REPORT # 592

TAX SECTION

New York State Bar Association

Report on Service Contracts for Qualifying Facilities

by the committee on Depreciation and Amortization

November 4, 1988

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for Qualifying Facilities

Dear Commissioner Gibbs:

I enclose a report on Service Contracts for Qualifying Facilities prepared by our Committee on Depreciation and Amortization. The report was written by Stephen B. Land. Helpful comments were received from Richard J. Bronstein, William L. Burke, Patricia Geoghegan, Ann Pollock and Kurt F. Rosell. The report was approved at a meeting of our Executive Committee on October 18, 1988.

The report endorses a recent private ruling clarifying the application of section 7701(e)(3) to a service contract involving a solid waste disposal facility, and recommends that the Service provide similar guidance in the form of a published ruling on which taxpayers can rely. The Committee on Depreciation and Amortization would be pleased to assist you in preparing the text of such a published ruling.

Sincerely,

Herbert L. Camp

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Tax Report #592

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Report on Service Contracts for Qualifying Facilities

by the committee on Depreciation and Amortization

November 4, 1988

NEW YORK BAR ASSOCIATION
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Report on Service Contracts for Qualifying Facilities

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This report [1]/ comments on a recent private letter ruling concerning service contracts under Section 7701 (e)(3) of the Internal Revenue Code, and makes recommendations for the publication of a Revenue Ruling on that subject.

The provider of services under a service contract can, in some circumstances, suffer a loss of accelerated depreciation (and investment credit on transitional property) if the service contract is recharacterized as a lease. The distinction between a service contract and a lease is generally based on all the circumstances, and its application can be uncertain. To limit that uncertainty for contracts involving solid waste disposal, energy and clean water facilities, Section 7701(e)(3) provides a four-part safe harbor test for such contracts. Unfortunately, some aspects of the four-part test are also uncertain, thus

[1]/ This report was prepared by the Committee on Depreciation and Amortization. The principal draftsman was Stephen B. Land. Helpful comments were received from Richard J. Bronstein, William L. Burke, Patricia Geoghegan, Ann Pollock and Kurt F. Rosell.

preventing the test from fulfilling its intended purpose. The service recipient, often a municipality, may therefore be required to pay higher rates for the services in order to induce the service provider to accept the tax risk.

The Internal Revenue service recently released private letter ruling 8749045, dated September 4, 1987 (the “Private Ruling”), which addresses many issues regarding the safe harbor test. The Private Ruling concludes that an agreement between the taxpayer and a county involving solid waste disposal facility will be treated as a service contract and not as a lease for Federal income tax purposes.

The Private Ruling is helpful to the extent that it provides tax practitioners with guidance regarding the Service’s views on whether the service contract addressed in that ruling satisfies the safe harbor. The Committee generally approves of the approach taken by the Service in that Ruling. The Committee is aware, however, of a significant number of privately-owned solid waste facilities that will be placed in service in the near future, each of which will presumably involve a service contract. Because practitioners cannot assure their clients that the service contracts involved in those transactions will receive the same treatment as the service contract described in the Private Ruling, many service providers will be inclined to seek their own private rulings. The Service could increase the level of certainty in the service contract area (and reduce the incentive to seek private rulings) by issuing a Revenue Ruling that incorporates the conclusions reached in the Private Ruling. Also, because not all service contracts that satisfy the safe harbor will be identical to the contract described in the Private Ruling, it would be helpful if the Service included in the Revenue Ruling some more general rules, as described below.

I. Background.

The Tax Reform Act of 1984 included legislation, originally proposed by Representative J.J. Pickle, that eliminated accelerated depreciation for property leased to tax-exempt entities and widened previously existing restrictions on the investment credit for such property. [2/] Prior law disallowed the investment credit for property “used” by tax-exempt entities, but that restriction could be avoided in some circumstances by making the property available to the tax-exempt entity under an arrangement that was treated as a service contract rather than as a lease to the tax exempt entity. To address that potential for tax avoidance, the Tax Reform Act of 1984 added Section 7701(e),

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[2/] Those rules are now codified in Section 48(a)(4) and (5)and Section 168(h) of the Internal Revenue Code of 1986 (the “Code”). Unless otherwise indicated, a reference herein to a Section” refers to a section of the Code.

which provides that whether an arrangement is a service contract or a lease for Federal income tax purposes is to be determined based on all relevant factors, including six factors identified in the statute.[3/]

The version originally passed by the House contained a safe harbor for solid waste disposal facilities, and subsequent versions expanded the safe harbor to cover certain energy and water treatment facilities. Arrangements involving facilities eligible for the safe harbor do not need to satisfy the general six-factor test. Those

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[3/] The six factors, set forth in whether or not:

(A) the service recipient possession of the property,
(B) the service recipient
(C) the service recipient Section 7701(e)(1), are
is in physical controls the property, has a significant economic or possessory interest in the property,
(D) the service provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract,
(E) the service provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient, and
(F) the total contract price does not substantially exceed the rental value of the property for the contract period.

facilities must instead satisfy a four-factor test to qualify for the safe harbor.

