T.C. Summary Opinion 2019-1

UNITED STATES TAX COURT

CHRISTOPHER JOHN TOTTEN, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 10691-14S. Filed January 29, 2019.

Christopher John Totten, pro se.

Peter T. McCary and A. Gary Begun, for respondent.

SUMMARY OPINION

ASHFORD, Judge: This case was heard pursuant to the provisions of section 7463 of the Internal Revenue Code in effect when the petition was filed.[1]

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[1]Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the years at issue, and all Rule references are to the Tax Court Rules of Practice and Procedure. Some monetary amounts are rounded (continued...)

Pursuant to section 7463(b), the decision to be entered is not reviewable by any other Court, and this opinion shall not be treated as precedent for any other case.

By statutory notice of deficiency dated February 6, 2014, respondent determined the following deficiencies in petitioner's Federal income tax, additions to tax pursuant to section 6651(a)(1), and accuracy-related penalties pursuant to section 6662(a) for the 2009 and 2010 taxable years (years at issue):

Year	Deficiency	Addition to tax sec. 6651(a)(1)	Accuracy-related penalty sec. 6662(a)
2009	$18,364	$3,052	$3,673
2010	33,755	7,107	6,751

After concessions, the following issues remain for decision:

(1) whether an individual retirement account (IRA) distribution of $43,503 that petitioner received was a taxable distribution for 2010;

(2) if so, whether petitioner is liable for the 10% additional tax imposed by section 72(t) on the IRA distribution for 2010;

(3) whether the payment of $2,968 that petitioner received was taxable gross receipts he should have reported on Schedule C, Profit or Loss From Business, for 2010;

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[1](...continued)
to the nearest dollar.

(4) whether petitioner is entitled to deductions claimed on Schedule A, Itemized Deductions, for unreimbursed employee business expenses of $27,953 and $26,460, amounts greater than respondent allowed, for 2009 and 2010, respectively;

(5) whether petitioner is entitled to Schedule A miscellaneous itemized deductions of $89 for tax preparation fees and $1,963 for attorney's and accountant's fees for 2009 and $106 for tax preparation fees for 2010;

(6) whether petitioner is entitled to a Schedule A deduction for charitable contributions of $18,414, an amount greater than respondent allowed, for 2009;

(7) whether petitioner is entitled to a deduction of $8,000 for repair expenses claimed on Schedule E, Supplemental Income and Loss, for 2009;

(8) whether petitioner is entitled to a capital loss deduction of $3,000 claimed on Schedule D, Capital Gains and Losses, for 2010;

(9) whether petitioner is entitled to residential energy credits of $2,130, an amount greater than respondent allowed, for 2009 and $183 for 2010;

(10) whether petitioner is entitled to a first-time homebuyer credit of $5,625 for 2010; and

(11) whether petitioner is liable for additions to tax for failure to timely file a tax return for the years at issue.

We resolve all issues in favor of respondent.

Background

Some of the facts have been stipulated and are so found. The stipulation of facts, first supplemental stipulation of facts, second supplemental stipulation of facts, and the attached exhibits are incorporated herein by this reference. Petitioner resided in Florida when he timely filed his petition with the Court.

I. Petitioner's Medical Sales Work

During the years at issue petitioner was a medical sales representative, working as a full-time "W-2 wage earner" for an employer and as an independent contractor primarily for a medical sales company.[2] As an employee petitioner sold and provided repair services for medical equipment, medical supplies, and computer systems. As an independent contractor he sold small accessories that complemented his employer's medical products and that his employer did not sell.

Petitioner worked out of his home office and drove his 2004 Mercedes Benz E500 (2004 Mercedes) to various medical facilities and hospitals within his designated geographical territory of Central Florida to sell the medical products of his employer and the medical sales company. Because the medical products

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[2]Petitioner's Form 1040, U.S. Individual Income Tax Return, for 2009 (2009 return) included two Forms 1099-MISC, Miscellaneous Income, one from the medical sales company and one from a medical center.

complemented each other, petitioner drove the same route and visited the same physicians and hospitals for both his employer and the medical sales company each week. Petitioner would occasionally travel outside the designated geographical territory of his employer, but when he did so it was by plane, an expense for which his employer reimbursed him. His employer did not, however, reimburse travel expenses within his designated geographical territory.

II. Petitioner's Additional Income in 2010

In 2010 the parent company of one of petitioner's clients asked him to install a computer server and a workstation. Petitioner purchased the computer server, the necessary software, and the workstation and installed them for the parent company. He received $2,968 from the parent company in 2010.

Petitioner also received an IRA distribution of $43,503 in 2010. As of the close of 2010 petitioner was under 59½ years of age.

III. Petitioner's Real Property

During the years at issue petitioner resided at all times at his home on Bimini Drive (Bimini property) in Orlando, Florida, which he purchased in 2004. Petitioner purchased a condominium on Travini Circle (Travini property) in Sarasota, Florida, in 2005 as an investment property and rented it to tenants during the years at issue. On June 1, 2010, petitioner purchased a property on L.B.

McLeod Road (McLeod property) in Orlando, Florida, but he did not reside at the property in 2010.

IV. 2009 Tax Return

Petitioner used tax preparation software to prepare his 2009 return and filed it late, on September 6, 2011. On the 2009 return he listed the Bimini property address as his home address. He reported wages of $153,926 ($153,026 paid from his employer and $900 paid from a financial services employer), $7 of ordinary dividends, and $900 of other income from a Form 1099-MISC.[3]

Petitioner attached to the 2009 return a Schedule A, a Schedule C, and a Schedule E. He claimed $66,727 of itemized deductions on the Schedule A, a $24,474 deduction on the Schedule C for a net loss for his business as a medical sales representative, and a $9,821 deduction on the Schedule E for a rental real estate loss for the Travini property.

A. Schedule A for 2009

As relevant here, on the Schedule A petitioner claimed a deduction of $18,414 for noncash charitable contributions and miscellaneous deductions (before application of the 2% floor of section 67(a)) of $30,005. A Form 8283,

[3]The record does not include a copy of a Form 1099-MISC reporting $900 for 2009, and neither petitioner nor respondent explained whether this reported amount related to petitioner's work as a medical sales representative.

Noncash Charitable Contributions, attached to the 2009 return, provided the details of petitioner's Schedule A noncash charitable contributions. In Part I of Section A of this form, captioned "Donated Property $5,000 or Less and Certain Publicly Traded Securities--Information on Donated Property", he reported donating clothes, computers, and furniture with an aggregate reported fair market value of $2,164 to a donation center, and in Part I of Section B of this form, captioned "Donated Property Over $5,000 (Except Certain Publicly Traded Securities)--Information on Donated Property", petitioner reported donating to a foundation "[n]ew toys, [h]ousehold items, money"[4] with an aggregate reported appraised fair market value of $16,250.

The Schedule A miscellaneous deductions consisted of $27,953 for unreimbursed employee business expenses, $89 for tax preparation fees, and $1,963 for attorney's and accountant's fees. According to a Form 2106-EZ, Unreimbursed Employee Business Expenses, attached to the 2009 return, petitioner's unreimbursed employee business expenses consisted of $18,089 for passenger automobile expenses using the standard mileage rate and $9,864 for business expenses other than passenger automobile expenses, parking fees, tolls,

[4]In the description of donated property, following "money" is a word beginning with the letter "c" that is cut off by the next column.

transportation, travel expenses, and meal and entertainment expenses. On the Form 2106-EZ petitioner reported driving his passenger automobile 32,889 miles for business, zero miles for commuting, and 3,162 miles for other purposes.

B. Schedule C, Schedule E, and Credits for 2009

As relevant here, on the Schedule C petitioner reported total gross receipts of $2,628 from the medical sales company and the medical center and total expenses of $27,102, including $18,089 for car and truck expenses. On the Schedule E petitioner reported, among other things, $850 of rental income and $16,107 of total expenses, including $8,000 for repairs, for the Travini property.

Petitioner also claimed a residential energy efficient property credit of $2,130, shown on a Form 5695, Residential Energy Credits, for qualified geothermal heat pump property costs of $7,100 related to the Bimini property.

V. 2010 Tax Return

Petitioner used tax preparation software to prepare a Form 1040 for 2010 (2010 return) and filed it late, on October 3, 2011. On the 2010 return he listed the McLeod property address as his home address. He reported wages of $110,523 (paid from his employer) and $36 of taxable interest. He also reported $43,503 as an "IRA distribution" on line 15a of the 2010 tax return, with "ROLLOVER" noted next to line 15a, and reported zero as the "Taxable amount" of the IRA distribution on line 15b. Petitioner attached to the 2010 return a Schedule A, a Schedule C, and a Schedule D. He claimed $34,286 of itemized deductions on the Schedule A, a $692 deduction on the Schedule C for a net loss for his business as a medical sales representative, and a $3,000 deduction on the Schedule D for a net long-term capital loss (after the limitation imposed by section 1211(b)).

A. Schedule A for 2010

As relevant here, on the Schedule A petitioner claimed a deduction (before application of the 2% floor of section 67(a)) of $26,566 for miscellaneous deductions consisting of $26,460 for unreimbursed employee business expenses and $106 for tax preparation fees. According to a Form 2106-EZ attached to the 2010 return, petitioner's unreimbursed employee business expenses consisted of $16,801 for passenger automobile expenses using the standard mileage rate, $153 for travel expenses while away from home overnight, $25 for meals and entertainment expenses (after reducing the amount by the 50% limitation imposed by section 274(n)), and $9,481 for business expenses other than passenger automobile expenses, parking fees, tolls, transportation, travel expenses, and meal and entertainment expenses. On the Form 2106-EZ petitioner reported driving his passenger automobile 33,601 miles for business, zero miles for commuting, and 1,889 miles for other purposes.

B. Schedules C and D for 2010

As relevant here, on the Schedule C petitioner did not report any gross receipts or the $2,968 he received from the parent company in 2010.

On the Schedule D petitioner reported long-term capital losses consisting of $42,250 from the sale of 306.1620 shares of Munder Growth Opportunities Fund Class A (Munder Growth) and $452 from the sale of 32.3450 shares of Davis New York Venture Fund Class A (Davis NY Venture). On the Schedule D petitioner reported the following:

Property	Date acquired	Date sold	Sale price	Cost or other basis
Munder Growth	May 15, 2003	Oct. 13, 2010	$8,000	$50,250
Davis NY Venture	May 15, 2003	Oct. 13, 2010	1,048	1,500

C. Credits for 2010

Petitioner also claimed a nonbusiness energy property credit of $183, shown on a Form 5695, for qualified natural gas, propane, or oil furnace or hot water boiler costs of $610 related to the Bimini property. Lastly, petitioner claimed a credit of $5,625 on a Form 5405, First-Time Homebuyer Credit and Repayment of the Credit. On the Form 5405 petitioner listed a property on Marathon Avenue

(Marathon property) in Orlando, Florida, as the home qualifying for the credit. Petitioner reported purchasing the property on June 1, 2010, and entering into a binding contract to purchase the property before May 1, 2010.

Discussion

I. Burden of Proof

In general, the Commissioner's determinations set forth in a notice of deficiency are presumed correct and, except for the burden of production in any court proceeding with respect to a taxpayer's liability for any "penalty, addition to tax, or additional amount", see sec. 7491(c), the taxpayer bears the burden of proving otherwise, see Rule 142(a); Welch v. Helvering, 290 U.S. 111, 115 (1933). The burden of production remains on the taxpayer even with respect to the additional tax under section 72(t) because the section 72(t) additional tax is a "tax" and not a "penalty, addition to tax, or additional amount" within the meaning of section 7491(c). See Elaine v. Commissioner, T.C. Memo. 2017-3, at *6 (and cases cited thereat).

However, for this presumption to adhere in cases (such as this one) involving unreported income, the Commissioner must provide some reasonable foundation connecting the taxpayer with the income-producing activity. See Blohm v. Commissioner, 994 F.2d 1542, 1549 (11th Cir. 1993), aff'g T.C. Memo.

1991-636. Once the Commissioner has done this, the burden of proof shifts to the taxpayer to prove by a preponderance of the evidence that the Commissioner's determinations are arbitrary or erroneous. Helvering v. Taylor, 293 U.S. 507, 515 (1935). It is undisputed that during the years at issue petitioner was a medical sales representative. Petitioner also conceded that he received $2,968 from the parent company of one of his clients. On the basis of this credible and undisputed evidence, we are satisfied that respondent has proved a likely source of the unreported income.[5] Thus, the burden of proof shifts to petitioner to show that respondent's determination in regard to the unreported income was arbitrary or erroneous.[6]

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[5]As noted, supra pp. 8-9, petitioner did report on his 2010 return that he received an IRA distribution of $43,503 (but reported zero as the taxable amount).

[6]We also note that, under sec. 6201(d), if a taxpayer asserts a reasonable dispute with respect to an item of income reported on an information return filed by a third party and the taxpayer meets certain other requirements, the Commissioner bears the burden of producing reasonable and probative evidence, in addition to the information return, concerning the portion of the deficiency attributable to the income item. Petitioner has not raised a reasonable dispute with respect to the accuracy of income reporting by the third parties here. Indeed, he concedes that he received the reported income. To the extent petitioner attempts to dispute the accuracy of the reporting, see infra pp. 13, 16, we conclude in any event it is not reasonable under sec. 6201(d), see, e.g., Carlson v. Commissioner, T.C. Memo. 2012-76; Hyde v. Commissioner, T.C. Memo. 2011-131. Accordingly, the burden of production with respect to the income in this case does not shift to respondent under sec. 6201(d).

Petitioner does not otherwise contend that the burden of proof should shift to respondent under section 7491(a) as to any relevant issue of fact, nor has he established that the requirements for shifting the burden of proof under section 7491(a)(2) have been met. Accordingly, the burden of proof remains on petitioner.

II. Taxability of IRA Distribution and Additional Tax Under Section 72(t)

Petitioner conceded that he received an IRA distribution of $43,503 in 2010. However, petitioner reported the IRA distribution as a nontaxable rollover on his 2010 return. Section 408(d)(1) provides that any amount paid or distributed out of an IRA is included in the gross income of the payee or distributee as provided under section 72. An amount will not be treated as a taxable distribution from an IRA if it is a qualified rollover. Sec. 408(d)(1), (3). A distribution is considered a qualified rollover distribution if the entire amount an individual receives is paid into a qualifying IRA or other eligible retirement plan within 60 days of the distribution. Sec. 408(d)(3). Petitioner testified that he used the funds to pay medical expenses. The IRA distribution did not therefore meet the requirements for a qualified rollover distribution. We sustain respondent's determination that the IRA distribution was a taxable distribution for 2010.

Section 72(t) imposes an additional 10% tax on early distributions from a qualified retirement plan, including an IRA, made to a taxpayer before he attains the age of 59½. See secs. 72(t)(1), (2)(A)(i), 4974(c)(4). Petitioner had not attained the age of 59½ when he received the distribution at issue. The IRA distribution was therefore an early distribution subject to the additional 10% tax.

The additional 10% tax, however, does not apply for certain enumerated exceptions. See sec. 72(t)(2). Petitioner asserts that the exceptions for a distribution attributable to the individual's being disabled within the meaning of section 72(m)(7) and a distribution made to an individual for medical care expenses apply to his distribution. See sec. 72(t)(2)(A)(iii), (B).

Section 72(m)(7) provides that a person shall be considered "disabled" if "he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration." The regulations provide that "[a]n individual will not be deemed disabled if, with reasonable effort and safety to himself, the impairment can be diminished to the extent that the individual will not be prevented by the impairment from engaging in his customary or any comparable substantial gainful activity." Sec. 1.72-17A(f)(4), Income Tax Regs. Whether an impairment constitutes a "disability" is to be determined by considering all of the facts in the case. Sec. 1.72-17A(f)(2), Income Tax Regs.

Although petitioner submitted evidence that sufficiently proves that during the year at issue he had a serious medical illness, he was employed full time throughout 2010 as a medical sales representative. According to petitioner's mileage logs for the years at issue, he drove between 71 and 240 miles on a given day within his designated geographical territory. His 2009 and 2010 returns, apart from the IRA distribution in 2010, show that his employment was his primary source of income during those years. Petitioner's work with his employer and as an independent contractor with the medical sales company required him to travel daily within his designated territory to sell medical equipment. We do not doubt that petitioner's illness placed certain limitations on him. However, his illness clearly did not prevent him from engaging in "substantial gainful activity". See id. subpara. (4). We find that petitioner was therefore not "disabled" within the meaning of section 72(t)(2)(A)(iii).

Further, petitioner did not present any evidence to support his contention that he used the funds from the IRA distribution to pay for medical care expenses in 2010.

On the record before us, we find that none of the enumerated statutory exceptions applies to petitioner. We sustain respondent's determination to impose the section 72(t) additional tax on the total amount of the IRA distribution for 2010.

III. Schedule C Gross Receipts

Petitioner conceded that he received $2,968 from the parent company in 2010. Respondent determined that petitioner should have reported that income as Schedule C gross receipts. Petitioner asserts that the amount was not taxable income but rather reimbursement for items he had purchased on behalf of the parent company.

Section 61(a) defines gross income as "all income from whatever source derived", including compensation for services, whether furnished by the taxpayer as an employee, a self-employed person, or an independent contractor, and gross income derived from a business. See sec. 61(a)(1) and (2); Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955). Petitioner argued at trial that the payments from the parent company were to reimburse him for his purchases of the computer server and the workstation he had installed for them in 2010. While reimbursement may be a possible explanation for the payments, petitioner's assertions are not supported by credible evidence.

Petitioner introduced at trial only the bottom portion of a check stub with an invoice date of June 14, 2010, for $1,905 and the notation "SERVER" as the description. Petitioner testified that this payment was a reimbursement for his purchase of the computer server and that he received a separate check as reimbursement for his purchase of the workstation. However, the check stub neither states the name of the payor nor provides an explanation of the description. Moreover, petitioner did not present any evidence showing he had purchased the computer server and the workstation.

Even if petitioner had been reimbursed for his purchases of the computer server and the workstation, he would have been compensated in some amount for the accompanying services he provided to the parent company to install the equipment. On his 2010 Schedule C, however, petitioner reported zero gross receipts and did not provide any evidence, including testimony, as to whether that income was reported elsewhere on his 2010 return. Petitioner also did not provide any testimony to establish whether his services for the parent company were services provided through his employer. Accordingly, we sustain respondent's determination to include the $2,968 from the parent company in petitioner's income as Schedule C gross receipts for 2010.

IV. Deductions

Tax deductions are a matter of legislative grace, and the taxpayer bears the burden of proving entitlement to any deduction claimed. INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992); New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934). This burden requires the taxpayer to demonstrate that the claimed deductions are allowable pursuant to some statutory provision and to substantiate the expenses giving rise to the claimed deductions by maintaining and producing adequate records that enable the Commissioner to determine the taxpayer's correct liability. Sec. 6001; Higbee v. Commissioner, 116 T.C. 438, 440 (2001); Hradesky v. Commissioner, 65 T.C. 87, 89-90 (1975), aff'd per curiam, 540 F.2d 821 (5th Cir. 1976).

A. Schedule A Deductions for Unreimbursed Employee Business Expenses for the Years at Issue

Petitioner claimed Schedule A deductions for unreimbursed employee business expenses for the years at issue in the following categories as reported on his 2009 and 2010 Forms 2106-EZ: (1) passenger automobile expenses using the standard mileage rate for the years at issue; (2) business expenses other than passenger automobile expenses, parking fees, tolls, transportation, travel expenses, and meals and entertainment expenses for the years at issue; (3) travel expenses while away from home overnight for 2010; and (4) meal and entertainment expenses for 2010.

Section 162 allows a taxpayer to deduct all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. See sec. 162(a); sec. 1.162-1(a), Income Tax Regs. Generally, the performance of services as an employee constitutes a trade or business. Primuth v. Commissioner, 54 T.C. 374, 377 (1970). Unreimbursed employee business expenses are generally deductible under section 162(a), subject to the 2% floor of section 67(a).

A taxpayer cannot deduct employee business expenses to the extent he is entitled to reimbursement from his employer for those expenses. See Lucas v. Commissioner, 79 T.C. 1, 7 (1982). The taxpayer bears the burden of proving that he is not entitled to reimbursement from his employer for such expenses. See Fountain v. Commissioner, 59 T.C. 696, 708 (1973). The taxpayer can prove that he is not entitled to reimbursement by showing, for example, that he is expected to bear these costs. See id. at 708. An expense for which the taxpayer is entitled to (but does not claim) reimbursement from his employer is generally not considered "necessary" and thus is not deductible under section 162. Orvis v. Commissioner, 788 F.2d 1406, 1408 (9th Cir. 1986), aff'g T.C. Memo. 1984-533; Podems v. Commissioner, 24 T.C. 21, 22-23 (1955).

Whether an expense is deductible under section 162 is a question of fact to be decided on the basis of all the relevant facts and circumstances. Cloud v. Commissioner, 97 T.C. 613, 618 (1991) (citing Commissioner v. Heininger, 320 U.S. 467, 473-475 (1943)). Under the Cohan rule, if the taxpayer establishes that an expense is deductible but is unable to substantiate the precise amount, the Court may estimate the amount of the deductible expense, bearing heavily against the taxpayer whose inexactitude is of his own making. See Cohan v. Commissioner, 39 F.2d 540, 543-544 (2d Cir. 1930); see also Vanicek v. Commissioner, 85 T.C. 731, 742-743 (1985). In order for the Court to estimate the amount of a deductible expense, the taxpayer must establish some basis upon which an estimate may be made. Norgaard v. Commissioner, 939 F.2d 874, 879 (9th Cir. 1991), aff'g in part, rev'g in part T.C. Memo. 1989-390; Vanicek v. Commissioner, 85 T.C. at 742-743. Otherwise an allowance would amount to "unguided largesse." Norgaard v. Commissioner, 939 F.2d at 879 (quoting Williams v. United States, 245 F.2d 559, 560 (5th Cir. 1957)).

The Cohan rule, however, is superseded--that is, estimates are not permitted--for certain expenses specified in section 274, such as traveling expenses (including meals and lodging while away from home), entertainment expenses, and "listed property" (including passenger automobile) expenses. Secs.

274(d), 280F(d)(4)(A)(i); sec. 1.274-5T(a), Temporary Income Tax Regs., 50 Fed. Reg. 46014 (Nov. 6, 1985) (flush language); see Boyd v. Commissioner, 122 T.C. 305, 320 (2004). Instead, these types of expenses are subject to strict substantiation rules. Sanford v. Commissioner, 50 T.C. 823, 827 (1968), aff'd per curiam, 412 F.2d 201 (2d Cir. 1969); sec. 1.274-5T(a), Temporary Income Tax Regs., supra. These strict substantiation rules generally require the taxpayer to substantiate with adequate records or by sufficient evidence corroborating the taxpayer's own statement (1) the amount of the expense; (2) the time and place the expense was incurred; (3) the business purpose of the expense; and (4) in the case of an entertainment expense, the business relationship between the person entertained and the taxpayer. Balyan v. Commissioner, T.C. Memo. 2017-140, at *7; sec. 1.274-5T(b), Temporary Income Tax Regs., 50 Fed. Reg. 46014 (Nov. 6, 1985). For "listed property" expenses, including passenger automobile expenses, in addition to the time such expenses were incurred and their business purpose, the taxpayer must establish the amount of the business use and the total use of such property. Balyan v. Commissioner, at *7-*8; sec. 1.274-5T(b)(6)(i)(B), Temporary Income Tax Regs., 50 Fed. Reg. 46016 (Nov. 6, 1985). Generally, deductions for meal and entertainment expenses are subject to the 50% limitation imposed by section 274(n).

Substantiation by adequate records requires the taxpayer to maintain (1) an account book, diary, log, statement of expense, trip sheet, or similar record prepared contemporaneously with the expenditure and (2) documentary evidence, such as receipts or paid bills, which together provide each element of an expenditure. Balyan v. Commissioner, at *8; sec. 1.274-5(c)(2)(iii), Income Tax Regs.; sec. 1.274-5T(c)(2), Temporary Income Tax Regs., 50 Fed. Reg. 46017 (Nov. 6, 1985).

Petitioner testified that his employer did not reimburse expenses for travel within his designated geographical territory but it did reimburse for expenses, including out of pocket expenses, for travel outside of his designated geographical territory as well as expenses for large dinners and educational seminars. Petitioner did not produce a copy of his employer's reimbursement policy although he testified that he had a copy of it. While we find his testimony credible as to his employer's reimbursement policy, petitioner has failed to substantiate his expenses by adequate records or by sufficient evidence corroborating his own statement.

1. Passenger Automobile Expenses

Petitioner claimed deductions for expenses for his 2004 Mercedes, a passenger automobile, using the standard mileage rate, of $18,089 and $16,801 for 2009 and 2010, respectively. Expenses for a passenger automobile cannot be estimated because they are subject to the strict substantiation rules of section 274(d). See sec. 1.274-5(j)(2), Income Tax Regs. Respondent conceded that petitioner was entitled to a deduction of $7,907 for expenses for his 2004 Mercedes for 2009.

On his Forms 2106-EZ petitioner reported driving his 2004 Mercedes 32,889 miles for business, zero miles for commuting, and 3,162 miles for other purposes in 2009 and 33,601 miles for business, zero miles for commuting, and 1,889 miles for other purposes in 2010. Petitioner testified that his work with his employer and as an independent contractor for the medical sales company required him to travel to various medical facilities and hospitals within his designated geographical territory to sell medical equipment. Petitioner also testified that he traveled the same route from his home office to the same medical facilities and hospitals for both his employer and the medical sales company because the medical products complemented each other. Petitioner introduced monthly mileage logs for the years at issue and to substantiate the expenses for his 2004 Mercedes. Petitioner testified that the mileage reported in the mileage logs was attributable only to his travel within his designated geographical territory and not to travel outside that territory. The record does not indicate whether petitioner maintained the mileage logs contemporaneously. Even if they were maintained contemporaneously, we do not find that petitioner's mileage logs for the years at issue adequately meet the strict substantiation rules of section 274(d) or are credible.

The monthly mileage logs for the years at issue list four weeks per month from Monday to Friday without any corresponding dates and list the names of medical facilities or hospitals with a corresponding figure representing an alleged mileage calculation. The mileage logs fail to identify a business purpose for the miles recorded, including whether sales were made for his employer or the medical sales company or both at each location. According to the mileage logs, petitioner drove a total of 28,752 business miles and 11,849 business miles in 2009 and 2010, respectively, for his business, less than the figures reported on the Forms 2106-EZ for both years.

Furthermore, petitioner's mileage logs are also contradicted by a maintenance report petitioner introduced for his 2004 Mercedes. According to the maintenance report, petitioner's 2004 Mercedes was driven 32,986 total miles between April 24, 2009, and January 31, 2011, whereas petitioner reported on his mileage logs driving 40,601 business miles alone between May 2009 and December 2010.

Accordingly, we sustain respondent's disallowance of the Schedule A deductions for passenger automobile expenses for 2009 in excess of what respondent has already allowed, and 2010.[7]

2. Other Business Expenses

Petitioner also reported other business expenses of $9,864 and $9,481 for 2009 and 2010, respectively, in connection with his employment as a medical sales representative. Respondent conceded that petitioner was entitled to a deduction of (1) $175 for cellular phone services for 2009, (2) $1,200 for storage expenses for each of the years at issue, and (3) $1,531 for various other expenses for 2010. At trial petitioner did not testify or produce records to identify and substantiate any other business expenses for 2009 or 2010 in excess of what respondent has allowed. Petitioner has not established that these other expenses were paid or incurred or that they were ordinary and necessary. Accordingly, we sustain respondent's disallowance of the Schedule A deductions for other business expenses for the years at issue in excess of what respondent has already allowed.

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[7]The Court notes that for 2009 petitioner reported expenses of $18,089 for his 2004 Mercedes on both his Schedule A and Schedule C. In addition to the conceded Schedule A deduction of $7,907 for expenses for his 2004 Mercedes for 2009, respondent also conceded that petitioner was entitled to a Schedule C deduction of $7,907 for car and truck expenses for his medical sales trade or business for 2009 for the 2004 Mercedes.

3. Travel and Meal and Entertainment Expenses

Lastly, petitioner reported travel expenses while away from home overnight of $153 and meal and entertainment expenses of $25 for 2010. Travel and meal and entertainment expenses cannot be estimated because they are subject to the strict substantiation rules of section 274(d). Petitioner did not testify or produce documents to identify and substantiate these expenses. Petitioner thus has not established that these expenses were paid or incurred or that they were ordinary and necessary. We sustain respondent's disallowance of the Schedule A deductions for travel and meal and entertainment expenses for 2010.

B. Schedule A Deductions for Tax Preparation Fees for 2009 and 2010 and Attorney's and Accountant's Fees for 2009

Petitioner claimed Schedule A miscellaneous deductions (before application of the 2% floor of section 67(a)) of $89 and $106 for tax preparation fees for 2009 and 2010, respectively, and $1,963 for attorney's and accountant's fees for 2009. Petitioner testified that he used tax preparation software to prepare his 2009 and 2010 tax returns but did not provide any testimony to explain the attorney's and accountant's fees for 2009. Regardless, petitioner at trial did not offer any testimony or records or other sufficient evidence to substantiate these expenses.

We sustain respondent's disallowance of these Schedule A miscellaneous deductions for the years at issue.

C. Schedule A Deduction for Charitable Contributions for 2009

Petitioner claimed a Schedule A deduction of $18,414 for noncash contributions for 2009. A taxpayer may deduct charitable contributions made during the taxable year. Sec. 170(a)(1). A charitable contribution is defined as "a contribution or gift to or for the use of" a charitable organization. Sec. 170(c). However, deductions for charitable contributions are allowed only if the taxpayer satisfies statutory and regulatory substantiation requirements. See sec. 170(a)(1); sec. 1.170A-13, Income Tax Regs. The required substantiation depends on the size of the contribution and on whether it is a gift of cash or property.

For any contributions of cash, checks, or other monetary gifts, the taxpayer must substantiate each contribution with a bank record (i.e., canceled check) or a written communication (i.e., receipt or letter) from the charitable organization showing the name of the organization, the date of the contribution, and the amount of the contribution. Sec. 170(f)(17). For any contributions of property other than money, the taxpayer must substantiate each contribution with a receipt (e.g., letter or other written communication) from the charitable organization showing (1) the name of the organization, (2) the date and location of the contribution, and (3) a description of the property in reasonably sufficient detail (though the fair market value need not be stated). Sec. 1.170A-13(b)(1), Income Tax Regs.

For any contributions of $250 or more,[8] the taxpayer must substantiate the contribution with a "contemporaneous written acknowledgment" from the charitable organization. Sec. 170(f)(8)(A). The written acknowledgment must include: (1) the amount of cash and a description (but not the value) of any property other than cash contributed, (2) whether the charitable organization provided any goods or services in consideration for the contribution, and (3) a description and good-faith estimate of the value of any goods or services provided by the charitable organization, or if such goods and services consist solely of intangible religious benefits, a statement to that effect.[9] Sec. 170(f)(8)(B); sec. 1.170A-13(f), Income Tax Regs. The acknowledgment is "contemporaneous" if the taxpayer obtains it from the charitable organization on or before the earlier of: (1) the date the taxpayer files a tax return for the year of contribution or (2) the

[8]"Separate contributions of less than $250 are not subject to the requirements of sec. 170(f)(8), regardless of whether the sum of the contributions made by a taxpayer to a donee organization during a taxable year equals $250 or more." Sec. 1.170A-13(f)(1), Income Tax Regs.

[9]Sec. 170(f)(8)(D) provides an exception to the contemporaneous written acknowledgment requirement. Petitioner does not assert that this exception applies.

due date, including extensions, for filing that tax return. Sec. 170(f)(8)(C). In the absence of a contemporaneous written acknowledgment meeting the statute's requirements, "[n]o deduction shall be allowed". Sec. 170(f)(8)(A).

To substantiate a contribution exceeding $500 the taxpayer is required to maintain additional reliable written records for each item of donated property. Sec. 170(f)(11)(A); sec. 1.170A-13(b)(2) and (3), Income Tax Regs. These records must include, among other things: (1) the approximate date the property was acquired and the manner of its acquisition, (2) a description of the property in detail reasonable under the circumstances, (3) the cost or other basis of the property, (4) the fair market value of the property at the time it was contributed, and (5) the method used in determining its fair market value. Sec. 170(f)(11)(B); sec. 1.170A-13(b)(2)(ii)(C) and (D), 3(i), Income Tax Regs.

There are also more rigorous substantiation requirements for contributions of property exceeding $5,000. Sec. 170(f)(11)(C). To substantiate a contribution exceeding $5,000 the taxpayer must also (1) obtain a "qualified appraisal"[10] of the items and (2) attach to his tax return a fully completed "appraisal summary".[11]

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[10]Sec. 170(f)(11)(E)(i) and sec. 1.170A-13(c)(3)(ii), Income Tax Regs., provide rules governing the requirements for a qualified appraisal.

[11]Sec. 1.170A-13(c)(4), Income Tax Regs., provides the rules governing the (continued...)

Sec. 170(f)(11)(A), (C); sec. 1.170A-13(c)(2), Income Tax Regs. The IRS has prescribed Form 8283 to be used as the appraisal summary. Costello v. Commissioner, T.C. Memo. 2015-87, at *15; Jorgenson v. Commissioner, T.C. Memo. 2000-38, 2000 Tax Ct. Memo LEXIS 38, at *25.

"[S]imilar items of property" must be aggregated in determining whether gifts exceed the $500 or $5,000 thresholds. Sec. 170(f)(11)(F). The term "similar items of property" is defined as "property of the same generic category or type", such as clothing, furniture, electronic equipment, household appliances, toys, and everyday kitchenware. Sec. 1.170A-13(c)(7)(iii), Income Tax Regs.

On his 2009 Form 8283 petitioner reported that on March 10, 2009, he donated clothes, computers, and furniture to the donation center with an aggregate fair market value of $2,164; that the date acquired was "various"; that the contributed items were acquired by purchase; that he had a cost or adjusted basis in the contributed items of $10,478; and that "consignment shop" was the method used to determine the fair market value. On the 2009 Form 8283 petitioner also reported that he donated to the foundation new and unopened toys, household items, and money with an appraised fair market value of $16,250 and with

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[11](...continued)
requirements for an appraisal summary.

December 2009 as the date acquired; that the contributed items were acquired by purchase; that he had a cost or adjusted basis in the contributed items of $16,250; and that their overall physical condition was “brand new items unopened”. At trial petitioner argued that a portion of his noncash contributions also included the value of a vehicle--a 1998 Mercedes C280W (1998 Mercedes)--he had donated in 2009.

Respondent conceded that petitioner substantiated $3,709 of noncash charitable contributions[12] and $135 of cash charitable contributions[13] for 2009. Respondent contended that petitioner is entitled neither to a deduction for the remaining amount, $14,570, of noncash contributions to the donation center and the foundation nor to any deduction for the vehicle donation because of lack of substantiation. We agree with respondent.

With respect to the contribution of money to the foundation listed on his 2009 Form 8283, petitioner did not offer any testimony or records to identify and substantiate this cash contribution.

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[12]Respondent did not specify whether the conceded amount of $3,709 was attributable to noncash contributions to the donation center, the foundation, or both.

[13]Petitioner introduced at trial two letters from separate charitable organizations acknowledging receipt of his cash donations of $100 and $35.

At trial petitioner introduced (1) three handwritten receipts from the donation center dated March 10, April 4, and August 8, 2009, listing various donated items;[14] (2) four photographs of toys and individuals collecting the toys; (3) an in-kind donation form from the foundation for a donation on December 21, 2009, listing the donated items as "305 New Toys, 2 Bicycles, 1 Blanket" with an estimated value of $6,250; (4) a letter from the foundation dated January 11, 2010, acknowledging receipt of petitioner's "generous contribution of holiday gifts"; and (5) a bill of sale for the 1998 Mercedes, listing the date petitioner purchased the vehicle as December 24, 2007, for a cash value of $9,025.

With respect to the contributions of property, we must aggregate similar items to determine what substantiation was required because the aggregate values of the claimed contributions of property exceed $5,000. The property petitioner allegedly donated may be grouped into the following categories: clothing, furniture, electronic equipment, household items, household appliances, toys,

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[14]The March 10, 2009, receipt lists: "4 Computer Monitors, 6 Dell Desktop 6x270, 1 19" TV, 1 Office Chair, 1 Desk, 2 Bags of Clothing, 1 King Bed Set, 2 HP Printers, 1 Coffee table, bag of cookware, 1 Polaroid Camera, 1 Pair Boots, 15 Dress Shirts, 1 Mini Refrigerator--Pepsi". A portion of the April 4, 2009, receipt is cut off, including the year, because of how the document was copied, but respondent did not object to its being admitted on that basis. This receipt lists: "Clothing, Glass, Dishes, Christmas". The August 8, 2009, receipt lists: "1 HP Desktop Computer".

kitchenware, and a vehicle. Except with respect to the vehicle as discussed below, petitioner's failure to maintain adequate records makes it impossible to itemize values for each category in order to determine what substantiation was required for each category. Petitioner testified that the aggregate value of the property donated to the donation center was based on the value assigned by the donation center to similar items for sale at the time of the donation. He also testified that the aggregate estimated value he listed in the foundation's in-kind donation form, \$6,250, was based on the actual costs of the items. Petitioner contended that he had saved the receipts for each item to document his donation but had attached the receipt to the items when they were donated to the foundation. Petitioner testified that he had kept an itemized list of the donations to the foundation in a notebook where he had written the name of the item and the assigned value but no longer had this notebook.

Even so, petitioner failed to satisfy any of the substantiation requirements for the noncash contributions. He did not provide respondent or the Court with a contemporaneous written acknowledgment from the donation center or the foundation for the donations. Additionally, he did not maintain written records establishing when or how the donated items were acquired or their cost. Petitioner also did not maintain written records establishing how he calculated the fair market values for the donated items. Petitioner acknowledged at trial that he did not obtain a qualified appraisal for any of the donated items. Petitioner also did not attach a fully completed appraisal summary to his 2009 return; his 2009 Form 8283 lists "various" for the dates the items donated to the donation center were acquired and fails to contain the signature of petitioner, the appraiser, or the foundation for the items donated to the foundation. See sec. 1.170A-13(c)(4), Income Tax Regs. He therefore failed to satisfy the substantiation requirements for any contributions of property exceeding $250, $500, or $5,000 in value.

With respect to the contribution of the vehicle, petitioner contended that he donated the 1998 Mercedes in 2009. Section 170(f)(12)(A)(i) provides that a taxpayer is not entitled to a deduction for a contribution of a "qualified vehicle"[15] with a claimed value exceeding $500 unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgment[16] of the contribution by the charitable organization. Petitioner testified that he donated the vehicle to a women's charity whose name he could not remember. He acknowledged he did

[15]Sec. 170(f)(12)(E) provides rules governing the requirements for a qualified vehicle.

[16]Sec. 170(f)(12)(B) provides rules governing the requirements for a contemporaneous written acknowledgment to substantiate the contribution of a qualified vehicle.

not have a receipt to show to whom and when the vehicle was donated but believed he had valued the vehicle at around $9,000 using the Kelly Blue Book. Petitioner merely provided testimony and not any additional documentation to substantiate the vehicle donation, including a contemporaneous written acknowledgment or an appraisal summary for a donation of property exceeding $5,000. See sec. 170(f)(11)(C); sec. 1.170A-13(c)(2)(i)(B), Income Tax Regs.

We do not doubt that petitioner donated property to the donation center and the foundation in 2009. However, the Code imposes a series of increasingly rigorous substantiation requirements for larger gifts, especially when they consist of property rather than cash. Petitioner did not satisfy the substantiation requirements under section 170 and the regulations thereunder. Accordingly, we sustain respondent's disallowance of the Schedule A noncash charitable contribution deduction for 2009 in excess of what respondent has already allowed.

D. Schedule E Deduction for Repairs for 2009

Petitioner claimed a Schedule E deduction of $8,000 for repairs to the Travini property for 2009. Sections 162 and 212 generally permit a taxpayer to deduct ordinary and necessary business expenses paid or incurred during the taxable year in carrying on a trade or business or for the production of income. The taxpayer may deduct amounts paid for repairs and maintenance to property if the amounts paid are not otherwise required to be capitalized. Sec. 1.162-4(a), Income Tax Regs. Capital expenditures include amounts paid for permanent improvements or betterments made to increase the value of property. INDOPCO, Inc. v. Commissioner, 503 U.S. at 83; see sec. 263(a)(1).

Petitioner testified that he had installed granite countertops in the kitchen, carpets in the bedrooms, and hardwood floors in the remaining rooms of his rental property, the Travini property. Respondent contends that petitioner failed to substantiate that he paid the expenses in 2009 or the amounts of the expenses. In the alternative respondent argues that, even if petitioner did pay and substantiate the expenses, he is not entitled to deduct the cost of those repairs because they are capital expenditures. We agree with respondent that petitioner failed to substantiate that he had paid the expenses in 2009 and therefore do not need to address whether the expenditures are currently deductible or required to be capitalized.

Petitioner testified that he had placed receipts for the repairs in an envelope but could not find them. Petitioner introduced the following to substantiate the repairs to the Travini property: (1) an undated real estate listing that describes the upgrades, including "real wood flooring" and granite countertops in the kitchen; (2) a portion of an appraisal dated September 13, 2005, listing the flooring as

"Carpet/Vinyl(Good)"; (3) a document titled "Project Estimate Hardwood Install" from Lowe's Companies, Inc., dated February 21, 2006, listing a total estimate of \$3,820;[17] and (4) five undated photographs of hardwood floors and the installation of the countertops. While petitioner may have installed new hardwood floors, carpets, and granite countertops at the Travini property, he did not produce any documentation establishing that the renovations were paid for in 2009. We sustain respondent's disallowance of the Schedule E deduction for repairs for 2009.

E. Schedule D Deduction for Capital Loss for 2010

Petitioner reported a net long-term capital loss of \$42,702 on his 2010 Schedule D derived from the sale of the Munder Growth and Davis NY Venture shares, which resulted in a \$3,000 deduction after the limitations imposed by section 1211(b). Section 165(a) allows a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise. A loss from the sale or exchange of a capital asset is allowed as a deduction only to the extent permitted in sections 1211 and 1212. Sec. 165(f). Section 1211(b) allows

[17]On the basis of petitioner's testimony at trial, the Court held the record open for the limited purpose of giving petitioner an opportunity to proffer certain evidence in support of certain claimed deductions. One of the proffered documents was this estimate, to which respondent reserved an objection on grounds of relevance and authenticity. We overrule respondent's objection.

noncorporate taxpayers to deduct losses on the sale or exchange of capital assets to the extent of the gain from such sales or exchanges, plus the lower of: (1) $3,000 or (2) the excess of such losses over such gains.

To be entitled to a deduction under section 165(a), a taxpayer is required to keep records to establish the deduction to which he is entitled. Sec. 6001. To deduct a section 165(a) loss from the sale or exchange of a capital asset the taxpayer must establish, among other things, his cost or adjusted basis for purposes of determining the loss he must recognize on a sale of the capital asset. See secs. 165(f), 1001(a), (c). The loss is equal to the excess of the adjusted basis over the amount realized. See secs. 1001(a) and (b), 1011(a). In certain circumstances, we may use the Cohan rule to estimate a taxpayer's basis in an asset at the time of transfer. See Grp. Admin. Premium Servs., Inc. v. Commissioner, T.C. Memo. 1996-451, 1996 Tax Ct. Memo LEXIS 469, at *37 n.16. For the Court to estimate basis, the taxpayer must provide some reasonable evidentiary basis for the estimate. Vanicek v. Commissioner, 85 T.C. at 742-743.

Respondent disputes petitioner's reported adjusted bases of $50,250 in the Munder Growth shares and $1,500 in the Davis NY Venture shares and, in turn, the resulting realized long-term capital losses of $42,250 and $452, respectively, from the sales of his shares on October 13, 2010. Respondent conceded that petitioner substantiated a cost basis of $755 in the Davis NY Venture shares. However, respondent contends that petitioner has not substantiated any adjusted basis in the Munder Growth shares or an adjusted basis greater than $755 in the Davis NY Venture shares. On the basis of these contentions, respondent argues that, rather than capital losses, petitioner realized long-term capital gains of $8,000 in the Munder Growth shares and $293 in the Davis NY Venture shares in 2010.

Petitioner introduced at trial a UBS PaineWeber Resource Management Account statement (UBS statement) for the month of April 2003, the month before he acquired the Munder Growth and Davis NY Venture shares he sold on October 13, 2010. The UBS statement provided a summary of the values of the Munder NetNet Fund Class A (Munder NetNet Fund) shares and the Davis NY Venture shares, among other investments, that petitioner already owned in April 2003.[18] According to the UBS statement, the Munder NetNet Fund shares were valued at $12.22 per share and the Davis NY Venture shares were valued at $21.52 per share in April 2003.

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[18]According to the UBS statement, petitioner had previously purchased Munder NetNet Fund shares on April 13, 2000, and Davis NY Venture shares on April 4, 2001. Petitioner had an adjusted basis of $755 in the Davis NY Venture shares he had purchased on April 4, 2001.

We find that petitioner has substantiated an aggregate adjusted basis in the Munder Growth shares of $12.22 per share for a total adjusted basis of $3,741. Respondent did not dispute in the notice of deficiency, at trial, or on brief that petitioner acquired 306.1620 Munder Growth shares on May 15, 2003. Petitioner testified that, although his 2010 Schedule D lists the shares as "Munder Growth Opportunities Fund Class A", the shares he sold were Munder NetNet Fund shares, implying that the fund had changed names sometime between the acquisition and sale dates. We find credible the implication that the mutual fund changed names during the course of petitioner's ownership of its shares. Under the Cohan rule, we find that the UBS statement serves as a reasonable evidentiary basis for an estimate. According to the UBS statement, the Munder Growth shares were priced at $12.22 per share in April 2003, about a month before petitioner purchased the 306.1620 shares he sold in 2010. We therefore conclude that petitioner has substantiated an aggregate adjusted basis of $3,741 (306.1620 shares purchased multiplied by $12.22 per share) in the 306.1620 Munder Growth shares he purchased on May 15, 2003. Consequently, petitioner realized a long-term capital gain of $4,259 ($8,000 sale price over $3,741 adjusted basis) from the sale of the 306.1620 Munder Growth shares in 2010.

Petitioner has not, however, substantiated an adjusted basis in the Davis NY Venture shares in excess of the amount respondent has conceded. The UBS statement does not support such a finding. Petitioner is therefore not allowed an additional adjusted basis in excess of the $755 respondent has conceded.[19] Consequently, petitioner realized a long-term capital gain of $293 ($1,048 sale price over $755 adjusted basis) from the sale of the 32.3450 Davis NY Venture shares in 2010.

Accordingly, we conclude that petitioner did not realize a net long-term capital loss but instead realized a net long-term capital gain of $4,552, consisting of a realized long-term capital gain of $4,259 from the sale of the Munder Growth shares and $293 from the sale of the 32.3450 Davis NY Venture shares in 2010. We sustain respondent's disallowance of the Schedule D net long-term capital loss deduction.

V. Credits

Credits, like deductions, are a matter of legislative grace, and a taxpayer bears the burden of proving that he is entitled to any credit claimed. See Rule

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[19]Respondent did not explain how he arrived at the conceded adjusted basis of $755 in petitioner's Davis NY Venture shares. That amount, perhaps coincidentally, corresponds to petitioner's adjusted basis in the Davis NY Venture shares he purchased on April 4, 2001, as reported on the UBS statement. See supra note 18.

142(a); Deputy v. du Pont, 308 U.S. 488, 493 (1940); New Colonial Ice Co. v. Helvering, 292 U.S. at 440; Segel v. Commissioner, 89 T.C. 816, 842 (1987).

A. Energy Credits for 2009 and 2010

Petitioner claimed a residential energy efficient property credit of $2,130 for 2009 and a nonbusiness energy property credit of $183 for 2010 related to the Bimini property. Section 25D(a) allows a taxpayer a residential energy efficient property credit (section 25D credit) against tax in an amount equal to the sum of the following expenditures made by the taxpayer during the year: (1) 30% of qualified solar electric property expenditures, (2) 30% of qualified solar water heating property expenditures, (3) 30% of qualified fuel cell property expenditures, (4) 30% of qualified small wind energy property expenditures, and (5) 30% of qualified geothermal heat pump property expenditures.[20] Section 25C(a) allows the taxpayer a nonbusiness energy property credit (section 25C credit) against tax in an amount equal to 30% of the sum of the following expenditures by the taxpayer during the year: (1) the amount paid for qualified energy efficiency improvements and (2) the amount paid for residential energy

[20]Sec. 25D(d) defines each type of expenditure.

property expenditures.[21] The section 25C credits allowed for 2009 and 2010 under section 25C(a) cannot exceed $1,500 in the aggregate. Sec. 25C(b).

According to his 2009 Form 5695, petitioner claimed a section 25D credit of 30%, or $2,130, based on "qualified geothermal heat pump property" costs of $7,100. "Qualified geothermal heat pump property" is any equipment that "uses the ground or ground water as a thermal energy source to heat * * * [the taxpayer's residence] or as a thermal energy sink to cool * * * [the taxpayer's residence], and * * * meets the requirements of the Energy Star program" in effect at the time the expenditure was made. Sec. 25D(d)(5)(B). Petitioner argues that the section 25D credit was based on his purchases of an air conditioning system and four solar-powered vent fans in 2009.

The parties agree that petitioner substantiated the purchase of an air conditioning system for $6,250 for 2009. However, respondent contends that petitioner is entitled to a section 25C credit, not a section 25D credit, because the air conditioning system does not meet any of the definitions of the property qualifying for a section 25D(a) credit. Under that premise, respondent conceded that petitioner is entitled to a section 25C credit equal to 30% of the cost of the air

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[21]Sec. 25C(c) and (d) defines a "qualified energy efficiency improvements" and "residential energy property expenditures", respectively.

conditioning unit, or $1,875, but that the amount is limited to $1,500 pursuant to section 25C(b).

Petitioner introduced at trial (1) an invoice from Crums Climate Control, Inc. (invoice), dated April 28, 2009, and (2) a Certificate of Product Ratings by the Air-Conditioning, Heating, and Refrigeration Institute (AHRI certificate) dated October 22, 2009. The invoice, among other things, describes the air conditioning system as an "A/C Condenser 4 Ton Heatpump York 2 Speed 140A" and lists five components of the air conditioning system with a model number for each component. The AHRI certificate is for a product listed as "Split System: Heat Pump with Remote Outdoor Unit-Air-Source" consisting of an outdoor and an indoor component. The model numbers for these two components match the model numbers of two out of the five components listed in the invoice. The AHRI certificate states: "This combination qualifies for a Federal Energy Efficiency Tax Credit when placed in service between Feb 17, 2009 and Dec 31, 2010". Petitioner argues that the AHRI certificate certifies his eligibility for the section 25D credit. Respondent argues that neither the invoice nor the AHRI certificate mentions the words "solar", "fuel cell", "wind", or "geothermal".

The IRS issued Notice 2009-41, 2009-19 I.R.B. 933, to provide interim guidance for the procedures that manufacturers could follow to certify property as eligible for the section 25D credit and the conditions under which a taxpayer claiming the section 25D credit could rely on the manufacturer's certification. The notice states:

> (2) Taxpayer Reliance. * * * [A] taxpayer may rely on a manufacturer's certification in determining whether property is eligible for the credit under § 25D. A taxpayer is not required to attach the certification statement to the return on which the credit is claimed. However, § 1.6001-1 (a) of the Income Tax Regulations requires that taxpayers maintain such books and records as are sufficient to establish the entitlement to, and amount of, any credit claimed by the taxpayer. Accordingly, a taxpayer claiming a credit for residential energy efficient property should retain the certification statement as part of the taxpayer's records for purposes of § 1.6001-1(a).

Notice 2009-41, sec. 3.02(2), 2009-19 I.R.B. at 934. However, the AHRI certificate is not a manufacturer's certificate because it specifically lists the manufacturers for the outdoor and indoor components as "York, Unitary Products Group" and "Advanced Distributor Products", respectively. Further, the AHRI certificate does not contain the required content to constitute a valid manufacturer's certificate statement.[22] Id. sec. 3.02(1). Petitioner did not present

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[22]The IRS notice requires that the manufacturer's certification statement contain the following: (1) the name and address of the manufacturer; (2) identification of the property as a solar electric property, solar water heating property, fuel cell property, small wind energy property, or geothermal heat pump property; (3) the make, model number, and any other appropriate identifiers of the property; and (4) a declaration, signed by an authorized person. Notice 2009-41,

(continued...)

any other additional documentation to support his claim for a section 25D credit for the air conditioning system expenditures.

With respect to the solar-powered vent fans, petitioner testified that he purchased four fans for $175 each in 2009. Petitioner introduced at trial (1) five undated photographs of the installed solar-powered vent fans and (2) an Amazon.com printout dated May 3, 2016, of a “DC HOUSE 25W Solar Powered Attic Ventilator Gable Roof Vent Fan with 30W Foldable Solar Panel”. Petitioner argues that the photographs demonstrate he purchased the solar-powered vent fans and that the Amazon.com printout demonstrates the price he paid. However, neither the photographs nor the printout establishes that the expenditures were made in 2009. We therefore do not need to decide whether the solar-powered vent fans qualified for the section 25D credit for 2009.

According to his 2010 Form 5695, petitioner claimed a section 25C credit of 30%, or $183, based on a “qualified natural gas, propane, or oil furnace or hot water boiler”. Petitioner presented at trial (1) four undated photographs of the installation of a tankless electric water heater and (2) an undated one-page advertisement for “Tempra Whole House Tankless Electric Water Heaters”. Here

[22](...continued)
sec. 3.02(3), (5), 2009-19 I.R.B. 933, 934.

too, neither the photographs nor the advertisement establishes that the expenditures were made in 2010. We therefore do not need to decide whether the water heater qualified for the section 25C credit for 2010. Even if petitioner had substantiated the expenditures for the water heater for 2010, he had already reached the $1,500 limitation for 2009 alone; and therefore under section 25C(b) he would not be allowed any credit for qualified property for 2010.

In sum, we sustain respondent's disallowance of the section 25D credit for 2009, and petitioner is entitled a section 25C credit of $1,500 as respondent conceded. We also sustain respondent's disallowance of the section 25C credit for 2010.

B. First-Time Homebuyer Credit for 2010

Petitioner claimed a first-time homebuyer credit (FTHB credit) of $5,625 for 2010. Section 36(a) allows a first-time homebuyer of a principal residence a credit against tax of 10% of the purchase price of the principal residence. For purposes of this section, the term "principal residence" has the same meaning as in section 121. Sec. 36(c)(2). A first-time homebuyer is any individual who has had no present ownership interest in a principal residence during the three-year period ending on the date of the purchase of the principal residence in question. Sec.

36(c)(1). Section 36(c)(6) expands the scope of the FTHB credit by making it available to "long-time residents":

> In the case of an individual * * * who has owned and used the same residence as such individual's principal residence for any 5-consecutive-year period during the 8-year period ending on the date of the purchase of a subsequent principal residence, such individual shall be treated as a first-time homebuyer for purposes of this section with respect to the purchase of such residence.

The FTHB credit is available only for a principal residence purchased on or after April 9, 2008, and before May 1, 2010. Sec. 36(h)(1). Where the taxpayer enters into a written binding contract before May 1, 2010, the purchase deadline is extended to October 1, 2010. Sec. 36(h)(2).

The parties at trial, and respondent on brief, contended that petitioner claimed the FTHB credit for the McLeod property, even though petitioner's 2010 Form 5405 listed the Marathon property as the home qualifying for the FTHB credit.[23] Regardless of the property purchased, petitioner does not qualify for the first-time homebuyer credit because he failed to prove he entered into a written binding contract for the purchase before May 1, 2010.

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[23]Line A of the 2010 Form 5405 states: "Address of the home qualifying for the credit(if different from the address shown on page 1 of Form 1040 or Form 1040X)". Petitioner's 2010 return listed the McLeod property as his home address.

On his Form 5405 petitioner reported that he purchased the residence on June 1, 2010, and at trial testified that he purchased the residence in June or July 2010. Petitioner therefore fails to meet the purchase deadline--May 1, 2010--under section 36(h)(1). To qualify for the extended purchase deadline--October 1, 2010--under section 36(h)(2), petitioner must establish that he entered into a written binding contract before May 1, 2010. Petitioner did not offer any testimony or documentation on when he entered into a written binding contract for either property. We sustain respondent's disallowance of the first-time homebuyer credit for 2010.

VI. Additions to Tax

Finally, we address whether petitioner is liable for additions to tax under section 6651(a)(1) for failure to timely file his returns for the years at issue.

Section 6651(a)(1) imposes an addition to tax for a taxpayer's failure to file a required Federal income tax return on or before the specified filing date, including extensions. As noted supra p.11, the Commissioner bears the burden of production with respect to any addition to tax. Sec. 7491(c). The Commissioner satisfies his burden of production by providing sufficient evidence to show that the taxpayer filed his Federal income tax return late. Wheeler v. Commissioner, 127 T.C. 200, 207-208 (2006), aff'd, 521 F.3d 1289 (10th Cir. 2008); Higbee v. Commissioner, 116 T.C. at 447.

The record includes petitioner's returns for 2009 and 2010, which were required to be filed by April 15, 2010, and April 18, 2011, respectively, see sec. 1.6072-1, Income Tax Regs., but were filed past these specified filing dates on September 6, 2011, and October 3, 2011,[24] respectively. Respondent has therefore met his burden of production with respect to the additions to tax under section 6651(a)(1) for the years at issue.

Application of the section 6651(a)(1) addition to tax may be avoided if the taxpayer shows that the failure to timely file was due to reasonable cause and not due to willful neglect. "If the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time, then the delay is due to a reasonable cause." Sec. 301.6651-1(c)(1), Proced. & Admin. Regs. The taxpayer can show that he did not act with "willful neglect" if he can "prove that the late filing did not result from a 'conscious, intentional failure or reckless indifference.'" Niedringhaus v. Commissioner, 99 T.C. 202, 221 (1992) (quoting United States v. Boyle, 469 U.S. 241, 245-246 (1985)). The

[24]The parties stipulated that petitioner's 2010 return was filed late without an extension.

burden of showing reasonable cause under section 6651(a)(1) remains with petitioner. See Higbee v. Commissioner, 116 T.C. at 447-448.

Petitioner argues that he filed his returns for the years at issue late because he did not have some of the information necessary to complete these returns by the filing deadlines and he believed an extension was required only if the return resulted in a tax liability, not a refund. Such a belief does not establish reasonable cause or a lack of willful neglect. See Calloway v. Commissioner, 135 T.C. 26, 45-46 (2010) (finding that the taxpayers' belief that they would be entitled to a refund established neither reasonable cause nor the absence of willful neglect), aff'd, 691 F.3d 1315 (11th Cir. 2012).

Petitioner also argues that his health was not good in the years at issue. He testified that he suffered, and continues to suffer, from a medical condition that required him to have continuous blood and other lab work. Petitioner also testified that he suffered with sleep problems, low energy levels, and depression and that he was on medication during 2009 and 2010. Respondent argues that petitioner did not introduce any evidence showing that he was incapacitated when his returns for 2009 and 2010 were due or how his health problems prevented him from timely filing these returns. We agree with respondent.

Although we are sympathetic to petitioner's health problems, a taxpayer's selective inability to perform his or her tax obligations while performing his regular business and personal activities does not excuse his failure to file. See Godwin v. Commissioner, T.C. Memo. 2003-289, 2003 Tax Ct. Memo LEXIS 292, at *27. Despite his health problems, petitioner engaged in many normal activities, including being gainfully employed, driving throughout his designated geographical territory each week for work, managing his rental property, purchasing a third home, and engaging in charitable endeavors.

