Power Down: Like-Kind Exchanges and SILOs Do Not Mix in *Exelon*

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When structuring transactions to achieve substantial tax benefits, carefully consider the potential application of judicial doctrines such as substance over form.

In *Exelon*,[1] the Seventh Circuit turned off the lights on Exelon's attempt to use SILO transactions with tax-exempt entities to obtain the benefits of a like-kind exchange. The court concluded that the substance of the transactions that Exelon had entered into were loans, not purchases of real property, and as a result the like-kind exchanges were not effective.

Background

In 1999, after deregulation of the energy industry in Illinois, Exelon, an Illinois-based energy company, decided to sell its fossil-fuel power plants, intending to use the proceeds to finance improvements to its nuclear plants and infrastructure. It sold all of its fossil-fuel power plants for $4.8 billion, over $2 billion more than expected. Using $2.35 billion of the proceeds to update its nuclear fleet, Exelon was left with approximately $2.45 billion to invest. It was also left with a significant tax bill. It thus began looking for a strategy that could reduce or defer the tax on the gain.

Exelon was advised in this quest by PwC, which suggested that Exelon use a like-kind exchange to reduce its taxable gain from the sale or power plants. Exelon identified two of its own fossil-fuel power plants that were good candidates for like-kind exchanges: the Collins Plant, to be sold for $930 million, $823 million of which would be taxable gain; and the Powerton Plant, to be sold for

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$870 million, $683 million of which would be taxable gain. It then identified three investment candidates for the exchanges:

- The J.K. Spruce Plant Unit No. 1 ("Spruce"), a coalfired plant in Texas that would replace the Collins Plant.
- Two coal-fired plants in Georgia—Plant Robert W. Sherer Units No. One, Two, and Three ("Sherer") and Plant Hal Wansley Units No. One and Two ("Wansley")—which together would replace the Powerton Plant.

To carry out its purported like-kind exchanges, Exelon entered into six "sale-and-leaseback" transactions. In each of the three representative transactions, Exelon leased an out-of-state power plant from a tax-exempt entity for a period longer than the plant's estimated useful life. Exelon then immediately leased the plant back to that entity for a shorter sublease term and provided to the tax-exempt entity a multimillion-dollar accommodation fee for engaging in the transaction, along with a fully funded purchase option to terminate Exelon's residual interest at the end of the sublease.

Exelon asserted that it had acquired a genuine ownership interest in each of the plants as a result of the transactions, thus qualifying them as like-kind exchanges under Section 1031, entitling it to defer tax on the $1,231,927,407 gain it realized from the sale of its power plants. Exelon also claimed $93,641,195 in deductions on its 2001 return for depreciation, interest, and transaction costs as lessor of the plants.

The IRS disallowed the like-kind exchanges because they involved sale-in, lease out (SILO) arrangements with the owners of the power plants. According to the IRS, these transactions did not transfer genuine ownership of the underlying property to Exelon, so that the like-kind exchanges were ineffective. The IRS also asserted an accuracy-related penalty for the years at issue. The deficiencies totaled almost $440 million without interest, and the 20% penalty added significantly to the total tax bill.

After a 13-day trial, the Tax Court agreed with the IRS, applying the substance-over-form doctrine to conclude that the transactions in question, like SILO transactions, failed to transfer to Exelon a genuine ownership interest in the out-of-state plants. As a result, Exelon was not entitled to like-kind exchange treatment or its claimed deductions. The Tax Court agreed with the IRS that, in substance, Exelon's transactions most closely resemble loans from Exelon to the tax-exempt entities.

To be entitled to the benefits of a like-kind exchange, Exelon had to acquire a genuine ownership interest in the replacement plants.

