**DEPARTMENT OF THE TREASURY**
**INTERNAL REVENUE SERVICE**
**WASHINGTON, D.C. 20224**

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

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

FROM: Richard G. Goldman
Special Counsel (Tax Practice & Procedure)
Field Service Division CC:DOM:FS:PROC

SUBJECT: Request for Chief Counsel Advice -

This Field Service Advice responds to your memorandum dated October 12, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

A=
B=

ISSUES

1. Would it violate section 6103(a) of the Internal Revenue Code for Taxpayer 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 transaction in which Taxpayer B participated that other parties to the transaction 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 above information, may it then disclose the 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 other parties involved in the specific lease stripping transaction in which B participated by summonsing third parties pursuant to A's examination, would it violate section 6103(a) for the team to disclose the information by including it in the RAR issued to A?

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 (such as the promoter) to the specific lease stripping transaction in which B participated also participated in lease stripping transactions other than the one at issue in A's examination?

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?

6. If A's examination team obtained information showing that other parties to the lease stripping transaction in which B participated also participated in lease stripping transactions other than the one at issue in A's examination by summonsing the information from third parties pursuant to A's examination, would it violate section 6103(a) for A's examination team to disclose that information in the RAR issued to A?

CONCLUSIONS

1. Section 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 transaction in which B participated that other parties to the transaction provided to the Service in connection with their own returns or the examination of their own returns, provided that A's examination team establishes a "need to know" such information in order to perform a tax administration function.

2. Under sections 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, provided that the 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 sections 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 other parties involved in the specific lease stripping transaction in which B participated, if such information was collected by the Service with regard to A's

liability or possible liability under the Code, and such disclosure would not seriously impair Federal tax administration.

4. Section 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 the promoter) to the lease stripping transaction in which B participated also participated in lease stripping transactions other than the transaction at issue in A's examination, 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 sections 6103(h)(4)(B) and/or (C), as such information does not directly relate to a transactional relationship between A and those other third parties.

6. Under sections 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 transaction in which B participated also participated in similar lease stripping transactions, if such information was collected by the Service with regard to A's liability or possible liability under the Code, and such disclosure would not seriously impair Federal tax administration.

FACTS

A is the parent of a consolidated group of which B is a subsidiary. The lease stripping transaction in the examination of A involves a number of parties, including B. The lease stripping transaction at issue consists of the following steps:

- A foreign limited life company leased computer equipment from a United States corporation which had already leased such equipment to end users.

- A United States limited partnership then subleased the equipment from the foreign limited life company subject to the end user leases.

- This United States limited partnership prepaid a substantial portion of the rents it was obligated to pay the foreign limited life company under the sublease, thereby "stripping" the rental income from the sublease.

- A finance company loaned the United States limited partnership the funds used to prepay the rents. The United States corporation which leased the computer equipment to the foreign limited life company guaranteed this loan.

• The foreign limited life company invested the prepaid rents in United States Treasury securities.

• A bank guaranteed a portion of the rent that the foreign limited life company was obligated to pay the United States corporation and took a security interest in the United States Treasury securities purchased by the foreign limited life company with the prepaid rents.

• A promoter marketed the leasehold position to A, which is a United States corporation distinct from the United States corporation previously mentioned. This resulted in B purchasing the foreign limited life company's leasehold position. The foreign limited life company claimed to have realized the rental income from the leased computer equipment while B claimed entitlement to the deductions and reported those losses.

The examination team for A is considering whether the losses reported by B from this purported lease transaction are allowable. The Service characterizes these types of arrangements where the income is improperly separated from related deductions as a "lease strip" or "stripping transaction." In order to evaluate the applicability of various potential grounds for disallowing the losses, including the sham transaction doctrine and Code section 482, the examination team is attempting to develop the facts regarding the relationship between the participants in the transaction and whether they were acting pursuant to a common prearranged plan.

The United States corporation other than A and the United States limited partnership are or have been under examination. In addition, there is another United States limited partnership under examination by the same audit team that handled the audit of the United States limited partnership. Apparently, this other limited partnership performs the same role for third parties in other lease stripping transactions as the limited partnership involved in the transaction with B. The audit team handling these examinations requested information from those partnerships by Information Document Requests (IDRs). Those partnerships produced the information to the audit team handling those examinations.

Apparently, the promoter owns a substantial interest in each of these partnerships. Additionally, other unrelated taxpayers are under examination who have engaged in lease stripping transactions promoted by the promoter that are similar to the lease stripping transaction at issue and that involve the same or related parties. The examination team for A is aware of information that has been developed during those examinations of unrelated taxpayers that would be beneficial for the Service's use in analyzing the applicability of various potential grounds for disallowing the losses reported from the lease stripping transaction at issue.

LAW AND ANALYSIS

**1. Would it violate section 6103(a) of the Internal Revenue Code for A's examination team to obtain from sources within the Service, such as other examination teams or issue specialists, information relating to the lease stripping transaction in which Taxpayer B participated that other parties to the transaction provided to the Service 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 sections 6103(b)(1) and (b)(2), unless disclosure is authorized under a specific provision of Title 26. 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 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.

