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## FISCAL IMPACT REPORT

**ORIGINAL DATE** 1/28/2016  
**SPONSOR** Trujillo, CA **LAST UPDATED** \_\_\_\_\_ **HB** 163

**SHORT TITLE** Home Energy & Water Efficiency Tax Credit **SB** \_\_\_\_\_

**ANALYST** Graeser

### REVENUE (dollars in thousands)

Estimated Revenue *								Recurring or Nonrecurring	Fund Affected
FY16	FY17	FY18	FY19	FY20	FY21	FY22	FY23		
(\$500.0)	(\$1,510.0)	(\$1,830.0)	(\$2,000.0)	(\$2,000.0)	(\$2,000.0)	(\$1,010.0)	(\$200.0)	Recurring	General Fund

Parenthesis ( ) Indicate Revenue Decreases

\* The LFC estimate reported here is largely driven by assumptions based on capacity of the Home Energy Consultant industry in the state. It differs from the TRD estimate. See “Fiscal Implications” below for more detail.

### ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY16	FY17	FY18	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected **
<b>Total</b>		\$70.0	\$70.0	\$140.0	Recurring	General Fund

Parenthesis ( ) Indicate Expenditure Decreases

\*\* Energy, Minerals and Natural Resources Department

### SOURCES OF INFORMATION

LFC Files

#### Responses Received From

Energy, Minerals and Natural Resources Department (EMNRD)

Taxation and Revenue Department (TRD)

### SUMMARY

#### Synopsis of Bill

House Bill 163 creates a new section of the Income Tax Act to produce a one-time credit against the taxpayer’s income tax liability called the “home energy and water efficiency income tax credit”. The tax credit’s purpose is to increase the efficiency of energy and indoor water use of existing residences in the state. To be eligible for a home energy and water efficiency income tax

credit, the taxpayer’s improvements must have increased the primary residence’s energy or indoor water efficiency by at least fifteen percent. The taxpayer will need an inspection from a qualified assessor approved by the energy, minerals, and natural resources department prior to and after the improvements are made. The taxpayer will be responsible for the costs of the inspection. The amount of the credit ranges from \$1,200 to \$4,000, based on the percentage of improved efficiency (see table below).

<b>Energy Efficiency Improvement Percentage</b>	<b>Tax Credit Amount (\$USD)</b>
Between 15 and less than 25	1,200
Between 25 and less than 35	2,500
35 or more	4,000

<b>Indoor Water Usage Efficiency Improvement Percentage</b>	<b>Tax Credit Amount (\$USD)</b>
Between 15 and less than 25	500
Between 25 and less than 35	750
35 or more	1,000

For *credits claimed* in the period between January 1, 2017 and December 31, 2019, TRD will cap the credit at \$1 million annually – presumably based on the calendar year. For credits claimed between January 1, 2020 and December 31, 2022 the department will cap the credit at \$2 million annually. Claims denied because of the caps become first in the queue for the following year.

***Unusually, the credit is refundable and can be claimed by persons with no income tax liability. The bill does not require the claimant to have paid for the energy or water-saving improvements.***

HB 163 further requires EMNRD to promulgate rules establishing procedures to certify qualified efficiency increases made to the taxpayer’s primary residence for the purpose of obtaining the home, energy, and water efficiency income tax credit. Implicitly, but not explicitly, EMNRD is required to establish a certification program for home energy assessors.

The Taxation and Revenue Department (TRD) will be required to compile annual reports to evaluate the effectiveness of the credit. Beginning in 2018, and every three years thereafter that the credit is in effect, TRD will be required to present the annual reports to the Revenue Stabilization and Tax Policy Committee and the Legislative Finance Committee with an analysis of the effectiveness and cost of the credit and whether the credit is performing the purpose for which it was created.

Taxpayers may not claim the business facility rehabilitation credit (7-2-18.4 NMSA 1978) and this credit in the same year.

**EFFECTIVE DATES**

There is no effective date of this bill. It is assumed the effective date is 90 days after this session ends (May 18, 2016). The provisions of the act apply to taxable years beginning on or after January, 1 2016.

**FISCAL IMPLICATIONS**

TRD reports that it does not have the necessary data to complete a precise analysis of the bill’s fiscal impact. Their estimate is shown on Table 1. EMNRD does not have data on how many potential homeowners would take advantage of this program. However, EMNRD anticipates that this program will take time to develop based on their experience with other similar tax credit programs that they manage because it will require the homeowner to make an initial investment to obtain the energy and water assessment required by the bill.