On the basis of the record before us, we find that petitioner did not have reasonable cause for failing to timely file his returns for the years at issue, and we sustain the additions to tax under section 6651(a)(1) for the years at issue.

We have considered all of the arguments made by the parties and, to the extent they are not addressed herein, we find them to be moot, irrelevant, or without merit.

To reflect the foregoing,

Decision will be entered under Rule 155.

T.C. Memo. 2018-164

UNITED STATES TAX COURT

MARC CHREM AND ESTHER CHREM, ET AL.,[1] Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 23516-16, 23517-16, 25417-16, 25418-16, 25419-16, 25420-16, 25421-16, 25422-16, 25423-16, 25424-16, 25425-16.

Filed September 26, 2018.

Brian B. Snarr and Michael Craig Weinstein, for petitioners.

Patrick F. Gallagher, Rose E. Gole, and Gennady Zilberman, for respondent.

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[1]Cases of the following petitioners are consolidated herewith: Jacqueline Ashkenazi, docket No. 23517-16; Albert Ashkenazi, docket No. 25417-16; David I. Ashkenazi and Linda Yedid, docket No. 25418-16; Ely I. Ashkenazi and Paulina Ashkenazi, docket No. 25419-16; Isaac E. Ashkenazi, docket No. 25420-16; Jack E. Ashkenazi, docket No. 25421-16; Joseph E. Betesh and Sally Ashkenazi, docket No. 25422-16; Saul E. Ashkenazi and Pauline J. Salame, docket No. 25423-16; Mark Chraime and Barbara Chraime, docket No. 25424-16; and Ralph Gindi and Grace Gindi, docket No. 25425-16.

[*2] MEMORANDUM OPINION

LAUBER, Judge: These consolidated cases are before the Court on the parties' cross-motions for partial summary judgment. Petitioners (along with eight other individuals or couples) owned 100% of the stock of Comtrad Trading, Ltd. (Comtrad), a closely held Hong Kong corporation. A related company proposed to purchase 100% of Comtrad's stock for $4,500 per share. After Comtrad's shareholders agreed to tender about 87% of their shares, petitioners donated the balance of their stock to a charitable organization. The acquiring company then completed the acquisition, purchasing the donated stock for $4,500 per share.

On their 2012 Federal income tax returns, petitioners claimed charitable contribution deductions for their gifts, valuing the donated stock at $4,500 per share. In timely notices of deficiency the Internal Revenue Service (IRS or respondent) determined that petitioners were liable for tax under the assignment of income doctrine on their transfers of stock to the charity. The IRS also determined that petitioners had failed to obtain and (where applicable) attach to their returns "qualified appraisals" of the donated property. See sec. 170(f)(11)(C) and (D).[2]

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[2]All statutory references are to the Internal Revenue Code (Code) in effect for the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure. We round all monetary amounts to the nearest dollar.

[*3] Petitioners seek summary judgment with respect to the first determination, and the parties have filed cross-motions for summary judgment with respect to the second pair of determinations. Concluding that material disputes of fact exist, we will deny all the motions.

Background

The following facts are drawn from the parties' pleadings, motion papers, and the declarations and exhibits attached thereto. These facts are stated solely for purposes of ruling on the pending motions for summary judgment, not as findings of fact in these cases. See Rule 1(b); Fed. R. Civ. P. 52(a); Cook v. Commissioner, 115 T.C. 15, 16 (2000), aff'd, 269 F.3d 854 (7th Cir. 2001). All petitioners resided in New York when they filed their petitions.

Formed in August 2001, Comtrad was a Hong Kong corporation that did business in Hong Kong and Shenzhen, China. As of October 2012 it had 7,000 shares of outstanding common stock, 5,425 of which were owned by petitioners. Eight other individuals or couples, some of whom appear to have family ties to petitioners, owned the remaining 1,575 shares.

Comtrad performed testing and quality control services for three related companies that produced and marketed consumer electronic products. Comtrad selected suppliers, took title to component parts manufactured by those suppliers,

[*4] performed testing on those components to verify specifications and ensure quality, and managed the logistics of delivering the components to its customers. Comtrad received for its services commissions ranging between 3.5% and 8%, computed as markups on its total costs.

Comtrad's principal customer was SDI Technologies, Inc. (SDI), which manufactured and marketed a broad range of consumer electronic products, including clock radios, home audio systems, headphones, and computer accessories. SDI accounted for 83% of Comtrad's revenue and 76% of its gross profit in 2011.

SDI is a U.S. corporation that elected to be treated as an S corporation for Federal income tax purposes. Virtually all of SDI's stock was owned during 2012 by an employee stock ownership plan (ESOP).[3] Petitioners and other Comtrad shareholders appear to have been beneficiaries of the ESOP. SDI and Comtrad were also related through common management. A majority of each company's board of directors served as directors for both companies.

In late 2012 SDI made a proposal to acquire 100% of Comtrad's stock. The stated purposes of this acquisition were: (1) to recapture for SDI the commissions

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[3]An ESOP is a tax-exempt plan that invests primarily in the securities of its sponsoring employer. See Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. No. 93-406, sec. 2003(e)(7), 88 Stat. at 976 (codified as amended at sec. 4975(e)(7)).

[*5] it had been paying Comtrad, (2) to achieve greater vertical integration and control over product sourcing in Asia, (3) to give SDI control of certain trademarks held by Comtrad, and (4) to "take advantage of the favorable tax treatment that would be afforded Comtrad's net earnings due to SDI's status as an S corporation" whose shares were owned by an ESOP.

It was proposed that the stock acquisition would proceed in two steps. SDI would first purchase 6,100 Comtrad shares from petitioners and the other Comtrad shareholders. The proposed purchase price was $4,500 per share, for a total of $27,450,000. The consideration paid by SDI for this tranche was to consist of $450,000 in cash and $27 million in subordinated 15-year promissory notes bearing 8% annual interest.

The second step involved the remaining 900 shares of Comtrad's outstanding stock. In connection with SDI's acquisition of the 6,100 shares, petitioners agreed to donate 900 shares to the Jewish Communal Fund (JCF), an organization exempt from Federal income tax under section 501(a) and (c)(3). SDI agreed to purchase each share tendered by JCF for $4,500 in cash.

Petitioners agreed, after donating their shares to JCF, "to use all reasonable efforts" to cause JCF to tender the 900 shares to SDI. If the donors failed to persuade JCF to do this, it was expected that SDI would use a "squeeze-out merger, a

[*6] reverse stock split or such other action that will result in SDI owning 100% of * * * Comtrad." If SDI failed to secure ownership of JCF's shares within 60 days of acquiring the 6,100 shares, the entire acquisition would be reversed out and SDI would return the 6,100 shares to the tendering Comtrad shareholders.

As noted above, virtually all (99.9%) of SDI's shares were owned by an ESOP. Because SDI and Comtrad were related parties, the trustee for the ESOP believed that ERISA[4] required it to secure a fairness opinion to ensure that SDI paid no more than "adequate consideration" for the Comtrad stock. See 29 U.S.C. secs. 1106(a) (generally prohibiting transactions between ERISA plans and parties in interest), 1108(b)(17)(A) (permitting such transactions if the plan pays no more than "adequate consideration"), 1002(18)(B) (defining adequate consideration by reference to "the fair market value * * * as determined in good faith by the trustee" in accordance with regulations promulgated by the Secretary of Labor).

The ESOP trustee hired Empire Consultants, LLC (Empire), to provide a fairness opinion supported by a valuation report. In describing the proposed transaction, Empire expressed its understanding that SDI would acquire 100% of Comtrad's stock "in two stages." "The first stage," according to Empire, "involves the

[4]ERISA is an acronym for the Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (codified as amended at various sections of 29 U.S.C. (2012)).

[*7] acquisition of 6,100 shares, or approximately 87.1%, of Comtrad's outstanding ordinary shares," for $27,450,000 in cash and promissory notes. "Simultaneously with SDI's acquisition of the 6,100 shares," Empire stated, "certain of Comtrad's shareholders will transfer 900 shares" to JCF. "The second stage of the Proposed Transaction involves the acquisition of the JCF shares for $4,500 per share or $4.05 million in aggregate."

Using regulatory guidelines and professional standards that it deemed relevant,[5] Empire provided its estimate of the fair market value (FMV) of "100% of the ordinary shares of Comtrad * * *." It employed a market approach and a discounted cashflow approach, and it applied a 5% downward adjustment to reflect a discount for lack of marketability.[6] It concluded that the FMV of Comtrad, "valued on a going concern basis," was between $29.5 million and $32.4 million, or $4,214 to $4,626 per share.

Empire submitted its findings to the ESOP trustee in a "restricted use appraisal report" dated December 8, 2012, and a fairness opinion dated December 10, 2012 (collectively, Empire report). Given the range of FMVs it determined for

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[5]Empire stated that it performed its appraisal according to guidelines set by the Department of Labor, the IRS, and the American Society of Appraisers.

[6]In explaining this relatively small discount, Empire "note[d] that the appropriate level of discount is materially less on a control block than it would be on a minority interest block."

[*8] Comtrad, Empire opined that the proposed transaction was fair to the beneficiaries of SDI's ESOP. Empire emphasized that its report was for the "the sole use of * * * [the ESOP trustee] in its fiduciary capacity" and could "not be used for any other purpose or by any other user(s) without the express consent of Empire." Empire expressly stated that its appraisal "does not take into consideration any tax consequences related to Comtrad's selling shareholders."

On December 12, 2012, two days after the date of Empire's fairness opinion, SDI purchased 6,100 shares of Comtrad stock from petitioners and the other Comtrad shareholders. The parties dispute when petitioners donated their 900 shares to JCF; petitioners assert that these donations occurred on December 5, whereas respondent contends that they occurred no earlier than December 10, allegedly after JCF unconditionally agreed to sell the 900 shares to SDI. But the parties agree that JCF formally tendered its 900 shares to SDI on December 12, the same day on which the other Comtrad shareholders tendered their shares. And the parties agree that JCF received the same per-share price, $4,500, that the other Comtrad shareholders received, but that JCF was paid entirely in cash.

All petitioners timely filed (sometimes jointly) Forms 1040, U.S. Individual Income Tax Return, for 2012. On their respective Schedules A,

[*9] Itemized Deductions, petitioners claimed noncash charitable contributions for the stock they donated to JCF, as follows:

Petitioner(s)	Docket No.	Shares contributed	Claimed deduction
Marc Chrem & Esther Chrem	23516-16	45	$202,500
Jacqueline Ashkenazi	23517-16	45	202,500
Albert Ashkenazi	25417-16	125	562,500
David I. Ashkenazi & Linda Yedid	25418-16	90	405,000
Ely I. Ashkenazi & Paulina Ashkenazi	25419-16	90	405,000
Isaac E. Ashkenazi	25420-16	125	562,500
Jack E. Ashkenazi	25421-16	125	562,500
Joseph E. Betesh & Sally Ashkenazi	25422-16	35	157,500
Saul E. Ashkenazi & Pauline J. Salame	25423-16	125	562,500
Mark Chraime & Barbara Chraime	25424-16	50	225,000
Ralph Gindi & Grace Gindi	25425-16	45	202,500
Total		900	4,050,000

When a taxpayer makes a charitable contribution of property (other than publicly traded securities) valued in excess of $5,000, he is required to secure a “qualified appraisal.” Sec. 170(f)(11)(C). If he claims a value in excess of $500,000 for such property, he is required to attach a copy of the appraisal to his

[*10] return. Sec. 170(f)(11)(D). None of petitioners secured for their contributions, or attached to their returns, an appraisal that was addressed to them.

However, each of petitioners' returns included an "appraisal summary" on Form 8283, Noncash Charitable Contributions. In Part I of these forms, captioned "Information on Donated Property," petitioners noted the number of Comtrad shares that each had donated. They stated that they had acquired those shares by purchase and supplied their respective cost bases for the donated shares. Gregory Sullivan, the managing director of Empire who had signed the fairness opinion issued to the ESOP trustee, signed the "Declaration of Appraiser" on each Form 8283. Saul Wadowski, an officer of JCF, signed the "Donee Acknowledgment" on each form, which listed December 5, 2012, as the date on which JCF had received the donated stock.

The IRS selected all of petitioners' returns for examination and requested that they supply qualified appraisals to substantiate their claimed deductions. In response each petitioner supplied a copy of the report that Empire had prepared for the ESOP trustee. The IRS issued notices of deficiency to all petitioners, determining that they were liable for tax under the anticipatory assignment of income doctrine on their transfers of shares to JCF. The IRS also disallowed in full the claimed charitable contribution deductions for failure to satisfy the

[*11] requirements of section 170(f)(11). Finally, the IRS determined that petitioners were liable for 20% accuracy-related penalties under section 6662(a) and, in the alternative, 40% "gross valuation misstatement" penalties under section 6662(h).

Petitioners timely petitioned this Court for redetermination. On February 1, 2017, the Court consolidated the 11 cases for purposes of trial, briefing, and opinion. On March 8, 2018, respondent filed his motion for partial summary judgment. Petitioners filed their cross-motion one week later.

Discussion

I. Summary Judgment Standard

The purpose of summary judgment is to expedite litigation and avoid costly, time-consuming, and unnecessary trials. Fla. Peach Corp. v. Commissioner, 90 T.C. 678, 681 (1988). Under Rule 121(b), we may grant summary judgment when there is no genuine dispute as to any material fact and a decision may be rendered as a matter of law. Sundstrand Corp. v. Commissioner, 98 T.C. 518, 520 (1992), aff'd, 17 F.3d 965 (7th Cir. 1994). In deciding whether to grant summary judgment, we construe factual materials and inferences drawn from them in the light most favorable to the nonmoving party. Id.; see Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 255 (1986). However, the nonmoving party may not rest upon the

[*12] mere allegations or denials in his pleadings but instead must set forth specific facts showing that there is a genuine dispute for trial. Rule 121(d); see Sundstrand Corp., 98 T.C. at 520.

II. Assignment of Income

Petitioners seek summary judgment on respondent's application of the assignment of income doctrine to their donations of stock. A longstanding principle of tax law is that income is taxed to the person who earns it. United States v. Basye, 410 U.S. 441, 450 (1973) ("[H]e who earns income may not avoid taxation through anticipatory arrangements no matter how clever or subtle[.]"). Thus, a person anticipating receipt of income "cannot avoid taxation by entering into a contractual arrangement whereby that income is diverted to some other person." Id. at 449 (citing Lucas v. Earl, 281 U.S. 111, 115 (1930)).

This Court has previously considered the assignment of income doctrine as applied to charitable contributions. In the typical scenario, the taxpayer donates to a charity stock that is about to be acquired by the issuing corporation via redemption, or by another corporation via merger or acquisition. In determining whether the taxpayer has assigned income in these circumstances, one relevant question is whether the prospective acquisition is a mere expectation or a virtual certainty. "More than expectation or anticipation of income is required before the

[*13] assignment of income doctrine applies." Greene v. United States, 13 F.3d 577, 582 (2d Cir. 1994).[7]

Another relevant question is whether the charity is obligated, or can be compelled by one of the parties to the transaction, to surrender the donated shares to the acquirer. Rev. Rul. 78-197, 1978-1 C.B. 83 (1978); see Rauenhorst v. Commissioner, 119 T.C. 157, 166 (2002) (finding "the donee's control to be * * * an important factor"). The existence of an "understanding" among the parties, or the fact that transactions occur simultaneously or according to prearranged steps, may be relevant in answering that question. See, e.g., Blake v. Commissioner, 697 F.2d 473, 480 (2d Cir. 1982) (stating that an "understanding" among the parties need not be "legally enforceable under state law"), aff'g T.C. Memo. 1981-579; Ferguson v. Commissioner, 108 T.C. 244 (1997) (finding assignment of income with respect to proceeds of merger that occurred contemporaneously with charitable contribution), aff'd, 174 F.3d 997 (9th Cir. 1999).

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[7]Compare, e.g., Palmer v. Commissioner, 62 T.C. 684, 695 (1974) (finding no assignment of income where stock was transferred before corporation had voted to redeem it), aff'd, 523 F.2d 1308 (8th Cir. 1975), with Ferguson v. Commissioner, 174 F.3d 997, 1006 (9th Cir. 1999) (finding an assignment of income where stock was donated after tender offer had effectively been completed and it was "most unlikely" that the offer would be rejected), aff'g 108 T.C. 244 (1997), and Hudspeth v. United States, 471 F.2d 275, 279 (8th Cir. 1972) (finding an assignment of income where stock was donated after shareholders had voted and taken steps to liquidate the corporation).

[*14] We conclude that there exist genuine disputes of material fact that prevent us from resolving the assignment of income issue summarily. Comtrad and SDI were related by common management, the interests of both companies appear to have been aligned, and both companies seemingly desired that the stock acquisition be completed. If so, these facts may support the conclusion that the acquisition was virtually certain to occur. Respondent also points to emails and an alleged exchange of documents between JCF and petitioners on November 12, 2012. This evidence may support respondent's contention that JCF agreed in advance to tender its shares to SDI and that all steps of the transaction were prearranged.

The parties also dispute the dates on which relevant events occurred. Petitioners assert that they transferred their shares to JCF on December 5 and there appears to be documentary evidence arguably supporting that assertion. Respondent contends that JCF did not acquire ownership of its 900 shares until (at the earliest) December 10, allegedly after JCF unconditionally agreed to sell the 900 shares to SDI. That contention derives arguable support from other documentary evidence, as well as from Empire's description of the proposed transaction, which recited that petitioners would transfer 900 shares to JCF "[s]imultaneously with SDI's acquisition of the 6,100 shares."

[*15] There are also genuine disputes of material fact concerning the extent to which JCF, having received the 900 shares, was obligated to tender them to SDI. Empire stated in its report that petitioners would use "all reasonable efforts to cause * * * [JCF] to agree to sell the shares to SDI." At this juncture the record includes little if any evidence concerning petitioners' ability to sway JCF's actions or JCF's separate negotiations (if any) with SDI. Respondent contends that JCF had no meaningful discussions with SDI at all but was "simply informed by petitioners" that the 900 shares should be tendered at once. A trial will be necessary to determine whose version of the facts is correct.

One fact potentially relevant to this question concerns JCF's fiduciary duties as a custodian of charitable assets. If JCF tendered its Comtrad shares, it would immediately receive $4,050,000 in cash. If it refused to tender its shares and the entire transaction were scuttled, JCF would apparently be left holding a 13% minority interest in a closely held Hong Kong corporation, the market value of which might be questionable.

In sum, viewing the facts and the inferences that might be drawn from the facts in the light most favorable to respondent as the nonmoving party, we find that there exist genuine disputes of material fact that prevent summary

[*16] adjudication of the assignment of income issue. To the extent petitioners seek summary judgment on this question, we will deny their motion.

III. Charitable Contribution Deductions

A. Governing Legal Framework

Section 170(a)(1) allows as a deduction any charitable contribution made within the taxable year. If the taxpayer makes a charitable contribution of property other than money, the amount of the contribution is generally equal to the FMV of the property when contributed. See sec. 1.170A-1(c)(1), Income Tax Regs. "A charitable contribution shall be allowable as a deduction only if verified under regulations prescribed by the Secretary." Sec. 170(a)(1).

The Secretary has prescribed extensive regulations governing verification of charitable contributions. See sec. 1.170A-13, Income Tax Regs. A taxpayer who claims a deduction for a contribution of property (other than publicly traded securities) valued in excess of $5,000 must obtain a "qualified appraisal" of the property. Sec. 170(f)(11)(C). He must also attach to his return "such information regarding such property and such appraisal as the Secretary may require," which includes a fully completed appraisal summary on Form 8283. Id.; see Jorgenson v. Commissioner, T.C. Memo. 2000-38, 79 T.C.M. (CCH) 1444, 1450; sec. 1.170A-13(c)(2), Income Tax Regs. When a contribution of property is valued in excess of

[*17] $500,000 the taxpayer must attach a copy of that appraisal to his return. Sec. 170(f)(11)(D). This last requirement applies to the four petitioners who claimed charitable contribution deductions of $562,500. See supra p. 9.

Section 170(f)(11)(E)(i) defines "qualified appraisal" to mean an appraisal performed by a qualified appraiser that "is treated for purposes of this paragraph as a qualified appraisal under regulations or other guidance prescribed by the Secretary." The regulations prescribed by the Secretary require that a "qualified appraisal" include (among other things) the following: (1) "[a] description of the property in sufficient detail for a person who is not generally familiar with the type of property to ascertain that the property that was appraised is the property that was (or will be) contributed," (2) a "statement that the appraisal was prepared for income tax purposes," (3) "[t]he date (or expected date) of contribution to the donee," (4) "[t]he date (or dates) on which the property was appraised," and (5) "[t]he appraised fair market value * * * of the property." Sec. 1.170A-13(c)(3)(ii), Income Tax Regs.

In Bond v. Commissioner, 100 T.C. 32, 41 (1993), we held that the regulatory reporting requirements listed above, while "helpful to respondent in the processing and auditing of returns on which charitable deductions are claimed," are "directory and not mandatory." Thus, in appropriate circumstances, these require-

[*18] ments can be satisfied by substantial, rather than literal, compliance. Id. at 42; see Hewitt v. Commissioner, 109 T.C. 258, 265, n.10 (1997) (describing substantial compliance as satisfied where the taxpayer has "provided most of the information required" or made omissions "solely through inadvertence"), aff'd without published opinion, 166 F.3d 332 (4th Cir. 1998). While substantial compliance may excuse minor, technical, or merely procedural defects, it offers no relief to taxpayers who have failed to disclose information that goes to "the essential requirements of the governing statute." Estate of Evenchik v. Commissioner, T.C. Memo. 2013-34, 105 T.C.M. (CCH) 1231, 1234 (quoting Estate of Clause v. Commissioner, 122 T.C. 115, 122 (2004)).

Section 170(f)(11)(A)(ii)(II) excuses failure to satisfy the reporting requirements discussed above if it is shown that such failure "is due to reasonable cause and not to willful neglect." The formulation of this defense--requiring the existence of "reasonable cause" and the absence of "willful neglect"--resembles that appearing in numerous Code provisions that impose penalties or additions to tax. See, e.g., secs. 6039G(c)(2), 6704(c)(1), 6652(f)-(j), 6709(c); see also sec. 6664(c)(1) (requiring that the taxpayer have "reasonable cause" and have "acted in good faith"). Although section 170(f)(11)(A)(ii)(II) relieves the taxpayer from disallowance of a deduction rather than from imposition of a penalty, we have

[*19] construed the contours of these defenses similarly. See Alli v. Commissioner, T.C. Memo. 2014-15, 107 T.C.M. (CCH) 1082, 1096; Crimi v. Commissioner, T.C. Memo. 2013-51, 105 T.C.M. (CCH) 1330, 1353.

"Reasonable cause requires that the taxpayer have exercised ordinary business care and prudence as to the challenged item." Crimi, 105 T.C.M. (CCH) at 1353 (citing United States v. Boyle, 469 U.S. 241 (1985)). "The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances." Sec. 1.6664-4(b)(1), Income Tax Regs. Reasonable cause may be shown by establishing reliance on the advice of a tax professional. But such "advice must generally be from a competent and independent advisor unburdened with a conflict of interest and not from promoters of the investment." Mortensen v. Commissioner, 440 F.3d 375, 387 (6th Cir. 2006), aff'g T.C. Memo. 2004-279.

B. Analysis

While not challenging Empire's status as a "qualified appraiser," respondent urges that petitioners have failed, in two respects, to satisfy the regulatory reporting requirements. Respondent first contends that the Empire report does not constitute a "qualified appraisal." Even if it is a "qualified appraisal," respondent contends that those petitioners who donated stock valued in excess of $500,000

[*20] are entitled to no deductions because they did not attach copies of that appraisal to their tax returns as section 170(f)(11)(D) requires. Petitioners contend that they substantially complied with all of the regulatory reporting requirements or, in the alternative, that they had reasonable cause for failing to do so.

As respondent observes, the Empire report in several respects fits awkwardly with the appraisal reporting requirements. For starters, it is not addressed to petitioners, it does not examine any charitable contributions of property, it does not set forth the "date (or expected date) of the contribution," and it does not include a statement that it "was prepared for income tax purposes." See sec. 1.170A-13(c)(3)(ii), Income Tax Regs. Quite the contrary: The report explicitly states that it was prepared for ERISA compliance purposes, that it was intended solely for the use of the ESOP trustee, and that it "d[id] not take into consideration any tax consequences related to Comtrad's selling shareholders."

Respondent further emphasizes that Empire did not value the specific property that each petitioner actually contributed. Petitioners individually donated to JCF between 35 and 125 shares of Comtrad stock. The largest block represented only 1.8% of Comtrad's 7,000 outstanding shares, and petitioners collectively donated fewer than 13% of its outstanding shares.

[*21] But whereas petitioners contributed small minority interests, Empire valued Comtrad "on a going concern basis" and determined the value of "100% of the ordinary shares of Comtrad." In so doing Empire discharged the mission the ESOP trustee had entrusted to it, that is, to determine whether SDI's offering price of $4,500 was fair to the Comtrad shareholders. Since Empire was valuing the entire company, it correctly applied no minority discount. And while it applied a discount of 5% for lack of marketability, that adjustment was small because "the appropriate level of discount is materially less on a control block than it would be on a minority interest block." Had Empire been asked to value the minority interest block that each petitioner donated to JCF, Empire would obviously have written a very different sort of report.

When an appraisal values property different from that which was actually contributed to charity, that failure can be fatal because it "goes to the essence of the information required." Costello v. Commissioner, T.C. Memo. 2015-87, 109 T.C.M. (CCH) 1441, 1447 (holding that an appraisal was not "qualified" where it valued the wrong asset); Estate of Evenchik, 105 T.C.M. (CCH) at 1234 (holding that an appraisal was not "qualified" because it valued corporate assets, whereas the taxpayer had donated corporate stock). Citing cases such as these, respondent contends that petitioners neither strictly nor substantially complied with the regu-

[*22] latory reporting requirements because the Empire report valued the wrong asset and (for that reason) neglected to apply the discounts that should appropriately be applied when valuing minority stock interests.

Petitioners reply that this is a case of "no harm, no foul." SDI was offering to buy 100% of Comtrad's shares and to pay the same price ($4,500) for each share. That being so, petitioners say, all of Comtrad's shares had equal value, and there was no logical reason to apply a minority interest discount to the shares tendered by JCF. Indeed, because JCF received cash for its 900 shares, whereas the other Comtrad shareholders received mostly promissory notes, JCF's shares, as compared with those other shares, may arguably have justified a valuation premium rather than a discount.

For these reasons, petitioners urge that they substantially complied with the appraisal reporting requirements. Although Empire did not recite the analysis set forth in the preceding paragraph, it described the proposed transaction in detail and made clear that SDI was offering to buy each share tendered by JCF for $4,500 in cash. Under these circumstances, petitioners say, it would be obvious to any sophisticated reader that no minority discount was required, thus neutralizing respondent's argument that Empire valued the wrong property.

[*23] Petitioners admit that the Empire report did not explicitly state that "the appraisal was prepared for income tax purposes." See sec. 1.170A-13(c)(3)(ii)(G), Income Tax Regs. But Empire allegedly followed IRS guidelines when doing its valuation, and the Empire professional who signed the appraisal also signed the Forms 8283 attached to petitioners' returns. Petitioners admit that the Empire report did not explicitly state "the date (or expected date) of contribution to the donee." Id. subdiv. (ii)(C). And while the parties dispute the exact date on which the contributions occurred, the Empire report makes clear that all relevant events occurred sometime between December 5 and 12, 2012. Petitioners contend that any technical shortcomings of the Empire report can thus be excused on grounds of substantial compliance.[8]

The four petitioners who made contributions valued in excess of $500,000 have a second hurdle to overcome. Section 170(f)(11)(D) required them, not only to get a qualified appraisal, but also to attach a copy of that appraisal to their 2012

[8]See, e.g., Zarlengo v. Commissioner, T.C. Memo 2014-161, 108 T.C.M. (CCH) 155, 163 (finding appraisal "qualified" where contribution dates were listed in the appraisal summary); Gorra v. Commissioner, T.C. Memo. 2013-254, 106 T.C.M. (CCH) 523, 533-534 (finding appraisal "qualified" where Commissioner could discern that the contribution was made during a specific month); Consol. Inv'rs. Grp. v. Commissioner, T.C. Memo. 2009-290, 98 T.C.M. (CCH) 601, 614 (finding appraisal "qualified" despite omission of any statement regarding income tax purpose); Simmons v. Commissioner, T.C. Memo. 2009-208, 98 T.C.M. (CCH) 211, 215-216 (finding appraisal "qualified" despite omission of an explicit statement regarding income tax purpose), aff'd, 646 F.3d 6 (D.C. Cir. 2011).

[*24] tax returns, which they did not do. They say that they nevertheless "substantially complied" with this requirement by attaching to their return a fully completed Form 8283. But the Code requires that a taxpayer in this position attach to his return both an appraisal summary and a copy of the appraisal itself. Compare sec. 170(f)(11)(C), with id. subpara. (D). When a statute separately requires that a taxpayer satisfy two requirements, it is not obvious that literal compliance with the first constitutes substantial compliance with the second.[9]

Even if petitioners did not strictly or substantially comply with the regulatory reporting requirements, they all seek haven in section 170(f)(11)(A)(ii)(II). That provision excuses failure to satisfy the reporting requirements discussed above if it is shown that such failure "is due to reasonable cause and not to willful neglect." Petitioners allege that their 2012 returns were prepared by an experienced certified public accountant (CPA), that they supplied her with the Empire report and all relevant information about the Comtrad stock acquisition, and that she did not direct any of petitioners to include a copy of the Empire report with

[9]Petitioners cite section 1.170A-13(c)(4)(iv)(H), Income Tax Regs., in support of their position. That section provides possible relief where a donor, owing to "a good faith omission," fails to attach "an appraisal summary" to his return. In that event the charitable contribution deduction will not be automatically denied if the taxpayer supplies a Form 8283 within 90 days of an IRS request therefor. Ibid. But there is no comparable relief provision covering situations where the donor, having reported a value in excess of $500,000 for donated property, fails to attach to his return a copy of the appraisal itself.

[*25] their returns. The record as it stands now is silent concerning the advice (if any) that the CPA provided petitioners regarding the Empire report and whether they relied in good faith on whatever advice she may have supplied. For these reasons, we conclude that petitioners' ability to rely on the "reasonable cause" defense of section 170(f)(11)(A)(ii)(II) presents genuine disputes of material fact that are not susceptible to resolution by summary judgment.

Barring settlement, these cases will need to go to trial on the assignment of income issue and on petitioners' entitlement to the "reasonable cause" defense. Under these circumstances we deem it prudent, for two reasons, to deny in their entirety both pending motions for partial summary judgment. First, if petitioners prevail on the "reasonable cause" defense, it will be unnecessary for us to decide whether they substantially complied with the appraisal reporting requirements.

Second, there could be some factual overlap between the two sets of issues. During trial of the assignment of income issue, we will need to determine (among other things) whether the prospective acquisition of Comtrad's stock was a mere expectation or a virtual certainty. See supra p. 13. The resolution of that factual question could affect whether petitioners substantially complied (or had reasonable cause for failing to comply) with the appraisal reporting requirements. That might be so (for example) if petitioners contend that they did not need to get

[*26] an appraisal at all, or were advised that they did not need to get an appraisal, because the value of the Comtrad stock was fixed at $4,500 per share by an offer from SDI that was certain to close.

To reflect the foregoing,

An appropriate order will be issued.

JR - Lauber cons. w/ 23517-16, et al.

ORIGINAL

SEC

UNITED STATES TAX COURT

MARC CHREM & ESTHER CHREM,	)	
Petitioners,	)	
v.	)	Docket No. 23516-16
COMMISSIONER OF INTERNAL REVENUE,	)	
Respondent.	)	

DECISION

Pursuant to the agreement of the parties in this case, it is

ORDERED AND DECIDED: That there is a deficiency in income tax due from petitioners for the taxable year 2012 in the amount of $29,967.00; and

That there is a penalty due from petitioners for the taxable year 2012, under the provisions of I.R.C. § 6662(a), in the amount of $1,498.35.

(Signed) Albert G. Lauber
Judge

Entered: **JUL 19 2019**

* * * * *

SERVED Jul 19 2019

It is hereby stipulated that the Court may enter the foregoing decision in this case.

It is further stipulated that interest will accrue and be assessed as provided by law on the deficiency and penalty due from petitioners.

It is further stipulated that, effective upon the entry of this decision by the Court, petitioners waive the restrictions contained in I.R.C. § 6213(a) prohibiting assessment and collection of the deficiency and penalty (plus statutory interest) until the decision of the Tax Court becomes final.

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Date: JUL 1 1 2019

T.C. Memo. 2019-64

UNITED STATES TAX COURT

MITCHEL SKOLNICK AND LESLIE SKOLNICK, ET AL.,[1] Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 24649-16, 24650-16, 24980-16. Filed June 3, 2019.

B. Paul Husband and Erin C. Prutow, for petitioners.

Kristina L. Rico, Kirsten E. Brimer, Harry J. Negro, Brian S. Jones, and Jeannine A. Zabrenksi, for respondent.

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[1]Cases of the following petitioners are consolidated herewith: Mitchel Skolnick and Brianna Skolnick, docket No. 24650-16; and Eric Freeman, docket No. 24980-16.

[*2] MEMORANDUM OPINION

LAUBER, Judge: These consolidated cases were tried at a special session of the Court beginning April 8, 2019, in Philadelphia, Pennsylvania. A central question is whether petitioners' horse-related activity, undertaken through Bluestone Farms, LLC (Bluestone Farms), constituted an "activity not engaged in for profit" within the meaning of section 183.[2] Currently before the Court is a motion in limine filed by respondent seeking to exclude from evidence the expert witness report of David Reid. Petitioners filed an objection to the motion, and the Court heard argument at the outset of trial and again following respondent's voir dire of Mr. Reid. We will grant the motion and exclude Mr. Reid's report.

Background

Petitioners proposed Mr. Reid as an expert to value their herd of horses at two times. Mr. Reid is the owner of Preferred Equine Marketing, Inc. (Preferred Equine), a bloodstock agency for the standardbred horse industry. He avers that since 1986 his company has served as an agent for sellers (and occasionally for buyers) at numerous public auctions and private sales of standardbred horses. He

[2]All statutory references are to the Internal Revenue Code in effect at all relevant times, and all Rule references (unless otherwise noted) are to the Tax Court Rules of Practice and Procedure. We round all monetary amounts to the nearest dollar.

[*3] avers that Preferred Equine is now the leading bloodstock agency in North America and has participated since 1989 in auction sales of 20,000 horses generating gross proceeds of at least $500 million. Indicating some familiarity with our Rules, Mr. Reid disclosed that he has not authored a publication during the past 10 years and has not testified as an expert witness during the past 4 years. See Rule 143(g)(1)(D) and (E).

Mr. Reid's proposed testimony consists of a 3-1/2-page report with a pair of attached spreadsheets. The substance of his report (putting aside paragraphs devoted to formal aspects and his qualifications) consists of three paragraphs that take up less than two pages. He opines that "the appraisal of horses is not an exact science and is greatly influenced by numerous economic and social factors." In particular, he states that the valuation of horses "can be affected in a volatile way as a result of any natural disaster, disease outbreaks, global crisis or governmental actions."

In paragraph 4 of his report Mr. Reid sets forth "brief guidelines" that he considers relevant in valuing different types of horses. For weanlings and yearlings he says that "conformation and sire play a vital role." For broodmares he says that "breeding status, soundness, health conditions and performance of off

[*4] spring remain strong factors in evaluation." For stallions and stallion shares[3] he says that "breeding soundness, fertility or lack of, overall health conditions and performance of offspring are strong factors in evaluation."

Attached to Mr. Reid's report are two spreadsheets. The first spreadsheet lists 93 horses (or stallion shares) allegedly owned by Bluestone Farms in August 2010. The second spreadsheet lists 60 horses (or stallion shares) allegedly owned by Bluestone Farms in August 2017. Mr. Reid compiled these spreadsheets near the time of preparing his report in February 2019.

Each spreadsheet lists horses by category (weanlings, yearlings, brood-mares, stallions/stallion shares, racehorses, and retired horses). For each horse the spreadsheet shows the sex, year of birth, parents (sire and dam), and Bluestone Farms' ownership percentage. The final column of each spreadsheet shows the "appraised value of Bluestone Farms' interest" in each horse. Putting aside retired horses, which he values at $1 each, the appraised values range from $2,500 to $1,900,000.

Mr. Reid does not explain, in his report or in the attached spreadsheets, how he arrived at these values. Rather he states: "In evaluating this herd, I based the values assigned on our experience in the marketplace for the past 25 years along

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[3]A stallion share is an interest in a syndicate that owns a stallion.

[*5] with our sales database from previous sales within the industry."[4] Mr. Reid does not explain how he used data from the database to generate his assigned values, nor does he include the database as an exhibit to his report.

Discussion

Tax Court proceedings are conducted in accordance with the Federal Rules of Evidence (Fed. R. Evid.). See sec. 7453; Rule 143(a). Testimony by expert witnesses is governed by Fed. R. Evid. 702 and 703. The former provides that a witness who is "qualified as an expert by knowledge, skill, experience, training, or education may testify in the form of an opinion" if his testimony will help the trier of fact and the following conditions are met:

- the testimony is based on sufficient facts or data;
- the testimony is the product of reliable principles and methods; and
- the expert has reliably applied the principles and methods to the facts of the case.

In the Tax Court, a party who calls an expert witness must cause that witness to prepare a written report, which is served on the opposing party and lodged with the Court before trial. See Rule 143(g)(1). The pretrial order in these cases

[4]Mr. Reid does not list a coauthor for his report, but he testified during voir dire that "our experience" refers to his own experience and that of his late business partner, who died in 2012.

[*6] directed that the last day to exchange and submit to the Court expert witness reports was February 26, 2019. If the expert is qualified, his report is "received in evidence as the direct testimony of the expert witness." Rule 143(g)(2).

Because the written report serves as the direct testimony of the expert witness, the report must comply with the requirements for expert testimony set forth in Fed. R. Evid. 702. Rule 143(g)(1) accordingly requires that an expert witness report "shall contain" (among other things) the following: "(A) a complete statement of all opinions the witness expresses and the basis and reasons for them; (B) the facts or data considered by the witness in forming * * * [his opinions]; [and] (C) any exhibits used to summarize or support * * * [his opinions.]"

We conclude that Mr. Reid's report does not satisfy the requirements of the Federal Rules of Evidence or this Court's Rules. His report does not set forth any "facts or data" on which he relied. Fed. R. Evid. 702(b); Rule 143(g)(1)(B). Although he avers that he consulted an in-house database, his report includes no data from that database, and he does not attach a printout of the database as an exhibit to his report. He does not identify the valuation "principles and methods" that he employed in performing his appraisal. See Fed. R. Evid. 702(c). Although his "brief guidelines" list nine factors that he believes affect valuation, he does not explain how he applied or weighted those factors when attaching a dollar figure to

[*7] each horse. His report thus fails to establish that he "reliably applied the principles and methods to the facts of the case." See Fed. R. Evid. 702(d).

Mr. Reid avers that the valuation of horses "can be affected in a volatile way" by external factors such as "governmental actions." The testimony at trial indicated that certain governmental actions by the States of New Jersey and Pennsylvania may have had effects (beneficial or detrimental) on the standardbred industry generally and particularly on Bluestone Farms, which is near Trenton, New Jersey. Mr. Reid does not mention these governmental actions and does not explain what effect those actions might have had on the value(s) of Bluestone Farms' horses as of 2010 and 2017, his selected valuation dates.

Mr. Reid avers that a horse's conformation, overall health conditions, breeding/pregnancy status (for broodmares), and fertility or lack thereof (for stallions) play "vital" or "strong" roles in valuing horses. His report includes no information on any of these points with respect to any of the 153 horses (and stallion shares) that he appraised. His report does not indicate that he personally viewed any of the horses. And his report does not explain what (if any) data he consulted in order to evaluate, in February 2019, the conformation, health conditions, breeding/pregnancy status, or fertility of the horses owned by Bluestone Farms in August 2010 and August 2017, respectively.

[*8] Testimony based on scientific, technical, or other specialized knowledge is subject to the Court's gatekeeping function, which forecloses expert testimony that does not "rest[] on a reliable foundation" or is not "relevant to the task at hand." Daubert v. Merrell Dow Pharm., Inc., 509 U.S. 579, 597 (1993); see Kumho Tire Co. v. Carmichael, 526 U.S. 137, 149 (1999) (extending the principles of Daubert to all expert testimony). "In exercising this function, trial judges have 'considerable leeway in deciding in a particular case how to go about determining whether particular expert testimony is reliable.'" Santa Monica Pictures, LLC v. Commissioner, T.C. Memo. 2005-104, 89 T.C.M. (CCH) 1157, 1237 (quoting Kumho Tire Co., 526 U.S. at 152); see Neonatology Assocs., P.A. v. Commissioner, 115 T.C. 43, 85 (2000), aff'd, 299 F.3d 221 (3d Cir. 2002); cf. ZF Meritor, LLC v. Eaton Corp., 696 F.3d 254, 293 (3d Cir. 2012) ("Under the deferential abuse of discretion standard, we will not disturb a district court's decision to exclude testimony unless we are left with 'a definite and firm conviction that the court below committed a clear error of judgment.'" (quoting In re TMI Litig., 193 F.3d 613, 666 (3d Cir. 1999), amended, 199 F.3d 158 (3d Cir. 2000))).

We conclude that Mr. Reid's testimony, as embodied in his written report, does not "rest on a reliable foundation" because it does not set forth the facts or data on which he relied, the methodology he employed, or the manner in which he

[*9] applied to the facts of these cases the valuation factors he deemed relevant. The dollar values he assigns range from $2,500 to $1,900,000, but the totality of his "appraisal" of each horse is simply a number inserted into a box on a spreadsheet. This amounts to an ipse dixit. Because he offers no explanation or analysis to show how he derived these dollar figures, his testimony does not meet the requirements of Fed. R. Evid. 702 or Rule 143. See Oddi v. Ford Motor Co., 234 F.3d 136, 158 (3d Cir. 2000) (noting that an expert's "ipse dixit does not withstand Daubert's scrutiny"); Giles v. Commissioner, T.C. Memo. 2006-15, 91 T.C.M. (CCH) 684, 692-693 (rejecting report of horse appraiser who summarily described her methodology as resting on "comparable values of horses").

During oral argument petitioners urged four reasons why we should reach a different conclusion. First, they noted that they had supplied to respondent, four days before trial, a thumb drive containing Mr. Reid's in-house database. This 11th-hour action does not meet the requirements of our Rules. Rule 143(g)(1) expressly requires that the report itself include the facts and/or data considered by the witness in forming his opinions.

Mr. Reid's in-house database evidently includes hundreds or thousands of horse sales, very few of which would be linked or correlated to the horses owned by Bluestone Farms at the relevant times. It is unreasonable to expect respond-

[*10] ent's counsel, four days before trial, to get on top of a massive database and be prepared to use it in cross-examining Mr. Reid. We find that the failure to provide this database to respondent in a timely fashion--viz., on February 26, 2019, when expert witness reports were required to be exchanged--has caused undue prejudice by "significantly impairing the opposing party's ability to cross-examine the expert witness" and "by denying the opposing party the reasonable opportunity to obtain evidence in rebuttal to the expert witness's testimony." Rule 143(g)(2); see In re TMI Litig., 193 F.3d at 722 (upholding the exclusion of expert testimony where "the substance of the experts' reports" was disclosed too late for the opposing party to prepare cross-examination); Boltar, LLC. v. Commissioner, 136 T.C. 326, 337-340 (2011) (declining to permit a late-filed supplement to an incomplete expert report because it "would prejudice respondent in preparing rebuttal and would undermine the purpose of pretrial exchange of expert reports").[5]

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[5]Even if we accepted the late-provided database as part of Mr. Reid's report, it would not save his report from the lack of a defined methodology or from the failure to show how he applied valuation principles to the facts of these cases. See Elcock v. Kmart Corp., 233 F.3d 734, 749 (3d Cir. 2000) ("[N]othing in either Daubert or the Federal Rules of Evidence requires a district court to admit opinion evidence that is connected to existing data only by the ipse dixit of the expert." (quoting Kumho Tire Co., 526 U.S. at 157)).

[*11] Second, petitioners urge that, under the Federal Rules of Evidence, a witness can be qualified as an expert by experience alone. That is correct. But Fed. R. Evid. 702 provides that a witness who is qualified as an expert by experience may testify in the form of an opinion "if" specified conditions are met. Those conditions are that the testimony "is based on sufficient facts or data," "is the product of reliable principles and methods," and reflects the reliable application of those principles and methods to the facts of the case. Mr. Reid's report does not satisfy these conditions. While an expert can be qualified on the basis of his experience, he cannot cite his experience as the sole basis for putting a dollar value on a horse. He must show his work, viz., the data he considered and the methodology he applied to produce his results. See Feinberg v. Commissioner, T.C. Memo. 2017-211, 114 T.C.M. 471, 472-473 (excluding appraisal testimony where expert did not provide sufficient data to show that "the opinions expressed are based on anything other than his own conjecture"), aff'd, 916 F.3d 1330 (10th Cir. 2019); Giles, 91 T.C.M. (CCH) at 692-693 (rejecting appraisal testimony where expert failed to explain the nature of her methodology and the reasons for her conclusions).

Third, petitioners note Mr. Reid's voir dire testimony that he regularly used spreadsheets resembling those attached to his expert report to supply information

[*12] to clients of his bloodstock agency. But what is acceptable in a commercial context is not necessarily reliable as expert testimony in Federal court. A person intending to bid on a horse may rely on a dollar estimate supplied by his blood-stock agent, much as a person intending to bid on a house may rely on a dollar estimate supplied by his realtor. In neither case may the customer be interested in how his agent came up with that number. But under our adversarial system, the Federal Rules of Evidence impose higher standards for expert witness testimony in Federal court. See Fed. R. Evid. 702, Adv. Comm. Note to 2000 Amendment ("The trial court's gatekeeping function requires more than simply 'taking the expert's word for it.'" (citing Daubert v. Merrell Dow Pharm., Inc., 43 F.3d 1311, 1319 (9th Cir. 1995))).

Finally, petitioners assert that the valuation of horses is more art than science, citing Justice Stewart's famous apothegm from a different context: "I know it when I see it." Jacobellis v. Ohio, 378 U.S. 184, 197 (1964) (Stewart, J., concurring). This may be a practical approach to identifying pornography, but it is not, for the reasons we have stated, an acceptable approach to formulating expert appraisal testimony under the Federal Rules. We accept petitioners' point that an expert appraising a herd of horses need not necessarily supply, for each horse, the massive volume of data that courts customarily receive from experts appraising

[*13] real estate. But the horse appraiser must still explain how he got to his results, which requires that he show the data he considered, the methodology he applied, and the manner in which he applied his methodology to reach his valuation outcomes. Without that information, the Court has no means of examining whether the report "rests on a reliable foundation and is relevant to the task at hand." Daubert, 509 U.S. at 597.

To reflect the foregoing,

An order will be issued granting respondent's motion in limine.

147 T.C. No. 9

UNITED STATES TAX COURT

EXELON CORPORATION, AS SUCCESSOR BY MERGER TO UNICOM CORPORATION AND SUBSIDIARIES, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

EXELON CORPORATION AND SUBSIDIARIES, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 29183-13, 29184-13. Filed September 19, 2016.

P, a corporation engaged in the production, transmission, and distribution of electricity to residential, commercial, and industrial customers in Northern Illinois, sold its fossil fuel power plants in 1999 for $4.813 billion. Seeking to manage the taxable gain of $1.6 billion resulting from the sale, P pursued a series of like-kind exchanges employing sale-leaseback strategies between P and unrelated third parties C and M, each of the latter a tax-exempt public utility. P fully funded the transactions using the proceeds from the sale of its own power plants. In the transactions, C or M would lease a power plant to P for a term exceeding the plant's useful life, receiving in turn a lump-sum payment of cash, and P would sublease the power plant back to C or M. Part of the amount paid to C or M would be returned to P as a prepayment of the sublease, another part would be set aside for investment and to secure a cancellation option allowing C and M to purchase back their power plants at the end of the sublease periods, and the remainder would be retained by C and M 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 C and M would exercise their cancellation options and regain ownership of the power stations leased to P. The primary tax benefits that P expected to derive were from the deferral of income tax under I.R.C. sec. 1031 and various deductions related to the replacement properties. P identified appropriate replacement properties, conducted due diligence, and closed the transactions within the timeframes provided for in I.R.C. sec. 1031.

Held: The agreements between P and C and M are not true leases but rather properly characterized as loans since the transactions did not transfer the benefits and burdens of ownership to P. The substance of the transactions is not consistent with their form.

Held, further, P did not satisfy the requirements of I.R.C. sec. 1031 for the 1999 tax year since P exchanged power plants for an interest in financial instruments.

Held, further, P is not entitled to depreciation deductions claimed for 2001 with respect to its transactions with C and M.

Held, further, P may not deduct interest or include rental income with respect to the transactions with C and M for the 2001 tax year since the transactions are not lease agreements for Federal tax purposes under I.R.C. sec. 467.

Held, further, P must include in income for the 2001 tax year original issue discount income arising out of P's equity contribution, which is to be repaid with interest through the cancellation options in P's agreements with C and M.

Held, further, P is not entitled to deduct transaction costs related to its transactions with C and M for its 2001 tax year and must instead include them as an additional amount lent to C and M.

Held, further, P is liable for accuracy-related penalties under I.R.C. sec. 6662 for the 1999 and 2001 tax years on the grounds of negligence or disregard of rules or regulations. P did not show reasonable cause and good faith under I.R.C. sec. 6664(c) to meet the exception for those penalties.

David F. Abbott, Joel V. Williamson, Erin G. Gladney, Kristin M. Mikolaitis, Andrew W. Steigleder, Michelle A. Spiegel, and Michael D. Educate, for petitioner.[1]

Matthew I. Root, Elizabeth P. Flores, Steven N. Balahtsis, Abigail F. Dunnigan, Lisa M. Goldberg, Casey R. Kroma, and Michael T. Shelton, for respondent.

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[1]Natasha Goldvug represented petitioner at trial. On October 28, 2015, she filed a motion to withdraw as counsel for petitioner, which the Court granted on October 29, 2015.

LARO, Judge: These cases are consolidated for purposes of trial, briefing, and opinion. Respondent determined the following deficiencies and penalties in petitioner's[2] Federal income tax in timely issued notices of deficiency:

Year	Deficiency	Penalty sec. 6662(a)
1999	$431,174,592	$86,234,918
2001	5,534,611	1,106,922

Petitioner timely filed petitions with the Court seeking redetermination of these deficiencies and penalties.

The deficiencies at issue arise out of petitioner's participation in six transactions that respondent labeled sale-in/lease-out (SILO) transactions in an alleged like-kind exchange under section 1031.[3] The transactions are as follows:

Counterparty	Transaction name
City Public Service	Spruce
Municipal Electric Authority of Ga.	Scherer 1, Scherer 2, Scherer 3
Municipal Electric Authority of Ga.	Wansley 1, Wansley 2

[2]In this Opinion, references to petitioner include both Exelon Corp. and Exelon Corp. as successor to Unicom Corp., which merged with Exelon Corp. on October 20, 2000, and thereafter went out of existence.

[3]Unless otherwise indicated, section references are to the Internal Revenue Code (Code) as applicable for the years in issue. Rule references are to the Tax Court Rules of Practice and Procedure. Dollar amounts are rounded to the nearest dollar.

The parties have agreed, with the Court's approval, to reduce the number of transactions to be tried to three "test transactions": Spruce, Scherer 1 (Scherer), and Wansley 1 (Wansley), and to apply the Court's methodology in this Opinion to the remaining transactions.[4]

The parties have resolved two issues by filing stipulations of settled issues with the Court. The parties have agreed that petitioner is entitled to the benefits of interest netting as provided in section 6621(d) for 1999, the amount of which will be determined after the parties submit Rule 155 computations. The parties have also agreed that petitioner is not subject to the penalty under section 6662 for the 2001 tax year for an underpayment due to a substantial understatement of income tax, although petitioner still may be subject to the section 6662 penalty for 2001 on account of negligence or disregard of rules or regulations.

We decide the following issues:

1. whether the substance of the test transactions is consistent with their form. We hold that it is not;

2. whether petitioner has satisfied the requirements of section 1031. We hold that it has not;

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[4]Our rulings in this Opinion with respect to Wansley 1 will be determinative for Wansley 2. Our rulings with respect to Scherer 1 will be determinative for Scherer 2 and Scherer 3.

3. whether petitioner is entitled to depreciation deductions claimed for 2001 with respect to the test transactions. We hold that it is not;

4. whether petitioner must include in income in 2001 original issue discount income related to the test transactions. We hold that it must;

5. whether petitioner is entitled to deduct amortized transaction costs related to test transactions for its 2001 tax year. We hold that it is not; and

6. whether petitioner is liable for penalties under section 6662 for the 1999 and 2001 tax years. We hold that it is.

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulations of fact and the facts drawn from stipulated exhibits are incorporated herein, and we find those facts accordingly. At the time of filing the petitions, Exelon, the primary petitioner, had its principal place of business in Chicago, Illinois. The parties agree that these cases are appealable to the Court of Appeals for the Seventh Circuit.

Background

I. Exelon and Its Subsidiaries

Commonwealth Edison Co. (ComEd) was organized in Illinois on October 17, 1913, as a result of the merger of Cosmopolitan Electric Co. into ComEd.

Unicom Corp. (Unicom) was created in January 1994 as a holding company for ComEd. Unicom Investment, Inc. (UII), was created on April 23, 1999, as a wholly owned subsidiary of Unicom.

Exelon Corp. (Exelon), petitioner in these cases and the successor by merger to Unicom and its consolidated subsidiaries (Unicom Group), was incorporated in February 1999. Exelon became the parent corporation of PECO Energy Co. (PECO) and Unicom through merger on October 20, 2000. As a result of the merger of Exelon and Unicom, Unicom went out of existence. After the merger, Exelon wholly owned PECO and owned more than 99% of ComEd.

Both Unicom and Exelon used the calendar year as their tax year. Both companies were accrual basis taxpayers during all relevant periods.

II. Unicom's Decision To Sell Fossil Fuel Power Generation Assets

A. ComEd's Power Generation Business in 1999

In 1999 ComEd engaged in the production, transmission, and distribution of electricity to residential, commercial, and industrial customers in Northern Illinois. ComEd operated in Chicago, Illinois, under a nonexclusive electric franchise ordinance. ComEd received approximately one-third of its ultimate revenues from customers in Chicago.

In addition, ComEd operated its electric business outside of Chicago in 395 municipalities under nonexclusive franchises that were received under certificates of convenience and necessity granted by the Illinois Commerce Commission (ICC). ComEd owned and operated a full spectrum of assets necessary to produce and deliver electricity to its customers, including power generation plants (both fossil fueled and nuclear fueled), the high-voltage transmission system which transported the electricity from the generators to the service areas, and the low-voltage distribution system needed to provide the electricity to end users.

B. Deregulation of the Electric Industry and Unicom

The 1990s marked a shift in the regulatory framework for the electric industry. Before 1996 most electric utility companies were vertically integrated conglomerates which, similarly to ComEd, owned a full spectrum of assets for production and delivery of electricity to the customers. By April 1996 the Federal Energy Regulatory Commission (FERC) had issued final rules requiring nondiscriminatory access to the transmission grid controlled by vertically integrated utilities.

These rules opened the market to smaller utilities and power generators and provided an opportunity for the formation of "wholesale" energy companies. Instead of investing in their own transmission capacity, smaller energy producers could now use the transmission system already in place regardless of who owned it to deliver power to their customers.

Many States pursued their own restructuring strategies for electric industry deregulation, some of them requiring separation of power generation from sales to final customers. On December 16, 1997, Illinois enacted the Electric Service Customer Choice and Rate Relief Law, codified at 220 Ill. Comp. Stat. Ann. 5/16-101 to -130 (West 2013). Unlike other States, Illinois did not enact deregulation legislation requiring divestiture of power generation and allowed electric utilities a choice of how they wished to pursue the transition.

These regulatory changes resulted in the transformation of the power industry by the early 2000s from a number of separate vertically integrated utilities to a network of businesses where the various elements of the supply chain were being operated separately and interacted through market-based contracts and power exchanges.

To face the challenges of the changing market, Unicom decided to evaluate its operations in Illinois, including its nuclear and fossil fuel power plants. Although Unicom management believed the company was well positioned to succeed in the new market structure, the study revealed that Unicom would have to make significant changes to its operation model in order to stay competitive long term. Unicom and ComEd considered multiple options, including continued operation with accelerated depreciation, indefinite suspension from operation, a sale of assets to a third party, and retirement or closure of assets. Unicom needed of cash to maintain and expand its nuclear generation facilities and distribution system. After determining that operation of fossil fuel power plants would bring less value than immediate sale, Unicom decided in July 1998 that it was time to divest itself entirely of its fossil-fueled power generation business. At that time Unicom estimated it would receive approximately $2.5 billion from the sale.

C. Unicom's Sale of the Fossil Fuel Power Plants

Unicom started looking for an appropriate buyer for its fossil fuel power plants in 1999. One prospective buyer offered Unicom $3 billion for the plants. Unicom's management, however, believed that the company could get a better deal. Eventually, Edison Mission offered Unicom $4.8 billion for the fossil fuel power plants, almost twice the initial estimate.

The $4.8 billion offer would enable ComEd to upgrade its nuclear plants and make the necessary investments in its distribution system. On March 22, 1999, ComEd entered into an asset sale agreement with Edison Mission (EME agreement). To effect the sale, ComEd transferred its interests in the fossil fuel power plants to UII pursuant to an agreement dated May 11, 1999, subject to the

EME agreement. UII agreed to pay ComEd $4.813 billion for the assets, in the form of a demand note in the amount of $2.35 billion and the difference in interest-bearing term notes.

After receipt of the assets, UII would immediately transfer the assets to Edison Mission and receive $4.813 billion in cash. Immediately after receipt of the cash, UII would pay the $2.35 billion aggregate principal due to ComEd under the demand note. UII would pay the amount due under the demand note with interest-bearing term notes. Upon the notes' maturity, UII would pay the principal amount of the notes. Edison Mission acted through its subsidiary, Midwest Generation. Deloitte & Touche LLP Valuation Group (Deloitte) performed a valuation allocating the sale price among the transferred power plants.

On December 15, 1999, UII closed the sale to Edison Mission with respect to two plants, the Collins Generating Station (Collins station or Collins power plant) and the Powerton Generating Station (Powerton station or Powerton power plant) for $930 million and $870 million, respectively. These stations together had a book value of approximately $1.3 billion at the time of the sale. Pursuant to EME agreement terms, UII transferred the Collins and Powerton stations to State Street Bank & Trust Co. (State Street), the qualified intermediary for the putative like-kind exchange described more fully in the following sections, and State Street then transferred the stations to Edison Mission in exchange for the consideration described above.

In its filings with the ICC, ComEd represented that the sale would not impair ComEd's obligations to provide power to customers because ComEd would be buying back the output generated by the sold power plants for a number of years and would also be able to buy energy on the open market. ComEd planned to reinvest some of the proceeds in its remaining lines of business and to pay the transaction expenses.

III. Unicom's Search for Tax Planning Opportunities

After Unicom announced the planned sale of the fossil fuel power plants in May 1999, it became clear that there would be a large taxable gain resulting from the sale. Unicom diligently searched for opportunities to minimize the tax impact and to reinvest some of the proceeds of the sale.

Richard Roling, assistant vice president of tax and assistant comptroller at Unicom from the early 1990s through 2001, was responsible for the tax function at Unicom, including filing tax returns, planning, research, and ensuring compliance with the tax laws. In 1999 Mr. Roling reported to Robert E. Berdelle, controller of Unicom at the time. Mr. Berdelle's responsibilities included safeguarding Unicom's assets, maintaining books and records, and issuing financial reports and regulatory filings. Furthermore, Mr. Berdelle supervised Unicom's tax department, along with Unicom's business planning and other functions.

