

[Senate Bill 1059](#) (Hill)

Date: May 21, 2020 (Amended)

Program: Property Taxes

Sponsor: Author

Revenue and Taxation Code Section 64.1

Effective: Upon chaptering

Mark Durham (Chief) 916.274.3423

Glenna Schultz (Analyst) 916.274.3362

Ronil Dwarka (Revenue) 916.274.3391

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**Summary:** For a legal entity that owns an active solar energy system pursuant to a partnership flip transaction, this bill provides that neither an initial transfer of a capital and profits interest in the legal entity, nor any subsequent change in the allocation of the capital and profits of the legal entity among the members, is a change in control of, or a transfer of the majority interest in, the legal entity.

**Summary of Amendments:** Since our last analysis, SB 1059 was amended to remove the proposed changes to the active solar energy system new construction exclusion and instead add a change in control exclusion for a partnership flip transaction involving a legal entity that owns an active solar energy system.

**Fiscal Impact Summary:** Indeterminable.

**Existing Law:** Under the California Constitution, all property is taxable unless specifically exempted.<sup>1</sup> The Constitution limits the assessed value of property upon which the property tax is imposed. For property tax purposes, real property is reassessed to its current market value when real property undergoes a change in ownership or is newly constructed.<sup>2</sup> Generally, the law establishes a property's assessed value at its market value<sup>3</sup> on the date purchased (base year value) and requires additional assessments to reflect certain construction activities that qualify as "new construction."

**Change in Ownership.** Different change in ownership laws apply to a person or legal entity who purchases or leases California real property than to a person or legal entity who obtains ownership interests in a legal entity (e.g., voting stock in a corporation, capital and profits in a limited liability company or partnership) that holds an interest in California real property.<sup>4</sup> As a general rule, transfers of ownership interests in legal entities do *not* constitute a change in ownership (and, therefore, no reassessment) of the legal entity's real property.<sup>5</sup> However, there are two exceptions wherein the transfer of ownership interests in a legal entity would trigger a change in ownership of the real property owned by the legal entity.

- **Change in Legal Entity Control.** RTC section [64\(c\)\(1\)](#) requires reassessment when any person or entity obtains control through direct or indirect ownership or control of more than 50 percent of corporation voting stock, or obtains a majority interest (more than a 50 percent ownership interest) in any other type of legal entity. The reassessment applies to all real property owned by the acquired legal entity (and any entity under its control).

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<sup>1</sup> Article XIII, [section 1](#) of the California Constitution.

<sup>2</sup> California Constitution, article XIII A, [section 2](#); RTC section [110.1](#).

<sup>3</sup> The assessed value is based on 1975 market value for property that has not changed ownership since that date.

<sup>4</sup> California Constitution, article XIII A, section 2; RTC sections [60 – 69.5](#).

<sup>5</sup> RTC section 64(a).

*This staff analysis is provided to address various administrative, cost, revenue, and policy issues; it is not to be construed to reflect or suggest the BOE's formal position.*

- **Cumulative Transfers by "Original Co-owners."** RTC section 64(d) requires reassessment when voting stock or other ownership interests representing cumulatively more than 50 percent of the total interests in a legal entity are transferred by any of the "original co-owners" in one or more transactions.<sup>6</sup> The reassessment applies to only the real property previously excluded from change in ownership under RTC section [62\(a\)\(2\)](#).

**New Construction.** When substantial additions or alterations occur, the law requires the assessor to increase the assessment to reflect the value of "newly constructed" property.<sup>7</sup> The assessor assigns the assessable new construction with its own distinct base year value. The remainder of the property's assessment is unaffected and retains its base year value.<sup>8</sup> The Constitution allows the Legislature to provide that the term "newly constructed" does not include certain construction activities. These are commonly called "new construction exclusions." Any value added by these additions or alterations is not subject to the property tax, until the real property undergoes a change in ownership.

**Active Solar Energy System New Construction Exclusion.** The California Constitution<sup>9</sup> grants the Legislature the authority to exclude the construction or addition of any active solar energy system from the definition of assessable new construction. Revenue and Taxation Code (RTC) section [73](#) implements the new construction exclusion, which is available through the 2023-24 fiscal year. Section 73 is scheduled to sunset on January 1, 2025. Any active solar energy system that was excluded prior to this date will continue to be excluded until a change in ownership occurs.