Because very little activity is anticipated in tax year 2016, TRD assumes there is a minimal FY16 fiscal impact. TRD also assumes 100 certificates will be issued for both home energy efficiency and indoor water user efficiency in tax year 2017. The number of certificates is expected to grow at the same rate as the sustainable building tax credit in subsequent years. TRD assumes the majority of these certificates will be issued to the “between 25 percent and less than 35 percent” category since EMNRD anticipates this category will be the most popular based on the degree of difficulty to attain.

**Table 1.**

<b>Estimated Revenue *</b>					<b>Recurring or Nonrecurring</b>	<b>Fund Affected</b>
<b>FY15</b>	<b>FY16</b>	<b>FY17</b>	<b>FY18</b>	<b>FY19</b>		
Minimal	(\$150.0)	(\$410.0)	(\$520.0)	(\$760)	Recurring	General Fund

LFC staff do not agree with TRD’s assumptions or estimate for the following reasons:

1. The sustainable building credit really only applies to high-end construction. The construction is permitted and, therefore, the quality is inspected by city, county or state inspectors. With the credit of the bill, there is no independent means of assuring that the designed modifications to the building envelope are actually accomplished or accomplished to an acceptable degree of durability and quality. Because of this, there is substantially greater opportunity for misstatement and outright fraud with the home, energy, and water efficiency tax credit than for the sustainable building credit. In addition, the scale of projects subject to credit pursuant to the provisions of this bill is far smaller and therefore far more accessible to the general public.
2. The analogue to this credit is much more likely to be Santa Fe’s rooftop water catchment system program than the sustainable building credit. Santa Fe County passed an ordinance relating to Water Harvesting and Conservation in 2003. Testimony from Santa Fe County and Santa Fe businesses involved in selling and installing water harvesting systems estimates that in 2013 there were an estimated 500 residential systems and 35 commercial systems installed in Santa Fe County. The cost of a residential system including installation is estimated to be between \$7,000 and \$40,000, whereas the cost of a commercial system including installation is estimated to be between \$30,000 and

\$140,000. This is far closer to the scale of investment creditable pursuant to the provisions of this bill.

3. Santa Fe Community College has had a sustainable building program for several years and has certified a number of Home Energy Rating System (HERS) raters and Leadership in Energy Efficient Design (LEED) inspectors. At the moment, there are no course offerings leading to either HERS or LEED inspector certification. However, there are 14 certified HERS companies in New Mexico listed on the Residential Energy Services Network (RESNET). If each firm is capable of doing 250 energy audits a year, and 50 percent of the energy audits lead to home energy efficiency plans that will result in at least 20 percent overall envelope efficiency improvement and 34 percent of those plans end up with tax certificates and the average improvement is in the 30 percent range (\$2,300 credit per home), then the total aggregate credit per year from this sample will be about (\$1,400.0). In addition to the sample, there will be additional credits generated by the indoor water use features (for which there is virtually no standard), and for plans and installations generated by assessors not listed on RESNET. The estimate adds 20 percent to the sample estimate for the home energy portion of the credit to account for the water conservation credit and then adds 20 percent to account for qualified assessors that may not be listed on RESNET. The average tax for the population that is likely to claim this credit is between \$2,000 and \$2,500. Thus, the average claimant would be able to apply the full amount of the earned credit on the claimant's personal income tax return for the year of installation or the following year.
4. Home weatherization under the Low Income Home Energy Assistance Program (LIHEAP) program is eligible for this credit. Each remediation project costs an average of \$5,000 and improves home energy efficiency by an average 30 percent. These projects would be eligible for this credit if a qualified assessor were to audit the house before and after remediation. To the extent the New Mexico Mortgage Finance Authority (MFA) and the Human Services Department (HSD) understand this opportunity, an average of 400 homes a year would become eligible for a credit pursuant to the provisions of this bill. The bill does not require the taxpayer to own the home, nor does the bill require the resident to pay for the improvements. The credit is refundable.

The LFC staff revenue estimate listed in the table on page 1 assumes that 78 percent of the credit would be claimed on the personal income tax return for the year of installation. RESNET listed firms and a number of others are currently doing home energy audits, building remediation plans and supervising the installation of the recommended energy and water efficiency improvements. There will be some latency period for this industry, since the credit applies to improvements installed beginning January 1, 2016. However, credits granted for improvements installed in early 2016 could be filed with TY 2016 tax returns – particularly if the taxpayer filed for a two-month extension of time to file TY 2016 returns. This strategy is relatively sophisticated, but the HERS raters hired as assessors could learn how to counsel their clients to take maximal advantage of the credit. This is a much different latency as was experienced for the sustainable building credit.