Mr. Roling approached Arthur Andersen (Unicom's auditor at the time), Pricewaterhouse Coopers (PwC), and Deloitte to identify the appropriate tax strategy. Arthur Andersen presented Unicom with a strategy involving a foreign currency swap, but Mr. Roling rejected it because it was too complex and did not align with the existing Unicom business. PwC first presented the idea of a like-kind exchange coupled with a sale-leaseback to Unicom sometime in August and September 1999.

In essence, PwC suggested that its strategy would allow Unicom to defer the recognition of gain on Unicom's sale of the fossil fuel power plants through a section 1031 like-kind exchange into a "passive leveraged lease investment." Instead of paying the tax on the gain, Unicom would be able to reinvest that sum. The deferred tax would be financially similar to a 0% borrowing note. By reinvesting it, Unicom could receive a significant yield premium. Moreover, leveraging the new lease in such a manner would leave Unicom in substantially the same cash position.

The PwC strategy envisioned a lease term in the range of 20-25 years with an "enhancement and defeasance structure providing for AA rated or better enhancement of the lessee's entire financial obligations to Unicom." PwC compared the costs for maintaining the new lease investment with maintaining a typical debt private placement. Under the strategy, Unicom would lease the exchange assets to the lessee under a triple net lease with an end-of-term fixed purchase option. Unicom would pass on a portion of its tax deferral benefit to the lessees through a reduction in rental obligation. The lessee would "defease its rental obligations, and thereby monetize the lower rental cost into an upfront cash benefit."[5]

PwC pointed out to petitioner that municipal utilities and rural electric cooperatives seeking to monetize tax benefits they could not use because of their tax-exempt status would be interested in entering into a sale-leaseback transaction. PwC also suggested that taxable entities desiring to obtain low cost/off-balance-sheet financing alternatives might also be interested.

After the initial consultation with PwC, Mr. Roling decided to present the idea of the like-kind exchange to his superiors.

[5]The final structure of the like-kind exchange and sale-leaseback was different, as explained further in this Opinion.

IV. Unicom's Decision To Enter Into the Test Transactions

Mr. Roling first presented the PwC strategy to Mr. Berdelle. Although Mr. Berdelle initially did not fully understand the strategy, he decided it had promise and was in line with Unicom's tax strategy. John C. Bukovski, the chief financial officer of Unicom, gave Mr. Roling permission to move forward with the like-kind exchange strategy and present it to the Unicom's board of directors for consideration and approval.

On October 5, 1999, two months after receiving ICC approval to sell ComEd's fossil fuel power plants, ComEd submitted a notice to the ICC stating that it was considering entering into a like-kind exchange for at least several of the fossil fuel power plants.

On October 14, 1999, Unicom and PwC executed an agreement whereby Unicom retained PwC to act as its financial adviser in connection with the proposed like-kind exchange strategy. On October 20, 1999, Mr. Berdelle provided information on the strategy to Unicom's board of directors. He presented the strategy during the board meeting held on October 27, 1999, seeking and receiving approval for various preliminary steps necessary to pursue the concept and preserve the option of entering into a like-kind exchange transaction.

Mr. Berdelle assembled a team to further evaluate the like-kind exchange opportunity. That team consisted of a number of Unicom's employees from various departments, including the tax department, treasury and finance departments, engineers, and outside consultants. Core members of the team, including Mr. Berdelle, Robert Hanley, a tax department employee, and Mr. Roling, would meet weekly, if not more often, to discuss the status of the project.

Neither Mr. Roling nor anyone on his staff in the tax department had any experience with like-kind exchanges. Because Unicom did not have the internal expertise necessary to adequately assess all of the legal and technical aspects of the proposed like-kind exchange, Unicom employed a number of consultants and advisers to work on the project, including performing due diligence of potential replacement properties.

Unicom retained a Chicago law firm, Winston & Strawn LLP (Winston & Strawn) to advise on the legal aspects of the transaction, including its tax consequences. In addition, in March or April of 2000 Unicom engaged Stone & Webster Management Consultants, Inc. (Stone & Webster), to provide engineering and environmental reports on prospective replacement properties. Unicom retained Deloitte to conduct an appraisal of the relinquished properties and potential replacement properties in November 1999. In addition, petitioner engaged PwC (financial and accounting adviser), Arthur Andersen (accounting adviser), Sidley Austin (regulatory counsel), Vinson & Elkins (Texas counsel), and Holland & Knight (Georgia counsel).

V. Identification of Properties To be Relinquished in the Like-Kind Exchange

On or about December 9, 1999, six days before the closing of the sale under the EME agreement, Unicom identified the Collins and Powerton stations as the properties it would try to exchange for like-kind replacement properties. Mr. Roling concluded, on the basis of the valuations from Deloitte, that the fair market value of the Collins station at that time was $930 million, with an expected taxable gain of $823 million, while the fair market value of Powerton station was $870 million, with an expected taxable gain of $683 million. Unicom did not plan to execute a like-kind exchange for any of the other fossil fuel power plants it was selling.

VI. Identification of Like-Kind Replacement Properties and Due Diligence

A. Identification of Replacement Properties

Because section 1031 has a strict timeframe for identification--on or before the 45th day after the date on which the relinquished property is transferred--and acquisition of replacement property--within 180 days of the date on which the relinquished property is transferred (or, if earlier, the transferor's tax return due date for the year in which the transfer of the relinquished property occurs)--Unicom started looking for potential replacement properties before the closing of the sale under the EME agreement.

By November 1999 PwC had identified 26 prospective lessees. Unicom did not participate in the initial identification process. On or about November 9-10, 1999, PwC, on behalf of Unicom, sent proposals to a number of potential lessees for the sale-leaseback portion of the like-kind exchange. PwC contacted both taxable and tax-exempt entities. City Public Service (CPS) and Municipal Electric Authority of Georgia (MEAG) were among the potential lessees contacted by PwC. Each proposal sent by PwC contained statements indicating that Unicom was simultaneously soliciting other prospective lessees for expressions of interest and that the proposal was subject to due diligence by Unicom and its consultants. After receiving initial expressions of interest from several potential lessees, Unicom and its advisers analyzed the submitted materials.

The closing of the sale of the two fossil fuel power plants under the EME agreement on December 15, 1999, started the clock under section 1031. Unicom and UII had to identify like-kind replacement properties by January 29, 2000 (45 days from closing), and had to acquire the properties by June 12, 2000 (180 days from closing).

On January 28, 2000, Unicom timely submitted to State Street, the qualified intermediary, its identification of like-kind replacement properties for both the Collins and Powerton stations. Unicom identified the Spruce station and certain related common facilities owned by CPS as a replacement for the Collins station. Unicom identified a 15.1% undivided interest in the Wansley station and a 30.2% undivided interest in the Scherer station (both owned by MEAG) as a replacement for the Powerton station. Those partial interests in the Wansley and Scherer stations were at that time owned by MEAG as a tenant in common along with Georgia Power Co., Oglethorpe Power Corp., and the City of Dalton, Georgia.

B. <u>Due Diligence on Replacement Properties</u>

1. <u>Engineering and Environmental Analysis</u>

Walter Hahn, a mechanical engineer with expertise in plant operability and over 25 years' experience working on power plants, was ComEd's director of technical services in 2000. Mr. Hahn coordinated engineering and environmental analysis efforts for the like-kind exchange project at ComEd. To perform the analysis, Mr. Hahn hired Stone & Webster, an engineering consulting firm that ComEd had previously used for other engineering studies.

Stone & Webster assessed the power plants' contemporaneous condition and expected remaining life, the projected capital costs, operating and maintenance expenses, and environmental issues relating to the future operations and maintenance of the replacement stations and conducted an environmental permit review and permit compliance assessment. Stone & Webster's review process involved data collection, site visits, and the review and analysis of all information obtained before drafting reports and offering conclusions.

Stone & Webster's team found the Wansley and Scherer stations to be well maintained and in clean and orderly condition, probably in the top 2%-3% of units in the country in generation, efficiency, and overall availability and reliability. Stone & Webster's team found that the Spruce station was also well maintained, was running at good efficiency, and could run at high capacity factors. However, Stone & Webster did uncover certain problems with the plants. For example, Stone & Webster identified stress corrosion cracking in the low pressure turbine sections of the Wansley station. Stone & Webster also raised concerns about the potential for the U.S. Environmental Protection Agency to take action relating to maintenance activities at Wansley. At the Scherer station, Stone & Webster identified spills associated with transformer failures and fires. Unicom chose not to follow up on any of these and other findings.

In addition, two ComEd engineers visited all of the stations before June 2000. Their review, however, was not as thorough as Stone & Webster's and involved only short site visits and interviews. ComEd engineers did not find any problems with any of the stations.

2. Appraisal of Replacement Properties

Deloitte prepared appraisal reports for all three replacement properties as well as for the fossil fuel power plants sold by Unicom under the EME agreement. The reports provided current valuations of the replacement properties, as well as valuation opinions as to the plants' residual values and remaining useful lives, and the likelihood of the prospective lessees' being economically compelled to exercise their cancellation or purchase options. In preparing the reports, Deloitte sought to address specific requirements set forth in Internal Revenue Service (IRS) published guidance on leasing transactions, such as the requirements articulated in Rev. Proc. 75-21, 1975-1 C.B. 715, and Rev. Proc. 75-28, 1975-1 C.B. 752.

By letter dated December 29, 1999, Winston & Strawn provided Deloitte with a list of "appraisal conclusions we anticipate will be necessary to support our tax opinion issued in connection with any leasing transaction entered into by ComEd [Unicom's subsidiary]." That list was later reproduced almost verbatim in Deloitte appraisal reports. The following table shows side by side some of the conclusions from the Winston & Strawn letter and conclusions appearing in the Deloitte appraisal reports.[6]

Winston & Strawn Letter	Spruce Appraisal Report (Deloitte)
6) as of the Closing Date, it is reasonable to expect that the fair market value of the Leased Property will substantially exceed the applicable Early Termination Amount at all times during the Lease Term;	6. As of the Closing Date, it is reasonable to expect that the fair market value of the Facility will substantially exceed the applicable Early Termination Amount at all times during the Lease Term;
7) the Purchase Option Price is no less than 105% of the estimated "fair market value" of the Leased Property as of the expiration of the Lease term, taking into account inflation and any reasonably anticipated improvements or modifications to the Leased Property and after subtracting from such value any cost to the Lessor of acquiring possession of the Leased Property at the end of the Lease Term;	7. The Cancellation Option Price is no less than 105% of the estimated "fair market value" of the Facility as of the expiration of the Lease Term, taking into account inflation and any reasonably anticipated improvements or modifications to the Facility and after subtracting from such value any cost to the Lessor of acquiring possession of the Facility at the end of the Lease Term;
8) as of the Closing Date, the Leased Property's remaining economic useful life is __ years, and therefore the Leased Property will have a remaining economic useful life at the expiration of the maximum Service Agreement Term equal to at least 20 percent of its	8. As of the Closing Date, the Facility's remaining economic useful life is expected to be 52 years, and therefore the Facility is expected to have a remaining economic useful life at the expiration of the maximum Service Agreement Term equal to at

[6]The Scherer, Wansley, and Spruce appraisal reports prepared by Deloitte contain mostly similar boilerplate in the conclusions, with slight differences attributable to the specific terms of the transactions and fair market value figures. We use the appraisal for the Spruce station as an example to illustrate the effect of the Winston & Strawn letter on the conclusions reached by Deloitte.

remaining useful life as of the Closing Date;	least 20 percent of its remaining useful life as of the Closing Date;
9) the Leased Property will have a "fair market value" at the expiration of the maximum Service Agreement Term (determined without regard to inflation or deflation or any future improvements) that is equal to at least 20 percent of the current "fair market value" of the Leased Property and after subtracting from such value any cost to the Lessor of acquiring possession of the Leased Property at the end of the Lease Term;	9. The Facility will have a fair market value at the expiration of the Lease Term of 38.4 percent of Closing Date fair market value (determined without regard to inflation or deflation or any future improvements) and a fair market value at the expiration of the maximum Service Agreement Term of 20.0 percent of Closing Date fair market value (determined without regard to inflation or deflation or any future improvements). Both uninflated residual values are at least 20 percent of the current fair market value of the Facility and after subtracting from such value any cost to the Lessor of acquiring possession of the Facility at the end of the Lease Term;
12) neither the physical attributes of the Leased Property, the financial standards of the Qualified Operator or Qualified Bidder, the applicable return provisions or other terms and conditions of the Lease, Operating Agreement or Power Purchase Agreement, nor any other identifiable factor known to the Appraiser after due inquiry, will create a material inducement to Lessee to exercise the Purchase Option with respect to the Leased Property;	13. Neither the physical attributes of the Facility, the financial standards of the Qualified Operator or Qualified Bidder, the applicable return provisions or other terms and conditions of the Lease, Operating Agreement or Power Toll Processing Agreement, nor any other identifiable factor known to the Appraiser after due inquiry, will create a material inducement to Lessee to exercise the Cancellation Option with respect to the Facility;
13) based on the comparative costs of the reasonably anticipated alternatives	14. Based on the comparative costs of the reasonably anticipated alternatives

expected to be available to Lessee at the expiration of the Lease Term, Lessee will not be under any economic compulsion to exercise the Purchase Option;	expected to be available to Lessee at the expiration of the Lease Term, Lessee will not be under any economic compulsion to exercise the Cancellation Option;
17) the fixed net return required under the Service Agreement Option is less than 90% of the expected "fair market value" of such payments so that the Service Agreement Option does not create an economic compulsion for the Lessee to exercise the Purchase Option and it is expected that the Lessor will not exercise the Service Agreement Option;	18. The fixed net return required under the Service Agreement Option is less than 95 percent of the expected "fair rental value" so that the Service Agreement Option does not create an economic compulsion for the Lessee to exercise the Cancellation Option and it is expected that the Lessor will not exercise the Service Agreement Option;

Winston & Strawn provided continuous and substantial feedback to Deloitte on the drafts of the appraisal reports. Although Winston & Strawn did not give Deloitte directions as to the specific fair market value for each replacement property, Deloitte knew from its previous work on appraising Unicom's plants sold under the EME agreement how much gain Unicom was looking to defer.

With respect to all three replacement properties, Deloitte discussed the results obtained under three standard valuation approaches: cost of replacement approach, market approach, and discounted cashflow approach. Deloitte concluded that the discounted cashflow analysis represented the most reliable approach to determining the current fair market value of the assets in the test transactions in all of the cases.[7]

To arrive at the fair market values of the replacement plants at the end of the sublease terms, Deloitte used the maximum Federal statutory corporate income tax rate of 35% and a State corporate income tax rate of 9% (total of 40.85%) even though the plants were in Texas, which did not have a State corporate income tax, and in Georgia, which had a 6% State corporate income tax rate.[8] Deloitte used the same discount rate of 10% for all three plants and assumed inflation of 2.5% per annum. Deloitte did not perform any sensitivity analysis.

For the Spruce station, Deloitte assumed the plant capacity factor to be 90.3% in 2000, declining to 58.7% in 2032 and to 49.6% in 2052. For the Wansley station, Deloitte assumed the plant capacity factor of 66.5% in 2000, declining to 39.2% in 2028 and to 32.6% in 2044. For the Scherer station, Deloitte assumed the plant capacity factor to be 66.5% in 2000, declining to 39.9%

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[7]We note, however, that Deloitte relied mostly on the cost approach to determine the fair market value of the assets at the end of the leaseback term.

[8]At the time of Deloitte's appraisal, Texas had a corporate franchise tax equal to the greater of 0.25% of a corporation's net taxable capital or 4.5% of its net taxable earned surplus. Tex. Tax Code Ann. sec. 171.002 (West 2000). In addition to its corporate income tax, Georgia levied a graduated corporate net worth tax, ranging from $10 to $5,000. Ga. Code Ann. sec. 48-13-73 (2013).

by 2030. Deloitte did not analyze in its appraisal reports how a change in a capacity factor might influence the future fair market value of the assets at issue.

After performing the analysis, Deloitte concluded that CPS and MEAG would not be economically compelled to exercise their cancellation or purchase options at the end of their respective subleases. If based on the Deloitte analysis, the fair market value of all the replacement properties at the end of the leaseback term would be less than the cancellation or purchase option price. In arriving at this conclusion, Deloitte did not consider noneconomic factors or any arrangements between the parties setting aside the money for the option payment at the beginning of the lease.

3. <u>Financial and Economic Analysis</u>

Ruth Ann Gillis, Unicom's chief financial officer in 1999-2000, coordinated the financial and economic due diligence on the Spruce, Wansley, and Scherer transactions. Ms. Gillis reviewed both the creditworthiness of CPS and MEAG and the quality of the leased stations. At the end of the due diligence process, Ms. Gillis felt comfortable recommending that the board of directors enter into the transactions.

PwC acted as a financial adviser in connection with the like-kind exchange and the sale-leaseback transactions. PwC's engagement included the following services: (i) assessing Unicom's specific needs from economic, tax, accounting, commercial, and regulatory standpoints in connection with the proposed like-kind exchange; (ii) developing a strategy matching target replacement property with the relinquished property; (iii) identifying target replacement property owned by both tax-exempt lessees and taxable lessees; (iv) arranging for a tax and accounting analysis regarding the like-kind exchange; (v) providing economic analyses and pricing models and issuing reports regarding accounting treatment for the life of the like-kind exchange; and (vi) issuing an opinion regarding the application of accounting principles to the like-kind exchange. Subsequently, PwC also acted as the designated tax shelter organizer on behalf of Exelon and registered the transactions with the IRS as a confidential tax shelter.

Petitioner retained First Chicago Leasing Corp. (FCLC), a wholly owned subsidiary of Banc One Capital Corp. (Banc One), to serve as a supplemental investment adviser to the Unicom Group. FCLC provided Unicom with financial and risk analysis of, and advice relating to, the like-kind exchange. FCLC considered all material credit risks as having been adequately addressed through the transaction structure and financial enhancements such that the transactions at issue possessed above-average safety from a credit risk perspective with respect to payment of scheduled rent, purchase options, or early termination damage claims, thus protecting Unicom's investment return. FCLC advised that CPS and MEAG were generally very credit-worthy, strong, investment-grade entities and would remain primarily liable for all rent and purchase option obligations. FCLC also concluded that Unicom would not suffer losses due to failure on the part of CPS and MEAG to pay rent, sums due for purchase options, or liquidated damages at the appropriate times.

With respect to the risk of bankruptcy of CPS or MEAG, FCLC concluded that "the potential adverse effects of the real estate classification in a bankruptcy are being borne in these transactions by the credit support parties and not Unicom." FCLC further concluded that Unicom could rely on being able to get a full payout in cash if a bankruptcy of a lessee occurred. FCLC did not evaluate the risks related to the service contract period after the expiration of the sublease to CPS or MEAG.

Marsh USA, Inc., advised Unicom on standard insurance practices for the U.S. utility industry and the appropriate terms for property damage and commercial liability insurance in the Spruce, Wansley, and Scherer transactions.

4. Legal and Tax Analysis

Winston & Strawn analyzed the qualification of the replacement properties against the relevant tax tests for like-kind exchanges, helped negotiate the transactions with CPS and MEAG, drafted the various transaction documents, and analyzed the tax consequences thereof. Winston & Strawn also analyzed the relevant leasing authorities and legal risks associated with the Spruce, Wansley, and Scherer transactions. Winston & Strawn worked with local legal counsel in Illinois, Georgia, and Texas to assist with regulatory, corporate, real estate and title, and engineering and surveying issues with respect to the Spruce, Wansley, and Scherer stations.

Winston & Strawn was closely involved in the due diligence process, including marking up the engagement agreement with Deloitte and, as previously discussed, providing Deloitte with a list of desirable conclusions and comments on the appraisal report drafts.

Winston & Strawn provided two tax opinion packages containing opinion letters and supporting memoranda to Unicom, dated as of the closing of the sale-leaseback transactions, on the Federal income tax treatment of the transactions. The opinion package for the exchange of the Collins station for Spruce totaled 357 pages, while the opinion package for the exchange of the Powerton station for Wansley and Scherer was 392 pages. Winston & Strawn's primary tax opinions concluded the following.

(a) The exchange of Unicom's fossil fuel power generating facilities in Illinois with the lessees' fossil fuel power generating facilities "should be treated as a valid exchange of like kind or like class property under section 1031 of the Code."

(b) Each of the Spruce, Wansley, and Scherer leases "will be treated as a true lease for federal income tax purposes pursuant to which UII [Unicom] will directly or indirectly receive the taxable income and deductions associated with the ownership of" the Spruce, Wansley, and Scherer stations, respectively.

(c) Substantially all of the section 467 rental payments "will be treated" as loans to Unicom "rather than as current rental income."

(d) The Spruce, Wansley, and Scherer leases "will transfer ownership" of the Spruce, Wansley, and Scherer stations to Unicom for Federal income tax purposes.

Although Winston & Strawn provided generally favorable opinions, it separately warned Unicom that there are certain risks related to Federal tax law, including recent guidance by the Internal Revenue Service on lease-in/lease-out (LILO) transactions and the possibility that the proposed transaction might be subsequently classified as a corporate tax shelter.

Unicom retained Vinson & Elkins LLP to provide legal advice and opinion as to Texas law relevant to the Spruce transaction. Unicom retained Holland & Knight LLP to provide legal advice and opinion as to Georgia law relevant to the Scherer and Wansley transactions.

With respect to the review by Unicom's own employees of the analysis and conclusions provided in the Winston & Strawn legal opinions, Mr. Roling testified that he did not get beyond the first seven of several hundred pages of the opinion,[9] and Unicom's internal tax personnel also did not review the legal analysis in the draft opinions. Mr. Berdelle, however, testified that he did read the Winston & Strawn tax opinions in their entirety.

C. Board Approval

At the March 9, 2000, Unicom board meeting, John Rowe, Chief Executive Officer and Chairman of ComEd and Unicom, introduced a discussion of the proposed like-kind exchange, and Mr. Berdelle presented information to the board

[9]Mr. Roling testified that he read seven pages of an opinion, but it is not apparent to which opinion he referred. The record shows that Winston & Strawn provided two tax opinion packages, in addition to drafts throughout the preparatory stages of the transactions. However, in certain places, the record indicates that an employee of petitioner reviewed an "opinion", in the singular. Here and elsewhere in our Opinion, we use the singular and the plural forms of the word as appropriate to reflect whichever grammatical number the record establishes on that particular point.

on the like-kind exchange and the sale-leaseback proposal as it had developed since the December 1999 board meeting. On March 28, 2000, the board received a memorandum explaining the nature of the transactions and a credit and investment analysis, as well as expected economic results.

On April 4, 2000, Mr. Berdelle presented the proposed like-kind exchange to the board in more detail, and representatives of the Winston & Strawn team and Mr. Jenkins from PwC responded to the board's questions about the credit risks, the tax risks, and the financial returns associated with the transaction. Mr. Rowe, Mr. Berdelle, and Ms. Gillis all recommended that the board approve the like-kind exchange, and the board followed their advice.

At the time the transactions were approved, some results of the due diligence, including legal opinions, valuation reports, and engineering due diligence reports, were not yet available in their final form. It is unknown whether the board reviewed the draft reports and opinions, but the board memorandum dated March 28, 2000, discussed some tax and legal risks.[10]

[10]Specifically, appendix D discussed the risks related to the MEAG transaction, and appendix E discussed the risks related to the CPS transaction. On the risks related to a MEAG bankruptcy, the conclusion was that the risk was mitigated by MEAG's inability to become a debtor under current Georgia law. On the risks related to a CPS bankruptcy, it was considered to be an "unlikely event" mitigated by the credit enhancement.

Test Transactions

I. Spruce

A. CPS and Its Decision To Enter Into the Spruce Transaction

CPS is a municipal gas and electric utility owned by the City of San Antonio, Texas, that sells gas and electricity to its customers. CPS' mission statement obligates CPS to provide low-cost, reliable gas and electricity service to its customers. As an entity owned by a municipality, CPS is tax exempt.

In the late 1990s CPS' electric system served a territory consisting of substantially all of Bexar County, Texas, and small portions of seven adjacent counties. The CPS system was within the Electric Reliability Council of Texas (ERCOT) region, which was entirely within the State of Texas and served about 85% of Texas' electrical load. ERCOT includes approximately 500 power plants. ERCOT is not connected to the national grid, and, as a result, Texas power producers are not subject to FERC regulations.

CPS owned 15 electric generating units and a 28% interest in the South Texas Project's two nuclear generating units. The Spruce station's generating capacity was approximately 12.3% of the generating capacity of CPS' electric system. The electricity prices for CPS' customers in 1999 were the lowest among the 20 largest cities in the United States and the lowest among major Texas cities.

CPS’ board of trustees has five members: one director is always the mayor of the City of San Antonio, and the other four each represent one quadrant of the city. As a part of the City of San Antonio, CPS has its financial statements included in the annual financial reports of the City of San Antonio. The City of San Antonio shares in CPS’ revenues, and the percentage of gross revenues to be paid over or credited to the City of San Antonio each fiscal year by CPS is determined (within the 14% limitation) by the governing body of the City of San Antonio.

CPS had been presented with other similar transaction opportunities before Unicom’s proposal, but CPS rejected these prior proposals for various reasons. After receiving the proposal from Unicom and reviewing valuations and the transaction documentation, the CPS board determined that the transaction did not violate CPS’ bond covenants and gave its approval for the transaction in 2000. The City Council of San Antonio also approved the Spruce transaction. A January 27, 2000, CPS presentation to the San Antonio City Council Executive Board described the Spruce transaction as a “sale of tax benefits to a taxable entity.” In making the decision, CPS did not obtain an appraisal of its own and relied on the appraisal prepared by Deloitte for Unicom.

In order to proceed with the Spruce transaction, the City of San Antonio brought suit in Texas State court to obtain a declaratory judgment on the continued validity of certain covenants in its outstanding public securities issued for the purpose of financing the construction and improvement of its electric and gas systems, which included the Spruce station. The City of San Antonio represented in the petition that the encumbrance would be limited to the value of the private company's (Unicom's) "future right to obtain a possessory leasehold interest in the [f]acility (a) after the 30-year lease back to the City has expired and (b) if the City elects not to exercise its right to cancel the [headlease] after the 30-year lease back to the City has expired." In the initial draft of the petition, the City also represented that it intended to exercise the cancellation option. However, this statement was later deleted at the suggestion of Winston & Strawn and PwC, who reviewed the petition on behalf of Unicom and provided comments.

The City of San Antonio represented in its petition that it retained fee ownership in the Spruce station and retained possession and rights to operate it during the leaseback term. The City of San Antonio also represented that all the rent would be prepaid six months after the closing date on the leaseback transaction and that the City of San Antonio would make an investment that upon maturity would provide the amounts necessary to pay for the cancellation option.

The City estimated that the net present value of the rights which Unicom would acquire in the future was approximately $40 million.

B. Key Terms of the Spruce Lease and Sublease

1. Lease and Sublease

On June 2, 2000, the City of San Antonio, acting by and through CPS, entered into a sale-leaseback transaction with Unicom, through UII and its wholly owned subsidiaries, Spruce Equity Holdings, L.P., and Spruce Holdings Trust, with respect to the Spruce station. In essence, the money transferred by Unicom to CPS was to be split in three funds: the first fund would be returned to Unicom as a prepayment of sublease by CPS, the second fund would be set aside for investment that would secure the payment of the cancellation option should CPS decide not to reacquire the Spruce station at the end of the sublease, and the third fund would be retained by CPS and could be used for its current needs.

a. Spruce Headlease Agreement

Pursuant to the headlease agreement for the Spruce transaction (Spruce headlease), CPS leased the Spruce station to Unicom for a term of 65 years, starting June 2, 2000, and terminating on June 2, 2065 (Spruce headlease term), unless terminated earlier. The Spruce headlease term exceeded the Spruce station's estimated remaining useful life of 52 years, as determined in the Deloitte appraisal report dated June 2, 2000 (Spruce appraisal). Since the headlease term exceeded the plant's remaining useful life, the transaction could qualify as a sale, making it a SILO, not a LILO.

Under the Spruce headlease, Unicom agreed to pay $725 million to CPS on the closing date, June 2, 2000 (Spruce headlease rent). This amount was equal to the estimated fair market value of the Spruce station on the closing date according to the Spruce appraisal prepared by Deloitte. The appraised fair market value served as the basis for determining Unicom's investment in the transaction, and the parties did not further negotiate the investment amount. Deloitte estimated that as of the end of the Spruce sublease in 2032 the fair market value of the Spruce station would be $626 million if based on the discounted cashflow analysis ($609.6 million if based on the cost approach).

b. Spruce Sublease Agreement

Under the Spruce sublease agreement (Spruce sublease), CPS leased back from Unicom all of Unicom's right, title, and interest in the Spruce station under the Spruce headlease. The sublease term commenced on June 2, 2000, and was scheduled to terminate on March 2, 2032, for a term of 31.75 years.

Under the Spruce sublease, CPS was obligated to prepay rent to Unicom for the entire sublease term in the amount of $557,329,539 on November 30, 2000

(Spruce base rent). The Spruce base rent accrued and was allocated annually pro rata, commencing on the first day of the sublease term. If the Spruce sublease terminated early, Unicom was required to return to CPS any unaccrued base rent.

The Spruce sublease was a net lease, requiring CPS to pay all costs and expenses in connection with the Spruce station. In addition, CPS was required to maintain insurance on the Spruce station under the terms of the sublease.

2. Default

The parties to the Spruce transaction agreed that the Spruce headlease could not be terminated or extinguished by any circumstances of any character or for any reason, with certain limited exceptions including CPS' defaulting under the Spruce sublease terms.

The Spruce sublease provided for early termination if CPS were to default under the terms of the sublease. The events of default included, among other provisions, failure to pay the Spruce base rent, failure of any material representation or warranty made by CPS, or failure to properly maintain the Spruce station. In case there was significant damage to the Spruce station so as to render the station beyond repair, CPS could elect to either replace the Spruce station or terminate the Spruce sublease.

In any of these scenarios, Unicom had a number of remedies against CPS, including collecting the stipulated loss value of the Spruce sublease, and taking possession of the Spruce station to operate, sell, or sublease it to somebody else. The stipulated loss value was predetermined on the closing date and based on the Deloitte Spruce appraisal and was meant to ensure Unicom's return on the investment.

3. Property Rights and Obligations

Under the Spruce headlease, Unicom had the right to use, operate, and possess the Spruce station without interference from CPS. Unicom did not have any obligations to CPS in respect of maintenance, operation, or insurance of the Spruce station under the headlease. Upon the Spruce headlease expiration, Unicom could return the Spruce station to CPS. Unicom was not obligated to make any representations or warranties with respect to the Spruce station except that it was free and clear of liens in case CPS decided to exercise its cancellation option at the end of the Spruce sublease term.

The Spruce sublease was a triple-net lease, meaning that CPS was responsible for all the costs and expenses, foreseen or unforeseen, in connection with the Spruce station, including costs of operation, maintenance, insurance, improvements and other expenses. The Spruce sublease contained a covenant of quiet enjoyment in favor of CPS unless it defaulted under the sublease. CPS could, at its own expense, use, operate, service, repair, and maintain the property as long as it complied with the industry standards and applicable laws and did not have a material adverse effect on the Spruce station, did not result in risk of criminal liability, and did not involve any material risk of loss, forfeiture, or sale of the Spruce station. CPS was solely responsible for environmental compliance and any necessary remedial measures. CPS was also responsible for obtaining and maintaining property and liability insurance coverage meeting certain requirements set out in the Spruce sublease agreement.

Unicom's rights under the Spruce sublease were very limited. Unicom had the right to inspect the Spruce station no more than once a year. CPS was required to seek Unicom's consent with respect to proposed improvements, corporate consolidations, subleases, and assignments.

CPS had limited rights to encumber the property throughout the Spruce sublease term, and could not create any liens on the property after the Spruce sublease term expiration. Unicom, on the other hand, could incur liens on the property after the termination of the Spruce sublease, provided that CPS did not exercise its cancellation option.

CPS took the Spruce station from Unicom on an as-is basis. However, at the end of the Spruce sublease term CPS was required to return the Spruce station in good working order and meeting the predetermined minimum operational standards. For example, the Spruce Station was required to have an annual ratio of the actual net generation to the normal claimed capacity operating for 8,760 hours/year of at least 82.0%. The Spruce station was required to have the ratio of available generation to maximum generation of at least 89% and have an annual ratio of the heat energy output of not more than 10,950 Btu/kWh. These conditions applied to the return of the Spruce station at the end of the Spruce sublease term in 2032 as well.

If CPS decided to return the station to Unicom at the end of the sublease, CPS was required to arrange at its own expense for any necessary permits for Unicom to operate the Spruce station and for engineering and environmental inspections, as well as to arrange for Unicom fuel supply contracts and transmission agreements, together with other agreements necessary to operate the station. Failure to comply with these requirements would trigger a CPS default under the agreement, and Unicom could pursue its contractual remedies.

4. Cashflows

Unicom paid $725 million to CPS under the Spruce headlease on June 2, 2000. Of that amount, CPS retained a lump sum of approximately $88 million, of which the City of San Antonio received about $12.3 million.

On the same date, CPS entered into the collateralized payment undertaking agreement (CPUA) with AIG Financial Products (Jersey), Limited (AIG-FP). Under the CPUA, CPS would pay AIG-FP a fee of $88,995,790 (undertaking fee). In exchange, AIG-FP would use the proceeds from the undertaking fee to make payments to Unicom, for the benefit of CPS, at the end of the Spruce sublease term in the amounts and on the dates specified in the CPUA. In essence, the payments matched both in timing and amount the amounts CPS would owe to Unicom upon CPS' exercise of the fixed purchase option (cancellation option) available to CPS at the end of the Spruce sublease term. The cancellation option allowed CPS to terminate the Spruce headlease at the end of the Spruce sublease term and completely regain the ownership of the station.[11]

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[11]CPS' payment to AIG-FP of the undertaking fee was absolute, unconditional, irrevocable, and not refundable to CPS under any circumstances, including CPS' bankruptcy. CPS did not have any rights or interest in any portion of the undertaking fee, and the fee could not be subject to any lien, claim, or remedy by CPS or its creditors. After the payment, the undertaking fee ceased to be an asset of CPS and became an asset of AIG-FP.

The CPUA required AIG-FP to deliver the cash received as the undertaking fee to Wilmington Trust Co. to be held as collateral pledged primarily to Unicom until CPS paid its obligations under the various transaction agreements. In the event of an early termination of the Spruce sublease, Unicom would receive a "termination amount" under the terms of the CPUA from the undertaking fee proceeds.

As additional protection of Unicom's interest in the amounts set aside under the CPUA, American International Group, Inc. (AIG), guaranteed the obligations of AIG-FP under the CPUA. CPS also obtained a financial guaranty insurance policy from Financial Security Assurance (FSA). Specifically, the policy provided certain protections to CPS in case of its bankruptcy or in the event of CPS' default or early termination of the sublease.

Further, from the Spruce headlease rent, CPS transferred the following amounts to secure the Spruce sublease base rent due on November 30, 2000:

(1) about $327.3 million to Wilmington Trust Co. as custodian of an account that would be pledged to Unicom;

(2) about $50 million to an account pledged to AIG Financial Products Corp. to support CPS' obligations under the letter of credit reimbursement agreement;

(3) about $162 million to an account pledged to FSA to support CPS's obligations under the insurance and indemnity agreement to the Spruce sublease.[12]

C. End of Sublease Term

1. CPS's Cancellation Option

At the end of the Spruce sublease term, March 2, 2032, CPS would have the option of terminating the Spruce sublease and causing Unicom to terminate the Spruce headlease (cancellation option) for the price of $733,849,606. Because the entire amount of the cancellation option payment was financed through the CPUA, CPS would not have to contribute or borrow any additional cash. According to the appraisal prepared by Deloitte, the fair market value of the Spruce station on the cancellation option exercise date in 2032 would be around $626 million if based on a discounted cashflow analysis and around $609.6 million if based on a cost approach.

If CPS chose not to exercise the cancellation option, it would trigger provisions of the Spruce sublease describing conditions for returning the Spruce station to Unicom. Among other things, CPS would have to ensure that the station meet operational standards, arrange for various inspections, obtain operating

[12]Although the total amount set aside was roughly $539 million, some of the money was invested by the custodians in low-risk securities to provide sufficient income to cover the entire $557 million Spruce base rent.

permits for Unicom, and arrange for Unicom to enter into fuel supply contracts, transmission agreements, and other contracts with third parties necessary to operate the Spruce station. Failure to comply with these requirements would trigger a default and the right of Unicom to seek contractual remedies, as discussed below.

2. Unicom's Options

If CPS chose not to exercise the cancellation option at the end of the sublease term, Unicom would have three choices. First, Unicom could require CPS to arrange for a "qualified operator" to enter into an operating agreement with Unicom. Second, Unicom could require CPS to arrange for a "qualified bidder" to enter into a service agreement. If Unicom did not provide CPS with written notice of which option it decided to exercise, Unicom would be deemed to have exercised both the operating agreement and the service agreement options. Finally, Unicom could take possession of the Spruce station and could operate it and sell its energy production without exercising the operating agreement or service option.

If Unicom exercised the service agreement or operating agreement option and CPS failed to implement the service agreement or operating agreement option by the end of the Spruce sublease, such failure would constitute an event of default and trigger the right of Unicom to pursue appropriate remedies. However, under certain circumstances CPS would have another opportunity to exercise the cancellation option at the same price.

a. Operating Agreement

Under the operating agreement option, CPS was required to find a qualified operator for the Spruce station. CPS could not be the qualified operator. A qualified operator would have to, among other requirements, have its senior long-term debt rated no lower than Aa2 by Moody's and AA by S&P or have a comparable rating by another rating agency acceptable to Unicom or be deemed similarly creditworthy in the sole opinion of Unicom. Alternatively, a qualified operator could obtain a guaranty of its obligations under the operating agreement by any person with its senior unsecured long-term debt rated no lower than Aa2 by Moody's and AA by S&P, or have a comparable rating by another rating agency acceptable to Unicom.

The operating agreement option contemplated that the electric output of the Spruce station would be sold to third parties under the power toll processing agreements, discussed in the next section.

Deloitte included in its appraisal a list of potential power purchasers and operators. The only entity with an acceptable credit rating was General Electric

Corp., meaning that most potential qualified operators would have to make guaranty arrangements.

3. Service Agreement

If CPS did not elect to exercise its cancellation option and Unicom elected to exercise the service agreement option, CPS was required to arrange for the submission of one or more bids from qualified bidders to enter into the power toll processing agreement with Unicom for a term of 9.58 years. Unicom expected the power toll processing agreement to be substantially in the form attached to the Spruce sublease agreement. CPS was also required to arrange for the qualified bidder to satisfy all of the conditions precedent to entering into the power toll processing agreement on or before the expiration date for the Spruce sublease.

A qualified bidder would have to have--or have its obligations under the power toll processing agreement guaranteed by any person that had--senior unsecured long-term debt obligations rated no lower than Aa2 by Moody's and AA by S&P or have a comparable rating for its senior unsecured long-term debt obligations by another rating agency acceptable to Unicom. If a bidder or a guarantor did not have debt with such a rating, Unicom could determine whether the bidder or guarantor satisfied the creditworthiness requirements at its sole discretion.

The power purchase bids would have to provide Unicom with net power revenue in the amounts and at the times set forth in the Spruce sublease. Unicom could reject any bid if it concluded that the bid would require the Spruce station to be operated inconsistently with the standards and operational practices and policies of operators of similar facilities in similar circumstances. In that event, CPS would be entitled to arrange for one or more alternative bids. If CPS were unable to find a qualified bidder or Unicom rejected all bidders on or before the Spruce sublease expiration date, CPS would have to exercise the cancellation option.

II. Scherer and Wansley

A. MEAG and Its Decision To Enter the Scherer and Wansley Transactions

MEAG was created by the State of Georgia to own and operate electric generation and transmission facilities and supply bulk wholesale electric power to its 49 member municipalities, 48 cities, and one county in Georgia. MEAG's mission is to deliver low-cost power to its participants and, with respect to its own generation plants, operate them at the lowest cost. MEAG sells power to its cities at cost and any profit it earns has to inure to the benefit of its cities.

MEAG is a member of a power marketing agency called the Energy Authority, which optimizes MEAG's resources and identifies the most economical method for MEAG to supply power to its members. These options could entail selling output to the market from one of the power plants MEAG owns and then buying lower-cost power from a third party, or selling some of MEAG's extra capacity during colder months to Florida, North Carolina, or Alabama.

MEAG's portfolio of assets consists primarily of investments in power plants, including undivided ownership interests in the Scherer and Wansley stations.[13] Typically, MEAG issues debt to finance the construction of a power plant, capitalizing the interest during the construction, and then bills cities monthly for the debt service, the operating expenses, and the fuel expenses.

MEAG is a governmental entity and is tax exempt. State law restricts MEAG's investments primarily to U.S. Treasuries, repurchase agreements backed by treasuries and agencies, and money market funds that have treasuries and agencies. In 1999 MEAG opened an account with $435 million that was intended to grow with interest until 2008 when MEAG thought deregulation would occur, but the power market in Georgia was never deregulated.

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[13]Georgia Power Co., Oglethorpe Power Corp., and the City of Dalton are the coowners of the Scherer and Wansley Stations. Georgia Power Corp. operates the Scherer and Wansley Stations.

James Fuller was MEAG's treasurer at the time the Wansley and Scherer transactions were negotiated and closed. Mr. Fuller led MEAG in the negotiations with petitioner and the other third parties involved in the transactions. During the negotiations, Mr. Fuller reviewed the transaction documents and the terms relating to the fixed price purchase option. Mr. Fuller also reviewed the Deloitte appraisal, but MEAG did not do an appraisal of its own. MEAG originally acquired the Wansley and Scherer stations at cost.

Before entering into the Scherer and Wansley transactions, MEAG obtained certain consents from the coowners of the stations, Georgia Power Co., Oglethorpe Power Corp., and the City of Dalton. MEAG also retained R.W. Beck to evaluate the impact of the sale of these plants on MEAG's participants to comply with the provisions of the bond indentures issued to finance the Wansley and Scherer stations.

B. Key Terms of the Scherer Transaction

Plant Robert W. Scherer Unit Nos. 1 and 2 (Scherer station) is on a 12,000-acre site near Forsythe, Georgia, and includes a powerhouse containing Units 1 through 4, various ash ponds, a water pond, a coal storage yard, a 550-kilovolt substation, and a man-made lake. Only Units 1 and 2 of the Scherer station were part of the leasing transactions with Unicom. The leased property did not include the coal stockpile, inventories, intangibles, and unit trains owned by MEAG at the sites. Units 1 and 2 of the Scherer station are conventional coal-fired units equipped with a single boiler and turbine generator, commissioned in 1982 and 1984, respectively.

1. <u>Lease and Sublease</u>

On June 9, 2000, Unicom, acting through Scherer Holdings 1, LLC, and UII, entered into a sale-leaseback transaction with MEAG involving an undivided interest in the Scherer station (Scherer transaction).

a. <u>Headlease</u>

Pursuant to the headlease agreement for the Scherer transaction (Scherer headlease), MEAG leased to Unicom (i) a 10.0% undivided interest in the Unit 1 site, the Unit 2 site and the unit common facilities site, and a 5.0% undivided interest in the Plant Scherer Common Facilities Site, (ii) a 10.0% undivided interest in Unit , Unit 2, and the unit common facilities, and (iii) a 5.0% undivided interest in the Plant 27 Scherer Common Facilities (collectively, Scherer station) for a term of 61.75 years, starting June 9, 2000 and terminating on September 9, 2061 (Scherer headlease term), unless terminated earlier. The Scherer headlease term exceeded the Scherer station's estimated remaining useful life of 49 years, as determined in an appraisal report on the Scherer Station dated June 9, 2000, prepared by Deloitte (Scherer appraisal).

Under the Scherer headlease, Unicom agreed to pay MEAG $201,986,755 on the closing date, June 9, 2000 (Scherer headlease rent). The Scherer headlease rent equaled the estimated fair market value of the Scherer station as of June 9, 2000, as determined by Deloitte in the Scherer appraisal. The parties did not further negotiate the fair market value of the station, and Mr. Fuller could not recall whether MEAG had obtained written advice on the valuation of the Scherer station from anyone other than Deloitte.

MEAG had the right to inspect the Scherer station site throughout the duration of the headlease. Unicom did not have any obligations to MEAG as to maintenance, operation, or insurance of the interests conveyed under the headlease.

b. Sublease

On the same date, June 9, 2000, Unicom and MEAG entered into an agreement to lease back the Scherer station (Scherer sublease). MEAG leased back from Unicom all of Unicom's right, title, and interest in the Scherer station under the Scherer headlease. The sublease term commenced on June 9, 2000, and was scheduled to terminate on September 9, 2030, for a total term of 30.25 years (Scherer sublease term).

MEAG had an absolute and unconditional obligation to prepay Scherer sublease rent of $157,414,216 to Unicom on December 7, 2000. Similar to the Spruce transaction, the Scherer sublease was a triple net lease, meaning that MEAG was solely responsible for any expenses associated with the sublease. The parties allocated all the risks related to the Scherer sublease to MEAG. MEAG was also responsible for maintaining property and liability insurance which met the requirements set forth in the Scherer sublease.

2. Default

Similarly to the Spruce transaction, MEAG and CPS could not declare a default under the headlease. The Scherer sublease, however, had provisions outlining what events would constitute a default by MEAG. Such events included, among others, MEAG's failure to pay the Scherer sublease rent on time, failure of material representation or warranty, or failure to properly maintain the Scherer station. MEAG had an opportunity to cure such defaults.

In addition, the Scherer sublease also specified certain "Events of Loss", in case of which MEAG could elect to either rebuild or replace the specific unit in question or to terminate the sublease with respect to that unit.

In the event of default, Unicom had the following contractual remedies: (1) enforce performance by MEAG at MEAG's cost or recover damages for a breach; (2) terminate the Scherer sublease and demand that MEAG return possession of the subleased assets to Unicom; or (3) demand that MEAG pay any supplemental sublease rent due plus the stipulated loss value, and, upon such payment, transfer all of its right, title, and interest in the leased assets back to MEAG. If Unicom chose to proceed with the second or third option, it was required to return unaccrued rent in the form of an early termination amount, as determined on schedule 2 of the Scherer sublease agreement. If Unicom chose to proceed with the second option, MEAG would still have an option to purchase the undivided interest in the Scherer station at a price equal to the higher of stipulated loss value as of the date of sublease termination due to a default or the then fair market sale value.

If an event of loss occurred and MEAG chose not to rebuild or replace a specific unit, MEAG would have to pay Unicom a stipulated loss value, as set forth in schedule 2 to the Scherer sublease agreement. Unicom would then have to pay to MEAG an early termination amount, which would reflect any unaccrued rent as of the date of the event of loss.

3. Property Rights and Obligations

Unlike the Spruce transaction, where Unicom received a 100% interest in the Spruce station, the Scherer headlease transferred only a partial interest in the Scherer station to Unicom. Unicom received a right of quiet enjoyment under the headlease. This, however, did not result in Unicom's authority to operate the Scherer station.[14] Unicom had the right to use the ground interest to construct, install, operate, use, repair, and relocate and remove facilities and structures on or under the Scherer site. Unicom, however, in general did not have any obligations to MEAG with respect to maintenance, operation, or insurance of the Scherer station interest under the headlease.

Upon the expiration of the Spruce headlease, Unicom was to return its interest to MEAG on the "as is" and "with all faults" basis. MEAG had the right to inspect the property after the expiration of the leaseback term. Unicom was responsible for a percentage of certain taxes and assessments with respect to the ground interest described in the Scherer headlease agreement from the date the leaseback to MEAG ended and until the end of the headlease. Both MEAG and

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[14]Operation of the Scherer station was governed by the agreement among MEAG, Georgia Power Co., Oglethorpe Power Corp., and the City of Dalton. At the time Unicom and MEAG entered into the sale-leaseback arrangements, Georgia Power Co. operated both the Scherer and Wansley stations.

Unicom agreed to limit their ability to incur liens with respect to the Scherer station interest transferred by the Scherer headlease.

Under the Scherer sublease, MEAG received the same interest in the Scherer station it transferred to Unicom under the Scherer headlease. Overall, the rights of MEAG under the sublease were similar to the rights of CPS under the Spruce sublease. MEAG's rights with respect to subleasing its interest during the sublease term were broader than those of CPS: MEAG did not need separate approval for a sublease if it met certain requirements. Unicom had the right to inspect the premises during the sublease once a year and the right to consent to the assignment by MEAG of its rights under the Scherer sublease.

Under the Scherer sublease, MEAG took the Scherer station interest from Unicom on an as-is basis. If MEAG or other tenants in common of the Scherer station did not exercise the purchase option at the end of the Scherer sublease or if MEAG was required to return the Scherer station interest to Unicom after a default, MEAG was required to meet certain conditions, including having the Scherer station meet certain operational standards and be free from major defects, in good working order, and in a good state of repair. Unicom was entitled to receive, and MEAG agreed to deliver, the Scherer station with at least a 62% capacity factor based on 8,760 hours of operation per year and net energy output of 87.5%. In addition, MEAG was required to be in compliance with other agreements governing ownership and operation of the Scherer station and have no outstanding amounts due under those contracts.

If MEAG were required to return the Scherer station interest to Unicom, and Unicom chose the service agreement option, MEAG was to arrange at its own expense for any necessary permits for Unicom or a qualified bidder under the service agreement to operate the Scherer station. MEAG was also required to arrange for an environmental inspection, as well as to arrange for Unicom fuel supply contracts and transmission agreements, together with any other agreements necessary to operate the station. Failure to comply with the prerequisites to returning the Scherer station interest would trigger for MEAG, under certain circumstances, the requirement to pay to Unicom an amount equal to the diminution in the fair market sale value of the interest caused by MEAG's failure to comply with the return conditions.

4. Cashflows and Collateral Agreements

Unicom and MEAG chose to structure the cashflows for the Scherer and Wansley transactions differently from those for the Spruce transaction. In part this was so because of MEAG's limited authority to invest in securities.

Pursuant to the Scherer headlease, on June 9, 2000, Unicom paid the Scherer headlease rent of $201,986,755 to MEAG.

On June 9, 2000, MEAG entered into the Government securities pledge agreement (Scherer pledge agreement) with Ambac Credit Products, LLC (Ambac Credit), and State Street, as agent and intermediary. Pursuant to the Scherer pledge agreement, MEAG would pay from the Scherer headlease rent $152,228,894 to State Street to purchase Government securities on the closing date of the Scherer transaction. The pledge agreement required MEAG to pledge these Government securities to Ambac Credit first and Unicom second to secure MEAG's obligation under the Scherer sublease to make the Scherer base rent payment on December 7, 2000.

State Street also paid Ambac Credit $1,544,674 on the closing date of the Scherer 1 transaction on behalf of MEAG. In exchange, Ambac Credit agreed to make certain payments on behalf of MEAG pursuant to a credit swap agreement between Ambac Credit and UII (UII swap agreement). The payment also covered the financial guaranty insurance policy issued by Ambac Assurance Corp., No. SF0353BE, dated June 9, 2000 (Scherer FGIP).

Under the UII swap agreement, Ambac Credit was obligated to pay UII the excess of the stipulated loss value over all payments UII received with respect to the stipulated loss value or purchase option price from other sources, plus the early termination amount. In exchange, UII would be required to surrender its right, title, and interest under the Wansley transaction to Ambac Credit, the swap provider.

Under the Scherer FGIP, Ambac Assurance Corp. unconditionally and irrevocably guaranteed the payments by the swap provider under the UII swap agreement. The payment obligation under the UII swap agreement is triggered by the occurrence of any of several events, including MEAG's failure to pay the base rent or the stipulated loss value, certain misrepresentations by MEAG, MEAG's insolvency or bankruptcy, and MEAG's failure to perform or observe the covenants and obligations under the Wansley transaction documents.

On June 9, 2000, MEAG entered into a credit swap agreement with Ambac Credit (MEAG swap agreement). Ambac Credit paid MEAG $372,890, and MEAG agreed to make the payments described in the MEAG swap agreement. MEAG's payment obligations under the MEAG swap agreement are the same as those described under the UII swap agreement. State Street paid $1,000,934 of various transaction expenses on the closing date of the Scherer transaction on behalf of MEAG.

On June 9, 2000, MEAG also transferred $47,576,143 to various collateral accounts for investment in short-term collateralized flex repurchase agreements. The collateral accounts served as collateral for MEAG's purchase option obligation under the Scherer sublease.

The effect of the transactions discussed above was to set aside funds from the Scherer headlease rent to fund MEAG's obligations to pay the Scherer rent and the purchase option under the Scherer sublease.

5. End of Sublease Term

Similarly to the Spruce transaction, at the end of the sublease term MEAG or one of its cotenants in common could exercise the purchase option to regain all the rights to the Scherer station. If that did not happen, Unicom could exercise its rights under the operating agreement or service agreement option, or could choose to purchase and sell its share of the Scherer output on the market.[15]

a. MEAG's Purchase Option

At the end of the Scherer sublease term, September 9, 2030, MEAG has the option of terminating the Scherer sublease and causing Unicom to terminate the Scherer headlease for the price of $179,284,424 (Scherer purchase option). If

[15]As discussed supra note 14, Unicom's authority to operate the Scherer station was limited, so we do not consider it as a viable possibility in our analysis.

MEAG chooses not to exercise the Scherer purchase option, one or more of MEAG's cotenants in common will then have the right to acquire Unicom's interest in the Scherer station.[16] To exercise the Scherer purchase option, MEAG will have to give written notice to Unicom no later than January 15, 2029.

If neither MEAG nor its cotenants in common decide to exercise the Scherer purchase option, MEAG will have to comply with all of the requirements for returning the Scherer station interest to Unicom as described above.

b. Unicom's Options

i. Operating Agreement Option

Under the terms of the Scherer sublease, if neither MEAG nor its cotenants exercise their purchase options, Unicom can exercise the operating agreement option. This option will not be available to Unicom if, at the time of exercise, MEAG is not an operator of the Scherer station under the agreements governing MEAG's relationships with cotenants and management and operation of the Scherer station.

If MEAG is an operator of the Scherer station, Unicom can then require MEAG to arrange for a qualified third party to enter into an operating agreement

[16] Georgia Power Co., Oglethorpe Power Corp., and the City of Dalton all had the right to exercise the purchase option for the undivided interest in the Scherer station if MEAG chose not to.

with Unicom to operate the Scherer station. The electric output of the Scherer station would be sold to third parties under power purchase agreements while the station was operated and maintained on behalf of Unicom by the qualified operator.

A qualified operator would, among other requirements, have, or have its obligations guaranteed by a guarantor who has, a rating not lower than Aa2 by Moody's and AA by S&P, or be deemed similarly creditworthy by Unicom and be otherwise reasonably acceptable to Unicom. Failure by MEAG to implement its obligations under the operation agreement option would lead to MEAG's default under the Scherer sublease. Under certain circumstances, MEAG and its cotenants would get another opportunity to exercise the purchase option. If they decided not to do so, Unicom would have to use other remedies available to it under the Scherer sublease.

ii. Service Agreement Option

If MEAG or its cotenants chose not to exercise the purchase option and MEAG was not an operator of the Scherer station at that time, the only option available to Unicom would be to exercise its rights under the service agreement option.

Under the service agreement option, Unicom could require MEAG to arrange for the submission of one or more power purchase bids from "qualified bidders" to enter into power purchase agreements with Unicom.

Similarly to the Spruce transaction, a qualified bidder would have to meet certain creditworthiness requirements or have its obligations under the power purchase agreement guaranteed by an entity with sufficient creditworthiness. MEAG could itself submit a bid as a qualified bidder subject to meeting all the qualified bidder requirements. The parties contemplated that a qualified bidder would enter into a power purchase agreement and would purchase the electric output from the Scherer station for the term of 8.69 years. On the basis of the Deloitte appraisal, the parties believed that after the end of the power purchase agreement term, the remaining economic useful life of the assets under the Scherer headlease would be 10.6 years or 20.53% of the estimated overall useful life remaining as of the closing date in 2000.

The requirements for the net power revenue under the power purchase agreement to be received by Unicom were predetermined and set out as schedules to the Scherer sublease. However, these payments were not guaranteed unless the plant actually produced power in the required amounts and at certain efficiency standards.

Unicom could reject any bids at its sole discretion. If MEAG failed to provide Unicom with qualified bidders to enter into the power purchase agreement or if Unicom rejected all such bids, that would constitute an event of default under the agreement. Under certain circumstances, MEAG would have an additional opportunity to exercise the purchase option. Otherwise, Unicom could use the standard remedies available under the provisions governing events of default.

Similar to the Spruce sublease, if Unicom did not give notice as to which option it elected, it would be deemed to have elected to exercise both the operating agreement and the service agreement options if both options are available. MEAG's failure to implement its obligations under both options would constitute its default under the sublease, which would result in either another chance to exercise the purchase option or Unicom's entitlement to other contractual remedies.

C. Key Terms of the Wansley Transaction

Power Plant Wansley (Wansley station), on a 5,225-acre site near Carrollton, Georgia, included two conventional power generation units, as well as a 320-acre ash disposal pond, a 126-acre potable water pond, a 40-acre coal storage yard, a 15-acre 500-kilovolt substation, and a 606-acre service water pond that provides cooling water for the plant. At the time of the transaction in 2000, Wansley station comprised two self-contained 865 MW coal-fired units. Units 1 and 2 are conventional coal-fired units equipped with a single boiler and turbine generator, commissioned in 1982 and 1984, respectively. The leased property did not include the coal stockpile, inventories, intangibles, and unit trains owned by MEAG at the sites.

1. Lease and Sublease

a. Headlease

On June 9, 2000, MEAG entered into the Wansley transaction with Unicom (through Wansley Holdings 1, LLC and UII) involving an undivided interest in Plant Hal Wansley Units 1 and 2 (together, Wansley station), as well as certain common facilities. In the Wansley transaction, MEAG leased a 10% undivided interest in the Wansley station[17] to Unicom through its wholly owned subsidiaries for a term of 56.75 years (Wansley headlease). Deloitte appraised the undivided interest in the Wansley station as of the closing date of June 9, 2000, at $172 million. Deloitte determined that the Wansley headlease term of 56.75 years exceeds the Wansley station's estimated remaining useful life of 45 years.

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[17]For the sake of clarity, references in this Opinion to the lease or sublease of the Wansley station are to be understood as referring to a lease or sublease of the 10% undivided interest in the Wansley station.

On June 9, 2000, under the Wansley headlease, Unicom paid $172,185,430 to MEAG for the lease of the Wansley station (Wansley headlease rent). According to Deloitte, the Wansley headlease rent was approximately equal to the estimated fair market value of the Wansley station on June 9, 2000. The appraised fair market value served as the basis for determining Unicom's investment in the transactions, and the parties did not further negotiate the investment amount. Deloitte estimated that as of the end of the sublease the fair market value of the Wansley station would be about $485 million if based on the discounted cashflow approach and $481 million if based on the cost approach.[18]

b. Sublease

On June 9, 2000, MEAG and Unicom, through Wansley Holdings 1, LLC, entered into the sublease agreement, whereby MEAG leased the Wansley Station back (Wansley sublease) from Unicom for a term of 27.75 years. MEAG leased back from Unicom all of Unicom's rights, title, and interest in the Wansley station. The Wansley sublease was scheduled to terminate on March 9, 2028. Under the terms of the Wansley sublease, MEAG was obligated to pay rent to Unicom of

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[18]The Wansley appraisal prepared by Deloitte did not allocate the values between Wansley 1 and 2.

$134,087,903, on December 7, 2000, six months after the closing of the Wansley transaction (Wansley base rent).

