Arizona Companies Win Preferential Tax Treatment For Solar Panels

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In this article, the three discuss the Arizona Court of Appeals' ruling in *SolarCity Corp. v. Arizona Department of Revenue*, which upheld the constitutionality of a state law allowing leased solar panels to have zero value when property tax is assessed. The authors ponder the implications of the DOR appealing the case to the Arizona Supreme Court.

In an opinion released May 18, 2017, the Arizona Court of Appeals sided with SolarCity and SunRun in their dispute with the Arizona Department of Revenue, finding that state law allowing the companies' leased solar panels to have zero value for purposes of assessing property tax did not run afoul of the Arizona Constitution.[1] In reaching this conclusion, the court of appeals affirmed in part and reversed in part the Arizona tax court's ruling.[2]

This case represents a ray of good news for an industry that has been under storm clouds recently, with financial problems causing companies like Sungevity and OneRoof to be sold in distressed transactions. However, the story is not quite over: The DOR is likely to appeal the case to the Arizona Supreme Court. The supreme court has discretion to hear the case. Courts with discretionary jurisdiction typically avoid thorny tax cases; it would bode well for SolarCity and SunRun if that trend continues in this instance.

SolarCity and SunRun, two of the largest marketers of distributed solar energy in the United States, offer leases and power purchase agreements for rooftop solar panel systems to owners of residential and

[1] *SolarCity Corp. v. Arizona Department of Revenue*, No. 1 CA-TX 15-0008 (Ariz. Ct. App., Div. 1 May 17, 2017).

[2] *SolarCity Corp. v. Arizona Department of Revenue*, TX 2014-000129 (Ariz. Tax Ct. June 1, 2015).

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commercial buildings.[3] Typically, these rooftop systems are grid-tied so that excess electricity not used on site by the building owner can be transferred to a utility under a net-metering arrangement. At issue before the Arizona Tax Court was whether SolarCity and SunRun's leased solar panels could take advantage of an Arizona "zero-value" statute providing that systems "designed for the production of solar energy primarily for on-site consumption are considered to have no value and to add no value to the property on which such device or system is installed" when property tax is assessed.[4] While the tax court appears to have rejected the DOR's argument that the zero-value statute by its terms does not apply to leased systems, it concluded that the zero-value statute is unconstitutional under the Arizona Constitution for two reasons.

First, under the constitution's so-called exemptions clause, the Arizona Legislature can choose not to tax specific property, but it cannot exempt otherwise taxable property.[5] The tax court reasoned that because there is no specific constitutional or statutory provision excluding solar energy systems from taxation, the zero-value statute, which effectively exempts the solar panels from taxation through a valuation mechanism rather than a direct exclusion, violates the exemptions clause.

Second, the constitution's so-called uniformity clause mandates that all taxes must be uniform upon the same class of property.[6] The tax court maintained that the zero-value statute violates this in two ways. First, in contrast to the zero-value statute that applies to systems designed for the production of solar energy primarily for on-site consumption, a second state statute provides that "electric generation facilities . . . located in this state, that [are] used or useful for the generation . . . of electric power . . . derived from solar . . . not intended for self-consumption"[7] are to be valued for tax purposes at 20 percent of the equipment's depreciated cost.[8]

As a result of this disparate treatment, the court held that the zero-value statute impermissibly distinguishes between solar energy systems used primarily for on-site consumption (that is, distributive generation systems) and centralized power systems not intended for self-consumption. In reaching this conclusion, the court implicitly took the position that distributive generation systems and centralized power systems are the same class of property, at least for property tax purposes. Second, the court noted that because the zero-valuation statute applies only to property designed "primarily" for on-site production, which as interpreted by the Corporation Commission means that the system's total output cannot exceed 125 percent of the amount of electricity used on site by the building owner, the zero-value statute impermissibly distinguishes between on-site systems based on how much electricity the customer uses.

The Arizona Court of Appeals rejected both constitutional arguments. Regarding the exemptions clause argument, the appellate court

[3] The courts' opinions and SolarCity and SunRun's complaint only reference leased systems. However, power purchase agreements for rooftop systems are permissible in Arizona, and in fact the DOR's memorandum regarding the valuation of rooftop solar systems that triggered this litigation provided identical treatment for leased systems and those subject to a power purchase agreement. We can only speculate that SolarCity and SunRun made the strategic decision to streamline their case by only addressing leased systems. This strategy may have served them well, as the holding of the Arizona Court of Appeals seems to be able to be extended to power purchase agreements. The court of appeals, as well as the tax court, found that leased rooftop systems are not subject to the 20 percent valuation standard applicable to renewable energy generation facilities because they do not deliver the electricity they produce through a transmission and distribution system as required to apply the 20 percent valuation standard under the applicable statute; factually that is also the case for rooftop systems subject to power purchase agreements.

Rather, the courts found that the leased rooftop systems would be subject to the zero-valuation standard applicable to solar systems designed primarily for on-site consumption; factually there is no difference between the on-site consumption of a leased rooftop system and a rooftop system subject to a power purchase agreement. Further, the court of appeals' arguments to uphold the zero-valuation statute's constitutionality appear to apply regardless of whether the statute is interpreted to include rooftop systems subject to a power purchase agreement. Accordingly, solar companies should be in good stead to apply the holding to their rooftop systems subject to power purchase agreements that generate electricity used by the owner of the roof.

