Rev. Proc. 2017-19

SECTION 1. PURPOSE

This revenue procedure provides a safe harbor under which the Internal Revenue Service (Service) will not challenge the treatment of an Energy Savings Performance Contract (ESPC) Energy Sales Agreement (ESA) between an Energy Service Company (ESCO) and a Federal Agency (FA) as a service contract under § 7701(e)(3) of the Internal Revenue Code (Code). The revenue procedure also provides an example of an ESPC ESA.

SECTION 2. BACKGROUND

.01. 42 U.S.C § 8287 authorizes FAs to enter into ESPC ESAs with ESCOs for the purpose of achieving energy savings and benefits ancillary to energy savings. It also sets forth certain requirements for such ESPC ESAs. The ESPC ESA project structure is intended to facilitate onsite renewable energy generation projects.

.02. The Office of Management and Budget (OMB) issued OMB Memorandum M-12-21 to provide further guidance to FAs regarding ESPCs that include third-party owned and operated onsite renewable energy generation assets and how they will be treated for Federal budgeting purposes. Specifically, OMB Memorandum M-12-21 requires title to the renewable energy generation asset to transfer to the FA at the end of the ESPC term.

.03. The ESPC ESA is a type of ESPC that facilitates third-party owned and operated onsite energy generation projects in compliance with ESPC authority and OMB Memorandum M-12-21. An ESPC ESA may also include the implementation of other energy and water conservation measures as part of a comprehensive project.

.04. The example in Section 5 of this revenue procedure illustrates a typical ESPC ESA that would satisfy the requirements of 42 U.S.C § 8287 and OMB Memorandum M-12-21.

.05. Section 48(a) provides for an investment tax credit for certain energy property, including solar energy property described in § 48(a)(3)(A)(i).

.06. Section 50(b)(4)(A)(i) disallows the investment tax credit if the property is used by the United States, any State or political subdivision thereof, any possession of the United States, or any agency or instrumentality of any of the foregoing. This disallowance applies to property used under a lease unless the term of such lease is less than 6 months.

.07. Section 7701(e) provides rules to determine, for federal income tax purposes, whether a contract that purports to be a service contract should be treated as a lease of property. Section 7701(e)(1) generally provides that a service contract will be treated as a lease of property if it is properly treated as a lease of property, taking into account all relevant factors including whether or not:

the service recipient is in physical possession of the property;

the service recipient controls the property;

the service recipient has a significant economic or possessory interest in the property;

the service provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract;

the service provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient; and

the total contract price does not substantially exceed the rental value of the property for the contract period.

.08. Notwithstanding the general rule of § 7701(e)(1), § 7701(e)(3) provides special rules for contracts or arrangements involving solid waste disposal, a cogeneration or alternative energy facility, and clean water facilities. Section 7701(e)(3)(D) provides that an "alternative energy facility" means a facility producing electrical or thermal energy if the primary energy source for the facility is not oil, natural gas, coal or nuclear power. Section 7701(e)(3)(A) provides that a purported service contract with respect to this type of facility will be treated as a service contract.

.09. Section 7701(e)(4) provides that the special rule in § 7701(e)(3) will not apply, and thus the general rule in § 7701(e)(1) will apply, to any contract with respect to the facilities described in § 7701(e)(3) if:

> the service recipient (or a related entity) operates the facility;
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> the service recipient (or a related entity) bears 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 shut-down for repairs, maintenance, or capital improvements, or (iii) the bankruptcy or other financial difficulty of the service provider;
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> the service recipient (or a related entity) receives any significant financial benefit if the operating costs of such facility are less than the standards of performance or operation under the contract, 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; and
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> the service recipient (or a related entity) has 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.

SECTION 3. SCOPE

.01. The safe harbor in section 4 of this revenue procedure applies to any ESPC ESA between an ESCO and a FA for the provision of electricity through an alternative energy facility, as defined in § 7701(e)(3)(D), that satisfies the requirements of 42 U.S.C § 8287 and OMB Memorandum M-12-21. It may not be relied upon, in whole or part, for any other kind of transaction.

.02. The safe harbor provided in section 4 of this revenue procedure applies only if all the requirements of section 4 are satisfied.

