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Legal Update
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IRS Provides Safe Harbor for Solar Contracts with Federal Agencies

On January 19, 2017, the US Internal Revenue Service (IRS) released Revenue Procedure 2017-19 (the "Rev. Proc.") providing a safe harbor for certain alternative energy sales contracts with federal agencies to be treated as service contracts under Section 7701(e)(3).[1] The safe harbor is important because, if such a contract is treated as a lease to the federal agency, a solar project would constitute "tax-exempt use property" that is ineligible for the investment tax credit (ITC) and accelerated depreciation (including bonus depreciation).[2]

Background

42 U.S.C. Section 8287 allows federal agencies to enter into an Energy Savings Performance Contract (ESPC) Energy Sales Agreement (ESA) subject to certain requirements. In 2012, the Office of Management and Budget (OMB) issued OMB Memorandum M-12-21 (the "OMB Memorandum") providing further guidance for ESPC ESAs, including a requirement that the renewable energy generation asset is transferred to the federal agency at the end of the contract term.

These OMB rules have applied most commonly to distributed generation solar projects; however, they also apply to other types of distributed energy projects and to water conservation projects.

Under Section 50(b)(4)(A)(i), the ITC is not available for property used by a federal agency or other tax-exempt or foreign entity under a lease with a term of six months or more. Section 7701(e) provides general rules for determining whether a contract that purports to be a service contract should instead be treated as a lease. Section 7701(e)(3)(A) provides a special rule for contracts involving alternative energy facilities or municipal waste water treatment facilities. Under the special rule, a purported service contract with respect to such a facility will be respected as a service contract. However, the special rule identifies four situations (commonly referred to as "kickouts") in which a purported service contract is precluded from being within the special rule and which thus operate as requirements to the applicability of the special rule.[3]

- First, the service recipient (e.g., the federal agency) may not operate the facility.
- Second, the service recipient may not bear any significant financial burden if there is nonperformance under the contract, unless this burden is due to (i) reasons beyond the control of the service provider, (ii) a temporary shutdown for repairs, maintenance or capital improvements or (iii) the bankruptcy or other financial difficulty of the service provider.
- Third, the service recipient may not receive any significant financial benefit if the operating costs of the facility are less than expected, unless the benefit arises from reduced payments by the service recipient

because of increased production or efficiency or the recovery of energy or other products.

- Fourth, the service recipient may not have an option or obligation to purchase all or part of the facility at a fixed and determinable price, other than for the fair market value of the facility.

Safe Harbor

The Rev. Proc. provides a safe harbor for an ESPC ESA with a federal agency to be treated as a service contract under Section 7701(e)(3). If the safe harbor is satisfied, the IRS *will no*t challenge on audit the treatment of the ESPC ESA as a "service contract." Section 7701(e)(3) is itself a safe harbor, so the Rev. Proc. essentially provides an administrative safe harbor to the statutory safe harbor.

To satisfy the safe harbor of the Rev. Proc., all of the following requirements must be satisfied:

- First, the total term of the ESPC ESA cannot exceed 20 years, and the term must be consistent with and appropriate for the scope and scale of the project.
- Second, the ESPC ESA must satisfy the requirements of 42 U.S.C. Section 8287 and the OMB Memorandum.
- Third, under no circumstance may the federal agency operate the renewable energy asset; in the event of a shut down or a mechanical issue, the federal agency is to immediately notify the energy service company.
- Fourth, the energy service company must bear all financial risk for nonperformance except to the extent attributable to a temporary shutdown for maintenance, repairs or capital improvements.
- Fifth, the price of electricity cannot be reduced if operating costs are reduced.
- Sixth, the federal agency may have a purchase option or may be required to purchase the project at the end of the contract term for its then fair market value (which, as an example illustrates, may be demonstrated by an appraisal process).

The Rev. Proc. includes an example of an ESPC ESA that meets the requirements for service contract treatment under the safe harbor.

The safe harbor is intended to provide guidance for an ESPC ESA, and the IRS will not rule on qualification under Section 7701(e)(3) for such federal agency contracts. The Rev. Proc. provides that it is effective on the date it is published in the Internal Revenue Bulletin, which as of January 24, 2017, has yet to occur.[4] Further, the Rev. Proc. provides that the IRS will not challenge the service contract treatment of an ESPC ESA entered prior to the effective date if all of the requirements are satisfied.

Analysis

As a general matter, the solar industry is grateful to the IRS for tackling this issue. Although the Rev. Proc. raises or leaves certain questions unanswered, any guidance is generally preferable to no guidance.

The Solar Energy Industries Association (SEIA) in a letter commenting on the OMB Memorandum asked the Department of Energy (DOE) for guidance that addressed the tax ownership of the project, in addition to guidance under Section 7701(e)(3).[5] The Rev. Proc. is silent on *ownership*, leaving open the possibility that the IRS could, as a technical matter, assert that a service contract within the safe harbor (i.e., that avoids lease characterization) vests tax ownership in the federal agency. The legislative history to Section 7701(e) appears to contemplate such a possibility: it explains that the section does not change present law standards whereby "a tax-exempt entity could be treated as the owner of property under a purported lease, service contract, or other arrangement."[6] However, this statement could be referring only to a purported service contract that is *not* respected as such under Section 7701(e) (i.e., that is recharacterized as a lease under Section 7701(e)).[7] That interpretation appears to be the most sensible as it would be analytically inconsistent for a contract to *not* be deemed a "lease" but to nonetheless be deemed to transfer tax ownership to the party being served by the underlying property.

