Exelon Corp. v. Commissioner, 147 T. C. No. 9 (2016) (United States Tax Court, 2016)

In Exelon Corp. v. Commissioner, the U. S. Tax Court ruled that Exelon's sale-leaseback transactions, intended to defer tax on a $1. 6 billion gain from selling power plants, did not qualify as like-kind exchanges under IRC Section 1031. The court held these transactions were loans in substance, not leases, due to the circular flow of funds and lack of genuine ownership risk. This decision reaffirmed the IRS's challenge against tax avoidance through structured finance deals, impacting how such transactions are structured and reported for tax purposes.

Parties

Exelon Corporation, as successor by merger to Unicom Corporation and subsidiaries, was the petitioner. The Commissioner of Internal Revenue was the respondent.

Facts

In 1999, Unicom Corporation, a predecessor to Exelon, sold two fossil fuel power plants, Collins and Powerton, for $4. 813 billion, resulting in a taxable gain of $1. 6 billion. To manage this gain, Unicom pursued a like-kind exchange under IRC Section 1031, engaging in sale-leaseback transactions with City Public Service (CPS) and Municipal Electric Authority of Georgia (MEAG). These transactions involved leasing replacement power plants in Texas and Georgia, which were then immediately leased back to CPS and MEAG, with funds set aside for future option payments. Unicom invested its own funds fully into these deals, expecting to defer the tax on the sale and claim various tax deductions related to the replacement properties.

Procedural History

Exelon filed its tax returns for 1999 and 2001, claiming the like-kind exchange and related deductions. The IRS issued notices of deficiency in 2013, disallowing the deferred gain and deductions, and imposing accuracy-related penalties under IRC Section 6662. Exelon contested these determinations by timely filing petitions with the U. S. Tax Court. The court conducted a trial, considering extensive evidence and expert testimonies, and ultimately issued its opinion on September 19, 2016.

Issue(s)

Whether the substance of Exelon's transactions with CPS and MEAG was consistent with their form as like-kind exchanges under IRC Section 1031?

Whether Exelon is entitled to depreciation, interest, and transaction cost deductions for the 2001 tax year related to these transactions?

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Whether Exelon must include original issue discount income in its 2001 tax return related to these transactions?

Whether Exelon is liable for accuracy-related penalties under IRC Section 6662 for the 1999 and 2001 tax years?

Rule(s) of Law

IRC Section 1031(a)(1) allows nonrecognition of gain or loss on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for like-kind property intended for similar use. The regulations specify that “like kind” refers to the nature or character of the property.

The substance over form doctrine allows courts to disregard the form of a transaction and treat it according to its true nature for tax purposes. Under this doctrine, transactions structured as leases may be recharacterized as loans if they lack genuine ownership attributes.

IRC Section 6662 imposes accuracy-related penalties for negligence or disregard of rules and regulations, which can be avoided if the taxpayer had reasonable cause and acted in good faith.

Holding

The court held that the transactions between Exelon and CPS/MEAG were not true leases but loans, as they did not transfer the benefits and burdens of ownership to Exelon. Consequently, Exelon failed to satisfy the requirements of IRC Section 1031 for a like-kind exchange, and it was not entitled to the claimed depreciation, interest, and transaction cost deductions for the 2001 tax year. Exelon was required to include original issue discount income for the 2001 tax year and was liable for accuracy-related penalties under IRC Section 6662 for both 1999 and 2001 tax years.

Reasoning

The court applied the substance over form doctrine, concluding that the transactions were more akin to loans due to the circular flow of funds and lack of genuine ownership risk. The court analyzed the likelihood of CPS and MEAG exercising their purchase options at the end of the leaseback period, finding it reasonably likely given the return conditions and economic incentives. The court disregarded the Deloitte appraisals as unreliable due to interference from Exelon’s legal counsel and failure to account for return conditions, which significantly increased the likelihood of option exercise.

The court also considered the economic substance doctrine but resolved the case on substance over form grounds, finding that Exelon did not acquire a genuine leasehold or ownership interest in the replacement properties. The court rejected

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Exelon’s reliance on its tax adviser’s opinions as a defense against penalties, citing the adviser’s involvement in the transaction structuring and the flawed appraisals.

Disposition

The court sustained the IRS’s determinations, requiring Exelon to recognize the 1999 gain from the power plant sales, disallowing the claimed deductions for 2001, requiring the inclusion of original issue discount income for 2001, and upholding the accuracy-related penalties for both years. The case was set for further proceedings under Tax Court Rule 155 to determine the exact amounts.

Significance/Impact

The Exelon Corp. decision reinforces the IRS’s stance against tax avoidance through structured finance transactions, particularly sale-leaseback deals intended to qualify as like-kind exchanges. It clarifies that such transactions must transfer genuine ownership risks and benefits to be respected as leases for tax purposes. The decision impacts how corporations structure similar transactions, emphasizing the need for genuine economic substance over mere tax deferral strategies. It also highlights the importance of independent appraisals and the potential pitfalls of relying on advisers who are involved in transaction structuring.

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