



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

OFFICE OF  
CHIEF COUNSEL

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MEMORANDUM FOR ATLANTA ASSOCIATE AREA COUNSEL CC:SB:3:ATL

FROM: Acting Deputy Assistant Chief Counsel (Disclosure & Privacy Law) CC:PA:DPL

SUBJECT: Disclosure of Return Information of Buyer of Business to Seller-

This is in response to your request for advice concerning disclosure of third party tax return information to the petitioners in the above-referenced case in response to interrogatories served on the IRS. This document is not to be cited as precedent.

LEGEND:

A=  
B company=  
year 1=  
year 2=  
year 3=  
year 4=  
year 5=  
\$a=  
\$b=

ISSUE:

Whether the tax return information of the buyers of a business may be disclosed, pursuant to I.R.C. § 6103, to the petitioners in this litigation, one of whom was the seller of the business, in response to a five-part interrogatory propounded by the petitioners?

CONCLUSION:

In response to the interrogatory, the buyers' treatment for tax purposes of certain payments made to one of the petitioners (petitioner husband) may be disclosed to the petitioners only if you find that the tests laid out in either I.R.C. §§ 6103(h)(4)(B) or (C) are satisfied by the facts of this case. To satisfy I.R.C. § 6103(h)(4)(B), the treatment of

the payments on the buyers' returns must directly relate to the resolution of an issue in the litigation, while under I.R.C. § 6103(h)(4)(C) the return information must directly relate to a transactional relationship between the buyers and the petitioner husband which directly affects resolution of a litigation issue. Return information requested by the petitioners in their interrogatory that is other than the buyers' treatment of the payments for the years in issue, namely information on how the IRS has handled the buyers' treatment of the payments, does not appear to directly relate to an issue in the case or to a transactional relationship that directly affects an issue in the case.

### FACTS:

As we understand it, petitioner husband was the owner of a B company which he sold in year 1, and the petitioner and the buyers entered into agreements for the payment of \$a to petitioner for his stock in the company and \$b for covenants not to compete against the company. The \$b for petitioner's covenants not to compete was apparently paid out over the period of year 2 through year 5. The issue, or one of the issues, in the litigation is the proper characterization of the non-compete payments in tax years year 4 and year 5. The petitioners reported the payments as ordinary income on their returns for those years (as well as for year 2 through year 3) and now contend the payments were actually for the petitioner husband's stock in the company. If the payments were for stock (capital assets), the petitioners may then treat the payments as capital gains which can be offset by capital losses under Code section 1211.

Petitioners have served interrogatories on the respondent, and interrogatory number A, which has five parts, relates to the buyers' treatment of the non-compete payments. The first part of the interrogatory (A.a) requests information on "[h]ow the buyers/payors characterized those payments." The remaining four parts concern when and how the IRS learned of the buyers' treatment of the payments as remuneration for the covenants not to compete; any steps the IRS has taken to protect its interest in the payments, *i.e.*, statute extensions; the tax years that were still within the limitations period for assessment of tax when the IRS learned of the buyers' treatment of the payments as non-compete payments; and extensions of, "or other exceptions" to, the statute of limitations.

### LAW AND ANALYSIS:

To respond to interrogatory number A would require that the IRS disclose to the petitioners the tax return information of those taxpayers who purchased the B company from petitioner husband. I.R.C. § 6103(a) prohibits the disclosure of a tax return or return information except as authorized by a provision of the Code. I.R.C. § 6103(h)(4), in pertinent part, provides:

A return or return information may be disclosed in a Federal or State judicial or administrative proceeding pertaining to tax administration, but only—

. . . .

(B) if the treatment of an item reflected on such return is directly related to the resolution of an issue in the proceeding; [or]

(C) if such return or return information directly relates to a transactional relationship between a person who is a party to the proceeding and the taxpayer which directly affects the resolution of an issue in the proceeding; . . . .

This Tax Court litigation is a federal judicial proceeding pertaining to tax administration within the meaning of section 6103(h)(4). A disclosure “in the proceeding” includes not only disclosures during the trial, but also disclosures during settlement negotiations and in formal and informal (Branerton) discovery.

Regarding subsection (h)(4)(B), because one of the issues in the case is the nature of the payments made by the buyers to the petitioner, as either payments for transfer of stock ownership or for the petitioner’s covenants not to compete, the relevant question is whether the buyers’ treatment of such payments on their returns for years 4 and 5 directly relates to the resolution of an issue in the proceeding.

Regarding subsection (h)(4)(C), there is a transactional relationship between the petitioner husband and the taxpayers whose return information is sought: that of buyer and seller. Similar to our analysis under subsection (h)(4)(B), the relevant question would be whether the buyers’ treatment of the payments directly affects resolution of the issue of the seller’s treatment of the payments. We note that the legislative history of the Tax Reform Act of 1976, which added subsection (h) to section 6103, provides as an example of a situation falling within section 6103(h)(4)(C), “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.” S. Rep. No. 94-938, 325 (1976). The report goes on to note that 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.’” Id.

As noted above, the resolution of the disclosure issue turns on whether, under the substantive law, the treatment on the buyer’s return (or other third party return information the IRS has received or collected) directly relates to the resolution of the issue in the case. While the legislative history of section 6103 suggests that the information would be directly related, you are more familiar with the particular facts of this case and the current law in this area and we leave this determination to your

discretion. We also note, in this regard, that you have filed a motion in limine requesting the Court to prohibit petitioners from introducing any evidence to vary the terms of the agreement. To the extent the Court grants the motion, it would appear that the third party information would no longer have any affect on the resolution of the case, and thus disclosure would not be permitted.

In addition to requesting the treatment of the payment on the buyer's return, the remaining interrogatories request information on the assessment limitations period and actions taken by the IRS in response to the buyers' treatment of the payments. This information does not appear to directly relate to the issue of how the payments should be treated on petitioners' returns nor does it directly relate to the transactional relationship between the buyers and petitioner husband. Therefore, it does not appear that return information of the buyers should be disclosed in response to the last four parts of the interrogatory (A.b-e). Also, any return information for tax years other than year 4 or year 5 should not be disclosed. Finally, return information need not be disclosed under section 6103(h) if disclosure would identify a confidential informant or seriously impair civil or criminal tax investigation.

If you determine that the requested third party return information cannot be disclosed, you should indicate in the answer that the information is third party return information that cannot be disclosed because it does not directly affect or directly relate to the resolution of an issue in the proceeding, citing section 6103(h)(4)(B) and/or (C). Depending on the procedural posture of the case, you may wish to submit some or all of the third party return information to the court in camera to make a determination as to whether the tests in section 6103(h)(4)(B) and/or (C) are met.

If you have any questions, or if we can provide any further assistance, please call us at (202) 622-4580.