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

OFFICE OF CHIEF COUNSEL

Number: **200128055**
Release Date: 7/13/2001

CC:LM:MCT:SLC:HMLewis
SPR-116598-01

May 31, 2001

UILC:6103.14-00, 7213.00-00, 7213A.00-00, 7431.00-00

MEMORANDUM FOR JOHN PETRELLA
Director of Field Operations, East
Communications, Technology & Media LM:CTM

FROM: CYNTHIA J. MATTSON
Deputy Division Counsel
Large and Mid-Size Business CC:LM

SUBJECT: Execution of Nondisclosure and Nonuse Agreement between Service Expert and Taxpayer

This Chief Counsel Advice responds to your inquiry of March 15, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

ISSUE

Whether the Service, as requested by taxpayers, should permit experts engaged by the Service to enter into nondisclosure and nonuse agreements with the taxpayers.

CONCLUSION

The experts retained by the Service should not enter into nondisclosure and nonuse agreements with taxpayers. The federal statutory safeguards presently in place adequately protect the interests of taxpayers when experts engaged by the Service have access to returns or return information and should be the exclusive means for preventing improper disclosure and use of such information.

FACTS

The Service entered into a contract with a corporation to provide outside expert assistance with respect to the examination of taxpayer claims. The experts' duties include the examination of taxpayers' books and records supporting the claims and interviewing taxpayers' employees.

When the Service enters into a contract with a third party contractor, it is standard practice to have the contract contain provisions concerning disclosure and safeguarding of taxpayer information. The Service's contract with the corporation includes standard IRS acquisition procedures (IRSAP) clauses regarding unauthorized disclosure: IRSAP 1052.224-9000, Disclosure of Information-Safeguards (January 1998); IRSAP 1052.224-9001, Disclosure of Information (January 1998); and IRSAP 1052.224-9002, Disclosure of Information-Inspection (December 1988).

The Disclosure of Information-Safeguard portion of the contract provides, in part, that the corporation agrees to comply and assumes responsibility for compliance by its employees with respect to these disclosure matters. Failure to comply with these procedures is a breach of the contract and the contract may be terminated. Disclosure or referral to other than an officer or employee of the corporation is prohibited unless prior written approval is given by the Service.

The contract sets forth the penalties prescribed by the Code with respect to an unauthorized disclosure of return and return information by the corporation's experts. The corporation is required to inform in writing each person who receives taxpayer returns or return information that such information can be used only for a purpose and to the extent authorized by the contract and that further disclosure of such information for an unauthorized purpose constitutes a felony punishable by a fine not exceeding $5,000 and imprisonment of up to five years, or both, together with the costs of prosecution. See section 7213(a)(1). The corporation is also required to inform in writing each such person that any unauthorized disclosure of information may result in an award of civil damages against that person in an amount not less than $1,000 for each instance of unauthorized disclosure plus in case of willful disclosure or a disclosure from gross negligence, punitive damages plus the cost of that action. See sections 7431(a)(2) and (c). See also Treas. Reg. § 301.6103(n).

The contract sets forth the penalties prescribed by the Code with respect to an unauthorized inspection of return and return information by the corporation's experts. The corporation is required to inform in writing each person that the inspection of returns or return information for a purpose not authorized therein constitutes a criminal misdemeanor punishable upon conviction by a fine not exceeding $1,000 or imprisonment not to exceed one year, or both, together with the costs of prosecution. See sections 7213(A)(a)(1)(B) and (b)(1). The corporation is also required to inform in writing each such person that any unauthorized inspection may also result in an award of $1,000 against that person for each act of unauthorized inspection or disclosure or the sum of actual damages sustained by the plaintiff plus in the case of a willful inspection or an inspection as a result of gross negligence, punitive damages and costs of the action. See sections 7431(a)(2) and (c).