To reach this conclusion, the court first analyzed the parties' rights and obligations during the sublease term for each transaction. In doing so, it concluded that Exelon "did not face any significant risks indicative of genuine ownership" during that period. In particular, the court found that the transactions' "circular flow of money" precluded Exelon from having any real investment in the plants, despite using its own funds (as opposed to borrowed funds in a traditional SILO) to finance the headlease payments. In addition, the court found that each sublease allocated all costs and risks associated with the plants to the sublessees, and that each transaction's defeasance structure left Exelon able to "fully recover its investment" in the unlikely event of either a lessee bankruptcy or an early termination of the sublease.

Next, the court reviewed the parties' options at the end of the sublease terms and found that there was a "reasonable likelihood" that the lessees would each exercise its purchase option, meaning Exelon's profit was fixed at the onset of each transaction, and thus Exelon did not acquire any benefits or burdens of ownership. The court rejected Exelon's reliance on the properties' residual values to establish genuine ownership.

The Tax Court also sustained the penalties that were proposed by the IRS.

Seventh Circuit Decision

The Seventh Circuit started its opinion with a brief discussion of a SILO transaction, which is a transaction designed to transfer tax benefits associated with property ownership from a tax-exempt entity to a taxable one. All SILOs are structured similarly. First, the tax-exempt entity leases the asset to the taxpayer under a "headlease" for a term that exceeds the useful life of the asset, thereby qualifying the lease as a "sale" for federal tax purposes. The taxpayer concurrently leases the asset back to the tax-exempt entity for a term that is less that the asset's useful life. That lease, called a "sublease," is a "net" lease, meaning that the tax-exempt entity is responsible for all expenses normally associated with ownership of the asset, and retains legal title.

Each "sublease" contains an option under which the tax-exempt entity can repurchase the asset at the end of the sublease term at a set price. This option is "fully funded" with funds provided by the taxpayer for that purpose at the outset of the transaction. As a result, the tax-exempt entity has no risk of losing control of the asset.

The taxpayer prepays its entire "rent" under the headlease in one lump-sum payment at closing. Typically, this rent prepayment is funded in part with the taxpayer's own funds and in part with a nonrecourse loan, although in some instances (as in the instant case) the taxpayer funds the entire prepayment with its own funds. Most of the taxpayer's prepaid rent is deposited into restricted accounts that are nominally held by the tax-exempt entity but are pledged to secure the tax-exempt entity's rental obligations under the sublease and to fund its repurchase option at the end of the sublease term. A small percentage of the headlease rent prepayment, usually between 4% and 8% of the asset value, is paid to the tax-exempt entity as its ac-

commodation fee for participating in the SILO transaction.

The taxpayers' headlease prepayment is invested in high-grade debt with the growth of the account managed to ensure that the tax-exempt entity has sufficient funds to repurchase the asset from the taxpayer at the conclusion of the sublease without adding any funds of its own. The repurchase or "exercise price" is set at the beginning of the SILO transaction and can be exercised simply by giving notice.

In the unlikely event that the tax-exempt entity chooses not to exercise its repurchase option, the transaction generally provides the taxpayer with two options. First, it can elect a "return option" under which it takes immediate control of the asset or, more likely, it can exercise what is called the "service contract option" under which the tax-exempt entity is required to satisfy several conditions before continuing to use the asset or arranging for its use by a third party.

A SILO transaction offers three forms of tax benefits to the taxpayer:

1. It can take deduct depreciation on the asset for the remainder of its useful life.
2. It can deduct interest payments made from any loan used to finance the taxpayer's prepayment of rent under the headlease.
3. It can deduct certain transaction costs associated with the SILO.

These benefits are partially offset by the taxpayer's receipt of income at the end of the sublease if the tax-exempt entity exercises its repurchase option, but "the deferral of tax payments during the life of the sublease has substantial economic value to the taxpayer."

The Exelon transaction had the added wrinkle that it involved a like-kind exchange. PwC proposed that the SILO would be used to transfer tax ownership of the power plants to Exelon as replacement property for a like-kind exchange while ensuring that all operational risk relating to the power plants would remain with underlying lessees.