Under the four-factor test, set forth in Section 7701(e)(4), an arrangement pertaining to a qualifying facility which purports to be a service contract will not be recharacterized as a lease, provided that none of the following four elements is present:

Operation Test. The service recipient (or a related entity) operates the facility. Section 7701(e)(4)(A)(i).

Financial Burden Test. The service recipient (or a related entity) bears any significant financial burden if there is nonperformance under the contract or arrangement by the service provider, other than from temporary shut-downs for repairs, maintenance or capital improvements, the bankruptcy or similar financial difficulty of the service provider, or other reasons beyond the control of the service provider. Section 7701 (e)(4)(A)(ii) and (c)(i).

Financial Benefit Test. The service recipient (or a related entity) receives any significant financial benefit if the operating costs of the facility are less than the standards of performance or operation under the contract or arrangement, other than from decreases in the payments by the service recipient under the contract or arrangement caused by increased production or efficiency or the recovery of energy or other products. Section 7701(e)(4)(A)(iii) and (C)(ii).

Purchase Option Test. 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 fair market value. Section 7701(e)(4)(A)(iv). In applying the four tests, there are not taken into account (i) any rights of the service recipient to inspect the facility, exercise its sovereign powers, or act in the event of a breach of contract by the service provider or (ii) any allocation of any financial burden or benefits in the event of any change in any law. Section 7701(e)(4)(B).

Despite the number of interpretive issues, discussed below, that arise in attempting to apply the four tests, there was, before the release of the Private Ruling, no interpretive authority other than some examples given, in the legislative history of the 1984 Act.[4/] The stakes are high: if the safe

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4/ H. Rep. No. 432, Part 2, 98th Cong., 2d Sess. 1158-1159 (1984); S. Prt. No. 169, 98th Cong., 2d Sess. 143-146 (Corn. Print 1984) (the “Senate Report”); Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 98th Cong., 2d Sess. 65-67 (1984) (the “General Explanation”).

harbor does not apply, and the contract is treated as a lease under the general rule, then no investment credit will be allowed (regardless of whether the facility is otherwise grandfathered under the Tax Reform Act of 1986) and depreciation will be allowed only on a straight-line basis over 125% of the term of the contract. Sections 48 (a)(4) and (5), and 168 (g)(1)(B) and (h). Because of those stakes, a contractual provision that makes sense in view of the legitimate non-tax objectives of the parties will become problematic even if it presents only a slight risk that the safe harbor will not apply. The resulting uncertainty is contrary to the intent of the safe harbor rule. Accordingly, the Service should make public its resolution of the interpretive issues in the form of a published ruling on which taxpayers can rely.

II. Issues to be Addressed in the Revenue Ruling.

A. Operations Test. The operations test is straightforward, and the only guidance that might be useful in a ruling would be a general statement that the service recipient's right to operate the facility upon the occurrence of a future event would not run afoul of the test unless the event happens. That idea is already implicit in the statute, which provides that the service recipient's rights to exercise sovereign powers and to act after a breach by the service provider are not to be taken into account under the safe harbor rules.

B. Financial Burden Test. The facility may be financed by obligations that are secured by the revenues from the facility. In order for the security to provide sufficient protection to the holders of the obligations, the service fee will be payable in all events, regardless of whether the service provider is performing its obligations under the service agreement. The published ruling should make clear, as does the Private Ruling, that such an unconditional service fee does not violate the Financial Burden Test, provided that the service provider is obligated to reimburse the service recipient for losses caused by the service provider's nonperformance.5/ If the facility is able to accept less than the promised tonnage of waste, or produces a higher than promised tonnage of residue, the service recipient might be reimbursed for the excess of its landfill costs over what its costs would have been had the facility performed as intended. Full reimbursement for those costs should not be required by the Financial Burden Test, however, because the legislative history regards such service provider's nonperformance. 5/ The published ruling should provide guidance on how to determine the service recipient’s costs that arise from the service provider’s nonperformance, including whether the Financial Burden Test ever requires the service provider to pay to the service recipient more than a reimbursement of the service fee.

