among the other investors in the same or substantially similar tax shelter arrangements.

III. The Item Test

Under section 6103(a), returns and return information may not be disclosed by the Service except as authorized by the Code. Several exceptions to section 6103(a) may apply in the context of disclosures of third party tax information in administrative and judicial proceedings

relating to tax administration. The section 6103(h)(4)(B) exception to the disclosure prohibition, the "item test," permits disclosure of third party returns and return information in judicial or administrative proceedings pertaining to tax administration,

> if the treatment of an item reflected on such [third party's] return is directly related to the resolution of an issue in the proceeding.

Under section 6103(h)(4)(B)'s item test, the disclosure of tax information of taxpayers who participated in substantially similar transactions promoted by the same promoter is permitted, so long as the tax information directly relates to the resolution of an issue in the proceeding. On the other hand, the disclosure of tax information of taxpayers participating in tax shelters promoted by different promoters or taxpayers participating in different tax shelters promoted by the same promoter, in general, may not be covered by the item test. In an unpublished order in *ACM v. Commissioner*, T.C. Docket No. 10472-93 (August 18, 1995), in ruling on discovery motions concerning the depositions of nonparty witnesses, the Tax Court permitted the use of third party pattern evidence, stating "if transactions reported on a third party return are directly related to an issue in the proceeding, not only the pertinent portions of the return but also any extrinsic information obtained by the IRS regarding the tax treatment of the reported transaction may be offered into evidence without violating section 6103." Slip op. at 34-35. As was stated in *United States v. Northern Trust Co.*, 210 F. Supp. 2d 955, 957 (N.D. Ill. 2001), while section 6103(h)(4)(B) does not require any transactional nexus between the third party and the taxpayer, the "[third party's] tax return's contents must be germane to an element of the claim, not simply be used to impeach a witness' credibility, and must apply to the specific taxpayer's liability, not analogous third parties."

Whether third party information directly relates to an issue will depend, first, upon the nature of the particular proceeding and, second, on the particular issues in dispute in that proceeding. For example, the way a third party reported a tax shelter loss on a tax return can directly relate to the issue of whether the taxpayer (who is the party to the proceeding at issue) should be allowed to claim a loss from a substantially similar tax shelter, since the collective conduct, *i.e.*, pattern evidence, of all of the investors in reporting the losses from these transactions can be used to demonstrate that none of the investors could realistically have had a bona fide business or investment purpose. Accordingly, information obtained in the examination of the third party's return that directly relates to the resolution of an issue in the taxpayer's proceeding, such as promotional material that the third party received from the common promoter, or responses to IDRs inquiring about the third party's non-tax purpose for investing in the substantially similar transaction, can be disclosed in that proceeding.

The following example illustrates this application of the item test. In a judicial proceeding, the Government argues that Investor A engaged in an abusive transaction for the sole purpose of tax avoidance. Investor A responds that the transaction was motivated by the non-tax purpose of portfolio diversification and was tailored to effect this specific purpose. The Government refutes Investor A's contention by showing that the transaction was not unique and that other taxpayers (Investors B, C, D, E and F) all participated in substantially similar transactions through the same promoter, all reported similar items of income, deduction and loss, and all claimed a similar non-tax purpose for entering into the transaction. The treatment of an item reflected on Investor B, C, D, E and F's returns is directly related to the resolution of an issue in Investor A's proceeding (whether the loss reported by Investor A arose from a transaction that was a sham in substance because it lacked independent economic substance or business

purpose). As a result, in Investor A's judicial proceeding, the disclosure of tax information obtained during the Service's examinations of Investors B, C, D, E and F regarding their reporting of the tax shelter loss is permissible as pattern evidence.

IV. The Transaction Test

Disclosures in investor/promoter administrative or judicial tax proceedings may also be permitted under section 6103(h)(4)(C), the "transaction test." Under the authority of this provision, a third party's tax information may be disclosed in judicial or administrative proceedings pertaining to tax administration if the third party's tax information directly relates to a transactional relationship between a person who is a party to the proceeding and the third party and directly affects the resolution of an issue in the proceeding. For instance, in *Balanced Financial Management, Inc. v. Fay*, 662 F. Supp. 100 (D. Utah 1987), the disclosure of a promoter's tax information in pre-filing notification letters sent to investors was held to be proper under section 6103(h)(4)(C).

The following example illustrates an application of the transaction test. In a section 7408 injunction action against Promoter A, the Government intends to disclose certain tax information of Investor B relating to his participation in the tax shelter promoted to him by Promoter A. This return information consists of the information provided to Investor B by Promoter A outlining the details of the shelter and the details of Investor B's specific investment in the tax shelter. Pursuant to section 6103(h)(4)(C), a third party's tax information can be introduced in the injunction action provided the third party's tax information directly relates to a transactional relationship between the taxpayer who is a party to the proceeding and a third party, which directly affects the resolution of an issue in the proceeding. Thus, Investor B's tax information can be introduced in the injunction action against Promoter A, under the authority of section 6103(h)(4)(C), since it directly relates to a transactional relationship between Promoter A and Investor B and directly affects the resolution of an issue in the injunction proceeding.

V. Additional Considerations

Chief Counsel employees should continue to strike a fair and reasonable balance between the need to use third party tax information and the degree of intrusion on that third party taxpayer's privacy. Consideration should be given to other methods of proof that do not require disclosure of third party tax information, such as summaries or compilations. We should offer in evidence only those returns or portions of returns, and only those items of return information, that specifically meet the item or transaction tests. In general, public identification of specific taxpayers should be avoided, except when it is determined to be necessary to the matter before the court. In judicial tax proceedings, courts may be requested to consider appropriate protective orders. In Tax Court proceedings or when providing advice to the Department of Justice with respect to any proposed protective order regarding disclosures of third party tax information under section 6103(h)(4)(B) or (C), Chief Counsel employees must consult with Branch 3 of the Administrative Provisions and Judicial Practice Division, at (202) 622-7950. APJP Branch 3 shall provide appropriate guidance in dealing with any proposed protective order on a case-by-case basis.

If neither the item nor transaction test can be met, necessary third party returns and return information should be obtained using available and authorized information gathering tools.

When using those information gathering tools, privacy concerns of third parties should be respected, particularly third party identifiers.

For further information regarding this notice, contact Sarah Tate of the Office of the Associate Chief Counsel (Procedure & Administration), Disclosure and Privacy Law Division, at (202) 622-4570.

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_____/s/_____
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