

Confidentiality in M&A and Most Routine Transactions No Longer Triggers Tax Reporting Problems

On December 29, 2003, the Treasury Department and the IRS amended the reportable transaction regulations¹ so that most routine transactions that are confidential for business reasons will no longer be subject to the special tax reporting and other requirements of the regulations.

Reporting Requirements

The reportable transaction regulations are part of the Treasury Department's efforts to curb abusive tax shelters. Here is a brief summary of the reportable transaction reporting requirements (which were not changed by the amendments): Participants in a reportable transaction are—under both the old and the amended versions of the regulations—required to report the transaction on IRS Form 8886, which must be filed with the participant's tax return for the year in which the transaction occurs. Form 8886 must identify, among other things, the name and address of each "material advisor," the facts of the transaction and the expected tax benefits of the transaction (including both a description and an estimate of the amount). While there are currently no specific federal penalties for failure to file a Form 8886: (a) failure to file Form 8886 is a violation of the federal tax regulations; (b) pending legislation would impose significant federal penalties for failure to file Form 8886; and (c) under current law, non-filing of Form 8886 may affect the application of other penalty provisions of the Internal Revenue Code if they otherwise apply to the transaction. Note that a separate Form 8886 generally must be filed for each

reportable transaction. In addition, California now imposes its own requirement to report reportable transactions and imposes penalties for failure to do so. Read our recent Cooley Alert describing California's tax shelter law at <http://www.cooley.com/news/alerts.aspx?ID=000038453020>.

Any material advisor to a reportable transaction must comply with the "list maintenance" rules. A "material advisor" is defined as any person who: (a) receives a minimum fee in connection with a reportable transaction and (b) makes or provides any statement, oral or written, to any person as to the potential tax consequences of that transaction. The minimum fee is \$250,000 where the taxpayer is a corporation and \$50,000 for all other transactions. The material advisor must maintain for seven years a list containing details of the transaction and provide the list to the IRS upon request. The list must contain, among other things: (a) a description of the transaction; (b) any material tax advice given with respect to the transaction; and (c) a list of all transaction participants, their tax basis in the assets transferred and the amount paid to each.

The Old "Confidential Transaction" Rules

The previous version of these regulations (effective on February 28, 2003) treated many routine transactions as "confidential transactions"—one category of reportable transaction. A "confidential transaction" previously included a transaction in which one party made a statement to the other about the tax aspects of the transaction and the

parties entered into a confidentiality or nondisclosure agreement with respect to the transaction.² Thus, transactions such as mergers and acquisitions, loans and debt issuances, licensing transactions, private equity financings, private equity fund formations and many others were often treated as confidential transactions. A transaction that otherwise was treated as a confidential transaction was exempt from such treatment if the parties were permitted to disclose to any and all persons at any time the tax treatment and tax structure of the

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transaction. The previous version of the regulations included specific language that—if included in transaction documents—created a presumption that the transaction was not a confidential transaction.³

The New “Confidential Transaction” Rules

The December 29th amendments substantially narrow the scope of the “confidential transaction” prong of the regulations so that most routine transactions will no longer be treated as confidential transactions. This means that taxpayers will not be required to file Form 8886 for such transactions or employ any special disclosure language in transaction documents. It also means that material advisors will not be required to maintain lists for such transactions. Note that because the California definition of “reportable transaction” follows the federal definition, these amendments also narrow the transactions subject to California’s tax shelter law. Read our recent Cooley Alert describing California’s tax shelter law at <http://www.cooley.com/news/alerts.aspx?ID=000038453020>.

Under the amended rules, a transaction will not be treated as a confidential transaction UNLESS a tax advisor:

- (i) provides tax advice to a participant in the transaction; AND
- (ii) limits (either expressly or otherwise) the participant’s ability to disclose the tax treatment or tax structure of the transaction (and such limitation on disclosure protects the confidentiality of that advisor’s tax strategies); AND
- (iii) receives a minimum fee (\$250,000 where the taxpayer is a corporation and \$50,000 for all other transactions).

The key to this new definition, and the reason its scope is more narrow than before, is that it no longer focuses on confidentiality per se, but on confidentiality imposed by an advisor—something rarely present in routine business transactions.

The amendments can be relied upon for transactions entered into on or after January 1, 2003. (Note that transactions entered

into before February 28, 2003 were not subject to the broadly applicable provisions of the regulations in any event.) Thus, for transactions that are excluded under the new definition, no Form 8886 or disclosure file (or safe harbor language) is required, regardless of when the transaction closed.

Examples of Newly-Excluded Transactions

Transactions that will now usually be excluded from confidential transaction treatment (but which were often caught under the old definition) include (among others):

- ▶ Mergers and acquisitions
- ▶ Venture capital financings
- ▶ Initial public offerings
- ▶ License transactions and other technology transfers
- ▶ Outsourcing transactions
- ▶ Collaboration and technology development agreements
- ▶ Employment, consulting and other services agreements
- ▶ Loans and debt issuances
- ▶ Litigation-related payments/transactions

Private Equity Fund Formations

There is some residual concern about application of the amended confidential transaction rules to the issuance and transfer of private equity fund interests (and related capital contributions and distributions). As part of their fundraising efforts, most fund sponsors provide potential investors with a confidential offering document containing, among other things, a description of the general tax aspects of investing in the fund. Since most private equity funds are required to pay a management fee to the fund’s management, it is conceivable that the combination of a tax discussion in the sponsor’s confidential offering document and the management fee could cause a fund formation to be treated as a confidential transaction under the amended regulations.