In 2011, the Legislature added findings and declarations,<sup>10</sup> which provide that in cases where a newly constructed active solar energy system is sold or transferred in sale-leaseback arrangements, partnership flip structures, or other transactions to take advantage of federal tax benefits, the active solar energy system new construction exclusion applies, as long as (1) the system is newly constructed or added, and (2) no other taxpayer has received the exclusion for that same system. The new construction exclusion remains in effect only until there is a subsequent change in ownership.

**Proposed Law:** This bill provides that, where a legal entity owns an active solar energy system pursuant to a partnership flip transaction, neither an initial transfer of a capital and profits interest in the legal entity nor any subsequent change in the allocation of the capital and profits of the legal entity among the members constitutes a change in control or a majority interest in the legal entity. This bill also provides that these provisions do not apply to any real property owned by the legal entity, other than the active solar energy system.

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<sup>6</sup> **Proportional Ownership Interests Exclusion Creates "Original Co-owner" Designation.** Under RTC section 62(a)(2), a transfer of real property to a legal entity does not result in a reassessment if the transfer is merely a change in the method of holding title and the proportional ownership interests of the transferors and transferees in the real property transferred are *exactly* the same before and after the transfer. However, after a transfer of real property qualifies for this exclusion from reassessment, the person(s) or entity(ies) holding ownership interests in the legal entity immediately after the transfer are considered "**original co-owners**" for purposes of tracking subsequent transfers by original co-owners of those interests. When such transfers cumulatively exceed 50 percent, the real property previously excluded from reassessment under RTC section 62(a)(2), is subject to reassessment under RTC section 64(d), absent an applicable exclusion.

<sup>7</sup> Article XIII A, section 2 of the California Constitution (Proposition 13) and RTC section [70](#). Additionally, "supplement assessment" laws make the new construction taxable as of the completion date.

<sup>8</sup> Unless the new construction replaces certain types of existing improvements, in which case the value attributable to those preexisting improvements is deducted from the property's existing base year value.

<sup>9</sup> Article XIII A, section 2(c)(1).

<sup>10</sup> [ABx1 15](#) (Stats. 2011, ch. 3).

**Effective Date.** If enacted, these provisions will become effective immediately.

**Findings and Declarations.** In order to finance the construction of new active solar energy systems, solar developers may enter into financing arrangements, including sale-leaseback arrange, partnership flip structures, or similar transactions, with investors (purchasers) that may also be eligible for federal tax benefits. In 2011, the Legislature stated its intent that RTC section 73 was amended to clarify that the purchaser of the active solar energy system in a sale-leaseback arrangement, partnership flip structure transaction, or similar transaction receive an exclusion until there is a subsequent change in ownership. This bill states that the intent of this bill, for purposes of the RTC section 73 new construction exclusion, a subsequent change in ownership does not include a change in control among the partners in a partnership flip transaction, resulting solely from a change in the allocation of the partnership's capital and profits among the partners, if the mechanics of the change were in place at the time the active solar energy system is acquired by the partnership.

**In General: Property Tax System.** Article XIII, section 1 of the California Constitution provides that all property is taxable at the same percentage of "fair market value," unless specifically exempted, or authorized for exemption. Article XIII A, section 2 defines "fair market value" as the assessor's opinion of value for the 1975-76 tax bill, or, thereafter, the appraised value of property when purchased, newly constructed, or a change in ownership has occurred. This value is generally referred to as the "base year value." Annual adjustments to the base year value are limited to 2 percent or the rate of inflation, whichever is less. Article XIII A, section 2 also provides for certain exclusions from consideration as a "change in ownership" and "newly constructed" as approved by voters via constitutional amendments.

**New Construction.** The California Constitution does not define the terms "new construction" or "newly constructed." RTC section 70 defines these terms, in part, to mean:

- Any addition to real property, whether land or improvements (including fixtures), since the last lien date.
- Any alteration of land or any improvements (including fixtures) since the last lien date that constitutes a "major rehabilitation" or that converts the property to a different use.

A major rehabilitation is any rehabilitation, renovation, or modernization that converts an improvement or fixture to the substantial equivalent of a new improvement or fixture.

