

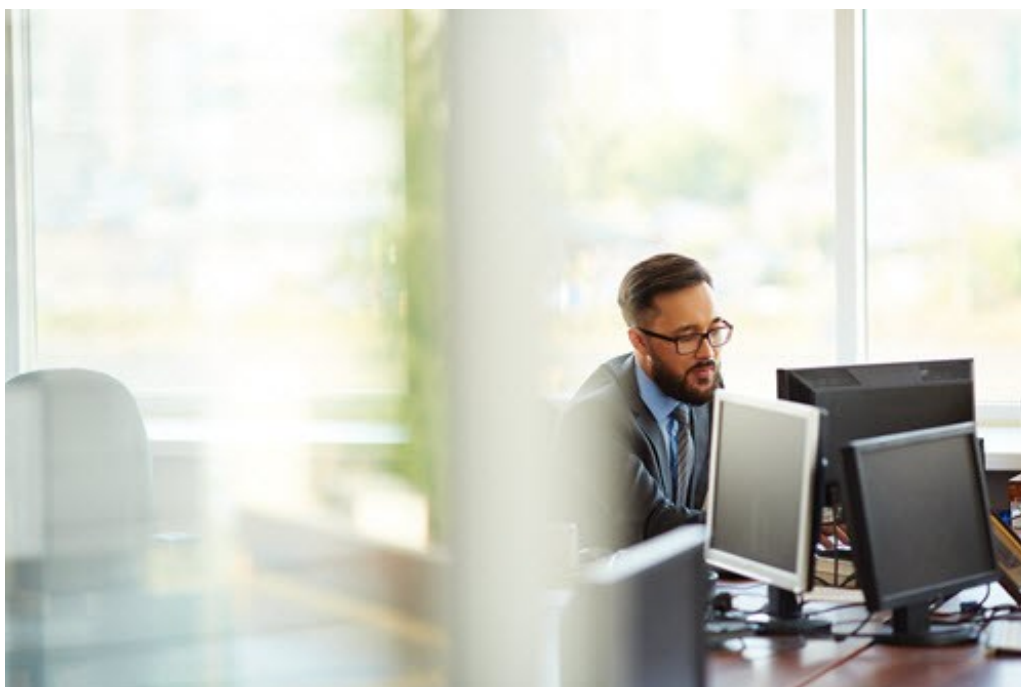
Exelon Corp. v. Commissioner

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National Association of Certified Valuators and Analysts

A Decision that Illustrates the Importance of Appraiser Independence

To successfully work in the field of business valuation, appraisers must perform assignments with impartiality, objectivity, and independence, and without consideration of personal interests or the interests of those who hired them. Should such bias be found, the appraisal could be considered worthless and the expert's reputation damaged, with even worse ramifications for the client. A recent Tax Court case illustrates this point.



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Exelon Corp. v. Commissioner (2016 U.S. Tax Ct. LEXIS 26, Sept. 19, 2016) deals with an I.R.C. Section 1031 exchange. Section 1031 exchanges allow taxpayers to defer the tax on capital gains if the proceeds from the sale are rolled over into similar "like-kind" property.

In this case, the taxpayer was faced with a \$1.6 billion taxable gain resulting from the sales of two fossil fuel power plants. To manage the tax burden, Exelon entered a Section 1031 exchange, using sales proceeds to lease similar power plants from unrelated third parties (TP). The terms of the sale-leaseback exceeded the leased plant's useful life. The leases were prepaid in a lump sum by the taxpayer who, in turn, sublet the power plants back to TP. The subleases had a cancellation/purchase option.

It was expected that this cancellation option would be exercised by the TP and that the TP would regain ownership

of the power stations. The primary tax benefits to the taxpayer were the deferral of income tax under Section 1031 and various deductions related to the replacement properties.

The Court decided the transactions failed to qualify as a Section 1031 exchange, and the taxpayer was not entitled to the various deductions it had claimed related to the transactions. In arriving at its decision, the Court stated that Exelon did not acquire a beneficial ownership of the properties that it leased back to the TP. More importantly, however, the Court ruled in favor of [accuracy-related penalties](#) of more than \$87 million.

IRS Code Section 6664 provides an exception to the penalty if a taxpayer can show reasonable cause and good faith; for example, if the taxpayer relied on professional advice and it can be proven that those advisers have the necessary credentials and possess the proper experience, training, and expertise. The Court in *Exelon*, however, said that reliance on a professional tax adviser does not automatically establish good faith.

Exelon hired a prominent law firm to provide tax advice and issue a legal opinion regarding the transaction. Exelon also hired a nationally known financial firm to appraise the relinquished properties and replacement properties. The Tax Court found that despite the law firm's legal opinion regarding the transaction, Exelon was still liable for the accuracy-related penalty.

It was revealed through discovery that the lawyers provided continuous feedback to the appraisers, which included a list of "appraisal conclusions we anticipate will be necessary to support our tax opinion issued in connection with any leasing transaction." The Tax Court noted that the list appeared "almost verbatim" in the appraisal reports.

The Court indicated that the law firm interfered with the integrity and independence of the appraisal process by providing the appraiser with a list of conclusions it expected to see in the appraisals, to be able to issue tax opinions. This degree of interference "improperly tainted the...appraisal, rendering it useless," the Court stated. Further, because the law firm directed the conclusions of the appraisers, the Tax Court was highly suspicious that the tax opinions were similarly tainted.

The Court stated, "we cannot condone the procuring of a tax opinion as an insurance policy against penalties where the taxpayer knew or should have known that the opinion was flawed." The Tax Court concluded that Exelon "could not have relied on the tax opinions in good faith because petitioner, with its expertise and sophistication, knew or should have known that the conclusions in the tax opinions were inconsistent with the terms of the deal." It was ruled that Exelon did not have good faith and reasonable cause under Section 6664(c) and that it was liable for the penalty, due to a "disregard of rules and regulations within the meaning of Section 6662 with respect to ascertaining the tax consequences of the test transactions."

Exelon is an interesting case for many reasons. First, it presents many factors to consider regarding the replacement property in a Section 1031 exchange. Specifically, the Tax Court said that Exelon did not appear to have true ownership interests; did not face a substantial risk of loss; lacked maintenance, operation and insurance obligations; and did not have to meet any return conditions in the case of a termination. Second, it warns taxpayers that merely relying on professional advice is not enough to shield them from the penalties of an improper tax filing. Finally, it emphasizes the importance of appraisers remaining impartial, objective, and independent. Once these attributes are perceived to be lost, the ramifications to all parties can be severe.

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