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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE CHIEF COUNSEL ADVICE

MEMORANDUM FOR JODY TANCER
ASSISTANT DISTRICT COUNSEL
BROOKLYN DISTRICT COUNSEL CC:NER:BRK

FROM: David L. Fish
Chief, Branch 4 (Disclosure Litigation) CC:EL:D

SUBJECT: Request for Chief Counsel Advice

This Chief Counsel Advice responds to your memorandum dated March 20, 2000, requesting our assistance in determining whether the proposed disclosures in the six questions presented below would violate I.R.C. § 6103. This document is not to be cited as precedent.

LEGEND
A=
B=
C=
D=
E=
F=
G=
H=
I=
J=
K=
Trust 1=
Trust 2=
year 1=

date 1=
date 2=
$a= $
$b= $
$c= $
$d= $
$e= $
$f= $
$g= $
$h= $
Greenacre=

ISSUES 1. Would it violate I.R.C. § 6103(a) for the examination team of Taxpayer A (A) to obtain from sources within the Internal Revenue Service (Service), such as other examination teams or issue specialists, information relating to the lease stripping transactions to which F's basis in the property he transferred to B is traceable that other parties to the lease stripping deals provided to the Service in connection with their own returns or the examination of their own returns?

2. If A's examination team may obtain the information described in 1 above, may it then disclose that information to A by including it in the Revenue Agent's Report ("RAR") issued to A?

3. If A's examination team obtained information relating to the lease stripping transactions to which F's basis in the property that he transferred to B is traceable by summonsing third parties pursuant to A's examination, would it violate I.R.C. § 6103(a) for the team to disclose the information by including it in the RAR issued to A?

4. Would it violate I.R.C. § 6103(a) for A's examination team to obtain from sources within the Service, such as other examination teams or issue specialists, information relating to whether other parties to the specific lease stripping transactions to which F's basis in the property that he transferred to B is traceable also participated in other lease stripping deals?

5. If A's examination team may obtain the information described in 4, above, may it then disclose that information to A by including it in the RAR issued to A?

6. If A's examination team obtained information showing that other parties to the lease stripping transactions to which F's basis in the property that he transferred to B is traceable also participated in other lease stripping deals by summonsing the information from third parties pursuant to A's examination, would it violate I.R.C. § 6103(a) for A's examination team to disclose that information in the RAR issued to A?

CONCLUSIONS: 1. I.R.C. § 6103(h)(1) authorizes A's examination team to obtain from sources within the Service, such as other examination teams or issue specialists, information relating to the specific lease stripping transactions to which F's basis in the property that he transferred to B is traceable that other parties to the lease stripping deals provided to the Service in connection with their own returns or the examination of their own returns. A's examination team has a need to know the information to perform a tax administration function.

2. Under I.R.C. § 6103(h)(4)(B) and/or (C), A's examination team may disclose the information obtained in issue 1 above to A by including the information in the Revenue Agent's Report ("RAR") issued to A during A's examination as that third party tax information directly relates to a transactional relationship between A and those third parties which directly affects the resolution of an issue in the proceeding.

3. Under I.R.C. §§ 6103(e)(1)(D) and (e)(7), A's examination team may disclose to A in its RAR information summonsed from third parties which relates to the lease stripping transactions to which F's basis in the property that he transferred to B is traceable because such information was collected by the Service with regard to A's liability or possible liability under the Code, and if such disclosure would not seriously impair Federal tax administration.

4. I.R.C. § 6103(h)(1) authorizes the examination team of A to obtain from sources within the Service, such as other examination teams or issue specialists, information relating to whether other parties (such as F) to the specific lease stripping transactions to which F's basis in the property that he transferred to A is traceable also participated in other lease stripping deals, provided that A's examination team establishes a need to know such information in order to perform a tax administration function.

5. The third party information obtained by A's examination team in issue 4 above is not disclosable to A under either the item or transaction tests of I.R.C. § 6103(h)(4)(B) and/or (C) as such information does not directly relate to a transactional relationship between A and those third parties.

