Federal Circuit Clarifies Third-Party Return Information Disclosure Exception

by Jeremiah Coder

A January 20 order by the Federal Circuit helps bring some clarity to the availability of nonparty taxpayer information in tax litigation by establishing firmer guidelines for when otherwise nondisclosable return information should be released by the federal government.

As a case of first impression for the Federal Circuit, the per curiam order provides a narrow framework for allowing taxpayers to access third-party tax information for litigation purposes under section 6103(h)(4)(B). The court held that, ultimately, disclosure of protected return information is permissible only when the item or transaction at issue is "directly related," thereby requiring a high threshold of relevance capable of resolving the precise tax issue involved in litigation. (For *In re United States*, No. 992, see *Doc 2012-1221* or *2012 TNT 14-23*.)

While the general principles of section 6103 keep taxpayer return information confidential and outside public purview, subsection (h)(4)(B) grants taxpayers limited means to access third-party return information in a judicial or administrative proceeding when the information is "directly related to the resolution of an issue in the proceeding."

In the case before the Federal Circuit, the IRS assessed a section 4681(a)(2) excise tax on Panasonic Communications Corp. of America for the alleged existence of ozone-depleting chemicals (ODCs) in telephones the company imported to the United States. While manufacturers can self-certify to the IRS the existence and amount of ODCs (and the resulting tax liability), the Service contracted with a federally funded research center to develop an ODC manufacturing test out of concern that foreign manufacturers were escaping tax liability by submitting false certifications.

Based on test results of the company's imported telephones, the IRS assessed Panasonic for unpaid excise taxes. The company paid the tax and filed a refund suit claim in the Court of Federal Claims, arguing that the test used by the federal government was "scientifically invalid and unreliable" because no ODCs were used in the manufacturing process. During litigation, Panasonic requested access to information from test results of other audited taxpayers. Despite the government's objection, the Court of Federal Claims granted the request to compel discovery. The claims court held that the test results from other taxpayers were "derivatively part of the 'treatment' of ODC tax liability." (For *Panasonic Communications Corp. of America v. United States*, No. 1:09-cv-00793 (Fed. Cl. 2011), see *Doc 2011-8608* or *2011 TNT 78-9*.)

The government filed a procedural petition asking the circuit court to intervene and issue a writ of mandamus to block the claims court judge's order compelling discovery of the nonparty return information. The circuit court agreed that the lower court had

committed an abuse of discretion in requiring the government to turn over the test results.

The circuit court found that the statute's "directly related" requirement to allow disclosure was ambiguous, so it looked at the legislative history for direction. While a related exception in section 6103(h)(2)(B) permits disclosure of a third-party return when the treatment of an item on the return is relevant to resolving the taxpayer's liability, Congress intended subsection (h)(4)(B) to be a "narrower exception," the court concluded. Failure to satisfy the more generous (h)(2)(B) item test means disclosure is not appropriate under (h)(4)(B), the court said. Thus, there can be no direct relation of an item's treatment on a third party's return to a taxpayer's issue "when the only link between [the two] is the same tax treatment for a similar item of liability, income, deduction, or credit," the order states.

A broader reading of section 6103(h)(4)(B) would "essentially rewrite the statute" so that the "release of third party taxpayer information would be the norm rather than the exception," the circuit court warned. The circuit court's order dismisses the reasoning of the claims court in *Shell Petroleum*, making clear that how the Federal Rules of Evidence might interpret the directly related requirement is not coextensive with the statute and noting that the evidentiary rules are an inappropriate basis to construe the disclosure exception.

Over the past decade, the Court of Federal Claims has addressed the section 6103(h)(4)(B) discovery issue several times, but the various holdings have produced inconsistent principles for when taxpayers might gain access to third-party tax returns.

In *Shell Petroleum*, the claims court held that the IRS had to provide the company with information about the production methods its competitors used in producing oil from tar sands so it could determine whether the technology it used was "widely available." The court required the government to turn over, for in camera inspection, certificates used to claim the tar sand tax credit, despite the IRS's section 6103 objection, finding that the certificates were directly related to the question of the taxpayer's entitlement to the tax credit. The court reserved the ability to redact the certificates to the extent possible to avoid disclosure of return information while providing production method information. (For *Shell Petroleum Inc. v. United States*, No. 97-975 T (Ct. Fed. Cl. 2000), see *Doc 2000-16765* or *2000 TNT 117-10*.)

But the federal claims court a year later denied a taxpayer's litigation request for information from the IRS regarding the underlying identity of parties who had requested technical advice memorandums and private letter rulings. The court held that that information was not directly related for purposes of section 6103(h)(4)(B) because "the only link between the taxpayer seeking the information and the third party is [that] both taxpayers claimed the same tax treatment for a similar item." The tax treatment of an item on a third party's return "has no legal relevance to the proper tax treatment of that same item on the return of the taxpayer requesting disclosure," the court concluded. (For *Vons Companies Inc. v. United States*, No. 00-234T, (Ct. Fed. Cl. 2001), see *Doc 2001-28118* or *2001 TNT 219-59*.)

Alex E. Sadler of Ivins, Phillips & Barker said the Federal Circuit's January 20 order was important because "taxpayers frequently seek discovery from the government regarding the treatment of other taxpayers to establish a pattern or practice within an industry, to show disparate treatment by the IRS of similarly situated taxpayers, or, as in the *Panasonic* case, for some other reason particular to the case." Section 6103 is often relied on by the government in objecting to discovery requests, so the order "breaks new ground and provides useful guidance" for future discovery requests in litigation, he said.

The order reflects "a strong interest in protecting the confidentiality of tax return information, which the court emphasized was essential to sound tax administration, and in interpreting exceptions to the general rule of confidentiality very narrowly," Sadler said. "The court's analysis of the statutory text and legislative history is well reasoned, but it does put taxpayers in the difficult position of not being able to determine how the IRS has dealt with other similarly situated taxpayers on an item that is relevant to the issues in a case."

While agreeing with the result in the case, Sadler said that "as a policy matter, it would seem that some accommodation -- such as allowing such discovery in a way that does not jeopardize the third parties' privacy rights -- is worth consideration."

Mark D. Allison of Caplin & Drysdale said the Federal Circuit presented a better interpretation than the claims court. "It would be a potentially dangerous precedent and a slippery slope for the IRS to be compelled to produce taxpayer information merely on the basis of such information having comparable characteristics or issues to the taxpayer under audit or in litigation," he said. Although there may be relevance as to how similarly situated taxpayers are treated, "it is still a reach" for the IRS to be required to produce or to voluntarily provide that information in such a fashion, he said.

But Allison added that taxpayers should probably have a right to understand the testing used by the IRS in assessing a tax liability. Obtaining the results of the testing on a redacted basis that does not reveal or suggest the identity of the other taxpayers may be a solution, he said, although he added, "That, of course, may not be possible if disclosure of the other taxpayers' products is necessary."

George A. Hani of Miller & Chevalier said that despite attempts at redaction to minimize disclosure of return information irrelevant to the issue in a judicial proceeding, "taxpayers can often put the pieces together" to get a sense of what competitors are doing. Companies are extremely sensitive to disclosure of section 6103 information because that information "can indicate the technologies used, or even supply sources, that may not be known to other firms within their industry," he said. "I think courts generally recognize the large competition stakes, and so there is a trend toward permitting only narrow discovery from the government in such instances."