

**Office of Chief Counsel
Internal Revenue Service
memorandum**

CC:PA:BR:07
DL-108980-08

date: May 7, 2008

to: Robert D. Uhar
Director, Office of Safeguards

from: Charles B Christopher
Chief, Branch 7
(Procedure & Administration)

subject: Other Agency Confidentiality Agreements

This memorandum is in response to your February 28, 2008, request for an opinion concerning the issues presented by federal, state and local government agencies that require the execution of confidentiality agreements by Internal Revenue Service (IRS) employees and contractors.

BACKGROUND

It is our understanding that an unspecified number of federal, state and local government agencies are requiring IRS Disclosure Enforcement Specialists and IRS contractors to sign confidentiality agreements before they are granted access to the facility to perform safeguard reviews. In many cases, the state and local government agencies explain they are satisfying their own state legal requirements to safeguard federal tax information (FTI) and state tax data. You related that there are instances where the safeguard review team must decide between halting the review or signing the confidentiality agreement. You believe that section 6103(p)(4) of the Internal Revenue Code (I.R.C. or Code) grants the IRS authority to conduct the reviews without the conditions or restrictions.

You attached sample agreements from several state and local government entities to your memorandum. We note that these agreements are written for state employees or state contractors and include language relating to both state and federal statutes prohibiting disclosure of confidential information.

ISSUE

Whether federal, state or local government agencies receiving FTI can require that IRS employees or contractors sign confidentiality agreements to obtain access to the agency's facility or information technologies to conduct safeguard reviews.

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CONCLUSION

IRS employees and contractors are performing a federal function when they conduct safeguard reviews. Pursuant to the Supremacy Clause of the United States Constitution, state and local government agencies cannot enforce a requirement that IRS employees or contractors sign confidentiality agreements as a condition to their access to the facility or technology. While federal agencies can enforce a requirement that IRS employees or contractors execute confidentiality agreements, we believe the IRS can and should take practical steps to avoid legal confrontation. That is, the IRS should make assurances of confidentiality when arrangements are made for the safeguard review.

PRACTICAL CONSIDERATIONS

As we explain more fully below, IRS employees and contractors are not subject to state or local government confidentiality agreements while performing their federal function duties. This position creates considerable tension between the IRS and state and local government agencies. Moreover, the Supremacy Clause does not apply to other federal agencies, so they are not prohibited from requiring IRS employees or contractors to execute confidentiality agreements. Such tension among the stakeholders, some of whom provide valuable information back to the IRS in the form of state tax data or state audit information, is not conducive to a cooperative relationship. Section 11.3.36.1(2) of the Internal Revenue Manual observes that:

[t]he safeguard program should be a cooperative effort with the recipient agencies, their authorized agents, their authorized contractors, and with IRS contractors, to ensure the confidentiality of the tax data. Interaction and education are key elements in promoting protection of tax information. However, in order to fulfill legal responsibilities, the program must also maintain a viable enforcement capability.

We believe that these confidentiality agreements are not intended to interfere with the IRS safeguard reviews, but rather reflect the state and local government agencies enforcement of their own laws to protect confidential information in this age of data security concerns.

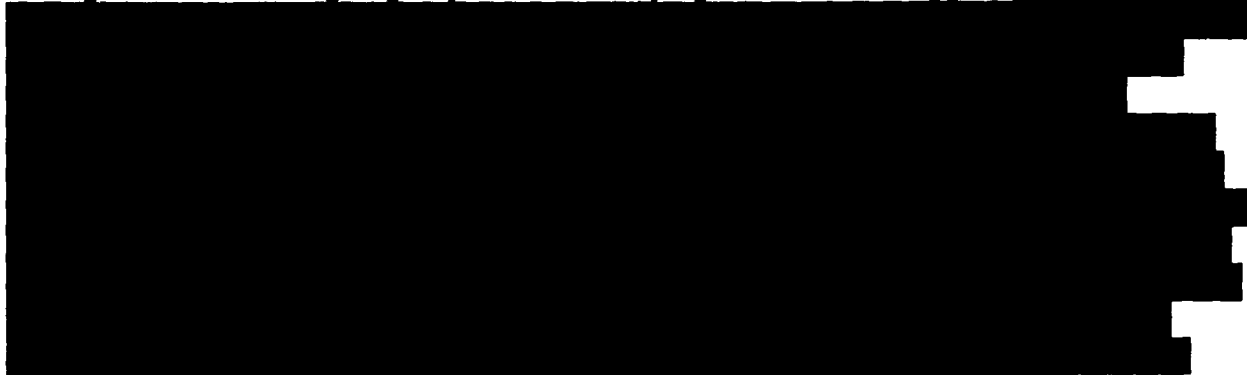
As you are aware, Temporary Treasury Regulation § 301.6103(p)(4)-1T, which describes procedures relating to safeguards for returns and return information, refers to guidance published by the IRS. Publication (Pub.) 1075, Tax Information Security Guidelines for Federal, State and Local Agencies and Entities (Rev. 10/2007), is the guidance referenced in the temporary regulation.

Section 2.7 of Pub. 1075 describes the initiation of IRS safeguard review as follows:

The IRS initiates the review by verbal communication with an agency point of contact. The preliminary discussion will be followed by a formal engagement

letter to the agency head, giving official notification of the planned safeguard review.

To avoid situations where the IRS employees or contractors must choose between halting the review or signing any confidentiality agreement, we suggest



To the extent that you have requested our legal views, our analysis of the issues appears below.