.03. The safe harbor provided in section 4 of this revenue procedure provides guidance to ESCO taxpayers that are establishing or participating in an ESPC ESA with a FA in lieu of providing a letter ruling to those ESCO taxpayers. Therefore, the Service will not rule on whether an ESPC ESA between an ESCO and FA will be considered a service contract under § 7701(e)(3).

SECTION 4. SAFE HARBOR

.01 *Safe harbor*. If an ESPC ESA entered into between an ESCO and a FA satisfies all of the requirements of section 4.02 of this revenue procedure, the Service will not challenge the treatment of the ESPC ESA as a service contract under § 7701(e)(3).

.02 *Requirements*. The ESPC ESA must satisfy the following requirements:

(1) *Term.* The total term of the ESPC ESA cannot exceed 20 years in length. The term must be consistent with and appropriate for the scope and scale of the renewable project.

(2) *Other Federal guidance*. The ESPC ESA must satisfy the requirements of 42 U.S.C § 8287 and OMB Memorandum M-12-21.

(3) *Operation of Alternative Energy Facility.* Under no circumstances will the FA attempt to operate the renewable energy generation asset. In the event of a shut-down or mechanical issue, FA will immediately notify the ESCO or its designated contractor.

(4) *Risk*. The ESCO bears all financial risk for non-performance, except to the extent such non-performance is attributable to a temporary shut-down of the facility for repairs, maintenance, or capital improvements.

(5) *Reduced Costs.* The contract price for electricity will not be reduced if operating costs should diminish.

(6) *Equipment Purchase.* The FA may have the option to purchase, or may be required to purchase, the renewable energy generation asset at the end of the contract term, for its fair market value (FMV) at the time of the purchase.

SECTION 5. EXAMPLE

ESCO contracts with FA under an ESPC ESA to install, maintain ownership of (until the end of the contract), and provide operation and maintenance of a renewable energy generation asset at a federal site. The FA will purchase all of the electricity generated onsite at a rate that is less than the FA's current and forecasted electricity rate.

- The contract term is 20 years.
- The contract price, including operation and maintenance, is based on a fixed per-kWh basis and must be paid for by the FA from the energy savings provided under the project.
  - The ESCO bears all financial risk for non-performance.
  - The contract price does not vary if the operating costs are lower than expected.
- The FA will purchase the renewable energy generation asset at FMV as appraised at the time of the sale by the end of the contract term, consistent with OMB Memorandum 12-21.
  - The ESCO will transfer a portion of the payments it receives from the FA into a reserve account held by the ESCO for the FA's future purchase of the onsite renewable energy assets. The amount charged for each payment period will include both the price of power and an amount for the reserve account (separate and in addition to the price of power).
  - The ESCO's deposit into the reserve account will be based on the estimated future FMV of the on-site renewable energy generation assets. To ensure that the reserve account has sufficient funds for the FMV purchase by the FA at the end of the contract term, there may be periodic reappraisals of the onsite renewable

assets and contract modifications (if and as necessary). Any excess reserve account funds after the onsite renewable asset purchase may be used to offset the final ESPC ESA payments. Alternatively, in the event of termination, funds in the reserve account at that time may be used to satisfy any termination liability of the FA, and any excess amounts will be returned to the FA.
    - The FMV will be determined at the time of sale by a mutually agreed upon independent appraiser with expertise in the relevant onsite renewable energy asset industry. The valuation made by the appraiser shall be binding upon the parties in the absence of fraud or error.
- The ESPC ESA includes a schedule for each year which establishes the maximum termination liability of the FA in the event of termination prior to the end of the contract term.

This ESPC ESA satisfies the requirements of the safe harbor in section 4 of this revenue procedure and the Service will not challenge the treatment of the ESPC ESA as a service contract under § 7701(e)(3).

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective for transactions entered into on or after the date of publication in the Internal Revenue Bulletin. If an ESPC ESA entered into between an ESCO and a FA prior to this date satisfies all of the requirements of the safe harbor provided in section 4 of this revenue procedure, the Service will not challenge the treatment of the ESPC ESA as a service contract under § 7701(e)(3).

SECTION 7. DRAFTING INFORMATION

The principal author of this revenue procedure is Philip Tiegerman of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this revenue procedure contact Philip Tiegerman at (202) 317-6853.