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New Regulations on Tax Reportable Transactions – Effect on Confidentiality Agreements

Our firm believes that the confidentiality language in most agreements should be modified to exclude certain tax-related matters. The modification that is described below is highly desirable, and we expect that it will become standard practice.

As part of its effort to eliminate abusive tax shelters, the Internal Revenue Service recently issued final regulations requiring all taxpayers to disclose "reportable transactions" on their tax returns. The disclosure is made by completing a disclosure statement (Form 8886) and attaching it to the tax return for the year in which the transaction takes place; the statement must also be sent to the "Office of Tax Shelter Analysis" at the Internal Revenue Service. In addition, any "material advisor" in a reportable transaction must maintain a list of investors who purchased an interest in a transaction, as well as copies of documents, advice and other information. A material advisor is a person who makes a statement about any tax aspect of a reportable transaction and receives a fee of at least $50,000 (or $250,000 if all of the participants are corporations).

What, then, is a "reportable transaction"? First, a "transaction" includes just about every binding agreement that attorneys negotiate and draft; it includes every settlement agreement in a civil litigation, an employment agreement, a book contract, a license agreement, everything. A reportable transaction is a transaction that falls into any one of six categories, but this memo concerns only one of the categories – transactions that are "offered under conditions of confidentiality." The other categories include transactions of a type identified by the IRS as abusive tax shelters, transactions involving certain types of losses in excess of specified amounts, transactions in which fees are refunded if expected tax consequences are not achieved, transactions with certain book-tax accounting differences and certain transactions involving short holding periods for assets.

A transaction is considered offered under conditions of confidentiality if a participant's disclosure "of the tax treatment or the tax structure of the transaction" is limited in any way by an express or implied understanding or agreement with any person who makes or provides any statement (oral or written) as to the potential tax consequences of the transaction. Further, a transaction is considered offered under conditions of confidentiality if a person knows or has reason to know that the use or disclosure of information relating to a

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structure or tax aspects is "limited in any other manner (such as where the transaction is claimed to be proprietary or exclusive)."

The important point to note is that ***any transaction*** will be a reportable transaction, regardless of the tax characteristics of the transaction and regardless of the presence or absence of tax-related motivations, if the transaction is considered offered under conditions of confidentiality. As a result, a transaction that is not at all intended to be a "tax shelter" will in fact be subject to the new disclosure and list-maintenance rules merely by reason of the presence of "standard" confidentiality language.

The regulations also provide a presumption that a transaction is not considered offered under conditions of confidentiality if each participant is expressly authorized to disclose "the tax treatment and tax structure" of the transaction. In general, this presumption is available only in cases in which the authorization is effective upon commencement of discussions. This means that it is not enough (subject to a special rule for M&A transactions, discussed below) to enter into a release of confidentiality restrictions at the time that a definitive agreement is executed.

In the case of a potential acquisition of business assets from a corporation, or of more than 50% of the stock of a corporation that conducts an active business that the acquirer intends to continue, the authorization to disclose the tax treatment and tax structure can be delayed until the earliest of a public announcement of the transaction, a public announcement of discussions relating to the transaction or the execution of an agreement to enter into the transaction (which will generally be a definitive agreement, and which should not include a non-binding letter of intent). The regulations also permit restrictions that are reasonably necessary to comply with securities laws.

We therefore expect that parties will modify confidentiality agreements in most cases, so that transactions do not become reportable transactions solely because of confidentiality provisions.

These new rules are effective for transactions entered into after March 4, 2003. (Also, temporary regulations that were issued in October 2002 impose disclosure requirements for transactions entered into on or after January 1, 2003.) If an agreement containing confidentiality provisions has already been executed, and a transaction is expected to be consummated after March 4, 2003, we believe that the parties should consider modifying the confidentiality language at the earliest opportunity.

If you have any questions concerning these new regulations, please contact:

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