The contract requires the corporation to inform its officers and employees of the penalties for improper disclosure imposed by the Privacy Act of 1974, 5 U.S.C. § 552(a). It also provides that 5 U.S.C. § 552a(I)(1), which is made applicable to

contractors by 5 U.S.C. § 552a(m)(1), provides that any officer or employee of a contractor, who knowingly and willfully makes a disclosure that is prohibited by the Privacy Act is guilty of a misdemeanor and fined not more than $5,000.

The contract provides that the corporation will advise personnel receiving “Official Use Only” information that the “Official Use Only” information disclosed to them can be used only for the purpose and to the extent authorized and that further disclosure of “Official Use Only” information by any means, for a purpose not authorized, may subject the offender to criminal sanctions imposed by 18 U.S.C. §§ 641 and 3571. Section 641 of 18 U.S.C. provides that whoever knowingly converts to his use or the use of another, or without authority sells, conveys, or disposes of any record of the United States or whoever receives the same with the intent to convert it to his use or gain, knowing it to have been converted, will be guilty of a crime punishable by a fine or imprisoned up to ten years or both; and section 3571 provides for the amounts of fines to be imposed.

The contract also gives the Service the right to send its personnel into the corporation’s offices for inspection of the facilities and operations and on the basis of such inspection, may require specific measures where the corporation is found to be noncompliant with contract safeguards.

To comply with the requirements of the contract, the corporation has its experts execute a nondisclosure agreement. This agreement states that the corporation has provided the expert with a copy of the corporation’s contract with the Service concerning the Disclosure of Information-Safeguard portions of the contract, and that the expert has read, understood, and agreed to comply with these Disclosure of Information-Safeguard portions. In this nondisclosure agreement, the expert also states that the expert is aware that there are penalties for improper disclosure imposed by the Privacy Act of 1974, 5 U.S.C. § 552(a), sections 7213 and 7431 of the Code, and 18 U.S.C. §§ 641 and 3571. In addition, the experts engaged by the corporation receive specific training concerning unauthorized disclosure of taxpayer information.

You have received notification from several taxpayers that they are concerned about the disclosure of their respective property, proprietary information, business processes and business practices to the corporation's experts. The taxpayers appear to be more concerned that the experts may be able to utilize the information that is provided to them for the experts’ gain or as future competitors, rather than disclosure of their tax information. Several taxpayers have advised the Service that they will not provide relevant information to the Service unless or until the corporation or the corporation's experts enter into separate nondisclosure and nonuse agreements with the taxpayer. In support of this position, the taxpayers have argued in the main:

1. They want to have privity with the expert so that they can bring their own action against the expert and not rely on the Service or the Department of Justice to enforce the provision.

2. They believe that the monetary penalties under the statutory provisions listed in the contract do not give them adequate compensation for any damages caused if the expert converted the information to his or her own use or sold it to a competitor. Thus, they insist that the separate nondisclosure and nonuse agreement with the expert contain equitable provisions such as injunctions against the expert and also provide for litigations and cost awards.

3. They believe that the statute of limitations for bringing an action under section 7431 does not provide them sufficient protection, and have requested a five year statute of limitations from the date of the original disclosure to the expert.

4. They believe that the Privacy Act provides them no protection.

5. They want the contract to provide that the expert will advise the taxpayer of all other corporation experts that are furnished such information and each of these experts will also execute a similar nondisclosure agreement with the taxpayer prior to being furnished such information.

6. They want the expert to be required to notify the taxpayer if the expert is requested or required to provide testimony about the information in any legal or other proceeding and the expert will cooperate with the taxpayer if the taxpayer seeks to obtain a protective order.

We also note that taxpayers' proposed nondisclosure and nonuse agreements contain provisions that are not uniform. For example, they each provide that the agreements will be governed by the laws of different states. They have different periods for bringing suits against the expert. The remedies and damages are not the same. In addition, what constitutes a breach of the agreement is not the same.