[4] Ariz. Rev. Stat. section 42-11054(C)(2).

[5] Ariz. Const. Art. IX, section 2(13). ("All property in the state not exempt under the laws of the United States or under constitution or exempt by law under the provisions of this section shall be subject to taxation to be ascertained as provided by law").

[6] Ariz. Const. Art. IX, section 1. ("All taxes shall be uniform upon the same class of property within the territorial limits of the authority levying the tax, and shall be levied and collected for public purposes only").

[7] Ariz. Rev. Stat. section 42-14155(C)(3).

[8] Ariz. Rev. Stat. section 42-14155.

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countered that the zero-value statute does not exempt solar panels from taxation; rather, the "statute's plain language indicates that the Legislature chose to exercise its power of taxation and assign a value of zero to installed grid-tied photovoltaic and solar energy systems when applying standard appraisal methods and techniques." Accordingly, the court held that the zero-value statute does not violate the exemptions clause.[9] The court's approach recalls that taken outside the property tax arena, where the difference between an exemption (which is narrowly construed against taxpayers) and an exclusion from tax (which is construed against the government) can mean the difference between winning and losing — even though the tax impact of an exemption and an exclusion may be the same.[10]

Turning to the challenge under the uniformity clause, the court of appeals looked at the characteristics of distributive generation systems. It concluded that those systems are not of the same class of property as centralized power systems, notwithstanding that the distributive generation systems may be grid-tied, because marketers of distributed solar energy (such as SolarCity and SunRun) (1) are not direct competitors of utilities, (2) provide different services than utilities, (3) have different customer bases than utilities, and (4) use different types of equipment than utilities. The court said that while excess electricity generated by the solar panels may be supplied to the grid, it does not change the result because any distribution is only a secondary function of the solar panels. Further, the appellate court argued that because the zero-value statute looks at the design of the system rather than the actual production, the tax court erred in asserting that the zero-value statute impermissibly distinguishes between taxpayers based on the amount of electricity the customer uses. Accordingly, the court of appeals held that the fact that the zero-value statute distinguishes between solar distributive generation systems and centralized power systems is not a violation of the uniformity clause.

One issue that did not arise is that in some utility districts, such as in areas of Massachusetts, a residential solar system will transmit all of its power to the grid and then draw from the grid all of the power that the home requires. The homeowner is then billed for the excess of what was drawn from over what was provided to the grid. The economics are the same as the residential solar arrangements in Arizona. But under a literal reading of the Arizona residential solar property tax exclusion, the Massachusetts-type arrangement would not qualify for the exclusion because those systems are arguably not "designed for the production of solar energy primarily for on-site consumption" because the electrons produced by the system are transmitted by the grid elsewhere to be consumed. The Arizona exclusion appears to have been drafted in a highly formalistic manner that serves no apparent policy objective.

The Arizona Legislature could have avoided these ambiguities and the resulting dispute by premising the exclusion on the system's size. For instance, systems with a capacity of less than 1 megawatt could have been provided the exclusion, while systems with a capacity of a megawatt or more could have been provided the 20 percent valuation. The Legislature may have rejected a size threshold out of a concern that owners of large systems would try to game the rule by attempting to divide their systems into multiple systems that are each less than the threshold; however, such a concern could have been addressed by deeming for property tax purposes that all systems sited on contiguous land are a single system.[11]

[9] While we are neither philosophers nor mathematicians, we would be remiss if we didn't note that the dispute between the tax court and the appellate court regarding whether zero valuation is the equivalent of exclusion from taxation is evocative of the somewhat arcane discussion of whether zero is a proper number or merely a proxy for nothing. *See, e.g.*, John Matson, "The Origin of Zero," *Scientific American* (Aug. 21, 2009).

[10] *See, e.g.*, *Grace v. N.Y.S. Tax Commission*, 332 N.E.2d 886 (N.Y. 1975) ("'A statute which levies a tax is to be construed most strongly against the government and in favor of the citizen. The government taxes nothing except what is given by the clear import of the words used and a well-founded doubt as to the meaning of the act defeats the tax' . . . however, [where] it is undisputed that the taxpayer's income is subject to the taxing statute, but he claims an exemption from taxation, a different rule applies. An exemption from taxation 'must clearly appear, and the party claiming it must be able to point to some provision of law plainly giving the exemption'"). Citations omitted. *See also In re Prospect Park Health and Racquet Association*, Dkt. 81196, 811608 (N.Y.S. Tax Appeals Tribunal) (holding that because the participatory sport is an exclusion from the sales tax and not an exemption, it must be construed in favor of the taxpayer; charges imposed by tennis facility were not held not subject to sales tax).

[11] *See, e.g.*, I.R.S. Notice 2013-29, section 4.04(2) (defining "single project" with an eight-factor test that includes contiguous land).

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Having held that it does not violate the Arizona Constitution, the court of appeals concluded that the zero-value statute can be applied to SolarCity and SunRun's leased solar panels to effectively exempt the solar panels from property tax. The court of appeals correctly found that solar distributive generation systems and centralized power systems are different classes of property for purposes of the uniformity clause. It will be interesting to see if the Arizona Supreme Court chooses to hear this case involving an intersection of tax law and electrical engineering and if so whether it concurs with the appellate court. ■

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