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The Seventh Circuit Affirmed the U.S. Tax Court in *Exelon Corporation v. Commissioner* – Having Expert Tax Advisors on Your Team Will Not Always Relieve You From the Imposition of Accuracy-Related Penalties

By Larry Brant and Peter Evalds on 12.6.18 | Posted in 1031 Exchanges, Tax Court, Tax Penalties

In *Exelon*, the Seventh Circuit held that exchanges by Exelon Corporation ("Taxpayer") of nuclear power plants for long-term leasehold interests in power plants located in other states were not exchanges qualifying for like-kind exchange treatment under Code Section 1031. According to the court, the Taxpayer did not acquire the benefits and burdens of ownership but rather received an interest more in the nature of a loan, which was not like-kind with the relinquished real property.

The IRS issued notices of deficiency for tax years 1999 and 2001. The tax deficiency for 1999 was in excess of $431 million. On top of that, the Service imposed a 20% accuracy related penalty under Code Section 6662(a) that exceeded $86 million. For 2001, the deficiency was a bit over $5.5 million. Again, for good measure, the Service tacked on a 20% accuracy related penalty of about $1.1 million.

The U.S. Tax Court affirmed both the deficiency assessment and the imposition of accuracy related penalties. *Exelon Corp. v. Comm'r*, 147 TC 230 (2016). On October 3, 2018, the U.S. Court of Appeals for the Seventh Circuit affirmed the Tax Court. *Exelon Corp. v. Comm'r*, 122 AFTR 2d ¶2018-5299 (2018).

The saga of Exelon Corporation is a long and complex read, but the morals to the story definitely warrant tax advisors dedicating the time to understand the case.

Facts

In 1999, following deregulation of the energy industry in Illinois, Taxpayer (Unicom Corp., which merged into Exelon Corp in 2000) decided to dispose of its fossil-fuel power plants and use the proceeds to improve its nuclear plants. The fossil-fuel plants were set to sell for approximately $4.8 billion. The Taxpayer planned to use almost $2.35 billion of the sale

proceeds to improve its nuclear plants, leaving approximately $2.45 billion it could deploy for other business purposes.

Facing an astronomical tax bill arising from the gain of $1.6 billion on the disposition of its fossil-fuel power plants, the Taxpayer commenced searching for ways to diminish or defer the gain. In that pursuit, it approached three large accounting firms for assistance.

As a viable solution, one of the accounting firms suggested that the fossil-fuel power plants be disposed as part of a like-kind exchange under Code Section 1031. Pursuant to the accounting firm's complex proposal, the replacement property in the exchange could be long-term leasehold interests in power plants owned by tax-exempt public utilities.

In pursuit of this complex proposal, the Taxpayer engaged the services of three large accounting firms (serving financial advisory, appraisal, and accounting roles), several large prominent law firms (advising with respect to transaction and tax issues, regulatory issues, and state law issues), and an engineering firm.

To implement the proposal, the Taxpayer pursued six complex long-term lease transactions with two tax-exempt public utilities which leasehold would serve as its replacement property in the exchange. Specifically, the Taxpayer leased power plants from the public utilities under triple net leases that exceeded the useful lives of the plants. Then, it subleased the power plants back to the same public utilities for shorter periods of time. The utilities had the option to repurchase the plants at the end of the subleases.

The rent under the leases was paid upfront from the sales proceeds of the Taxpayer's fossil-fuel power plants. The rent paid to the utilities under each lease was allocated as follows: (1) part of the rent was returned to the Taxpayer within six months of the commencement of the sublease as prepayment of rent under the sublease; (2) another part of the rent was set aside by the public utility to secure the repurchase option at the end of the sublease; and (3) the balance of the rent was paid to the utility as an accommodation fee for entering into the transaction.

