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NEW TAX SHELTER REPORTING REQUIREMENTS MAY APPLY TO NON-ABUSIVE TRANSACTIONS — WHAT BORROWERS AND M&A PARTIES MUST KNOW

The Internal Revenue Service ("IRS"), in an effort to curtail the promotion and implementation of tax shelters and other "potentially abusive transactions," recently issued a series of regulations requiring taxpayers (broadly defined to include corporations, partnerships, individuals, trusts and estates) to identify and report on their federal income tax returns, certain transactions that the taxpayer participated in during the year. These regulations are sweeping in scope and may require disclosure of routine, non-abusive transactions such as commercial finance and mergers and acquisitions transactions. However, the mere fact that a transaction must be identified and reported on a tax return does not necessarily mean that the transaction is improper or that it will be challenged by the IRS.

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Reportable Transactions Generally

The new tax shelter regulations describe six broad categories of transactions that must be reported on IRS Form 8886 and attached to a taxpayer's federal income tax return. These categories of transactions, referred to as "Reportable Transactions," are as follows:

1. Listed transactions,
2. Confidential transactions,
3. Transactions with contractual protection,
4. Loss transactions,
5. Transactions with a significant book-tax difference, and
6. Transactions involving a brief asset holding period.

This article focuses on the confidential transactions category, and how typical finance and merger and acquisition transactions with confidentiality provi-sions may fall within the scope of the tax shelter reporting requirements. As discussed below, typical confidentiality clauses in commercial finance and merger and acquisition agreements could trigger these reporting requirements even though such transactions are not generally thought of as tax shelters.

Confidential Transactions — Application to Finance and M&A Deals/Proposed Solutions

The new tax shelter regulations define a "confidential transaction" as any transaction that limits a party's ability to disclose the tax treatment or tax structure of a transaction.[1] However, because standard confidentiality agreements, as well as standard provisions contained in finance and merger and acquisition documentation, typically contain a blanket restriction on the disclosure of any aspect of a transaction, these restrictions may inadvertently cause a taxpayer to fall within the scope of the regulations.

For example, many finance commitment letters, loan documents and merger and acquisition agreements are often entered into under conditions of confidentiality which limit the information that may be disclosed to third parties or used for any purpose unrelated to the proposed transaction. This strict restriction on disclosure of information also inherently restricts a party from being able to disclose the tax treatment or tax structure of the transaction. Consequently, unless an exception to the transaction's con-fidentiality provision is made to allow for disclosure of the tax treatment or tax structure of the transaction, a taxpayer may unwittingly fall within the scope of the tax shelter reporting rules.

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Because the IRS is specifically focused on tax related disclosure, restricting the disclosure of other aspects of a transaction pursuant to a confidentiality agreement generally will not cause a transaction to be treated as "confidential" within the meaning of these rules. For this reason, deal documentation will now typically contain a statement to the effect that:

> Notwithstanding any confidentiality obligations to the contrary, the taxpayer (and each employee, representative, or other agent of the taxpayer) may disclose to any and all persons, without limitation of any kind, the tax treatment and tax structure (as such terms are defined in Treasury Regulation §1.6011-4(c)) of the transaction and all materials of any kind (including opinions or other tax analyses) that are provided to the taxpayer relating to such tax treatment and tax structure.

If the parties to the transaction expressly agree to permit disclosure of the tax treatment and tax structure of the transaction, such as by incorporating the above language in their documents, the regulations will generally presume that the transaction is not a "confidential transaction" for purposes of these rules and therefore reporting of such transactions will not be required.

These regulations also provide exceptions to permit taxpayers to comply with securities laws (*i.e.*, the disclosure of the tax treatment or tax structure of the transaction is subject to restrictions reasonably necessary to comply with securities laws and such disclosure is not otherwise limited) and for certain mergers and acquisitions. For example, a corporate merger or acquisition transaction negotiated on a confidential basis will generally not be considered a confidential transaction for purposes of these rules if the taxpayer is permitted to disclose the tax treatment and tax structure of the transaction after the earliest of: (i) the date of the public announcement of discussions relating to the transaction; (ii) the date of the public announcement of the transaction;

[1] The "tax treatment" of a transaction is the purported or claimed federal income tax treatment of the transaction. The "tax structure" of a transaction is any fact that may be relevant to understanding the purported or claimed federal income tax treatment of the transaction.

or (iii) the date of the execution of an agreement (with or without conditions) to enter into the transaction. Although this exception for corporate mergers and acquisitions will not by its terms apply to acquisitions of limited liability companies (that do not elect to be taxed as corporations) and partnerships, the exception, oddly enough, also does not apply to mergers and acquisitions of S corporations. Therefore, careful consideration should be given as to the timing and scope of limiting the disclosure of confidential information, if at all, with respect to mergers and acquisitions.

Finally, if a finance or merger or acquisition agreement is entered into prior to the effective date of the new regulations (February 28, 2003), and is amended after the effective date of these regulations, the parties should consider whether the transaction should be grandfathered or whether the confidentiality provisions of the agreement should be amended to allow disclosure of the tax treatment or tax structure of the transaction.

Conclusion

The new tax shelter reporting requirements are sweeping in scope and apply to countless transactions, including many routine non-tax avoidance transactions. Corporations, partnerships, individuals, trusts and estates need to be mindful of these reporting requirements when entering into transactions such as commercial finance and merger and acquisition transactions to determine whether reporting is required, and if so, whether any exceptions can be utilized. Noncompliance with these reporting requirements (even if inadvertent) will generally result in unwelcome penalties.

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