6. Under I.R.C. §§ 6103(e)(1)(D) and (e)(7), A's examination team may disclose to A in its RAR, information summonsed from third parties showing that other parties to the lease stripping transactions to which F's basis in the property that he transferred to B is traceable, also participated in lease stripping deals other than the ones to which F's basis is traceable by summonsing the information from third parties pursuant to A's examination because such information was collected by the Service with regard to A's liability or possible liability under the Code, and if such disclosure would not seriously impair Federal tax administration.

FACTS: The facts, as we understand them, are based on information Brooklyn District Counsel received from the examination team of A. The lease stripping transaction at issue in the examination of A, a U.S. corporation, involves a number of parties consisting of the following steps.

• A filed a consolidated Federal income tax return for the year ended December 31, year 1 as the common parent of a consolidated group that included, among other subsidiaries, B and C.

• On date 1, as part of a transaction that A reported qualified for non-recognition treatment under Code section 351, A and C transferred Greenacre to B. In exchange, A and C received common stock of B. Also on date 1, B sold Greenacre to D, a real estate investment trust, which leased it back to A. A reported a gain of $a from the sale of Greenacre to D.

• F, a citizen and resident of a foreign country doing business as E, also contributed property to B as part of the transaction that A reported qualified for non-recognition treatment under I.R.C. § 351. The property contributed by F consisted of 100% interests in two U.S. business trusts: Trust 1 and Trust 2. In exchange B gave F $b and preferred stock.

• The assets of Trust 1 consisted of a small number of shares of preferred stock of G that is a subsidiary of H. The assets of Trust 2 consisted of a small number of shares of preferred stock of I, a corporation that is a subsidiary of J.

• Pursuant to Code section 362(a), A reported a $c carryover basis in the property F contributed. That total consisted of $d for the shares of G preferred stock and $e for the shares of I preferred stock. A reported on the I.R.C. § 351 statement that the fair market value of the property contributed by F was $f.

• On date 2, B sold the property F had contributed to it to K for $f. It reported a $g long term capital loss on the sale based on the difference between the $h basis it claimed in the property and the $f sale price. B used that capital loss to offset the gain it reported from the sale of Greenacre.

F's basis in the property he transferred to B is traceable back to multiple party transactions in which parties not subject to United States tax claimed to have realized the rental income from leased equipment and parties subject to United States tax (H's subsidiary, G and J's subsidary, I) claimed entitlement to deductions relating to the leased equipment. The Service has characterized this type of transaction as a "lease strip" or "stripping transaction." See Notice 95-53, 1995-2 C.B. 334. The Service believes the claimed tax treatment in these transactions improperly separates income from related deductions and that such transactions accordingly do not produce the tax

consequences desired by the parties. Id. Notice 95-53 states that, depending upon the facts of the case, the Service may apply the business purpose doctrine, the substance-over-form doctrine (including the step transaction and sham doctrines), and other authorities to challenge the tax consequences claimed by the parties to lease stripping deals.[1]

Consistent with the Service's announcement in Notice 95-53 that it will challenge the tax consequences claimed by the parties to lease stripping transactions, the examination division has examined the lease stripping deals from which the basis claimed by F and carried over to B is traceable.

Based on advice previously received from the National Office that the examination team of A develop the facts with respect to F's basis in the property that he transferred to B and the underlying lease stripping transactions to which that basis is traceable, the A examination team has requested from the and examination teams documents and materials regarding the lease stripping deals. The A examination team would like to be able to disclose information obtained from the and examination teams in a Revenue Agent's Report ("RAR") to be issued to A.

Law and Analysis:

1. Would it violate section 6103(a) for A's examination team to obtain from sources within the Internal Revenue Service (Service), such as other examination teams or issue specialists, information relating to the lease stripping transactions to which F's basis in the property he transferred to B is traceable, that were provided to the Service by other parties to the lease stripping transaction in connection with their own returns or the examination of their own returns?

Section 6103(a) prohibits Service employees from disclosing "returns" or "return information," as those terms are defined in Code sections 6103(b)(1) and (b)(2), unless disclosure is authorized under a specific provision of Title 26. Code section 6103(b)(2) defines return information to include, among other things, any data which is received by, recorded by, prepared by, furnished to, or collected by the Service with respect to a

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[1] The other authorities that might be applied to challenge the tax consequences claimed by the parties to lease stripping deals include: Code sections 269, 382, 446(b), 482, 701 or 704, 7701(l), and the regulations of each section, and authorities that recharacterize certain assignments or accelerations of future payments as financing.

return or with respect to the determination of the existence or possible existence of liability or the amount of liability of any person under Title 26.

