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MEMORANDUM FOR: ERIC W. JOHNSON
ATTORNEY, LARGE & MIDSIZE BUSINESS

FROM: Joseph W. Clark
Chief, Branch 3
(Collection, Bankruptcy and Summonses)

SUBJECT: Scope of software protections under I.R.C. § 7612

This memorandum responds to your request for advice dated September 13, 2002, regarding the Service's obligations under I.R.C. § 7612(c). The Service is conducting an investigation of a large corporate taxpayer. Pursuant to the investigation, the Service requested copies of computer software, as defined in section 7612, used to calculate elements of the taxpayer's international tax obligations. The taxpayer expressed a willingness to provide the information voluntarily. The taxpayer indicated, however, that its contractual agreement with the software provider requires the taxpayer to obtain written assurances from the Service that it will treat the information confidentially. The taxpayer requested that the Service execute a confidentiality agreement.

Conclusion

All software provided to the Service, either voluntarily or via a summons, is statutorily entitled to the protections embodied in sections 7612(c) and 6103. These sections provide the statutory boundaries of disclosure. Accordingly, the confidentiality of the software requested from the taxpayer is adequately protected without any collateral agreement. Prior to receipt of the software, the Code requires the Service to issue notification listing the names of all persons who will have access to the software. Thus, the Service will provide adequate assurances that it will treat the software as protected under section 7612 without entering into a collateral agreement. Furthermore, the Service has a strong policy interest in avoiding any contractual agreement that alters statutory rights and obligations. Under the facts of this case the Service should not execute any confidentiality agreement.

Analysis

Section 7612(a)(1) generally bars the Service from summoning tax-related computer software source code. Section 7612(b) provides specific exceptions to the general bar. Any software or related materials that are provided to the Service receive the specific statutory safeguards set fourth in I.R.C. § 7612(c), which include: 1) the software may be used only in connection with the examination of the taxpayer's return and any related proceeding; 2) the Service must furnish, in advance, a written list of the names of persons who will have access to the software to both the taxpayer and owner of the software; 3) the software will be maintained in a secure area and, in the case of computer software source code, will not be removed from the owner's place of business without either the owner's consent or a court order; 4) except as necessary, the software may not be copied; all copies must be numbered and certified as the only copies; when the analysis is complete all copies must be returned and/or deleted; 5) the persons who access the software must provide the Service with written certification, upon penalty of perjury, that all copies and related materials have been returned and/or deleted and no other copies were made; 6) the software may not be decompiled or disassembled; 7) the Service must furnish to the taxpayer and the software owner its agreement with non-Service employees who have access to the software stating that such person agrees not to disclose software (except to people authorized by the Code) and not to participate in developing similar software for at least two years; 8) the software will be treated as return information under section 6103, and 9) any willful disclosure of the software protected by these safeguards is subject to the criminal penalties set forth in I.R.C. § 7213.

Section 7612(a)(2) provides that the protections afforded in 7612(c)(2) are afforded to <u>any</u> software "provided to the Secretary under this title." Although 7612(b)(1) exempts section (a)(1) when certain requirements are met, together these two subsections only limit the power of the Service to summons tax related computer software source code. They do not affect the Service's authority to summons software that is either not "tax related" or not "source code." Nor does 7612(b) limit the general requirement to protect the confidentiality of "software" under subsection (c)(2). Sections 7612(d)(1) through (3) defines software broadly, including both source code and machine code as well as any manuals and any materials created as part of the design process. Under this expansive definition, if a set of computer files does not require an additional program (other than an operating system and/or a program to convert source code to executable code) to cause the computer to execute designed functions, it is protected under 7612(c)(2).

This interpretation is consistent with the legislative history of section 7612. Congress determined that section 7612(c) protects trade secrets and confidential information that the Service obtains in an examination of "any computer software program or source code that comes into the possession or control of the Secretary in the course of any examination with respect to any taxpayer." S. Rep. No 105-174 at 73. The legislative history clearly supports the view that section 7612, while generally restricting the ability

of the Service to summons tax-related computer software, provides an expansive interpretation for the protections embodied in subsection (c)(2).

Notwithstanding this expansive definition of software, disputes may arise as to whether computer files are in fact software as defined under the Code. It is clearly within a taxpayer's rights to refuse production of software (absent a summons) without a guarantee that the Service will protect that software. Section 7602(a)(1), while permitting the Service to review relevant information, does not compel a taxpayer to produce it. Rather, to compel production the Service must utilize its summons power under 7602(a)(2) and seek judicial enforcement under section 7604, as limited by section 7612(a)(1) and (b). While the taxpayer may properly refuse production without a summons if the Service does not enter into an agreement that the software will be treated as protected under 7612(c), the company may not require an agreement in the event the Service issues a summons for the documents.