LAW AND ANALYSIS

Federal statutes provide for both civil and criminal penalties in the event of unauthorized inspection or disclosure of returns and return information by an outside expert hired by the Service. In answer to the first of the taxpayer concerns, these statutes provide the taxpayer the right to bring its own civil suit against the expert. Section 6103(n) and its implementing regulation, Treas. Reg. § 301.6103(n)-1, allow for the disclosure of returns and return information to contractors for services relating to tax administration. Under section 7431(a)(1), a taxpayer whose return or return information was knowingly or negligently inspected or disclosed by an "officer or employee of the United States" may sue the United States in district court for economic damages resulting from the disclosure. Under section 7431(a)(2), if the unauthorized inspection or disclosure is made by a person who is not a government employee or officer, the taxpayer may sue that person in district court. Thus, in the case of an unauthorized inspection or disclosure by an employee of a section 6103(n) contractor, such as one of corporation's experts, that employee would be liable to the taxpayer, not the United

States. The taxpayer need not rely on the Service or the Department of Justice to enforce the provisions against unauthorized inspection or disclosure.

Another concern raised by the taxpayers is the adequacy of recovery in a section 7431 lawsuit, particularly with respect to the use of their property or business practices to their competitive disadvantage. Section 7431(c) provides for the recovery, whether the defendant is the United States or an individual, of the greater of the plaintiff's actual damages resulting from the unauthorized inspection or disclosure, plus punitive damages if willful, or $1,000 for each unauthorized act. If a corporation expert made an unauthorized inspection or disclosure of a taxpayer's return information, the taxpayer would be entitled to recover under section 7431 all economic damages resulting from the disclosure. The recoverable damages would include any damages from a competitor's use of the return information, assuming the taxpayer can establish that the disclosure was the cause of the damages. See Jones v. United States, 9 F. Supp. 2d 1119, 1137-38 (D. Neb. 1998) (holding that the common law elements of causation must be proven to recover actual damages under section 7431, that is, cause in fact and proximate cause), rev'd in part on other grounds, 207 F.3d 508 (8th Cir. 2000).

The taxpayers have also expressed their desire to be able to recover litigation costs and attorney fees when bringing suit against the corporation's experts, as well as pursuing injunctions and other equitable remedies against the experts. Under section 7431, a plaintiff may recover reasonable attorney fees, if the plaintiff is the prevailing party and the plaintiff's net worth does not exceed certain prescribed dollar amounts,[1] and litigation costs. As for equitable remedies, such as temporary or permanent injunctions, although section 7431 does not by its terms provide for them, some courts have indicated that a plaintiff may nevertheless obtain equitable remedies in response to an unauthorized disclosure or threatened disclosure. See, e.g., Tierney v. Regan, 718 F.2d 449, 457 (D.C. Cir. 1983) (plaintiffs were entitled to a declaratory judgment that contemplated disclosures were unauthorized where statutory damages under section 7431 were an inadequate remedy).[2]

The taxpayers have also expressed concern that the two-year statute of limitations for an action under section 7431 is too short and that the nondisclosure restrictions on the corporation's experts should be five years from receipt of the information. Section 6103, however, is more protective than this five-year rule because the

---

[1] In the case of a corporation, the company's net worth may not exceed $7 million at the time the action was filed. Sections 7430(c)(4)(A)(ii), 7431(c)(3); 28 U.S.C. § 2412(d)(2)(B).

[2] While a taxpayer may have an equitable remedy against the corporation's experts for unlawful disclosures, no such remedy would exist against the United States, for disclosures in the context of examination or collection activity, due to the statutory bar of the Anti-Injunction Act, I.R.C. 7421(a).