Section 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 when the 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 that was provided to the Service by other parties to the lease stripping transaction in connection with the returns or examination of those parties' 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 the transaction, 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 the examination team would occur during the course of the team's official duties of tax administration, i.e., the examination of A. Thus, assuming that the exam team has an official need to know in order to conduct the examination, e.g., the information is helpful in identifying parties to the transaction or analyzing the legal and factual issues, the disclosure of such information is authorized under section 6103(h)(1).

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

As was discussed in issue 1 above, information that was provided to the Service by other parties to the lease stripping transaction in connection with their returns or examination of their 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 sections 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 specifically lifts the confidentiality constraints and 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 an item and transaction test, 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 statutorily protected 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 statutorily 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) permits A's examination team to disclose to A, in its audit, information that was provided to the Service by other parties to the lease stripping transaction in connection with their returns or examination of their returns. It is District Counsel's belief that an RAR would be issued in connection with the audit of the Federal income tax return of A. It is the Service's position that an examination is an administrative tax administration proceeding.[1] 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)).

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[1] 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 truly be incongruous to require the Service to wait until the case is litigated to disclose any third party information supporting an adjustment.

The next question we must address, 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 A's audit. There are two statutory requirements under section 6103(h)(4)(C) that must be met in order for third party tax information to be disclosed 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 transaction, which relates to the particular lease stripping transaction, meets the first part of the test. Generally, it would also appear that such information would directly relate to the resolution of the issue in the proceeding, i.e., whether the transaction is void under the sham transaction doctrine and Code section 482 . However, the item and transaction tests are factually nuanced, and each item of information needs to be evaluated separately to determine whether it meets the test.[2] Thus, under sections 6103(h)(4)(B) and/or (C), the third party taxpayers' information related to the particular lease stripping transaction under examination may be disclosed by the Service to A in an RAR to be issued to A during A's examination.

**3. If A's examination team obtained information relating to other parties involved in the specific lease stripping transaction in which B participated by summonsing third parties pursuant to A's examination, would it violate section 6103(a) for the team to disclose the information by including it in the RAR issued to A?**

Section 6103(a) prohibits Service employees from disclosing "returns" or "return information" as those terms are defined in sections 6103(b)(1) and (b)(2), unless disclosure is authorized under a specific provision of Title 26. 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 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. The relevant inquiry is whether the summonsed information is the return information of A.

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[2] 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, i.e., 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).

In answering this question, we point out that your incoming request makes clear that the information being summonses by A's exam team will be done so pursuant to A's examination. As such, 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). 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.[3] Therefore, under 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.[4]

**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 (such as the promoter) to the specific lease stripping transaction in which B participated also participated in lease stripping transactions other than the one at issue in A's examination?**

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 transaction provided that the examination team has a need to know such information in order 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 in order to perform a tax administration function.

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

[4] Alternatively, a party's own return information can be disclosed to that party during an examination pursuant to 6103(h)(4)(A). See the discussion in issue 2 above.

**5. If A's examination team may obtain the information described in issue 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 a narrowly tailored exception to the confidentiality requirements of section 6103(a), which specifically lifts the confidentiality constraints and 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 sections 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).[5]

Further, Congress, in its deliberations on sections 6103(h)(4)(B) and (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 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 (such as the promoter) 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 sections 6103(h)(4)(B) and/or (C).

District Counsel cited to several cases where the court admitted so called "pattern evidence," evidence that the parties to the proceeding engaged in similar transactions with other third parties. Although courts have admitted "pattern evidence" in tax shelter cases where the substance of the transaction is questioned, generally we do not believe those courts had the section 6103 issue

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[5] 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.

before them, and, in any event, we do not believe that the statutory language of the legislative history noted above supports disclosure of "pattern evidence" in tax proceedings.

District Counsel states that evidence regarding business practices is relevant to determining the validity of a scheme and to provide information about the background of a transaction. It is clear from the legislative history noted above that Congress intended to impose a standard that is higher than mere relevance. Congress could easily have imposed such a standard, but instead chose a much more narrowly circumscribed relationship requiring some dealings between the parties and a direct relationship to the resolution of an issue in the proceeding. As such, the third party taxpayer information collected by the Service that does not relate to the transaction at issue is not disclosable to A under either the item or transaction tests of sections 6103(h)(4)(B) and/or (C).

**6. If A's examination team obtained information showing that other parties to the lease stripping transaction in which B participated also participated in lease stripping transactions other than the one at issue in A's examination by summonsing the information from third parties pursuant to A's examination, would it violate section 6103(a) for A's examination team 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 again point out that your incoming request makes clear that the information being summonsed by A's exam team will be done so pursuant to A's examination. 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).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

None.

If you have any further questions, please call the branch telephone number.