Market Responses to the New Treasury Regulations on Corporate Tax Shelters: The Impact of Confidentiality Agreements

The latest set of post-Enron Treasury Regulations, governing the registration and disclosure of “tax shelter” transactions (Treas. Regs. §§ 1.6011-4, 301.6111-2, and 301.6112-1), are pervasive in nature, potentially defining as “tax shelters” numerous legitimate business transactions. This commentary focuses on one particular aspect of the broad reach of these regulations, namely, how standard confidentiality agreements can unwittingly cause an associated M&A or financing transaction to be treated as a “tax shelter” for which registration, disclosure, and collection and maintenance of data on participants, offerees, and others may be required. The market is developing responses to this problem that will require corporations and their advisers to consider carefully the use of confidentiality agreements and the potential impact of the regulations. Jones Day has established a task force, the members of which are listed below, to monitor future developments with respect to the regulations and to provide a centralized means of advising clients on questions that arise under them.

As discussed in further detail below, legitimate non-tax motivated transactions will fall within the reach of the new Treasury Regulations merely because they are offered under conditions of confidentiality. The regulations provide a seemingly easy fix to this problem through the use of explicit agreements permitting disclosure of the tax aspects and tax structure of the transaction. As a result, “anti-confidentiality” language is now finding its way into transaction documentation. Nevertheless, it is important to realize that in many cases, the consequences of including tax disclosure boilerplate may lead to undesirable consequences and must be carefully considered.

Background

The new regulations largely complete Treasury’s program to establish a regulatory regime that will provide the IRS with notice of transactions deemed likely to be tax shelters—through registration of transactions with the IRS (the “Registration Rules”), tax return disclosure by the participating taxpayers (the “Disclosure Rules”), and maintenance of customer lists by the professionals involved (the “List Maintenance Rules”). When first issued in February 2000, the regulations responded to concerns about growth in the marketing of tax shelter products to corporations. The new regulations go much further and bring within their scope large numbers of legitimate business transactions that have little to do with tax avoidance. The new final regulations are generally effective for transactions entered into on or after February 28, 2003, but taxpayers may choose to apply them (rather than the earlier regulations) for transactions entered into on or after January 1, 2003.

The Registration Rules. The new regulations regarding registration of “tax shelters” with the Treasury (Treas. Regs. § 301.611-2) continue to cover transactions subject to “conditions of confidentiality,” i.e., limitations on the participants’ ability to disclose the tax aspects or tax structure of the transaction to others.¹ Most transactions have been able to avoid registration, even when they meet the other requirements of those rules (e.g., having tax avoidance or evasion as a significant purpose), by permitting disclosure by participants.

The Disclosure Rules. Under the Disclosure Rules (Treas. Regs. §1.6011-4), taxpayers must file reports with respect to a wide variety of transactions, most of which are not “tax shelters” for purposes of the registration requirements or

¹ The definition of “conditions of confidentiality” is almost exactly the same as that for the Disclosure Rules, discussed below.
even “tax-motivated” in any normal sense. The principal types of transactions covered by the Disclosure Rules are as follows:

• **Confidential Transactions.** Like the earlier regulations, the Disclosure Rules apply to transactions offered under “conditions of confidentiality,” which is defined to include any express or implied understanding that the participant will not disclose the potential “tax treatment” or “tax structure” of the transaction. Restrictions on disclosing non-tax aspects of the transaction are not subject to the rule, but the boundary between the two is not clear at this point. This aspect of the regulations is discussed at greater length below.

• **Contractual Protection.** This standard has been substantially narrowed in the new regulations. The previous regulations required disclosure of transactions with tax indemnities, tax call rights, tax gross-ups, and tax insurance. The new regulations cover only transactions where the taxpayer has a right to a full or partial refund of the fees that it has paid if the intended tax consequences are not sustained (or if the fees payable are contingent on the intended tax consequences).