The Wansley sublease was a net lease, similar to the Spruce and Scherer subleases. MEAG was responsible for all costs and expenses associated with the Wansley station throughout the sublease. In addition, MEAG had to maintain property and liability insurance on the Wansley station meeting the requirements set out in the sublease.

2. Default

Provisions governing events of default and events of loss are substantially the same in the Wansley and Scherer transactions. The Wansley sublease outlines different operating standards that the station must meet if it is returned to Unicom in an event of default, but other conditions are either very similar or the same.

3. Property Rights

The property rights of Unicom and MEAG under the Wansley transaction are substantially identical to those in the Scherer transaction and need not be separately stated here.

4. Cashflows and Collateral Agreements

MEAG and Unicom used the same structure of cashflows and collateral agreements for the Wansley transaction as for the Scherer transaction.

Pursuant to the Wansley headlease, on June 9, 2000, Unicom paid the Wansley headlease rent of $172,185,430 to MEAG.

On June 9, 2000, MEAG entered into the Government securities pledge agreement with Ambac Credit and State Street as agent and intermediary. MEAG paid State Street $129,768,893 from the Wansley headlease rent to purchase Government securities on that same date. MEAG pledged the Government securities to Ambac Credit and Unicom to secure MEAG's obligation to pay the base rent under the Wansley sublease on December 7, 2000. It was projected that the Government securities would equal the Wansley base rent of $134,087,903.

On June 9, 2000, MEAG provided UII with the UII swap agreement and the financial guaranty insurance policy issued by Ambac Assurance Corp., No. SF0356BE, dated June 9, 2000 (Wansley FGIP). On the same date, State Street, on behalf of MEAG, paid Ambac Credit $1,200,317.76, in consideration of Ambac Credit's agreement to make the payments described in the UII swap agreement and in the Wansley FGIP. The obligations of the parties are the same as under the UII swap agreement and the Wansley FGIP in the Scherer transaction.

On June 9, 2000, MEAG entered into the MEAG swap agreement with Ambac Credit, and Ambac Credit paid MEAG $287,226 in consideration of MEAG's agreement to make the payments described in the credit swap between

MEAG and Ambac Credit. MEAG's payment obligations under the MEAG swap agreement are the same as those described under the UII swap agreement. On behalf of MEAG, State Street Bank also paid $860,927 of transaction expenses on the closing date.

Also on the closing date, MEAG transferred $40,642,518 to collateral accounts for investment in short term collateralized flex repurchase agreements, as collateral for the purchase option, with a pledge first to Ambac Credit and second to UII.

5. End of Sublease Term

The end of sublease term options for Unicom and MEAG regarding the Wansley station are substantially the same as those in the Scherer transaction. MEAG and Georgia Power Co. could exercise the purchase option at the end of the Wansley sublease. The purchase option price was set at $143,543,915. If they chose not to do so, Unicom would be able to proceed with the operating agreement and service agreement options, similar to the provisions in the Scherer transactions. Alternatively, Unicom could get its share of the Wansley station output and sell it on the market.

Under the service agreement option, the electric output from the Wansley station would be purchased by third parties for the term of 8.09 years, and after the end of the power purchase agreement term the parties projected the remaining economic useful life of the Wansley station to be 9.17 years, or 20.38% of the estimated overall useful life remaining as of the closing date in 2000.

D. MEAG's Net Present Value Benefit

MEAG was entitled to receive a payment of approximately $110 million for its participation in the Scherer and Wansley transactions (MEAG NPV benefit). Mr. Fuller informed MEAG's board of directors in June 2000 that the MEAG NPV benefit for entering into the transactions would be approximately 11.19% of the value of each lease in the Wansley station and 12.34% of the value of each lease in the Scherer station. MEAG placed the NPV benefit into a trust account with State Street until 2014, at which time MEAG was expected to transfer the funds to the municipal competitive trust. MEAG's rights to use the NPV benefit until then were limited under the corresponding agreements because the trust account was pledged to lower the cost of insurance of the transactions and to secure the payment of early termination fees.

Post-Closing Events

I. Construction of Spruce II

At the time that CPS built the Spruce station, CPS had also intended to build, on an unspecified future date, a second generating plant (Spruce II) on the same site as the Spruce station. The Spruce transaction documents reflected the existence of such plans but in terms that did not convey absolute certainty.

On June 16, 2004, CPS informed Unicom in writing of CPS' intention to exercise its right to install and use additional facilities on the site of the Spruce station. CPS intended for this expansion--Spruce II--to share facilities with the Spruce station, such as a "control room", a "computer room", "coal conveyers", a "demineralizer", a "limestone silo ball mill", and a "limestone slurry storage tank". Although CPS would also build other operational facilities strictly for the benefit of Spruce II's operations, those facilities would be situated on the same land occupied by the Spruce station.

The letter dated June 16, 2004, from CPS requested prior written approval of the Spruce II construction from Unicom under the terms of the Spruce headlease. In evaluating CPS' request, Thomas Miller, Exelon's vice president of finance, and Randy Specht, from petitioner's engineering group, visited the Spruce site on December 17, 2004. Messrs. Miller and Specht met with CPS' plant personnel and toured the facility. In addition to the tour, Mr. Miller requested written representations from CPS that the Spruce II station would not interfere with or harm petitioner's interest in the Spruce station. CPS provided such written representations. Exelon, which at the time became a successor to Unicom by virtue of merger, then executed an approval authorizing the construction of the Spruce II plant. Exelon did not visit the site after the Spruce II project was completed in 2010 to examine the outcome.

II. Registration of the Test Transactions as Corporate Tax Shelters

On or about April 5, 2000, before the closing of the test transactions, Winston & Strawn circulated the initial draft of a designation agreement whereby PwC as designated organizer agreed to register the Spruce, Scherer, and Wansley transactions as tax shelters with the IRS in accordance with section 6011 and applicable regulations. On May 2, 2000, PwC informed the parties involved in the test transactions that the transactions would be registered as confidential corporate tax shelters pursuant to section 6111(d) and applicable regulations and provided the parties with the proposed designation agreement which, upon execution, would appoint PwC as a designated organizer. On or about June 9, 2000, PwC and the other parties involved in the Scherer, Wansley, and Spruce transactions entered into a designation agreement for registration of confidential tax shelters under section 6111(d).

On or about June 1, 2000, PwC filed with the IRS in Kansas City, Missouri, Form 8264, Application for Registration of a Tax Shelter (Confidential Corporate

Tax Shelter), for the Spruce transaction. On June 16, 2000, the IRS assigned tax shelter registration No. 00167000008 to the Spruce transaction.

On or about July 13, 2000, PwC filed a supplemental Form 8264 with the IRS in Kansas City, Missouri, for the Spruce, Scherer, and Wansley transactions. On July 18, 2000, the IRS issued tax shelter registration No. 00167000008 for the Scherer and Wansley transactions.

Unicom's tax return for its 1999 tax year included an appropriate disclosure statement under the then-effective regulations for a reportable transaction for UII on account of the test transactions. It also properly disclosed tax shelter registration No. 00167000008 on Form 8271, Investor Reporting of Tax Shelter Registration Number, issued by the IRS in connection with the Spruce, Scherer, and Wansley transactions. PwC monitored the status of the tax shelter registrations, including the registration No. 00167000008, for Unicom/UII and the Spruce, Scherer and Wansley transactions.

III. MEAG Collateral Substitution

Enhancements in the Scherer and Wansley transactions were structured differently from those in the Spruce transaction. CPS and Unicom used a CPUA as credit enhancement to secure the sublease obligations and provide the funds for the cancellation option exercise to CPS at the end of the sublease. In the Scherer and Wansley transactions, MEAG and Unicom used credit swap contracts issued by Ambac Credit to secure the payment of the purchase option exercise price. Under the swap contracts, MEAG would pledge high-quality securities primarily to Ambac Credit and secondarily to UII to pay the termination fees under the subleases or purchase option price. MEAG determined how it wanted to invest the money, with the ultimate goal to have sufficient funds to pay the purchase option price at the end of the Scherer and Wansley subleases.

Initially MEAG decided to invest the funds in short-term repurchase agreements, Federal agency discount notes, and a managed portfolio with Government-backed agency and Treasury securities. These short-term investments were rolled over and reinvested as they came due. Any ongoing investment risk, such as changes in interest rates over time, was borne entirely by MEAG.

In 2001 MEAG first suggested changing its investment portfolio by investing either in adjustable rate mortgage securities guaranteed by a Federal agency or Government-sponsored enterprise or in short-term money market funds rated AAA. Exelon agreed to the substitution. The securities continued to be pledged to Ambac Credit and Exelon.

Because the early 2000s ended up being a period of low interest rates, the funds invested by MEAG grew at a rate insufficient to fully fund the future purchase options. In 2006 MEAG proposed another substitution to Exelon, whereby MEAG would replace the existing collateral with a pledge of MEAG's own newly issued bonds insured by Ambac Credit. In August 2006 Exelon agreed to MEAG's request. This allowed MEAG to receive the funds it needed for environmental compliance and certain operational needs. Overall, MEAG replaced $173 million worth of collateral securities with its own bonds. MEAG also pledged an extra $81,171,330 of securities to Ambac Credit in 2007. In essence, MEAG remained obligated under the sublease agreements, and the bonds securing those sublease obligations were just another form of MEAG payment obligation.

When Ambac Credit's credit rating declined, MEAG contacted Exelon and received a waiver of the requirement that the bond insurance company maintain a certain credit level.

IV. Postclosing Monitoring

After the closing dates of the Spruce, Wansley, and Scherer transactions, the lessees were required to provide Unicom with certain financial and operational information. For example, CPS contacted petitioner regarding the impact of higher property insurance rates following the September 11, 2001, attacks. In addition, as discussed above, Unicom consented to the construction of Spruce II and the MEAG collateral substitution.

In 2008 employees from Exelon's corporate finance and asset management groups inspected the Spruce, Wansley, and Scherer stations as part of a "compliance review" to ensure that the facilities were being operated and maintained properly. Before the on-site inspections, Exelon's employees reviewed various operating and financial performance indicators and data, and also requested applicable documents for the leased stations from CPS and MEAG. The review did not raise any red flags. Exelon did not conduct compliance reviews in any other years even though it had the right to visit the sites and request related documents each year.

V. Early Termination of the Spruce Transaction

Pursuant to an omnibus termination agreement, on or about February 26, 2014, CPS and Exelon terminated the Spruce transaction. Upon termination of the Spruce transaction, Exelon received $335 million in exchange for terminating its interests in the Spruce station. Possession of the Spruce station passed to CPS, free and clear of any claims or liens by Exelon.

Tax Returns, Notices of Deficiencies, Trial

I. Tax Returns

A. 1999 Tax Year

Unicom timely filed the Unicom Group's consolidated Federal income tax return for the 1999 tax year. On or about April 1, 2004, Exelon, as successor to Unicom, filed Form 1120X, Amended U.S. Corporation Income Tax Return, for the Unicom Group's 1999 tax year. On or about August 25, 2004, Exelon filed a second amended tax return for the Unicom Group's 1999 tax year. On or about January 9, 2007, Exelon filed a third amended tax return for the Unicom Group's 1999 tax year.

On its 1999 income tax return, Unicom had indicated taxable income of $2,484,829,531 and filed Form 8824, Like-Kind Exchanges, describing the transactions at issue here. Unicom had not included in income deferred section 1031 gain of $1,231,927,407 arising out of the test transactions.

B. 2001 Tax Year

On or about September 26, 2002, Exelon, as successor to Unicom, filed its consolidated Federal income tax return for the 2001 tax year. On or about April 1, 2004, Exelon filed an amended tax return for its 2001 tax year. On or about January 30, 2007, Exelon filed a second amended tax return for the 2001 tax year.

On its 2001 income tax return, Exelon reported taxable income of $1,412,586,105. With respect to the transaction with CPS, Exelon had claimed a depreciation deduction of $2,968,648 an interest expense deduction of $38,261,289, and an amortized transaction costs deduction of $183,708. Exelon reported $40,476,248 of taxable rental income. Exelon had not reported taxable original issue discount income with respect to the transaction (which respondent determined claims to be $5,939,981 for the 2001 tax year).

With respect to the transactions with MEAG, Exelon had claimed a depreciation deduction of $5,447,849 an interest expense deduction of $46,547,887, and an amortized transaction costs deduction of $231,814. Exelon reported $50,370,556 of taxable rental income. Exelon had not reported taxable original issue discount income with respect to the transaction (which respondent determined claims to be $7,078,805 for the 2001 tax year).

II. Notices of Deficiency

A. 1999 Tax Year

On September 30, 2013, respondent timely issued a statutory notice of deficiency to petitioner for its income tax liabilities for the tax year ending December 31, 1999 (1999 notice of deficiency). Respondent determined a deficiency in tax for 1999 of $431,174,592 and a penalty under section 6662(a) of $86,234,918.

Respondent disallowed petitioner's treatment of the transactions with CPS and MEAG as section 1031 like-kind exchanges. The 1999 notice of deficiency stated that deferred section 1031 gain of $1,231,927,407 should be included in income for tax year 1999, because petitioner "did not acquire and retain significant and genuine attributes of a traditional owner, including the benefits and burdens of ownership, of the Replacement Property."

The 1999 notice of deficiency determined a section 6662 accuracy-related penalty of 20% on the grounds of negligence or disregard of rules and regulations, or a substantial understatement of income tax.

B. 2001 Tax Year

On September 30, 2013, respondent timely issued a separate statutory notice of deficiency to petitioner for its income tax liability for the tax year ending December 31, 2001 (2001 notice of deficiency). Respondent determined a deficiency in tax for 2001 of $5,534,611 and a penalty under section 6662(a) of $1,106,922.

The 2001 notice of deficiency disallowed depreciation deductions of $2,968,648 and $5,447,849 claimed by Exelon for the CPS and MEAG sale-leaseback transactions, respectively, because "the taxpayer failed to acquire and retain significant and genuine attributes of a traditional owner, including the benefits and burdens of ownership". Respondent disallowed interest expense deductions of $38,261,289 and $46,547,887, and amortized transaction costs deductions of $183,708 and $231,814, for the CPS and MEAG transactions, respectively. Respondent determined that because the transactions with CPS and MEAG were in substance loans, petitioner should have reported original issue discount (OID) income of $5,939,981 and $7,078,805 resulting from the deemed loans to CPS and MEAG, respectively. Furthermore, according to respondent, because petitioner did not acquire ownership interests in the CPS and MEAG transactions, it was not required to report rental income of $40,476,248 and $50,370,556, respectively, from the subleases in 2001.

In the alternative, respondent determined that sale-leaseback transactions with CPS and MEAG lack economic substance and should be disregarded for Federal income tax purposes. Accordingly, respondent disallowed petitioner's deductions of depreciation, interest expense, and transaction costs, and reversed rental income.

The 2001 notice of deficiency imposed a 20% accuracy-related penalty under section 6662 on the grounds of "negligence or disregard of rules and regulations regarding * * * [petitioner's] tax treatment of the SILO transactions."

In the alternative, respondent determined the section 6662 penalty for 2001 for a substantial understatement of income tax attributable to a tax shelter item of a corporation. Respondent conceded the issue of a substantial understatement of income tax under section 6662(a) and (b)(2) for 2001 before trial, so we need not in this Opinion address this ground for imposition of the section 6662 penalty for 2001.

III. Trial

Exelon timely filed petitions in both cases on December 13, 2013. The Court held a three-week special trial session in Chicago, Illinois. During the trial, the parties presented the testimony of 16 fact witnesses and 10 expert witnesses. Both parties rely heavily on expert opinions to support their arguments. The parties' expert witnesses, their qualifications, and their Court-recognized areas of expertise are listed below. We also briefly summarize the conclusions of the experts in their respective expert reports.

A. Petitioner’s Expert Witnesses

1. Stewart Myers

The Court recognized Stewart Myers as an expert in finance, valuation, and investments in the energy industry, as well as analysis of complex financial transactions including leases and real options. Prof. Myers has a Ph.D. in finance and economics from Stanford, and he is the Robert C. Merton professor of financial economics at the MIT Sloan School of Management, where he has taught since 1966.

Prof. Myers’ graduate-level textbook, Principles of Corporate Finance (with Professors Richard Brealey and Franklin Allen) is a highly regarded treatise. He has also published dozens of articles on corporate finance and financial economics. He was also a director for Entergy Corp., a large public utility and merchant power generator based in New Orleans, Louisiana, that also has generating plants in the eastern and northeastern United States.

In his expert report Prof. Myers discussed the primary factors that affect the decisions of the parties involved in the test transactions to exercise their respective options. Prof. Myers testified that, while both MEAG and CPS do not pay income tax, their tax-exempt status does not affect their valuation of the leased stations.

Prof. Myers also testified that the accepted financial practice always makes decisions based on after-tax cashflows and rates of return.

Prof. Myers conducted sensitivity analysis involving several variables such as inflation and electricity price to determine the range of future market values of residual interests in the Spruce, Scherer, and Wansley stations and to see how it would affect the decisions of CPS and MEAG to exercise their cancellation/purchase options at the end of the sublease terms. He concluded that both CPS and MEAG would return their respective interests in the subleased stations to Exelon if the values of these interests at the end of the sublease terms were less than the purchase option prices. This would also cover the “base” scenario outlined in the Deloitte appraisal.

We find Prof. Myers’ sensitivity analysis helpful because it illustrates that even a difference of 1%-2% in the inflation rate would dramatically change the future market value of an interest over a 30-year term. For example, in the case of the Spruce station, a 4% inflation rate--1.5% higher than the rate assumed by Deloitte--would result in the future market value of the plant of $971.1 million, almost $250 million above the exercise price of $723.2 million for the cancellation option and almost $350 above the fair market value projected by the Deloitte appraisal. Conversely, a 1% inflation rate--1.5% lower than the rate assumed by

Deloitte--would result in the future market value of the plant of $394.2 million, almost $330 million less than the cancellation option exercise price and over $200 million less than the fair market value projected by the Deloitte appraisal.

2. John Reed

The Court recognized John J. Reed as an expert in transactions involving energy, industry firms and assets, energy market economic analyses, and evaluation and financial analysis related to the energy industry. Mr. Reed is a graduate of the Wharton School of the University of Pennsylvania, where he received a bachelor of science degree in finance.

Mr. Reed is currently the chairman and CEO of Concentric Energy Advisors, Inc., a financial advisory and management consulting firm for energy industry firms. Mr. Reed has over thirty-five years of experience in the energy industry, including as an executive in energy consulting firms and as chief economist for Southern California Gas Co., the largest U.S. gas utility. He has also been involved in the purchase, sale, and valuation of energy-related assets, including the sales of over 50 fossil fuel power generating facilities.

In his expert report Mr. Reed concluded that, at the time Unicom, CPS, and MEAG entered into the test transactions, a significant uncertainty existed with respect to the future value of the Scherer, Spruce, and Wansley stations. Mr. Reed concluded that CPS' and MEAG's tax-exempt status would not influence their analysis of the future market value of the plants.

3. Karl A. McDermott

The Court recognized Karl A. McDermott as an expert in regulatory economics, the history of regulation, and capital investment decisionmaking in the power utility industry in the United States. Prof. McDermott has a Ph.D. in economics from the University of Illinois at Urbana-Champaign and serves as the Ameren distinguished professor of business and government at the University of Illinois Springfield. He has served as a lecturer and teacher for 36 years on topics regarding public utilities, banking, energy market regulation, gas wholesale markets, and macroeconomics. He has also published articles on the energy industry, the ICC, and energy market regulation. Prof. McDermott served as a commissioner for the ICC from 1992 to 1998, during the period when Illinois deregulated its energy market.

Prof. McDermott provided the Court with a primer on the U.S. energy market that also covered the periods both before and after many States (including Illinois) deregulated. In his expert report Prof. McDermott concluded that Unicom's investment in leases with CPS and MEAG allowed it to achieve the same risk and reward profile it had had before the deregulation of generation assets in Illinois. Prof. McDermott stated that bankruptcy of CPS or MEAG was a relatively low probability although such bankruptcies had occurred in other jurisdictions.

4. Stuart Gilson

The Court recognized Stuart Gilson as an expert in the financial consequences of bankruptcy, including decisionmaking and financial consequences relating to bankruptcy proceedings. Prof. Gilson has a Ph.D. in finance from the University of Rochester and is a tenured professor in the Finance Department of Harvard Business School. His academic and consulting experiences focus on corporate finance, business valuation, credit analysis, and corporate restructuring and bankruptcy; and he has written several articles and case studies on those subjects.

In his expert report Prof. Gilson concluded that Unicom faced a risk of loss arising from a CPS or MEAG bankruptcy.[19] In the event of a CPS or MEAG bankruptcy, section 502(b)(6) of the Bankruptcy Code could limit the recovery available to Unicom to rent for the greater of one year or 15%, not to exceed three

[19]Prof. Gilson assumed that Georgia bankruptcy law would be changed to allow municipalities to take advantage of chapter 9 of the Bankruptcy Code. Alternatively, Prof. Gilson assumed that MEAG could have filed for protection under chapter 11 of the Bankruptcy Code if the bankruptcy court had determined that MEAG did not qualify as a municipality.

years, of the remaining term of the sublease. In his analysis Prof. Gilson did not consider various credit enhancements and contractual provisions available to Unicom in the case of a CPS or MEAG bankruptcy. Prof. Gilson concluded that the net financial impact on Unicom of an early sublease rejection would depend on the fair market value of the facility at the time of rejection. At low fair market value, Unicom could experience a loss at sublease rejection, but with the fair market value increase the net financial impact on Unicom would become increasingly positive.

5. Mark E. Zmijewski

The Court recognized Mark E. Zmijewski as an expert in the field of accounting, and particularly accounting for financial analysis of leases. Prof. Zmijewski is the Leon Carroll Marshall professor of accounting at the University of Chicago Booth School of Business, where he has served on the faculty since 1984. Prof. Zmijewski has an M.B.A. in accounting and a Ph.D. in accounting from the State University of New York at Buffalo. Prof. Zmijewski teaches courses in valuation, mergers and acquisitions, financial analysis, accounting, and entrepreneurship. He has also published articles on accounting, discounted cashflow valuations, and securities regulation.

In his expert report Prof. Zmijewski concluded that the test transactions were structured as direct financing leases rather than SILOs. Prof. Zmijewski also concluded that the test transactions are not front loaded under any of the options available in the lease and are not tax driven.

6. Ingrid Sarapuu

The Court recognized Ingrid Sarapuu as an expert in lease financing, leasing, and asset financing. Ms. Sarapuu has an M.B.A. from the University of Chicago Booth School of Business. She has been a licensed securities principal with Series 7, 24, 63, and 79 certifications. She also has over 30 years of executive experience in leveraged leasing and corporate finance in the private sector. In her expert report Ms. Sarapuu concluded that the test transactions are consistent with traditional leasing structures. Ms. Sarapuu also opined that Unicom engaged and appropriately employed various specialists and advisers to complete the test transactions.

7. Nancy Heller Hughes

The Court recognized Nancy Heller Hughes as an expert in the valuation of power facilities. Ms. Hughes has an M.B.A. in finance and accounting from the University of Chicago Booth School of Business. She is also an accredited senior appraiser in the public utility discipline (as certified by the American Society of

Appraisers) and a certified depreciation professional (as certified by the American Society of Appraisers). She has also performed many appraisal and depreciation studies for businesses in the energy industry.

Ms. Hughes opined in her expert report that the Deloitte appraisals of Spruce, Scherer, and Wansley used an appropriate process for the purpose of producing credible appraisal reports under the Uniform Standards of Professional Appraisal Practice (USPAP). Ms. Hughes concluded that Deloitte's conclusions were appropriate, supported in its appraisal reports, and prepared in accordance with generally accepted appraisal procedures. Ms. Hughes did not offer an opinion of what the fair market value of the Spruce, Scherer, and Wansley stations would be at various stages of the test transactions.

B. Respondent's Expert Witnesses

1. Douglas J. Skinner

The Court recognized Douglas J. Skinner as an expert in accounting and financial economics. Dr. Skinner is the deputy dean for faculty and Eric J. Gleacher distinguished service professor of accounting at the University of Chicago Booth School of Business. Dr. Skinner holds a Ph.D. in applied economics: accounting and finance from the University of Rochester. Dr. Skinner has published research on a variety of topics in accounting, auditing, and corporate finance, including how securities prices respond to corporate disclosures, how accounting information is used in contracts between various corporate stakeholders, the nature of corporate debt agreements, and many others.

Dr. Skinner concluded that the analyses in the Deloitte appraisals are flawed in a number of respects, but focused on two flaws in particular. First, in performing the discounted cashflow calculations necessary to value the underlying assets at the end of the sublease term, Deloitte applied the maximum statutory corporate income tax rate to the forecasted cashflows. Dr. Skinner opined that in asset valuation, the tax status of the buyer or seller can matter. According to Dr. Skinner, here, where both CPS and MEAG are tax-exempt entities, their cashflows are about 40% higher than the cashflows Deloitte assumes, significantly increasing the value of the assets at the sublease termination dates. Second, Dr. Skinner concluded that Deloitte also applied too high a discount rate to these cashflows, further reducing the estimated value of the assets.

Dr. Skinner recalculated the value of each asset using Deloitte's cashflows and applying a 0% tax rate and lower discount rates of 6.1% for Spruce and 6.3% for Wansley and Scherer. His calculations show an estimated value for each asset at the sublease expiration date that is substantially higher than the cancellation/purchase option exercise price. Thus, Dr. Skinner concluded that it was nearly certain that CPS and MEAG will exercise their respective cancellation/purchase options at the end of the sublease terms, allowing Exelon to obtain the option proceeds without ever bearing any significant risk of loss.

In addition Dr. Skinner opined that CPS and MEAG would be economically compelled to exercise their cancellation/purchase options because of the "onerous" conditions they would face if they did not exercise their respective options.

Dr. Skinner in his expert report shows that, absent tax benefits available under section 1031, Exelon would never recover its initial investment in the lease. Thus, Dr. Skinner concluded that Exelon would be able to generate a positive return from the transactions only because of the tax benefits.

2. Christopher Knittel

The Court recognized Christopher Knittel as an expert in energy and environmental economics, industrial organization, and regulation. Dr. Knittel is the William Barton Rogers professor of energy economics in the Sloan School of Management at the Massachusetts Institute of Technology. He has a Ph.D. in economics from the University of California at Berkeley. Dr. Knittel's research focuses on energy and environmental economics and policy, and how consumers, firms, and policymakers interact in the marketplace. Dr. Knittel has written articles on topics related to energy markets, policy and pricing; testified in front of the U.S. House of Representatives Subcommittee on Agriculture, Energy and Trade; and consulted for large corporations and regulatory agencies on energy and environmental issues.

Dr. Knittel opined that the test transactions did not provide Exelon with new sources of operating profits, improve the company's environmental impact or supply management, assist Exelon with gaining market-entry benefits, improve knowledge-sharing, or achieve economies of scale. Dr. Knittel also opined that the test transactions were not compelled by the Illinois Restructuring Act. On the basis of his analysis of the potential direct and ancillary economics, he concluded that the test transactions did not provide Exelon with any non-tax-related economic benefits.

3. Uppender Saraon

The Court recognized Uppender Saraon as an expert in structured finance and leasing transactions. Mr. Saraon is a former director of Citigroup with a graduate degree in management from the MIT Sloan School of Management. Mr. Saraon opined that the structure of the test transactions, including the credit enhancement provisions, was very different from traditional U.S. leveraged leases.

C. Concurrent Witness Testimony Procedure

The Court, with prior agreement of the parties, directed certain expert witnesses, including Prof. Myers, Dr. Skinner, and Mr. Reed, to testify concurrently. The procedure was implemented in substantially the same way as in Rovakat, LLC v. Commissioner, T.C. Memo. 2011-225, slip op. at 29-30, aff'd, 529 F. App'x 124 (3d Cir. 2013). See also Green Gas Del. Statutory Tr. v. Commissioner, 147 T.C. __, __ (slip op. at 52, 60-61) (July 14, 2016); Buyuk, LLC v. Commissioner, T.C. Memo. 2013-253, at *29-*30, *39-*40; Crimi v. Commissioner, T.C. Memo. 2013-51, at *34, *40-*43. The Court found the procedure especially helpful in illuminating the major aspects of certain issues in these cases and enabling the Court to facilitate its findings of fact.

OPINION

I. Overview

Section 1031(a)(1) prevents the recognition of gain or loss "on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment." Our task in these cases is to analyze a set of transactions in which petitioner engaged in an attempt to defer taxation of almost $1.6 billion of gain on the sale of its two power plants. To achieve this result, petitioner entered into what it asserts were deferred like-kind exchanges under section 1031, with the replacement property being interests obtained in sale-leaseback transactions. The character of that replacement property interest is yet to be determined.

While traditional LILOs and SILOs involved leveraged leases, petitioner invested the proceeds from the sale of its own power plants to fully fund the transactions. The purported tax benefits were primarily derived from the deferral of income tax under section 1031 and various deductions related to the replacement properties. Although this Court has previously ruled on the tax consequences of certain SILO and LILO transactions, we have never ruled on the tax consequences of an ostensible like-kind exchange involving a SILO-like transaction funded fully by a taxpayer's own equity contribution. Therefore, these cases present an issue of first impression.

We note that while these cases involve several issues separate from but related to the validity of the test transactions under section 1031, our analysis of the latter question will govern our disposition of the former. Accordingly, we shall turn first to the section 1031 like-kind exchange issue.

A. Overview of the Parties' Arguments

1. Petitioner's Arguments

In 1999 after conducting an evaluation of its strengths and weaknesses in the new deregulated energy market, petitioner decided to sell its entire fleet of fossil fuel power plants. After realizing that the sale would occur at a price almost two times higher than petitioner's initial estimate, petitioner sought ways to preserve the gain and possibly defer the income tax.

Petitioner contends that the test transactions represent valid deferred section 1031 like-kind exchanges, where petitioner exchanged its "active" ownership interests in two power plants in Illinois for "passive" leasehold interests in power plants in Georgia and Texas. Petitioner argues that it engaged in thoughtful decisionmaking and an extensive due diligence process in an effort to maximize the value for its shareholders and diversify its risks. Petitioner asserts that it acquired benefits and burdens of ownership with respect to assets involved in the test transactions because petitioner remained exposed to significant risks not only during the residual period of the headleases but also during the leaseback period.

Petitioner opposes respondent's attempts to characterize the test transactions as SILOs because they are structured not as leveraged leases but as direct leases financed entirely from petitioner's own funds. As petitioner sees it, it merely reinvested the proceeds from the sale of its assets into similar assets in other geographical areas.

In doing so, petitioner maintains it acted in good faith and relied on services of independent and highly qualified advisers. Thus, petitioner argues that it should not be held liable for the penalties under section 6662 proposed by respondent.

2. <u>Respondent's Arguments</u>

Respondent primarily contends that the test transactions among petitioner, CPS, and MEAG did not transfer any benefits and burdens of ownership to petitioner because they were not true leases. Respondent argues that petitioner's SILOs were "prepackaged, promoted tax products which subjected [p]etitioner to no residual value risk, only a theoretical, de minimis credit risk." In essence, as respondent sees it, the test transactions are more similar to low-risk loans. Thus, because petitioner exchanged ownership interests in power plants for financial instruments (low-risk loans), petitioner failed to meet section 1031 like-kind exchange requirements.

Further, respondent argues that because the substance of each test transaction is a loan rather than a lease, these loans should generate original issue discount (OID) income under section 1272. According to respondent, petitioner is not entitled to depreciation deductions under section 168, interest deductions under section 467, or transaction cost deductions under section 162.

In the alternative, respondent argues that the test transactions lack economic substance because they were driven by tax considerations and the desire to defer taxation of a $1.6 billion gain, not by a legitimate business purpose. Accordingly, respondent urges the Court to disregard the test transactions altogether and conclude that petitioner failed to enter into a like-kind exchange. Respondent maintains that petitioner never expected to realize pretax benefits from the test transactions alone. However, together with the tax deferral benefits available under section 1031, petitioner would be able to more than make up for the economic losses associated with the test transactions.

Further, respondent argues that petitioner is also liable for accuracy-related penalties under section 6662 for both tax years, 1999 and 2001, for negligently engaging in transactions that it should have known were "too good to be true". According to respondent, petitioner's tax reporting also resulted in a substantial understatement of income tax for the 1999 tax year.

B. Primer on Leveraged Leases, LILOs, and SILOs

We have discussed in detail the seminal cases and regulations related to leveraged leases, LILOs, and SILOs in this Court's opinion in John Hancock Life

Ins. Co. (U.S.A.) v. Commissioner, 141 T.C. 1, 15-16, 54-77 (2013). We briefly reiterate some of that analysis here to provide the reader with sufficient details relevant to the cases at hand.

Frank Lyon Co. v. United States, 435 U.S. 561 (1978), is the seminal Supreme Court case discussing leveraged lease transactions. The taxpayer in Frank Lyon engaged in a sale-leaseback transaction to finance the construction of a new building. Out of the required $7.64 million, Frank Lyon invested $500,000 of its own money and financed the remainder with a third-party lender through a secured mortgage with the building serving as a collateral. In addition, Frank Lyon made a promise to assume personal responsibility for the loan's repayment and an assignment to the lender of the rental payments under the lease. Id. at 566-568.

The lease in Frank Lyon was a net lease requiring lessee to pay taxes, insurance, and utilities. Lessee had an option to purchase the building at certain times during the lease and at the end of the 25-year lease term. Lessee also had an option to renew the lease for additional periods of time. Frank Lyon claimed depreciation deductions and interest expense deductions related to the building. Id. at 567-569.

After considering the transaction, the Supreme Court held that the form of a sale-leaseback transaction will be respected for Federal tax purposes as long as the lessor retains significant and genuine attributes of a traditional lessor. Id. at 584. The Supreme Court recognized that these attributes necessarily depend on the facts of a particular case. Id. According to the Supreme Court, several factors weighed in favor of the taxpayer in Frank Lyon. Frank Lyon bore the financial risks of the transaction by assuming responsibility for loan repayment and investing its own money in the transaction. Id. at 581. The Supreme Court concluded that there was a real possibility that the lessor could walk away from the transaction at the end of the initial lease. The parties negotiated the deal in good faith and were independent of each other. The parties paid the same tax rates, making the transaction tax neutral. The rent and purchase option prices were reasonable, and Frank Lyon assumed the credit risk of the lessee's defaulting on its rent payments. Id. at 575-584.

Around the time the Supreme Court issued its ruling in Frank Lyon, the Government was working on developing a set of rules to determine whether a leveraged lease transaction is a true lease or something else. In 1975 the Commissioner issued guidelines for advance ruling purposes on whether a leveraged lease will be respected for Federal tax purposes as a lease. Rev. Proc.

75-21, 1975-1 C.B. 715. In 1984 Congress enacted what has become known as the "Pickle rule", which subjected property leased to a tax-exempt entity to unfavorable depreciation rules. Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 31, 98 Stat. at 509.

The unintended consequence of the Pickle rule was the proliferation of LILO transactions with tax-exempt entities. LILO transactions were designed to work around the Pickle rule because the taxable party leased the property from the tax-exempt counterparty instead of buying it, and then immediately subleased it back to the tax-exempt entity. To fund the transaction, the taxable party typically took out a nonrecourse loan covering 80%-90% of the initial lease. See John Hancock Life Ins. Co. (U.S.A.) v. Commissioner, 141 T.C. at 11.

The sublease to a tax-exempt entity would typically be shorter than the initial lease term. At the end of the sublease, the tax-exempt entity usually has the option to purchase the remainder of the leasehold interest in the initial lease. Even if the tax-exempt entity decides not to exercise its purchase option, the taxable party could still compel the tax-exempt entity to renew the sublease, take possession of the asset, or procure the replacement sublease. To return the asset to the taxable party, the tax-exempt entity would typically need to meet certain conditions, including refinancing the nonrecourse loan involved in the transactions. Failure to meet the return conditions meant that the tax-exempt entity had to exercise the purchase option. See Id.

In 1999 LILO transactions became less popular because of a change in the regulations under section 467, which required that prepayment of the initial lease rent be treated as a loan for tax purposes. Id. at 16; see also sec. 1.467-4, Income Tax Regs. After that, investors started using SILOs to obtain similar results. See John Hancock Life Ins. Co. (U.S.A.) v. Commissioner, 141 T.C. at 16.

A typical SILO transaction would be similar to a LILO except that the term of the initial lease extends beyond the remaining useful life of the asset, as is the case with the Spruce, Scherer, and Wansley test transactions here. Thus, the initial lease is treated as a sale for Federal tax purposes. The end-of-sublease options for the taxable entity usually include either compelling the lessee to arrange a service contract for the asset for a predetermined term or to take possession of the asset. Id.

The payments in SILO and LILO transactions are typically secured by the various defeasance instruments. Although the form of such instruments differs from one transaction to another, typically they entail setting aside several deposits with third-party financial institutions--payment undertakers--for various payments due under the transaction documents, including purchase options. Id. at 12. As a result of defeasance, the parties to the transaction do not have to come up with any out-of-pocket payments during the initial lease term. Id.

In 2002 the Commissioner issued Rev. Rul. 2002-69, 2002-2 C.B. 760, which explained that LILO transactions should be properly characterized as a future interest in property. Consequently, a taxpayer may not deduct rent or interest paid or incurred in connection with such a transaction. In the ruling the Commissioner stated that he would challenge tax benefit claims based on LILO transactions under the substance over form and economic substance doctrines. Id.

Congress eliminated the benefits associated with LILO and SILO transactions in the American Jobs Creation Act of 2004, Pub. L. No. 108-357, secs. 847-849, 118 Stat. at 1601. John Hancock Life Ins. Co. (U.S.A.) v. Commissioner, 141 T.C. at 16. That law was prospective in effect and did not apply to transactions entered by taxpayers before its effective date. Id.

C. Recent SILO/LILO Cases

As this Court observed in 2014 in John Hancock Life Ins. Co. (U.S.A.) v. Commissioner, 141 T.C. at 58, "[t]axpayers have lost their fight for claimed tax benefits in SILO and LILO transactions in all Courts of Appeals in which they have appeared." This still remains true.

The Commissioner has often used the doctrines of economic substance and substance over form to challenge the legitimacy of sale-leaseback transactions. See, e.g., Id. at 58-77 (analyzing prior SILO/LILO cases and arguments advanced by the litigants). We will discuss these judicial doctrines in more detail in other parts of this Opinion.

Our conclusion on whether petitioner entered into a valid like-kind exchange under section 1031 hinges on the proper characterization of the test transactions. If the transactions did not transfer the benefits and burdens of ownership to petitioner, then the test transactions are properly characterized not as leases but as loans. And if the transactions are characterized as loans, then petitioner had exchanged power plants for interests in financial instruments, which would cause petitioner to fail the requirements of section 1031. To aid in our analysis, we examine two cases, Consol. Edison Co. of N.Y., Inc. v. United States (ConEd II), 703 F.3d 1367 (Fed. Cir. 2013), rev'g and remanding Consol. Ed. of N.Y., Inc. v. United States (ConEd I), 90 Fed. Cl. 228 (2009), and John Hancock Life Ins. Co. (U.S.A.) v. Commissioner, 141 T.C. 1, in chronological order. While Consol. Edison and John Hancock did not involve purported section 1031 like-kind exchanges, the similarities between the two cases and the instant cases are many, and their legal reasoning is apposite here.

1. Consol. Edison

There are many factual similarities between the cases at hand and the facts in Consol. Edison, so we will briefly reiterate the key facts.

In the mid-to-late 1990s Consolidated Edison (ConEd) was a publicly held vertically integrated utility company organized and operating in New York. ConEd I, 90 Fed. Cl. at 232. In an attempt to offset the effects of the electric industry deregulation, ConEd underwent a major internal restructuring and decided to enter, through one of its subsidiaries, into one or more LILO investments. Id. at 233-234. On December 15, 1997, ConEd entered into a LILO transaction with EZH, a Dutch electric utility (ConEd LILO). Id. at 234-235.

ConEd retained Cornerstone Financial Advisors L.P. to obtain financial services in connection with the EZH LILO. Id. at 234. ConEd retained the law firms of Shearman & Sterling, LLP as its United States legal counsel, and Loeff, Claeys, Verbeke as its Dutch legal counsel, as well as Deloitte as its appraiser, Duke Engineering & Services as its independent engineer, and Tauw Milieu, International, as its environmental consultant. Id. at 235.

Under the terms of the ConEd LILO, ConEd leased from EZH a 47.47% undivided interest in a Dutch power plant for 43.2 years. ConEd II, 703 F.3d at 1370. ConEd immediately leased back the interest to EZH for a term of 20.1

years. Id. at 1370-1371. At the end of the sublease term, EZH could exercise the purchase option and terminate the transaction. Id. at 1372. If EZH declined to exercise the purchase option, ConEd could either force it to renew the sublease for an additional term of 16.5 years or take possession of the interest in the power plant and operate it during the remaining term of the initial lease. Id.

In its appraisal Deloitte concluded that there would be no "economic compulsion" for EZH to exercise the purchase option at the end of the sublease because the option price exceeded the projected value of the property. Id. at 1379. Richard Ellsworth, who led the Deloitte appraisal team, testified at trial that he did not consider any noneconomic factors in arriving at this conclusion. Id. at 1379-1380. On the basis of this conclusion and the record of the case as developed at trial, the trial court concluded that the ConEd LILO was a true lease. ConEd I, 90 Fed. Cl. at 340. The Court of Appeals for the Federal Circuit reversed and remanded the case. ConEd II, 703 F.3d at 1369.

The Court of Appeals explained that at the time the trial court rendered its ruling it did not have the benefit of the decision in another LILO/SILO case, Wells Fargo & Co. v. United States, 641 F.3d 1319 (Fed. Cir. 2011). ConEd II, 703 F.3d at 1377. Thus, the trial court used the wrong legal standard in determining whether ConEd acquired benefits and burdens of ownership in the ConEd LILO.

Id. The Court of Appeals clarified that the relevant standard was whether there was a reasonable likelihood that the purchase option at the end of the sublease period would be exercised, not whether this outcome was "certain" or "virtually certain". Id. at 1376.

The Court of Appeals concluded that the analysis performed by Deloitte for the ConEd LILO was "boilerplate" and was insufficient to support ConEd's claims. Id. at 1378-1379. The Court of Appeals noted that Richard Ellsworth, who prepared the appraisal for the ConEd LILO, admitted at trial that Deloitte "never once found that there was 'economic compulsion' to exercise a purchase option" in about a hundred appraisal reports prepared for LILO transactions. Id. at 1380. The Court of Appeals commented that the appraisal failed in several respects, including not considering noneconomic factors, defeasance of funds for the purchase option payment, and the costs to EZH that would result from ConEd's exercise of the renewal or retention options. Id. at 1379.

After considering the arguments of the parties in ConEd II, the Court of Appeals concluded that "EZH was reasonably likely to exercise the purchase option * * * [and] ConEd has failed to show that the substance of the transaction included a genuine leasehold interest in which ConEd would bear the benefits and burdens of a lease transaction." Id. at 1381. Accordingly, ConEd's deductions related to the LILO were properly disallowed. Id.

2. John Hancock Life Ins. Co. (U.S.A.) v. Commissioner

This Court first considered the Federal income tax consequences of SILO and LILO transactions in John Hancock Life Ins. Co. v. Commissioner, 141 T.C. 1. John Hancock Life Insurance Co. (John Hancock) entered into 27 LILOs and SILOs between 1997 and 2001. Id. at 6. The Court considered seven test transactions, including three LILOs and four SILOs (John Hancock test transactions). Id.

John Hancock invested in SILOs and LILOs primarily as a means to diversify its investments in domestic and international assets to provide it with sufficient cashflow. Id. at 8. All of the John Hancock test transactions had a typical structure for LILOs and SILOs, featuring a set of agreements including a headlease, a sublease with a fixed purchase option at the end, and various defeasance arrangements.

The Court considered the application of both the economic substance doctrine and the substance over form doctrine to the John Hancock test transactions: "In order to conclude that John Hancock is entitled to its claimed deductions, we must determine both that the test transactions have economic substance and that the substance of each test transaction is consistent with its form. There is no clear formula by which to answer these questions, nor do we attempt to create one." Id. at 78.

The Court analyzed both objective and subjective sides of the John Hancock test transactions and concluded that they satisfied the economic substance inquiry because John Hancock had a realistic expectation of profit and a business purpose when entering into the transactions. Id. at 78-89.

To determine whether the John Hancock test transactions' form was consistent with their substance, the Court followed the same analysis the Supreme Court used in Frank Lyon for leveraged leases. Id. at 89-90 (citing Frank Lyon, 435 U.S. at 584). Thus, the Court had to determine whether John Hancock held a true leasehold interest in each LILO property and obtained an ownership interest in each SILO property. John Hancock Life Ins. Co. (U.S.A.) v. Commissioner, 141 T.C. at 89-90.

After discussing various factors previously considered in other cases, the Court reiterated its commitment to evaluate the John Hancock test transactions on the basis of the overall facts and circumstances in determining whether the substance of the transactions was consistent with their form. Id. at 90-91 (citing Levy v. Commissioner, 91 T.C. 838, 860 (1988), Torres v. Commissioner, 88 T.C.

702, 721 (1987), Gefen v. Commissioner, 87 T.C. 1471, 1490-1495 (1986), Mukerji v. Commissioner, 87 T.C. 926, 967-968 (1986), and Estate of Thomas v. Commissioner, 84 T.C. 412, 433-438 (1985)). For each of the John Hancock test transactions, the Court considered risk allocation during the initial lease period, likelihood of purchase option exercise by the original property holder at the end of the sublease term, end-of-sublease alternatives for the parties involved in the transaction and related costs and risks.

The Court concluded that for all test transactions, John Hancock did not assume more than a de minimis risk during the sublease period because of contractual protections, various credit enhancements, and rent defeasance. Id. at 94, 113-114, 145.

Next, the Court evaluated the likelihood of the original property holders' exercising their respective purchase options at the end of subleases. The Court recognized that "[t]he courts that have analyzed SILO and LILO cases have adopted varying standards in determining whether a party to a SILO or LILO transaction will exercise its purchase option." Id. at 95. After analyzing various standards, the Court adopted the "reasonable likelihood" standard articulated by the Courts of Appeals for the Second Circuit in Altria Grp., Inc. v. United States, 658 F.3d 276, 286 (2d Cir. 2011), and the Federal Circuit in ConEd II, 703 F.3d at

1379, and Wells Fargo, 641 F.3d at 1329. Id. at 95-97. The inquiry into the likelihood of purchase option exercise is determinative because if the original property holder is reasonably expected to exercise the purchase option at the end of the sublease, the obligations of the parties under SILO/LILO would offset each other, so that a taxpayer would be insulated from any economic risk of loss and would not be able to take advantage of any potential gain. Id. at 94. Instead, a taxpayer would be guaranteed a fixed return on its investment at the end of a sublease term. This would indicate that the taxpayer did not obtain any benefits or burdens associated with the leasehold or ownership interest transferred in a SILO/LILO.

For the LILO transactions in John Hancock, the Court concluded that "any legal, political, industrial, or technical objections to the nonexercise of the purchase options can be overcome, and thus are not determinative of whether [the LILO counterparty] is reasonably likely to exercise its purchase option." John Hancock Life Ins. Co. (U.S.A.) v. Commissioner, 141 T.C. at 99, 107. Thus, the Court based its ultimate conclusion primarily on financial analysis, including a comparison of the costs of the purchase option and alternative end-of-sublease options. In all LILO test transactions, the Court concluded that it was reasonably likely that the LILO counterparties would exercise their respective purchase options. Id. at 109-110. The Court came to the same conclusion for one of the SILO transactions, the SNCB SILO. Id. at 145. Thus, the Court held that the substance of all the LILO and SNCB SILO transactions was inconsistent with their form and that these transactions resembled loans because John Hancock did not acquire genuine attributes of ownership or leasehold interest. Id. at 109-110, 145. As a result, the Court held that John Hancock was not entitled to rental expense and depreciation deductions related to these transactions. Id. at 109-110, 145. The Court also disallowed the interest expense for the nonrecourse loans John Hancock took out to finance the transactions. Id. at 146-147. Further, the Court recharacterized the equity contributions into these transactions as a loan giving rise to the original issue discount (OID) income. Id. at 148. The Court held that pursuant to section 1.1273-2(g)(4), Income Tax Regs., John Hancock's transaction costs with respect to LILOs and the SNCB SILO must be included as an additional amount lent to borrowers and are not deductible under section 162. Id. at 149.

For the remaining SILO transactions, the Court concluded, after considering financial analyses presented by the parties and various nonfinancial constraints, that exercising the purchase option at the end of the sublease was not the only financially viable alternative for the SILO counterparties. Id. at 123, 131-132. According to the appraisals, the projected fair market value of the assets involved in the remaining SILOs was going to be substantially lower than the purchase option exercise price. Id. at 114-115, 123-124. Thus, the Court assumed that these options would not be exercised and proceeded with the analysis of whether John Hancock had any economic risk after the end of the sublease and until the end of the lease. The Court then concluded that John Hancock indeed faced economic risks indicative of ownership during that period under the service contract option because any payments under that option were not guaranteed. Id. at 132-135. Thus, the Commissioner did not succeed with the substance-over-form argument for these remaining transactions.

With respect to the remaining SILO transactions, the Court held that John Hancock acquired a future interest in the transferred assets and was thus not entitled to depreciation deductions before the purchase option exercise date. John Hancock Ins. Co. (U.S.A.) v. Commissioner, 141 T.C. at 137. Because John Hancock had only future interest in the assets, the Court disallowed any interest deductions as well. Id. at 147. However, the Court refused to apply the OID rules to John Hancock's equity contributions in these transactions. Id. at 148. The Court allowed a deduction for transaction expenses related to the acquisition of a future interest in the underlying assets. Id. at 149.

II. Whether the Substance of the Test Transactions Is Consistent With Their Forms

We will first address the issue of whether the substance of the test transactions is consistent with their forms because this is the primary argument on which respondent challenges petitioner's 1999 like-kind exchange. From the notices of deficiency and the parties' filings in these cases, it appears that respondent did not directly challenge the 1999 like-kind exchange gain deferral under the economic substance doctrine. Respondent asserts this economic substance argument only with respect to depreciation, interest, and transaction cost deductions reported on the 2000 tax return.

A. Substance Over Form Doctrine Overview

The courts have long used the substance over form doctrine to determine the true nature of a transaction and appropriately recast it for Federal income tax purposes. See Feldman v. Commissioner, 779 F.3d 448, 455 (7th Cir. 2015), aff'g T.C. Memo. 2011-297, John Hancock Life Ins. Co. (U.S.A.) v. Commissioner, 141 T.C. at 57 (citing United States v. B.F. Ball Constr. Co., 355 U.S. 587 (1958), and Commissioner v. Court Holding Co., 324 U.S. 331 (1945)). We apply the substance over form principles only when warranted and generally respect the form of a transaction. John Hancock Life Ins. Co. (U.S.A.) v. Commissioner, 141 T.C. at 57 (citing Gregory v. Helvering, 293 U.S. 465 (1935), and Blueberry Land

Co., Inc. v. Commissioner, 361 F.2d 93, 100-101 (5th Cir. 1966), aff'g 42 T.C. 1137 (1964)).

We view the transactions as a whole to determine whether the substance over form doctrine applies. See Commissioner v. Court Holding Co., 324 U.S. at 334; John Hancock Life Ins. Co. (U.S.A) v. Commissioner, 141 T.C. at 91. As the Supreme Court held in Frank Lyon, 435 U.S. at 584, the form of a sale-leaseback transaction will be respected for Federal tax purposes as long as the lessor retains significant and genuine attributes of a traditional lessor. We also look at whether the taxpayer has undertaken substantial financial risk of loss of its investment on the basis of the value of the underlying property. Coleman v. Commissioner, 16 F.3d 821, 826 (7th Cir. 1994), aff'g T.C. Memo. 1987-195 and T.C. Memo. 1990-99.

The courts considering SILO/LILO transactions have almost universally concluded that the taxpayers never obtained the benefits and burdens of ownership or attributes of a traditional lessor and, thus, were not entitled to claim various associated deductions. See ConEd II, 703 F.3d at 1381-1382 (finding that the LILO was not a genuine lease and sublease); Altria Grp., Inc. v. United States, 658 F.3d at 291 (affirming jury finding that a series of LILO and other transactions failed the substance over form inquiry); Wells Fargo, 641 F.3d at 1330 (sustaining the trial court's conclusion that the SILO transactions ran afoul of the substance over form doctrine); BB & T Corp. v. United States, 523 F.3d 461, 464 (4th Cir. 2008) ("[A]lthough the [transaction] form * * * involved a lease financed by a loan, BB & T did not actually acquire a genuine leasehold interest[.]"); John Hancock Life Ins. Co. (U.S.A.) v. Commissioner, 141 T.C. at 109-110, 145 (concluding that all LILO transactions and some SILO transactions at issue were in substance financial instruments, loans); UnionBanCal Corp. v. United States, 113 Fed. Cl. 117, 136 (2013) (concluding that the taxpayer did not obtain the requisite ownership interest to claim the deductions); AWG Leasing Tr. v. United States, 592 F. Supp. 2d 953, 981-982 (N.D. Ohio 2008) (finding that a SILO transaction involving an interest in a German waste-to-energy plant did not convey an ownership interest to the taxpayer to justify the deductions). The only notable exception is the SILO transactions analyzed in John Hancock Life Ins. Co. (U.S.A.) v. Commissioner, 141 T.C. at 111-137, where this Court concluded that because exercising the purchase option at the end of the sublease was not the only economically viable option for the original property owners and John Hancock was exposed to more than de minimis risk after the end of the sublease period, John Hancock acquired a future ownership interest in the underlying properties.

B. Spruce Transaction

1. Sublease Term Risks

Petitioner advances several arguments to support its contention that it indeed had acquired benefits and burdens of ownership during the sublease term. First, petitioner maintains that it made a meaningful equity contribution to acquire the leases. Unlike parties in traditional LILO/SILO transactions, petitioner did not use any loans to pay the Spruce headlease rent. Instead, it paid with the proceeds of a recent sale of its own power plant. CPS returned only 76.9% of the headlease rent to prepay the rent during the Spruce sublease term. Petitioner argues that the 23.1% CPS retained after prepayment of the Spruce sublease rent satisfies any equity tests derived from judicial decisions and administrative guidance.

Second, petitioner maintains that the rights and obligations conveyed by the Spruce headlease and sublease agreements are typical of traditional leases and significantly alter the rights of the parties. Specifically, petitioner cites the necessity for CPS to obtain consent for improvements that could have a material impact on the value of the subleased property.

Third, petitioner points to its extensive due diligence efforts as indicative of obtaining a true ownership interest in the Spruce station.

Finally, petitioner claims that it was exposed to a significant risk of loss in case of CPS' bankruptcy and sublease rejection because of the limitations of section 502(b)(6) of the Bankruptcy Code.

We begin with an observation that what made SILO and LILO transactions abusive was not only the amount of equity invested by the parties entering into such transactions but rather the circular flow of money such transactions created. As the Court of Appeals for the Federal Circuit explained in Wells Fargo, 641 F.3d at 1330:

> [W]e are left with purely circular transactions that elevate form over substance. The only flow of funds between the parties to the transaction was the initial lump sum given to the tax-exempt entity as compensation for its participation in the transaction. From the tax-exempt entity's point of view, the transaction effectively ended as soon as it began. The benefits to Wells Fargo continued to flow throughout the term of the sublease, however, in the form of deferred tax payments. The third-party lender and its affiliate were also compensated for their participation, as were the creators and promoters of the transactions. These transactions were win-win situations for all of the parties involved because free money--in the form of previously unavailable tax benefits utilized by Wells Fargo--was divided among all parties. The money was not entirely "free," of course, because it was in effect transferred to Wells Fargo from the public fisc.

Here, the funds necessary to fund the headlease rent came from the untaxed proceeds of the Collins power plant sale by petitioner. In addition to attempting to reap the benefits of long-term tax deferral under the section 1031 rules for like-kind exchanges, petitioner claimed various tax deductions associated with its participation in the Spruce, Scherer, and Wansley transactions. Unlike the taxpayer in Frank Lyon, which entered into a sale-leaseback with another taxable entity such that the transaction was tax neutral as a result, petitioner entered into a transaction with a tax-exempt entity. This would allow petitioner to double-dip into the tax benefits by deferring the tax under section 1031 and using deductions related to the test transactions.

The structure of the cashflows in the Spruce transaction guaranteed the return of 76.9% of petitioner's initial investment just six months after the closing date in the form of rent prepayment under the Spruce sublease. During that period, CPS obtained credit enhancements to secure the payment of the rent. The rest of petitioner's investment was either used to pay the accommodation fee to CPS in the form of the NPV benefit or set aside pursuant to the Spruce CPUA to secure the payments of the stipulated loss value during the period of the Spruce sublease or the payment of the purchase option price at the end of the sublease. CPS obtained credit enhancement and insurance for the CPUA from AIG, and the interest rate risk was also insured.

Thus, similarly to traditional SILOs or LILOs, the Spruce transaction created a circular flow of money accompanied by a transfer of tax benefits from a tax-exempt to a taxable entity. See Wells Fargo, 641 F.3d at 1330. In addition, the terms of the Spruce transaction ensured that only six months into the deal petitioner would be in the same cash position as if it had taken out a loan to finance the transaction, similar to traditional SILOs and LILOs. In effect, CPS did not have any control over petitioner's investment after the closing of the transaction with the exception of the NPV benefit, which was CPS' reward for entering into the Spruce transaction. Accordingly, we are not persuaded by petitioner's argument that a 100% upfront out-of-pocket investment precludes the finding that any of the test transactions were abusive.

We also disagree with petitioner's argument that the Spruce headlease or sublease somehow significantly altered the parties' rights and obligations with respect to the Spruce station. Under the Spruce headlease, petitioner did not have any obligations to CPS in respect of the maintenance, operation, or insurance of the Spruce station during the sublease term or the remainder of the headlease. If petitioner were to return the Spruce station to CPS at the end of the headlease or if the headlease was terminated, it was not required to meet any return conditions except making sure the Spruce station was free from petitioner's liens.

Under the terms of the Spruce sublease, CPS accepted all the risks related to the operation of the Spruce station throughout the sublease term. CPS also agreed to observe certain maintenance and operating standards, subleasing restrictions, assignment rights, restrictions and requirements pertaining to alterations and modifications, environmental compliance, and minimum insurance coverage. These restrictions were designed to insulate petitioner's risk during the sublease term and ensure that in the worst case scenario--if CPS does not exercise its cancellation option at the end of the sublease--the Spruce station would be in good working condition. In short, CPS merely agreed to operate the station during the sublease term in the same manner a reasonable owner would. Similar to John Hancock, there is no evidence that before the closing date CPS was not already adhering to the same operating, maintenance, or environmental standards. See John Hancock Life Ins. Co. (U.S.A.) v. Commissioner, 141 T.C. at 113. Petitioner's expert Prof. McDermott also concluded that the contractual terms of the test transactions mitigated many risks of ownership, including technological obsolescence, failure of utility assets, long-term market value changes, failure of payments, and changes in Government or regulatory requirements.

With respect to sublease and assignment restrictions, CPS could always ask petitioner for consent, the same as for improvements that could materially affect the value of the leased property. In fact, in 2004, when CPS decided to build Spruce II, which would share the site and some facilities with the Spruce station, petitioner gave its consent after a short site visit and receipt of a written confirmation from CPS that the construction was not going to affect the Spruce station value. Petitioner did not bother to visit the site after Spruce II was finally completed and started to work.