PwC explained to Exelon that the transactions would be similar to maintaining a typical debt private placement, and that the fundamental risks for Exelon would be the credit of the lessee and the federal tax risk that the IRS would not respect the form of the transaction. PwC explained that the credit risk would be addressed through the transactions' "defeasance strategy," and the tax risk would be mitigated by obtaining an appraisal and other expert opinions to support the conclusion that the fixed purchase option was not "practically compelled." Prior to making its pitch to Exelon, PwC had assisted other clients to implement SILO transactions, including as part of its "Like-Kind Exchange Program."

Exelon spared no expense in hiring experts to assist it in the transaction. Winston & Strawn ("Winston") was hired as legal counsel and to provide a tax opinion; local counsel was hired in the states where the power plants were located; and regulatory counsel was also hired. Exelon also hired an engineering firm, Stone & Webster, to confirm the operating status of the plants, and it hired Deloitte to provide an appraisal of the value and useful life of the plants being acquired.

Exelon also took steps to make sure that the plants would be properly operated. The operators had to either have a suitable credit rating (at the time, only General Electric satisfied this requirement) or obtain a guarantee of its obligations from someone with such a rating. In the end, Exelon entered into back-to-back credit swaps with an insurance company, Ambac Credit Products, LLC, to make Exelon whole in the event the plants did not continue to operate.

In its opinion, the Seventh Circuit first noted that a taxpayer can arrange its affairs to decrease the amount of tax which would otherwise be owed. However, a taxpayer cannot claim tax benefits not conferred by Congress by setting up sham transactions that lack any legitimate business purpose or by affixing labels that do not accurately reflect the transactions' true nature.

As a result, judicial anti-abuse doctrines have developed to "prevent taxpayers from subverting the legislative purpose of the tax code."[2] One such doctrine, the substance-over-form doctrine applied by the Tax Court, "provides that the tax consequences of a transaction are determined based on the underlying substance of the transaction rather than its legal form."[3] In applying this doctrine, the Supreme Court has "looked to the objective economic realities of a transaction rather than the particular form the parties employed," and "has never regarded the simple expedient of drawing up papers as controlling for tax purposes when the objective economic realities are to the contrary."[4]

Exelon contended on appeal that the Tax Court had treated its transaction like tax shelters that lacked economic substance, whereas Exelon had only obtained tax benefits under Section 1031, which are benefits conferred by Congress. The Seventh Circuit responded that the Tax Court had focused on the substance of the underlying SILO transactions rather than their form in order to determine whether or not Exelon had acquired the benefits and burdens of ownership of the plants. To be entitled to the benefits of a like-kind exchange, Exelon had to acquire a genuine ownership interest in the replacement plants.

The Seventh Circuit concluded that the net leases of the plants under the SILO transaction allocated all of the costs and risks associated with the plants to the sublessees (and not to Exelon). When this limited risk was combined with the defeasance structure and circular cash flows, the Seventh Circuit reached the "inescapable conclusion" that Exelon did not face any significant risk indicative or genuine ownership of the plants. Exelon's argument that it faced risk from a potential bankruptcy of the underlying lessees was rejected as contrary to the facts and Exelon's own conclusions that the risk of bankruptcy was very low in this case.

Exelon also argued that it faced real risk at the end of the subleases that the sublessee may not exercise its option at the end of the initial lease term. The Tax Court had concluded that it was reasonably likely that the options would be exercised, while Exelon claimed that the option should not be treated as likely

1 122 AFTR2d 2018-6138 (CA-7, 2018), *aff'g* 147 TC 230 (2016).

2 Coltec Indus., Inc., 454 F.3d 1340, 1353 (CA-F.C., 2006).

3 Wells Fargo, 641 F.3d 1319, 1325 CA-F.C., 2011).

4 Frank Lyon Co., 435 U.S. 561, 573 (1978) (internal quotations omitted).

to be exercised unless the lessee was economically compelled to do so. The Seventh Circuit rejected the "standard" proposed by Exelon, holding that a reasonable expectation or likelihood was required and not economic compulsion.