Estimating the cost of tax expenditures, generally, is difficult. Confidentiality requirements surrounding certain taxpayer information create uncertainty, and analysts must frequently interpret third-party data sources. The statutory criteria for a tax expenditure may be ambiguous, further complicating the initial cost estimate of the expenditure's fiscal impact. Once a tax expenditure has been approved, information constraints continue to create challenges in tracking the real costs (and benefits) of tax expenditures.

The provisions of HB 163 are counter to the LFC tax policy principles of adequacy, efficiency and equity. Due to the increasing cost of tax expenditures, revenues may be insufficient to cover growing recurring appropriations.

Aspects of the bill that are virtually impossible to determine are:

- Home equity of the taxpayer since it depends on the size and condition of the property;
- Access to upfront financing to pay the assessor and fund the recommended improvements;
- Quality of installation of the improvements and the homeowners personal income tax liability in the absence of the credit.

A majority of the taxpayers who would qualify for this credit (homeowners) are likely to itemize deductions. For this population, a decrease in state income taxes results in an increase in federal income tax. Typically, 30 percent of the state general fund cost becomes a transfer to the federal treasury.

## **SIGNIFICANT ISSUES**

Existing home owners face cost barriers and lack of objective information to make energy and water savings retrofit decisions for their homes. HB 163 provides assistance to address existing homes with energy efficiency and water consumption improvements especially during the current drought situation. The New Mexico housing stock is approximately 900,000 homes. Nationally, 94 percent of the housing stock is more than 25 years old based on the 2010 census, causing these homes to very energy-inefficient.

There are a number of distinct issues with the proposed credit on this bill:

- The fixed-dollar amount credits, based on a percentage improvement in the energy efficiency, means that there is no way of ensuring that this credit is equitable or related directly to a system-wide improvement in system efficiency;
  - A small, inefficient, house, treated with relatively inexpensive improvements would probably generate greater amounts of allowed credits than improvements to a larger, efficient house. The metric of concern to the state would be energy-saved system-wide per dollar of state cost.
- There is no independent means of ensuring that planned improvements are actually installed permanently;
  - For example, if the plan provides for the replacement of windows, but the homeowner simply caulks and tapes the seams, a blower door check could not distinguish between the relatively expensive solution and the very cheap solution.
- The verification mechanism relies heavily on competent and ethical behavior of unlicensed, but perhaps certified, "assessors."

- The home-energy improvements will not be considered permitted construction, since they will not change the footprint of the residence. Therefore, the quality of installation of the improvements will not be inspected by the Regulation and Licensing's Construction Industries Division, nor by any city or county building inspector.
- This refundable credit can be claimed by a resident of rental unit, Allowing this refundable credit for improvements to the renter of property

MFA's LIHEAP program reported in 2014 that it costs approximately \$5,000 to weatherize each home treated under the weatherization program (See the analysis of HB-104 of 2014 session). For the last few years, funding for the weatherization program has been primarily federal. Because this program does not require a cash outlay by the applicant, homes that have been "weatherized" would probably generate an income tax credit.

### **PERFORMANCE IMPLICATIONS**

EMNRD notes, "... currently, EMNRD reviews the Commercial and Residential Sustainable Building Tax Credits, Solar thermal and solar electric tax credits, Geothermal Ground Coupled Heat Pump Tax Credit, Renewable Energy Production Tax Credit and the Agriculture Biomass Tax Credit. EMNRD will experience additional workload in reviewing and processing applications with limited staff resources."

The LFC tax policy of accountability is partially met with the bill's requirement to report annually to an interim legislative committee regarding the data compiled from the reports from taxpayers taking the deduction and other information to determine whether the deduction is meeting its purpose. The problem is that the applied credit data report will be accumulated and compiled by TRD, but the analysis of the effectiveness and cost of the credit and whether the credit is performing the purpose for which it was created is assigned to TRD, but TRD does not have the information on energy or water saved, which data will be held by EMNRD. It is not clear that the two agencies can divulge information to the other that will allow either agency to prepare a report to the legislature.

### **ADMINISTRATIVE IMPLICATIONS**

EMNRD notes, "... HB 163 requires EMNRD to develop and promulgate rules for program implementation, as well as develop qualification criteria. Different software will need to be evaluated for use in connection with this credit."

TRD reports a moderate impact on TRD's IT Division. It will involve changes to the corporate and personal income tax returns, which can be done with year-end change and changes in the business credit manager in GenTax.

