IV.A.4. Exit Strategy

Introduction

In examining an abusive tax shelter issue, it is important to determine whether the taxpayer had an exit strategy and/or an exit tax strategy. Although the term "exit strategy" may be used to refer to either one, they are actually different, as discussed below. The existence of an exit strategy and/or exit tax strategy is relevant to evaluating business purpose and economic substance. Exit strategies may indicate:

- that a taxpayer's decisions were tax driven rather than economically motivated;
- that the accommodating party worked with the taxpayer to accomplish the steps necessary to deliver a permanent long term tax benefit for the taxpayer in exchange for a fee, and
- that the steps in the transaction were prearranged and predetermined.

Furthermore, as discussed below, because many tax shelters initially appear to be timing issues, and are characterized by the taxpayers as such, it is important to determine as early as possible whether there are exit tax strategies.

Agents should ascertain whether such strategies were developed and whether they were employed. All facts relating to exit strategies should be obtained, including when and how the strategies were developed, and their impact on the economic and tax consequences of the transaction..

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Definition

An "exit strategy" is usually developed before the taxpayer enters into the transaction. Often, the term refers to a means by which the taxpayer can exit from or unwind the transaction prior to its contemplated termination, in the event that future circumstances adversely impact the taxpayer's ability to secure the contemplated tax benefits.

> Example 1 - A taxpayer may wish to prematurely exit or unwind a transaction based on a change in the law or an adverse Treasury interpretation of a tax provision.
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> Example 2 - A taxpayer who engaged in a tax shelter transaction to generate a capital loss to offset an anticipated capital gain may wish to unwind it if the anticipated capital gain does not in fact materialize.

Exit strategies eliminate the risk that the taxpayer will be forced to participate in a transaction that may become disadvantageous. Exit strategies of this type are relevant, among other things, in ascertaining the taxpayer's business purpose for entering into the transaction.

Example - Winn-Dixie

In Winn-Dixie v. Commissioner, 113 T.C. 254, 276-277 (l999), aff'd254 F.3d 1313 (11th Cir. 2001), promotional materials provided to the taxpayer prior to entering into the transaction specifically discussed the legislative status of the leveraged COLI. These materials recognized that the COLI program could lose its attractiveness to the taxpayer if the taxpayer's marginal tax rate on interest deductions became low and remained low or if the taxpayer became an alternative minimum taxpayer, or if the intended premium payment strategy became invalid through regulation. The materials then assured the taxpayer that if it became necessary or useful to terminate the COLI Pool, or to discontinue further borrowing, Winn-Dixie would be able to do so without significant adverse effect, and discussed the various available methods.

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Control of Assets

Exit strategies may also be developed at the planning stage of an abusive tax shelter transaction in order to ensure that the taxpayer can extricate itself from the transaction after it has secured the desired tax objectives. In addition, the taxpayer may wish to insure that it can protect and effectively control any assets it contributes, at least transitorily, to the venture, and to exit the venture with its assets in tact.

> Example - As part of a strategy to secure a capital loss, a taxpayer may be required, at least in form, to sell an equity interest in its business to an accommodating party. However, the taxpayer may also have a right of first refusal protecting the interest from sale or disposition to a third party and a call option insuring that at a given time, the interest can be "reacquired" and the accommodating party's participation in the transaction terminated.

Frequently, investments, partnerships, or joint ventures appear from the transactional documents to contemplate long or indefinite terms, but side agreements, understandings, or other provisions of the agreement and/or the conduct of the parties, including exit strategies, reflect the limited nature and duration of the relationship.

Exit Tax Strategy

An "exit tax strategy" is a strategy that allows a taxpayer to convert what would otherwise be a temporary (i.e., timing) tax benefit into a permanent one. An "exit tax strategy" is frequently needed because many tax shelter transactions exploit provisions which under normal circumstances only result in timing benefits. For example, a tax straddle generates a loss in the first year, but a corresponding gain in the second year. Traditional sale-leasebacks also generally create only timing benefits. Thus, current lease strips were developed which generate permanent deductions to the taxpayer by stripping off the income to a tax-neutral party before the taxpayer enters into the transaction.

Agents will frequently encounter exit tax strategies in abusive tax shelter cases involving partnerships, because they often have a "built-in" tax gain to the taxpayer at the time the transaction is terminated. As a result of upfront tax benefits such as capital losses, taxpayers are frequently faced with an outside basis in the partnership substantially lower than the value of the partnership assets at the end of the transaction.

Permanent Deferrals

Taxpayers will generally seek a strategy for converting temporary benefits into permanent deferrals before entering into the transaction, although such strategies may also be developed at a later time. Permanent deferrals are far more beneficial and temporary deferrals may not justify the expense of the transaction and the audit risk. In addition, unless the tax benefits can be permanently deferred, the taxpayer may not be able to utilize the tax benefits for financial accounting purposes. See ACM Partnership, TC Memo. 1997-115, at 2203, discussing Colgate's efforts, in conjunction with its independent auditor and investment banker promoter, to avoid the built in gain from the low outside basis in the partnership and deferred tax liability through a series of contemplated tax-free asset and stock transfers among Colgate affiliates some time after the favorable tax benefits were secured.

How to Secure Information

The information and documents necessary to identify exit strategies will depend on the facts and circumstances of the case. However, agents should always document the entire structure of the transaction, as contemplated and as executed, from "cradle to grave." Agents should secure information regarding the totality of the transaction -- as presented by the promoter, as understood by the taxpayer, accommodating parties, and other participants, at its inception as well as executed. All agreements, contracts, and understandings between the parties, written and oral, including revisions, modifications, and amendments thereto (such as partnership agreements, equipment leases, licenses, etc.), should be secured and read carefully and in conjunction with each other to ascertain exit strategies. Agreements on exit strategies may not always be readily apparent and occasionally agents will need to glean them from the conduct and actions of the parties.

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Documentation

A case should not be closed without documenting how the transaction was terminated, even if it requires securing information outside of the audit cycle. As discussed in the IDR and summons discussions above, it is permissible to seek information from subsequent years under I.R.C. § 7602 as long as it is for the purpose of ascertaining the correctness of the return under examination or determining the liability of the taxpayer for the year under investigation. Any taxpayer objection to providing information outside the audit cycle which pertains to the transaction (including how the transaction was terminated and whether tax liability was permanently deferred) should be referred to local counsel. Documents relating to termination and deferral should reveal the exit strategies and tax strategies both conceived and utilized.

Exit strategies and exit tax strategies may be developed by the promoter and reflected in promotional materials. However, these strategies may also have been developed by the taxpayer with the assistance of the promoter, in-house or outside counsel, accounting firm, or even the accommodating party. Information should be sought from all of these sources.

Additionally, a good potential source of information regarding exit tax strategies when dealing with publicly-held corporate taxpayers is the independent auditor's audit workpapers. Book/tax differences may create issues for financial accounting purposes, so the workpapers often describe the transaction and solutions such as exit strategies to deal with those issues.

In drafting IDRs or summonses or in conducting interviews, agents should avoid using the terms "exit strategy" or "exit tax strategy" unless those terms are fully defined, to avoid the possibility that the taxpayer will not understand what is being sought. IDRs, summonses, and interview questions should be worded to fit the particular transactions in question.