I.R.C. § 6103(h)(1) authorizes the disclosure of returns or return information to officers and employees of the Treasury Department whose official duties require such disclosure for tax administration purposes. Tax administration is defined as "the administration, management, conduct, direction, and supervision of the execution and application of the internal revenue laws or related statutes . . . ." I.R.C. § 6103(b)(4). In essence, section 6103(h)(1) authorizes access to tax information to an employee of the Service when that employee establishes a "need to know" in order to perform a tax administration function. An examination of a taxpayer's return is a tax administration function.

Here, information relating to the lease stripping transactions to which F's basis in the property that he transferred to B is traceable that was provided to the Service by other parties to the lease stripping deals in connection with their own returns or the examination of their own returns is the return information of those particular taxpayers. Under section 6103(h)(1), A's examination team is authorized to obtain return information collected by the Service during the examinations of other parties to those transactions, provided that the examination team has a need to know such information in order to perform a tax administration function. Review of such information by A's examination team would occur during the course of the team's official duties of tax administration, i.e., the examination of A. Given that the National Office previously advised that such information is helpful in determining the proper basis of the property that F transferred to B, the examination team of A has a need to know the information and the disclosure of such information to A's examination team is authorized under section 6103(h)(1).

2. If A's examination team may obtain the information described in 1 above, may it then disclose that information to A by including it in the Revenue Agent's Report ("RAR") issued to A?

As was discussed in issue 1 above, information relating to the lease stripping transactions to which F's basis in the property that he transferred to B is traceable that other parties to the lease stripping transaction provided to the Service in connection with their own returns or the examination of their own returns is the return information of those particular taxpayers. Although section 6103(h)(1) permits A's examination team to obtain that information, this section does not authorize the examination team to disclose the information of those other taxpayers to A in its RAR. Third party tax

information may only be disclosed by the Service to A under I.R.C. § 6103(h)(4)(B) and/or (C).

Section 6103(h)(4) is a narrowly tailored exception to the confidentiality requirements of section 6103(a), which authorizes disclosure of certain tax returns and return information in judicial or administrative tax proceedings. Subparagraphs (B) and (C) of section 6103(h)(4) establish item and transaction tests, respectively, under which returns and return information of taxpayers who are not parties to such proceedings may nevertheless be disclosed. Under section 6103(h)(4)(B), a third party taxpayer's returns or return information may be disclosed in judicial or administrative tax proceedings only "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)(C), a third party taxpayer's returns or return protected information may be disclosed in judicial or administrative tax proceedings only "if such [third party's] return or return information directly relates to a transactional relationship between a person who is a party to the proceeding and the [third party] taxpayer which directly affects the resolution of an issue in the proceeding . . . ."

In the circumstances presented here, the relevant inquiry is whether subsection (B) and/or (C) permit A's examination team to disclose to A, in its examination, information relating to the lease stripping transactions to which F's basis in the property that he transferred to B is traceable, that was provided to the Service by other parties to the lease stripping deals in connection with their own returns or the examination of their own returns.

It is the Service's position that an examination is an administrative proceeding pertaining to tax administration.[2] First Western Government Securities, Inc. v. United States, 796 F.2d 356, 360 (10th Cir. 1986), aff'g, 578 F. Supp. 212 (D. Colo. 1984); Nevins v. United States, 88-1 U.S.T.C. ¶9199 (D. Kan. 1987) (reasoning that audit is administrative proceeding for purposes of Code section 6103(h)(4)); but see Mallas v. United States, 993 F.2d 1111, 1121-22 (4th Cir. 1993) (reasoning that audit is not an administrative proceeding for purposes of Code section 6103(h)(4)). An RAR is one of the final steps and is a part of the examination of the Federal income tax return of A.