Exelon next argued that the Tax Court erred in its application of the reasonably likely standard. The Seventh Circuit again disagreed, accepting the expert opinion furnished at trial by the IRS and rejecting the conclusions that Deloitte had reached. The Tax Court also rejected Deloitte's appraisals because it found that Winston had interfered with the integrity and independence of the appraisal process by providing Deloitte with the wording of the conclusions it expected to see in the final appraisal reports. The Seventh Circuit rejected Exelon's argument that Winston was merely providing the existing guidance and tests on the issue of what is considered to be a lease. Winston provided Deloitte a detailed list of specific conclusions that Winston needed in order to issue the necessary tax opinion. Deloitte's conclusions mirrored those in Winston's letter almost word for word.

The Seventh Circuit also concluded that there was a more fundamental problem with Exelon's position that the set purchase option prices far exceeded the fair market value of the plants at the end of the subleases. Even if we were to accept that position, it does not lead to Exelon's conclusion that "no reasonable person would overpay" that much.

To be sure, no reasonable entity would overpay if it was paying with its own money. But here, the sublessees could exercise the purchase options without paying a single cent of their own money. Thus, Exelon's argument does not reflect the economic reality of the transactions. "Because the purchase is free to [the sublessees], price cannot be [an] obstacle."[5] And, because the sublessees do not retain any of the money set aside for the purchase option if they do not exercise it, they have no economic incentive not to do so. Indeed, exercising the options leaves the sublessees in precisely the same position as if they had not entered the transactions, except millions of dollars richer.

Exelon's final argument on the merits was that the Tax Court had erred in its understanding of the end-of-lease conditions which related to the likelihood that the option would be exercised. Exelon contended that the Tax Court had confused the terms "availability factor" with "capacity factor," but the Seventh Circuit disagreed, finding that the sublessees were not worried about the return conditions because they always intended to exercise the purchase options; there was never any incentive for them not to do so. The record clearly showed the sublessee's intent, which established that the benefits and burdens of ownership were not borne by Exelon.

The Seventh Circuit then turned to the penalties which had been approved by the Tax Court. Exelon argued that it had relied on the advice of competent and independent professionals. The Seventh Circuit noted, however, that mere reliance on counsel is not sufficient to relieve the taxpayer from penalties. In *American Boat Co., LLC*,[6] the Seventh Circuit had stated:

> To constitute reasonable cause, the reliance must have been reasonable in light of the circumstances. This is a fact-specific determination with many variables, but the question "turns on 'the quality and objectivity of the professional advice obtained.'" [Internal quotations and citations omitted.]

To establish the defense, the taxpayer, at a minimum, must show that the advice was "(1) based on all relevant facts and circumstances, meaning the taxpayer must not withhold pertinent information[;] and (2) not based on unreasonable factual or legal assumptions, including those the taxpayer knows or has reason to know are untrue." The taxpayer's education, sophistication, business experience, and purpose for entering the questioned transaction are also relevant factors to be considered.

The Tax Court had found that Exelon did not rely in good faith on Winston's tax opinions because Exelon "knew or should have known" that Winston's conclusions were flawed in light of the "obvious inconsistency" of the physical return condition specified in the contracts and the capacity factors projected by Deloitte for the plants at the end of the subleases, which made exercise of the purchase options more likely. The Tax Court found that Exelon must have appreciated that it would be very expensive for the sublessees to sufficiently upgrade the plants to meet the return capacity requirements. Thus, the court concluded that Exelon must have understood that Winston's tax opinions, based on the Deloitte appraisals, were flawed.

Exelon contended that the Tax Court had erred in its conclusion that Exelon must have understood that the tax opinion was flawed, repeating its prior contention that the Tax Court was wrong in concluding that the options were reasonably likely to be exercised. The Seventh Circuit disagreed, stating that Exelon was a sophisticated operator and, as such, knew or should have known that it was reasonably likely, or even highly likely, that the options would be exercised. The Seventh Circuit also found that the record was replete with evidence that Exelon knew that Winston was supplying Deloitte with the conclusions that resulted in the favorable legal opinion.