The SEIA letter had asked the DOE to bless a purchase option (or requirement) at "the *higher of* fair market value and fixed purchase price."[8] The IRS did not do that. Nevertheless, a 1987 private letter ruling had sanctioned a transaction that had a "higher of" feature of a sort. In the 1987 ruling, the service recipient could purchase the facility for the higher of fair market value and the value of bonds outstanding, if certain defaults due to force majeure events occurred. However, the purchase option that was available at the end of the term, and analogous to the purchase option addressed in the Rev. Proc., was for the fair market value of the facility as determined at the time.[9] Because the Rev. Proc. is silent on this "higher of" question, it creates no inference as to whether such a purchase option would meet the requirements of Section 7701(e)(4)(iv). To be sure, it is possible that the IRS was not even aware of the request in the SEIA letter because it was addressed to DOE.

A further observation is that the example in the Rev. Proc. allows the federal agency to be required to fund a reserve to enable it to exercise the purchase option. In the leasing industry, the IRS was offended by leases with this feature (i.e., a "defeased" lease), even leases that were structured that way in order to meet requirements of the Federal Transit Administration that are similar to the OMB Memorandum. Specifically, in Notice 2005-13, the pre-funded purchase option was a factor the IRS used to attack so-called "sale-in lease-out" transactions and to make them "listed transactions" that are flagged for audit and disclosure and subject to increased penalties. That view was reflected in Section 470(d)(1)(C)(iii), which has a prohibition on more than 50 percent of a purchase option being pre-funded in a lease to a tax-exempt entity. If a contract with a tax-exempt entity (e.g., a federal agency) is characterized as a lease, it would be subject to Section 470's loss trapping rule, unless the contract meets the requirements for the exception in Section 470(d), which a contract with a pre-funded purchase option would not.

Structuring Recommendations

A close reading of the Rev. Proc. suggests that solar companies should consider the following recommendations in structuring their ESPC ESAs with federal agencies:

- Given the Rev. Proc.'s silence on tax ownership, avoid structuring transactions with purchase obligations; that is, provide the federal agency with a "call" option, but do not provide the service provider with a "put" option.
- In light of the fact that the Rev. Proc. did not respond to the comment requesting guidance on a "higher of" purchase option, do not include a floor on the federal agency's "call" option; that is, it should be simply "fair market value" at the end of the contract term.
- Based on the example, consider obtaining an independent appraisal to support the fair market value of any purchase option price.

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Endnotes

1 Unless otherwise specified, all section references are to the Internal Revenue Code of 1986, as amended.

2 I.R.C. §§ 50(b), 168(g)(3). The contract, as a *lease* to a tax-exempt entity, would also be subject to Section 470's loss trapping rules, unless it satisfied the exception in Section 470(d).

3 I.R.C. § 7701(e)(4).

4 On January 20, 2017 (the day after the Rev. Proc. was released to the public), the White House issued the *Memorandum for the Heads of Executive Departments and Agencies; Regulatory Freeze Pending Review*. That memorandum freezes the issuance of new regulations and *guidance documents*. "Guidance document" is defined as "any agency statement of general applicability and future effect that sets forth a policy on a statutory, regulatory, or technical issue or an interpretation of a statutory or regulatory issue." The Rev. Proc. may be considered a "guidance document" because it sets forth a policy with future effect on a technical issue, and thus is subject to the freeze. On the other hand, it is unclear whether the Rev. Proc. would fall within the scope of the freeze. This is due to the fact that the IRS made the Rev. Proc. available to the public prior to the issuance of the White House memorandum (even though it had not been published in the Internal Revenue Bulletin), and the White House memorandum does not discuss effective dates tied to publication in the Internal Revenue Bulletin. However, if the Rev. Proc. is subject to the White House memorandum, our expectation is that the Rev. Proc. would be published in the Internal Revenue Bulletin once the freeze is lifted. Nevertheless, even once the Rev. Proc. is published, the IRS has the ability to revoke it without notice.

5 https://www.regulations.gov/document?D=EERE-2016-FEMP-0036-0006.

6 H.R. REP. No. 98-432, at 1149 (1984).

7 An argument can be made that the legislative history distinguishes between the general rule in Section 7701(e)(1) and the special rule under Section 7701(e)(3). The general rule under Section 7701(e)(1) provides rules for when a service contract shall be treated as a lease, taking into account all relevant factors, but it does not provide an affirmative rule to treat a purported service contract as such. Thus, Section 7701(e)(1) is arguably only providing that a service contract will be *recharacterized* as a lease in accordance with the relevant factors as established under tax ownership principles. In contrast, the safe harbor under Section 7701(e)(3) appears to be a per se rule that a contract with respect to an alternative energy facility that purports to be a service contract *shall be treated* as a service contract (subject to the kickouts described above). Thus, while the general rule arguably may not override tax ownership principles, the special rule of Section 7701(e)(3) that affirmatively provides rules for when a certain contract will be treated as a service contract could be construed as overriding tax ownership principles.

8 The New York State Bar Association Section of Taxation made a similar request in a 1988 report in conjunction with a requested revenue ruling: "In certain circumstances, the service recipient may have the option to purchase the facility at the higher of fair market value or a formula ... sufficient to provide the service provider with a return on its investment. The [revenue] ruling should make clear that such a purchase option, which always results in a price that is greater than or equal to fair market value, satisfies [Section 7701(e)(4)(iv)], because the service contract rules were designed to insure that the service recipient does not enjoy the benefits (or bear the risks) of ownership to any significant extent. An option to purchase the facility at greater than its fair market value cannot be viewed as transferring any benefit of ownership of the facility to the service recipient." *Report on Service Contracts for Qualifying Facilities,* N.Y.S.B.A. SEC. OF TAX'N (Nov. 4, 1988).

9 P.L.R. 87-49-045 (Sept. 4, 1987).