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[2] The disclosure of third party tax information necessary to substantiate the Service's position in the examination facilitates early resolution of issues at the administrative level. It would be incongruous to require the Service to wait until the case is litigated to disclose any third party information supporting an adjustment.

Having concluded that an examination is an administrative proceeding pertaining to tax administration, the next question to be addressed, then, is whether the item and/or transaction tests of section 6103(h)(4)(B) and/or (C) are met in order to allow the Service to disclose third party information in an RAR to be issued to A during its examination. There are two statutory requirements under section 6103(h)(4)(C) that must be met for third party tax information to be discloseable in an administrative proceeding. The first requirement is that the third party tax information must relate to a transactional relationship between the taxpayer and the third party. The second requirement is that the information directly affects the resolution of an issue in the proceeding.

Here, the return information of the other parties to the lease stripping transactions to which the basis of the property received by B is traceable, which relates to the particular lease stripping deals to which the basis in the property is traceable, meets the first part of the test. The basis of the property that B received from F is traceable directly to the lease stripping transactions. The second requirement of the transactional relationship test is also met as the information directly affects the resolution of an issue in the proceeding (whether the lease stripping transactions were shams so that F's basis in the property he contributed to B would be zero).[3] Thus, under sections 6103(h)(4)(B) and/or (C), information relating to the lease stripping transactions to which F's basis in the property that he transferred to B is traceable that other parties to the lease stripping deals provided to the Service in connection with their own returns or the examination of their own returns may be disclosed by the Service to A in an RAR to be issued to A during its examination.

3. If A's examination team were to obtain information relating to the lease stripping transactions to which F's basis in the property that he transferred to B is traceable by summonsing third parties pursuant to A's examination, would it violate Code section 6103(a) for the team to disclose that information by including it in the RAR issued to A?

As noted previously, section 6103(a) prohibits Service employees from disclosing "returns" or "return information" as those terms are defined in sections 6103(b)(1) and

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[3] While we have analyzed this under the transaction test, it is clear from the legislative history that the same principles would apply to the item test, for example, that the information relate to some dealings or transaction between the parties. See Tavery v. United States, 32 F.3d 1423, 1430 (10th Cir. 1994), Lebaron v. United States, 794 F. Supp. 947 (C.D. Cal. 1992).

(b)(2), unless disclosure is authorized under a specific provision of Title 26. It is our understanding that the information would be summonsed by A's exam team via summonses titled "In the matter of A" from the third parties pursuant to its examination of A. As such, the summonsed information would constitute the return information of A as that information would be collected by the Service with regard to A's liability or possible liability under the Code.[4] First Western Government Securities, Inc. v. United States, 796 F.2d at 359-60; Mid-South Music Corp. v. United States, 818 F.2d 536 (6th Cir. 1987). Section 6103(e) is an exception to the confidentiality provisions of 6103(a) that provides for disclosure of tax information to the taxpayer and certain other persons having a material interest. Specifically, section 6103(e)(1)(D) provides for the disclosure, upon written request, of a return of a corporation or a subsidiary to any person delineated in this provision. Further, section 6103(e)(7), provides for the disclosure of return information to any person authorized by this subsection to receive the return, if such disclosure would not seriously impair Federal tax administration.[5] Therefore, under Code sections 6103(e)(1)(D) and 6103(e)(7), A's examination team may disclose the summonsed tax information to A, provided that such disclosure would not seriously impair Federal tax administration.[6]

4. Would it violate section 6103(a) for A's examination team to obtain from sources within the Service, such as other examination teams or issue specialists, information relating to whether other parties to the specific lease stripping transactions to which F's basis in the property that he transferred to B is traceable, also participated in other lease stripping deals?

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[4] Your office should contact the Assistant Chief Counsel (General Litigation) to ensure that the examination team is in compliance with the requirements of section 3417 of the IRS Restructuring and Reform Act (Pub. L. No. 105-206, 112 Stat. 685, 757 (1998)), which amended I.R.C. § 7602(c), notice of IRS contact of third parties.

[5] A written request is not required for return information, as opposed to the return.

