

Confidentiality Bites: What You Don't Know Can Hurt You...

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Treasury has finalized its regulations on the tax shelter disclosure rules. In doing so, it has put some teeth into the disclosure rules for reportable transactions under Section 6011(a), registration of confidential corporate tax shelters under Section 6111(d), and maintaining lists of potentially abusive tax shelters under Section 6112.

Catching a Tiger by its Toe

The manner in which the term “reportable transaction” is defined leaves much to the imagination. As it stands, many ordinary business transactions could arguably unintentionally fall within its bailiwick. There are six categories of reportable transactions: listed transactions, confidential transactions,

transactions with contractual protection, loss transactions, transactions with significant book-tax difference, and transactions involving a brief holding period.

A very large problem with these menacing definitions is that many ordinary, even non-tax motivated transactions (yes, believe it or not, they do exist), are ensnared by the definition of confidential transactions (the second category under reportable transactions). *See* Treas. Reg. § 1.6011-4(b)(3).

A transaction is considered confidential 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. In other words, the confidentiality language that is included in many documents involving standard, run-of-the-mill business transactions may actually have the opposite effect of what you intended. It may actually require your client to disclose the transaction to the IRS (doesn't sound like very much fun does it?). Nowadays, confidentiality bites!

Consider some of the transactions that you may have recently handled: litigation settlements, real estate transactions, sale-leaseback transactions, licensing agreements, trade-secret agreements, employment agreements, service agreements, financing agreements, and financial guarantees. If you included confidentiality provisions in any of the documents involving these transactions, then you may have triggered the disclosure requirement (doesn't seem hardly fair does it?).

Tell Your Friends

On the other hand, the regulations generally provide a presumption of non-confidentiality if the taxpayer receives written authorization to disclose the tax treatment and tax structure of the transaction. As a result, many abusive transactions may be able to avoid being defined as a confidential transaction by including language authorizing the taxpayer

to disclose the transaction. The language must read, "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." It doesn't seem fair that just because the big promoters of those abusive tax shelters (we won't name names, but I think everyone know who we are talking about) know to include this specific language that they can prevent their transactions from being defined as confidential transactions.

If your transaction has been caught by the confidential transaction net, thereby becoming a reportable transaction, then it must be reported to the IRS on a Form 8886 disclosure statement that must be attached to and filed with the taxpayer's tax return (gee, I'm not sure if this will increase your audit risk). This form must identify the type of transaction, the participants, the facts of the transaction, and the tax benefits involved. The regulations provide for two notable exceptions to being labeled as a confidential transaction.

Your Get Out of Jail Free Card

A transaction is not considered offered to a taxpayer under conditions of confidentiality if 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 (seems reasonable to me).

So what happens when you want to wet your whistle with a little m&a activity? Are you going to have to tell the whole world what you are up to next time you do a deal? Well, kinda sorta. If you are involved in an asset acquisition (either taxable or tax-free), the transaction will generally not be considered a confidential transaction under the new regulations so long as the participants are permitted to disclose the tax aspects of the transaction when details of the overall transaction are made public. However, this exception does not apply if the taxpayer's ability to consult an independent tax advisor is limited in any way. Clearly, this is

something to keep in mind the next time you put a deal together.

Winding Up

Finally, the new regulations have deleted language that was previously included in the proposed regulations clarifying the fact that a common law privilege held by a taxpayer does not cause a transaction to be confidential. (You know how we lawyers like to label everything Attorney-Client Confidential / Privileged Communication.). The IRS and Treasury believed that this clarification was not necessary because the attorney-client privilege (or the confidentiality privilege of Section 7525(a)) does not affect whether a transaction is confidential and does not restrict the taxpayer's ability to disclose the tax treatment or tax structure of a transaction.

There have been many recent suggestions to changing the confidentiality provision, including removing the provision entirely, adding language to the definition to exempt more business transaction, and adding language to specifically target tax shelters.

We'll see what Treasury does in reaction to what is now developing into a public outcry. In the meantime, be careful because the confidential transaction definition may bite you and send your client to the dog pound at the same time. Instead of protecting yourself and your client, by adding confidential language to a document, you actually may be forcing your client to disclose to the IRS the very transaction you are trying to keep confidential (and exposing yourself to malpractice).