With respect to any new construction, the law requires the assessor to determine the added value upon completion. The value is established as the base year value for those specific improvements qualifying as "new construction" and is added to the property's existing base year value. When new construction replaces certain types of existing improvements, the value attributable to those pre-existing improvements is deducted from the property's existing base year value.<sup>11</sup>

**New Construction Exclusions.** Certain types of construction activity are excluded from assessment as "new construction" via constitutional amendment. Consequently, while these improvements may increase the value of the property, the additional value is not assessable. Relevant to this bill, Proposition 7, approved by California voters in November 1980, created an exclusion for active solar energy systems.

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<sup>11</sup> RTC section [71](#).

**Overview of Solar Energy New Construction Exclusion.** An "active solar energy system" is defined in RTC section 73 as a system that uses solar devices, which are thermally isolated from living space or any other area where the energy is used, to provide for the collection, storage, or distribution of solar energy. An active solar energy system may be used for any of the following:

- Domestic, recreational, therapeutic, or service water heating
- Space conditioning
- Production of electricity
- Heat processing
- Solar mechanical energy

An active solar energy system includes storage devices, power conditioning equipment, transfer equipment, and parts related to the functioning of those items. "Parts" includes spare parts that are owned by the owner of, or maintenance contractor for, an active solar energy system for which the parts were specifically purchased, designed, or fabricated for installation in that system. Such a system includes only equipment used up to, but not including, the stage of conveyance or use of the electricity.

An active solar energy system also includes pipes and ducts that are used exclusively to carry energy derived from solar energy. Pipes and ducts that are used to carry both energy derived from the sun and energy derived from other sources may be considered active solar energy system property only to the extent of 75 percent of their full cash value.

This exclusion is scheduled to sunset on January 1, 2025. Any active solar energy system that was completed and excluded from assessment prior to this date will continue to be excluded until a change in ownership occurs.

An active solar energy system does not include auxiliary equipment, such as furnaces and hot water heaters, that use a source of power other than solar energy to provide usable energy. Dual use equipment, such as ducts and hot water tanks, that is used by both auxiliary equipment and solar energy equipment is considered active solar energy system property only to the extent of 75 percent of its full cash value.

RTC section 73 explicitly provides that the exclusion does not apply to solar swimming pool heaters or hot tub heaters. By definition, the exclusion does not apply to "passive" solar systems. Lastly, the exclusion does not apply to wind energy systems.

**Exclusion Extended to Initial Purchaser.** RTC section 73 was amended in 2008<sup>12</sup> to extend the new construction exclusion after a change in ownership if a new building is initially constructed with an active solar energy system incorporated and subsequently sold by the developer. Specifically, in the case where an active solar energy system is incorporated by an owner-builder in the initial construction of a new building that the owner-builder does not intend to occupy or use (i.e., a building offered for sale, such as a new home in a subdivision or a new warehouse), the exclusion for the system applies to the building's first buyer if (1) the owner-builder did not receive the exclusion for the same system, (2) if the initial buyer purchased the new building prior to that building becoming subject to reassessment to the owner builder,<sup>13</sup> and (3) a claim<sup>14</sup> is filed with the County Assessor.

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<sup>12</sup> [AB 1451](#) (Stats. 2008, ch. 538).

<sup>13</sup> RTC section 73(e)(1).

<sup>14</sup> RTC section 73(e)(1)(A); [BOE-64-SES](#), *Initial Purchaser Claim for Solar Energy System New Construction Exclusion*.

If the exclusion is eligible to be extended to the initial purchaser, then in determining the base year value to be established as a result of the change in ownership, the base year value is reduced by the portion of the purchase price that is attributable to the active solar energy system. Thereafter, any subsequent change in ownership of the property ends the exclusion of the value of the active solar energy system from property tax.

**Common Transactions that may be Eligible for Federal Tax Benefits.** Under the 2011 legislative intent language, newly constructed active solar energy systems continue to receive the property tax exclusion if they are transferred using certain transactions that require the active solar energy system to be sold or transferred to a third party that may qualify for federal tax benefit. Transactions that may be eligible for federal tax benefits include, but are not limited to, the following:

- *Sale-leaseback transactions* involve the sale of a property in which the seller immediately begins to lease the property from the buyer. Thus, the seller no longer has ownership of the property, but operates it for the duration of the lease agreement.
- A *partnership flip transaction* is a financing arrangement between a renewable energy developer and a single or multiple tax investors whereby the parties form a partnership or limited liability company to develop and/or own an active solar energy system. This structure involves the tax investor making an investment in the partnership or limited liability company in exchange for the majority of the tax attributes (i.e., federal tax credits, depreciation, and net income) until the investor achieves its pre-established yield. The investor's share of these items is then reduced. The reduction is known as the "flip."