[6] Alternatively, A's own return information can be disclosed to A pursuant to section 6103(h)(4)(A). That section authorizes the disclosure of a taxpayer's return information "in a Federal or State judicial proceeding pertaining to tax administration . . . if the taxpayer is a party to the proceeding, or the proceeding arose out of, or in connection with, determining the taxpayer's civil or criminal liability, or the collection of such civil liability, in respect of any tax imposed under this title[.]" As discussed above, an examination is an administrative tax proceeding to which the taxpayer is a party.

As discussed in issue 1 above, section 6103(h)(1) authorizes the disclosure of returns or return information to officers and employees of the Treasury Department for tax administration purposes. In essence, that section authorizes access to tax information when the employee establishes a "need to know" in order to perform a tax administration function. Therefore, under section 6103(h)(1), the examination team of A is authorized to obtain return information collected by the Service during the examinations of other parties to the lease stripping transactions to which F's basis to the property that he transferred to B is traceable, provided that the examination team has a need to know the information to perform a tax administration function. Similarly, A's examination team is authorized to obtain from Exam or Counsel issue specialists information relating to other cases involving lease stripping transactions with the same or other third party participants if the team has a need to know the information to perform a tax administration function. F's basis in the property he contributed to B hinges on whether the lease stripping transactions from which his basis was derived had economic substance. As the National Office recommended in prior advice the examination team of A needs to develop the facts relevant to whether those transactions had economic substance.

It is our understanding that A's examination team has a need to obtain information relating to whether other parties to the specific lease stripping transactions to which F's basis in the property that he transferred to B is traceable also participated in lease stripping deals other than the ones to which F's basis is traceable because that information is relevant to the basis of that property. Whether the other parties engaged in similar lease stripping transactions is pattern evidence which is relevant to whether the lease stripping deals from which F's basis is traceable had economic substance and whether the parties were acting in concert for purposes of Code section 482.

Courts have admitted pattern evidence in tax shelter cases where, as here, respondent attacks the substance of the transactions. In Sochin v. Commissioner, 843 F.2d 351 (9th Cir. 1988), aff'g sub nom. Brown v. Commissioner, 85 T.C. 968 (1985), the Court of Appeals found that the Tax Court acted well within its discretion in admitting evidence of other investor transactions because they were relevant to the determination that the transaction engaged in by the taxpayers was a sham. Similarly, in Brannen v. Commissioner, 78 T.C. 471 (1982), aff'd, 722 F.2d 695 (11th Cir. 1984), the Court admitted evidence with respect to 19 other similar partnerships, which all had the same mailing address, were operated by one individual, and were marketed through flip charts presenting the financial and tax aspects of the program. Likewise, and despite the Court's decision not to "try all of the partnerships in [this] one case," this Court found evidence of the activities of the promoter and his controlled and affiliated entities relevant to whether the transactions at issue had economic substance and were

entered into with a profit objective. Barrister Equipment Associates Series #115, Barrister Associates, Tax Matters Partner v. Commissioner of Internal Revenue, T.C. Memo. 1994-205.

In addition, evidence regarding business practices is relevant to determining the validity of a scheme and to provide information about the background of a transaction. Karme v. Commissioner 73 T.C. 1163 (1980), aff'd, 673 F.2d 1062 (9th Cir. 1982). As stated by the Court of Appeals in affirming the Tax Court's decision, "[a]lthough the testimony did not relate to the particular transaction giving rise to the deficiency, it did tend to establish a pattern or practice of tax planning of which this transaction was a part, and it was within the tax court's discretion to admit." Karme, 673 F.2d at 1064.

As such, the examination team of A may obtain from sources within the Service, such as other examination teams or issue specialists, information relating to whether other parties to the specific lease stripping transactions to which F's basis in the property that he transferred to B is traceable also participated in other lease stripping deals.

5. If A's examination team may obtain the information described in 4 above, may it then disclose the information to A by including it in the RAR issued to A?

As stated in issue 2 above, section 6103(h)(4) is an exception to the confidentiality requirements of section 6103(a), which specifically authorizes disclosure of certain tax returns and return information in judicial or administrative tax proceedings. As discussed above, the return information of third parties may only be disclosed in judicial or administrative tax proceedings if the item or transaction test in section 6103(h)(4)(B) and/or (C) are met.