If the facility generates revenues from steam or electrical production or from recycled materials, the service fee formula may contain a credit equal to a portion of those revenues. Section 7701(e)(4)(C)(ii) provides that such a credit is not to be taken into account in applying the Financial Benefit Test. Although the statute contains no comparable rule that is expressly applicable to the Financial Burden Test, Congress arguably intended the safe harbor to be available regardless of how the parties divided the risks of energy production or materials recovery. The published ruling should therefore make clear, the extent, if any, to which the Financial Burden Test requires the service provider to reimburse the service recipient for any decreases in a service fee credit resulting from energy or recovered materials revenues lost because of the service provider's nonperformance.

In applying the Financial Burden Test, there are excluded from consideration any burdens caused by (i) nonperformance for reasons beyond the control of the service provider (Section 7701 (e)(4)(A)(ii)); (ii) a change in law (Section 7701 (e)(4)(B)(ii)); or (iii) a temporary shut-down of the facility for repairs, maintenance or capital improvements, or the bankruptcy or similar financial difficulty of the service provider (Section 7701 (e)(4)(C)(i)). It would be helpful if the published ruling contained a non-exclusive list of events or circumstances covered by those exclusions, which might include the following:

(i) typical force majeure events;
(ii) court orders and other legal process;
(iii) loss of necessary permits;
(iv) strikes or work stoppages;
(v) changes in law that affect the operation or terms of permits for the facility;
(vi) loss of necessary utility services;
(vii) failure of a steam or electricity purchaser to purchase under the terms of the relevant energy contract (unless caused by the fault of the service provider);
(viii) presence of unexpected conditions (such as subsurface hazardous waste) at the facility site;
(ix) nonperformance by a supplier or subcontractor (unless caused by the fault of the service provider); and
(x) inability to dispose of residue caused by any of the foregoing.

The ruling should also indicate whether the service recipient must be protected against risks of the service provider's nonperformance in areas unrelated to the operation of the facility. For example, if a component of the service fee is a pass-through of debt service on tax exempt bonds issued to finance the facility, then acts or failures to act by the service provider could cause the bonds to become taxable, which might in turn result in an adjustment to the interest rate on the bonds. The service agreement described in the Private Ruling provides protection to the service recipient against that risk, but it is unclear whether the Financial Burden Test requires it.

A component of the service fee described in the Private Ruling is an allowance for “pass-through” costs, including certain taxes and community fees and costs of insurance, utilities, site preparation, site rental, unacceptable and hazardous waste disposal, ash disposal and scrubber reagent. The agreement provides for the suspension of pass-through costs during periods of non-performance by the service provider, and the Private Ruling states that the suspension “also insures” that the Financial Burden Test will be met. Suspension may be necessary to provide proper reimbursement of the service fee, but should not be required if the costs would be incurred absent the non-performance and the service provider otherwise undertakes to reimburse the service recipient for its additional disposal costs.

C. Financial Benefit Test. Where pass-through costs are a component of the service fee, any reduction in such costs will generate a financial benefit to the service recipient. The Private Ruling concludes that the Financial Benefit Test is satisfied notwithstanding the potential for savings in pass through costs, because the potential downward adjustments in the service fee “do not result from increased operating efficiencies." However, some of those items, such as the costs of utilities and scrubber reagent, might well be decreased as a result of operating efficiencies.

More fundamentally, the statute as at odds with itself: subsection (e)(4)(A)(iii) requires that there be no significant financial benefit the operating costs [the] facility are less than the standards of performance or operation," but subsection (e)(4)(C)(ii) expressly permits such a benefit if the service fee is reduced by reason of "increased production or efficiency." What does it mean for the operating costs, of the facility to be less than the standards of performance or operation, if not from increased production or efficiency? In the case of purchased utilities, adjustments for changes in price levels might be distinguished from changes in usage levels. Is one permissible, but not the other? If so, which one?

The text of the statute offers little guidance, but the legislative history applies the Financial Benefit Test only to operating cost reductions that arise "as a result of technological changes or other efficiencies introduced by the service provider.[6/]" At a minimum, therefore, the published ruling should state that the Financial Benefit Test does not apply to cost savings from other factors, such as the availability of more or higher quality waste.

In this circumstance, the conclusion of the Private Ruling that the presence of pass-through costs does not violate the Financial Benefit Test appears to be consistent with the spirit of the statute. The published ruling should identify a

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[6/] Senate Report, supra, n. 5, at 143; General Explanation, supra n. 5, at 64.

list of permissible pass-through costs, which might include the following:

(i) government fees, taxes, and other similar charges;
(ii) property and liability insurance premiums;
(iii) costs of acceptance testing, including environmental testing;
(iv) utilities, such as electricity, natural gas, and water;
(v) site acquisition costs or ground rent;
(vi) site preparation costs;
(vii) unacceptable or hazardous waste disposal costs;
(viii) ash disposal costs;
(ix) costs of scrubber reagent;
(x) incremental costs of extending receiving hours; and
(xi) issuance costs of tax-exempt or taxable bonds issued to finance the facility.

