IRS’s New Rules Regarding Tax Shelter Disclosure May Be Implicated in Common M&A Transactions

On February 28, 2003, the IRS adopted Treasury Regulation Section 1.6011-4 (the “New Rules”) requiring taxpayers to disclose to the IRS a broad range of transactions entered into on or after February 28, 2003. While the New Rules are designed to enhance the IRS’s ability to regulate “abusive tax shelter” transactions, they go well beyond what are commonly viewed as tax shelters and cover a wide range of nonabusive transactions, including certain merger and acquisition (“M&A”) transactions. Failure to make the required disclosures and other filings may result in substantial penalties to the taxpayer. In addition, tax advisors (e.g., outside tax counsel or other tax advisors) involved in the transaction may be required to maintain lists of participants in the transaction and to supply such lists to the IRS upon request. By taking advantage of the New Rules’ exceptions, a taxpayer may eliminate the reporting and document retention requirements in the context of an M&A transaction and any penalties arising out of the failure to disclose a reportable transaction.

Confidential Transactions

The New Rules create six categories of “reportable transactions.” A taxpayer who participates in any reportable transaction must report each such transaction to the IRS by filing a Form 8886 with the taxpayer’s annual tax return for the period in which the reportable transaction occurred. A typical M&A transaction may likely be deemed a “confidential transactions,” one of the six categories of reportable transactions. Under the New Rules, a “confidential transaction” is any transaction “offered to a taxpayer under conditions of confidentiality if the taxpayer’s disclosure of the tax treatment or the tax structure of the transaction is limited in any manner by an express or implied understanding or agreement with or for the benefit of any person who makes or provides a statement, oral or written, to the taxpayer . . . as to the potential tax consequences that may result from the transaction, whether or not such understanding or agreement is legally binding.” Taxpayers must be especially vigilant of this requirement in the context of an M&A transaction as it is very common to see confidentiality obligations not only in definitive acquisition agreements, but also in binding or non-binding letters of intent or bid letters or in nondisclosure agreements entered into at the very early stages of a transaction. In addition, because the New Rules cover non-binding agreements or understandings, it is important to carefully review offering memoranda and “banker’s books” to determine whether such documents contain confidentiality obligations that might subject the taxpayer to the reporting requirements of the New Rules. Finally, it is important to keep in mind that under the New Rules, confidentiality obligations can also arise from oral understandings or agreements.

Whether agreements, documents or other materials contain express confidentiality obligations, or a tax payer is concerned that such confidentiality provisions may be implied, the taxpayer can ensure that such confidentiality obligations will not apply to tax matters associated with the transaction by adopting some of the non-confidentiality language provided below.

Exceptions to the Reporting Requirements

The New Rules provide two exceptions to the reporting requirements that would otherwise apply to confidential transactions. First, a transaction will not be deemed to be a confidential transaction to the extent that the disclosure of the tax treatment or tax structure of the transaction is subject to restriction reasonably necessary to comply with securities laws and such disclosure is not otherwise limited. Taxpayers should be careful in relying on this exception because in most cases federal and state securities laws do not impose an overall requirement of confidentiality, but rather simply prohibit selective disclosure. In addition, the IRS has stated that it will apply this exception very narrowly.

The second exception to the confidential transactions reporting requirements applies to many common M&A transactions (the “M&A Exception”). The M&A Exception applies to:

• a taxable or tax-free acquisition of the historic assets of a corporation

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that constitute an active trade or business that the acquiror intends to continue; and

- a taxable or tax-free acquisition of more than 50% of the stock of a corporation that owns historic assets used in an active trade or business that the acquiror intends to continue,

so long as in either case, the taxpayer is permitted to disclose the tax treatment and tax structure of the transaction no later than the earlier of (i) the date of the public announcement of the discussions relating to the transaction, (ii) the date of the public announcement of the transaction, or (iii) the date of the execution of an agreement (with or without conditions) to enter into the transaction.

It is important to understand that the M&A Exception does not apply to acquisitions of less than 50% of a corporation’s stock or to acquisitions of interests or assets from non-corporate entities. The M&A Exception also will not apply where the taxpayer's ability to consult any tax advisor regarding the tax treatment or tax structure of the transaction is limited in any way.

**Practical Application of the New Rules and the M&A Exception**

If a taxpayer deems it more desirable to forego the reporting requirements rather than maintain the confidentiality of the tax treatment or tax structure of a transaction, then the taxpayer should insist that certain language be added to all agreements or letters of intent or other preliminary agreements that relate to the due diligence process or preliminary negotiations and that contain confidentiality provisions. In such cases, the following language may be added to the appropriate document to address the implications of the New Rules.

“Notwithstanding anything to the contrary set forth herein, the parties to this Agreement acknowledge and agree that any party to this [Agreement] (and any employee, shareholder, representative or other agent of any party hereto) may disclose to any and all persons without limitation of any kind, the tax treatment and tax structure of the Transaction and all materials of any kind (including opinions or other tax analyses) that are provided to the party relating to such tax treatment and tax structure; provided that, such disclosure may not be made (i) until the earlier of (1) the date of the public announcement of discussions relating to the Transaction, (2) the date of the public announcement of the Transaction, or (3) the date of the execution of an agreement (with or without conditions) to enter into the Transaction, or (ii) to the extent reasonably necessary to comply with any applicable federal or state securities laws. The preceding sentence is intended to cause the Transaction to be treated as not having been offered under conditions of confidentiality for purposes of Section 1.6011-4(b)(5) (or any successor provision) of the Treasury Regulations promulgated under Section 6011 of the Internal Revenue Code of 1986, as amended, and shall be construed in a manner consistent with such purpose.”

At this stage of the transaction, it is also not uncommon for the tax treatment or tax structure of the transaction to be undetermined. Under these circumstances, the taxpayer may want to keep its options open as to whether disclosure of the tax treat-
to an understanding of the tax treatment or tax structure of the transaction. Such documents would include, but not necessarily be limited to, written analyses, correspondence and agreements between the taxpayer and any advisors or the other party in a reportable transaction and any other documents discussing or referring to the tax treatment or tax structure of the transaction. The documents must be retained until the expiration of the statute of limitations applicable to the final taxable year for which disclosure of the transaction was required by the New Rules and must be disclosed to the IRS upon request.

Satisfying the Reporting Requirements

In the event a taxpayer deems it advisable (or is otherwise required) to disclose a reportable transaction, then such taxpayer must file with the IRS a Form 8886 with its tax return for each taxable year in which the taxpayer participates in a reportable transaction. Form 8886 requires, among other things, that the taxpayer identify each person paid a fee in connection with the transaction if such person promoted or recommended participation in the reportable transaction or provided tax advice with respect to the transaction, as well as certain information about the tax benefits expected to arise from the transaction. Because it may be difficult to gather such information many months later when the taxpayer is preparing its tax return, a prudent taxpayer will gather such information during the pendency of the reportable transaction. The taxpayer must also retain a copy of all documents and other records related to a transaction subject to disclosure under the New Rules that are material

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