Congress, in giving examples of the item and transaction tests, clearly indicated that the information meeting such tests had to relate to some relationship or dealings between the parties:

> The return or return information of a third party would be disclosed . . . in the event that the treatment of an item reflected on his return is or may be relevant to the resolution of an issue of the taxpayer's liability under the Code. Thus, for example, the returns of subchapter S corporations, partnerships, estates and trusts may reflect the treatment of certain items which may be relevant to the resolution of the taxpayer's liability because of some relationship (i.e., shareholder, partner, beneficiary) of the taxpayer with the corporation, partnership, estate, or trust.

> In cases involving the assessment of a penalty upon a person for failure to pay over withholding taxes, the reflection of such items on a corporate return as wages paid, taxes withheld, and the corporate office held by the person, may be relevant to the resolution of the issue of liability for the penalty.
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> The treatment (or absence of treatment) of alleged loans and gifts on a return may also be relevant to the resolution of the issue in criminal fraud net worth cases.
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> The return or return information of a third party would also be disclosed . . . where the third party's return or return information relates . . . to a transaction between the third party and the taxpayer whose liability is or may be at issue and the return information pertaining to that transaction may affect the resolution of an issue of the taxpayer's liability. For example, the treatment on a buyer's return regarding his purchase of a business would be relevant to the seller's tax liability resulting from the sale of the business. The buyer may be amortizing what he claims to be a covenant not to compete, whereas the seller may be claiming capital gain treatment upon the alleged sale of "goodwill."

S. Rep. No. 94-935, at 325 (1976).[7]

Further, Congress, in its deliberations on section 6103(h)(4)(B) and/or (C), provided two clear examples illustrating its intention that disclosure of similarly situated but unrelated third party taxpayers' tax information in tax proceedings, was not authorized:

> The return reflecting the compensation paid to an individual by an employer other than the taxpayer whose liability is at issue would **not** meet either the item or transaction tests described above in a reasonable compensation case. Thus, for example, the reflection on a corporate return of the compensation paid its president would not represent an item the treatment of which was relevant to the liability on an unrelated corporation with respect to the deduction it claims for the salary it paid its president.
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> In section 482 cases (involving the reallocation of profits and losses

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[7] The legislative history quoted above pertain to disclosures to the Department of Justice for use in tax matters. The tests for disclosure of third party information in section 6103(h)(4) are similar, although the tests are stricter, requiring that the information directly affects or directly relates to the resolution of an issue in the proceeding.

> among related companies), where it is sometimes necessary to determine the prices paid for certain services and products at arms-length between unrelated companies, the return or return information of a company which was unrelated to the taxpayer company would **not** be disclosable under either the item or transaction tests described above.

Id. at 325-326 (emphasis added).

Here, the issue of whether the other parties to the transaction engaged in similar lease stripping transactions does not directly relate to a transactional relationship between A and the third party taxpayers. Rather, those other transactions, though similar to the transaction at issue, are unrelated to the transaction under examination here. As such, the third party taxpayer information collected by the Service is not disclosable to A under either the item or transaction tests of section 6103(h)(4)(B) and/or (C).

6. If the examination team of A were to obtain information showing that other parties to the lease stripping transaction at issue participated in other lease stripping transactions by summonsing the information from third parties, would it violate section 6103(a) for the examination team of A to disclose that information in the RAR issued to A?

As stated in issue 3 above, the relevant inquiry is whether the summonsed information is the return information of A. In answering this question we are assuming that the summonses issued by the Service are titled "In the matter of A." Thus, the information to be summonsed from the third parties would constitute the return information of A as that information was collected by the Service with regard to A's liability or possible liability under the Code. First Western Government Securities, Inc. v. United States, 796 F.2d at 359-60; Mid-South Music Corp. v. United States, 818 F.2d 536 (6th Cir. 1987). As discussed in issue 3 above, A's return information may be disclosed to A under section 6103(e)(7) in conjunction with section 6103(e)(1)(D).[8]

Please call (202)622-4570 if you have any further questions.

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[8] Alternatively, as was discussed in footnote 7, the information can also be disclosed to A pursuant to section 6103(h)(4)(A).