• **Book/Tax Differences.** Like the previous regulations, the new regulations require disclosure of transactions where the accounting and tax treatment of any item or items of income or loss (on a gross rather than a net basis) differ by more than $10 million in any taxable year. Published guidance (Rev. Proc. 2003-25) issued along with the regulations contains a list of common book/tax differences that will not result in a disclosure obligation.

• **Loss Transactions.** Disclosure is required for transactions for which a taxpayer claims a loss (in the case of corporations) of at least $10 million (again computed gross, not net) for any one taxable year or at least $20 million cumulatively (for the first six years of the transaction). Published guidance (Rev. Proc. 2003-24) issued along with the regulations contains a list of loss transactions that are not covered.

• **Listed Transactions.** These are specific transactions identified by the IRS in published guidance (including guidance issued under the previous regulations) and widely considered to be tax abuses. Transactions deemed “substantially similar” to those identified must also be disclosed.

The **List Maintenance Rules.** Like the previous regulations, the new regulations (Treas. Regs. § 301.6112-1) require “material advisors” in transactions subject to the Registration or Disclosure Rules who earn fees in excess of a threshold amount ($250,000 in the case where all participants are corporations) to maintain lists of participants and other basic information. The lists must be supplied to the IRS upon request, enabling the IRS to audit on a mass basis all participants in transactions that the IRS deems abusive. The new regulations narrow the List Maintenance Rules significantly by providing that a “material advisor” becomes subject to the list maintenance requirements only if it makes a statement that relates to a tax aspect of the transaction. The new rules also provide an exception for statements made in publicly available documents filed with the SEC prior to the close of the transaction. On the negative side, the new regulations greatly restrict claims by “material advisors” that turning the lists over to the IRS would violate a privilege (e.g., the attorney-client privilege).

**Confidentiality**

The offering of a transaction to any potential participants under “conditions of confidentiality” is enough to cause the transaction to be caught in the web of the new tax shelter regulations. A condition of confidentiality includes any manner of limitation on disclosure, whether express or implied, by agreement or understanding. This is the case even if the disclosure limitations are not legally binding or where the limitations may be inferred from the proprietary or exclusive nature of the transaction or from the prior conduct of the parties. The confidentiality in question, however, only extends to the tax treatment or tax structure of the transaction. Disclosure of other aspects of the transaction may be restricted without causing the transaction to be treated as confidential within the meaning of the regulations.

The regulations provide a presumption that a transaction is not offered under conditions of confidentiality if express written authorization is provided by the transaction’s promoter (and other persons making statements about the potential tax consequences of the transactions) to the taxpayer permitting disclosure and including language substantially similar to:

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 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.

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This written authorization must permit disclosure from the outset of communication with the offeree and must be provided within 30 days from the first communication of any statement concerning any tax consequences of the transaction. For M&A transactions, the permission to disclose tax information may be delayed until the first public announcement concerning the transaction or the execution of an agreement to enter into the transaction. Given the desire to ensure that most garden-variety transactions fall within the presumption of non-confidentiality, practitioners have, with tongue-in-cheek, speculated that the business cards handed out upon first meeting with participants in transactions will have language authorizing tax disclosure printed on their backs.

The tax treatment of a transaction includes any purported or claimed Federal income tax treatment of the transaction. The tax structure of the transaction includes any facts that may be relevant to understanding the tax treatment of the transaction. The market has largely responded to the regulations by providing parties with the explicit permission to disclose the “tax treatment” and “tax structure” of transactions. What exactly constitutes the tax treatment and tax structure of a transaction is what the market has now begun to grapple with.

