



TaxNewsFlash

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Tax Court: Like-kind exchange, sales-leaseback rules not satisfied; accuracy-related penalties apply

The U.S. Tax Court today issued an opinion concluding that an electric power corporation that had sought to manage its taxable gain of \$1.6 billion from the sale of fossil fuel power plants in 1999—through a series of like-kind exchanges using sale-leaseback strategies entered into between the taxpayer and unrelated third parties (tax-exempt public utilities)—did not satisfy the like-kind exchange requirements of section 1031 and that agreements it entered into and involving the public utilities were not true leases, but were loans because the transactions did not transfer the benefits and burdens of ownership to the taxpayer.

The case is *Exelon Corp. v. Commissioner*, 147 T.C. No. 9 (September 19, 2016). Read the 176-page [opinion](#) [PDF 547 KB] of which 93 pages present the factual background in this case.

Background

The Tax Court's briefly summarized the facts in this case as follows:

- The taxpayer was a corporation engaged in the production, transmission, and distribution of electricity to residential, commercial, and industrial customers.
- The taxpayer sold its fossil fuel power plants in 1999 for \$4.813 billion.
- The taxpayer, seeking to manage the taxable gain of \$1.6 billion resulting from the sale, pursued a series of like-kind exchanges employing sale-leaseback strategies between the taxpayer and unrelated third parties (tax-exempt public utilities).
- The taxpayer fully funded the transactions using the proceeds from the sale of its own power plants.

- In the transactions, the public utilities would lease a power plant to the taxpayer for a term exceeding the plant's useful life, receiving in turn a lump-sum payment of cash, and the taxpayer would sublease the power plant back to the public utility. Part of the amount paid to the public utility would be returned to the taxpayer as a prepayment of the sublease. Another part would be set aside for investment and to secure a cancellation option allowing the public utilities to purchase back their power plants at the end of the sublease periods. The remainder would be retained by the public utilities and used for their own needs.
- Since exercising the cancellation options was expected to be the only economically viable option, the parties to the transactions anticipated that at the end of the sublease periods, the public utilities would exercise their cancellation options and regain ownership of the power stations leased to the taxpayer.
- The primary tax benefits that the taxpayer expected to derive were from the deferral of income tax under section 1031 and various deductions related to the replacement properties. The taxpayer had identified appropriate replacement properties, conducted due diligence, and closed the transactions within the timeframes provided for under the like-kind rules of section 1031.

Tax Court's findings

The IRS issued deficiency notices for 1999 and for 2001. For 1999, the IRS determined a deficiency in tax exceeding of \$431 million and a penalty under section 6662(a) exceeding \$86 million. The Tax Court upheld the deficiency determination and penalty assessment for 1999.

Concerning the 2001 tax year, the Tax Court upheld that deficiency determination and concluded that the taxpayer:

- Was not entitled to depreciation deductions claimed with respect to the transactions with the public utilities
- Could not deduct interest or include rental income with respect to the transactions with the public utilities because the transactions were not lease agreements under section 467
- Must include in income the original issue discount income arising out of the taxpayer's equity contribution (which was to be repaid with interest through the cancellation options in the taxpayer's agreements with the public utilities)
- Was not entitled to deduction the transactions costs related to the transactions with the public utilities, but must include these as additional amounts loaned to the public utilities

- Was liable for accuracy-related penalties under section 6662, given that the taxpayer did not show reasonable cause and good faith

This discussion simply sets forth the ultimate findings in this case, and is based on a preliminary reading of the court's opinion as issued late this afternoon.

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