Next, we do not find that petitioner's own due diligence efforts are indicative of any ownership rights. Respondent points out that petitioner had to complete the due diligence process within the strict time limits imposed by section 1031. As a result, petitioner did not follow up on certain red flags raised in engineering reports. Moreover, Mr. Roling and others in petitioner's tax department only cursorily reviewed the tax opinion packages prepared by Winston & Strawn. Mr. Berdelle, who testified that he read the entire Winston & Strawn tax opinion, did not act on or inquire about inconsistencies therein of which petitioner was, or should have been, aware.

In most prior SILO/LILO cases taxpayers also engaged in extensive due diligence before to entering into the transactions, including hiring prominent law firms to draft documents, accounting firms to structure transactions and provide appraisals, and engineering firms to evaluate the properties. See, e.g., ConEd I, 90 Fed. Cl. at 234-235. That nonetheless did not prevent the courts in those cases from holding that the substance of such transactions was inconsistent with their form and that the taxpayers did not obtain genuine attributes of ownership. See, e.g., ConEd II, 703 F.3d at 1378-1379, 1381 (discussing the appraisal prepared by Deloitte and concluding that it was insufficient to support the taxpayer's contentions and was boilerplate; holding that the taxpayer failed to obtain genuine attributes of ownership to support the claimed deductions).

Finally, petitioner argues that it faced a substantial risk of loss in the event of CPS bankruptcy despite the available credit enhancements. Petitioner attempts to distinguish these cases from the SILO and LILO transactions in John Hancock on this ground because in John Hancock none of the tax-exempt counterparties were subject to the limitations stated in section 502(b)(6) of the Bankruptcy Code.[20] Respondent maintains that this risk was illusory and petitioner would be able to recover its investment even if section 502(b)(6) of the Bankruptcy Code limited the recovery available through the bankruptcy proceedings.

We agree with respondent. Petitioner's claim is inconsistent with the record and is a mere attempt to blow out of proportion the risk of loss in the event of CPS' bankruptcy. First, according to FCLC, petitioner's credit adviser, CPS was generally very creditworthy. FCLC opined that the payment obligations and

[20]Sec. 502(b)(6) of the Bankruptcy Code limits a lessor's claim for liquidated damages in bankruptcy resulting from the termination of a lease of real property to an amount not to exceed three years' rent plus any unpaid rent due under the lease at the time a debtor files its bankruptcy petition.

associated risks had been effectively identified and supported by credit enhancements so even in the case of CPS' bankruptcy petitioner would be able to fully recover its investments from the credit enhancement providers.

In 2000 CPS had one of the highest credit ratings in the country, and had cash on hand of over $450 million and a reserve fund surety policy in excess of $225 million. The City of San Antonio itself would have to file for bankruptcy before CPS became bankrupt. As of 2000 there had never been a failure of a major municipality in the history of the State of Texas. PwC explained that there was "bulletproof assurance" to Unicom that there was no practical exposure to loss during the first nine months of the CPS transaction, and that CPS' going bankrupt within the first six months of the transaction was commercially impossible. In addition, CPS obtained sufficient credit enhancements to secure the risk of rent nonpayment or early sublease termination.

We find that petitioner's speculations on what might happen if CPS filed for bankruptcy do not add anything of substance to our analysis. No transaction is absolutely protected from all possible risks, including catastrophic economic events or destruction of property "by a biblical flood or a superbolide meteor". UnionBanCal Corp., 113 Fed. Cl. at 135. The record here supports respondent's argument that petitioner faced a risk of loss only in such a catastrophic event.[21] We do not consider this risk sufficient to hold that petitioner had genuine attributes of ownership during the Spruce sublease term. See id.

We also find that petitioner was sufficiently protected from the risk of economic loss if the Spruce sublease terminated early. The sublease agreement contained provisions that guaranteed that petitioner would receive stipulated loss value payments in the event of CPS' default. These payments were predetermined and set forth in a schedule to the Spruce sublease agreement. The payments would be made out of the funds set aside at the closing date pursuant to the CPUA.

Petitioner argues that in case of an early Spruce sublease termination petitioner would have to return any unaccrued prepaid rent to CPS. This argument ignores the fact that after netting the unaccrued prepaid rent and the stipulated loss value, petitioner would still recover its full investment in the lease, including transaction fees and interest through the time of default. As Mr. Berdelle explained in a memorandum prepared for the Unicom board meeting on April 4, 2000, requesting the approval of the like-kind exchange plan,

> [t]he stipulated loss values also include additional earnings protection of about $3 million per each $100 million of initial investment. For

[21]Petitioner's own expert Mr. McDermott stated in his expert report that the bankruptcy of a municipal utility is a relatively low-probability event but has occurred in other jurisdictions.

> example, if there was a default on both the MEAG and CPS transactions (about $1.6 billion), Unicom would receive its investment and about $48 million pretax income in the year of default as earnings protection.

The Spruce transaction documents were drafted to reflect this understanding. We are thus satisfied that petitioner did not face any significant risks indicative of genuine ownership during the Spruce sublease term.

2. CPS Cancellation Option Decision

We next consider whether petitioner acquired the benefits and burdens of ownership in the light of the options available to petitioner and CPS at the end of the Spruce sublease period. First, we decide whether CPS was reasonably expected to exercise its cancellation option at the end of the Spruce sublease period. If it was, petitioner's profit was fixed at the outset of the Spruce transaction and petitioner did not acquire any benefits and burdens of ownership with respect to the Spruce station. See John Hancock Life Ins. Co. (U.S.A.) v. Commissioner, 141 T.C. at 139-143.

Petitioner relies primarily on the Deloitte Spruce appraisal to show that CPS was not "economically compelled" to exercise the cancellation option at the end of the Spruce sublease. This is so, as petitioner sees it, because the cancellation option price was set above the expected future fair market value of the Spruce plant at the end of the Spruce sublease term. To support the Deloitte appraisal findings, petitioner invited several experts to submit expert reports and testify during the trial. We will discuss this testimony in due course.

Respondent relies primarily on the analyses of Dr. Skinner to argue that because CPS is a tax-exempt entity, it valued the Spruce station at a much higher level. Dr. Skinner asserts that there are a number of flaws with the Deloitte appraisal, including the very high corporate income tax rate and discount rate. Dr. Skinner suggested that because CPS was a tax-exempt entity, it would be more appropriate to use a 0% corporate income tax rate and a discount rate equal to CPS' weighted average cost of capital, about 6.1%.[22] This would result in a much higher projected value for the Spruce plant at the expiration of the sublease.

At the beginning of our analysis, we specify what constitutes "reasonable likelihood" that a purchase option will be exercised at the end of the sublease period. We reiterate that this Court does not require an "inevitable", "economically compelled", or similar threshold for purchase option exercise likelihood in evaluating SILO/LILO transactions. See id. at 95-97. We are also not requiring a "more likely than not" likelihood of purchase option exercise.[23]

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[22]Dr. Skinner explained that because CPS did not pay dividends to its shareholders, the appropriate weighted average cost of capital should be based on the interest CPS usually paid on its bonds.

[23]One of the recent cases considered by the Court of Federal Claims, while (continued...)

We are looking simply at whether "in the light of all of the facts and circumstances known on the closing dates of the transactions, whether * * * [the taxpayer's] lessee counterparties were reasonably likely to exercise their purchase options." See Id. at 97.

Petitioner asserts that the Court of Appeals for the Seventh Circuit compared the option exercise price to the anticipated fair market value of the leased assets expected as of the closing of the lease in determining whether a transaction constitutes a true lease. See, e.g., In re Marhoefer Packing Co., Inc., 674 F.2d 1139, 1144-1145 (7th Cir. 1982) (considering whether option price was "nominal" in comparison to the fair market value of leased assets at the time the option could be exercised "as anticipated by the parties when the lease * * * [was] signed," for purposes of determining whether the lease should be recharacterized as a security interest); M & W Gear Co. v. Commissioner, 446 F.2d 841, 846 (7th Cir. 1971) (respecting Tax Court's finding that the lessee, rather than the lessor, acquired an equity interest in property, where "that the fair market value * * * was

[23](...continued)
acknowledging the reasonable likelihood standard as articulated in Wells Fargo & Co. v. United States, 641 F.3d 1319 (Fed. Cir. 2011), and Consol. Ed. of N.Y., Inc. v. United States, 90 Fed. Cl. 228 (2009), rev'd and remanded, 703 F.3d 1367 (Fed. Cir. 2013), seems to use a "more likely than not" standard in its actual analysis. See UnionBanCal Corp. v. United States, 113 Fed. Cl. 117, 131-132, 135-136 (2013).

at least twice as much as * * * [lessee’s] option price”), aff’g 54 T.C. 385 (1970). These cases lead petitioner to assert that “the appropriate standard for analyzing a lessee’s purchase option must focus on objective economic realities and whether those realities compel exercise or strongly favor exercise to a degree of certainty.”

We do not find that the cases petitioner cites establish a legal standard incompatible with this Court’s analysis in John Hancock and require economic compulsion or circumstances that “strongly favor exercise to a degree of certainty.” In M & W Gear Co. v. Commissioner, 446 F.2d at 844-845 (discussing in detail evidence regarding the intent of the parties), the Court of Appeals for the Seventh Circuit considered not only the comparable sale prices for the leased assets, but the intent of the parties at the time of entering the transaction. In In re Marhoefer Packing Co., Inc., 674 F.2d at 1141, the same Court of Appeals discussed only the issue of whether a specific lease in question with a $1 purchase option qualified as a true lease or a security under the provisions of the Uniform Commercial Code. This discussion is not pertinent here because it does not pertain to any tax law issues. Finally, none of the cases petitioner cites involve a lease supported by defeasance arrangements where both a lessee and a lessor would have certain options at the end of the lease and where the lessee would have some obligations under options available to the lessor.

Thus, we will follow the legal standard of "reasonable likelihood" that this Court has adopted in John Hancock following the Courts of Appeals for the Second Circuit and the Federal Circuit. As to comparing the option exercise price to the estimated future value of the asset in the context of SILO/LILO transactions, this Court previously explained in John Hancock Life Ins. Co. (U.S.A.) v. Commissioner, 141 T.C. at 99-100:

> [Lessee's] purchase option decision is not a choice between the purchase option price and the estimated fair market value of the remaining leasehold interest. It is a choice between the cost to [lessee] * * * of exercising its purchase option and its expected costs of not exercising its purchase option. In determining its expected costs of not exercising its purchase option, * * * [the lessee] must analyze the likelihood and consequences of * * * [the taxpayer's] choosing between the * * * [various options available to the taxpayer under the lease.]

Neither petitioner nor respondent argues that there are legal, political, industrial, or technical reasons that would weigh in favor of or against CPS' exercise of its cancellation option.[24] We will thus first concentrate on the financial and economic aspects of the Spruce transaction and then will consider other factors that we deem important for our analysis. See id. at 99.

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[24]Respondent argues that because of the perceived synergies CPS could have derived from operating Spruce station and Spruce II together CPS was more likely to exercise the cancellation option at the end of the sublease term. Because CPS obtained petitioner's permission and constructed Spruce II several years into the sublease term, we do not rely on this argument in our analysis.

Petitioner argues that it would be financially disadvantageous for CPS to exercise its cancellation option.[25] According to the Spruce appraisal prepared by Deloitte and dated as of the Spruce transaction closing date, June 2, 2000, the fair market value of the Spruce plant was expected to be around $626 million on the basis of a discounted cashflow analysis[26] at the time the Spruce cancellation option can be exercised (adjusted for inflation at 2.5% per annum). The Spruce cancellation option price was set at $733,849,606. Petitioner suggests that this should be the end of the analysis because a reasonable person acting in its best

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[25]We note that the Spruce transaction was terminated pursuant to the agreement of the parties in 2014. Exelon received an additional $335 million as the stipulated loss value payment from the CPUA proceeds, and CPS received $1 million. The record does not state the reason for termination.

[26]The value would be $609,600,000 using a cost approach. The Spruce appraisal stated, in relevant part:

> We are of the opinion that the discounted cash flow analysis provides a stronger indication of fair market value for the Facility than the cost approach since the discounted cash flow analysis reflects the impact to fair market value of the encumbered cash flows of the Facility. Since cash flows during this period are difficult to forecast with accuracy, we have conservatively relied upon the cost approach as the stronger indicator to estimate the residual value of the Facility at the end of the Lease Term and at the end of the Service Agreement Term.

We note that the cost approach would result in lower projected future fair market value according to Deloitte appraisals for the test transactions. We will use the discounted cashflow analysis because petitioner relied mostly on discounted cashflow in pricing the Spruce, Scherer, and Wansley transactions. We believe this will provide us with more consistent results.

economic interest would not overpay over a hundred million dollars for an asset when it can easily replace the asset on the market.

Petitioner's expert Prof. Myers conducted the sensitivity analysis of the Deloitte appraisal by changing certain assumptions such as the rate of inflation and electricity prices. His report and testimony mostly confirmed the obvious: when we change the assumptions used in the Deloitte appraisal, we are going to end up with different results. However, we found Prof. Myers' analysis helpful because it shows a range of possible scenarios related to the cancellation option exercise decision. Instead of giving the parties to a transaction a snapshot of the value using rigid assumptions as in the Deloitte appraisals, Prof. Myers' sensitivity analysis represents a more reliable tool to evaluate the range of scenarios based on varying economic assumptions. The following table sets out the fluctuation of the projected future value of the Spruce plant under various assumptions[27] according to Prof. Myers:

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[27]For the base case scenario, Prof. Myers used Deloitte forecasted cashflows; average inflation at 2.5% throughout the headlease term; electricity prices starting at $31.75 per MWh in 2000 adjusted for inflation annually; plant capacity factor at 90.3% in 2000, declining to 58.7% in 2032, and to 49.6% in 2052; corporate tax rate of 40.85%.

Scenario	Projected Spruce value in 2032	Likely outcome and comments
Base case	$618.3 million	CPS returns Spruce to Exelon and replaces Spruce on the market; Exelon is better off not exercising the service agreement option.
Inflation +1.5% from base case	$971.1 million	CPS exercises cancellation option.
Inflation −1.5% from base case	$394.2 million	CPS returns Spruce to Exelon and replaces Spruce on the market; CPS has to pay a $125.9 subsidy to a PTPA provider to enter into the service agreement with Exelon; CPS still has $203.1 million overall benefit.
Electricity prices +30% above base case	$953.5 million	CPS exercises cancellation option.
Electricity prices −30% from base case	$283.2 million	CPS returns Spruce to Exelon and replaces it on the market; CPS has to pay a $175.4 million subsidy to a PTPA provider to enter into the service agreement with Exelon; CPS still has $264.6 million overall benefit.

According to Prof. Myers, CPS would never elect to repurchase the Spruce station and cancel the headlease to avoid the cost of a PTPA subsidy. In other words, if CPS deems it undesirable to exercise the purchase option, it will always be better off with paying a subsidy to the PTPA provider and walking away from the Spruce station at the end of the Spruce sublease term. Prof. Myers also concluded that it was appropriate for Deloitte to use the 40.85% corporate tax rate and a 10% discount rate because the tax-exempt status of an actual lessor does not affect its pricing considerations when most other players on the market are taxable entities.

Another expert who testified on behalf of petitioner, Mr. Reed, also opined that because of uncertainty about the future "it would have been impossible based on any realistic assessment of the future value of Exelon's interest in the Facilities to determine whether or not the parties were reasonably expected to exercise their respective options."

Petitioner also introduced the testimony of Ms. Hughes, who opined that Deloitte complied with the USPAP standards and its analysis framework was appropriate and reasonable. Although the courts have previously admitted expert reports with similar conclusions, such reports were given little weight. See, e.g., ConEd II, 703 F.3d at 1380 (discussing Kelly expert report). We find that Ms. Hughes' report did not add anything of substance to the discussion. Ms. Hughes did not perform her own analysis and did not opine on the fair market value of the assets at issue. She merely attempted to bolster the credibility of the Deloitte work, and we do not find this attempt particularly helpful. As this Court has previously explained, an appraiser's compliance with USPAP is not the sole determining factor as to whether the appraiser's valuation report is reliable. See Whitehouse Hotel Ltd. P'ship v. Commissioner, 131 T.C. 112, 127-128 (2008) (declining to adopt USPAP as the sole standard for reliability of an appraisal), vacated and remanded on other grounds, 615 F.3d 321 (5th Cir. 2010); SWF Real

Estate LLC v. Commissioner, T.C. Memo. 2015-63, at *98 (declining to find that an appraisal report was unreliable solely for failure to comply with USPAP requirements and stating that the Court will independently review the report for reliability).

Respondent's primary expert witness, Dr. Skinner, challenged the Deloitte appraisal because it used too high a tax rate and discount rate. Dr. Skinner suggested that because CPS was a tax-exempt entity, Deloitte should have used pretax cashflows to determine the fair market value of the Spruce plant at the end of the sublease. Dr. Skinner also asserted that the appropriate discount rate for the Spruce plant should be 6.1%, on the basis of CPS' weighted average cost of capital. With the corrected assumptions, Dr. Skinner concluded that it would be beneficial for CPS to exercise the cancellation option because it would value the Spruce plant much higher than the Deloitte appraisal, at $1.5 billion. Dr. Skinner further concluded that CPS would be "nearly certain" to exercise the cancellation option at the end of the sublease term.

First, we agree with petitioner that to the extent Deloitte was tasked to determine the fair market value of the Spruce plant at certain points, it should have disregarded the tax status of the actual buyer and should have used the prevailing market discount rate. It is well established that fair market value is "the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy and sell and both having reasonable knowledge of relevant facts." Bank One Corp. v. Commissioner, 120 T.C. 174, 209, 304-306 (2003), aff'd in part, vacated in part on other grounds, and remanded sub nom. JPMorgan Chase & Co. v. Commissioner, 458 F.3d 564 (7th Cir. 2006); Crimi v. Commissioner, T.C. Memo. 2013-51, at *60 (citing United States v. Cartwright, 411 U.S. 546, 551 (1973)); see also sec.1.170A-1(c)(2), Income Tax Regs. As this Court explained, under the willing buyer and willing seller standard, "[t]he willing buyer and the willing seller are hypothetical persons, rather than specific individuals or entities, and the individual characteristics of these hypothetical persons are not necessarily the same as the individual characteristics of the actual seller or the actual buyer." Estate of Trenchard v. Commissioner, T.C. Memo. 1995-121, 69 T.C.M. (CCH) 2164, 2169 (citing First Nat'l Bank of Kenosha v. United States, 763 F.2d 891, 893-894 (7th Cir. 1985), Estate of Curry v. United States, 706 F.2d 1424, 1428-1429, 1431 (7th Cir. 1983), Estate of Bright v. United States, 658 F.2d 999, 1005-1006 (5th Cir. 1981), and Estate of Newhouse v. Commissioner, 94 T.C. 193, 218 (1990)). This court has previously declined to narrow the scope of willing buyer and willing seller to a particular category of parties. Bank One Corp. v. Commissioner, 120 T.C. at 315.

The hypothetical willing buyer and willing seller test applies in situations where the amount of tax due depends directly on the fair market value of the property at issue. However, our task here is not to determine the fair market value of the property, but rather whether it was reasonably likely that in the year 2032 CPS would exercise its cancellation option. As previously stated, that depends on weighing the cost to CPS of exercising the option against the cost to CPS of not exercising the option. The parties to the transaction are not hypothetical, but are CPS and petitioner, each with unique characteristics. It is therefore entirely proper for us to consider those unique characteristics in evaluating the likelihood that the cancellation option at issue here would actually be exercised.

We agree with Prof. Skinner that there are several flaws in the Deloitte appraisal. First, Deloitte used the 9% State corporate income tax rate in all appraisals for test transactions. According to Deloitte, “[t]he 9 percent tax rate represents the appropriate corporate income tax rate in the state of Texas’ stepped tax rate schedule based upon tax year and taxable amount.” In the context of the Spruce transaction, this statement sounds odd. Texas does not impose a State corporate income tax. It is possible that the cashflows from the Spruce plant thus would be taxed at a different rate. This could potentially increase the value of the

Spruce plant in both 2000 and 2032. However, we do not think this flaw necessarily fatal to the Spruce appraisal.[28]

Second, we find that Winston & Strawn attorneys interfered with the appraisal process' integrity and independence by providing Deloitte with the wording of the conclusions it expected to see in the final appraisal reports. Deloitte confirmed in its engagement letter that "[t]he appraisal will be conducted in conformity with the * * * [USPAP] of the Appraisal Foundation and the Principles of Appraisal Practice and Code of Ethics of the American Society of Appraisers." USPAP ethics rules require an appraiser to "perform assignments with impartiality, objectivity, and independence, and without accommodation of personal interests." Appraisal Foundation, Uniform Standards of Professional Appraisal Practice 2 (1999). USPAP ethics rules also prohibit an appraiser from accepting an assignment "that includes the reporting of predetermined opinions and conclusions." Id.

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[28]If we calculate the present value of a stream of revenue equal to $100 per year at 10% discount rate and with a 40.85% tax rate over a period of 30 years and compare the results with the present value of the same revenue stream taxed at 35%, the difference will exceed $50. We note, however, because the tax rate affects the numerator in the present value calculation, slight fluctuations in the tax rate may not have a significant enough effect to require completely discarding an appraisal as unreliable. To compare, a 1% change in the discount rate, which affects the denominator, would also bring up by $50 the present value of the revenue stream above.

Petitioner argues that the list of conclusions Winston & Strawn communicated to Deloitte was merely a statement of the existing guidance and tests on the issue of what is considered a true lease. We do not find this argument persuasive. According to petitioner, Deloitte's appraisal team was known for its expertise and experience in the appraisal field. There was no reason for concern that Deloitte was unaware of the existing guidance on characterization of leases for Federal tax purposes. We see Winston & Strawn's letter dated December 29, 1999, informing the Deloitte team of the conclusions the law firm needed to see in order to issue an opinion at the requisite level as an attempt to obtain certain results. Our finding is supported by a pattern of communications between Winston & Strawn and Deloitte where Winston & Strawn provided regular feedback at all stages of the project, starting with Deloitte's engagement letter.

Petitioner asserts, and Deloitte's representative, Mr. Ellsworth, testified on this point at trial, that Deloitte arrived at the fair market value of the assets at issue independently. Nonetheless, even if that is true, Deloitte also performed the appraisal of the relinquished power plants, Powerton and Collins. Deloitte therefore was aware of the amount of untaxed gain petitioner was looking to defer. This further undermines the reliability of the appraisal reports Deloitte provided for all test transactions.

Further, in analyzing the likelihood of cancellation option exercise by CPS, Deloitte failed to consider the costs of a potential subsidy CPS would have to pay to a qualified bidder or operator to entice such a bidder/operator to enter into an operating agreement or PTPA with petitioner if the energy industry does not fare as well as expected. Prof. Myers, however, considered such costs and concluded that in most cases CPS would still be better off taking the money and returning the Spruce station to petitioner.

As to the likelihood of the cancellation option's exercise, it is unhelpful to petitioner's argument that Deloitte failed to consider the costs that CPS would have to incur to bring the Spruce plant to the required (per the Spruce sublease agreement) minimum operation standards for estimated annual capacity, net energy output, and efficiency. Meeting these requirements is a prerequisite for CPS to return the Spruce station to Exelon at the end of the sublease term. According to the Spruce sublease agreement, if CPS were to fail to deliver the Spruce station meeting the minimum operating and efficiency requirements, it would have to pay the diminution of fair market value or will be given another chance to exercise the cancellation option. Prof. Myers also failed to take these costs into consideration in his analysis.

Thus, the price of failing to exercise the cancellation option for CPS would consist of (1) undertaking investments required to bring the Spruce station into compliance with the minimum operating standards and other return requirements; (2) securing a replacement property or source of electricity and related costs; and (3) potential subsidies to qualified bidders and transaction costs should Exelon decide to exercise the operating agreement or the service agreement options.

To be more specific, CPS and petitioner agreed that if CPS decided to return the Spruce station at any time during the sublease or at the end of the sublease term in 2032, the Spruce station was required, at a minimum, to have an annual ratio of the actual net generation to the normal claimed capacity of at least 82% (capacity factor), operating for 8,760 hours per year. The Spruce station was also required to have the ratio of available generation to maximum generation of at least 89% and have an annual ratio of the heat energy output of not more than 10,950 Btu/kWh.

Deloitte and Prof. Myers, however, used significantly lower capacity factors in their computations. These figures were based on Deloitte's due diligence of the Spruce station and the engineering reports provided by Stone & Webster. Both Deloitte and Prof. Myers assumed the plant capacity factor to be 90.3% in 2000, with gradual decline to 58.7% in 2032 (the end of the sublease term) and to 49.6%

in 2052 (end of the Spruce headlease). These numbers, according to Prof. Myers, reflected the gradual obsolescence of the plant.

Discounted cashflow analysis performed by Deloitte and Prof. Myers incorporated the plant capacity factor and the hours of operation to determine the cashflows from the Spruce plant and determine its value in 2032. This "real Spruce plant", however, was not what petitioner was entitled to receive at the end of the Spruce sublease period. Petitioner was entitled to receive, because CPS had agreed to deliver, a plant that would operate in 2032 at a plant capacity factor 23% greater than anticipated by petitioner's experts. This "hypothetical Spruce plant" would, therefore, generate a much higher revenue stream and would have a value significantly higher than the value projected by Deloitte and Prof. Myers.[29]

Therefore, we conclude that the plant Exelon was entitled to receive at the end of the sublease term had characteristics distinctly different from those

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[29]According to the Deloitte appraisal, the plant capacity factor for Spruce would go down to 72.2% by year 16 of the sublease, with the available hours of operation going down to 6,325. Deloitte estimated that the Spruce plant would operate at these levels up to year 30 of the sublease, and at year 31 of the sublease the Spruce plant capacity would be at 58.7%, with hours of operation at 5,139 per year. If the Spruce plant continued to operate throughout the term of the sublease at a minimum return requirements level (82% capacity factor and 8,760 operation hours per year), the cashflows in years 16-32 of the sublease would be at least 10% to 23% higher than anticipated by Deloitte. We also do not find reliable the Spruce plant value determined under the cost approach in the Deloitte appraisal. It is clear the appraisal considered the cost of purchasing an asset that would not meet the minimum operating requirements under the Spruce sublease agreement.

assumed by Deloitte and Prof. Myers. Although the parties did not submit any evidence regarding the amounts CPS would be required to invest in the Spruce station to meet the return standards, the requirement to do so significantly changes the economics of the Spruce transaction.

We note that Prof. Myers stated in his analysis that "a capacity factor 20% above [Deloitte] forecasts would move the return vs. cancel boundary up enough to include the base-case scenario [in Prof. Myers' analysis that petitioner would retain the plant]." What Prof. Myers has not considered in his analysis, however, is how the parties allocated the risks and costs related to the diminution in the power plant efficiency. According to the Spruce transaction agreement documents, that risk was shifted to CPS. As we explained, if the Spruce plant failed to meet the minimum operating standards at the time it was returned to Exelon, CPS would have to either pay up the diminution in fair market value or exercise the cancellation option to cut its losses.

Under the circumstances, we find it significantly more likely that CPS, should it attempt to walk away from the transaction and return the Spruce station to Exelon, would face substantial economic losses. Accordingly, we find that the range of scenarios under which CPS would decide to exercise its cancellation option is significantly broader than expected by petitioner's experts, including Prof. Myers.

We also find that both petitioner and CPS, experienced power plant operators having the benefit of professional legal and other advice, understood that the terms of the Spruce transaction were inconsistent with the Deloitte appraisal and the projected future value of the Spruce station. The parties understood that it would be very difficult, if not impossible, for CPS to return the Spruce plant at the end of a 32-year sublease in almost the same condition in which CPS received it in 2000 without significant investment. Thus, the parties understood and reasonably expected at the time of entering into the Spruce transaction that CPS would exercise the cancellation option at the end of the sublease because meeting the return conditions would be extremely burdensome. According to Prof. Myers' analysis, with the required capacity factor of 82% in 2032, more than 20% higher than projected in the Spruce appraisal, it would be economically beneficial for CPS to exercise its cancellation option.

Moreover, we note that when the City of San Antonio brought suit in court to obtain a declaratory judgment of the continued validity of certain covenants in its outstanding public securities--thereby allowing CPS to enter into the transaction with petitioner--in its initial draft of the petition the city represented that it intended to exercise the cancellation option. Even though this representation was subsequently deleted at the suggestion of Winston & Strawn and PwC, this Court infers an understanding among the parties that CPS would exercise the option to reacquire the Spruce plant. At the very least, it was reasonably likely at the time of the transaction that the purchase option would be exercised.

3. Conclusion

We hold that the Spruce transaction fails the substance over form inquiry because petitioner did not acquire the benefits and burdens of ownership of the Spruce station. Petitioner's investment was not subject to more than a de minimis risk of loss. We need not consider the risks and benefits to petitioner of the remaining headlease period because it was reasonably likely that the circular flow of money allowing petitioner to fully recover its investment and interest would close on the last day of the Spruce sublease.

We agree with respondent that the transaction most closely resembles a financial arrangement. Specifically, the Spruce transaction resembles a loan from Exelon to CPS. Exelon funded the Spruce transaction entirely with its own funds and received the funds back with interest in two tranches: the first tranche six months after the closing date and the second tranche at the end of the Spruce sublease term in the form of the cancellation option payment. Exelon's return on its investment was predetermined, and Exelon did not have an upside potential or much of downside risk with respect to the Spruce station. This is more indicative of a loan than of a genuine equity investment.

Accordingly, we sustain respondent's disallowance of Exelon's depreciation deductions claimed on the 2001 tax return with respect to the Spruce transaction.

C. Scherer and Wansley Transactions

Because the Scherer and Wansley transactions are structured and documented very similarly, we discuss them together. We use the same analysis framework as for the Spruce transaction.

1. Sublease Term Risks

Petitioner and respondent make the same arguments for the Scherer and Wansley transactions as for the Spruce transaction.

First, as we noted in discussing the Spruce transaction, a 100% out-of-pocket investment does not necessarily make a transaction nonabusive from a tax standpoint. Here, petitioner indeed used the untaxed proceeds from the sale of the Powerton station and did not use any loans to finance the Scherer and Wansley transactions (collectively, MEAG transactions). However, petitioner got 77.9% of its initial investment back just six months after the closing of the MEAG transactions in the form of prepaid rent from MEAG. A portion of the remaining 22.1% of the initial investment was placed into a trust account and invested in low-risk securities to provide for the payment of the MEAG purchase option at the end of the sublease period for MEAG transactions. Another portion was set aside to provide MEAG with the NPV benefit in consideration for entering into the transactions. For the same reasons we discussed for the Spruce transaction, we do not find that an out-of-pocket investment automatically shows that petitioner acquired benefits and burdens of ownership of Scherer and Wansley stations. This is especially important when six months into the transaction petitioner was in substantially the same cash position as with using loans to finance the leases.

Second, similarly to the Spruce transaction, we do not see the rights and obligations conveyed by the Scherer and Wansley respective headlease and sublease agreements as significantly altering the rights of the parties. Petitioner did not have any obligations to MEAG with respect to the maintenance, operation, or insurance of the Scherer and Wansley stations during the sublease term or the remainder of the headlease. Petitioner also did not have to meet any return conditions in the case of headlease termination. The rights and obligations of the parties under the Scherer and Wansley subleases were essentially the same as in the Spruce transaction, with MEAG bearing all the costs and risks related to the interests in the stations it conveyed to petitioner in the MEAG transactions. As we observed in the discussion of the Spruce sublease, the terms of the sublease agreements were designed to insulate petitioner from any operational risks.

Third, similar to the Spruce transaction, we do not find that petitioner's due diligence efforts are somehow indicative of a true ownership interest in the Scherer and Wansley stations.

We also do not find any merit in petitioner's argument that it was exposed to a risk of MEAG's going bankrupt during the Scherer and Wansley sublease terms. Petitioner received an opinion from Holland & Knight that confirmed that the laws of the State of Georgia did not allow municipalities to declare bankruptcy. Petitioner's own expert, Dr. Gilson, confirmed in his expert report that Georgia would have to change its laws to allow MEAG to declare bankruptcy. We consider this scenario highly unlikely. See UnionBanCal Corp., 113 Fed. Cl. at 135 (discussing that highly unlikely risks do not add substance to a LILO transaction). In any event, credit enhancements put in place at the outset of the MEAG transactions provided petitioner with sufficient protection from that risk.

We find that petitioner also did not face a substantial risk of loss with respect to the payment of the Scherer and Wansley rent by MEAG. The rent was prepaid six months into the sublease term, and the stipulated loss value provisions, together with MEAG and UII swaps, insulated petitioner from any significant risk of loss in this respect.

2. Purchase Option Decision

We now turn to an analysis of whether it was reasonably likely that at the closing of the Scherer and Wansley transactions MEAG would exercise its purchase option. Similarly to the Spruce transaction, we will look not only at fair market value of the assets involved as of the option exercise date, but also to the costs to MEAG if it decides to forgo exercising the option. We will also briefly address the rights of the Scherer and Wansley coowners, who also received a right to exercise the purchase option if MEAG decided to forgo it.

a. MEAG

Neither petitioner nor respondent argues that there are legal, political, industrial, or technical reasons that would weigh in favor of or against MEAG's exercise of its purchase option. Thus, we consider financial and economic aspects of the MEAG transactions first.

According to the Deloitte appraisal, the undivided interests petitioner received under the MEAG transactions were estimated to have fair market values of $203,800,000 for Wansley and $485,000,000 for Scherer using a discounted cash flow analysis,[30] adjusted for inflation at 2.5% per annum, at the respective lease expiration dates. The Wansley purchase option price was set at $214 million, and the Scherer purchase option price was set at $537.1 million, with $143,543,915 and $179,284,424 allocable to the Wansley and Scherer test transactions, respectively. Because the Deloitte appraisals and expert reports addressed the Wansley transactions without allocating the values between Wansley 1 and 2, we will use the aggregate analysis and will assume that the projected value of the Wansley interest conveyed in the test transaction bears the same ratio to the overall projected value of the Wansley as the purchase option exercise value for the test transaction to the overall purchase option price.

The Deloitte appraisals for the Scherer and Wansley stations suffer from the same deficiencies we identified in our review of the Spruce appraisal. Deloitte elected to use the 40.85% corporate tax rate that included a 9% State corporate tax rate, even though MEAG does not pay income tax (and even if it did, Georgia taxes its corporations at a flat 6% rate). Winston & Strawn attorneys were very closely involved in the appraisal report preparation process. Deloitte did not consider the costs MEAG would have to incur if it decided not to exercise the

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[30]The cost approach inflation-adjusted values are $191,300,000 for the Wansley and $481,000,000 for the Scherer interest. For the same reasons we discussed supra note 26, we will be using the discounted cashflow results.

purchase option, including the costs of bringing the plants up to the required operating standards. Deloitte also did not consider any additional factors that could make MEAG's cotenants consider exercising the purchase options, including obtaining majority control over the Scherer and Wansley stations.

Petitioner's expert witnesses made the same arguments as for the Spruce transaction. Mr. Reed opined that it was impossible to predict with a degree of certainty whether MEAG or its cotenants would exercise the purchase options at the end of the Scherer and Wansley subleases. Ms. Hughes opined that the Deloitte appraisals conformed with the USPAP principles and the Deloitte analysis was reasonable and appropriate. Prof. Myers conducted the sensitivity analysis of the Deloitte appraisals and confirmed that if the inflation or electricity prices were higher than predicted by Deloitte, it would increase the likelihood of MEAG's exercising the purchase options.[31] Prof. Myers concluded that MEAG would never purchase Wansley or Scherer in order to avoid the cost of a PTPA subsidy. Prof. Myers also recognized that changes in other factors, including capital investments, capacity factors, and discount rates will affect MEAG's decision.

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[31]We also note that Prof. Myers used a different corporate tax rate (38.9%) for the Wansley and Scherer transactions. His discounted cashflow results, however, were comparable to those in the Deloitte appraisal reports because of several adjustments made by Prof. Myers, such as capital investments.

Respondent's expert witness Dr. Skinner suggested that Deloitte should have used a 0% corporate tax rate to analyze the MEAG transactions and used a 6.3% discount rate based on cost of debt to MEAG. Dr. Skinner also suggested that Deloitte should have conducted sensitivity testing at least for corporate rates. With the new assumptions, Dr. Skinner concluded that MEAG would value the Scherer and Wansley stations a lot higher than the purchase option price and thus would be almost certain to exercise the purchase option.

For similar reasons as those we discussed for the Spruce transaction, we agree that Deloitte should have used a 0% corporate tax rate and the prevailing discount rate in its analysis.

As with the Spruce transaction, a further problem with the Scherer and Wansley appraisals is that Exelon was entitled to a operating efficiency of Scherer and Wansley at the end of the sublease significantly higher than the values used by Deloitte in the respective appraisals. If the Scherer and Wansley stations did not meet the minimum operating requirements outlined in the respective subleases, MEAG would have to pay damages reflecting the diminution in the value of the stations due to decreased efficiency. Deloitte and Prof. Myers failed to consider these costs in analyzing whether MEAG would exercise the purchase options at the end of the Scherer and Wansley subleases.

For Wansley, petitioner was entitled to receive, because MEAG had agreed to deliver, the Wansley station at the end of the sublease with a capacity factor of at least 62% based on 8,760 hours of operation per year with the net energy output of at least 85%. The Wansley appraisal by Deloitte and Prof. Myers' report assumed a plant capacity factor of only 66.5% in 2000, declining to 39.2% in 2028 (Wansley sublease expiration year) and to 32.6% in 2045. These numbers were based on the engineering reports prepared by Stone & Webster. Thus, petitioner was entitled to receive Wansley at the end of the sublease operating at a capacity factor only 4.5% lower than at the beginning of the sublease. Petitioner's entitlement with respect to the capacity factor was 22.8% higher than projected by Deloitte and Prof. Myers.

For Scherer, petitioner was entitled to receive, because MEAG had agreed to deliver, the Scherer station at the end of the sublease term in 2030 with at least 62% capacity factor based on 8,760 hours of operation per year and net energy output of 87.5%. Deloitte and Prof. Myers assumed the plant capacity factor to be 66.5% in 2000, declining to 39.9% in 2030. These numbers were based on the engineering reports prepared by Stone & Webster. Thus, petitioner was entitled to receive Scherer at the end of the sublease operating at a capacity factor only 4.5% lower than at the beginning of the sublease. Petitioner's entitlement with respect to the capacity factor at the time of the Scherer return was 22.1% higher than projected by Deloitte and Prof. Myers.

Our observations for the MEAG transactions are very similar to the Spruce transaction discussion. Both petitioner and MEAG had vast experience with operation of power plants. Both petitioner and MEAG had the benefit of legal, tax, and other professional advice before and at the time of entering the transaction. Both petitioner and MEAG agreed to the return conditions set out in the Scherer and Wansley sublease contracts and understood the importance of the minimum operating standards.

Thus, it was reasonably likely at the time the MEAG transactions were entered into that MEAG would exercise the purchase option at the end of the Scherer and Wansley subleases, because meeting the return conditions would be extremely burdensome, if not impossible, for MEAG.

Petitioner may argue that Exelon faced a risk that MEAG would not have sufficient funds to pay the purchase option exercise price. We observe that indeed MEAG replaced the collateral pledged to Ambac Credit and Exelon under the UII and MEAG swaps with MEAG's own debt. We also observe, however, that both Ambac Credit and petitioner consented to such an exchange. Ambac Credit and petitioner would not have consented to the collateral replacement if they had anticipated they would have any problems with the payment at the end of the sublease term. In fact, one of the goals of replacing the collateral was to replace the Government securities, which did not give sufficient yield in the beginning of the 2000s, with relatively secure but higher yield instruments. Because MEAG could not declare bankruptcy under the laws of Georgia, we find that petitioner did not bear any significant risk of nonpayment at the end of the sublease periods for the Scherer and Wansley stations.

b. Cotenants

One of the significant differences between the MEAG transactions and the Spruce transaction is that MEAG's cotenants in the Wansley and Scherer stations received the right to exercise the purchase option at the end of the subleases should MEAG fail to do so. Petitioner and respondent did not put much emphasis on that right in their briefs. Prof. Myers, petitioner's expert, concluded that cotenants would use the same analysis as MEAG to decide whether to exercise the purchase options. We agree with this statement, but we also emphasize that the cotenants may have some other significant considerations that may make it more likely that they will step in and purchase the interests in the Scherer and Wansley stations if MEAG fails to do so. This further insulates petitioner from the risk of loss in the MEAG transactions or a risk of MEAG's nonpayment.

3. Conclusion

We hold that the Wansley and Scherer transactions fail the substance-over-form inquiry because petitioner did not acquire the benefits and burdens of ownership of the Scherer and Wansley stations. It was reasonably likely at the time the MEAG transactions were entered into that MEAG or its cotenants would exercise the purchase options at the end of the sublease term. Accordingly, we do not need to consider the risks and benefits to petitioner of the remaining headlease periods. We agree with respondent that the MEAG transactions most closely resemble financial arrangements. Specifically, the MEAG transactions resemble loans from Exelon to MEAG because Exelon's income was predetermined and the transaction did not have an upside potential or significant downside risks for Exelon. Because Exelon funded the transactions with its own funds and there are two distinct tranches of money it expected to receive back, it is appropriate to characterize each transaction as creating two loan instruments: one to be repaid six months after the closing date in the form of prepaid rent, and the second to be repaid at the time of the purchase option payment. Accordingly, we sustain respondent's disallowance of Exelon's depreciation deductions claimed on the 2001 tax return with respect to the Spruce transaction.

III. Economic Substance of the Test Transactions

Respondent further asserts that we should disallow petitioner's depreciation, interest, and transaction cost deductions claimed on the 2001 tax return because the test transactions lacked economic substance. Respondent did not directly challenge the 1999 like-kind exchange gain deferral under the economic substance doctrine. Because we resolve the issues related to the disputed deductions claimed in petitioner's 2001 tax return on substance over form grounds, we need not address this alternative theory.

IV. Consequences for the 1999 Tax Year Section 1031 Like-Kind Exchange Adjustment

Section 1031(a)(1) provides: "No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment." The regulations further explain that "the words 'like kind' have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under * * * section [1031], be exchanged for property of a different kind or class." Sec. 1.1031(a)-1(b), Income Tax Regs.

We have held that all of the test transactions failed the substance over form inquiry because petitioner did not acquire the benefits and burdens of ownership in the assets involved in the test transactions. We have also concluded that the test transactions are more similar to loans made by petitioner to CPS and MEAG because petitioner's return on its investment was predetermined at the time petitioner entered into the test transactions. Accordingly, in 1999 petitioner exchanged the Powerton and Collins power plants for an interest in financial instruments. Such an exchange fails to meet the "like kind" requirement outlined in the Code and the regulations. Thus, petitioner must recognize the gain it received in 1999 on the sale of the Powerton and Collins plants under section 1001.

V. 2001 Interest Expense Deductions and Rental Income

Six months after the closing of the test transactions, petitioner received prepayment of all rent from CPS and MEAG due under the respective sublease agreements. Petitioner reported the rent payments as income according to the provisions of section 467.

Section 467 governs the reporting of rental income from rental agreements that are treated as leases for Federal income tax purposes and which either have increasing or decreasing rents, or prepaid or deferred rents. See sec. 467(d)(1); Sec. 1.467-1(c), (h)(12), Income Tax Regs. If a rental agreement constitutes a section 467 rental agreement, the lessor and the lessee must take into account only the sum of the section 467 rent and interest during the taxable year. Sec. 1.467-1(b), Income Tax Regs.

We have concluded that petitioner did not acquire the benefits and burdens of ownership in the Spruce, Wansley, or Scherer plant. We have also concluded that the test transactions most closely resemble financial arrangements in the form of loans from petitioner to CPS and MEAG. Thus, the agreements among petitioner, CPS, and MEAG are not lease agreements for Federal tax purposes under section 467, and petitioner may not deduct interest or include rental income with respect to them for the taxable year 2001. This is consistent with our conclusion that petitioner failed to enter into a like-kind exchange in 1999 and must recognize the gain on the sale of the Powerton and Collins stations.

VI. Original Issue Discount and Transaction Expenses

A taxpayer receives OID income when a debt instrument is issued for less than its face value. See Sec. 1273; United States v. Midland-Ross Corp., 381 U.S. 54, 85 (1965); and John Hancock Life Ins. Co. (U.S.A.) v. Commissioner, 141 T.C. at 147. "The holder of a debt instrument with OID generally accrues and includes in gross income, as interest, the OID over the life of the obligation, even though the interest may not be received until the maturity of the instrument." John

Hancock Life Ins. Co. (U.S.A.) v. Commissioner, 141 T.C. at 147 (citing section 1272(a)(1)).

Respondent argues that petitioner has OID income arising out of petitioner's equity contribution that would be repaid through the cancellation/purchase options with interest. Respondent suggests that such contributions should be treated in the same manner as a zero-coupon bond. Respondent further contends that the terms of each test transaction established a guaranteed, fixed return to Exelon through the use of defeasance instruments. Respondent maintains that we should follow the same approach as in John Hancock, where this Court upheld the Commissioner's recharacterization of a number of SILO transactions as in substance a loan from the taxpayer to the counterparties and applied the OID rules. Id. at 148.

Petitioner's main argument is that the test transactions should be characterized as leases, not loans, and thus petitioner does not have any OID income. For the reasons set forth in the previous portions of the opinion, this argument lacks merit. Because petitioner, CPS, and MEAG reasonably expected that the respective cancellation/purchase options would be exercised at the end of the sublease period, the purchase option price was fixed, and the funds for payments set aside (defeased) as of the closing date, the transactions represent fixed obligations similar to those discussed in John Hancock. Accordingly, we uphold respondent's application of the OID rules and his calculation of OID income thereunder.

In addition, we note that because each transaction was fully funded by petitioner's money and created two distinctive tranches of money--one payable in six months, one at the end of the respective sublease term--each tranche should be treated as a separate debt instrument under the OID rules.

Ordinary and necessary business expenses paid or incurred in carrying on any trade or business are generally deductible. See sec. 162(a). We have concluded as to all test transactions that they are properly characterized as loans from petitioner to CPS and MEAG. We also concluded that for each transaction, the loan consisted of two tranches, one due six months after the closing date, the other due at the time of the cancellation/purchase price option payment. Under section 1.1273-2(g)(4), Income Tax Regs., transaction costs must be included as an additional amount lent to the borrowers. See also John Hancock Life Ins. Co. (U.S.A.) v. Commissioner, 141 T.C. at 149. Thus, petitioner's transaction costs related to the test transactions are not deductible and should be allocated to the respective loans. The parties are further directed to address the issue of transaction cost allocation in Rule 155 computations.[32]

VII. Section 6662 Penalties

A. Overview

Section 6662(a) and (b)(1) and (2) imposes a 20% accuracy-related penalty on the portion of an underpayment of tax attributable to negligence or disregard of rules and regulations or a substantial understatement of income tax. The accuracy-related penalty does not apply to any portion of an underpayment for which a taxpayer had reasonable cause and acted in good faith. See sec. 6664(c)(1).

This Court previously held that the statutory provisions shifting the burden of production to the Commissioner with respect to penalties are inapplicable to corporations. See NT, Inc. v. Commissioner, 126 T.C. 191, 195 (2006) (holding that section 7491(c) does not apply to a C corporation's liability for a penalty, an addition to tax, or an additional amount). Petitioner in the consolidated cases before us is a corporation. Thus, the provisions of section 7491(c) do not apply.

Respondent determined accuracy-related penalties pursuant to section 6662(a) of $86,234,918 for the 1999 tax year and $1,106,922 for the 2001 tax year

[32]We recognize that there may be several ways to approach this issue. One way would be to allocate transaction costs pro rata to the amounts of the respective loans. The other way would be to allocate expenses on the basis of the billing records and invoices of petitioner's advisers related to the transactions at issue.

in the respective notices of deficiency. Respondent determined these penalties on the grounds of negligence and disregard of rules and regulations and substantial understatements of income tax. Respondent has conceded the substantial understatement of income tax grounds for the 2001 tax year.

Petitioner argues that no penalty is appropriate in these cases because petitioner was not negligent, did not disregard any applicable rules and regulations, and acted reasonably and in good faith when relying on the tax advice of its advisers, who adequately considered all relevant law under the applicable standards at the time of the transactions. In addition, petitioner asserts that the OID income cannot be included in the penalty computations because this argument has only recently been introduced and developed by the Commissioner and the courts, and petitioner could not anticipate such an assertion in 1999 and 2000, at the time of closing the transactions.

B. <u>Negligence or Disregard of Rules and Regulations</u>

We will address the issue of negligence or disregard of rules and regulations first because it was determined as the ground for penalties in both notices of deficiency on which these cases are based.

Section 6662(a) and (b)(1) imposes a 20% penalty on any portion of an underpayment of tax attributable to negligence or disregard of rules or regulations.

Negligence includes "any failure to make a reasonable attempt to comply with the provisions of the internal revenue laws or to exercise ordinary and reasonable care in the preparation of a tax return." Sec. 1.6662-3(b)(1), Income Tax Regs. Negligence is "strongly indicated" when the taxpayer fails to make a reasonable inquiry into correctness of an item that appears "too good to be true." Id. subpara. (1)(ii).

Disregard includes "any careless, reckless or intentional disregard of rules or regulations," which includes "the provisions of the Internal Revenue Code, temporary or final Treasury regulations * * * and revenue rulings or notices (other than notices of proposed rulemaking) issued by the Internal Revenue Service and published in the Internal Revenue Bulletin." Id. subpara. (2). Disregard is "careless" if the taxpayer does not use "reasonable diligence to determine the correctness of a [tax] return position that is contrary to the rule or regulation." Id. Disregard is "reckless" if the taxpayer "makes little or no effort to determine whether a rule or regulation exists under circumstances which demonstrate a substantial deviation from the standard of conduct that a reasonable person would observe." Id. Finally, disregard is "intentional" if a taxpayer knows of the disregarded rule or regulation. Id.

However, the penalty does not apply to any portion of an underpayment for which a taxpayer had reasonable cause and acted in good faith. See sec. 6664(c)(1). This defense can be established through reasonable and good-faith reliance on advice received from a competent tax professional. See United States v. Boyle, 469 U.S. 241, 250-251 (1985); sec. 1.6664-4(b)(1), Income Tax Regs.

Respondent argues that petitioner failed to make a reasonable attempt to comply with the existing tax laws and failed to exercise ordinary and reasonable care in the preparation of the tax returns for the years at issue. Respondent asserts that Exelon should have known that the like-kind exchange and the test transactions provided it with a result "too good to be true" and should have evaluated the transactions more carefully. Respondent also asserts that Exelon was aware that LILO transactions were already under scrutiny from the IRS and did not sufficiently closely review the tax opinions provided by Winston & Strawn at the time of entering into the transactions.

Petitioner, in turn, argues that it conducted a thorough due diligence of all aspects of the like-kind exchange and test transactions before deciding to engage in them. Petitioner also argues that it reasonably relied in good faith on the advice it received from its advisers on the various aspects of the transactions, including tax treatment. Because the issue of whether petitioner under section 6662(a) was negligent or disregarded rules or regulations is so closely intertwined in these cases with whether petitioner under section 6664(c) reasonably and in good faith relied on advice it received from tax professionals, we consider the two issues together.

It is well recognized that taxpayers may establish that they should not be liable for a section 6662 penalty if they acted in good faith and reasonably relied on advice of a tax professional. Reliance on a professional tax adviser, however, does not automatically establish reasonable cause and good faith. Sec. 1.6664-4(b)(1), Income Tax Regs. Instead, all facts and circumstances must be taken into account, including the taxpayer's knowledge and experience and the reliance on the advice of a professional. Id. In the case of reliance on an opinion or advice, the facts and circumstances inquiry should account for "the taxpayer's education, sophistication and business experience," as well as whether "the taxpayer knew, or reasonably should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law." Id. para. (c)(1).

To show that reliance on advice of a tax professional constitutes reasonable cause, the taxpayer must prove by a preponderance of the evidence the following three requirements: (1) the adviser was a competent professional who had sufficient expertise to justify reliance, (2) the taxpayer provided necessary and accurate information to the adviser, and (3) the taxpayer actually relied in good faith on adviser's judgment. Neonatology Assocs., P.A. v. Commissioner, 115 T.C. 43, 99 (2000), aff'd, 299 F.3d 221 (3d Cir. 2002). Reliance may be unreasonable when it is placed upon insiders, promoters, or their offering materials, or when the person relied upon has an inherent conflict of interest that the taxpayer knew or should have known about. Id. at 98. In addition, the advice must not be based on unreasonable factual or legal assumptions and must not unreasonably rely on representations, statements, findings, or agreements of the taxpayer or any other person. Sec. 1.6664-4(c)(1)(ii), Income Tax Regs.

Petitioner claims it reasonably relied in good faith on Winston & Strawn's tax advice and therefore no accuracy-related penalty should be imposed. Respondent contends that petitioner's reliance on Winston & Strawn was unreasonable and not in good faith because Winston & Strawn was too involved in the structuring of the transactions to provide a reliable tax opinion.

First, we will analyze the factors outlined in Neonatology. The record in these cases and the testimony of the parties establishes that petitioner carefully considered various factors, including necessary expertise in tax, in selecting its tax adviser. Winston & Strawn, in petitioner's opinion, was a strong firm possessing the necessary qualifications and expertise in handling similar deals.

We do not find that Winston & Strawn was so involved in structuring the transaction that reliance on its tax opinions was per se unreasonable. Petitioner contacted Winston & Strawn to provide advice on the transaction, and there is no evidence that Winston & Strawn had a conflict of interest in rendering its advice. Winston & Strawn billed its normal hourly rates, and its fee did not depend on the closing of the test transactions. Cf. Kerman v. Commissioner, T.C. Memo. 2011-54, slip op. at 43 (finding that a tax opinion was burdened with an inherent conflict of interest where the fee for it was based on the amount of loss generated for the taxpayers in a CARDS transaction), aff'd, 713 F.3d 849 (6th Cir. 2013). Thus, petitioner met the first prong of the Neonatology test.

As to the second prong of the Neonatology test, the parties do not dispute that Winston & Strawn was closely involved in the transactions and knew all the relevant facts to render a tax opinion. Respondent does not allege that petitioner misrepresented any material facts to Winston & Strawn, and the record does not contain any indicia that this was the case.

However, as we discussed above, Winston & Strawn's tax opinions were based in large part on the appraisals prepared by Deloitte. We found that Winston & Strawn interfered with the integrity and the independence of the appraisal process by providing Deloitte with a list of conclusions it expected to see in the appraisals to be able to issue tax opinions at the “will” and “should” level. Such interference improperly tainted the Deloitte appraisal, rendering it useless. Further, because Winston & Strawn directed the conclusions that Deloitte had to arrive at, we are highly suspicious that the tax opinions are similarly tainted.

We also concluded that the technical and engineering assumptions used in the Deloitte appraisals were inconsistent with the return conditions specified in the test transaction documents, which made the exercise of the purchase/cancellation options considerably more likely. Winston & Strawn, as the firm that drafted the transaction documents and was closely involved in all stages of the test transactions, knew or should have known of this defect and that its tax opinions were therefore based on unreasonable assumptions and arrived at unreasonable conclusions in the light of how the transactions were actually structured. See sec. 1.6664-4(c)(1)(ii), Income Tax Regs.

The third prong of the Neonatology test requires the taxpayer to show that it relied in good faith on the adviser’s judgment. There is a longstanding policy of not requiring taxpayers to second-guess the work of a tax professional providing the advice. As the Supreme Court has stated, “[t]o require the taxpayer to challenge the attorney, to seek a ‘second opinion,’ or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place." Boyle, 469 U.S. at 251; see also Bruce v. Commissioner, T.C. Memo. 2014-178, at *56-*57 (finding it was objectively reasonable for the taxpayer to rely on the advice of his longtime tax adviser, even though the Court concluded that the advice was incorrect), aff'd, 608 F. App'x 268 (5th Cir. 2015); Estate of Giovacchini v. Commissioner, T.C. Memo. 2013-27, at *113-*114 (finding reasonable cause and good faith where there was no requirement under the circumstances to second-guess the advice of a CPA).

Sophistication and expertise of a taxpayer are important when it comes to determining whether a taxpayer relied on a tax professional in good faith, or simply attempted to purchase an expensive insurance policy for potential future litigation. Petitioner had been involved in the power industry since 1913 and described itself as "an electric utility company with experience in all phases of that industry; from generation, transmission, and distribution to wholesale and retail sales of power." Although petitioner did not have experience with section 1031 transactions, it certainly had experience in operating power plants and must have understood the concept of obsolescence.

Petitioner indeed engaged many advisers to assist with the due diligence and documenting the transactions at issue. Petitioner's employees recognized that they did not have expertise in like-kind exchanges and thus sought help from outside lawyers, accountants, and other consultants to guide them in the transactions.[33] Petitioner formed an internal project team that was responsible for investigating and evaluating the like-kind exchange opportunity. The team included high-level employees with experience in tax, finance, and engineering. The team reported its findings to petitioner's board of directors, and the board approved the transactions. Although the board did not have the benefit of reviewing the final versions of the tax opinions, it did have a chance to ask questions of the Winston & Strawn team as well as the PwC team.

Petitioner's employees and the board, however, had other considerations in mind as well: They were under pressure to find a reasonable solution to the problem of higher-than-anticipated revenue from the sale of its fossil fuel power plants. The clock on the section 1031 transaction was ticking, and the amount at stake--over $1.6 billion of potentially taxable sale proceeds--was too significant to let the like-kind exchange plan fall apart. Our analysis of the test transactions shows that petitioner knew or should have known that CPS and MEAG were reasonably likely to exercise their respective cancellation/purchase options

[33]In addition to Winston & Strawn, petitioner engaged PwC (financial and accounting adviser), Arthur Andersen (accounting adviser), Sidley Austin (regulatory counsel), Deloitte (valuation), Stone & Webster (engineering and environmental adviser), Vinson & Elkins (Texas counsel), and Holland & Knight (Georgia counsel).

because they would not be able to return the Spruce, Scherer, and Wansley power plants to petitioner without incurring significant expenses to meet the return requirements.

It is true that Winston & Strawn provided a very favorable tax opinion on the test transactions, notwithstanding the obvious inconsistency of the return provisions and the projected plant capacity factor at the end of the respective subleases. Yet we are not persuaded that Winston & Strawn's tax opinion can serve as a shield for petitioner under the circumstances. We believe that petitioner fully recognized that a plant with a capacity factor of 82%--the minimum rate at which the Spruce station had to be running when returned by CPS upon expiration of the sublease--would be worth significantly more than the same plant with a capacity factor of 58%--the capacity factor used in the Deloitte appraisals.[34] Petitioner, as a sophisticated power plant operator, must have appreciated that it would be very expensive for CPS to sufficiently upgrade the plant to meet the capacity requirements. Thus, petitioner must have understood that Winston & Strawn's tax opinions, based on the Deloitte appraisals, were flawed.

This brings us to two conclusions: first, petitioner could not have relied on the Winston & Strawn tax opinions in good faith because petitioner, with its

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[34]See supra note 29 for a fuller explanation of these numbers. The difference in capacity factors for MEAG transactions was in the same range.

expertise and sophistication, knew or should have known that the conclusions in the tax opinions were inconsistent with the terms of the deal. Second, in the light of the previous conclusion, petitioner's alleged reliance on Winston & Strawn's tax advice fails the Neonatology test.[35]

We note that petitioner expended significant resources on due diligence and consulting fees related to the like-kind exchange and the test transactions. However, we find troubling petitioner's cavalier disregard of the risks connected with the test transactions and the underlying facts. Mr. Berdelle, petitioner's controller and a senior employee with substantial discretionary and strategic authority, testified that he had read the Winston & Strawn tax opinions and was otherwise intimately involved in the decisionmaking process behind the proposed transaction. In addition, Winston & Strawn had advised petitioner of certain tax risks that could accompany the proposed transactions, and indeed petitioner registered the test transactions as a confidential corporate tax shelter around the same time it entered into the transactions.