In typical M&A transactions, confidentiality agreements are the norm. From the outset of the process of selling a business, confidentiality concerns are addressed through the use of comprehensive confidentiality agreements. The seller typically is anxious to restrict access to its confidential operating and financial information for fear that competitors will be able to use such information to its detriment. Accordingly, it has been standard market practice to require all potential bidders to sign comprehensive confidentiality agreements restricting the use, retention, and disclosure of nonpublic information provided about the target company. These legitimate non-tax concerns now run counter to the tax shelter regulations. On the one hand, the inclusion of the confidentiality carve-out provided in the regulations, permitting the disclosure of the “tax treatment” and “tax structure” of the potential transaction and, perhaps more importantly, disclosure of “all materials of any kind … that are provided … relating to such tax treatment and tax structure” will cause the transaction to avoid the scope of the regulations. (In fact, many participants in the market are attempting to include such language in their confidentiality agreements.) On the other hand, permitting such disclosure and taking the risk that critical financial information may be made available to competitors in order to avoid the tax shelter regulations may, in many cases, be a greater problem to an operating business than complying with the Registration, Disclosure, and List Maintenance Rules. Cost, pricing, and margin data provided to a potential buyer at least arguably relates to the tax consequences of a purchase of the target. If so, that information may be disclosed under the standard boilerplate carve-out. Financial statements and internally generated financial reports (such as inventory aging reports) are potentially relevant to determining the tax consequences of a purchase of the target and might also need to be made freely disclosable to avoid the regulations. As a result, care must be taken before including carve-out language to confidentiality agreements for fear that critical proprietary information may be made available far beyond the group of hand-picked bidders for the target company.

Some consideration should also be given to when an offer to participate in a transaction is actually made. The rules relate to confidentiality imposed on offerees, and discussions that precede the making of an offer to participate in the transaction may fall outside the scope of the regulations. When a seller of a business first sends out operating data to potential bidders, it often is not making an offer to sell the target. In fact, at the early stage, the seller generally is only soliciting offers to purchase the target from the bidders. Including the tax-based “anti-confidentiality” language at the outset in the context of a sale of a business may be unnecessary. Full-blown confidentiality agreements may, in the proper contexts, be used at such an early stage without fear that the transaction will become subject to the regulations. It may be that only later in the sale process, when an actual offer to buy or sell the target is made, that a tax carve-out to the confidentiality agreement should be considered. Similarly, aspects of the new regulations may be avoided if the parties refrain from making statements relating to the potential tax consequences of the transaction.

Confidentiality agreements are also commonly used in many finance transactions. For example, the syndication of bank loans generally provides significant financial information to potential lenders, and such information may not be disclosed to third parties or used for any purpose unrelated to the loan transaction. Transactions of this sort have never been thought of as tax shelters, but the inclusion of confidentiality agreements in the standard deal documents may cause those transactions to come within the scope of the regu-
lations. As in the case of M&A transactions, careful thought should be given to the impact of permitting the unlimited disclosure of tax treatment, tax structure, and related materials. When finance transactions that were entered into prior to the effective date of the new regulations (February 28, 2003) are now amended, the parties should consider whether the transaction remains grandfathered or whether the parties must examine and consider amending the confidentiality arrangements.

Additional concerns exist when securities are being issued. Disclosure of information (including tax information) may constitute impermissible offering activity. The regulations provide a securities law exception to the confidentiality rules permitting restriction of disclosure of the tax aspects of the transaction where such restriction is reasonably necessary to comply with securities laws. A significant portion of the market appears to view this exception to apply to section 144A offerings and private placements (where disclosure could be viewed as a prohibited offering). Nonetheless, because the extent of the securities law exception in the regulations is not clear, tax carve-outs have started to appear in offering materials permitting disclosure of tax matters and tax structure “to the extent not otherwise prohibited by applicable securities laws.” At this point, it is not possible to speak of a standard market practice on this issue.

Litigation settlements present another area where the use of confidentiality agreements may be problematic. Failure to include the tax carve-out permitting disclosure of tax aspects or structure of a settlement may, unintentionally, cause the settlement to come within the ambit of the tax shelter regulations if the parties to the matter are subject to nondisclosure limitations. Treasury recently has acknowledged this problem and is considering whether a new exception should be included to exempt litigation settlements from the regulations.

Jones Day will continue to keep abreast of developments as the market sorts out its responses to the new regulations. If you have questions concerning the new regulations or possible responses to them, feel free to contact any member of the Jones Day task force on these regulations or your normal contacts at the Firm.

Further Information

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