SolarCity

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Via E-mail: sherrie.kinkle@boe.ca.gov

Sherrie Kinkle
California State Board of Equalization
Property and Special Taxes Department
PO Box 942879, MIC: 64
Sacramento, CA 94279-0064

RE: Comments on Proposed Revisions to Draft Guidelines for Active Solar Energy Systems New Construction Exclusion

Dear Ms. Kinkle,

SolarCity submitted comments on the State Board of Equalization's draft *Guidelines for Active Solar Energy Systems New Construction Exclusion* on November 23, 2011 and participated in the January 26, 2012 interested parties meeting to discuss proposed language for the Guidelines. SolarCity appreciates the opportunity to submit additional comments and respectfully proposes alternative language for the Guidelines.

These comments are limited to SBE's proposed rewrite of the Guidelines that was prompted by the comments of San Diego County Counsel (Comment 27 in SBE's comment matrix).

SolarCity Proposal

We propose that SBE's rewrite be modified as follows to clarify that a "flip" in a partnership flip transaction does not cause a change in ownership:

SOLARCITY PROPOSED MODIFICATION OF SBE REWRITE IN RESPONSE TO COMMENT 27

> Because the active solar energy system new construction exclusion was for the purpose of encouraging the building of active solar energy systems, and states explicitly that it covers "other transactions," the new construction exclusion should also be applied to active solar energy systems that are transferred during construction and where a change in control of the legal entity owning the active solar energy system occurs upon formation of ~~as part of~~ a partnership flip structure during or after construction. However, ~~no exclusion should be granted upon the ownership of the legal entity "flipping back" to the builder/ developer or a third party.~~the exclusion will be extinguished if the builder/developer or a third party exercises an option to acquire an interest in the legal entity and, through the exercise of the option, the person directly or indirectly acquires more than 50% of the capital and profits of the entity. The exclusion is not lost on transfer until a taxpayers receives the exclusion on a system on which construction has been completed. Additionally, construction in progress on the lien date would also qualify for the exclusion.

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This alternative language aligns the Guidelines with Property Tax Rule 462.180(d)(1)(B) set forth at 18 Cal. Code Regs. § 462.180(d)(1)(B), and with the economic reality of partnership flip transactions, as explained below.

Discussion

1. A "Flip" Is Not a Change in Ownership

A change in the percentage of tax items allocated to a partner under terms specified in an LLC or partnership's operating agreement from inception (i.e., a "flip" in a partnership flip transaction) is not a change in ownership. Rather, a change in ownership requires a transfer, reorganization or multi-tiering that causes a person to acquire more than 50% of the capital AND profits interests in a partnership or LLC. See 18 Cal. Code Regs. § 462.180(d)(1)(B).

San Diego County Counsel's comment (Comment 27) incorrectly assumes that such a transfer occurs when the flip occurs. During the January 26, 2012 interested parties meeting, San Diego County Counsel proposed alternative language that also is based on the same assumption. Specifically, San Diego County Counsel proposed that the final sentence of this section of SBE's proposed rewrite be modified to read as follows:

SAN DIEGO COUNTY COUNSEL PROPOSED MODIFICATION OF SBE REWRITE

"However, no exclusion should be granted upon the ~~ownership~~ controlling interest of the legal entity "flipping back" to the builder/developer or a third party."

This assumption is incorrect for two reasons. First, no transfer, reorganization or multi-tiering occurs by virtue of the flip. In a typical partnership flip deal, the investor is allocated up to 99% of the partnership tax items (income, loss, depreciation, credits, etc.) until the investor receives a target yield on its investment. Cash is distributed based on a different ratio agreed to by the partners. Often, as much as 100% of the cash is distributed to the developer for much of the pre-flip period. When the investor reaches its target yield, the partnership allocates these items in a different ratio. This is the "flip." This change is predefined in the operating agreement at the inception of the deal. Typically, the investor's post-flip share of these items is 5%, but the investor can receive 50% or more.

Second, the flip often does not affect whether the developer has more than 50% of the capital and profits in the partnership. The flip has no affect on a partner's capital. At all times, the partnership will liquidate in accordance with the partnership's capital accounts. Because the investor's share of tax losses is so high in the pre-flip period, its capital account is almost always near zero. This is especially true where there is project debt, since that allows the investor to claim depreciation beyond its equity investment.

The flip also does not alter a partner's overall profit share; it merely alters the partner's periodic allocation of profits. A partner's share of profits should be measured over the life of the deal, not on an allocation ratio for a particular date. Solar projects have a useful life of 30-35 years. This reduction usually occurs after only 5-10 years. The developer measures its return over the full life of the project. In fact, over the life of the partnership, the developer typically receives the bulk of the net income and cash. The investor receives only a 2-3% return on its cash investment, and during most of the pre-flip period, the investor does not receive any taxable income (i.e., just losses).

It also should be noted that the developer controls all day-to-day activities during the entire life of the partnership. The investor merely has a veto right over certain major decisions, such as selling the project.

2. The Exercise of a Purchase Option Is a Transfer, But Not Necessarily a Change in Ownership

While the flip is not a transfer (as suggested by San Diego County Counsel), a purchase of the investor's membership interest - either by the developer or a third party - would constitute a transfer. The developer often has an option to buy the investor's partnership interest after the flip; the option is exercisable at a fair market value purchase price, however, and thus cannot be assumed to occur. These are long-term deals that merely have temporary variances in certain sharing ratios.

The exercise of such an option is a transfer within the meaning of 18 Cal. Code Regs. § 462.180(d)(1)(B). However, that is just one element of what constitutes a change in ownership. A transfer does not, by itself, mean the developer will acquire more than 50% of the capital AND profits. In many cases, the developer has more than 50% of the capital AND profits from day one. If a person already has control of the partnership, acquisition of the remaining interests in capital and profits is not a change in ownership. See Cal. Rev. & Tax. Code § 64(c)(2).

Conclusion

For the reasons explained above, SolarCity's proposed modification of SBE's rewrite of the Guidelines in response to Comment 27 is appropriate and necessary to clarify that a "flip" in a partnership flip transaction does not cause a change in ownership.

Thank you for the opportunity to provide additional comments on the draft Guidelines and to propose alternative language. We would like to meet with you and other SBE staff to discuss our proposal, at your convenience.

Very truly yours,

Sanjay Ranchod

Sanjay Ranchod
Director of Government Affairs and Senior Counsel

cc: Dean R. Kinnee, SBE Department Chief
Richard S. Moon, SBE Tax Counsel
John Marciano, Chadbourne & Parke LLP