Discussion

Exelon was probably surprised—to the tune of around a billion dollars when interest is taken into account—by the courts' decisions in this case. Exelon believed that it had re-invested the proceeds from the sale of its fossil fuel plants into other power plants, which investment qualified as the acquisition of replacement property in a like-kind exchange. The transaction had been carefully structured so that Exelon did not need to operate the properties and to provide economic assurance against loss, as well as funds for the sublessees to purchase the property at the appropriate time.

5 BB&T Corp., 523 F.3d 461, 473 n.13 (CA-4, 2008).

6 583 F.3d 471, 481 (CA-7, 2009) (citing Reg. 1.6664-4(b)(1)).

7 AWG Leasing Trust, 592 F. Supp.2d 953 (DC Ohio, 2008); TIFD III, Inc., 604 Fed. Appx. 69 (CA-2, 2015), *rev'g* 8 F. Supp.3d 142; (DC Conn., 2014), 666 F.3d 836, *rev'g* 660 F. Supp.2d 367 (DC Conn., 2009), *on remand from* 459 F.3d 220 (CA-2, 2006), *rev'g and remanding* 342 F.Supp.2d 94 (DC Conn., 2004).

The disallowance of the claimed tax benefits, not to mention the penalties, must have been quite a shock to Exelon.

Several key points should be derived from this saga:

1. Taxpayers have to be careful about involvement in any transaction for which there is an acronym! Exelon's position was likely doomed as soon as the replacement property was labelled a SILO, because the courts have been very adverse to any marketed transaction that provides tax benefits. There are numerous examples of this trend, including Boss, Son-of-Boss, STARS, LILOs, SILOs, DAD, and CARDS. If a transaction can be labelled and sold to multiple taxpayers, it is most likely that a court will approach it with skepticism.
2. When considering a transaction that provides substantial tax benefits, be sure to carefully consider potential application of the judicial doctrines, including particularly whether the substance of the transaction is the same as its form. There have been multiple decisions where the courts have looked through alleged ownership of property and concluded that the alleged ownership was in fact a loan.[7] A careful review of the upside and downside potential of an investment is required if there are tax benefits to be achieved.
3. This decision shows the importance of a "second opinion" in connection with tax-favorable transactions. Exelon relied on the opinions of Winston and Deloitte to avoid penalties; both companies had been engaged to facilitate the transaction. The courts' decisions concerning penalties might have been completely different if Exelon, in addition to retaining Winston, had asked a law firm that was totally uninvolved in the transaction to provide an opinion. This would have been an added cost, but in light of the fact that the penalties alone will cost Exelon around $100 million, Exelon should have considered getting an additional opinion to support its position. Presumably Exelon did not want to have to pay for a second opinion, but this may be a situation where the taxpayer was penny wise but pound foolish.
4. This transaction also shows the importance of making investments that are not overly protected. A lot of the factual problems in this case arose because Exelon wanted to make sure that the sublessees would benefit economically from exercising their options; Exelon did not want to hold the assets forever. A defeasance trust is used to make sure there is money available, but it also suggests that there is a higher degree of certainty that a purchase will occur in the future. If there had been no defeasance trust account in this transaction, it is far less certain that the court would have ruled against Exelon.
5. Finally, although this case is only tangentially related to Section 1031, it does have some bearing. The decisions point out that replacement property in a like-kind exchange must be an ownership interest in the replacement property; acquisition of a financial interest without the benefits and burdens of ownership of the property is not sufficient. A related question under Section 1031 involves the acquisition of leasehold interests which have a long term; taxpayers who acquire leasehold interests must make certain that the substance of such interests is neither a loan nor a property interest recharacterized as a loan under Section 467. Section 1031 requires that both the relinquished and replacement properties are property interests that will be characterized as such; a property interest that lacks benefits and burdens of ownership is not sufficient.

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