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[35]Petitioner also alleges that it relied on its auditor, Arthur Andersen, to raise red flags about the transactions. According to petitioner, Arthur Andersen had no objections or challenges to petitioner's reporting of the like-kind exchange. Unlike petitioner, Arthur Andersen did not have the benefit of vast experience in operating power plants and may have overlooked the issue of return conditions. The record is also silent as to what documents related to the transactions were actually reviewed by Arthur Andersen and to what extent. We are thus not persuaded by petitioner's argument.

It is true that Mr. Roling and other employees of petitioner besides Mr. Berdelle had only cursorily read the opinion package prepared by Winston & Strawn. This fact on its own might be sufficient to demonstrate a failure by petitioner to exercise ordinary and reasonable care in entering into the transaction and preparing the related tax returns. However, considering that petitioner (1) was a sophisticated taxpayer, (2) claims to have read the Winston & Strawn tax opinions in their entirety, (3) knew or should have known that Winston & Strawn's tax opinions based on the Deloitte appraisal reports were flawed, (4) was apprised of the risk that the proposed transactions might be classified as corporate tax shelters and registered them as such with the IRS around the same time it entered into the test transactions, and (5) proceeded with the transactions anyway, we find that petitioner disregarded the applicable rules and regulations. At a minimum, petitioner carelessly disregarded the rules and regulations by failing to "exercise reasonable diligence to determine the correctness of a return position." See sec. 1.6662-3(b)(2), Income Tax Regs. Moreover, petitioner's use of Winston & Strawn's tax opinions--flawed as the opinions were because of Winston & Strawn's interference with the independence of the appraisal reports that undergirded them--was misguided. 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. A wink-and-a-smile is no replacement for independence when it comes to professional tax opinions.

We conclude that petitioner evinced disregard of rules and regulations within the meaning of section 6662 with respect to ascertaining the tax consequences of the test transactions. We further conclude that petitioner did not have reasonable cause and act in good faith within the meaning of section 6664(c). Accordingly, we uphold the accuracy-related penalties as determined by respondent for tax years 1999 and 2001. Because we have sustained the accuracy-related penalties on the ground of disregard of rules or regulations, we do not address the parties' arguments on a substantial understatement of income tax for the 1999 tax year.

C. OID Income

Petitioner argues that the OID income should not be a part of the penalties calculation under section 6662 because there was no guidance at the time petitioner filed its 1999 and 2001 returns that would suggest that the transactions could be recharacterized as loans, and petitioner could not anticipate this possibility. Petitioner also notes that respondent was inconsistent in his assertion of OID income in previous LILO/SILO cases.

Section 6662(a) imposes an accuracy-related penalty applicable “to any portion of an underpayment of tax required to be shown on a return”. Section 6664(a) defines an underpayment as “the amount by which any tax imposed by this title exceeds the excess of--(1) the sum of--(A) the amount shown as the tax by the taxpayer on his return, plus (B) amounts not so shown previously assessed (or collected without assessment), over (2) the amount of rebates made.” Neither section 6662 nor any other provision of the Code provides that an underpayment should be reduced because a taxpayer did not anticipate that the Commissioner would make a certain argument in litigating a tax case or because the Commissioner was inconsistent in his prior litigation strategy. We therefore find petitioner’s argument without merit. We hold that the OID income should be included in the calculation of the underpayment subject to the section 6662 penalty for the 2001 tax year.

VIII. Conclusion

We have considered all of the arguments that petitioner made, and to the extent not discussed above, conclude that those arguments not discussed herein are irrelevant, moot, or without merit. We have considered respondent’s arguments only to the extent stated herein.

To reflect the foregoing,

Decisions will be entered

under Rule 155.

Filed 11/1/17; Modified and Certified for Pub. 11/30/17 (order attached)

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

SECOND APPELLATE DISTRICT

DIVISION ONE

In re the Marriage of Stacy Dalgleish and Piero Selvaggio. STACY DALGLEISH, Plaintiff and Appellant, v. PIERO SELVAGGIO, Defendant and Appellant.	B266579 (Los Angeles County Super. Ct. No. BD430584)

APPEALS from orders of the Superior Court of Los Angeles County. Ralph C. Hofer, Judge. Affirmed in part and reversed in part with directions.

Law Office of Leslie Ellen Shear, Leslie Ellen Shear and Julia C. Shear Kushner for Plaintiff and Appellant.

Law Offices of James R. Eliaser, James R. Eliaser and Joanne D. Ratinoff for Defendant and Appellant.

Stacy Dalgleish, the petitioner in a marital dissolution proceeding, and Piero Selvaggio, the respondent in that proceeding, both appeal from postjudgment orders of the trial court. Those orders enforced one of the terms of the parties' stipulated judgment, which required an equalization payment from Selvaggio to Dalgleish following a joint appraisal of certain real property. Dalgleish claims that the trial court erred in awarding interest on that payment from the date of the trial court's ruling rather than the date the payment was due, about 19 months earlier. In his cross-appeal, Selvaggio claims that the trial court erred in finding that the appraisal in fact was a joint appraisal as required by the judgment. We agree with Dalgleish's claim and reject Selvaggio's. We therefore reverse the trial court's orders only with respect to the date when interest on the equalization payment began to accrue.

BACKGROUND

1. *The Appraisal*

On December 7, 2009, the parties executed and the trial court approved a 37-page "Stipulated Further Judgment on Reserved Issues" (Judgment) addressing property division and other topics. The Judgment stated that it was "the entire agreement of the parties exclusive of the issues of custody and visitation." The Judgment was filed on December 9, 2009.

In paragraph 1.C.iii, under the heading, "Equalizing Payments," the Judgment directed that: "The parties shall forthwith engage a joint real estate appraiser to appraise the real properties located at 3115 and 3125 Pico Boulevard, Santa Monica, California as of September 2, 2008 and their fair market values at the time of the Transmutation Agreement executed by the parties on May 1, 2003. If there was an increase in the fair market value of said properties between those two dates, then Respondent shall, within ten (10) days of receipt of the appraisal report, pay Petitioner, tax free, a sum equal to one-half ($^1/_2$) of the increase in value of said properties as determined by the appraiser." The Judgment did not provide any right or describe any procedure to challenge the results of the joint appraisal for purposes of calculating this payment (the Equalization Payment).

In late 2012 and early 2013, Judith Forman, counsel for Dalgleish, and James Eliaser, counsel for Selvaggio, had various communications with each other and with Larry Sommer, an appraiser, about retaining Sommer to conduct an appraisal of the properties on Pico Boulevard (the Pico Property). Sommer did not send out an engagement letter, but he understood that he had been retained by both parties and proceeded to work on appraising the Pico Property. During the course of his work he communicated with both parties jointly concerning the status of the project and when he would finish.

Sommer completed his work on the appraisal of the Pico Property (the Appraisal) and prepared a report that he sent to both parties on July 26, 2013. The Appraisal valued the Pico Property at $1,618,542 as of May 1, 2003, and $3,810,645 as of September 2, 2008. One-half the amount of the appreciation was therefore $1,096,051.50.

After the Appraisal was completed, the parties had various communications with each other about clearing title on the Pico Property. Then, in February 2014, a business lawyer for Selvaggio wrote to Sommer, raising questions about the methodology and the results of the Appraisal. In communications with Forman, Selvaggio's lawyer also questioned whether the parties had in fact jointly retained Sommer. The parties had further communications about the Appraisal and the Equalization Payment, but reached no agreement about the adequacy of the Appraisal and whether Sommer had been jointly retained.

2. *Dalgleish's Request for Order Enforcing the Judgment*

On August 6, 2014, Dalgleish filed a Request for Order (RFO), seeking enforcement of the Judgment with respect to the Equalization Payment. The RFO asked the trial court to find that the "amount of $1,095,000 was due from Respondent to Petitioner on August 5, 2013 under Paragraph 1.C.iii of the Judgment," and that under Code of Civil Procedure[1] section 685.010, "statutory interest at the rate of 10% per annum has been accruing on the amount of $1,095,000 since August 5, 2013 and shall continue to accrue until paid in full." Selvaggio opposed the motion on the ground that Dalgleish had never agreed to retain Sommer and the Appraisal was therefore not a joint appraisal as required by the Judgment.

The court held a hearing on the RFO on October 31, 2014. The court announced its tentative findings that: (1) there was no right under the Judgment to challenge the Appraisal; (2) Sommer was hired as a joint appraiser pursuant to paragraph 1.C.iii of the Judgment; and (3) even if there had been no agreement to hire Sommer, Selvaggio was equitably estopped from challenging whether the Appraisal was joint. During the argument that followed the court's tentative ruling, Selvaggio's counsel, Eliaser, made a request to cross-examine Sommer. After some discussion

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[1] Subsequent undesignated statutory references are to the Code of Civil Procedure.

about the consequences of Selvaggio's failure to file a written request for cross-examination under Family Code section 217, the court asked Dalgleish's counsel, Forman, whether she was willing to agree to an evidentiary hearing at which Sommer would testify, or whether she was satisfied with the record as it stood. The court stated that, if it were to enter a judgment without further proceedings, interest would run from the current date, "not last summer." Forman asked the court to confirm that, if she agreed to a further evidentiary hearing and Dalgleish prevailed, interest would be retroactive to October 31, 2014. The court replied, "Yes, it would be retroactive to today." Forman stipulated to the further hearing on Dalgleish's behalf.

The evidentiary hearing took place on March 11, 2015. Sommer testified that he understood he was jointly retained by Forman and Eliaser. At the conclusion of the hearing, the trial court announced its findings that the Appraisal was joint and that Selvaggio was to pay Dalgleish one-half of the $2,192,103 appreciation amount pursuant to paragraph 1.C.iii of the Judgment. The court stated that, although the Judgment required payment within 10 days, "[t]he court can alter that to be 90-day period with interest accruing as of October 31, 2014 pursuant to the court's prior order."

Eliaser asked to be heard on the issue of interest. He argued that interest could start to accrue only "from the date on which there is a ruling as to a sum certain," and that there was no sum certain until the court's ruling that day. The court accepted that argument and modified its ruling to order interest on the Equalization Payment beginning March 11, 2015. After some additional argument on the issue of interest, the court explained its reasoning that "today's ruling is a type of final judgment at which time the court is entering a specific amount of money that is due," and that therefore interest could not have accrued earlier.

The court declined further briefing on the issue. Dalgleish nevertheless filed a motion to change the court's order with respect to the date when interest began to accrue. After a hearing on May 12, 2015, the court denied Dalgleish's motion. The court found that Selvaggio "had a good faith basis to challenge the Appraisal such that there was no amount certain for a monetary judgment in existence until the court's ruling on March 11, 2015." The court also stated that "the judgment in terms of the amount of appreciation was contingent and there was no amount certain when the judgment was entered back in 2009. And the court has also found that the judgment was not self-executing, given these particular set of facts."

The court subsequently filed written orders setting forth its findings of fact and rulings on the issues of the joint Appraisal and interest on the Equalization Payment. The court found that "[t]here is ample evidence to determine through words, emails, and conversations and exchanges between the parties and the appraiser that the objective intent of the parties was to, and they did, jointly retain Mr. Sommer as their expert." Based upon the Appraisal and paragraph 1.C.iii of the Judgment, the court therefore found that the increase in fair market value of the Pico Property from May 1, 2003, to September 2, 2008, was $2,192,103, and that Selvaggio owed half that amount to Dalgleish.

Consistent with the trial court's oral findings at the May 12, 2015 hearing, the court's final order also stated that the "March 11, 2015 Ruling is a type of final judgment under CCP §665.020(a)[2] at which time the Court is entering a specific amount of money that is due, and therefore interest entered under this Code section could not have accrued prior to [March 11, 2015]." The court ordered that the amount of $1,096,051.50 was payable from Selvaggio to Dalgleish, with interest accruing at the statutory rate of 10 percent from March 11, 2015.

DISCUSSION

1. *Interest Began to Accrue on the Amount of the Equalization Payment When It Was Due Under the Judgment*

The parties agree that the issue of when interest begins to accrue on an amount included in a monetary judgment is a question of law that we review de novo. (See *Chodos v. Borman* (2015) 239 Cal.App.4th 707, 712 (*Chodos*).) We also independently interpret a marital settlement agreement incorporated into a dissolution judgment unless there is conflicting parol evidence affecting its meaning. (*In re Marriage of Simundza* (2004) 121 Cal.App.4th 1513, 1518.) Here, there is no parol evidence to interpret. We therefore apply a de novo standard to our review of the trial court's order concerning the

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[2] The court apparently intended to cite section 685.020, subdivision (a).

relevant date for computing interest on the Equalization Payment.

a. ***The $1,096,051.50 Equalization Payment is a money judgment to which statutory interest applies***

Section 685.020 provides that "interest commences to accrue on a money judgment on the date of entry of the judgment." Paragraph 1.C.iii of the Judgment required the payment of money by Selvaggio to Dalgleish. That portion of the Judgment was therefore a "money judgment" for purposes of section 685.020. (See § 680.270; *In re Marriage of Pollard* (1988) 204 Cal.App.3d 1380, 1383 (*Pollard*).)

In *Pollard,* a husband and wife reached an agreement on the division of equity in their residence that was incorporated into a judgment of dissolution. (*Pollard, supra,* 204 Cal.App.3d at p. 1382.) The wife was to continue to live in the residence, and the husband was to receive $33,429.50 as his equity share. (*Ibid.*) However, the wife did not have any present ability to pay that sum and minor children continued to live with her. Thus, the parties agreed that the sum would be due upon sale of the home. Their agreement gave the wife sole discretion to decide when to sell. (*Ibid.*) Over six years later, the wife still had not sold the residence, and the husband sought interest on the $33,429.50. (*Id.* at pp. 1382–1383.)

The court held that the $33,429.50 equalization payment was a "money judgment on which interest accrues from the date of its entry, in the absence of an express or implied agreement by the parties to the contrary." (*Pollard, supra,* 204 Cal.App.3d at p. 1382.) A contrary ruling would have permitted the wife to enjoy the use of the home and benefit from the appreciation on its value while depriving the husband of the use of his money award. (*Id*. at pp. 1382–1383.) The court cited *Wuest v. Wuest* (1945) 72 Cal.App.2d 101 (*Wuest*), which similarly held that a payment in lieu of a division of community property was a money judgment that accrued interest from the date of entry. (*Pollard,* at pp. 1384–1385.)

The parties here similarly agreed to a judgment that included an Equalization Payment to compensate Dalgleish for her share of the appreciation of the Pico Property. Interest on the payment began to accrue on the date it was due.[3] A contrary ruling would deprive Dalgleish of the value of the money she was due from her share of the Pico Property while Selvaggio continued to enjoy the benefit of appreciation on that property.

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[3] The parties agreed in their stipulated Judgment that the Equalization Payment was to be due, not on the date the Judgment was entered, but 10 days after receipt of the joint Appraisal. This is consistent with the general equitable principle that " 'a person *who does not know what sum is owed* cannot be in default for failure to pay.' " (*Lucky United Properties Investment, Inc. v. Lee* (2013) 213 Cal.App.4th 635, 652–653 (*Lucky*), quoting *Chesapeake Industries, Inc. v. Togova Enterprises, Inc.* (1983) 149 Cal.App.3d 901, 906.) Assessing interest from the date the payment was required under the Judgment is also logical, as otherwise Selvaggio would be charged with interest before a payment was actually due. (Cf. § 685.020, subd. (b) ["Unless the judgment otherwise provides, if a money judgment is payable in installments, interest commences to accrue as to each installment on the date the installment becomes due"].) In any event, Dalgleish seeks interest only from August 5, 2013—10 days after receipt of the Appraisal—and we therefore need not consider any argument that interest on the Equalization Payment should have begun to accrue at the time the Judgment was entered in 2009.

Selvaggio's reliance on *In re Marriage of Teichmann* (1984) 157 Cal.App.3d 302 (*Teichmann*) is misplaced. In that case, an interlocutory judgment of dissolution provided that the parties' residence was to be sold. After the sale, the wife was to receive $89,000 from the proceeds and the husband $3,100. After those payments, the balance of the equity was to be divided equally between the parties to effectuate " 'an exactly equal division of the community property.' " (*Id.* at p. 305.) However, because of market conditions the home was not sold for another 19 months. The wife, who continued to live in the residence until the sale, sought interest on the $89,000 from the date of the interlocutory judgment. (*Ibid.*)

The court held that the $89,000 sum was not a money judgment that accumulated statutory interest. The court distinguished other cases, including *Wuest,* in which "the recipient spouse was to receive payments directly from the other spouse." (*Teichmann, supra,* 157 Cal.App.3d at p. 307.) In contrast, the stipulated judgment in *Teichmann* simply divided the parties' property. (*Ibid.*)

Here, as in *Wuest*, the Judgment did not merely divide the parties' property but required one spouse, Selvaggio, to make an equalization payment of a specific amount to the other, Dalgleish. Moreover, unlike the wife in *Teichmann* who "shared equally the benefit of the increasing value of the home due to the 19 months' appreciation . . . and in the interim had full use and enjoyment of the property" (*Pollard, supra,* 204 Cal.App.3d at p. 1384), Dalgleish did not obtain any benefit from appreciation in the Pico Property after September 2, 2008, and did not enjoy any use of the property.

The trial court here apparently concluded that the relevant "judgment" for purposes of computing interest was not the parties' stipulated Judgment but rather its own March 11, 2015 ruling on Dalgleish's RFO. The court characterized that ruling as "a type of final judgment" that set the amount of money that was due and found that interest therefore could not have accrued earlier.

That ruling was erroneous. The trial court's March 11, 2015 order did not result in a new judgment, but simply enforced the already existing Judgment. For purposes of accruing interest, the "date of entry of the judgment" is the critical date, not the date when any postjudgment challenges might be resolved. (§ 685.020, subd. (a).)[4] Thus, the general rule is that "[a] judgment bears legal interest from the date of its entry in the trial court even though it is still subject to direct attack." (*Stockton Theatres, Inc. v. Palermo* (1961) 55 Cal.2d 439, 442.) Even when a judgment is modified on appeal, the "new sum draws interest from the date of entry of the original order, not from the date of the new judgment." (*Ibid.*) Only if a judgment is reversed on appeal does the new award subsequently entered by the trial court bear interest from the date of the new judgment. (*Id.* at pp. 442–443; see *Chodos, supra,* 239 Cal.App.4th at pp. 712–713.)

Although the court in *Wuest* did not discuss this rule, the result in that case was consistent with it. The court concluded that interest began to accrue on the husband's equalization debt when the original judgment was entered, even though the wife

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[4] Unless the clerk maintains a judgment book, the date of entry of a judgment is the date it is filed with the clerk. (§ 668.5.)

subsequently obtained a revised judgment after successfully challenging the portion of the original judgment that permitted the husband to pay his obligation in installments. (See *Wuest, supra,* 72 Cal.App.2d at pp. 111–112.)

b. *The appraisal procedure in the Judgment set a specific sum for payment*

Selvaggio also argues that interest could not accrue on the Equalization Payment until the trial court's March 11, 2015 ruling because, until that date, the amount of the payment was not a "sum certain" on which interest could be calculated. Although Selvaggio cites no statutory or case authority for this argument, it is apparently based on the equitable principle discussed above that a party cannot be in default for failure to pay a judgment until the party knows what amount he or she owes. (See *Lucky, supra,* 213 Cal.App.4th at pp. 652–653.) That principle does not apply here, as the Appraisal set the amount that Selvaggio owed.

The fact that the Appraisal established the specific amount of the Equalization Payment after the Judgment was already entered did not make a further court order necessary for the accumulation of interest. The Judgment did not contemplate any such order. It established no procedure to calculate the Equalization Payment other than the joint appraisal itself. Nor did the Judgment anticipate further negotiation to set the amount. By specifying a joint appraisal, the parties required agreement on the selection of the appraiser, not on the *amount* of the appraisal. The parties further agreed that the Judgment "constitutes the entire agreement of the parties exclusive of the issues of custody and visitation."[5]

A judgment may be final while still contemplating further acts by the parties to effectuate the judgment's terms. For example, the parties here included a typical term requiring them to "promptly execute all documents and instruments necessary or convenient to vest title and estates in the other as provided in this Stipulated Further Judgment to effectuate its purpose and intent." When such terms are included and a party fails to comply, further court action might be necessary to enforce the judgment. But the fact that, as here, it is necessary to file a postjudgment motion to obtain relief that the judgment requires does not affect the finality of the judgment for purposes of accruing interest, even if there is a good faith basis for the other party to oppose the motion.

Here, the Appraisal established the precise amount of the Equalization Payment. In ruling on Dalgleish's RFO, the trial court merely resolved a conflict over whether that amount was in fact *due*. In the analogous area of prejudgment interest under Civil Code section 3287, subdivision (a), certainty about the sum

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[5] In this respect, the appraisal process in the Judgment was similar to the typical procedure in which costs and attorney fees are ordered as part of a judgment but the amount of the costs and fees is not determined until after the judgment is entered. For prejudgment costs and fees set as a result of such a process, interest begins to accrue on the date the judgment is entered even though the actual amounts are determined later. (See *Lucky, supra,* 213 Cal.App.4th at p. 650.) Even postjudgment enforcement costs are incorporated into the principal amount of the judgment and accumulate interest when awarded. (*Id.* at pp. 651–654.)

owed is "absent when the *amounts* due turn on disputed facts, but not when the dispute is confined to the rules governing liability." (*Olson v. Cory* (1983) 35 Cal.3d 390, 402, italics added; see *Bullock v. Philip Morris USA, Inc.* (2011) 198 Cal.App.4th 543, 574 ["A legal dispute as to the plaintiff's entitlement to the amount awarded does not render the damages uncertain"]; *Wisper Corp. v. California Commerce Bank* (1996) 49 Cal.App.4th 948, 958 ["it is clear that Civil Code section 3287 looks to the certainty of the damages suffered by the plaintiff, rather than to a defendant's ultimate liability, in determining whether prejudgment interest is mandated"].)[6]

The same principle applies here. Selvaggio disputed whether the Appraisal met the requirements of the Judgment. He did not dispute the *amount* of the Appraisal, and the Judgment gave him no right to do so. Having lost his argument

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[6] Although we conclude that *postjudgment* interest was legally required on the Equalization Payment pursuant to the Judgment under Code of Civil Procedure section 685.020, subdivision (a), we note that, even if the trial court's March 11, 2015 ruling were considered to be a separate, operative "judgment" for purposes of setting the Equalization Payment, *prejudgment* interest on that payment would have been appropriate under Civil Code section 3287, subdivision (a). That subdivision provides that "[a] person who is entitled to recover damages certain, or capable of being made certain by calculation, and the right to recover which is vested in the person upon a particular day, is entitled also to recover interest thereon from that day." This provision reflects the general principle that "interest starts to accrue on the date that the amount owed has been fixed or can be determined with certainty." (*Lucky, supra,* 213 Cal.App.4th at p. 653.) The amount that Selvaggio owed was fixed by the Appraisal.

that the Appraisal was not a joint appraisal as required by the Judgment, he owed interest on the amount that the Appraisal set from the date that the Equalization Payment was due.

c. *The trial court did not have discretion to adopt a different date for the accrual of interest*

The trial court concluded that it was not required to award interest from August 5, 2013, but that the interest award was "discretionary based on various factors that the court has described." That conclusion was inconsistent with the law. The accrual of interest on a money judgment is governed by statute. (See § 685.020.) The court did not have discretion to alter the statutory date that interest began to accrue. (*In re Marriage of Hubner* (2004) 124 Cal.App.4th 1082, 1091.)

Selvaggio argues that the trial court had the discretion to change its October 31, 2014 decision that interest would be calculated from that date. But that argument does not address whether the trial court had the discretion to order interest only from March 11, 2015 (or, indeed, even from October 31, 2014, absent a stipulation by the parties). Selvaggio does not argue that Dalgleish agreed with the March 11, 2015 date, nor could he do so based on the record. The trial court did not have the discretion to order a date for the accrual of interest different from the statutory date absent agreement to that date by Dalgleish.

2. *Selvaggio Has Failed to Identify Error in the Trial Court's Ruling that the Appraisal Was a Joint Appraisal as Required by the Stipulated Judgment*

In his cross-appeal, Selvaggio argues that the trial court erred in finding that the Appraisal was joint. However, he supports this argument with only a half-page discussion in his opening brief that refers to just four items of evidence: (1) there was no engagement letter or other formal written agreement with Sommer; (2) only Selvaggio paid Sommer; (3) Forman "never confirmed" that she agreed Sommer would be the joint appraiser; and (4) Forman was "cagey and evasive" in her commitment to retain Sommer. Selvaggio refers to the same evidence in his one-page reply brief in arguing that "substantial evidence supports Cross-Appellant's assertion that it was not a joint appraisal."

Selvaggio misunderstands his task on appeal, and in doing so fails to support his cross-appeal with sufficient citations to, and discussion of, evidence in the record to merit consideration of the appeal. As with other factual findings, we review the trial court's ruling that the parties jointly hired Sommer under the substantial evidence standard. (*Jessup Farms v. Baldwin* (1983) 33 Cal.3d 639, 660 (*Jessup Farms*).) Under that standard, the power of this court " 'begins and ends with a determination as to whether there is any substantial evidence, contradicted or uncontradicted,' to support the findings below." (*Ibid.,* quoting *Crawford v. Southern Pacific Co.* (1935) 3 Cal.2d 427, 429.) We "view the evidence in the light most favorable to the *prevailing party*, giving [Dalgleish] the benefit of every reasonable inference and resolving all conflicts in [her] favor." (*Jessup Farms*, at p. 660, italics added.)

Selvaggio ignores this standard by citing only selected items of evidence that he claims support *his* interpretation of the facts. He does not acknowledge contrary evidence that supports Dalgleish's position and therefore never addresses the real issue on appeal, which is whether that evidence is sufficient to support the trial court's ruling in *Dalgleish's* favor. That failure results in the forfeiture of Selvaggio's cross-appeal. (*In re Marriage of Fink* (1979) 25 Cal.3d 877, 887 [" 'an appellant who contends that some particular finding is not supported is required to set forth in his brief a summary of the material evidence upon that issue. Unless this is done, the error assigned is deemed to be waived' "].)

Even if Selvaggio had not forfeited his argument, only a brief review of the trial court's findings is necessary to find abundant evidence supporting the court's ruling.

The trial court found an implied contract for the joint retention of Sommer based upon the record of the parties' communications. Selvaggio's counsel, Eliaser, first proposed hiring Sommer. Forman said that she wanted to speak with Sommer to discuss, among other things, cost and Sommer's neutrality, as Sommer had previously acted as Selvaggio's "unilateral appraiser." Forman did speak with Sommer. She testified that she subsequently notified Eliaser that she and Dalgleish "were in agreement that Mr. Sommer should perform the joint appraisal for the parties." Sommer testified that, after his conversation with Forman, he understood that both Forman and Eliaser were retaining him to prepare the Appraisal. The trial court found that both Forman and Sommer were "credible on this point."

The trial court noted that Sommer also testified that the reason he did not prepare an engagement letter was because "it slipped his mind and that he felt he did not need a joint retainer agreement because he knew both lawyers well and had worked with them over a course of time and that he started working because he received money to start the project." The evidence supports that finding. With respect to payment, the trial court found that "[t]here was discussion regarding how [Dalgleish] would reimburse [Selvaggio] for advancing the full amount of the payment up front." That finding is also supported by the evidence. Finally, the completed appraisal report stated that it was prepared for both parties, and the report was addressed and sent to both Forman and Eliaser.

This evidence, which Selvaggio does not address, is sufficient to support the trial court's ruling that the Appraisal was joint. We therefore reject Selvaggio's cross-appeal.

DISPOSITION

The trial court's orders filed May 29, 2015, and June 17, 2015, are reversed only insofar as they order interest on the $1,096,051.50 Equalization Payment to be calculated from March 11, 2015. The matter is remanded to the trial court with directions to enter an order awarding Dalgleish interest on the Equalization Payment calculated from August 5, 2013. In all other respects, the orders are affirmed. Dalgleish is entitled to her costs on appeal.

LUI, J.

We concur:

ROTHSCHILD, P. J.

CHANEY, J.

Filed 11/30/17

CERTIFIED FOR PUBLICATION

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

SECOND APPELLATE DISTRICT

DIVISION ONE

In re the Marriage of Stacy Dalgleish and Piero Selvaggio. STACY DALGLEISH, Plaintiff and Appellant, v. PIERO SELVAGGIO, Defendant and Appellant.	B266579 (Los Angeles County Super. Ct. No. BD430584) ORDER MODIFYING OPINION AND CERTIFICATION FOR PUBLICATION [NO CHANGE IN JUDGMENT]

It is ordered that the opinion filed herein on November 1, 2017, be modified as follows:

On page 1, the appearances for plaintiff and appellant are to read:

Law Office of Leslie Ellen Shear, Julia C. Shear Kushner and Leslie Ellen Shear for Plaintiff and Appellant.

There is no change in the judgment.

The opinion in the above-entitled matter filed on November 1, 2017, was not certified for publication in the Official

Reports. For good cause it now appears that the opinion should be published in the Official Reports, and it is so ordered.

ROTHSCHILD, P. J. CHANEY, J. LUI, J.

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

MILO H. SEGNER, JR, as Liquidating Trustee of the PR Liquidating Trust,	§	
Plaintiff,	§	
v.	§	**CIVIL ACTION NO. 3:12-CV-1318-B**
RUTHVEN OIL & GAS, LLC, ET AL.,	§	
Defendants.	§	

MEMORANDUM OPINION AND ORDER

In this bankruptcy dispute, trustee Milo Segner (Segner) seeks to recover about $21.7 million of fraudulently transferred money from Cianna Resources, Inc (Cianna). The only issue at trial was whether Cianna could avoid liability by showing that it received the money in exchange for value, in good faith, and without knowledge that the transfer was avoidable. A jury returned a verdict for Cianna. And Segner responded by moving for judgment as a matter of law and for a new trial. The Court **DENIES** both motions.

I.

BACKGROUND[1]

A. Factual History

Provident Royalties, LLC (Provident) engaged Ruthven Oil & Gas, LLC (Ruthven) to help it find and acquire mineral interests. Doc. 299-10, Pl. Mot. New Trial App., Ex. J. Ruthven approached Cianna to help it help Provident by acquiring mineral interests in certain Oklahoma

[1] This factual history is drawn from the evidence presented at trial and earlier stages of the case.

counties Provident specified. Trial Tr. Vol. I, 87–88. In a series of 197 transactions, Cianna acquired the mineral interests and transferred them to Ruthven, Doc. 299-7, Pl. Mot. New Trial App., Ex. G. Corresponding sums of money flowed from Provident to Ruthven to Cianna to the mineral owners. *Id.* Cianna received $500 per acre acquired in compensation. Trial Tr. Vol. I, 88. Overall, Provident transferred $48,812,882.24 to Ruthven, Doc. 100, Adopted Findings of Fact and Conclusions of Law, 2, and Ruthven sent $21,117,572.79 to Cianna. Bankr. Doc. 423-1, Am. Ruling, 25.

B. Procedural History

Provident filed for bankruptcy in June 2009, Bankr. Doc. 1, Compl., ¶ 24, and, in June 2011, Milo Segner filed this adversary proceeding in the bankruptcy court against Ruthven, Cianna, and others. *Id.* ¶ 1. The defendants moved in April 2012 to withdraw the reference from the bankruptcy court. Doc. 1, Mot. for Withdrawal of Reference. The case was reassigned to this Court in May 2013, Doc. 34, but the Court referred the case back to the bankruptcy court for pretrial matters to be resolved, Doc. 73, Order of Reference. After de novo review of a report and recommendation of the bankruptcy judge in September 2015, this Court determined that Provident's transfer of the $48,812,882.24 to Ruthven and subsequent transfers of that money by Ruthven, including the transfers to Cianna now at issue, are avoidable under 11 U.S.C. § 548(a)(1)(A). Doc. 100, Mem. Op. & Order, 2. And in November 2015, the Court dismissed Segner's claims against all of the defendants except for Cianna pursuant to a settlement agreement. Electronic Order Granting Doc. 105 Motion for Voluntary Dismissal of Claims.

After the settlement and a summary-judgment ruling establishing that Cianna was a transferee[2] as to the $21,117,572.79 it received from Provident via Ruthven, Doc. 242, Mem. Op. & Order, the only remaining issue was whether Cianna could establish the affirmative defense that required it to show that it received the money in exchange for value, in good faith, and without knowledge that the transfers were avoidable. *See* 11 U.S.C. § 550(b).[3] On that issue, a jury returned a verdict for Cianna. Doc. 296, Jury Verdict. Now, dissatisfied with the verdict and many of the Court's trial-related rulings, Segner has moved for judgment as a matter of law and a new trial. Doc. 297, Mot. J. as Matter of Law; Doc. 300, Mot. New Trial. The motions are ripe for review.

II.

LEGAL STANDARD

A. *Rule 50(b): Motion for Judgement as a Matter of Law*

A court should grant a motion for judgment as a matter of law under Federal Rule of Civil Procedure 50(b) only if "there is no legally sufficient evidentiary basis for a reasonable jury to find for that party on that issue." *Cano v. Bexar Co.*, 280 F. Appx. 404, 406 (5th Cir. 2008) (internal citations omitted). The Court "should consider all of the evidence—not just that evidence which supports the non-mover's case—but in the light and with all reasonable inferences most favorable to the party opposed to the motion." *Mosley v. Excel Corp.*, 109 F.3d 1006, 1008–09 (5th Cir. 1997). The court must not make credibility decisions or weigh the evidence in making its determination.

[2] A bankruptcy trustee can recover only from a transferee. 11 U.S.C. § 550(a).

[3] Section 550(b) states,

> The trustee may not recover under section (a)(2) of this section from
>
> > (1) a transferee that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided; or
> >
> > (2) any immediate or mediate good faith transferee of such transferee.

Reeves v. Sanderson Plumbing Prods., Inc., 530 U.S. 133, 150 (2000).

B. *Rule 59: Motion for New Trial*

A Court can "grant a new trial . . . after a jury trial, for any reason for which a new trial has heretofore been granted in an action at law in federal court." Fed. R. Civ. P. 59(a)(1)(A). In this Circuit, a district court can grant a new trial if "the verdict is against the great weight of the evidence . . . the trial was unfair, or prejudicial error was committed. *Smith v. Transworld Drilling Co.*, 773 F.2d 610, 613 (5th Cir. 1985). Courts are to decide whether to grant a new trial based on their assessment of the fairness of the trial and the reliability of the jury's verdict. *Seidman v. Am. Airlines, Inc.*, 923 F.2d 1134, 1140 (5th Cir. 1991). And the decision whether to grant a new trial is "within the sound discretion of the trial court." *Shows v. Jamison Bedding, Inc.*, 671 F.2d 927, 930 (5th Cir. 1982)).

III.

ANALYSIS

If a transfer is avoidable under the Bankruptcy Code, as the transfers to Cianna are, "the trustee may recover, for the benefit of the estate, the property transferred . . . from (1) the initial transferee of such transfer or . . . (2) any immediate or mediate transferee of such initial transferee." 11 U.S.C. § 550(a). But "[t]he trustee may not recover under section (a)(2) of this section from (1) a transferee that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided." § 550(b)(1). Cianna bore the burden at trial of establishing the elements of § 550(b)(1).

A. *Rule 50(b): Motion for Judgment as a Matter of Law*

Segner argues that the Court should award it judgment as a matter of law on Cianna's

§ 550(b) defense for five[4] reasons.

1. Oklahoma Documentary Stamp Act and Cianna's Good Faith

Segner argues that its evidence that Cianna violated the Oklahoma Documentary Stamp Tax Act (ODSTA) establishes as a matter of law that Cianna did not receive the money from Ruthven in good faith. Doc. 298, Pl. Mot. J. as Matter of Law Br., 1. But Segner's argument ignores that Cianna's good faith hinged on what it knew or should have known about Provident. *See In re Am. Hous. Found.*, 785 F.3d 143, 164 (5th Cir. 2015) (noting in fraudulent-transfer case that good-faith inquiry looks "to whether the [transferee] was on notice of the debtor's insolvency or the fraudulent nature of the transaction"). That Cianna overstated on ODSTA documents the value of the interests it transferred does not establish as a matter of law that Cianna knew or should have known that Provident was defrauding its investors. Of course, Segner characterized Cianna's stamp-tax misrepresentations as evidence that Cianna was part of, knew of, or should have known of Provident's scheme, but the jury disagreed. The Court will not disturb the jury's decision.

Segner now says the UCC's definition of good faith governs this case rather than the good-faith standard in the jury charge. Doc. 298, Pl. Mot. J. as Matter of Law Br., 2. But Segner waived this argument by not asking for the UCC definition to be included in the jury charge. *See* Doc. 228, Pl. Proposed Jury Instructions, 12.

Even if Segner did not waive this argument, the UCC's definition does not govern this case. Untethered from a transferee's knowledge of the bankrupt's relationship with its creditors, the UCC

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[4] Segner's fifth reason is that the jury's verdict was against the great weight of the evidence. The Court will address this argument in its discussion of Segner's motion for a new trial. Doc. 298, Pl. Mot. J. as Matter of Law Br., 16.

definition of good faith requires only honesty in fact and observance of reasonable commercial standards. Doc. 298, Pl. Mot. J. as Matter of Law Br., 2. The bankruptcy code does not include the UCC's definition, and Courts in this circuit have applied a definition of good faith tied to a transferee's knowledge or constructive knowledge of the bankrupt's financial situation, *Am. Hous.*, 785 F.3d at 164. The Court thus declines to apply the UCC's definition of good faith. Doc. 298, Pl. Mot. J. as Matter of Law Br., 2.

Segner's argument fails even under the UCC standard. Segner seems to propose a rule under which, if a party violates a law in the process of entering into a transaction, a court must find as a matter of law that the party did not enter into that transaction in good faith. Doc. 298, Pl. Mot. J. as Matter of Law Br., 4. Segner's rule is untenable. Surely a contracting party who violated the speed limit while driving to a contract closing would not transact bad faith by driving too fast.

Nor do the cases Segner cites support its conclusion that Cianna acted in bad faith. In *Rudiger Charolais Ranches v. Van de Graaf Ranches*, a rancher sold cattle to a merchant, who sold the cattle to a buyer. 994 F.2d 670, 671 (9th Cir. 1993). The buyer paid for and received the cattle but did not verify that the merchant owned the cattle. *Id.* After the merchant never paid the Rancher for the cattle, the rancher sought to recover from the buyer. *Id.* For the buyer to have held good title under Washington law, he had to have received the cattle in good faith. *Id.* at 672. And to have received the cattle in good faith, the buyer must have observed reasonable commercial standards when he purchased it. *Id.* The court found as a matter of law that the buyer did not observe reasonable commercial standards because he violated a Washington cattle-rustling-prevention statute by taking possession of the cattle without verifying that the merchant owned the cattle. *Id.* at 673. Segner says Cianna cannot have acted in good faith because, like the buyer, it violated the law—by lying on the

ODSTA. Doc. 298, Pl. Mot. J. as Matter of Law Br., 6.

This case is different from *Rudiger*. In *Rudiger*, the statute the rancher sought to enforce allowed buyers to keep stolen property if they observed reasonable commercial standards when they purchased the property. *Rudiger*, 994 F.2d at 672. Another statute required cattle buyers to take title papers with the purchased cattle to prevent cattle rustling. *Id.* Here, like in *Rudiger*, § 550(b) allows Cianna to keep what it received from Ruthven if it received the property in good faith. But unlike the cattle-rustling statute in *Rudiger*, the ODSTA is irrelevant to the question of whether a purchaser is receiving something to which another person might actually be entitled; it merely imposes a tax on transactions. This case would be like *Rudiger* had Cianna violated a statute requiring it to determine whether the funds it received might be claimed by anyone else, such as Provident's creditors. Because the ODSTA imposed no such obligation on Cianna, Segner's reliance on *Rudiger* is misguided.

So is Segner's reliance on *Philadelphia Gear Corp. v. Central Bank*, 717 F.2d 230 (5th Cir. 2001). There, a bank issued a letter of credit to a company. *Id.* at 232. To use the credit, the company had to submit drafts to the bank, and the drafts had to conform to the letter of credit's requirements. *Id.* The company submitted a number of drafts to the bank that did not follow the letter's requirements, and the company knew the drafts did not comply with the letter. *Id.* at 233. When the bank refused to honor the drafts, the company sued. *Id.* State law incorporated a duty of good faith into every contract and provided that, by presenting a draft, a beneficiary of a letter of credit warranted that the draft complied with the letter of credit. *Id.* at 238. The Fifth Circuit held that the company breached both duties by knowingly submitting nonconforming drafts and therefore could not recover. *Id.* Segner contends that Cianna should lose in this case because, like the company knowingly submitted nonconforming drafts to the bank, Cianna knowingly misrepresented the value of mineral interests on ODSTA documents. Doc. 298, Pl. Mot. J. as Matter of Law Br., 4–5.

Segner is incorrect. In *Philadelphia Gear Corp.*, the company acted in bad faith by breaching duties to the bank with which it contracted. *Phila. Gear. Corp.*, 717 F.2d at 238. But here, Segner does not complain that Cianna deceived Ruthven or breached any duty it owed Ruthven by lying on the ODSTA. Because Segner does not argue that Cianna breached a duty to Ruthven by violating the ODSTA, *Philadelphia Gear Corp.* does not compel the conclusion that Cianna acted in bad faith as a matter of law. The Court thus rejects Segner's ODSTA argument.

2. Unconscionability, Good Faith, and Value

Segner asks the Court to rule that the contracts in which Cianna transferred the mineral interests to Ruthven in exchange for the $21 million were unconscionable. Doc. 298, Pl. Mot. J. as Matter of Law Br., 6. And once the Court finds the contracts were unconscionable, Segner contends, the Court must find that Cianna did not receive the money in good faith or for value as a matter of law. *Id.* at 7. Segner correctly contends that unconscionability is an issue of law the Court must decide. *Hoover Slovacek LLP v. Walton*, 206 S.W.3d 557, 562 (Tex. 2006). But although courts have held that value under § 550(b) must be sufficient to support a contract,[5] Segner has cited no cases indicating that a federal court can take a § 550(b) affirmative defense away from a jury by finding that the transfer at issue involved an unconscionable contract.

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[5]*See* 5 Alan N. Resnick & Henry J. Sommer, Collier on Bankruptcy ¶ 550.03[1] at 550 (16th ed.) ("The 'value' required to be paid by a secondary transferee is merely consideration sufficient to support a simple contract . . . There is no requirement that the value given by the transferee be a reasonable or fair equivalent.").

This Court will not be the first. Importing the unconscionability doctrine would frustrate the purpose of § 550. Sections 550(a) and 550(b) strike a balance between protecting the creditors of bankrupt entities and entities who have received money from bankrupt entities in bona fide business transactions not designed to defraud creditors. Section 550(a) authorizes trustees to recover avoidable transfers, but § 550(b) prevents trustees from recovering avoidable transfers from subsequent transferees "that take[] for value, . . ., in good faith, and without knowledge of the voidability of the transfer. § 550(b)(1). An unconscionability finding could defeat a § 550(b) affirmative defense absent any reason to suspect fraud on creditors—thereby subverting § 550(b)'s protections for legitimate business transactions.

For example, before declaring bankruptcy, a debtor engages in an avoidable transaction with an immediate transferee. The entity pays the immediate transferee $1 million. Then, the immediate transferee, an expert artifact-collector, transfers the $1 million to an unsophisticated elderly couple in exchange for a rare artifact worth $10 billion. The elderly couple has no idea what the artifact is. The bankruptcy trustee cannot recover from the collector—who absconded with the artifact and left nothing behind. So the trustee goes after the elderly couple for the $1 million. If the Court were to find the contract unconscionable, the already-fleeced elderly couple would have to return the $1 million to the creditors of the bankrupt even though nothing indicates that they were in on, knew of, or should have known of any fraud on creditors. That would be absurd. On the other hand, if a trustee sued the elderly couple, there were a trial on the couple's § 550(b) defense, and the court instructed the jury as the Court instructed the jury in this case, the jury would likely find for the couple, as the couple gave some value in return for the artifact and was unaware of any fraud on creditors. The Court declines to subvert the bankruptcy code's protections for good-faith transferees by independently determining that the contracts between Ruthven and Cianna were unconscionable.

3. Measure of Value

Segner contends it deserves judgment as a matter of law because Cianna had to present evidence regarding the value of the mineral interests it transferred to Ruthven but did not. Doc. 298, Pl. Mot. J. as Matter of Law Br., 12.

The Court disagrees. Cianna needed to show only value sufficient to support a contract. Doc. 295, Jury Charge, 9; *supra* note 6. The jury heard evidence that Ruthven engaged Cianna to acquire mineral interests in certain areas in Oklahoma. Trial Tr. Vol. I, 87–88. The jury heard evidence also that Cianna found, acquired, and transferred to Ruthven the mineral interests, Doc. 299-7, Pl. Mot. New Trial App., Ex. G, and warranted title to those interests, Trial Tr. Vol. II, 161. Based on that evidence, the jury could have reasonably found that Cianna met the value requirement by doing what Ruthven asked.

Segner's argument that the Court's "mere-conduit" ruling required Cianna to meet § 550(b)'s value element by proving the value of the mineral interests it transferred to Cianna is incorrect. Doc. 298, Pl. Mot. J. as Matter of Law Br., 12. The ruling to which Seger refers is the summary-judgment order[6] in which the Court ruled that Cianna failed to create an issue of material fact as to whether it was a transferee under § 550(a) and therefore that Cianna was a transferee as to the $21 million as a matter of law. Doc. 242, Mem. Op. & Order, 17–18. Segner takes the Court's order to establish also, as a matter of fact, that Cianna could not have provided anything of value in its dealings with Ruthven other than mineral interests. Doc. 298, Pl. Mot. J. as Matter of Law Br., 13. But Segner is

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[6] The order was actually on Cianna's motion to reconsider the Court's original summary-judgment ruling.

wrong; the Court made no factual findings in the order. Although the Court found that Cianna failed to present evidence that it was not a transferee, the Court's ruling in no way required Cianna to present evidence of the value of the mineral interests it transferred to Ruthven to meet § 550(b)'s value element.

4. Transfer-By-Transfer

Segner argues that it is entitled to judgment as a matter of law because Cianna failed to establish the elements of § 550(b) for each of the 197 transfers. Doc. 298, Pl. Mot. J. as Matter of Law Br., 16. But the evidence permitted the jury to find that Cianna met § 550(b)'s elements for each of the transactions. *See infra* Section III.B.4.

B. Rule 59(a): Motion for New Trial

Segner argues that the Court should order a new trial for four reasons. Doc. 301-1, Pl. Mot. New Trial Br.

1. Prejudice Resulting from Discussion of Attorney Fees

Segner complains that Cianna's discussion of attorney fees during Segner's testimony and closing argument irreversibly prejudiced the jury against Segner. Doc. 301-1, Pl. Mot. New Trial Br., 2. Before trial, the Court granted Segner's fourth motion in limine, Doc. 268, Order on Pl. Mots. in Limine, which sought to prevent Cianna from discussing "professional fees incurred in prosecuting litigation on behalf of the PR Liquidating Trust," Doc. 222, Pl. Mots. in Limine, 3. During Cianna's cross examination of Segner, Cianna asked Segner how much the trust had paid in attorney fees. Trial Tr. Vol. III, 272. Segner responded $30 million. *Id.* Early the next morning, the Court instructed the jury to disregard the discussion of attorney's fees from the previous day. Trial Tr. Vol. IV, 38–40. Before closing arguments, the Court instructed the jury that closing statements are not evidence. Trial Tr. Vol. VI, 44. And during closing arguments, Cianna's attorney said,

> Now, you know, these guys are—they are great lawyers, dream team. They are really good lawyers. But we're talking about somebody's life here. $21 million is—is not something that you can just go cut a check for. You're talking about ruining lives for the sake of putting money in their pockets.
>
> Now, you have to follow the Court's instructions. I recognize that. And I'm not suggesting that you don't. But what I am telling you here is if you check no to all three questions and you don't check yes to all three questions, that's what's going to happen.

Id. at 122.

Neither instance of Cianna mentioning attorney fees warrants a new trial. Both the quality of the challenged statements and two other events at trial minimized any prejudice Segner suffered. First, the Court instructed the jury to disregard Segner's testimony that the PR Liquidating Trust spent $30 million in attorney fees, Trial Tr. Vol. IV, 38–40, and the Court instructed the jury that the lawyers' closing arguments were not evidence, Trial Tr. Vol. VI, 44. Because the Court must presume the jury followed its instructions, *see Weeks v. Angelone*, 528 U.S. 225, 234 (2000), the Court's limiting instructions cut against Segner's argument. Second, during cross, Segner testified that his firm charged the trust roughly $4.5 million in fees and that he personally received from the trust a contingency fee of 1.5% on recoveries. Trial Tr. Vol. III, 74–75. Segner's attorneys did not object to this testimony and did not challenge it in its motion for a new trial. Because Segner's testimony about his and his firm's fee arrangements with the trust demonstrated to the jury Segner's stake in the outcome of this case, Segner's testimony about the $30 million in attorney fees likely did not significantly and unfairly prejudice the jury against Segner given what the jury already knew about his fees. The Court thus finds that Segner was not prejudiced enough to deserve a trial.

The cases Segner cites do not counsel otherwise. In both *Hollybrook Cottonseed Processing,* *L.L.C. v. American Guaranty & Liability Insurance Co.*, and *Dun & Bradstreet, Inc. v. Miller*, the Fifth Circuit affirmed orders granting new trials because no evidence supported the juries' verdicts; only prejudice could explain the juries' decisions. 772 F.3d 1031, 1034 (5th Cir. 2014); 398 F.2d 218, 226 (5th Cir. 1968). This case is difference because ample evidence supports the jury's verdict. *See infra* Section III.B.4.

Nor is *Pollock & Riley, Inc. v. Pearl Brewing Co.*, 498 F.2d 1240 (5th Cir. 1974), apposite. *Pollock & Riley* was not a new-trial case but a pair of interlocutory appeals in which the Fifth Circuit decided that trial courts should not instruct juries about the treble-damages provisions of the federal antitrust laws because instructing the juries about the provisions might cause juries to award less damages even though the purpose of the treble-damages provisions was to deter antitrust violations. *Id.* at 1242–43. The case says nothing about the prejudice required for a trial court to grant a new trial. Segner contends that just as instructing juries about the treble-damages provisions would have undesirable effects on juries, Cianna's discussion of attorney fees was so prejudicial that the Court must grant a new trial. Doc. 301-1, Pl. Mot. New Trial, 6. But even if Cianna's mention the attorney fees was prejudicial, it was not prejudicial enough to warrant a new trial, especially in light of the Court's limiting instructions.

Edwards v. Sears, Roebuck & Co., 512 F.2d 276 (5th Cir. 1975), is also inapposite. *Edwards* was a wrongful-death case in which the Fifth Circuit said a trial court should have granted a new trial based on statements plaintiff's counsel made during closing argument. *Id.* at 279. Material facts not in evidence and inflammatory emotional appeals pervaded the plaintiff's counsel's closing. *Id.* at 284. Counsel discussed the value his son would place on his life, played on his friendship with the deceased, who he met in seminary, "evoked the image of the deceased's children crying at graveside and forlornly awaiting the return of their father," and urged the jury of a need for retributive payments. *Id.* at 285. This case is different from *Edwards* for two reasons. First, Segner does not complain that Cianna's counsel introduced facts not in evidence; Segner complains only about that counsel's remarks inflamed and prejudiced the jury against Segner. Second, Cianna's counsel's comments were not as inflammatory as the comments in *Edwards*. Mentioning that Segner and his attorneys stood to gain from a plaintiff's verdict was not nearly as inflammatory as invoking father–son bonds and children crying at a deceased's graveside in a wrongful-death case. The Court thus declines to order a new trial based on Cianna's fee-related comments.

2. Transfer-By-Transfer

Segner argues that the Court should have required the jury to answer whether Cianna met the § 550(b) elements separately for each of the 197 interests that Cianna transferred to Ruthven. Doc. 301-1, Pl. Mot. New Trial, 8. Erroneous jury instructions warrant a new trial only if they leave the Court with substantial and ineradicable doubt as to whether the jury has been properly guided in its deliberations. *Ganz v. Lyons P'ship, L.P.*, 961 F. Supp. 981, 996 (N.D. Tex. 1997).

The Court disagrees with Segner. Section 550(b) provides elements a transferee must meet for each avoided transfer. 11 U.S.C. § 550(b)(1). Thus in a case like this one involving multiple avoided transactions, a defendant must meet § 550(b)'s elements for each transaction to avoid liability. But even though a defendant must meet each element for each transaction, the same facts could establish § 550(b)'s elements for multiple transactions. Thus, § 550(b) does not generally require transaction-by-transaction jury questionnaires.

Nor do Segner's cases. Relying on *In Re SGSM Acquisition Co.*, 439 F.3d 233, 241 (5th Cir. 2006), Segner says the Fifth Circuit requires trial courts in § 550(b) cases to submit separate questions to juries for each transaction at issue, Doc. 301-1, Pl. Mot. New Trial, 10. Segner is wrong. *In Re SGSM* applied § 547(c)(4), not § 550(b). Under § 547(c)(4),

> a trustee may not avoid a transfer to or for the benefit of a creditor, to the extent that, after such transfer such creditor gave new value to or for the benefit of the debtor-(A) not secured by an otherwise unavoidable security interest; and (B) on the account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor.

11 U.S.C. § 547(c)(4). In a prior case, the Fifth Circuit rejected the "net result rule, under which 'all new value from subsequent advances was totaled and deducted from all eligible preference payments,'" in favor of a "trasfer-by-transfer approach that asks whether '(1) new value was extended after the preferential payment sought to be avoided, (2) the new value is not secured with an otherwise unavoidable security interest, and (3) the new value has not been repaid with an otherwise unavoidable transfer.'" *SGSM Acquisition Co.*, 439 F.3d at 241 (quoting *Laker v. Vallette (In Re Toyota of Jefferson, Inc.)*, 14 F.3d 1088, 1093 n.2 (5th Cir. 1999)). The case says nothing about § 550(b) much less about how jury charges must be worded.

Segner relies also on *In Re Provident Royalties, LLC*, 581 B.R. 185 (Bankr. N.D. Tex. 2017), an earlier opinion in this case. Doc. 301-1, Pl. Mot. New Trial, 10. In the opinion, the bankruptcy judge applied the single-satisfaction rule, which prevents a trustee from recovering more than a debtor transferred. *Provident Royalties*, 581 B.R. at 188–89. The bankruptcy judge determined that it had to look at each transaction that resulted in money flowing from Provident to Ruthven to Cianna to apply the single-satisfaction rule. *Id.* at 195. The opinion had nothing to do with the § 550(b) affirmative defense and does not indicate that the jury had to answer separate questions for each of the Ruthven–Cianna transfers.

Nor does *In Re Ramirez*, No. 09-7004, 2011 WL 30973 (S.D. Tex. Jan. 5, 2011), help Segner.

There the court had to determine whether three transactions were fraudulent, and therefore avoidable, under Texas law. *Id.* at *3–4. The case involved neither federal law nor a jury trial. *Id.* And all the court said was that it had to determine whether each of the transactions was fraudulent. *Id.* at 4. The Court said nothing about how courts must instruct juries in § 550(b) cases, or about whether separate proof was required for each transaction.

Nothing about the facts of this case require a transfer-by-transfer jury questionnaire either. Segner responds that the transactions were different from one another because the amount of red flags indicating fraud increased over time such that Cianna was less likely to meet § 550(b)'s requirements for later transactions than earlier ones. Doc. 301-1, Pl. Mot. New Trial, 11. But although the alleged red flags arose over time, Segner never argued that the court or jury should view later transactions differently than earlier ones. The jury moreover could have reasonably believed that evidence pertaining to all of the transactions showed that Cianna met § 550(b)'s elements for each transaction. After all, Kyle Shutt testified that he had no dealings with Provident, no knowledge of Provident or Ruthven engaging in conduct indicating fraud on Provident's creditors, and that the transactions at issue were consistent with Cianna's normal business practices. Trial Tr. Vol. II, 43, 59, 170. And that testimony applies to all of the transactions.

Segner argues also that the Court's failure to submit the case to the jury transfer by transfer prevented the jury from applying the evidence to § 550(b)'s value element because one aspect of Cianna's value defense was that it gave value in the form of signing non-compete and non-disclosure agreements. Doc. 301-1, Pl. Mot. New Trial, 13. According to Segner, because Cianna signed the agreements after it had completed many of the transactions at issue, any value given in the form of the agreements could have applied only to transactions that occurred after Cianna signed the agreements. *Id.* But signing the agreements was only one potential source of value. The jury heard evidence of value applicable to all of the transactions: Cianna found and acquired the mineral interests and warranted title in the transactions. Doc. 299-7, Pl. Mot. New Trial App., Ex. G; Trial Tr. Vol. II, 161. Because the jury could have reasonably relied on the sources of value applicable to all of the transactions, the Court declines to issue a new trial based on jury-instruction error.

3. Effect of Prior Findings

Segner challenges the Court's treatment of prior findings in two ways and attacks five of the Court's rulings in limine. Doc. 301-1, Pl. Mot. New Trial, 14.

a. The Court's Summary-Judgment Ruling that Cianna is a Transferee

Segner argues that the Court erred by permitting Cianna to introduce evidence contradicting the Court's summary-judgment ruling that Cianna was a transferee as to the funds it received from Ruthven. *Id.* Segner complains specifically that Cianna's evidence and argument regarding how it spent the money it received from Ruthven was a "disguised conduit argument." *Id.* at 15.

Segner is incorrect. Cianna's evidence and argument that it did not keep all of the funds it received from Ruthven did not contradict the Court's ruling because Cianna introduced evidence of how it spent the money it received to show it acted in good faith, not to argue that it is not liable for amounts it spent. Doc. 317, Def. Mot. New Trial. Resp. Br., 22.

b. Prior Findings Regarding the Provident Scheme

Segner argues that the Court should have allowed him to share certain "summary-judgment findings" regarding Provident insiders' criminal convictions and prior dealings as well as actions the Securities and Exchange Commission took in response to the Provident scheme. Doc. 301-1, Pl. Mot. New Trial, 16. But the Court allowed Seger to present to the jury much of what it wanted. The

Court allowed Segner to elicit from Dennis Roossien testimony about the double-flip pattern Joe Blimline used in the Provident scheme and past fraudulent schemes, Joe Blimline's criminal conviction and admission of fraud, and findings regarding Provident's fraudulent nature, and admitted evidence of kickbacks and inflated prices. Trial Tr. Vol. III, 206, 215; Vol. IV, 29; Vol. V, 17–21. Segner can really only complain that the Court should have let the evidence in earlier. But because the Court ultimately allowed much of the evidence and argument based on it, the Court's initial decision to exclude the evidence was not prejudicial enough to warrant a new trial.

c. Orders in Limine

Segner argues that the Court's rulings on five of Cianna's motions in limine gave Cianna an unfair advantage that only a new trial can cure. June 25, 2018. Doc. 301-1, Pl. Mot. New Trial, 21. The Court will address each of the five challenged rulings.

Segner first claims that the Court should not have prohibited Segner from presenting evidence that the same counsel that represented Ruthven and the Provident criminal defendants represented Cianna earlier in these proceedings. *Id.* at 21. The Court's ruling was unfair, according to Segner, because Cianna presented evidence that Segner had relentlessly pursued Cianna for seven years, but, because of the Court's ruling, Segner could not present evidence that this case has taken so long in part because of Cianna's decision to be represented an attorney who also represented Ruthven and the Provident criminal defendants. *Id.* But Segner waived its objection to this ruling by failing to offer the excluded evidence at trial. Regardless, Segner's argument lacks merit. Why these proceedings have lasted for so long was hardly relevant to the issues before the jury, so keeping out evidence of Cianna's prior counsel did not prejudice Segner enough for the Court to order a new trial.