However, the amended regulations provide that fees paid to a person in that person’s capacity as a party to a transaction are disregarded for purposes of determining

whether the minimum fee threshold of the new “confidential transaction” definition is satisfied. We believe that the fees paid to fund sponsor groups should be covered by this exclusion and therefore that most private equity fund formations should not be treated as confidential transactions and should not require the filing of Form 8886 or the use of any special language in transaction documents.⁴

Other Types of Reportable Transactions

In addition to confidential transactions, the regulations define five other categories of transactions as reportable transactions. These prongs of the regulations were not affected by the amendments described above and continue to apply as before. Most taxpayers will encounter these transactions less frequently. A brief description of the other reportable transaction categories follows.

Loss Transactions. In general, this category includes transactions in which a significant tax loss is realized. For corporations, a transaction falls within this category if it generated \$10 million of tax loss in a single year or \$20 million in any combination of years. For individuals, the corresponding thresholds are \$2 million and \$4 million. For transactions involving foreign currency trades, the threshold is a much lower \$50,000. The IRS has provided numerous exceptions to this category which have the effect of excluding most common transactions from coverage.⁵ The exceptions include a sale of any property where the seller has a “qualified basis” in the property and the property is not an interest in a passthrough entity. A seller will have a qualified basis in property when any of the following is true: (i) the seller’s basis in the property is equal to the amount of cash paid for the asset (plus improvement cost, and less depreciation and amortization), (ii) the seller has a substituted basis in the property because it was acquired as part of a tax-free reorganization, spinoff or like-kind exchange and the property given in exchange had a basis described in (i), or (iii) the seller received the property as a gift and the donor’s basis in the property is described in

(i). Note that a seller will NOT have a qualified basis in (and may therefore be required to disclose a loss on) (a) stock received in a taxable dividend and (b) stock on which dividends have been paid where such dividends reduced the basis of such stock.

Transactions with a Significant Book-Tax Difference. This category includes transactions where the GAAP and tax reporting differ substantially. This category applies only to reporting companies under the Securities Exchange Act of 1934 and other business entities that have \$250 million or more in gross assets. A transaction falls within this category if the amount for tax purposes of any item or items of income, gain, expense, or loss from the transaction differs by more than \$10 million on a gross basis from its book amount. Numerous exceptions apply for purposes of this category.⁶ Among others, book-tax differences arising in the following situations will not give rise to reportable transaction treatment: (i) compensation of employees and consultants, including stock options and pensions, (ii) any transaction where the book loss or expense is reported before or without a corresponding tax loss or expense, (iii) any transaction where the taxable income or gain is reported before or without corresponding book income or gain, (iv) tax expense, (v) charitable contributions, (vi) dividends, (vii) depreciation and amortization, (viii) debt forgiveness, (ix) tax-exempt interest income, (x) differences due to hedge accounting, (xi) mark-to-market accounting, and (xii) imputed interest.

Transactions with a Brief Asset Holding Period. This category includes transactions where the taxpayer claims a tax credit exceeding \$250,000 when the taxpayer has a holding period of 45 days or less.

Transactions with Contractual Protection. This category includes transactions where the fees paid to the material advisor are refundable or contingent, based on the expected tax benefits being obtained.

Listed Transactions. This category includes transactions identified as abusive by the IRS in published guidance.⁷

The foregoing is only a brief summary of the reportable transaction regulations. For the actual text of the amendments to the regulations, see <http://www.irs.gov/pub/irs-reg/td9108.pdf>. For the text of the regulations prior to amendment, see <http://www.irs.gov/pub/irs-reg/td9046.pdf>.

Conclusion

The amendments described above provide welcome relief from the reportable transaction regulations for many routine business transactions. The amendments mean that taxpayers will no longer be required to report most routine transactions on Form 8886—even if those transactions occurred prior to the date of the amendments. Transactions now should be subject to the “confidential transaction” prong of the regulations only when an advisor limits disclosure of tax advice rendered with respect to the transaction and receives a fee in excess of certain thresholds. This more limited definition also applies for purposes of California’s new tax shelter law. Other prongs of the reportable transaction rules are not affected by these amendments and remain in effect as before. If you have any questions about these regulations, please contact a member of your Cooley Godward team, or any member of the Cooley Tax Group. ■

Notes

¹ The regulations are contained in Treasury regulations sections 1.6011-4, 301.6111-2 and 301.6112-1.

² Transactions in which advisors imposed confidentiality were also included in the previous definition. The exact phraseology of the previous version of the regulations was as follows:

A confidential transaction is a transaction that is offered to a taxpayer under conditions of confidentiality. A transaction is considered 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 (or for whose benefit a statement is made or provided 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. A transaction also will be considered offered to a taxpayer under conditions of confidentiality if the taxpayer knows or has reason to know that the taxpayer’s use or disclosure of information

relating to the tax treatment or tax structure of the transaction is limited in any other manner (such as where the transaction is claimed to be proprietary or exclusive) for the benefit of any person, other than the taxpayer, who makes or provides a statement, oral or written, to the taxpayer (or for whose benefit a statement is made or provided to the taxpayer) as to the potential tax consequences that may result from the transaction.

³ The regulatory version of this language (which was often modified by the parties) was as follows:

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.

⁴ Other private equity fund transactions will continue to be subject to other prongs of the reportable transaction rules and the associated reporting and compliance requirements. In particular, tax write-offs and sales of securities at a significant loss may be treated as “loss transactions” (defined below) under the regulations.

⁵ The exceptions to the “loss transaction” category are described in IRS Revenue Procedure 2003-24.

⁶ The exceptions to the “significant book-tax difference” category are described in IRS Revenue Procedure 2003-25.

⁷ The most recent cumulative list of listed transactions is found in IRS Notice 2003-76. However, certain additional listed transactions have been identified by the IRS in published guidance since the date of that Revenue Procedure.