In the case of a partnership flip transaction, if the investment made by the tax investor causes it to obtain more than 50 percent of the capital and profits interests of the partnership or limited liability company (either upon the making of the initial investment or pursuant to subsequent changes in the capital and profits percentages owned by the investor required by the partnership or operating agreement), the change in control is excluded by the new construction exclusion and no reassessment of the active solar energy system will occur. However, if the developer or a third party subsequently obtains more than 50 percent of the capital and profits interests of the partnership or limited liability company, a change in control and reassessment of the active solar energy system will occur.<sup>15</sup>

**Legal Entity Change in Control or Ownership.** County Assessors discover most real property changes in ownership via grant deeds or other documents recorded with the County Recorder. However, real property owned by a legal entity may undergo a "change in control or ownership" with no grant deed or other document recorded that could alert the County Assessor to a reassessment. These types of changes in control or ownership are reported directly to the State Board of Equalization's (BOE) Legal Entity Ownership Program (LEOP) by the person or entity involved.

Existing law<sup>16</sup> requires legal entities to file a change in ownership statement (LEOP COS) with the BOE within 90 days of a change in control or ownership under RTC section 64(c) or (d). In the case of a change in control under RTC section 64(c), the person or legal entity that *acquired* control of the legal entity is responsible for filing the LEOP COS.

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<sup>15</sup> Letter To Assessors [2012/053](#), *Guidelines for Active Solar Energy Systems New Construction Exclusion*.

<sup>16</sup> RTC sections [480.1](#) and [480.2](#).

In addition to the self-reporting requirement to file a LEOP COS, the BOE may send a LEOP COS to an entity to complete and file with the BOE. Annually, the BOE canvasses legal entities with a query on the California Franchise Tax Board income tax return. County Assessors and other interested parties may send referrals reporting possible changes.

Once the BOE determines that a legal entity has undergone a change in control or ownership, the BOE notifies County Assessors of those legal entities' changes in control or ownership.

### **Commentary:**

1. **Author's Comment.** Existing law does not directly address whether the pre-set shift in allocations from an investor back to a developer as a result of a partnership flip at the flip point is a "change in ownership." This uncertainty is causing concern in the solar energy system industry, which is slowing down the building of new solar energy system projects, as investors are reluctant to put capital at risk partially due to this matter. To maintain accessibility to active solar energy systems and keep the original intent of the "newly constructed" exclusion, SB 1059 clarifies that a change in ownership does not occur – for purposes of the solar exclusion – as a result of a partnership flip.
2. **Section 73 is not a real property tax "exemption" for solar energy facilities, but a new construction "exclusion."** The new construction exclusion was created in 1980 via Proposition 7 to provide that the construction or addition of an active solar energy system to an existing property, by itself, would not lead to a revaluation of the property for property tax purposes. A new construction exclusion terminates if there is a transfer of the property resulting in a property's change in ownership (a reappraisal event). In the case of any locally assessed large scale solar project, only the active solar energy system improvements are eligible for the new construction exclusion, while the land remains subject to property tax.<sup>17</sup>
3. **Termination of New Construction Exclusion.** A new construction exclusion terminates if a change in ownership (a reappraisal event) occurs. For an excluded active solar energy system that is owned by a legal entity, if a person or entity subsequently obtains more than 50 percent of a corporation's voting stock or the capital and profits interests of a partnership or limited liability company that owns the active solar energy system, the change in control of the legal entity will result in a reassessment of any real property owned by the legal entity, including any excluded active solar energy systems.
4. **Legal Entity Change in Control.** Where a legal entity owns an active solar energy system pursuant to a partnership flip transaction, this bill provides that neither of the following is considered a change in control pursuant to RTC section 64(c)(1):
  - An initial transfer of a capital and profits interest in the legal entity,
  - Any subsequent change in the allocation of the capital and profits of the legal entity among the members.