There presumably should be some restriction on what might qualify as a pass-through cost, or the parties would be able to transfer the entire operating risk to the service recipient. Thus, the Financial Benefit Test, if it is to mean anything, should require that apart from pass-through costs the general operating and maintenance costs of the facility should be for the account of the service provider, and that any adjustments to the service fee in respect of general costs should be determined by reference to objective indices (such as those published by the Bureau of Labor Statistics) rather than the actual operations of the facility.

D. Purchase Option Test. When the facility site is leased from the service recipient, the site lease may provide that at the end of the lease term the service provider is obligated to raze or remove the facility, or may permit the service provider to abandon the facility to the service recipient. At a minimum, the published ruling should make clear that the Purchase Option Test is met if the term of the site lease is at least equal to the estimated useful life of the facility and the service provider has the right to remove the facility at the end of the site lease term. It would also be helpful if the ruling were to indicate whether the service agreement can permit the service provider to abandon the facility at the end of the site lease term without violating the Purchase Option Test.

Under the service agreement described in the Private Ruling, the service recipient had the option or obligation to purchase the facility at fair market value before the end of the term of the service agreement following certain unforeseen circumstances or a default by one of the parties. In each case, if there were project bonds outstanding at the time of the purchase, the service recipient could pay a portion of the purchase price by assuming liability on the bonds, in which case the principal amount of the bonds assumed would be credited against the cash portion of the purchase price. The Private Ruling acknowledges that such arrangements give the service recipient the right to take advantage of existing financing if the rates are favorable, but asserts that such right does not give the service recipient the right to purchase the facility at other than fair market value because the service recipient's borrowing cost is at a tax-exempt rate and the prevailing rates at the time of the purchase may be higher or lower than the rate on the bonds assumed. The relevance of that reasoning is not entirely clear, as the service recipient will presumably elect to assume the liability on the bonds only if the rate on the bonds is lower than then prevailing rates, so that the right to assume the bonds would only reduce the service recipient's overall cost of acquiring the facility. The conclusion of the Private Ruling is nonetheless sound, however, because the purchase price of the facility is its fair market value regardless of the availability of favorable financing terms. That conclusion should be confirmed in the published 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 value that is sufficient to repay the bonds and provide the service provider with a return on its investment. The published ruling should make clear that such a purchase option, which always results in a price that is greater than or equal to the fair market value of the facility, satisfies the Purchase Option Test. Such an option is consistent with the purpose of the statute, 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 benefits of ownership of the facility to the service recipient.

In the service agreement described in the Private Ruling, the service recipient had an option, if following an unforeseen circumstance the facility could not be repaired, to acquire the facility for an amount equal to the outstanding bonds, regardless of its fair market value. The Service accepted the presence of that option on the grounds that the amount was not presently fixed and determinable. The absence of a presently fixed and determinable price should not generally be sufficient to satisfy the Purchase Option Test, as a bargain purchase formula can easily be devised that is not presently fixed and determinable (e.g., 80% of then fair market value). The Service also noted that the option was exercisable only if the facility did not work and was therefore not a “solid waste facility” subject to the four tests. That is hardly a comforting rationale, as the failure to be a solid waste facility simply brings into play the more nebulous six-factor test. A better rationale is that the unforeseen circumstance is itself remote, and if it occurs an irreparable facility is unlikely to be worth more than the amount of outstanding bonds. Thus, such an option does not give the service recipient the type of interest in the facility that the Purchase Option Test was intended to restrict.

In the Private Ruling, upon a default by the service provider the service recipient had an option to purchase the facility at fair market value, but if the option were exercised the service provider was required to pay to the service recipient as liquidated damages the excess of the fair market value of the facility over the face amount of the bonds. The Service concluded that the liquidated damages did not cause the service recipient's option to be other than a fair market value option, accepting the stated purpose of the liquidated damages to compensate the service recipient for its losses caused by the service provider's default. A more straightforward approach would be to recognize that the option is not a fair market value option, but is nonetheless permitted under subsection (e)(4)(B)(i), which provides that the service recipient's right to act in the event of a breach by the service provided shall not be taken into account. Under that approach, the arrangements described in the ruling will not violate the Purchase Option Test regardless of whether the bargain element takes the form of liquidated damages.

III. Conclusion.

As the foregoing discussion demonstrates, three of the four tests necessary to satisfy the service contract safe harbor present difficult interpretive issues, especially in the absence of reliable authority. Publication of a ruling that incorporates the conclusions reached in the Private Ruling and that includes the general rules described above would help the safe harbor achieve its intended purposes without requiring the Service to issue numerous lengthy private rulings.