Second, Segner challenges the Court's decision to exclude evidence of how Kyle Shutt spent the money Cianna received from Ruthven. *Id.* Segner wanted to present evidence that, at the relevant time, Shutt purchased a Jaguar and two "modern art 'snake' lamps" for about $233,000. *Id.* Segner contends that it was unfair to prevent him from introducing evidence of Shutt's purchases because Cianna was allowed to elicit testimony from Shutt that he tithed to his church and spent the money he received from Ruthven in other run-of-the-mill ways. *Id.* Again, Segner did not attempt to admit this evidence at trial. And even if Segner's evidence of what Shutt purchased was relevant and probative, it was not important enough for its exclusion warrants a new trial.

Third, Segner complains that the Court should have allowed his attorneys to present evidence and argue that violating the ODSTA is a serious crime and that Shutt exposed himself to over 100 years in prison by violating it. *Id.* But Segner discussed the act at length in front of the jury. Not much would have been gained by telling the jury the extent of the penalty Shutt would have faced for violating the act. Although whether Cianna violated the act is probative of good faith, the extent of the penalty for violating the act is not. So the Court finds that its ruling on Cianna's sixth motion in limine was not prejudicial enough to warrant a new trial.

Fourth, Segner claims that the Court's ruling on Cianna's fifth motion in limine unfairly prejudice him by preventing him introducing Dennis Roossien's testimony about the Provident scheme and criminal conviction until the end of the trial. *Id.* at 22. The Court has already addressed this argument.

Segner's fifth argument concerns the Court's ruling on Cianna's seventh motion in limine, which excluded an email from Wendall Holland of Ruthven to Joe Blimline that discussed kickbacks and the artificially high prices at which Ruthven was selling mineral interests to Provident. *Id.* But, like Roossien's testimony, the Court allowed Segner to present the email to the jury. Thus, the Court's initial decision to exclude the email was not prejudicial enough for Segner to deserve a new trial.

4. Verdict Against Great Weight of Evidence

Segner says the Court must grant a new trial because the jury's verdict was against the great weight of the evidence. *Id.* at 23. A court can grant a new trial if "the jury verdict was against the great weight of the evidence." *Scott v. Monsanto Co.*, 868 F.2d 786, 789 (5th Cir. 1989). "Mere conflicting evidence or evidence that would support a different conclusion by the jury cannot serve as the grounds for granting a new trial." *Islander E. Rental Program v. Barfield*, 145 F.3d 359 (5th Cir. 1998) (per curiam).

The jury's verdict was not against the great weight of the evidence. As to § 550(b)'s value requirement, Cianna presented evidence that it found, acquired, and transferred to Ruthven the mineral interests Ruthven wanted and warranted title to those interests. Trial Tr. Vol. II, 43, 161. Segner is incorrect that Cianna's failure to present evidence of the value of the mineral interests and its own evidence of the interests' lack of value requires the court to discount Cianna's evidence. And Segner's evidence that Cianna received more than it gave Ruthven at best conflicts with Cianna's evidence. Conflict, though, is not enough for the Court to grant a new trial.

As to the good faith and knowledge requirements, Cianna's principal, Shutt, testified that Cianna had a longstanding business relationship with Ruthven, Trial Tr. Vol. I, 79, 84–90, he had no contact with and knew nothing about Provident, Trial Tr. Vol. II, 43, 170, the Ruthven transactions were similar to Cianna's transactions with other clients, Trial Tr. Vol. I, 75–77, and that he was never actually aware that Provident or Ruthven had engaged in fraudulent or otherwise unlawful conduct. Trial Tr. Vol. II, 170. Although Segner presented evidence it believed contradicted Cianna's evidence, Cianna's evidence is more than sufficient to support the jury's verdict. The jury could have reasonably believed based on the evidence before it that Cianna transacted with Ruthven as a matter of normal business. Even if the jury could have found for Segner based on the same evidence, the Court finds the verdict was not against the great weight of the evidence.

IV.

CONCLUSION

The Court **DENIES** Segner's motion for judgment as a matter of law and his motion for a new trial.

SO ORDERED.

SIGNED: June 28, 2018.

JANE J. BOYLE
UNITED STATES DISTRICT JUDGE

Filed 1/10/18; Certified for Publication 1/22/18 (order attached)

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

FOURTH APPELLATE DISTRICT

DIVISION THREE

LAND PARTNERS, LLC et al.,	
Plaintiffs and Appellants,	G053664
v.	(Super. Ct. No. 30-2013-00680074)
COUNTY OF ORANGE,	O P I N I O N
Defendant and Respondent.	

Appeal from a postjudgment order of the Superior Court of Orange County, Peter J. Wilson, Judge. Affirmed.

Enterprise Counsel Group, David A. Robinson, James S. Azadian and Cory L. Webster for Plaintiffs and Appellants.

Leon J. Page, County Counsel and Laurie A. Shade, Deputy County Counsel for Defendant and Respondent.

In this taxpayer refund action, Land Partners, LLC, and Los Alisos Ranch Company (collectively, Land Partners) appeal from a postjudgment order denying their motion for attorney fees brought pursuant to Revenue and Taxation Code section 5152.[1] Although the court had found the County of Orange Assessor (Assessor) used a constitutionally invalid methodology in valuing Land Partners' property for property tax purposes, the court determined there was no evidence the Assessor's actions were due to his subjective belief that a certain constitutional provision, statute, rule or regulation was invalid or unconstitutional. Because the court concluded proof of the latter was a statutory prerequisite to recovery of fees under the statute, it held Land Partners was not entitled to attorney fees.

Land Partners contend the court erred in interpreting section 5152. It asserts proof of the Assessor's subjective mindset is not required. Instead, it claims showing a violation of well-established and unambiguous law is sufficient for recovery of attorney fees. We disagree and affirm the order.

FACTS

Land Partners owns an approximately 68-acre parcel of land, improved with a mobile home park, in the City of Westminster. Following a change in ownership of the property, the Assessor reassessed it for property tax purposes. The Assessor's appraisal valued the property at $60,010,000, and Land Partners was sent a property tax bill based on that valuation.

Believing the Assessor erred in valuing the property, Land Partners appealed to the County of Orange Assessment Appeals Board. Following the receipt of

[1] All further statutory references are to the Revenue and Taxation Code unless otherwise stated.

oral and documentary evidence, the appeals board sustained the Assessor's valuation. This lawsuit ensued.

Land Partners' complaint for a property tax refund alleged the Assessor had overvalued the property by at least $22 million. It claimed the erroneous valuation was caused by the Assessor's incorrect application of the appropriate valuation method, the income method, which is described in rule 8 of the State Board of Equalization Property Tax Rules (Cal. Code Regs., tit. 18, § 8) (Rule 8). Among the relief sought was a refund of excess taxes collected by the County of Orange based on the alleged erroneous assessment and attorney fees.

Based on pretrial filings, it became clear to the court the parties agreed the income method was the proper appraisal method to use in valuing the property and the fair market value was the proper value standard. They disagreed, however, about the meaning of "fair market value" in the assessment context, including the types of data to be used in calculating the value.

Following a limited trial, during which the court received expert testimony from both parties concerning the proper application of the income method, the court concluded, "in material respects[,] the Assessor's valuation of the properties in question was arbitrary, in excess of discretion, and/or in violation of the standards prescribed by law." Specifically, it found the Assessor failed to recognize and apply directions from Rule 8 and section 502 of the State Board of Equalization's Assessors' handbook, meaning the "assessment was not in fact based on the economic reality of how the subject property would be bought and sold." The court explained this did not meet the constitutional mandate of "'achiev[ing] a reasonable estimate of the true value' of the property."

Among the particular errors the court identified were: (1) there was no evidence demonstrating the Assessor had considered any market data in calculating market rent for the mobile home spaces; (2) the Assessor did not use sufficient diligence to determine operating expenses based on market data; (3) there was a complete lack of evidentiary support for the Assessor's conclusion a 95 percent occupancy rate could be achieved within two years; (4) the Assessor erroneously refused to factor all known and reported damage at the property into his calculation of repair costs; and (5) the calculated repair costs lacked evidentiary support. It entered judgment accordingly and remanded the matter to the County of Orange Assessment Appeals Board so the board could hold further proceedings and receive evidence concerning the identified deficiencies.

No party appealed the court's decision on the merits.

Thereafter, Land Partners sought to recover attorney fees pursuant to section 5152. The court denied the motion. In doing so, it interpreted the statute as requiring a showing that the Assessor failed to apply a particular law, rule or regulation because the Assessor subjectively believed it was unconstitutional or invalid. The court declined to make such a finding. Land Partners timely appealed after entry of the order denying its motion for attorney fees.

DISCUSSION

"A request for an award of attorney fees is entrusted to the trial court's discretion and will not be overturned in the absence of a manifest abuse of discretion, a prejudicial error of law, or necessary findings not supported by substantial evidence." (*Yield Dynamics, Inc. v. TEA Systems Corp.* (2007) 154 Cal.App.4th 547, 577; see *Serrano v. Stefan Merli Plastering Co., Inc*. (2011) 52 Cal.4th 1018, 1025–1026.) Because the primary issue before us concerns legal entitlement to fees based upon statutory interpretation, our review is de novo. (*Goodman v. Lozano* (2010) 47 Cal.4th 1327, 1332.) The court's factual findings, however, are subject to the substantial evidence standard of review. (*Pellegrino v. Robert Half Internat., Inc*. (2010) 182 Cal.App.4th 278, 287-288.)

Though articulated in various ways, Land Partners' challenge concerns the type of evidence needed to establish entitlement to attorney fees under section 5152. As we explain, the interpretation of the statute urged by Land Partners is not supported by the unambiguous language of the statute or case law. (*Kirby v. Immoos Fire Protection, Inc.* (2012) 53 Cal.4th 1244, 1250 [in interpreting statute, "[i]f the statutory language is clear and unambiguous our inquiry ends"].)

Section 5152 provides, in relevant part: "In an action in which the recovery of taxes is allowed by the court, if the court finds that the void assessment or void portion of the assessment was made in violation of a specific provision of the Constitution of the State of California, of this division, or of a rule or regulation of the [State Board of Equalization], and the assessor should have followed the procedures set forth in Section 538 in lieu of making the assessment, the plaintiff shall be entitled to reasonable attorney's fees as costs in addition to the other allowable costs."

The section 538 procedures referenced in section 5152 concern the steps an assessor must follow when (a) the assessor believes a property should be assessed in a manner contrary to a specific state constitutional provision, statute, or rule or regulation, because of the assessor's belief the latter is unconstitutional or invalid; or (b) the assessor "proposes to adopt a general interpretation" of a specific state constitutional provision, statute, or rule or regulation, that would result in the denial of a property tax exemption to five or more persons. (§ 538, subd. (a).) Under either of these circumstances, the assessor may not make the assessment and must instead bring an action for declaratory relief against the State Board of Equalization. (*Ibid*.) Following entry of judgment in such an action, the assessor must levy assessments consistent therewith. (*Id*., subd. (b).)

Based on the clear language of these statutes, there are three prerequisites to obtaining attorney fees under section 5152 in a taxpayer refund action. First, the court must have allowed recovery of taxes. (§ 5152.) Second, the court must have found the void assessment, or portion thereof, was made in violation of a specific provision of the state constitution, the property tax statutes, or a State Board of Equalization rule or regulation. (*Ibid*.) Third, the court must find the assessor subjectively believed a specific provision of the state constitution, the property tax statutes, or a State Board of Equalization rule or regulation was unconstitutional or invalid, and assessed property contrary thereto, but the assessor failed to bring the requisite declaratory relief action. (See *Mission Housing Development Co. v. City and County of San Francisco* (1997) 59 Cal.App.4th 55, 88 ["By its own terms, section 5152 only applies where the assessor should have utilized the procedures set forth under section 538."].)

As for the last of these three elements, the subjective belief of the assessor may be demonstrated through statements made by the assessor or objective facts which evidence the assessor's subjective state of mind. In addition, care must be taken to distinguish between a situation in which an assessor believes a provision to be unconstitutional or invalid, and a situation in which an assessor misinterprets or misapplies a provision. The former would implicate section 5152, whereas the latter would not.

The decisions in *Prudential Ins. Co. v. City and County of San Francisco* (1987) 191 Cal.App.3d 1142 (*Prudential*) and *Phillips Petroleum Co. v. County of Lake* (1993) 15 Cal.App.4th 180 (*Phillips Petroleum*), are illustrative.

In *Prudential*, the plaintiff purchased a hotel property and, as part of the transaction, assumed a loan owed by the seller to Bank of America at a below market rate. (*Prudential*, *supra*, 191 Cal.App.3d at p. 1146.) The assessor placed a value on the hotel based on an inflated purchase price. (*Ibid*.) In doing so, it erroneously disregarded a State Board of Equalization rule which required the loan to be discounted to its cash equivalent. (*Id*. at pp. 1148-1149.) On appeal, the court upheld an award of attorney fees under section 5251. (*Prudential*, at p. 1156.) In doing so, the court looked to the assessor's testimony to determine his state of mind. (*Id.* at p. 1159.) Because the assessor had testified he disagreed with the board's rule (i.e., he believed it was invalid), the court concluded section 538's procedures should have been followed. (*Prudential*, at pp. 1159-1160.) With the assessor having failed to follow those procedures, the court found an attorney fee award under section 5152 was proper. (*Prudential*, at pp. 1160-1161.)

The same analysis was applied, but a different conclusion reached, in *Phillips Petroleum*. There, the court upheld the denial of attorney fees under section 5152 because "[t]here [was] no indication in the record that the assessor believed [the rule at issue] was unconstitutional or invalid." (*Phillips Petroleum*, *supra*, 15 Cal.App.4th at p. 198.) It rejected the notion that section 5152 attorney fees are implicated any time an assessor fails to apply a statue or regulation because he or she believes it inapplicable when it is, in fact, applicable. (*Phillips Petroleum*, at p. 198.) In addition, it emphasized the importance of a "factual finding by the court, as a prerequisite to an attorney fee award" (*id*. at p. 197), that the assessor made a "cognitive decision . . . a particular provision, rule or regulation [was] unconstitutional or invalid[,] either on its face or as applied to the circumstances in the case." (*Id*. at pp. 197-198.) Because the record showed the assessor had failed to apply a required rule due to "a misunderstanding of the law," and not due to a belief in its invalidity, the court concluded fees were not available under section 5152. (*Phillips Petroleum*, at p. 198.)

Here, the court expressly declined to find the Assessor's failure to follow the law was the result of his belief it was invalid or unconstitutional. Instead, it concluded the Assessor "just applied [the law] wrongly." As in *Phillips Petroleum*, this is not enough to trigger an award of attorney fees under section 5152.

Land Partners claims the Assessor testified he believed it was improper to apply a certain rule to the valuation of the property at issue. But the "rule" asserted by Land Partners is not the specific type of rule contemplated by section 538, subdivision (a). Here is the cited testimony from the pretrial deposition of George Singletary, the supervisor of the individual who prepared the appraisal for the County of Orange.

"Question: Is it your understanding that the result in applying the income method must always reflect the economic reality of how a particular type of property is actually bought and sold?

"Answer: No.

"Question: You do not agree that the result must reflect that economic reality; is that correct?

"Answer: No, I don't agree with that."

This deposition testimony was read after Mr. Singletary testified "I don't understand your term 'economic reality.'"

The testimony cited by Land Partners has little or nothing to do with a cognitive decision that a specific state constitutional provision, statute, or rule or regulation was unconstitutional or invalid. (§ 538, subd. (a).) Instead, the testimony was given in answer to a question which contained a snippet of a quotation from a California Supreme Court opinion, taken out of context, dealing with the issue whether a rule adopted by the Board of Equalization for the valuation of petroleum refinery property was constitutional. (*Western States Petroleum Assn. v. Board of Equalization* (2013) 57 Cal.4th 401, 408. At issue in the *Western States Petroleum* case, inter alia, was a determination of the proper "appraisal unit" for petroleum refinery property under section 51, subdivision (d), which provides: "For purposes of this section, 'real property' means that appraisal unit that persons in the marketplace commonly buy and sell as a unit, or that is normally valued separately." In deciding that the Board of Equalization's new rule appropriately required the "appraisal unit" for petroleum refinery properties to be the aggregate value of the land, improvements and fixtures together, not requiring separate valuations of the land and fixtures, the court noted the definition of "full cash value" for property tax purposes "contemplates that appraisal of real property will reflect the economic reality of how a particular type of property is actually bought and sold." (*Western States Petroleum Assn*., at pp. 422-423.) Here, the appropriate "appraisal unit" for Land Partners property was never an issue. Nor was there any controversy over how mobile home parks are bought and sold. The Supreme Court's choice of words in analyzing the issue before it in the *Western States Petroleum* case is simply not a specific state constitutional provision, statute, or rule or regulation within the meaning of section 538, subdivision (a). It was merely a recognition by the court that the purchase and sale of petroleum refinery properties normally include both the fixtures and the land, and the fact that such sales normally included both fixtures and land was an "economic reality" to be recognized in conducting an appraisal. Further, Singletary's testimony cannot reasonably be read as stating his cognitive decision that a specific state constitutional provision, statute, or rule or regulation is unconstitutional or invalid. And as the court noted, this testimony was not that of the appraiser who prepared the disputed appraisal. Rather, it was testimony of a County of Orange employee who supervised the person who prepared the appraisal.

Moving away from the Assessor's subjective belief, Land Partners urges us to adopt a rule that would allow recovery of fees under section 5152 anytime an assessor violates a "well-settled and unambiguous" appraisal rule. Alternatively, it proffers a "rebuttable presumption" test, under which it would be presumed an assessor's violation of a law or rule was due to a belief in its invalidity unless otherwise rebutted. Such interpretations find no support in the statute's unambiguous language, or the case law interpreting it. (*Kirby v. Immoos Fire Protection, Inc., supra*, 53 Cal.4th at p. 1250 [unambiguous statutory language governs].) Our role is not to rewrite the laws adopted by the Legislature; we interpret and apply them. (*Berry v. American Express Publishing, Inc*. (2007) 147 Cal.App.4th 224, 232.)

In sum, section 5152 does not apply whenever an assessor merely fails to apply a statute or regulation. "Sections 5152 and 538 require a cognitive decision on the part of the assessor that a particular provision, rule or regulation is unconstitutional or invalid either on its face or as applied to the circumstances in the case." (*Phillips Petroleum*, *supra*, 15 Cal.App.4th at pp. 197-198.) Accordingly, a factual finding by the court "that the reason the assessor did not apply a particular provision was that he or she believed it to be unconstitutional or invalid" is a prerequisite to an attorney fee award under this section. (*Id.* at p. 197; see *Prudential*, *supra*, 191 Cal.App.3d 1159-1160.) There was no such finding here, making the denial of Land Partners' request for attorney fees proper.

DISPOSITION

The postjudgment order is affirmed.[2] Respondent is entitled to its costs on appeal.

IKOLA, J.

WE CONCUR:

O'LEARY, P. J.

ARONSON, J.

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[2] The April 3, 2017 request for judicial notice is denied because it presents information not before the trial court at the time of its decision and thus not relevant to our review of the trial court's decision.

Filed 1/22/18

CERTIFIED FOR PUBLICATION

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

FOURTH APPELLATE DISTRICT

DIVISION THREE

LAND PARTNERS, LLC et al.,	
Plaintiffs and Appellants,	G053664
v.	(Super. Ct. No. 30-2013-00680074)
COUNTY OF ORANGE,	O R D E R
Defendant and Respondent.	

Defendant and respondent and the Los Angeles County Office of the Assessor have requested that our opinion filed on January 10, 2018, be certified for publication. It appears that our opinion meets the standards set forth in California Rules of Court, rule 8.1105(c). The requests are GRANTED.

The opinion is ordered published in the Official Reports.

IKOLA, J.

WE CONCUR:

O'LEARY, P. J.

ARONSON, J.

133 T.C. No. 2

UNITED STATES TAX COURT

SUZANNE J. PIERRE, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 753-07. Filed August 24, 2009.

P transferred cash and publicly traded securities to LLC, a New York limited liability company, in exchange for a 100-percent interest in LLC. P subsequently made four transfers of her interest in LLC to trusts established for the benefit of her son and granddaughter: P transferred as a gift a 9.5-percent interest in LLC to each trust and then sold a 40.5-percent interest in LLC to each trust in exchange for a promissory note. In valuing the transfers for Federal gift tax purposes, P applied substantial discounts for lack of marketability and control and therefore paid no gift tax on the transfers.

R argues, inter alia, that the transfers should be treated as transfers of the underlying assets of LLC because a single-member limited liability company is a disregarded entity under the “check-the-box” regulations of secs. 301.7701-1 through 301.7701-3, Proced. & Admin. Regs.

Held: For purpose of application of the Federal gift tax, the transfers are to be valued as transfers of interests in LLC, and LLC is not disregarded under the "check-the-box" regulations to treat the transfers as transfers of a proportionate share of assets owned by LLC.

Kathryn Keneally and Meryl G. Finkelstein, for petitioner.

Lydia A. Branche, for respondent.

WELLS, Judge:[1] Respondent determined deficiencies of $1,130,216.11 and $24,969.19 in petitioner's Federal gift tax and generation-skipping transfer tax for 2000 and 2001, respectively. The issue to be decided is whether certain transfers of interests in a single-member limited liability company (LLC) that is treated as a disregarded entity pursuant to sections 301.7701-1 through 301.7701-3, Proced. & Admin. Regs.,[2] known colloquially and hereinafter referred to as the check-the-box regulations, are valued as transfers of proportionate shares of the underlying assets owned by the LLC or are instead valued as transfers of

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[1]The Chief Judge reassigned this case for Opinion and decision to Judge Thomas B. Wells from Judge Diane L. Kroupa, who presided over the trial. Judge Kroupa does not disagree with our fact findings as they relate to the legal issue addressed in this Opinion.

[2]The check-the-box regulations refer to an entity with a "single owner". The New York statute that created the LLC in issue refers to owners of LLCs as "members". See N.Y. Ltd. Liab. Co. Law art. VI (McKinney 2007). For purposes of this Opinion, no difference in meaning is intended by the use of the terms "owner" and "member".

interests in the LLC, and, therefore, subject to valuation discounts for lack of marketability and control.[3]

FINDINGS OF FACT

Some of the facts and certain exhibits have been stipulated by the parties. The facts stipulated by the parties are incorporated in this Opinion and are so found. Petitioner resided in New York at the time she filed the petition.

Petitioner received a $10 million cash gift from a wealthy friend in 2000. Petitioner wanted to provide for her son Jacques Despretz (Mr. Despretz) and her granddaughter Kati Despretz (Ms. Despretz) but was concerned about keeping her family’s wealth intact. Richard Mesirow (Mr. Mesirow) helped petitioner develop a plan to achieve her goals.

On July 13, 2000, petitioner organized the single-member Pierre Family, LLC (Pierre LLC). Petitioner respected the formalities of formation in the State of New York, and Pierre LLC was validly formed under New York law. Petitioner did not elect to treat Pierre LLC as a corporation for Federal tax purposes by filing a Form 8832, Entity Classification Election, and therefore filed no corporate return for Pierre LLC.

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[3]In this Opinion, we decide only the legal issue set forth above. The following issues were argued by the parties but will be addressed in a separate opinion: (1) Whether the step transaction doctrine applies to collapse the separate transfers to the trusts and (2) the appropriate valuation discount, if any.

On July 24, 2000, petitioner created the Jacques Despretz 2000 Trust and the Kati Despretz 2000 Trust (sometimes collectively referred to as the trusts).

On September 15, 2000, petitioner transferred $4.25 million in cash and marketable securities to Pierre LLC.

On September 27, 2000, 12 days after funding Pierre LLC, petitioner transferred her entire interest in Pierre LLC to the trusts. She first gave a 9.5-percent membership interest in Pierre LLC to each of the trusts to use a portion of her then-available credit amount and her GST exemption. She then sold each of the trusts a 40.5-percent membership interest in exchange for a secured promissory note. The notes each had a face amount of $1,092,133. Petitioner set this amount using the appraisal by James F. Shuey of James F. Shuey & Associates that valued a 1-percent nonmanaging interest in Pierre LLC at $26,965. Mr. Shuey determined the value of a 1-percent interest by applying a 30-percent discount to the value of Pierre LLC's underlying assets. However, petitioner admits that because of an error in valuing the underlying assets, a discount of 36.55 percent was used in valuing the LLC interest for gift tax purposes.

Petitioner filed a Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, for 2000 and reported the gift to each trust of a 9.5-percent Pierre LLC interest. She reported the value of the taxable gift to each trust as $256,168 (determined by multiplying a 9.5-percent interest times the $26,965 appraised value of a 1-percent nonmanaging interest in Pierre LLC).

Respondent examined petitioner's gift tax return and issued a deficiency notice for 2000 and 2001. Respondent determined that petitioner's gift transfers of the 9.5-percent Pierre LLC interests to the trusts are properly treated as gifts of proportionate shares of Pierre LLC assets valued at $403,750 each, not as transfers of interests in Pierre LLC. Respondent further determined that petitioner made gifts to the trusts of the 40.5-percent interests in Pierre LLC to the extent that the value of 40.5 percent of the underlying assets of Pierre LLC exceeded the value of the promissory notes from the trusts. Respondent valued each of these transfers at $629,117 after taking into account the value of the promissory notes.

OPINION

I. The Parties' Contentions

The parties do not dispute that Pierre LLC was a validly formed LLC pursuant to New York State law, which recognized Pierre LLC as an entity separate from petitioner under New York State law.[4] They also agree that, at the time of the transfers,

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[4]Although respondent argues that the step transaction doctrine should apply to the gift and sale transfers in issue, respondent explicitly limits the proposed application of the step transaction doctrine to the events of Sept. 27, 2000, and thus (continued...)

Pierre LLC is to be disregarded as an entity separate from its owner "for federal tax purposes" under the check-the-box regulations. The parties disagree, however, about whether the check-the-box regulations require that Pierre LLC be disregarded for Federal gift tax valuation purposes.

Respondent argues that, because Pierre LLC is a single-member LLC that is treated as a disregarded entity under the check-the-box regulations, petitioner's transfers of interests in Pierre LLC should be "treated" as transfers of cash and marketable securities, i.e., proportionate shares of Pierre LLC's assets, rather than as transfers of interests in Pierre LLC, for purposes of valuing the transfers to determine Federal gift tax liability. Accordingly, respondent contends that petitioner made gifts equal to the total value of the assets of Pierre LLC less the value of the promissory notes she received from the trusts.[5]

Petitioner argues that, for Federal gift tax valuation purposes, State law, not Federal tax law, determines the nature of a taxpayer's interest in property transferred and the legal rights inherent in that property interest. Accordingly,

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[4](...continued)
does not advocate applying the step transaction doctrine to disregard Pierre LLC. As noted above, the step transaction issues will be addressed in a separate opinion.

[5]Respondent argues that the four transfers in issue should be collapsed into one transfer pursuant to the step transaction doctrine. As noted above, this issue will be addressed in a separate opinion.

petitioner contends that we must look to State law to determine what property interest was transferred and then value the property interest actually transferred to apply the Federal gift tax provisions to that value to ascertain gift tax liability. Petitioner argues that, under New York State law, a membership interest in an LLC is personal property, and a member has no interest in specific property of the LLC. N.Y. Ltd. Liab. Co. Law sec. 601 (McKinney 2007). Accordingly, petitioner argues that she properly valued the transferred interests in Pierre LLC for purposes of valuing her transfers to the trusts and that she properly applied lack of control and lack of marketability discounts in valuing[6] the transferred LLC interests.

Petitioner also contends that respondent bears the burden of proof on all fact issues because she has met the requirements of section 7491.[7] As the only issue decided in this Opinion is decided as a matter of law, we need not decide in this Opinion which party bears the burden of proof.[8]

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[6]As noted above, issues of valuation will be addressed in a separate opinion.

[7]Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the years in issue.

[8]The issues regarding which party bears the burden of proof will be addressed, if necessary, in a separate opinion.

II. The Historical Gift Tax Valuation Regime

We begin with a brief summary of the longstanding statutes, regulations, and caselaw that constitute the Federal gift tax valuation regime. Section 2501(a) imposes a tax on the transfer of property by gift. The amount of a gift of property is the value of the property at the date of the gift. Sec. 2512(a). It is the value of the property passing from the donor that determines the amount of the gift. Sec. 25.2511-2(a), Gift Tax Regs. "The value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of the relevant facts." Sec. 25.2512-1, Gift Tax Regs. Where property is transferred for less than adequate and full consideration in money or money's worth, the amount of the gift is the amount by which the value of the property transferred exceeds the value of the consideration received. Sec. 2512(b).

In addition to the statutes and regulations, there is significant Supreme Court precedent interpreting them and guiding the implementation of the Federal gift and estate tax.[9] The Supreme Court, in Bromley v. McCaughn, 280 U.S. 124 (1929), held

[9]The Federal estate tax is interpreted in pari materia with the Federal gift tax. See Estate of Sanford v. Commissioner, 308 U.S. 39, 44 (1939) (citing Burnet v. Guggenheim, 288 U.S. 280, 286 (1933)).

that the imposition of a gift tax is within the constitutional authority of Congress. The holding in Bromley turned on a finding that the gift tax is an excise tax rather than a direct tax. As the Supreme Court stated in Bromley v. McCaughn, supra at 135-136:

> The general power to "lay and collect taxes, duties, imposts, and excises" conferred by Article I, § 8 of the Constitution, and required by that section to be uniform throughout the United States, is limited by § 2 of the same article, which requires "direct" taxes to be apportioned, and section 9, which provides that "no capitation or other direct tax shall be laid unless in proportion to the census" directed by the Constitution to be taken. * * *
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> * * * a tax imposed upon a particular use of property or the exercise of a single power over property incidental to ownership, is an excise which need not be apportioned * * *
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> * * * [The gift tax] is a tax laid only upon the exercise of a single one of those powers incident to ownership, the power to give the property owned to another. * * *

The Supreme Court has also provided guidance as to the appropriate roles of Federal and State law in the valuation of transfers. A fundamental premise of transfer taxation is that State law creates property rights and interests, and Federal tax law then defines the tax treatment of those property rights. See Morgan v. Commissioner, 309 U.S. 78 (1940). It is well established that the Internal Revenue Code creates "'no property rights but merely attaches consequences, federally defined, to rights created under state law.'" United States v. Nat. Bank of

Commerce, 472 U.S. 713, 722 (1985) (quoting United States v. Bess, 357 U.S. 51, 55 (1958)). In Morgan v. Commissioner, supra at 80-81, the Supreme Court stated:

> State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed. Our duty is to ascertain the meaning of the words used to specify the thing taxed. If it is found in a given case that an interest or right created by local law was the object intended to be taxed, the federal law must prevail no matter what name is given to the interest or right by state law.

In Morgan, the Court disregarded the State law classification of a power of appointment as “special” where the rights associated with that power of appointment under State law (i.e., the power to appoint to anyone, including the holder’s estate and creditors) were properly classified under Federal law as a general power of appointment. As is standard in Federal estate and gift tax cases, the interest was created by State law, respected by the Court, and taxed pursuant to the Federal estate and gift tax provisions. In short, the Court ignored the label, not the interest created, and determined whether the interest fell within the Federal statute. This Court, in Knight v. Commissioner, 115 T.C. 506 (2000), followed the Supreme Court precedent discussed above. As we said in Knight v. Commissioner, supra at 513 (citing United States v. Nat. Bank of Commerce, supra at 722, United States v. Rodgers, 461 U.S. 677, 683 (1983), and Aquilino v. United States, 363 U.S. 509, 513 (1960)): “State law determines the nature of property rights, and Federal law determines the appropriate tax treatment of those rights."

Pursuant to New York law petitioner did not have a property interest in the underlying assets of Pierre LLC, which is recognized under New York law as an entity separate and apart from its members. N.Y. Ltd. Liab. Co. Law sec. 601. Accordingly, there was no State law "legal interest or right" in those assets for Federal law to designate as taxable, and Federal law could not create a property right in those assets. Consequently, pursuant to the historical Federal gift tax valuation regime, petitioner's gift tax liability is determined by the value of the transferred interests in Pierre LLC, not by a hypothetical transfer of the underlying assets of Pierre LLC.

III. The Check-the-Box Regulations and Single-Member LLCs

We next turn to the question of whether the check-the-box regulations alter the historical Federal gift tax valuation regime discussed above. Pursuant to the Internal Revenue Code, the income of a C corporation is subject to double taxation (once at the corporate level and once at the shareholder level) while the income of partnerships and sole proprietorships is taxed only once (at the individual taxpayer level). See Littriello v. United States, 484 F.3d 372, 375 (6th Cir. 2007). An LLC is a relatively new business structure, created by State law, that has some features of a corporation (i.e., limited personal liability) and some features of a partnership (i.e., management flexibility and pass-through taxation). McNamee v. Dept. of the Treasury, 488 F.3d 100, 107 (2d Cir. 2007). Section 7701, underpinning the check-the-box regulations, defines entities for purposes of the Internal Revenue Code "where not otherwise distinctly expressed or manifestly incompatible with the intent thereof". Section 7701 does not make it clear whether an LLC falls within the definition of a partnership, a corporation, or a disregarded entity taxed as a sole proprietorship.

Before the promulgation of the check-the-box regulations, the proliferation of revenue rulings, revenue procedures, and letter rulings relating to the classification of LLCs and partnerships for Federal tax purposes made the existing regulations "unnecessarily cumbersome to administer". Dover Corp. & Subs. v. Commissioner, 122 T.C. 324, 330 (2004). Those existing regulations, known as the "Kintner Regulations", had been in place since 1960.[10] In McNamee v. Dept. of the Treasury,

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[10]In Richlands Med. Association v. Commissioner, T.C. Memo. 1990-660, affd. without published opinion 953 F.2d 639 (4th Cir. 1992), we summarized the "Kintner Regulations" as follows:

> The Kintner Regulations * * * set forth six characteristics ordinarily found in a corporation which distinguish it from other organizations. Those characteristics are (1) associates, (2) an objective to carry on business and divide the gains therefrom, (3) continuity of life, (4) centralization of management, (5) limited liability, and (6) free transferability of interests. The regulations go on to note that, in some

(continued...)

supra at 108-109, the Court of Appeals for the Second Circuit, the court that would be the venue for any appeal of the instant case absent stipulation to the contrary, stated:

> The Kintner regulations had been adequate during the first several decades after their adoption. But, as explained in the 1996 proposal for their amendment, the Kintner regulations were complicated to apply, especially in light of the fact that
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>> many states ha[d] revised their statutes to provide that partnerships and other unincorporated organizations may possess characteristics that traditionally have been associated with corporations, thereby narrowing considerably the traditional distinctions between corporations and partnerships under local law.
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> Simplification of Entity Classification Rules, 61 Fed. Reg. 21989, 21989-90 (proposed May 13, 1996). * * *

To simplify the classification of hybrid entities, such as LLCs, the check-the-box regulations were promulgated. Section 301.7701-1(a)(1), Proced. & Admin. Regs., provides:

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[10](...continued)
cases, other factors may be found which may be significant in classifying an organization.

* * * Although the regulations cite the Supreme Court decision in Morrissey v. Commissioner, 296 U.S. 344 (1935), for the proposition that corporate status will exist if an organization “more nearly resembles” a corporation than a partnership or trust, the regulations adopt a mechanical test for determination of corporate status. Under that test, each of the four characteristics “apparently bears equal weight in the final balancing,” Larson v. Commissioner, * * * [66 T.C.] at 172, and an entity will not be taxed as a corporation unless it possesses more corporate than noncorporate characteristics. Section 301.7701-2(a)(3), Proced. and Admin. Regs.; Larson v. Commissioner, supra at 185. * * *

> Classification of organizations for federal tax purposes.--(a) * * * --(1) * * * The Internal Revenue Code prescribes the classification of various organizations for federal tax purposes. Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law. [Emphasis added].

Section 301.7701-3(a) and (b), Proced. & Admin. Regs., provides:

> Classification of certain business entities.--(a) * * * A business entity * * * can elect its classification for federal tax purposes as provided in this section. An eligible entity * * * with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner. Paragraph (b) of this section provides a default classification for an eligible entity that does not make an election. * * *
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> (b) Classification of eligible entities that do not file an election.--(1) * * * Except as provided in paragraph (b)(3) of this section, unless the entity elects otherwise, a domestic eligible entity is--
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> * * * * * * *
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> (ii) Disregarded as an entity separate from its owner if it has a single owner.
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> [Emphasis added.]

Accordingly, the default classification for an entity with a single owner is that the entity is disregarded as an entity separate from its owner. Sec. 301.7701-3(b)(1)(ii), Proced. & Admin. Regs. There is no question that the phrase “for federal tax purposes” was intended to cover the classification of an entity for Federal tax purposes, as the check-the-box regulations were designed to avoid many difficult problems largely associated with the classification of an entity as either a partnership or a corporation; i.e., whether it should be taxed as a pass-through entity or as a separately taxed entity. Simplification of Entity Classification Rules, 61 Fed. Reg. 21989-21990 (May 13, 1996). The question before us now is whether the check-the-box regulations require us to disregard a single-member LLC, validly formed under State law, in deciding how to value and tax a donor's transfer of an ownership interest in the LLC under the Federal gift tax regime described above.

IV. Whether the Check-the-Box Regulations Alter the Historical Federal Gift Tax Valuation Regime

Respondent points to a number of cases as support for the proposition that, pursuant to the check-the-box regulations, valid State law restrictions must be ignored for the purpose of determining the interest being transferred under the Federal estate and gift tax regime. Respondent cites McNamee v. Dept. of the Treasury, 488 F.3d 100 (2d Cir. 2007), a case decided by the Court of Appeals for the Second Circuit. However, respondent's reliance on McNamee is misplaced. In McNamee, the Court of Appeals held that State law cannot abrogate the Federal tax obligations of the owner of a disregarded entity under the check-the-box regulations. Id. at 111 (citing Littriello v. United States, 484 F.3d at 379). In issue in McNamee was the requirement to pay withholding taxes for a single-member LLC's employees. The Court of Appeals held that the owner of the single-member LLC there in issue was liable for the disregarded entity's taxes; it did not hold that an entity is to be disregarded in deciding what property interests are transferred under State law for Federal gift tax valuation purposes when an owner of an entity disregarded under the check-the-box regulations transfers an interest in that entity.[11]

Similarly, respondent's reliance on Shepherd v. Commissioner, 115 T.C. 376 (2000), affd. 283 F.3d 1258 (11th Cir. 2002), and Senda v. Commissioner, 433 F.3d 1044 (8th Cir. 2006), affg. T.C. Memo. 2004-160, is not convincing, as the facts of those cases differ significantly from the facts of the instant case. In Shepherd v. Commissioner, supra at 384, we looked to applicable State law to decide what property rights were conveyed. In Shepherd, the property the taxpayer possessed and transferred was his interests in leased land and bank stock. Id. at 385. Because the creation of the taxpayer's sons' partnership interests preceded the completion of the gift to the partnership, we found that the taxpayer made indirect gifts to his sons of his

[11]For the same reasons, Littriello v. United States, 484 F.3d 372 (6th Cir. 2007), and Med. Practice Solutions, LLC v. Commissioner, 132 T.C. __ (Mar. 31, 2009) (an Opinion of this Court following McNamee v. Dept. of the Treasury, 488 F.3d 100 (2d Cir. 2007)), are not controlling for the purpose of determining what interest is being transferred under the Federal gift tax valuation regime. Both of these cases, like McNamee, involve the classification of a single-member LLC (i.e., whether it is a pass-through entity or a separately taxed entity) for purposes of liability for employment taxes. Neither case addresses the valuation of transferred interests in a single-member LLC for purposes of Federal gift tax valuation.

interests in the land and bank stock. Id. at 389. The Court of Appeals for the Eleventh Circuit, in its opinion affirming Shepherd, highlighted the distinction between the facts of Shepherd and a hypothetical set of facts (more similar to the facts under consideration in the the instant case) when it noted that

> Thus, instead of completing a gift of land to a preexisting partnership in which the sons were not partners and then establishing the partnership interests of his sons (which would result in a gift of a partnership interest), Shepherd created a partnership in which his sons held established shares and then gave the partnership a taxable gift of land (making it an indirect gift of land to his sons).

Shepherd v. Commissioner, 283 F.3d at 1261 (fn. ref. omitted). In the instant case, petitioner completed a gift of cash and securities to Pierre LLC at a time when the trusts were not members of Pierre LLC and then later transferred interests in Pierre LLC to the trusts, which established the interests of the trusts in Pierre LLC.[12] Accordingly, Shepherd is consistent with the requirement that State law determines the interest being

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[12]Petitioner contributed the stock and securities to Pierre LLC approximately 12 days before she transferred the Pierre LLC interests to the trusts. In Holman v. Commissioner, 130 T.C. 170 (2008), we found that the indirect gift analysis of Shepherd v. Commissioner, 115 T.C. 376 (2000), affd. 283 F.3d 1258 (11th Cir. 2002), and Senda v. Commissioner, T.C. Memo. 2004-160, affd. by 433 F.3d 1044 (8th Cir. 2006), did not apply where assets were transferred to a partnership 5 days before the gifts of the partnership interests.

transferred. In the instant case, as discussed above, pursuant to New York law, petitioner transferred interests in Pierre LLC.

Senda v. Commissioner, supra, is also distinguishable. In Senda, the taxpayers were unable to establish whether they had transferred partnership interests to their children before or after they contributed stock to the partnership. Citing Shepherd v. Commissioner, supra, the Court of Appeals for the Eighth Circuit noted that the sequence was critical "because a contribution of stock after the transfer of partnership interests is an indirect gift". Senda v. Commissioner, supra at 1046.

Both Shepherd and Senda stand for the proposition that a transfer of property to a partnership for less than full and adequate consideration may represent an indirect gift to the other partners. In the instant case, petitioner contributed the cash and securities to Pierre LLC before transfers to the trusts were made and the trusts became members of Pierre LLC. Consequently, Shepherd and Senda are not controlling.

Petitioner relies heavily on Estate of Mirowski v. Commissioner, T.C. Memo. 2008-74. We do not find Estate of Mirowski to be controlling because the Commissioner did not rely on the check-the-box regulations with respect to the transfer of the LLC interests there in issue. However, we do note that in Estate of Mirowski we refused to adopt an interpretation that "reads out of section 2036(a) in the case of any single-member

LLC the exception for a bona fide sale * * * that Congress expressly prescribed when it enacted that statute." If respondent's interpretation were to prevail in the instant case, such an interpretation could create a similar result.[13]

The multistep process of determining the nature and amount of a gift and the resulting gift tax under the Federal gift tax provisions described above, i.e., (1) the determination under State law of the property interest that the donor transferred, (2) the determination of the fair market value of the transferred property interest and the amount of the transfer to be taxed, and (3) the calculation of the Federal gift tax due on the transfer, is longstanding and well established. Neither the check-the-box regulations nor the cases cited by respondent support or compel a conclusion that the existence of an entity validly formed under applicable State law must be ignored in determining how the transfer of a property interest in that entity is taxed under Federal gift tax provisions.

While we accept that the check-the-box regulations govern how a single-member LLC will be taxed for Federal tax purposes, i.e., as an association taxed as a corporation or as a disregarded entity, we do not agree that the check-the-box

[13]As noted above, see supra note 9, the Federal estate tax must be interpreted in pari materia with the Federal gift tax.

regulations apply to disregard the LLC in determining how a donor must be taxed under the Federal gift tax provisions on a transfer of an ownership interest in the LLC. If the check-the-box regulations are interpreted and applied as respondent contends, they go far beyond classifying the LLC for tax purposes. The regulations would require that Federal law, not State law, apply to define the property rights and interests transferred by a donor for valuation purposes under the Federal gift tax regime. We do not accept that the check-the-box regulations apply to define the property interest that is transferred for such purposes. The question before us (i.e., how a transfer of an ownership interest in a validly formed LLC should be valued under the Federal gift tax provisions) is not the question addressed by the check-the-box regulations (i.e., whether an LLC should be taxed as a separate entity or disregarded so that the tax on its operations is borne by its owner). To conclude that because an entity elected the classification rules set forth in the check-the-box regulations, the long-established Federal gift tax valuation regime is overturned as to single-member LLCs would be “manifestly incompatible” with the Federal estate and gift tax statutes as interpreted by the Supreme Court. See sec. 7701.

We note that Congress has enacted provisions of the Internal Revenue Code, see secs. 2701, 2703, that disregard valid State law restrictions in valuing transfers. Where Congress has determined that the “willing buyer, willing seller” and other valuation rules are inadequate, it expressly has provided exceptions to address valuation abuses. See chapter 14 of the Internal Revenue Code, sections 2701 through 2704, which specifically are designed to override the standard “willing buyer, willing seller” assumptions in certain transactions involving family members.

By contrast, Congress has not acted to eliminate entity-related discounts in the case of LLCs or other entities generally or in the case of a single-member LLC specifically. In the absence of such explicit congressional action and in the light of the prohibition in section 7701, the Commissioner cannot by regulation overrule the historical Federal gift tax valuation regime contained in the Internal Revenue Code and substantial and well-established precedent in the Supreme Court, the Courts of Appeals, and this Court, and we reject respondent’s position in the instant case advocating an interpretation that would do so. Accordingly, we hold that petitioner’s transfers to the trusts should be valued for Federal gift tax purposes as transfers of interests in Pierre LLC and not as transfers of a proportionate share of the underlying assets of Pierre LLC.

To reflect the foregoing,

An appropriate order will

be issued.

Reviewed by the Court.

COHEN, FOLEY, VASQUEZ, THORNTON, MARVEL, GOEKE, WHERRY, GUSTAFSON, and MORRISON, JJ., agree with this majority opinion.

COHEN, Judge, concurring: As the author of the Opinion for the Court in Med. Practice Solutions, LLC v. Commissioner, 132 T.C. __ (2009), I write to explain why my agreement with the majority opinion here is consistent with the conclusion in that case, which followed McNamee v. Dept. of the Treasury, 488 F.3d 100 (2d Cir. 2007). Briefly, I agree with the majority that McNamee and Med. Practice Solutions, LLC are classification cases that appropriately applied the check-the-box regulations of section 301.7701-3(b)(1)(ii), Proced. & Admin. Regs., in deciding whether the single owner/member of an LLC or the LLC was liable for employment taxes on the wages of the employees of the business in question. In contrast, this case involves the issue of the valuation for transfer tax purposes of certain interests in a single-owner LLC that that owner transferred. See majority op. p. 15. (McNamee and Med. Practice Solutions, LLC, along with Littriello v. United States, 484 F.3d 372 (6th Cir. 2007), and others cited in Med. Practice Solutions, LLC, will be referred to as the employment tax cases).

The check-the-box regulations might be applied to determine for gift tax purposes whether the owner of a single-member LLC or the LLC is the transferor of the assets used in the business or the activities for which the LLC was formed. In that event, the determination would parallel the determination in the employment tax cases as to who is liable for the Federal tax in dispute and would consider whether the LLC should be “disregarded” under those regulations. The only transfer at issue here, however, is the transfer by the owner of the LLC of certain interests that she held in that LLC.

Transfer tax disputes, including this one, more frequently involve differences over the fair market value of property, and fair market value is determined by applying the “willing buyer, willing seller” standard to the property transferred. See majority op. pp. 8-11. Where the property transferred is an interest in a single-member LLC that is validly created and recognized under State law, the willing buyer cannot be expected to disregard that LLC. See, e.g., Knight v. Commissioner, 115 T.C. 506, 514 (2000) (“We do not disregard * * * [a] partnership because we have no reason to conclude from this record that a hypothetical buyer or seller would disregard it.”).

Of course, Congress has the ability to, and on occasion has opted to, modify the willing buyer, willing seller standard. See, e.g., secs. 2032A, 2701, 2702, 2703, 2704; Holman v. Commissioner, 130 T.C. 170, 191 (2008) (applying section 2703 to disregard restrictions in a partnership agreement). In Kerr v. Commissioner, 113 T.C. 449, 470-474 (1999), affd. 292 F.3d 490 (5th Cir. 2002), we explained that the special valuation rules were a targeted substitute for the complexity, breadth, and vagueness of prior section 2036(c). We reaffirmed the willing buyer, willing seller standard, Kerr v. Commissioner, supra at 469, and concluded that the special provision in section 2704(b) did not apply to disregard the partnership restrictions in issue, id. at 473; see also Estate of Strangi v. Commissioner, 115 T.C. 478, 487-489 (2000), affd. on this issue, revd. and remanded on other grounds 293 F.3d 279 (5th Cir. 2002).

The majority opinion, majority op. pp. 13-15, discusses the adoption of the check-the-box regulations as a targeted substitute for the complexity of the Kintner regulations in classifying hybrid entities and thereby determining the tax consequences to those entities and their owners of the business or the activities for which those entities were formed. A targeted solution to a particular problem should not be distorted to achieve a comprehensive overhaul of a well-established body of law.

If the regulations expressly provided that single-owner LLCs would be disregarded in determining the identity of the property transferred and the value of that transferred property, we could debate the validity of the regulations and the degree of deference to be given to various expressions of an agency’s position. Here we are dealing only with respondent’s litigating position. The majority does not question the validity of the check-the-box regulations. The majority holds only that those regulations do not control the valuation issue in this case. See majority op. pp. 19-20.

The argument that the majority opinion disregards the plain meaning of the phrase “for federal tax purposes” in section 301.7701-3(a), Proced. & Admin. Regs., is unpersuasive. The plain meaning of the text of a regulation is the starting point for determining the meaning of that regulation. See Walker Stone Co. v. Secy. of Labor, 156 F.3d 1076, 1080 (10th Cir. 1998) (“When the meaning of a regulatory provision is clear on its face, the regulation must be enforced in accordance with its plain meaning.”). We see here, however, (1) ambiguity in the specific phrase “federal tax purposes” and (2) ambiguity in the term “disregarded”, both of which make plain meaning elusive.

First, the regulation does not provide that an entity will be disregarded “for all Federal tax purposes”. Instead, the regulation implements a statute that, by its terms, applies except where “manifestly incompatible with the intent” of the Internal Revenue Code. Sec. 7701(a). The language of the regulation requires a determination of which “federal tax purposes” are implicated and whether a given purpose might be manifestly incompatible with the Internal Revenue Code.

Second, the regulation states that an entity will be “disregarded as an entity separate from its owner”. Sec. 301.7701-3(a) and (b)(1)(ii), Proced. & Admin. Regs. (emphasis added). That sentence might mean that a disregarded entity is exempt from tax, that its transactions are disregarded and therefore not reported for tax purposes, or that transfers of interests in the entity are disregarded for Federal gift tax purposes and not taxed. While none of those meanings is likely, the ambiguity is inherent. Of course, the regulation must be interpreted in the light of the other principles of the Internal Revenue Code. Those other principles include the valuation principles discussed in the majority opinion. Respondent’s proposed application of the regulation is manifestly incompatible with those principles.

The majority’s approach is consistent with the principle that a regulation will be interpreted to avoid conflict with a statute. See LaVallee Northside Civic Association v. V.I. Coastal Zone Mgmt. Commn., 866 F.2d 616, 623 (3d Cir. 1989); see also Smith v. Brown, 35 F.3d 1516, 1526 (Fed. Cir. 1994); Phillips Petroleum Co. v. Commissioner, 97 T.C. 30, 35 (1991), affd. without published opinion 70 F.3d 1282 (10th Cir. 1995). It is also consistent with the express limitation of section 7701(a) on the scope of regulations that define terms. See majority op. p. 21. The majority’s interpretation of the scope of the check-the-box regulations harmonizes the classification purpose of those regulations with the statutory rules and case precedents that firmly establish the meaning of fair market value in transfer tax cases and the willing buyer, willing seller standard as the hallmark of that meaning.

Some final words about deference. As the majority opinion indicates, majority op. p. 12, section 7701(a) precludes the application of the definitions of the terms in that section where they are “manifestly incompatible with the intent” of the Internal Revenue Code. This case does not involve the question in Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837 (1984), of deference to the Commissioner’s interpretation of a statute that the Commissioner is charged with administering. Nothing in the check-the-box regulations or in the cases cited by respondent persuades us that those regulations require us to disregard a single-owner LLC where, as is the case here, to do so would be “manifestly incompatible” with the intent of other provisions of the Internal Revenue Code.

Judge Halpern in his dissenting opinion does not address the majority’s conclusion that respondent’s interpretation of the regulation is manifestly incompatible with other provisions of the Code. He asserts that “respondent’s position in this case * * * is consistent with the Commissioner’s administrative position for at least 10 years”. Dissenting op. p. 35. He cites Rev. Rul. 99-5, 1999-1 C.B. 434, which describes the Federal income tax consequences of a transfer under sections 721-723, 1001(a), and 1223. The ruling and the sections cited do not deal with transfer taxes generally or gift tax specifically. Moreover, the Internal Revenue Service has reversed itself with respect to application of the check-the-box regulations in employment tax situations and has adopted new rules as of January 1, 2009. See McNamee v. Dept. of the Treasury, 488 F.3d at 109; Littriello v. United States, 484 F.3d 372 (6th Cir. 2007); Med. Practice Solutions, LLC v. Commissioner, 132 T.C. at __ (slip op. at 7).

We have never accorded deference to the Commissioner's litigating position, as contrasted to (1) contemporaneous expressions of intent when the regulations were adopted and (2) consistent administrative interpretations before the litigation. See Gen. Dynamics Corp. & Subs. v. Commissioner, 108 T.C. 107, 120-121 (1997). Respondent does not argue here that respondent's interpretation of the regulation is entitled to deference. Neither the cases--Oteze Fowlkes v. Adamec, 432 F.3d 90, 97 (2d Cir. 2005), United States v. Miller, 303 F.2d 703, 707 (9th Cir. 1962), and Lantz v. Commissioner, 132 T.C. ___, ___ n.10 (2009) (slip op. at 23-24)--nor the so-called hornbook law on which Judge Halpern relies in his dissenting opinion requires us to give deference to respondent's litigating position that the check-the-box regulations apply in this case. We have no reason to believe that respondent's litigating position here is an interpretation of those regulations that reflects "the * * * fair and considered judgment [of the Secretary of the Treasury] on the matter in question." Auer v. Robbins, 519 U.S. 452, 462 (1997) (where the Supreme Court of the United States ordered the Secretary of Labor to file an amicus brief in a case between private litigants involving the interpretation of a regulation that the Secretary had promulgated, the Supreme Court accepted the Secretary's interpretation since in the circumstances of the case "There is simply no reason to suspect that the interpretation does not reflect the agency's fair and considered judgment on the matter in question."). Moreover, Judge Halpern's reliance on a footnote in Lantz v. Commissioner, supra, is misplaced. We there concluded that a taxpayer's pursuit of a particular type of relief would be fruitless in the face of the Commissioner's position, the validity of which had not been challenged. Neither case cited in that footnote adopts the litigating position of the party as distinct from preexistent and consistent administrative interpretations. See Bowles v. Seminole Rock & Sand Co., 325 U.S. 410, 414 (1945); Phillips Petroleum Co. v. Commissioner, 101 T.C. 78, 97 (1993), affd. without published opinion 70 F.3d 1282 (10th Cir. 1995).

WELLS, FOLEY, VASQUEZ, THORNTON, MARVEL, GOEKE, WHERRY, and GUSTAFSON, JJ., agree with this concurring opinion.

HALPERN, J., dissenting:

I. Introduction

We here face a task common in courts reviewing the actions of an administrative agency; i.e., we must construe an agency's statute and regulations and consider the agency's interpretation of those authorities. I agree with neither the approach the majority takes nor the conclusion it reaches. I agree with much of what Judge Kroupa writes but wish to emphasize how my approach differs from that of the majority.

II. The Language of the Regulation

That regulations, like statutes, are interpreted pursuant to canons of construction is a basic principle of regulatory interpretation. E.g., Black & Decker Corp. v. Commissioner, 986 F.2d 60, 65 (4th Cir. 1993), affg. T.C. Memo. 1991-557. In every case involving questions of statutory or regulatory interpretation, the starting point is the language itself. E.g., Bd. of Educ. v. Harris, 622 F.2d 599, 608 (2d Cir. 1979) (quoting Greyhound Corp. v. Mt. Hood Stages, Inc., 437 U.S. 322, 330 (1978)). The regulations we here construe are sections 301.7701-1 through -3, Proced. & Admin. Regs. (the so-called check-the-box regulations). We are particularly concerned with the language in section 301.7701-2(a), Proced. & Admin. Regs., describing what happens when a business entity with only one owner is disregarded as an entity separate from that owner; viz, "its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner." Given that Pierre LLC's owner, petitioner, is an individual, Pierre LLC's activities are treated in the same manner as those of a sole proprietorship. See id. Missing from the instruction (sometimes, the activities instruction), however, is its scope. Ostensibly, section 301.7701-1(a)(1), Proced. & Admin. Regs., provides that scope, stating that the activities instruction applies for "federal tax purposes".

Section 2501(a) imposes a tax on the transfer of property by gift. The tax is an excise tax imposed on the value of the property transferred. See id.; Dickman v. Commissioner, 465 U.S. 330, 340 (1984) ("The gift tax is an excise tax on transfers of property".). Section 2512(a) provides that the amount of a gift of property is the value of the property on the date of the gift. Respondent argues that, because petitioner elected to treat Pierre LLC as a disregarded entity, petitioner is properly "treated as transferring cash and marketable securities, as opposed to Pierre LLC interests, for federal gift tax purposes." Petitioner responds: "[T]he issue is the gift tax treatment of transfers of interests in an LLC", "not the imposition of a tax due as a result of the activities of a single-member LLC." In effect, petitioner argues that the activities instruction is irrelevant to any inquiry concerning her transfers of interests in the LLC, since that inquiry concerns her own activities and not her LLC's activities.

Petitioner's position bespeaks a distinction between a sole proprietor and her business that the activities instruction will not bear. A sole proprietorship is generally understood to have no legal identity apart from the proprietor. 18 C.J.S., Corporations, sec. 4 (2007) ("A sole proprietorship has no separate legal existence or identity apart from the sole proprietor."). Judge Richard A. Posner applied that rule of unity nicely in Smart v. Intl. Bhd. of Elec. Workers, Local 702, 315 F.3d 721, 723 (7th Cir. 2002): "Two plaintiffs are listed, but one is a sole proprietorship and the other the proprietor, so they are one, not two, in the eyes of the law * * *, and the one is the proprietor * * * not the proprietorship." I would read the activities instruction as plainly saying that Pierre LLC and petitioner constitute only one actor (i.e., petitioner) for Federal tax purposes (which, of course, encompass the Federal gift tax), so that any gift by petitioner of an interest in Pierre LLC is, as respondent argues, a gift of an interest in that LLC's cash and marketable securities.[1] Others may find the activities

[1] Treating the transfer of an interest in a single-member disregarded entity as a transfer of an interest in the entity's assets is in no way inconsistent with applying the "willing buyer, willing seller" standard for valuation purposes, see sec. 25.2512-1, Gift Tax Regs., as Judge Cohen suggests in her concurring opinion, p. 24. The willing buyer and willing seller (continued...)

instruction to be ambiguous, so I will proceed as if the instruction is not clear from the plain language of the regulation. I reject (and the majority does not contend) that the regulation plainly precludes considering the LLC's property (or at least interests therein) as the property petitioner transferred when she transferred interests in the LLC.

III. The Intent of the Secretary

If we accept that the activities instruction is ambiguous, then we must construe that provision. With respect to that task: "It is axiomatic that any regulation should be construed to effectuate the intent of the enacting body." United States v. Miller, 303 F.2d 703, 707 (9th Cir. 1962). Indeed, hornbook law holds:

> In construing an administrative rule or regulation, the court must necessarily look to the administrative construction thereof where the meaning of the words used is in doubt, and the courts will ordinarily show deference to such construction and give it controlling weight.