### **TECHNICAL ISSUES**

A number of terms and concepts in the bill are vague and should be defined. Simply requiring EMNRD to regulate the terms and concepts may not be adequate to prevent fraud and abuse of the proposed credit. At minimum, "primary residence," "Industry Standard Software," "assessor qualifications" and "indoor water use" should be defined in the bill. Without statutory guidelines, EMNRD will have a great deal of difficulty determining some of these issues.

Most of the software available to home-energy consultants uses rules of thumb and fairly rough thermal measurements. These are sufficient for planning and phasing residential improvements to improve energy performance, but not sufficiently accurate to determine whether recommended improvements have been installed competently to be durable and reliable. While water savings is fairly easy to establish for individual customers of municipal water systems or mutual or cooperative water systems, it is far more difficult to prove water savings for taxpayers on well or rooftop water catchment systems. Some thought should be given to this issue.

A competent home-energy consultant uses both hardware and software to determine the building envelope performance. Blower doors, thermal-imaging cameras, digital laser thermometers, pressure gauges and other sophisticated tools and hardware are used to determine infiltration and thermal leaks in the envelope. In most cases, these hardware measurements are coupled with the software to determine the building energy efficiency and the plausible improvements possible with various levels of remediation. Thus, the phrase on page 4, line 18 “using industry standard software programs before and after improvements are made ...” may allow lesser skilled and trained assessors to qualify residential improvements for the credit. At minimum, the bill should require the assessor qualifications to include being equipped with industry standard hardware, as well as software.

It is very unusual for this type of tax credit to be refundable, without reference to tax liability. There is some concern that this refundability may violate the anti-donation clause of the constitution (Article IX, Section 14). This bill provides for cash paid by the state in aid of a private individual. If the credit were non-refundable, then the provisions of this bill would be adjusting the tax liabilities of individuals based on the legislature’s constitutional prerogative to subsidize through the tax system behaviors deemed to be in the public interest.

It is unclear how the provisions in section 1, subsection E would be administered in the case that taxpayers had been denied a credit on a claim filed by December 31, 2022 because the cap had been exceeded. A strict reading of section 1, subsection E would imply that these denied claims would be extinguished and not allowed to roll over to the following year.

TRD points out additional concerns:

“Section F requires taxpayers to claim the credit in the taxable year in which the improvements are made or no later than one year following the end of the calendar year in which the improvement was made. Taxpayers unable to claim the credit for the tax year in which the improvements were made, because his/her application exceeds the aggregate annual cap, are placed in front of the queue of credit applications for the subsequent calendar year (See Section H). Even if the credit is approved by TRD in the next calendar year, the taxpayer cannot amend the return for the tax year when the improvements were made because of the aggregate cap. Additionally the taxpayer would not be filing the subsequent year’s return within one “calendar year” from the date of the improvements. In short, the way Subsection F is drafted “claim” would appear to be the actual claim against liability, not the application, and taxpayer’s may be barred from claiming the credit based solely on the cap. Thus, Subsection F may need revision to accommodate taxpayer’s that are placed in front of the next year’s queue.”

“Another potential issue regarding the timing of claiming this credit is that many individual homeowners may not be forward thinking or “tax-planning” with respect to this credit. In short, they make energy efficiency improvements and learn later that they cannot claim the credit because they did not have an inspection prior to making the improvements. The “effectiveness” of the credit TRD has to determine may be heavily impacted or skewed by taxpayers that were eligible but failed to have a prior inspection. The Department suggests: (1) making it much more clear in the statute that failure to get a prior inspection will result in disallowance; and (2) considering ways to publicize the credit to contractors, CPAs, and others so that taxpayers do not miss this critical step.”

“‘Primary Residence’ – Primary residence (Subsection N(2) (p.6, ll.13-18)) is defined to implicate many of the factually intensive issues involved with “residency” and “domicile.” There may be ways to simplify, such as allowing the credit for second homes or any residence that is not used to generate income or a “rental property.” Also, it could be made clearer that the primary residence must be located in New Mexico. Additional language in the definition of “primary residence” could be included, “... means the domicile where a person resides for most of the year in New Mexico,...”

#### OTHER SUBSTANTIVE ISSUES

Does the bill meet the Legislative Finance Committee tax policy principles?

1. **Adequacy:** Revenue should be adequate to fund needed government services.
2. **Efficiency:** Tax base should be as broad as possible and avoid excess reliance on one tax.
3. **Equity:** Different taxpayers should be treated fairly.
4. **Simplicity:** Collection should be simple and easily understood.
5. **Accountability:** Preferences should be easy to monitor and evaluate

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