Each sublease expressly provided that, if a utility did not exercise its repurchase option, the Taxpayer had several choices it could make, including: (1) it could require the utility to arrange for a third party to operate the plant or enter into a service agreement with the Taxpayer, or (2) the Taxpayer could take possession of the plant. Any third-party operator would need to have debt that was highly rated or the entity would need to secure a guarantee for its performance. If a utility could not successfully find a willing third party meeting that criteria, it would be required to exercise its repurchase option. Additionally, if a utility did not exercise its repurchase option, it would have to return the plants to the Taxpayer in a condition meeting high operational standards. Several of the transactions also extended the utility's repurchase

options to the utility's co-tenants.

Taxpayer's Position

The Taxpayer argued that it exchanged its "active" ownership interests in two power plants in Illinois for "passive" leasehold interests (equaling or exceeding 30 years in duration) in power plants in Georgia and Texas. The Taxpayer further argued that it acquired the benefits and burdens of ownership with respect to leased power plants because it was exposed to significant risks during the residual period of the leases as well as during the leaseback period. It asserted that the transactions were unlike sale-in, lease-out (SILO) transactions because they were structured not as leveraged leases, but as direct leases financed entirely from the Taxpayer's own funds. The Taxpayer further argued that it acted in good faith and relied on the advice of highly qualified independent advisors.

IRS's Position

The Service came out of the chute, arguing that the lease transactions did **not** transfer any benefits and burdens of ownership to the Taxpayer because they were not true leases. According to the IRS, they were "prepackaged, promoted tax products which subjected [Taxpayer] to no residual value risk, only a theoretical, de minimis credit risk." In essence, as the Service saw it, the transactions were more similar to low-risk loans. Thus, because the Taxpayer exchanged ownership interests in power plants for financial instruments (low-risk loans), it failed to meet the like-kind exchange requirements under Code Section 1031. Further, the Service asserted that, because the substance of each transaction was a loan rather than a lease, these loans should generate original issue discount (OID) income under Code Section 1272. The IRS additionally asserted that the Taxpayer was not entitled to depreciation deductions, interest deductions, or transaction cost deductions. The IRS ultimately concluded that the Taxpayer was liable for accuracy-related penalties under Code Section 6662.

U.S. Tax Court Decision

The U.S. Tax Court upheld the deficiency determination and the assessment of penalties for 1999. It held that the Taxpayer was not entitled to like-kind exchange treatment because the Taxpayer did not acquire a genuine ownership interest in the plants. The Taxpayer did not face any significant risks indicative of genuine ownership. The "circular flow of money" precluded the Taxpayer from having any real investment in the plants. Further, the subleases allocated the risks and costs associated with the plants to the subleases, and the Taxpayer was able to fully recover its investment if the utilities defaulted or became bankrupt.

The court found that there was a "reasonable likelihood" that the utilities would exercise the repurchase options. This meant that the Taxpayer's return was fixed, so it did not acquire any benefits or burdens of ownership. The court agreed with the IRS's expert that the residual values in the Taxpayer's appraisals were too low and thus did not reflect an accurate economic picture informing the likelihood of exercise.

Because the transactions were loans and not leases, the purported exchange was an exchange of real property in return for financial instruments. As a result, the requirements of Code Section 1031 were not met.

With respect to penalties, the court found that reliance on counsel was unreasonable. According to the court, the Taxpayer's counsel improperly interfered with the integrity of the appraisals conducted with respect to the replacement plants. The Taxpayer's lawyers had provided a list of conclusions it expected to see in the appraisal reports. Further, the court found that reliance on the conclusions in the appraisal reports was unreasonable. The reports did not consider the costs of the utilities not exercising their options. All of the parties expected that the utilities would exercise their purchase options because the return conditions were extremely burdensome.

For the 2001 tax year, the Tax Court agreed with the IRS and held that the Taxpayer could not deduct depreciation or interest, and could not include rental income because the purported leases were in the nature of loans. The Taxpayer was required to include in income OID income related to its equity contribution. The Taxpayer could not deduct transaction costs, but was required to treat them as additional loan amounts.

Seventh Circuit Decision

On appeal, the Taxpayer argued that the Tax Court: (1) used the wrong legal standard to determine whether the purchase options would likely be exercised; (2) wrongly dismissed the Taxpayer's expert analysis due to interference by counsel; and (3) misunderstood the sublease return conditions.