[1](...continued) are purely hypothetical figures. See Estate of Newhouse v. Commissioner, 94 T.C. 193, 218 (1990). That the hypothetical willing buyer is deemed to purchase an interest in the entity's assets (to value a hypothetical gift of that interest) is not inconsistent with the fact that a real buyer (and, by extension, a donee) would receive an interest in what has become a two-member unincorporated entity; i.e., for Federal tax purposes, a partnership. See sec. 301.7701-3(f)(2), Proced. & Admin. Regs. Thus, respondent's position does not require the real buyer to disregard the LLC, for it is an interest in an LLC with which he winds up.

73 C.J.S., Public Administrative Law and Procedure, sec. 212 (2004) (emphasis added); accord Oteze Fowlkes v. Adamec, 432 F.3d 90, 97 (2d Cir. 2005) ("An agency's interpretation of its own statute and regulation must be given controlling weight unless it is plainly erroneous or inconsistent with the regulation." (citations and internal quotation marks omitted)); Lantz v. Commissioner, 132 T.C. __, __ n.10 (2009) (slip op. at 23-24 n.10) (the same).

There is ample evidence that the Secretary, in the person of the Commissioner, construes the activities instruction to require that the wrapper be disregarded in determining the property the owner of a single-member disregarded entity transfers when she transfers an interest in the entity. That is, of course, respondent's position, which, because it is consistent with the Commissioner's administrative position for at least 10 years, cannot be dismissed as a mere litigating position.[2] Implementation of the check-the-box regulations has required the Commissioner to issue numerous interpretations. Ten years ago, in Rev. Rul. 99-5, 1999-1 C.B. 434, the Commissioner addressed the Federal income tax consequences of the sale by A, the owner of a

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[2] In Lantz v. Commissioner, 132 T.C. __, __ (2009) (slip op. at 35) (Halpern, J. dissenting), I dismissed the Commissioner's interpretation of sec. 301.9100-1(c), Proced. & Admin. Regs., as no more than a litigating position without merit, since it was "'plainly erroneous' and 'inconsistent with the regulation'". That is not so here.

single-member disregarded entity (an LLC), of a 50-percent ownership interest in the entity to B, with the result that the disregarded entity was converted into a partnership. The Commissioner held that B's purchase of 50 percent of A's ownership interest in the LLC is treated as the purchase of a 50-percent interest in each of the LLC's assets, "which are treated as held directly by A for federal tax purposes." Id. Therefore, the Commissioner continued: "Under § 1001, A recognizes gain or loss from the deemed sale of the 50% interest in each asset of the LLC to B." Id. In the intervening 10 years, the Commissioner has issued numerous letter rulings consistent with, and relying on, his interpretation in Rev. Rul. 99-5, supra, that a transfer by the owner of all or a part of his interest in a single-member disregarded entity is to be treated as the transfer by the owner of a proportional interest in the entity's assets.[3] Rev. Rul. 99-

[3] E.g., Priv. Ltr. Rul. 200825008 (Mar. 7, 2008) (limited partnership's distribution of membership interests in LLC, a single-member disregarded entity, "will be treated as a distribution of LLC's assets and liabilities to the Partners"); Priv. Ltr. Rul. 200824009 (Mar. 6, 2008) (trust's distribution to beneficiaries A and B of interests in X, a single-member disregarded entity, "should have been treated as a non-taxable pro rata distribution of d% of X's assets to A and e% of X's assets to B * * * as if such assets had been distributed outright from Trust to A and B"); Priv. Ltr. Rul. 200709036 (Nov. 28, 2006) ("Although Taxpayer transferred its interest in * * *, a disregarded entity, the sale of such interest is treated as a sale of the assets of the disregarded entity for federal income tax purposes."); Priv. Ltr. Rul. 200251008 (Sept. 11, 2002) (For purposes of sec. 1031 like-kind exchange provisions: "[T]ransfer of all the interest in * * * [disregarded entity] will be treated
(continued...)

5, supra, and the letter rulings are cited not as precedent, see sec. 6110(k)(3), but to show the Commissioner's consistency over a decade in disregarding the wrapper and treating the transfer of an interest in a single-member disregarded entity as a transfer of an interest in the disregarded entity's assets, see, e.g., Hanover Bank v. Commissioner, 369 U.S. 672, 686 (1962) ("[Private letter] rulings do reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws."). Granted, the interpretations address sales and other dispositions for purposes of the income tax, and the Commissioner apparently has made no interpretation particular to section 2501(a) and the gift tax. Yet, as the Court of Appeals for the District of Columbia Circuit recently observed in Murphy v. IRS, 493 F.3d 170, 185 (D.C. Cir. 2007) (admittedly an income tax case, but the court was speaking generally about gifts): "A gift is the functional equivalent of a below-market sale". See also sec. 25.2512-8, Gift Tax Regs. ("Transfers reached by the gift tax * * * embrace * * * sales, exchanges, and other dispositions of property for * * * [an inadequate] consideration".). Simply put, the difference between a sale and a gift is a difference in degree, not in kind.

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[3](...continued)
as a transfer of the assets of * * * [disregarded entity].").

Given the assumed ambiguity of the activities instruction in section 301.7701-2(a), Proced. & Admin. Regs., and the deference we show to the Secretary's construction of his regulations, I accept respondent's reading of the activities instruction as a plausible construction. That is, because petitioner elected to treat Pierre LLC as a disregarded entity, petitioner is properly "treated as transferring cash and marketable securities, as opposed to Pierre LLC interests, for federal gift tax purposes." I next consider the validity of the regulation.

IV. Chevron Deference

I review the validity of the regulation because, although the majority denies that it seeks to invalidate the regulation, I believe that it does not simply reject the meaning respondent ascribes to the activities instruction but, rather, accepts that meaning and rejects the activities instruction itself as an invalid construction of the statute.[4]

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[4] The majority at least conditionally accepts respondent's reading of the check-the-box regulations: "If the check-the-box regulations are interpreted and applied as respondent contends, they go far beyond classifying the LLC for tax purposes." Majority op. p. 20. Indeed, the majority speculates that the result of respondent's reading would be to "[overturn] the long-established Federal gift tax valuation regime * * * as to single-member LLCs". Majority op. p. 20. That, the majority concludes, "would be 'manifestly incompatible' with the Federal estate and gift tax statutes as interpreted by the Supreme Court. See sec. 7701." Majority op. p. 20. The majority thus seems to accept respondent's reading of the check-the-box regulations but to conclude that that reading, and thus the activities instruction itself, is invalid because "manifestly incompatible" with the

(continued...)

The validity of the check-the-box regulations, at least as they applied to imposing employment tax obligations directly on the owner of a single-member disregarded entity, has been upheld by this Court, Med. Practice Solutions, LLC v. Commissioner, 132 T.C. __ (2009), and two U.S. Courts of Appeals, McNamee v. Dept. of the Treasury, 488 F.3d 100 (2d Cir. 2007), and Littriello v. United States, 484 F.3d 372 (6th Cir. 2007).[5] Barring stipulation to the contrary, appeal of this case will lie to the Court of Appeals for the Second Circuit. See sec. 7482(b)(1)(A), (2).

In McNamee, the taxpayer had elected to treat his single-member LLC as a disregarded entity. The Commissioner sought to recover employment taxes from the taxpayer that the LLC had failed to pay, on the ground that the LLC was disregarded for Federal tax purposes. The taxpayer objected that no regulation could deprive him of the protection from liability that local law afforded him as a member of an LLC and argued that the check-the-box regulations "'directly contradict the relevant statutory provisions of the Internal Revenue Code'". McNamee v. Dept. of

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[4](...continued) Internal Revenue Code. In this section of this separate opinion, I show that the regulation in issue, including the activities instruction, is a valid interpretation of the statute. In sec. III., supra, of this separate opinion, I have set forth the reasons respondent's reading of that regulation must be accepted.

[5] For employment taxes related to wages paid on or after Jan. 1, 2009, a disregarded entity is treated as a corporation for purposes of employment tax reporting and liability. Sec. 301.7701-2(c)(2)(iv), Proced. & Admin. Regs.

the Treasury, supra at 104. The relevant statutory provisions were the first three paragraphs of section 7701(a), defining the terms “Person”, “Partnership”, and “Corporation”. Id. at 106.[6]

In upholding the check-the-box regulations against challenge in McNamee v. Dept. of the Treasury, supra at 105, the Court of Appeals applied the following standard:

> In reviewing a challenge to an agency regulation interpreting a federal statute that the agency is charged with administering, the first duty of the courts is to determine “whether the statute’s plain terms ‘directly addres[s] the precise question at issue.’” National Cable & Telecommunications Ass’n v. Brand X Internet Services, 545 U.S. 967, 986 * * * (2005) * * * (quoting Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 843 * * * (1984)). “If the statute is ambiguous on the point, we defer . .

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[6] In pertinent part, sec. 7701(a) provides as follows:

SEC. 7701. DEFINITIONS.

> (a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof--
>
> > (1) Person.--The term “person” shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation.
> >
> > (2) Partnership * * *.--The term “partnership” includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation * * *
> >
> > (3) Corporation.--The term “corporation” includes associations * * *

> . to the agency's interpretation so long as the construction is 'a reasonable policy choice for the agency to make.'" National Cable, 545 U.S. at 986 * * * (quoting Chevron, 467 U.S. at 845 * * *). * * *

The Court of Appeals found the definitions ambiguous with respect to the classification of single-member LLCs. Id. at 106-107. Emphasizing the taxpayer's choice in having his LLC disregarded or treated as a corporation, the court concluded that the check-the-box regulations "[provided] a flexible response to a novel business form" and "are [not] arbitrary, capricious, or unreasonable." Id. at 109. In other words, notwithstanding the protection from the liabilities of his LLC that Mr. McNamee enjoyed under local law, see id. at 107, nothing in the relevant section 7701(a) definitions deprived the Secretary of the authority to write a regulation permitting Mr. McNamee to waive that protection, at least as it pertained to the employment tax liabilities of the entity, in exchange for escaping the double taxation that would result if he failed to make that waiver, see id. at 109, 111. The Court of Appeals thus rejected Mr. McNamee's contention that the limited liability rights he enjoyed under local law protected him from the Commissioner's action to collect his LLC's unpaid payroll taxes. Id. at 111.

Contrary to the majority's suggestion that State law, not Federal law, defines for valuation purposes under the Federal gift tax the property rights and interests a donor transfers (see majority op. p. 19), McNamee v. Dept. of the Treasury, supra, stands for the proposition that Federal law, in the form of the check-the-box regulations, does define the property rights and interests so transferred. In other words, the Court of Appeals in McNamee construed the check-the-box regulations to modify the bundle of rights that Mr. McNamee enjoyed under local law and that constituted ownership of the LLC.

We are not at this point discussing the meaning of the activities instruction, having settled that in section III., supra, of this separate opinion. We are considering only the validity of the regulation, section 301.7701-2(a), Proced. & Admin. Regs., setting forth that instruction. In the light of McNamee v. Dept. of the Treasury, supra,[7] I find that the first three paragraphs of section 7701(a), which, as in that case, appear to be the relevant statutory provisions, do not plainly speak to the question of whether, for gift tax purposes, the Secretary may write a regulation requiring that the wrapper be disregarded in determining what property the owner of a single-member disregarded entity transfers when she transfers an interest in the entity. As to the question of what constitutes the bundle of rights enjoyed by the owner of a single-member disregarded

[7] In considering the persuasive value of another court's opinion, we must consider not only the result but the rationale for that result. See Seminole Tribe of Fla. v. Florida, 517 U.S. 44, 67 (1996) ("When an opinion issues for the Court, it is not only the result but also those portions of the opinion necessary to that result by which we are bound.").

entity, the Court of Appeals clearly stated that, at least for payroll tax purposes (under the preamendment version of the regulation), the limited liability that local law accorded the owner is ignored. McNamee v. Dept. of the Treasury, 488 F.3d at 111. Indeed, section 301.7701-1(a)(1), Proced. & Admin. Regs., provides: "Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law." If the definitions in section 7701(a)(1) through (3) are consistent with disregarding one right in the bundle of rights enjoyed by the owner of a single-member disregarded entity, why are they not consistent with disregarding more than one right in that bundle; indeed, why are they not consistent with disregarding the entirety of the bundle (i.e., the wrapper) that separates the owner from the underlying assets? McNamee thus convinces me that, in the context of this case, the check-the-box regulations are not arbitrary, capricious, or unreasonable, and, therefore, are valid.

As I point out in section III., supra, of this separate opinion, the Commissioner has plainly taken the position that, pursuant to the check-the-box regulations, for purposes of the income tax, the wrapper is disregarded and the owner of a single-member disregarded entity transferring an interest in the entity is deemed to transfer an interest in the underlying assets of the entity. Neither petitioner nor the majority suggests that transfers of interests in single-member disregarded entities cannot be treated as described. While the income tax provisions of the Internal Revenue Code are not to be construed as though they were in pari materia with the gift tax provisions, Farid-Es-Sultaneh v. Commissioner, 160 F.2d 812, 814 (2d Cir. 1947), revg. 6 T.C. 652 (1946), there is nothing in the definitions in section 7701(a)(1) through (3) of “Person”, “Partnership”, and “Corporation” that indicates that those terms should have different meanings for purposes of the income and gift tax provisions of the Internal Revenue Code.

While the majority does not acknowledge that it is addressing the validity of the check-the-box regulations, I believe that it is rejecting the activities instruction as an invalid construction of the statute. See supra note 4 and accompanying text. Its reason for doing so is that “the Commissioner cannot by regulation overrule the historical Federal gift tax valuation regime contained in the Internal Revenue Code and substantial and well-established precedent in the Supreme Court, the Courts of Appeals, and this Court”. Majority op. p. 21. While certainly the Secretary cannot by regulation overrule the Internal Revenue Code, judicial construction of a statute must, except in one instance, give way to later administrative construction:

> A court’s prior judicial construction of a statute trumps an agency construction otherwise entitled to

> Chevron deference only if the prior court decision holds that its construction follows from the unambiguous terms of the statute and thus leaves no room for agency discretion. * * *

Natl. Cable & Telecomms. Association v. Brand X Internet Servs., 545 U.S. 967, 982 (2005).

Moreover, while application of the check-the-box regulations to section 2501(a) may well result in a radical departure from settled rules, as the majority suggests, see majority op. p. 21, the majority fails to acknowledge that, at the time of their adoption, the check-the-box regulations represented a radical departure for income tax purposes from prior caselaw and regulatory precedent, beginning with the seminal Supreme Court case of Morrissey v. Commissioner, 296 U.S. 344 (1935). The Supreme Court in Morrissey used various factors to classify business trusts as either true trusts or associations taxable as corporations (associations). Subsequent regulations extended the factors approach to the classification of other business entities. The check-the-box regulations, in effect, overrule Morrissey by providing that, with certain exceptions, an unincorporated organization comprising two or more associates may elect its classification, as a partnership or corporation, for Federal tax purposes, regardless of the number of corporate characteristics it possesses under State (or foreign) law. Moreover, the right of an unincorporated single-member organization with a preponderance of corporate characteristics, which constitutes an entity separate from its owner under State (or foreign) law, to elect to be disregarded for Federal income tax purposes was unprecedented under the then-existing law.[8] The check-the-box regulations thus constituted a radical departure from existing jurisprudence that prompted many commentators to question their validity. See Dover Corp. & Subs. v. Commissioner, 122 T.C. 324, 331 n.7 (2004). That concern has been put to rest by McNamee v. Dept. of the Treasury, 488 F.3d 100 (2d Cir. 2007), Littriello v. United States, 484 F.3d 372 (6th Cir. 2007), and Med. Practice Solutions, LLC v. Commissioner, 132 T.C. __ (2009), all of which concerned single-member disregarded entities. If the check-the-box regulations trump Supreme Court precedent regarding the role of State law in determining entity classification for Federal income or employment tax purposes, then surely they must also supersede judicial precedent respecting State law concepts of property rights for

[8] See, e.g., Hynes v. Commissioner, 74 T.C. 1266, 1286 (1980) (State law trust with a single beneficiary classified as an association because it possessed a preponderance of corporate characteristics, including associates and a joint profit motive); Barnette v. Commissioner, T.C. Memo. 1992-371 (German GmbH wholly owned by U.S. corporation classified as an association because it possessed a preponderance of the remaining four corporate characteristics after disregarding the two corporate characteristics absent from both one-man corporations and sole proprietorships; viz, “associates” and an objective to carry on a business for “joint” profit), affd. without published opinion 41 F.3d 667 (11th Cir. 1994); see also Wirtz & Harris, “Tax Classification of the One-Member Limited Liability Company”, 59 Tax Notes 1829 (June 28, 1993).

Federal gift (and estate) tax purposes. Yet that is precisely the conclusion the majority denies.

Respondent’s interpretation of section 301.7701-2(a), Proced. & Admin. Regs., is a valid construction of section 7701(a)(1) through (3).

V. Conclusion

As stated above, section 2501(a) imposes a tax on the transfer of property by gift and section 2512(a) provides that the amount of a gift of property is the value of the property on the date of the gift. We are here required to identify for purposes of those provisions the property petitioner transferred when she conveyed two 9.5-percent interests in Pierre LLC to two trusts. Respondent argues that, because petitioner elected to treat Pierre LLC as a disregarded entity, she is properly treated as transferring two 9.5-percent undivided interests in the LLC’s assets rather than two 9.5-percent interests in the LLC itself. Respondent relies on the check-the-box regulations as authority to so identify the property petitioner transferred. After applying traditional tools of statutory and regulatory construction to the pertinent language of the regulations, I agree with respondent as to the identity of the property transferred.

In conclusion, I note that, when identifying the property transferred for purposes of the gift tax, applying the check-the-box regulations in the manner respondent construes them will not always be adverse to taxpayers. If the donor transfers a controlling interest in her single-member disregarded entity holding, say, real property, the discount attaching to the undivided interest in the real property deemed transferred may exceed the discount, if any, attaching to the controlling interest nominally transferred.[9] The check-the-box regulations put the choice of entity classification in the hands of the taxpayer. That the taxpayer bears any burden along with the benefits seems only fair.

KROUPA and HOLMES, JJ., agree with this dissenting opinion.

[9] Here it appears that petitioner has not claimed a discount on account of any undivided interest in property transferred.

KROUPA, J., dissenting: The majority opinion allows an octogenarian taxpayer to give away $4.25 million in cash and marketable securities at a substantial discount in gift taxes because she put them in a limited liability company (LLC), despite a regulation telling us that “for federal tax purposes,” that LLC should be “disregarded.” The majority is either ignoring the plain language of the regulation or silently invalidating it. I must respectfully dissent.

The majority fails to apply the plain language of sections 301.7701-1 through 301.7701-3, Proced. & Admin. Regs. (collectively the check-the-box regulations), which require that a single-member LLC be disregarded for “federal tax purposes.” As the trier of fact, I find no fault with the facts upon which the majority addresses the legal issue. I take exception, however, to how the majority frames the legal issue. Neither party argued that the regulations are invalid. Yet the majority has, in effect, invalidated the check-the-box regulations for Federal gift tax purposes without providing the necessary legal analysis to do so.

I. The Plain Language of the Check-the-Box Regulations

The check-the-box regulations provide that an “entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner.” Sec. 301.7701-3(a), Proced. & Admin. Regs. The regulations further provide that “[w]hether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.”[1] Sec. 301.7701-1(a)(1), Proced. & Admin. Regs. (emphasis added). The crux of my dispute with the majority is how the majority interprets these provisions.

The majority ignores the plain language of the check-the-box regulations and holds instead that Pierre LLC must be respected as an entity separate from petitioner for Federal gift tax purposes. The majority fails to discuss, however, what it means for an entity not to be “separate” from its owner. The regulations provide that the owner of a disregarded entity is treated as the owner of its property. See sec. 301.7701-3(g)(1)(iii) and (iv), Proced. & Admin. Regs. Likewise, the Court of Appeals for the Second Circuit, the court to which this case is appealable,[2] has said “‘if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship * * * of the owner.’” McNamee v. Dept. of the Treasury, 488 F.3d 100, 107-108 (2d Cir.

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[1]The Commissioner has set forth specific, limited exceptions in the regulations to this general rule that took effect after the year at issue. See sec. 301.7701-2(c)(2)(iii), (iv), and (v), Proced. & Admin. Regs. He has also issued Chief Counsel Advice 199930013 (Apr. 18, 1999) concluding that a single-member LLC could not be disregarded for collection purposes under secs. 6321 and 6331.

[2]Petitioner resided in New York when she filed the petition. See sec. 7482(b)(1)(A).

2007) (quoting section 301.7701-2(a), Proced. & Admin. Regs.). Yet the majority ignores these authorities and minimizes the check-the-box regulations as simply rules of classification for Federal income tax purposes. See majority op. pp. 11-15, 20. In doing so, the majority limits the phrase “federal tax purposes” to Federal income tax purposes. See majority op. pp. 19-20. The majority’s interpretation is wrong for several reasons.

First, the check-the-box regulations do not read “for federal income tax purposes.” Instead, the regulations are drafted broadly. The check-the-box regulations apply to the entire Code. See sec. 7701(a). Had the drafters of the check-the-box regulations intended that they apply only for income tax purposes, the drafters would have used the phrase “federal <u>income</u> tax purposes.” This phrase is used extensively throughout the regulations. See, e.g., sec. 1.6050K-1(e)(2), Income Tax Regs.; sec. 53.4947-1(b)(2)(iii), Foundation Excise Tax Regs.; sec. 301.6362-5(c)(1)(i), Proced. & Admin. Regs. The drafters expressed their intent when they chose not to limit the regulations’ scope to Federal <u>income</u> tax.

In addition, the drafters could have specifically excluded gift tax from the regulations’ scope had the drafters intended that result. They did not do so when the regulations were originally drafted. See T.D. 8697, 1997-1 C.B. 215. They also did not do so when the regulations were subsequently amended specifically to exclude employment and certain excise taxes from the regulations’ scope concerning disregarded entity status. See sec. 301.7701-2(c)(2)(iv) and (v), Proced. & Admin. Regs.; T.D. 9356, 2007-2 C.B. 675 (effective January 1, 2009). Tellingly, the preamble to the amended regulations states that single-owner entities “generally would continue to be treated as disregarded entities for other federal tax purposes” after amendment. See Notice of Proposed Rulemaking, 70 Fed. Reg. 60475 (Oct. 18, 2005). I fail to see how “for other federal tax purposes” means “for other Federal tax purposes except gift tax purposes.”

The check-the-box regulations expressly tell us to treat the owner of a single-member LLC as the owner of its assets. Sec. 301.7701-3(g)(1)(iii) and (iv), Proced. & Admin. Regs. In addition, the owner of a disregarded entity that elects to have the entity treated as a corporation is deemed to have contributed all of the assets and liabilities of the entity to a corporation in exchange for stock. Sec. 301.7701-3(g)(1)(iv), Proced. & Admin. Regs. Similarly, a single-member corporation that elects to be disregarded is treated as distributing all of its assets and liabilities to its single owner. Sec. 301.7701-3(g)(1)(iii), Proced. & Admin. Regs. The check-the-box regulations consistently treat single owners who choose noncorporate status for their LLCs as holding the property of these disregarded entities.[3]

The majority also fails to address other guidance from the Commissioner that treats the owner of a single-member LLC as the owner of its underlying property. Rev. Rul. 99-5, 1999-1 C.B. 434, describes the Federal tax consequences when a disregarded single-member LLC becomes an entity with more than one owner and is classified as a partnership for Federal tax purposes. The ruling requires that the single owner be treated as selling an interest in each of the assets if an interest in the LLC is sold. Id. The ruling also states that, if the interest is obtained through a capital contribution, the single owner is treated as having contributed all of the assets of the LLC to the new partnership for an interest. Id. In both instances, the single owner is treated as the owner of the assets of the LLC as required under the check-the-box regulations.

The majority further ignores the Commissioner's consistent treatment of single-member LLC owners as the owners of the LLC's underlying assets. The Commissioner has issued numerous private

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[3]There is nothing radical about this. It is essentially a limited form of piercing the corporate veil "for federal tax purposes." The State-law concept of piercing the corporate veil means, and the regulations echo, that a "court will disregard the corporate entity * * * and treat as identical the corporation and the individual or individuals owning all its stock and assets." 14 N.Y. Jur.2d Business Relationships sec. 34 (2009).

letter rulings on this issue.[4] For example, the owner of a single-member LLC is treated as owning the LLC’s underlying assets for purposes of determining like-kind exchange treatment on the exchange of property under section 1031(a)(1), though the owner has no State law property interest in the LLC’s assets.[5] See Priv. Ltr. Rul. 200732012 (May 11, 2007); Priv. Ltr. Rul. 200251008 (Sept. 11, 2002); Priv. Ltr. Rul. 200131014 (May 2, 2001); Priv. Ltr. Rul. 200118023 (Jan. 31, 2001); Priv. Ltr. Rul. 199911033 (Dec. 18, 1998); Priv. Ltr. Rul. 9807013 (Nov. 13, 1997); Priv. Ltr. Rul. 9751012 (Sept. 15, 1997). Despite the Commissioner’s consistent treatment of single owners as the owners of the LLCs’ underlying property, the majority insists that the check-the-box regulations do not apply to determine what property the single owner owns for Federal gift tax purposes. See majority op. p. 20.

I know of no provision in the Code that requires us to treat the term “property” used in section 1031(a)(1) differently for

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[4]Private letter rulings may be cited to show the practice of the Commissioner. See Rowan Cos. v. United States, 452 U.S. 247, 261 n.17 (1981); Hanover Bank v. Commissioner, 369 U.S. 672, 686-687 (1962); Dover Corp. & Subs. v. Commissioner, 122 T.C. 324, 341 n.12 (2004).

[5]This treatment has not been limited to like-kind exchange situations. See Priv. Ltr. Rul. 200134025 (May 22, 2001) (single member of a disregarded entity is treated as the owner of property it receives for purposes of the exemptions under sec. 514(b)(1)(A) and (c)(9)); Priv. Ltr. Rul. 9739014 (June 26, 1997) (a single-member LLC is a qualified subchapter S shareholder because the LLC is disregarded under the regulations).

purposes of section 2501, which imposes a tax on the transfer of property by gift. The Supreme Court has already told us that the meaning of the word "property" in the Code is a Federal question and Federal courts are "in no way bound by state courts' answers to similar questions involving state law." United States v. Craft, 535 U.S. 274, 288 (2002). The majority's reliance on what it calls the longstanding gift tax regime to create such a difference addresses neither the plain language nor the intent of the check-the-box regulations.

II. The Majority Invalidates the Regulations for Federal Gift Tax Purposes

The majority concludes that the check-the-box regulations do not apply for Federal gift tax purposes. See majority op. p. 20. I disagree. I do not minimize a plain language interpretation of the regulations as merely respondent's litigating position. To do so promotes a distinction without a difference. Instead, I interpret "federal tax purposes" to mean "federal tax purposes," including Federal gift taxes.

The majority, in effect, invalidates the check-the-box regulations to the extent that the term "federal tax purposes" encompasses Federal gift tax. The majority does not, however, provide the necessary analysis to do so. How could they, given that this Court and the Courts of Appeals for the Second and Sixth Circuits have recently blessed the regulations as "eminently reasonable"? McNamee v. Dept. of the Treasury, 488 F.3d at 109;

Littriello v. United States, 484 F.3d 372, 378 (6th Cir. 2007); see Med. Practice Solutions, LLC v. Commissioner, 132 T.C. __ (2009). Instead, the majority concludes that the Commissioner cannot by regulation overrule the Federal gift tax regime as interpreted by this Court and others. See majority op. p. 21.

The majority must provide further analysis. An agency may promulgate regulations that overcome the judiciary's prior construction of a statute, even an entire "regime's" worth of construction, unless that prior construction followed from the statute's unambiguous terms. See Natl. Cable & Telecomms. Association v. Brand X Internet Servs., 545 U.S. 967, 982 (2005); Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 863-864 (1984) (an agency may change its prior interpretation of a statute to meet changing circumstances); Dickman v. Commissioner, 465 U.S. 330, 343 (1984) ("it is well established that the Commissioner may change an earlier interpretation of the law, even if such a change is made retroactive in effect"). Thus, the majority's reliance on the longstanding gift tax regime before the issuance of the check-the-box regulations is not enough to invalidate the regulations if the related statute is ambiguous.

The Court of Appeals for the Second Circuit has already held that section 7701 is ambiguous as to the Federal tax treatment of single-member LLCs. McNamee v. Dept. of the Treasury, supra at 107. Further, the court concluded that the check-the-box regulations reasonably interpret, and fill gaps in, an ambiguous statute and are entitled to deference under Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., supra. McNamee v. Dept. of the Treasury, supra at 105-107; see Littriello v. United States, supra at 376-378. The majority ignores this relevant Second Circuit precedent and concludes, without discussion of any degree of deference, that an entity's classification for income tax purposes is irrelevant to how a donor must be taxed under the Federal gift tax provisions on a transfer of an ownership interest in the LLC. See majority op. pp. 19-20.

The majority misstates the issue. The majority writes that:

> While we accept that the check-the-box regulations govern how a single-member LLC will be taxed for Federal tax purposes, i.e., as an association taxed as a corporation or as a disregarded entity, we do not agree that the check-the-box regulations apply to disregard the LLC in determining how a donor must be taxed under the Federal gift tax provisions on a transfer of an ownership interest in the LLC. * * *

Majority op. pp. 19-20. The check-the-box regulations determine whether a single-member entity exists at all for Federal tax purposes rather than how that entity will be taxed.

The majority distinguishes between the "classification" and the "valuation" of an entity. But that distinction is false. The gift tax regulations provide guidance on how to value interests in a corporation, a partnership, and a proprietorship. See secs. 25.2512-2 and 25.2512-3, Gift Tax Regs. They do not provide guidance on how to value an interest in a single-member LLC.

Accordingly, we must first “classify” the entity, and only then can we “value” its interests. I submit that the ambiguity of section 7701 extends to gift tax valuation. The majority cannot trivialize the check-the-box regulations by dismissing them as irrelevant.

III. The Majority’s Reliance on the Gift Tax Regime

The majority concludes that it would be manifestly incompatible with the gift tax regime if we did not respect Pierre LLC for gift tax purposes because New York law provides that a member has no interest in specific property of the LLC while a membership interest in an LLC is personal property. N.Y. Ltd. Liab. Co. Law sec. 601 (McKinney 2007). I disagree. The check-the-box regulations provide the Federal tax consequences of what is, in effect, an agreement between the taxpayer and the Commissioner to treat an entity in a certain way for Federal tax purposes despite the entity’s State law classification. There is simply no LLC interest left to value for Federal gift tax purposes when a single-member LLC elects to be disregarded. It therefore does not matter whether State law recognizes an LLC as a valid entity or provides that a member has no interest in any of the specific property of the LLC. See sec. 301.7701-1(a)(1), Proced. & Admin. Regs. The check-the-box regulations specifically say that Federal law determines whether a single-member entity is recognized as separate from its owner. Id.

The majority dismisses relevant precedent from two Federal Courts of Appeals addressing this conflict between State law rights of single-member LLC owners and the consequences of disregarded entity status under the check-the-box regulations. See McNamee v. Dept. of the Treasury, 488 F.3d 100 (2d. Cir. 2007); Littriello v. United States, 484 F.3d 372 (6th Cir. 2007). The Court of Appeals for the Second Circuit rejected a taxpayer's argument that he was not liable for his single-member LLC's unpaid payroll taxes because Connecticut law provided that the owner is not personally liable for the LLC's debts. See McNamee v. Dept. of the Treasury, supra. The court noted that, while State laws of incorporation control various aspects of business relations, they may affect, but do not necessarily control, the application of Federal tax provisions. Id. at 111 (quoting Littriello v. United States, supra at 379). Accordingly, a single-member LLC is entitled to whatever advantages State law may extend, but State law cannot abrogate its owner's Federal tax liability. Id.

The majority minimizes this relevant analysis in McNamee and Littriello. The majority summarily concludes that it is not relevant because the courts did not specifically address gift tax. See majority op. p. 15. The courts had no reason to address gift tax issues. That does not mean, however, that the courts' analyses should be ignored.

Both the McNamee and Littriello courts recognized that the check-the-box regulations applied equally to the nonincome-tax issue of employment tax liability. Determining an owner’s liability for employment taxes is as far removed from determining the owner’s income tax liability as is determining the owner’s gift tax liability. The Code imposes both Federal employment tax liability and Federal gift tax liability separate and apart from determining a taxpayer’s income tax liability. The majority fails to recognize that the single owner’s liability for employment taxes turns upon disregarding the LLC for Federal tax purposes rather than upon the identity of the taxpayer. See Med. Practice Solutions, LLC v. Commissioner, 132 T.C. at __ (slip op. at 5) (a single-member LLC “and its sole member are a single taxpayer or person to whom notice is given”); see also McNamee v. Dept. of the Treasury, supra at 111 (an entity disregarded as separate from its owner “cannot be regarded as the employer”); Littriello v. United States, supra at 375, 378 (recognizing a single owner as the individual who “owns all the assets, is liable for all debts, and operates in an individual capacity”). Despite the majority’s wish, Pierre LLC does not exist apart from petitioner for gift tax purposes, and petitioner should be treated as holding its assets.

Further, the Second and Sixth Circuit Courts of Appeals stressed that the taxpayer could have escaped personal liability for the LLC’s tax debt if the taxpayer had simply elected corporate status for the single-member LLC. McNamee v. Dept. of the Treasury, supra at 109-111; Littriello v. United States, supra at 378. The same principle applies here. Petitioner could have elected to treat Pierre LLC as a corporation. She did not. The Supreme Court has repeatedly recognized that "while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not." Commissioner v. Natl. Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974). I would hold petitioner to her choice.

Finally, the majority overlooks the broad scope of the gift tax statutes in concluding that the check-the-box regulations are manifestly incompatible with the gift tax regime. Congress intended to use the term "gifts" in its most comprehensive sense. Commissioner v. Wemyss, 324 U.S. 303, 306 (1945). The gift tax applies whether the gift is direct or indirect. Sec. 2511. Accordingly, transfers of property by gift, by whatever means effected, are subject to Federal gift tax. Dickman v. Commissioner, 465 U.S. at 334. Moreover, we have used substance over form principles to get to the true nature of the gift where the substance of a gift transfer does not fit its form. See Kerr v. Commissioner, 113 T.C. 449, 464-468 (1999), affd. on another issue 292 F.3d 490 (5th Cir. 2002); Astleford v. Commissioner, T.C. Memo. 2008-128; Estate of Murphy v. Commissioner, T.C. Memo.

1990-472. We have also used the step transaction doctrine, which has been called "'well-established'" and "'expressly sanctioned'" in the area of gift tax where intra-family transactions often occur. See Senda v. Commissioner, 433 F.3d 1044, 1049 (8th Cir. 2006) (quoting Commissioner v. Clark, 489 U.S. 726, 738 (1989)), affg. T.C. Memo. 2004-160. The majority would instead have us apply the opposite approach, accepting petitioner's own label rather than the substance of her choice.

Despite this broad expanse of gift taxes, the majority would require Congressional action before any State law property right could be disregarded for Federal gift tax purposes. See majority op. pp. 20-21. The majority cites four special valuation statutes (sections 2701-2704) to imply that Congress will take action when necessary to overcome the "willing buyer, willing seller" gift tax valuation rule. See majority op. p. 21. I know of no authority, however, that prevents the promulgation of regulations affecting the so-called gift tax regime.

IV. Conclusion

The plain language of the regulations requires Pierre LLC to be "disregarded as an entity separate from its owner." Unlike the majority, I give meaning to these words. I do not minimize this language by labeling it a classification. A plain language interpretation of the check-the-box regulations must prevail. It is an interpretation of relevant regulations. It is not manifestly incompatible with the gift tax statutes.

For the foregoing reasons, I respectfully dissent.

COLVIN, HALPERN, GALE, HOLMES, and PARIS, JJ., agree with this dissenting opinion.

Filed 9/27/17

CERTIFIED FOR PUBLICATION

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

FOURTH APPELLATE DISTRICT

DIVISION TWO

LUZ SOLAR PARTNERS LTD., III et. al., Plaintiffs and Appellants, v. SAN BERNARDINO COUNTY et al., Defendants and Respondents.	E064882 (Super.Ct.No. CIVDS1413098) OPINION

APPEAL from the Superior Court of San Bernardino County. David Cohn, Judge. Affirmed.

Drinker Biddle & Reath, George T. Caplan, Kristopher S. Davis, and Paul M. Gelb for Plaintiffs and Appellants.

Jean-Rene Basle, County Counsel, and Richard D. Luczak, Deputy County Counsel, for Defendant and Respondent San Bernardino County.

Jean-Rene Basle, County Counsel, and Eric Yee, Deputy County Counsel, for Defendant and Respondent Assessment Appeals Board of San Bernardino – Board No. 2.

Plaintiffs and appellants Luz Solar Partners Ltd., III; Luz Solar Partners Ltd., IV; Luz Solar Partners Ltd., V; Luz Solar Partners Ltd., VI; Luz Solar Partners Ltd., VII; Luz Solar Partners Ltd., VIII and Harper Lake Company VIII; and Luz Solar Partners Ltd., IX and HLC IX (collectively "Luz Partners") challenge the assessment of real property improved with solar energy generating systems (SEGS units) for tax years 2011-2012 and 2012-2013. They contend that defendants and respondents San Bernardino County (County) and the Assessment Appeals Board of San Bernardino County (Appeals Board) erroneously relied on the State of California Board of Equalization's (Board) incorrect interpretation of the applicable statutes governing the method of assessing the value of the property. Rejecting their contention, we affirm.

I. PROCEDURAL BACKGROUND AND FACTS

In 1980, the Legislature was given "the authority to exclude the construction of certain active solar energy systems from property tax assessment." (Cal. Const., art. XIIIA, § 2.) As a result, it enacted Revenue and Taxation Code[1] section 73, which excludes newly constructed energy systems from the definition of "new construction" such that they are not considered, for property tax purposes, to be improvements that add value.[2] In 2011, "the Legislature added intent language declaring that section 73 was

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[1] Further unspecified statutory references are to the Revenue and Taxation Code.

[2] "The assessor shall administer this subdivision in the following manner: [¶] (A) The initial purchaser of the building shall file a claim with the assessor and provide to the assessor any documents necessary to identify the value attributable to the active solar energy system included in the purchase price of the new building. . . . [¶] (B) The assessor shall evaluate the claim and determine the portion of the purchase price that is

[footnote continued on next page]

enacted to encourage the building of active solar energy systems" by providing tax benefits for new construction. (§ 73 [Stats. 2011-2012, 1st Ex. Sess., ch. 3, § 2 (Assem. Bill XI 15), effective June 28, 2011].)

Between 1986 and 1991, Luz Partners built seven utility SEGS units. SEGS units generate electricity largely through solar energy; however, conventional boilers and furnaces fueled by natural gas are used as a backup source of power generation. The solar component is comprised of mirrors, conduits, generators, and transformers, and accounts for approximately 97 percent of the cost of installation of a SEGS unit. The nonsolar component is comprised of the natural gas boilers and furnaces, and accounts for approximately 3 percent of the cost of installation of the SEGS unit.

Until 2010, the County was the only California county to have real property improved with SEGS units (solar property). As such, the County had to develop its own procedure for assessing the solar property in compliance with section 73. The San Bernardino County Assessor (Assessor) did this by valuing the solar property with the nonsolar component of the SEGS unit based on the then-current market values for boilers and furnaces, and placing those values on the assessment rolls under the fixtures category. Under this method, the Assessor found that from year to year, these assessed

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attributable to the active solar energy system. The assessor shall then reduce the new base year value established as a result of the change in ownership of the new building by an amount equal to the difference between the following two amounts: [¶] (i) That portion of the value of the new building attributable to the active solar energy system." (Former § 73, subd. (e)(1) [Stats. 2008, ch. 538, § 1 (Assem. Bill 1451), effective Sept. 28, 2008].)

values generally declined as the boilers and furnaces depreciated. There is no dispute that the nonsolar component parts have lost most of their original value.

As more solar facilities were constructed throughout the state, assessors sought guidance on handling solar property appraisals from the Board. The Board provides guidance to county assessors in connection with the classification, assessment and taxation of property and does so, in part, by way of letters to assessors. (*Maples v. Kern County Assessment Appeals Bd.* (2002) 96 Cal.App.4th 1007, 1015.) It further is charged with promulgating rules and regulations to ensure statewide uniformity in appraisal practices. (Gov. Code, § 15606, subd. (c).)

On June 16, 2009, the Board issued a letter to assessors titled "Decline In Value: Excluded New Construction" with instructions to include the solar component of the SEGS unit in an estimate of full cash value of the solar property.[3] According to the Board's letter, pursuant to section 51,[4] the full cash value of the solar property (including

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[3] Later, on December 6, 2012, the Board issued "Guidelines for Active Solar Energy Systems New Construction Exclusion" to clarify the assessment methodology for solar properties.

[4] Section 51, subdivision (a), in relevant part, provides: "For purposes of subdivision (b) of Section 2 of Article XIIIA of the California Constitution, for each lien date after the lien date in which the base year value is determined pursuant to section 110.1, the taxable value of real property shall, except as otherwise provided in subdivision (b) or (c), be the lesser of: [¶] (1) Its base year value, compounded annually since the base year by an inflation factor . . . . [¶] . . . [¶] (2) Its full cash value, as defined in Section 110, as of the lien date, taking into account reductions in value due to damage, destruction, depreciation, obsolescence, removal of property, or other factors causing a decline in value." Section 51, subdivision (d), further defines real property as "that appraisal unit that persons in the marketplace commonly buy and sell as a unit, or that is normally valued separately."

[footnote continued on next page]

items exempted under section 73) is considered for fair market comparison purposes to the factored base year value. Under section 51, subdivision (a), real property is assessed on the basis of the lesser of two possible taxable values. One alternative is the base year value (i.e., the value of the property at the time of acquisition), as adjusted for inflation since the base year, not to exceed 2 percent each year, to produce the "factored" base year value. (§ 51, subd. (a)(1).) The other alternative is the full cash, or market, value.[5] (§ 51, subd. (a)(2).) The Board instructed assessors to "annually enroll the lower of a property's factored base year value or its full cash value as of the lien date, as defined in section 110." Section 110, in relevant part, provides that full cash value is "the amount of cash or its equivalent that property would bring *if exposed for sale* in the open market under conditions in which neither buyer nor seller could take advantage of the exigencies of the other. . . ." (§ 110, subd. (a), italics added.) The Board specified that the section 73 "exclusions do not extend through subsequent reassessment prompted by a change in ownership of the real property. When a property with excluded new construction sells, the excluded new construction becomes assessable along with everything else on the property. Since an estimate of full cash value for decline-in-value purposes is made as if the property was exposed for sale, the full cash value should not be reduced by the value

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[5] "In a rising real estate market, the factored base year value will generally be the lower of the two alternatives. But the full cash value of a parcel may drop below the factored base year value 'due to damage, destruction, depreciation, obsolescence, removal of property or other factors' [citation], such as a general decline in market demand. In that event, the assessor must base the assessment on that lower value." (*El Dorado Palm Springs, Ltd. v. Board of Supervisors* (2002) 104 Cal.App.4th 1262, 1271-1272 (conc. & dis. opn. of McKinster, J.).)

of any excluded new construction." In short, for the purpose of conducting a section 51 comparison to determine whether there has been appreciation or depreciation, the Board's guidelines directed that the factored base year value should include only the nonsolar component, but the current full cash value should include both the solar and the nonsolar component. The lower of the two values thus serves as the basis for calculating the amount of property tax owed.

When the Assessor applied the Board's assessment methodology to the 2011 and 2012 tax years, the result was an increase of approximately 150 percent in Luz Partners's taxes. Given the significant increase, Luz Partners applied for a changed assessment of seven solar properties. On May 7, 2014, following a hearing and briefing, the Appeals Board released its decision denying the application.

Luz Partners filed the underlying Superior Court action on September 5, 2014, seeking a refund of the alleged excess property taxes paid for the 2011 and 2012 tax years. They also challenged the constitutionality of the methodology used by the Assessor. On August 31, 2015, the trial court ruled against Luz Partners, and on October 5, 2015, it entered judgment in favor of the County and the Appeals Board.

II. DISCUSSION

This case concerns the validity of the assessment methodology that the Assessor uses to calculate the annual tax on solar properties (i.e., properties improved with the construction of SEGS units). The Assessor compared the solar property's factored base year value (including only the nonsolar fixtures, or 3 percent) with its current full cash value (including both solar and nonsolar fixtures, or 100 percent), and used the lower of the two for assessing the property tax owed.

A. Standard of Review.

"Where the taxpayer claims a valid valuation method was improperly applied, the trial court is limited to reviewing the administrative record. [Citation.] The court may overturn the assessment appeals board's decision only if there is no substantial evidence in the administrative record to support it. [Citation.] However, where the taxpayer challenges the validity of the valuation method itself, the court is faced with a question of law. In such a case, the court does not evaluate whether substantial evidence supports the board's decision, but rather must inquire into whether the challenged valuation method is arbitrary, in excess of discretion, or in violation of the standards prescribed by law. [Citation.]" (*Maples v. Kern County Assessment Appeals Bd.*, *supra*, 96 Cal.App.4th at p. 1013; see *Georgiev v. County of Santa Clara* (2007) 151 Cal.App.4th 1428, 1437.)

The interpretation and application of a statute is a question of law which is reviewed de novo on appeal. (*Reilly v. City and County of San Francisco* (2006) 142 Cal.App.4th 480, 487.) However, the Board's interpretation of the statutes it is charged with implementing is generally entitled to significant deference. (*Benson v. Marin County Assessment Appeals Bd.* (2013) 219 Cal.App.4th 1445, 1455-1457; see, e.g., *Coca-Cola Co. v. State Board of Equalization* (1945) 25 Cal.2d 918, 921 [administrative construction entitled to great weight]; see also *Sea World, Inc. v. County of San Diego* (1994) 27 Cal.App.4th 1390, 1405 [weight may be accorded to letters to assessors].)

The validity of the assessment methodology used by the Assessor in appraising the solar properties is a question of law subject to de novo review.

B. Analysis.

Luz Partners challenges the assessment methodology advanced by the Board, contending that it (1) violates sections 51 and 73 because it does not use the same "appraisal unit" when comparing the factored base year value to the current full cash value, and (2) treats the nonsolar component as if it were appreciating. These same claims are used to support Luz Partners's criticism of the trial court's order. As we explain below, we reject them.

1. The Appraisal Unit.

In order to determine whether the assessment methodology violates sections 51 and 73, we must begin with a determination of what constitutes the appraisal unit. The properties in this case are unique because they are improved with SEGS units that consist of active solar electric generating systems (solar component) and natural gas boilers and furnaces (nonsolar component) to make electricity. The nonsolar component (3 percent) of the SEGS unit is subject to taxation; however, under section 73, the solar component (97 percent), absent a change in ownership, is exempt from property taxation. The two systems can operate independently, but their values are dependent upon each other; neither component is bought or sold separately in the open market.

Luz Partners maintains that the proper appraisal unit consists solely of the nonsolar component not exempted from taxation under section 73. However, section 73 does not dictate what constitutes an appraisal unit when valuing SEGS units. Instead, the definition of appraisal unit is found in section 51, which provides that an appraisal unit is that which "*persons in the marketplace commonly buy and sell as a unit, or that is normally valued separately*." (§ 51, subd. (d), italics added; see *Western States Petroleum Assn. v. Board of Equalization* (2013) 57 Cal.4th 401, 417-418.) In this case, persons in the marketplace would purchase the real property improved by the SEGS unit (including both solar and nonsolar components) because there is no separate market for the nonsolar component (boilers and furnaces). (*Exxon Mobil Corp. v. County of Santa Barbara* (2001) 92 Cal.App.4th 1347, 1353 [in determining whether a property is part of a larger appraisal unit, the assessor or board should consider, among other factors, which unit is most likely to be sold, if the property were exposed to the open market].) Thus, the appraisal unit includes the real property improved with the integrated SEGS unit.

We reject the claim of Luz Partners that respondents changed the appraisal unit.[6] They contend that the respondents "ignore [Property] Tax Rule 461(e)[[7]] which states that 'the same' appraisal unit that is used for the base year value must be used for the current lien date value when conducting Section 51's decline in value analysis." They further contend that the appraisal unit is limited to the boilers and furnaces (3 percent of the

[6] On September 30, 2016, Luz Partners requested judicial notice of an excerpt from Section 504 of the Assessor's Handbook and the May 29, 2003, letter to assessors entitled "HIERARCHY OF PROPERTY TAX AUTHORITIES." On October 17, 2016, the County responded that it does not oppose the request. The request is granted. (Evid. Code, § 452, subd. (c); *Board of Supervisors v. Lonergan* (1980) 27 Cal.3d 855, 866, fn. 11.

[7] Cal. Code Regs., tit. 18, § 461, subd. (e).

original value of the SEGS unit) because that was the only taxable equipment considered in determining the factored base value.

As previously noted, the appraisal unit is what people "in the marketplace commonly buy and sell." (§ 51, subd. (d).) The properties at issue here are real properties improved with SEGS units that are used as integrated units, including both solar and nonsolar components. If and when Luz Partners decides to sell, it will sell the real properties improved with the SEGS units (including both solar and nonsolar components). The very fact that the parties were able to allocate 97 percent of the cost of the SEGS unit to the solar component, and 3 percent of the cost of the SEGS unit to the nonsolar component, means that it takes both components to make 100 percent of the SEGS unit. In assessing the solar property's base year value for taxation purposes, section 73 allows for the exclusion of the solar component, or 97 percent of each SEGS unit. As long as ownership of the solar property remains the same or there is no new construction, Luz Partners will continue to realize the benefits of the base year value. However, the appropriate appraisal unit remains the solar property, including the complete SEGS unit, because that is the only unit that captures the full cash value for comparison purposes under section 51, even though 97 percent remains exempt from taxation under section 73.

Notwithstanding the above, Luz Partners argues that Property Tax Rules, rule 324, together with section 73's mandate that the only taxable portion of the SEGS unit is the nonsolar component, require the conclusion that the proper appraisal unit is the property with the nonsolar component only. Not so.

Under the authority of Government Code section 15606, subdivision (c), the State Board of Equalization promulgated Property Tax Rules, rule 324. Said rule authorized the board "to determine the full value of property or other issues, while limited by the laws of this state and the laws of the United States . . . ." (Cal. Code Regs., tit. 18, § 324, subd. (b).) It further defined an appraisal unit of property as "a collection of assets that functions together, and that persons in the marketplace commonly buy and sell as a single unit or that is normally valued in the marketplace separately from other property, *or that is specifically designated as such by law*." (Cal. Code Regs., tit. 18, § 324, subd. (b), italics added.) It is the italicized language that Luz Partners relies upon to support its argument.

As previously noted, section 73 exempts the solar component of the SEGS units from taxation. However, section 51, subdivision (d), defines an appraisal unit as that which "persons in the marketplace commonly buy and sell as a unit, or that is normally valued separately." (§ 51, subd. (d).) Property Tax Rules, rule 324(b) prescribes consideration of both sections 51 and 73 in determining what constitutes an appraisal unit. Our analysis above does just that, and reconciles any alleged inconsistency in the statutes in favor of section 51, which specifically defines an appraisal unit.

2. The Assessment Methodology.

Prior to 2010, the Assessor considered the nonsolar component of the SEGS unit (3 percent) in establishing the base year value of the solar property. Furthermore, every year thereafter, the Assessor continued to look only at the nonsolar component of the SEGS unit (which depreciated every year) for calculating the real property's value for tax purposes. However, as more SEGS units were constructed, assessors sought guidance on how to value solar properties. In response, the Board analyzed and interpreted article XIII of the California Constitution, Property Tax Rules, rules 324 and 461 (Cal. Code Regs., tit. 18, §§ 324, 461) and sections 51 and 73, and issued its June 16, 2009, letter that provided the backbone of the authority, and the December 6, 2012, guidelines, which provided extensive details of assessing solar property.

According to the Board's guidelines, once a base year value of the solar property is established, section 73's job is complete, and the focus shifts to section 51 which, in accordance with Proposition 13 (limiting any increase of the value of real property except when there is a change of ownership or new construction) and Proposition 8 (providing for a reduction in real property assessments when there is a decline in market value), addresses any appreciation/depreciation in the solar property's value. Pursuant to section 51, the Assessor is to base the tax assessment on the lesser of the solar property's factored base year value (i.e., nonsolar equipment only pursuant to section 73) or the solar property's current full cash value (i.e., both nonsolar and solar equipment). Here, the lesser was the solar property's factored base year value. The value of the excluded solar equipment was never enrolled; it was only considered for comparing the factored base year value to the current full cash value. There was no violation of section 73 or any internal contradiction.

In challenging the new assessment methodology, Luz Partners asserts that it treats depreciating assets as if they were appreciating. It claims that by comparing the factored base year value (3 percent of the SEGS unit) against the current cash value (100 percent of the SEGS unit), the Assessor "always ends up treating the only taxable portion of these SEGS as if it were appreciating, and thereby increasing the value entered on the roll and increasing the taxes each year, even though the Non-Solar component, which is wholly comprised of equipment and machinery, incontrovertibly is depreciating." Once again, the claim of Luz Partners is premised on its view that the SEGS units should be separated into solar and nonsolar components, rather than looking at them as integrated units. However, as previously noted, the appraisal unit is the real property improved with the SEGS unit. A buyer in the marketplace will not purchase the real property improved with the nonsolar component of the SEGS unit only. Rather, a buyer purchases the real property improved with the entire SEGS unit. Prior to 2011, the assessment methodology used by the Assessor was not in compliance with the applicable law: the Assessor treated the taxable portion of the SEGS unit (the boilers and furnaces) as a depreciating asset and reduced its value as one would an ordinary piece of personal property. However, after receiving instructions from the Board, the Assessor began assessing the factored base year value of the solar property based on section 51's 2 percent maximum index rather than as a depreciating asset, enrolling the lesser factored base year value rather than the higher current full cash value.

For the above reasons, we conclude that the Board correctly interpreted the applicable law in setting forth the method of assessing the value of the solar properties.

III. DISPOSITION

The judgment is affirmed. Respondents to recover their costs on appeal.

CERTIFIED FOR PUBLICATION

RAMIREZ
P. J.

We concur:

MCKINSTER
J.

CODRINGTON
J.

NOT FOR PUBLICATION

FILED

JUN 21 2019

MOLLY C. DWYER, CLERK
U.S. COURT OF APPEALS

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

ESTATE OF EVA FRANZEN KOLLSMAN, DECEASED, JEFFREY HYLAND, EXECUTOR, Petitioner-Appellant, v. COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee.	No. 18-70565 Tax Ct. No. 26077-09 MEMORANDUM*

Appeal from a Decision of the United States Tax Court.

Argued and Submitted June 5, 2019
Portland, Oregon

Before: MURGUIA and HURWITZ, Circuit Judges, and ZIPPS,** District Judge.

The Estate of Eva Franzen Kollsman appeals the Tax Court's determination of the fair market value of two Old Master paintings, *Village Kermesse with Dance Around the Maypole* (*Maypole*) and *Orpheus Charming the Animals* (*Orpheus*). As

* This disposition is not appropriate for publication and is not precedent except as provided by Ninth Circuit Rule 36-3.

** The Honorable Jennifer G. Zipps, United States District Judge for the District of Arizona, sitting by designation.

a result of this determination, the Tax Court found there was a deficiency in estate tax due in the amount $585,836. The Estate also seeks a reduction in the interest owed on the deficiency. We have jurisdiction under 26 U.S.C. § 7482(a)(1) and affirm.

"[T]he Tax Court's determination of the value of property is a finding of fact, which we will reverse only for clear error." *Sammons v. Comm'r*, 838 F.2d 330, 333 (9th Cir. 1988) (citations omitted). We review issues of law de novo. *See Meruelo v.* Comm'r, 691 F.3d 1108, 1114 (9th Cir. 2012) (citation omitted).

1. The Tax Court correctly applied the law. The Tax Court correctly concluded that the relevant value of the paintings was the fair market value on the valuation date, the time of Kollsman's death. *See* Treas. Reg. 20.2031-1(a), (b). The Tax Court also correctly concluded that "[f]air market value for this purpose is the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." *See* Treas. Reg. 20.2031-1(b).

2. The Tax Court further correctly recognized that the hypothetical buyer and seller are presumed to have reasonable knowledge of the relevant facts affecting the property's value. *See Ebben v. Comm'r*, 783 F.2d 906, 909 (9th Cir. 1986). Testimony from a preeminent conservator and the IRS's expert witness, Dr. Peter Cardile, supports the Tax Court's finding that as of the valuation date, the

hypothetical buyer would know that cleaning was "a well advised and low-risk undertaking." *See Doherty v. Comm'r*, 16 F. 3d 338, 340 (9th Cir. 1994); *see also Furstenberg v. United States,* 595 F.2d 603, 609 (Ct. Cl. 1979) (considering fact that "a prospective buyer could have ascertained that a skillful cleaning effort [of a painting] probably would have been successful."). Even the Estate's expert witness, George Wachter, observed that "under all the dirt the pictures seemed to be in reasonably good condition." The Tax Court also did not err in concluding that Wachter exaggerated the dirtiness of the paintings and the risk of cleaning them.

3. The Tax Court did not improperly base its valuation on *Maypole's* sale price. Rather, in arriving at its valuation, the Tax Court primarily relied on Dr. Cardile's valuation. Moreover, the Tax Court did not err in finding that Wachter failed to explain the nearly fivefold increase in value between his valuation and the sale price. Although Wachter asserted that there was a surge in demand for Old Master paintings in 2009, the Estate failed to establish an increase in sales prices for individual paintings at Sotheby's in 2009. Additionally, Sotheby's Form 10K filed with the Securities and Exchange Commission for the relevant period contradicted Wachter's assertion.

4. The Tax Court did not err in rejecting Wachter's opinion in part because he did not support his valuations with comparable sales data. Wachter downplayed the importance of comparables in assessing value and failed to include any in his

expert report. He testified that when he arrived at his valuations, he was not interested in comparables. At trial, Wachter indicated that he had reviewed comparables only after the IRS challenged his methodology.[1]

5. The Tax Court did not err in largely accepting Dr. Cardile's valuations. Dr. Cardile explained his methodology, reliance on comparables, and research about the paintings' conditions. Moreover, the Tax Court did not wholly accept Dr. Cardile's valuations, instead applying discounts for both paintings based on the evidence. *See Estate of O'Connell v. Comm'r,* 640 F.2d 249, 253 (9th Cir. 1981) (finding that "the Tax Court did not commit reversible error" in choosing a valuation "within the range supported by the evidence"). In its valuation, the Tax Court thoroughly considered the evidence, and its valuation plausibly flowed from the record.

6. We lack jurisdiction to reduce the amount of interest owed on the deficiency. Interest on a tax deficiency is mandated by statute, 26 U.S.C. § 6601(a), and may not be reduced by the Tax Court. *Comm'r v. McCoy,* 484 U.S. 3, 7 (1987). We only have jurisdiction to review the decisions of the Tax Court. 26 U.S.C. §

[1] To the extent the Estate frames the issue as arising under Federal Rule of Evidence 703, its argument fails. "Rule 703 permits the admission of otherwise inadmissible evidence upon which an expert properly relies for the purpose of explaining the basis of the expert's opinion." *Hudspeth v. Comm'r*, 914 F.2d 1207, 1215 (9th Cir. 1990) (citation omitted). There is no showing that the Tax Court found Wachter's reference to comparables inadmissible. Instead, the court concluded that Wachter did not rely on comparables in the first instance.

7482(a)(1). We are "not empowered to proceed further to decide other questions relating to interest and penalty—questions that were not presented, and could not possibly have been presented, to the Tax Court—or to grant relief that the Tax Court itself had no jurisdiction to provide." *McCoy*, 484 U.S. at 6–7 (holding that appellate court lacked jurisdiction to forgive interest on a tax deficiency).

AFFIRMED.