LEGAL ANALYSIS

1. *Safeguard Reviews*

The Code does not specifically state that the Secretary of the Treasury (or IRS as his delegate) must conduct safeguard reviews to assure compliance with section 6103(p)(4), although we note that the legislative history of section 6103 clearly states the "IRS is to review, on a regular basis, safeguards established by other agencies." S. Rep. 94-938, *Report of the Committee on Finance on H.R. 10612*, 345 (1976). Nonetheless, the requirements stated in numerous provisions of section 6103(p) buttress the IRS's long-standing position that the IRS can and, indeed, must, conduct periodic reviews to assure compliance with the statute by FTI recipients. Section 6103(p)(4) provides in relevant part:

[a]ny Federal agency described in [enumerated] subsection[s] ... or commission described in subsection (d) ... or any appropriate State officer ... or any other person described in [enumerated] subsection[s] ... shall, as a condition for receiving returns and return information—

(B) establish and maintain, to the satisfaction of the Secretary, a secure area or place in which such returns or return information shall be stored....

If the Secretary determines that any such agency, body, or commission, including any agency, an appropriate State officer ... or any other person described in [enumerated] subsection[s] has failed to, or does not meet, the requirements of

this paragraph, he may, after any proceedings for review established under paragraph (7), take such actions as are necessary to ensure such requirements are met....

Thus, section 6103(p)(4) requires federal, state and local government agencies receiving tax returns and return information (FTI) to provide adequate safeguards to protect the confidentiality of the tax returns and return information to the satisfaction of the Secretary. Federal, state and local government agencies and their contractors that request receipt of FTI subject to the safeguards of I.R.C. § 6103(p)(4) must file a Safeguard Procedures Report (SPR) with the IRS prior to the receipt of the tax information. The IRS can review the recipient agency and contractor's procedures for protecting return information from unauthorized inspection or disclosure before the information is released. Afterward, these agencies or contractors file annual reports explaining continued compliance. Recipient agencies also must submit a revised SPR whenever significant changes occur in their safeguard program, which should take into consideration changes made by agency contractors. Additionally, I.R.C. § 6103(p)(8) requires states to safeguard the confidentiality of the copy of the federal return (or portion thereof) attached to, or reflected on, any state tax returns if inclusion is required by the state.

As oversight of the IRS efforts to police recipients' safeguard procedures, section 6103(p)(5) requires the Commissioner of the IRS to furnish annual reports to the House Committee on Ways and Means, the Senate Finance Committee, and the Joint Committee on Taxation on the procedures used by recipient agencies. The reports describe procedures and safeguards established by the various agencies and contractors receiving FTI, as well as indicating deficiencies on the part of the agencies and contractors.

The Secretary cannot adequately and fully determine if recipient agencies comport with their safeguard requirements without some form of inspection and review. The Secretary must have all the relevant information before him in order to make an informed decision. "Frequently, in legal connections, 'decision' means not only a result but the reasons for the result." *Cole v. Young*, 226 F.2d 337, 343 (D.C. Cir. 1955). Anything less and the Secretary's decision is vulnerable to attack as arbitrary by the recipient agency exercising its right to appeal the decision under Treas. Reg. § 301.6103(p)(7)-1T(c). Accordingly, in order to assure that agencies receiving FTI are complying with the requirements, the IRS Disclosure Enforcement Specialists in the Office of Safeguards or IRS contractors periodically conduct inspections of the facilities and determine if the recipient agencies are complying with the safeguard requirements.

2. Performing a Federal Function

You provided several sample state confidentiality agreements for our review. Each agreement is written for execution by a state employee and contains references to state, as well as federal, confidentiality statutes. When the IRS Disclosure Enforcement Specialist and IRS contractors perform site reviews of state and local government

agencies, they are performing a federal function because they are performing services on behalf of the Secretary of Treasury. Pursuant to the Supremacy Clause, Art. VI, cl.2, "a state is without power ... to provide conditions on which the Federal Government will effectuate its policies." *United States v. Georgia Public Service Comm'n*, 371 U.S. 285, 293 (1963). State and local government agencies may not encumber the exercise of federal authority. *Id.* See also *Mayo v. United States*, 319 U.S. 441 (1943) (the activities of the federal government are free from regulation by any state).

The Office of Legal Counsel of the United States Department of Justice has opined that:

[t]he activities of the Federal Government are presumptively free from state regulation, unless Congress has clearly authorized state regulation in a specific area. See *Hancock v. Train*, 426 U.S. 167, 178-79 (1976). State laws or court rules regulating the conduct of the employees of the United States in the performance of their official duties constitute regulation of the activities of the Federal government itself and are, therefore, also presumptively invalid.

9 OLC 71 (1985).

Case law supports our conclusion that IRS contractors, likewise, are free from state intervention when performing federal functions on behalf of the IRS. In *Hancock v. Train*, the Supreme Court held that a facility used for uranium enrichment, which was operated by private contractors on behalf of the Federal Government, was shielded from state regulation. See also *Brookhaven Science Associates v. Donaldson*, 2007 WL 2319141 at *6 (August 9, 2007, S.D.N.Y.) (private contractor, performing a Federal function on behalf of a federal agency, is shielded from direct state regulation) (citing *Hancock* at 178-179).

Here, the plain language of section 6103(p)(4) imposes a duty on the Secretary of the Treasury (or his delegate) to ensure that FTI is properly safeguarded. The IRS carries out this federal function through the Office of Safeguards. We believe state and local governments may not enforce a requirement that IRS employees and contractors sign confidentiality agreements because such requirements impose additional conditions to the performance of their federal function duties.¹

If you have any questions, please feel free to call A M Gulas, to whom this matter was assigned, at 202-622-4570.

¹ During a conversation, you indicated some concern that several state agencies were contemplating conducting reviews of IRS safeguard procedures, in light of recent Treasury Inspector General for Tax Administration reports criticizing IRS security procedures. We believe that the Supremacy Clause of the Constitution, and the case law interpreting it, bar such actions, as well.