The key issue in the case, according to the Seventh Circuit, was whether the Taxpayer acquired the benefits and burdens of ownership. The Tax Court did not err by using SILO/LILO cases to determine that issue. The appellate court agreed that the Taxpayer faced **no** real risk indicative of ownership. As to the possibility of bankruptcy, the utilities either could not or were highly unlikely to declare bankruptcy.

The appellate court held that the "reasonable expectation or likelihood" standard applied to the determination of whether the utilities would exercise their repurchase options. As to the application of the standard, the Seventh Circuit found that the Tax Court did not clearly err in

finding that the utilities were reasonably likely to exercise their repurchase options. The appeals court agreed with the Tax Court's determination that the Taxpayer's expert appraisal reports were flawed. According to the Tax Court, the appraisal reports underestimated the projected fair market value because a 9% state corporate income tax rate was used while the utilities were tax exempt and the state tax rates were 0% and 6%. Furthermore, the discount rate used was found to be too high. When corrected, the projected fair market values of the plants at the end of the subleases were much higher, thus indicating that the utilities were likely to exercise their options.

The appellate court agreed with the Tax Court that by providing the wording of necessary conclusions to be reached in the appraisal reports, the Taxpayer's counsel interfered with the integrity and independence of the appraisal reports. Additionally, the repurchase price was to be paid with money provided by the Taxpayer, so the utilities had little incentive not to exercise the option regardless of the fair market values of the plants at the end of the sublease terms.

Finally, the Seventh Circuit rejected the Taxpayer's argument that the Tax Court misunderstood the sublease return conditions. The subleases required that, if the utilities did not exercise their repurchase options, the plants would have to be returned to the Taxpayer in such condition that their "capacity factor" was at a certain level. The engineering reports estimated that the actual capacity factors at the end of the subleases would be substantially lower. Thus, the Tax Court determined that the utilities would have to put significant investment into the plants in order to return them in the condition specified in the subleases. As such, the utilities would be likely to exercise their repurchase options to avoid such onerous investment. The Taxpayer argued that the use of the term "capacity factor" in the subleases and engineering reports were not synonymous based on industry usage, but the Seventh Circuit agreed with the Tax Court that the definitions used in both documents were the same.

Further bolstering the conclusion that the parties intended for the utilities to exercise their repurchase options was evidence in the record that one of the utilities had represented in a draft court document that it intended to exercise the option (which was removed at the request of the Taxpayer's counsel) and the utilities' own internal documents so indicating.

The appellate court also upheld the Tax Court's imposition of negligence penalties. The court found that the Taxpayer was unable to use the "reasonable cause" defense to avoid penalties because it could not rely on its experts' analyses. The Taxpayer knew or should have known that its tax counsel's opinion was flawed due to the inconsistent treatment of capacity factors in the subleases and engineering reports. Furthermore, it knew or should have known that its attorneys' provision of necessary conclusions to the appraisers tainted the appraisal reports. There were multiple communications on which the Taxpayer was copied where the conclusions were stated and reiterated. Thus, the imposition of penalties was upheld.

Takeaways

The Exelon case leaves us with several takeaways, including:

1. In accordance with Treasury Regulation Section 1.1031(a)-1(c)(2), a leasehold interest of 30 years or more is considered an interest in real property for purposes of Code Section 1031.
2. A taxpayer must acquire the benefits and burdens in the replacement property in order for an exchange to qualify for tax deferral under Code Section 1031.
3. A taxpayer may **not** avoid the imposition of accuracy related penalties under Code Section 6662 on the basis of reliance on professional advice **unless the reliance is reasonable**. When a taxpayer knows or should reasonably know that its tax adviser's opinion is flawed or it knows or should know that its attorneys' or accountants have provided the appraisers with the "hoped-for" conclusions, the reliance on the professional advice is not reasonable and will not avoid penalties.

Tags: benefits and burdens, Code Section 1031, Code Section 6662, energy industry, Exelon Corporation, IRC Section 1031, IRS, leasehold interests, like-kind exchanges, Seventh Circuit, tax deficiency, Tax Laws, Tax Procedure