prohibition on unauthorized disclosure of return information in section 6103 has no such time limit. The two-year statute of limitations in section 7431(d) commences to run on the date the plaintiff discovered the unauthorized inspection or disclosure, which is ample time for an aggrieved taxpayer to file suit. It should be noted that section 7431(d) seems to codify the "discovery rule," which is the general rule that federal courts apply in determining when a cause of action accrues. Rotella v. Wood, 528 U.S. 549, 555 (2000); Cada v. Baxter Healthcare Corp., 920 F.2d 446, 450 (7th Cir. 1990). Under the discovery rule, a plaintiff's cause of action accrues, and the statute of limitations commences to run, when he discovered, or reasonably should have discovered, the injury. United States v. Kubrick, 444 U.S. 111 (1979); Connors v. Hallmark & Son Coal Co., 935 F.2d 336, 342 (D.C. Cir. 1991). As for section 7431, at least one court has held that the period begins to run when the plaintiff knew or should have known of the disclosure. Simpson v. United States, No. 90-30021-RV, 1991 U.S. Dist. LEXIS 15153, at *19 (N.D. Fla. Oct. 9, 1991). Additionally, courts have held that claims for unauthorized disclosure under the Privacy Act accrue when the plaintiff knew or should have known of the disclosure, although the limitations language of the Privacy Act is slightly different than that of section 7431 ("within two years from the date on which the cause of action arises"). Tijerina v. Walters, 821 F.2d 789, 797-98 (D.C. Cir. 1987); Pope v. Bond, 641 F. Supp. 489, 499 (D.D.C. 1986).

In addition to the civil remedies available to the taxpayers, other federal statutes serve as a safeguard for the protection of tax return information by imposing severe criminal penalties for willful unauthorized disclosure or inspection of returns and return information. Specifically, section 7213(a)(1) provides that any federal employee or section 6103(n) contractor, such as one of corporation's experts, who willfully discloses return information in violation of section 6103 shall be guilty of a felony punishable by a maximum fine of $5,000 and imprisonment up to five years. Under section 7213A, willful unauthorized inspection of returns and return information by a government employee or a section 6103(n) contractor is a crime punishable by a fine not to exceed $1,000, imprisonment up to one year, or both.[3]

The taxpayers, which are corporations, are correct about the inapplicability of the Privacy Act to them. By its terms, the Privacy Act only applies to information on an “individual,” which is defined as “a citizen of the United States or an alien lawfully admitted for permanent residence.” 5 U.S.C. § 552a(a)(2). All of the protective provisions of the Act apply only to individuals. It is our position that individuals acting in an entrepreneurial capacity, *e.g.,* as a sole proprietor, are covered, although there is a

---

[3] Additionally, under 18 U.S.C. § 1832, whoever, with intent to convert a trade secret, without authorization, copies, sends, mails, or communicates information to the economic benefit of someone that is not the owner of the information and that will injure the owner of a trade secret is subject to a fine under title 18 or imprisonment for not more than ten years, or both.

split among authorities on this point. Compare Shermco Indus. v. Secretary of the United States Air Force, 452 F. Supp. 306, 314-15 (N.D. Tex. 1978), and OMB Privacy Act Guidelines, 40 Fed. Reg. 28,948, 28,951 (1975), with Henke v. United States Dep't of Commerce, No. 94-0189, 1994 U.S. Dist. LEXIS 21257, at *1 (D.D.C. Aug. 19, 1994). The corporate taxpayers, however, involved with this matter are not individual entrepreneurs; but this fact does not severely limit a corporate taxpayer's protection from unauthorized inspection or disclosure because section 6103 is the controlling statutory authority on disclosure of tax returns and return information. Congress intended that section 6103 preempt the more general provisions of the Privacy Act. See Lake v. Rubin, 162 F.3d 113 (D.C. Cir. 1998); Cheek v. IRS, 703 F.2d 271 (7th Cir. 1983).

