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Tax Regs in Plain English

IRS Restructuring and Reform Act of 1998

3413 - Software Trade Secrets Protection

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Section 3413

A. Provision covered: RRA § 3413 - Software Trade Secrets Protection I.R.C. § 7612

B. Background Under prior law, there were no statutory restrictions on the ability of the Service to issue summonses for the production of computer source code, software programs and related materials whether such information was held by the taxpayer or a third party. Under Section 7602, the Service is authorized to examine any books, papers, records, or other data that may be relevant or material to determine the accuracy of a return. Congress believed that the intellectual property rights of the developers and owners of computer programs should be respected. Congress was concerned that the examination of computer programs and source code by the Service could lead to the diminution of those rights through the inadvertent disclosure of trade secrets and believes that special protection against inadvertent disclosure should be established. Congress believed that a summons for the production of computer source code should only be issued where the Service is not otherwise able to ascertain through reasonable efforts the manner in which a taxpayer has arrived at an item on a return, identifies with specificity the portion of the computer source code it seeks to examine, and determines that the need to see the source code outweighs the risk of unauthorized disclosure of trade secrets.

C. Change(s) A new section 7612 is added, and in general, prohibits the issuance of a summons for tax related computer software source code. The general prohibition does not apply to criminal tax investigations, to any tax-related computer software source code

developed by the taxpayer for internal use rather than for commercial distribution, or to communications between the owner of the source code and the taxpayer or related person, or to any source code which is required to be provided or made available pursuant to any other provision of the Code.

There are conditions under which a summons for source code may be issued: (1) the Service is unable to reasonably ascertain the correctness of any item on a return from the taxpayer's books and records or the software program and associated data, (2) the Service identifies with reasonable specificity the portion of the source code needed to verify the correctness of an item, and (3) the Service determines that the need for the source code outweighs the risk of unauthorized disclosure of trade secrets. The Service is considered to have satisfied the first two requirements if the Service makes a formal request for those items to the taxpayer and the owner of the software and the request is not satisfied within 180 days.

The provision authorizes courts in summons enforcement proceedings to issue any order necessary to prevent the improper disclosure of trade secrets and confidential information. In addition, the provision contains specific conditions with which the Service must comply when it receives computer source code and/or software programs. The provision does not prevent the Service from using knowledge that it obtains during the course of an examination. However, the Service is not permitted to use the source code or software to examine other taxpayers.

D. Impact

The provision will have a significant impact on audits, particularly in the foreign tax credit arena.

E. Necessary Actions

1. Actions/Procedures: The Internal Revenue Manual and the CCDM will be updated. In the interim, all issues relating to summonses for source code and software should be coordinated through District Counsel who will coordinate with the General Litigation Division and the Associate Chief Counsel (International).
2. Things we CAN do: The Service can continue to issue summonses for the executable copy of the software program, and the taxpayers books and records. The Service can also issue summonses for the source code in criminal investigations, for source code developed for internal use, and for communications between the owner of the source code and the taxpayer or a related party.
3. Things we CAN'T do: The Service can not issue summonses for tax related computer source code (except in criminal investigations and for source code related to software developed for internal use) until the requirements of section 7612 have been met.

F. Other Special Comments: None

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