In this particular situation, we understand the taxpayer desires to voluntarily comply with the information request. Under section 7612, the statute affords both the taxpayer and the software owner adequate assurances that the Service will treat the software as protected under subsection (c) without entering into a formal agreement. Although the Code does not specifically provide the Service authority to determine that a particular set of computer files fits the definition of software, section 7612(c) mandates the specific safeguards described above for handling software. Most important for this discussion, the Code requires that the Secretary provide a list of persons who will have access to the software prior to the actual receipt of the software by the Service.[1] Section 7612(c)(2)(B). This procedural requirement indicates congressional intent to vest the Secretary with the power to classify software as protected under section 7612. It would be impossible for the Secretary to fulfill his obligations under (c)(2) without such authority.

The protection afforded by this classification can be assured to the taxpayer without a specific agreement. A statement complying with section 7612(c)(2)(B) would be meaningless absent clear language indicating that the letter is in reference to software as defined in 7612(d)(1). The Case Manager, in coordination with Division Area Counsel, can properly issue such a statement as part of the required custody announcement.[2]

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[1]Although section 7612 establishes several procedural requirements on the Service when handling software, subsection (c)(2)(B) is the only pre-possession requirement. Accordingly, it is the only opportunity to affirmatively state the computer files will be deemed software as defined in 7612(d)(1) prior to receipt.

[2]IRM 25.5.6.10.2(1) provides that Division Area Counsel must be consulted to establish procedures for complying with the section 7612(c) and paragraph (2) provides that in CIC cases, the Case Manager has ultimate responsibility to assure that all

Although the Service has the authority to classify software under section 7612, we recognize there may be some practical problems that arise because this section requires classification before the software is reviewed by Service personnel. The Service will necessarily have to rely upon representations of the taxpayer in making this pre-access determination. Upon receipt of the files, the Service's initial task should be to verify the computer files are software as defined in 7612(d). It is our understanding that the Service has software experts assigned to the group that is auditing the taxpayer in this case. The Service will send in these experts to interpret and learn to use the software before any revenue agent will have access for audit purposes. The computer experts should satisfy themselves, after consultation with Division Area Counsel, that the files are indeed 7612(d) software before any other work is conducted on the files. If the Service is satisfied, the investigation can continue under the representations in the custody letter. If, on the other hand, upon initial examination or subsequently, either the computer experts or the Division Area Counsel determines the files are not software, the Service should immediately return any files and/or support material, disavow the custody agreement, and summons the material under 7602(a)(2). Of course, any information obtained due to the initial access to the computer files should be treated as taxpayer information covered by 6103.

This approach is consistent with the Service's long standing reluctance to enter into confidentiality agreements with taxpayers under investigation. Section 7612(c)(2)(H) provides that the software will be return information as defined in section 6103. Section 6103 is both a restrictive and permissive statute; while section 6103(a) lays out the general rule prohibiting the disclosure of returns and return information, subsections (c) through (o) provide exceptions permitting specific, limited disclosures. General confidentiality agreements may not provide similar exceptions, and there might be circumstances under which section 6103 allows for disclosure of return information but a nondisclosure agreement with the taxpayer does not. Additionally, executing agreements with taxpayers that bind the Service requires a delegation of authority. It is unclear who, if anyone, would have the delegated authority to either expand or contract the specific statutory protection created in section 7612. Executing such agreements could later create contractual litigation involving equitable estoppel and apparent authority. Finally, although Congress provided a general restriction on summoning information under 7612, it stated in the legislative history that "software or source code that is required to be provided under present law must be provided without regard to this provision." H.R. Conf. Rep. 105-599 at 274. A confidentiality agreement may restrict the Service's ability to obtain or use software that would otherwise be available under present law.

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requirements of the Code are met.

For the above reasons, we advise against entering into contracts that would purport to ensure rights under section 7612. However, a statement in a list of persons who will access information that the Service has determined is software as defined in 7612(d) is a necessary element of the statutory requirement. Accordingly, while indicating the software's right to protection, such a statement would not bind the Service to any terms except the statutory obligations. If the taxpayer finds this approach inadequate, we would recommend summoning the software.

If you have questions in this matter, please contact the attorney assigned to the case.