Finally, some courts have held that section 7431 is the exclusive remedy for damages for unauthorized disclosure of returns and return information. See Berridge v. Heiser, 993 F. Supp. 1136, 1145 (S.D. Ohio 1997) ("Section 7431 provides Plaintiffs with the exclusive remedy by which they may bring a cause of action for improper disclosure of return information."); Malis v. United States, No. 83-7767, 1986 U.S. Dist. LEXIS 16320, at *17 (C.D. Cal. Dec. 17, 1986). But see Sinicki v. United States Dep't of Treasury, No. 97-civ-0901, 1998 U.S. Dist. LEXIS 2015 (S.D.N.Y. Feb. 24, 1998) (plaintiff entitled to pursue recovery for wrongful disclosure under both the Privacy Act and section 7431). When a statute, like former section 7217, section 7431's predecessor, creates a new cause of action and provides a remedy to enforce that cause of action, the remedy is exclusive.[4] Fleischmann Distilling Corp. v. Maier Brewing Co., 386 U.S. 714, 720 (1967); Mahoney v. Crocker Nat'l Bank, 571 F. Supp. 287, 293 (N.D. Cal. 1983); Vandalia R.R. Co. v. Schnull, 122 N.E. 225, 226 (Ind. 1919), rev'd on other grounds, 255 U.S. 113 (1921). Other remedies, including common law remedies, such as breach of contract, are impliedly excluded. Shriver v. Woodbine Sav. Bank, 285 U.S. 467, 478 (1932); Watkinson v. Great Atlantic & Pacific Tea Co., Inc., 585 F. Supp. 879, 882 (E.D. Pa. 1984) (common law breach of contract claim for alleged age discrimination excluded by Pennsylvania Human Relations Act). A suit to enforce a nondisclosure agreement like those proposed by taxpayers would presumably be a basic breach of contract action. Arguably, then, these sorts of agreements, which seek to provide a common law remedy in addition to that of section 7431, are void as a matter of law. Cf. Johnson v. Sawyer, 47 F.3d 716, 729 (5th Cir. 1995) (subsequent history omitted) (for purposes of the Federal Tort Claims Act, the court found no indication that Texas would create, nor would the court create on its own, a common law cause of action for violation of section 6103(a) where there was already "a

---

[4] Prior section 7217 was repealed in 1982 and replaced with section 7431. (Current section 7217 concerns unlawful influence of certain Executive Branch officials over audits and tax investigations.) Regarding passage of former section 7217, the Senate Finance Committee "decided to establish a civil remedy for any taxpayer damaged by an unlawful disclosure of returns or return information." S. Rep. No. 94-938, at 348 (1976).

comprehensive and express statutory private cause of action[,]" *i.e*., section 7217, predecessor to section 7431.)

For the reasons stated above, we believe that the contract between the corporation and the Service, the nondisclosure agreements by the experts, and sections 6103, 7431, 7213 and 7213A are adequate protection for taxpayers and should be the exclusive means of redress for unauthorized inspection and disclosure of returns and return information. The nondisclosure agreements that taxpayers want the corporation's experts to sign do not offer any measurably greater protection to the companies than already exists under the framework provided by Congress. The taxpayers' proposed agreements prohibit use of "confidential information" by the experts beyond the limits of any examinations of tax claims. As a practical matter, such a prohibition is the same as that which applies to the experts under section 6103: they may not inspect or disclose any return information, which is essentially all information of the taxpayers the experts receive, beyond providing expert consulting services in furtherance of tax administration. Admittedly, the proposed agreements state that the taxpayers will be entitled to injunctions in the event of a breach or threatened breach of the agreements, while section 7431 does not expressly allow for injunctive relief. Although a court has not held that a plaintiff may obtain an injunction under section 7431, we are aware of no court that has held that an injunction may not be obtained. In addition, to obtain any injunction, whether to enforce a confidentiality agreement or to prevent an unauthorized disclosure of return information, a plaintiff must satisfy the same elements, including an inadequate remedy at law and irreparable harm.

Taxpayers want to provide that the expert will advise the taxpayer of all other corporation experts that are furnished such information and each of these experts will also execute a similar nondisclosure agreement with the taxpayer prior to being furnished such information. We believe the same protection is provided by the existing contract and nondisclosure agreements executed by the corporation's experts. The taxpayers also want the experts to be required to notify the taxpayers if an expert is requested or required to testify about confidential information and cooperate in securing a protective order. To the extent such a provision might impact or complicate the ability of an expert to testify on behalf of the Service in connection with the taxpayer's liability, the provision is unacceptable. To the extent an expert might be compelled to make an unauthorized disclosure of return information while testifying in any proceeding, including private litigation, the Service, through the Department of Justice, would seek a protective order.