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<sup>17</sup> If the land is government owned, the land could become subject to a possessory interest. Generally, a taxable possessory interest exists when a taxpayer possesses an interest in government real property that is durable, independent, exclusive of the rights held by others in the real property and the interest provides a private benefit to the possessor.

These provisions will apply only to a legal entity that owns an active solar energy system, either on its own property or leased to someone else where the remaining lease term is less than 35 years.<sup>18</sup> This bill specifies that these provisions apply only to an active solar energy system and do not apply to any other real property owned by the legal entity.

5. **Legal Entity Change in Ownership.** When real property is transferred to a legal entity or between legal entities that qualifies for exclusion under RTC section 62(a)(2) (i.e., the ownership interests in the real property are the same before and after the transfer), the owners are deemed "original co-owners" for purposes of future transactions. RTC section 64(d) requires reassessment when cumulatively more than 50 percent of the interests in the legal entity are transferred by any of the "original co-owners" in one or more transactions. The reassessment applies to only the real property previously excluded from change in ownership under RTC section 62(a)(2), including any active solar energy system owned by the legal entity. The exclusion from change in control proposed by this bill would not apply to a change in ownership under section RTC section 64(d).
6. **Solar Energy Systems Owned by Legal Entities.** The BOE notifies County Assessors of legal entities that have undergone a change in control or ownership. Information regarding active solar energy systems is not provided to the BOE on the LEOP COS. Since the BOE is not provided information on active solar energy systems, and the County Assessors receive legal entity-owned property information from the BOE, how will the County Assessors know what legal entities own active solar energy systems that may qualify for exclusion under this bill?
7. **Different Property Tax Treatment for Sale-Leaseback Financing Arrangements.** This bill grants favorable property tax treatment to partnership flip transactions that may not be available for sale-leaseback transactions. This bill excludes an active solar energy system from reassessment upon an initial partnership flip investment through the entire life of the investment, including when control of the legal entity reverts back to the developer. In a sale-leaseback transaction, the initial sale and leaseback of an active solar energy system are excluded from reassessment. However, at the end of the lease, a buyback of the active solar energy system by the developer/lessee may not be excluded from change in ownership.
8. **Does exclusion apply if there are new owners of an active solar energy system-holding legal entity?** The proposed statute is unclear as to whether it applies if a new partner enters the partnership, for example, if prior to the "flip," a partner sells its interest to a new partner. As currently drafted, and based on the legislative intent language, the entrance of a new partner would likely disqualify the active solar energy system-holding legal entity from this exclusion.
9. **State assessed properties are not eligible for the new construction exclusion because it is only applicable to locally assessed property.** In *ITT World Communications, Inc. v. City and County of San Francisco* (1985) 37 Cal.3d 859, the California Supreme Court ruled that Proposition 13's (article XIII A) assessment rollback, its 2 percent limit on annual assessment growth, and its limit on current market value assessment only upon a change in ownership or new construction did not apply to state-assessed property, only to locally assessed property. As a result, taxable property in California is now generally split into two major categories: locally assessed property

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<sup>18</sup> Under RTC section [61\(c\)](#) and Property Tax Rule [462.100](#), a lessee is considered the owner of leased property if the lease term is 35 or more years. When a lease term drops below 35 years, the primary ownership is shifted back to the lessor.

subject to article XIII A assessment limitations and state-assessed property not subject to those assessment limitations. Thus, active solar energy systems owned by public utilities and subject to BOE assessment do not benefit from the section 73 new construction exclusion; value of these properties would continue to be captured under the unitary approach to value.

**Costs:** The BOE would incur some minor absorbable costs to inform and advise county assessors of the change in law. In addition, the BOE may incur estimated costs of \$20,650 to update the LEOP computer program.

**Revenue Impact:** This bill's revenue impact depends on how many active solar energy systems are owned by legal entities, the number of legal entities that would undergo a change in control after the installation of the active solar energy system, and the market value of the active solar energy system at the time of the change in control. The value of an active solar energy system is variable and depends on the features of each system on a case-by-case basis. It is unknown how many active solar energy systems are owned by legal entities. The BOE does not have this data available; thus, the revenue impact is indeterminable.