We also have a concern about nondisclosure agreements that potentially conflict with 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. The nondisclosure agreements of the sort proposed by the taxpayers do not provide similar exceptions, and there might be circumstances under which section 6103 allows for a corporation expert to disclose return information but a

nondisclosure agreement with the taxpayer does not. Indeed, there might be times when the Service would want the expert to disclose return information pursuant to a section 6103 exception, but a nondisclosure agreement is a barrier. For example, consider the following hypothetical situation:

> In the course of investigating a corporate taxpayer's (taxpayer A's) claim for a tax benefit, a corporation expert, who entered into a nondisclosure agreement with the taxpayer similar to those proposed by the taxpayers, examined information relating to another taxpayer (taxpayer B), as well as taxpayer A. The information has relevance to B's entitlement to a business deduction under section 162 of the Code. The information is the return information of A because it was obtained by the Service in regard to A's tax liability, but it is not the return information of B because it was not obtained by the Service in connection with B's liability. Additionally, there is a transactional relationship between A and B, *i.e.*, B provided ancillary services to A in developing the property for which the tax benefit was claimed. The services B provided relate, in part, to its claimed business expense. Taxpayer B is the plaintiff in a Tax Court case involving the section 162 deduction. The Service proposes to have the expert testify in the case and disclose A's return information as it relates to B's deduction.

Under section 6103(h)(4)(C), such disclosure of A's return information would be permissible.[5] Section 6103(h)(4)(C) provides:

> A return or return information may be disclosed in a Federal or State judicial or administrative proceeding pertaining to tax administration, but only— . . . (C) if such return or return information directly relates to a transactional relationship between a person who is a party to the proceeding [(taxpayer B)] and the taxpayer [(taxpayer A)] which directly affects the resolution of an issue in the proceeding; . . . .

Although section 6103 would permit the testimony, the expert could not testify without exposing himself or herself to liability under the terms of the nondisclosure agreement as proposed by the taxpayers. Consequently, the expert might refuse to testify or otherwise make it very difficult for the Service to secure his or her testimony. Such a situation would obviously be adverse to the Service's interests.

We also believe that the taxpayers' proposals could create unncessary complexity and conflict. First, the proposed taxpayer agreements contain provisions that will be in conflict or differ from the existing contractual provisions. The existing agreements are governed by federal law, while the proposed agreements would be governed by a mix

---

[5]Additionally, disclosure of computer software under these facts would be permissible under section 7612(c), discussed below.

of various federal and state laws. Additionally, the agreements have different terms and conditions, specifically regarding periods of effectiveness and definitions. These differences in the agreements will cause uncertainty and added burden were there ever an unauthorized disclosure that resulted in litigation. The courts would have to determine what law applies, state or federal, and either reconcile the two agreements or determine that one applies and the other does not. This could result in separate suits in separate courts and, quite possibly, inconsistent outcomes.

Further, we note that the Service receives returns from millions of taxpayers from all 50 states. The Service and Counsel engage many experts and third-party contractors to perform its tax administration duties. If it became routine practice for a taxpayer to require all experts or third-party contractors that had access to its respective tax information to enter into a separate agreement with the taxpayer, then it would severely impact the administration of the tax system. Taxpayers would request different provisions and request that different state law provisions apply. Any agreement would probably necessitate negotiation and cause delay. We recognize that some taxpayers may be making this request for legitimate reasons, but it also could be used to cause delay and to subvert the examination system. Moreover, given the proper circumstances, the Service can summon the necessary records for its expert's review without the need for the expert to acquiesce to taxpayer demands for various additional agreements. See 26 U.S.C. § 7602. In this way, there is no reason why an expert should subject itself to further liability and agree to enter into these agreements with the taxpayer. Doing so can only cloud the expert's contractual relationship with the Service.

In lieu of the expert entering into additional nondisclosure agreements with the taxpayers, the Service should provide a copy of the expert's nondisclosure agreement and those contract terms dealing with disclosure and privacy to the taxpayer in order to assure the taxpayer that the corporation and the experts understand their statutory obligations regarding unauthorized inspections and disclosures.